



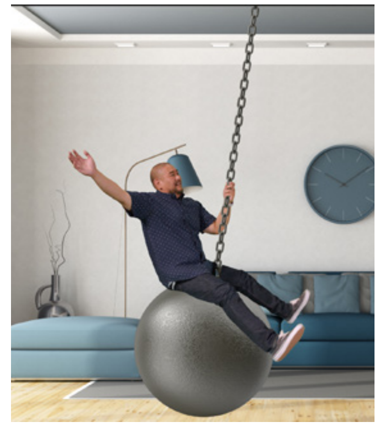

California Real Estate Principles

firsttuesday
the California real estate educators

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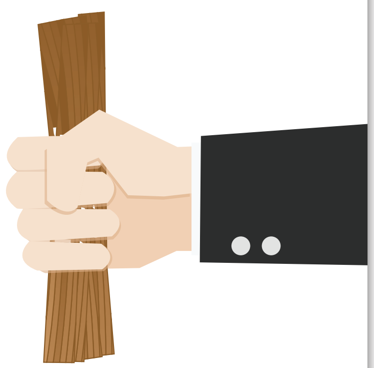
Ownership Concepts

Physical and legal aspects of real estate



For most situations, the term **"property"** means a physical or tangible thing. However, property can be more broadly defined, focusing on the *rights* which arise out of the object. Thus, property is referred to as a **bundle of rights**, which for the purposes of this material is real estate.

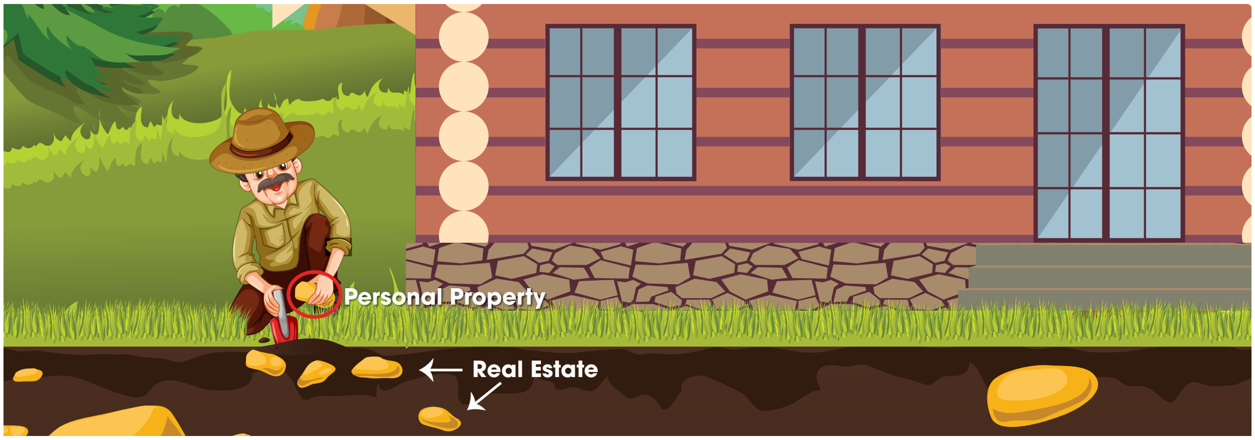
Further, property is anything which may be owned. In turn, *ownership* is the right to possess the property owned and use it to the exclusion of others. [Calif. Civil Code §654]

The *right to possess* and use property includes the rights to:

- occupy;
- sell or dispose;
- encumber; or
- lease.

Property is divided by types into two primary categories:

- **real estate**, also called *real property* or *realty*; and
- **personal property**, also called *personalty*. [CC §657]



Real estate is characterized as **immovable,** whereas personal property is **movable**. [CC §§659, 657]

Personal property is defined, by way of exclusion, as all property which is not classified as real estate. [CC §§658, 663]

While the distinction between real estate and personal property seems apparent at first glance, the difference is not always so clear.

Cutting up the real estate

Real estate may be physically cut up by **severance** of a part of the earth (i.e., removal of minerals). **Title** to real estate may also be cut up in terms of time, providing sequential ownership.

For example, *fee ownership* may be conveyed to one person for life, and on their death, transferred by the fee owner to another. *Time sharing* is another example of the allocation of ownership by time, such as the exclusive right to occupy a space for only three weeks during the year.

Title to real estate may also be *fractionalized* by concurrently vesting title in the name of co-owners, such as tenants-in-common, who each hold an undivided (fractional) ownership interest in the real estate.

Possession to real estate may be cut out of the fee ownership and conveyed for a period of time. For instance, the fee owner of real estate acting as a landlord conveys possession of the property to a tenant under a lease agreement for a fixed term, called a *tenancy*. When the tenancy expires or is terminated, possession of the property *reverts* to the landlord. The landlord retains fee title to the real estate at all times, subject to the *lease*.

Possession may also be cut up by creating *divided interests* in a property, as opposed to undivided interests. For example, an owner may lease a portion of their property to a tenant. The tenant, in turn, may sublease a portion of their space to yet another person, known as a *subtenant*.

Other non-possessory interests in real estate may be created, such as **liens**. *Liens* are interests in real estate which secure payment or performance of a debt or other monetary obligation, such as a:

- trust deed lien; or
- local property tax lien.

On nonpayment of a lien amount, the lienholder may force the sale of the real estate to pay off and satisfy the lien.

Thus, an owner's rights in a parcel of real estate extend beyond the mere physical aspects of the land, airspace and improvements located within the legally described boundaries of the property.

QUIZ

1. Property is best defined as:
   a. a moveable thing.
   b. a trade secret.
   c. a bundle of rights.

2. Property is divided by types into two primary categories:
   a. real estate and personal property.
   b. assets and liabilities.
   c. residential and commercial.

Real estate components and the boundaries of real estate

The **physical components** of real estate include:

- the land;
- anything affixed to the land;
- anything appurtenant (incidental rights in adjoining property) to the land; and
- anything which cannot be removed from the land by law. [Calif Civil Code §658]

Real estate includes buildings, fences, trees, watercourses and easements within a parcel's horizontal and vertical boundaries. Anything below the surface, such as water and minerals, or above the surface in the air space, such as crops and timber, is part of the real estate.

For example, the rental of a boat slip includes the water and the land below it, both of which comprise the total of the rented real estate. Thus, landlord/tenant law controls the rental of the slip. [**Smith** v. **Municipal Court** (1988) 202 CA3d 685]

In the case of a condominium unit, the **air space** enclosed within the walls is the real estate. The structure itself, land and air space outside the unit are the property of the association or all the owners of the separate parcels of air space within the condominium project, creating what is called a **common interest development (CID)**. [CC §4125]

Defining the legal description

A parcel of real estate is located by defining its legal description on the face of the earth. Using the property's *legal description*, a surveyor locates and sets the corners and *horizontal boundaries* of the parcel.

The legal, horizontal boundary description of real estate is documented in numerous locations, such as:

- deeds;
- public records of the county where the parcel is located;
- subdivision maps; and
- government surveys relating to the property.

Real estate is three-dimensional and reaches perpendicular to the horizontal boundary. In addition to the surface area between boundaries, the classic definition of real estate consists of the soil below to the core of the earth as well as the air space above to infinity.

All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate. The three-dimensional aspect of real estate has its source in the English common law. [Calif Civil Code §659]

QUIZ

1. The physical components of real estate include everything EXCEPT:
   a. the land.
   b. anything affixed to the land.
   c. anything which can be removed from the land.

2. What shape best illustrates the classic definition of real estate?
   a. Inverse pyramid.
   b. Static sphere.
   c. Convex rectangle.

Land, oil and gas

The first component of real estate is **land**. *Land* includes:

- soil;
- rocks;
- other materials of the earth; and
- the reasonable airspace above the earth. [Calif. Civil Code §659]

The soil and solid materials, such as ores and minerals, are considered land while they remain undisturbed as a part of the earth. For example, unmined gold dormant in the earth is real estate.

However, when the gold is mined, it becomes *personal property* since it is no longer embedded in the earth. The gold has been converted from something immovable — part of the rock below the soil — to something movable.

Minerals in the soil are *severable* from the earth. Also, fee ownership to the soil and minerals may be conveyed away from the ownership of the remainder of the land.

When ownership of minerals in a parcel of land is transferred, the transfer establishes two fee owners of the real estate located within the same legal description — an owner of the **surface rights** and an owner of the **mineral rights** beneath the surface.

These parties are not co-owners of the real estate, but individual owners of separate vertically-located portions of the same real estate. Both fee owners are entitled to reasonable use and access to their ownership interest in the real estate.

For example, an owner sells and conveys the right to extract minerals to a buyer. On conveyance, there now exists:

- a surface owner; and
- a mineral rights owner.

Later, the surface owner conveys the real estate to a developer. The developer subdivides the parcel of real estate and plans to construct homes on the lots.

The mineral rights owner objects to the construction, claiming the homes, if built, will interfere with their right to enter the property and remove their minerals.

Is the mineral rights owner entitled to enter the property to remove the minerals?

Yes! But only as necessary to use their mineral rights. The rights of the surface owner and the mineral rights owner are thus *balanced* to determine the precise surface location to be used to extract the minerals. [**Callahan** v. **Martin** (1935) 3 C2d 110]

The right to remove minerals from another's real estate is called a **profit a prendre**.

Fugacious matter

Unlike solid minerals which are stationary, oil and gas are mobile. Oil and gas are referred to as being **fugacious matter** as they are transitory.

Oil and gas are perpetually percolating under the earth's surface. Due to their fleeting nature, a real estate owner does not hold title to the physical oil and gas situated under the surface of their real estate. At any given time, a real estate owner will have more or less oil or gas depending on the earth's movements. The ownership interest in unremoved oil and gas is referred to as a **corporeal hereditament**.

In California, oil and gas are incapable of being owned until they are actually possessed. Once they have been removed, they become personal property. [**Callahan** v. **Martin** (1935) 3 C2d 110]

A fee owner has the exclusive right to drill for oil and gas on their premises, unless that right has been conveyed away to others.

Rather than owning the physical oil and gas, the fee owner has a right, called an *incorporeal hereditament*, to remove the oil or gas for their purposes. [**Gerhard** v. **Stephens** (1968) 68 C2d 864]

A land owner has the right to extract all the oil and gas brought up from their real estate even if it is taken from an underground pool extending into an adjoining owners' real estate. [**Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1938) 24 CA2d 587]

However, an owner may not slant drill onto another's property to reclaim the oil or gas that has flowed from their property. [Alphonzo E. Bell Corporation, *supra*]

QUIZ

1. The first component of real estate is land. Land includes all of the following EXCEPT:

    a. soil and rocks.

    b. reasonable airspace above the earth.

    c. crops cultivated for harvest and sale.

2. In California, oil and gas are incapable of being owned until they are actually possessed. Once they have been removed, they become:

    a. real estate.

    b. personal property.

    c. a license to possess property of another.

Airspace

Land also includes the airspace above the surface of a property. Under traditional English common law, the right to airspace continued to infinity. However, modern technological advances have altered the legal view on airspace.

For example, an owner runs a farm near a military airport with heavy air traffic. The government expands the military base by extending the runway to accommodate larger (and louder) aircraft. The aircraft, on their approach to the airport, now fly directly over the farmer's barn, scaring the animals and causing the farmer financial loss.

The farmer sues the government for trespass on their real estate since the airspace is being occupied by others — the military.

Can the owner keep the aircraft from flying into their real estate?

No! The common law doctrine regarding the ownership of airspace to the edge of the universe is obsolete. The owner only owns the airspace necessary to allow them a *reasonable use* of their real estate. The owner's real estate extends only so far above the surface of the earth as can be reasonably occupied or used in connection with the land. [**United States** v. **Causby** (1946) 328 US 256]

However, when the flight of airborne vehicles intrudes upon an owner's use and enjoyment of their real estate below, the intrusive entry may constitute a **taking** of the real estate. The continued noise and disturbance of low-flying aircraft has effectively *taken* something from the owner — the quiet use and enjoyment of their property. Thus, the owner needs to be compensated for their loss. [Causby, *supra*]

Other blue sky to be sold

The *airspace* portion of land has also been modernized with the concept of the **condominium**. An owner of a condominium unit legally owns the right to occupy the *parcel of airspace* they have acquired which is enclosed between the walls, ceilings and floors of the structure.

Included in these ownership rights are incidental rights of *ingress* and *egress*, called **appurtenances**. Also included is the *exclusive right* to use other portions of the real estate for storage and parking, plus an undivided fractional interest in the common areas, directly or through a homeowners' association (HOA). [Calif. Civil Code §4125]

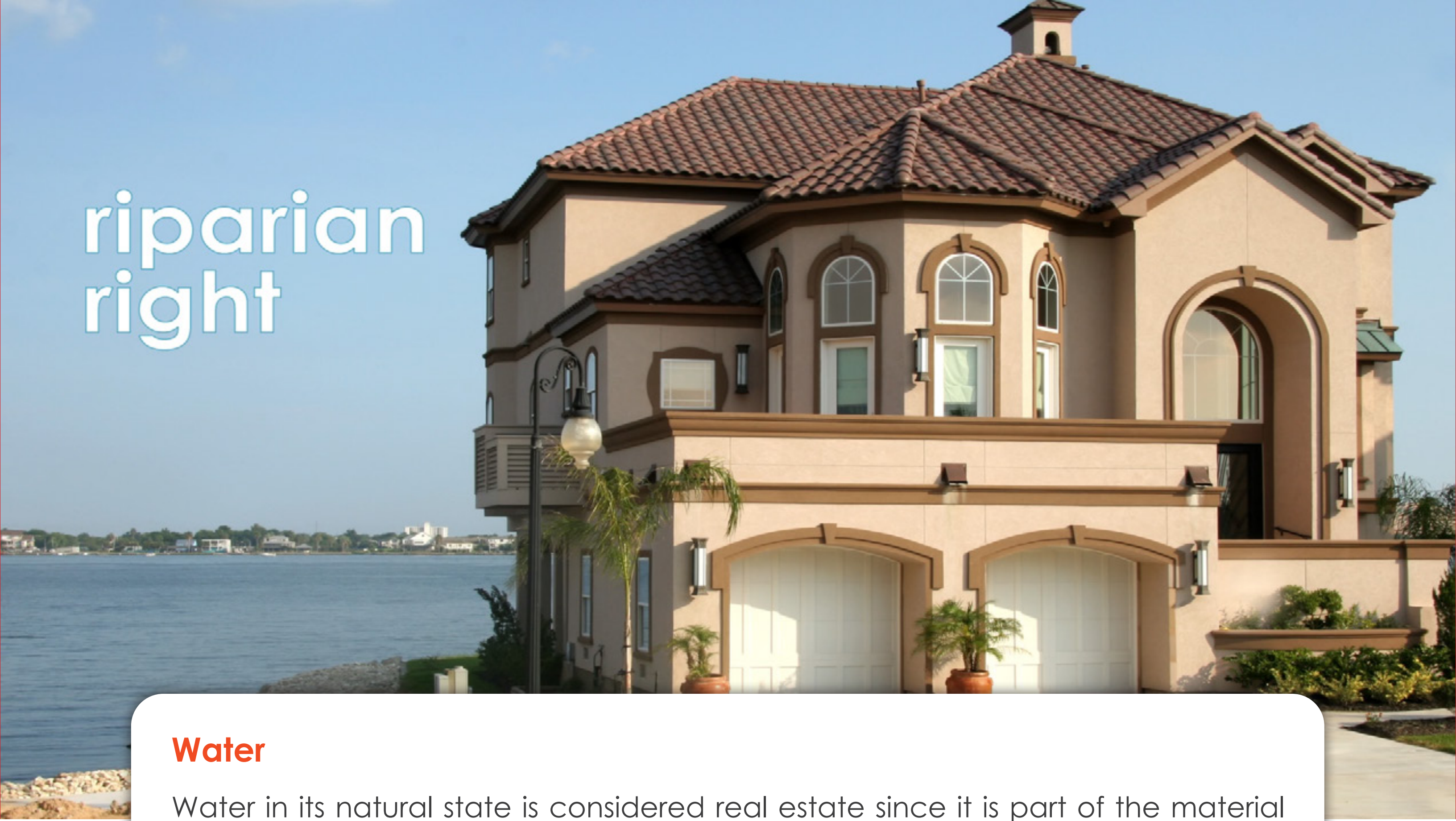
Also, the installation of **active solar collectors** has led to the right of access to sunlight and air which passes through airspace above property owned by others. This right of access to the sun for a solar collector is considered an *easement*. [Calif. Public Resources Code §§25980 et seq.; CC §801.5(a)(1)]

QUIZ

1. A property owner owns the airspace above their property:
   a. upward and into infinity.
   b. to the extent necessary to allow them a reasonable use of their real estate.
   c. to the height of the tallest improvement on the property.

2. When the flight of airborne vehicles intrudes upon an owner's use and enjoyment of their real estate below, the intrusive entry:
   a. may constitute a taking of the real estate.
   b. has no legal ramifications since the owner controls only a finite amount of airspace over the property.
   c. may not be pursued by the owner if the existence of the intrusive entry was properly disclosed.

riparian right



Water

Water in its natural state is considered real estate since it is part of the material of the earth. While water is real estate, the right to use water is an *appurtenant* (incidental) right to the ownership of real estate.

Three key rights in water need to be separately understood:

- the right to use water;
- the right to take water by **appropriation** rights; and
- the right to take water by **prescriptive rights**.

The right to use water is called a **riparian right**. Riparian rights refer to the rights of a real estate owner to take surface water from a running water source contiguous to their land, such as a river or stream. [Calif. Water Code §101]

The right to take water may be acquired by *appropriation*. The appropriator of water diverts water from a river or watercourse to their real estate for reasonable use. [**In re Water of Hallett Creek Stream System** (1988) 44 C3d 448]

Also, an individual may obtain *prescriptive rights* in water by wrongfully appropriating nonsurplus water openly and adversely under a claim of right for an uninterrupted period of at least five years. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

However, all water in the state of California belongs to the people based on a *public trust doctrine*. Riparian, appropriation and prescriptive rights are subject to the state's interest in conserving and regulating water use. [Wat C §101]

Water is used, not owned

Water belongs in one of two categories:

- **surface water**, consisting of watercourses, lakes, springs, marshes, ponds, sloughs and any other water flowing over the surface of the earth caused by rain, snow, springs or seepage; or
- **ground water**, consisting of percolating, subterranean bodies of water located in underground *basins*. [Restatement of the Law 2d Torts §§841, 845, 846]

Holders of rights to withdraw *surface waters* have **riparian rights**. Holders of rights to pump ground water have **overlying rights**.

The legal rights to extract and use water are based on priorities and are classified as:

- *land owner's rights* consisting of both riparian and overlying rights;
- *appropriation rights* to withdraw water under license from the state; and
- *prescriptive rights* to withdraw water legally entitled to be used by others.

Riparian rights refer to a land owner's appurtenant property right to withdraw water from an adjacent river or lake for beneficial use on their riparian land.

Overlying rights refer to a land owner's right to the use of ground water below the surface of their land.

An overlying land owner has rights to an allotment of water which is measured by the ground water in the basin over which their land is located. Overlying land owners have equal rights against other overlying land owners to a basin's ground water percolating underneath their land, subject to their *reasonable use* of the water.

Overlying and riparian rights are legally analogous to one another, except for the limitations placed on overlying land owners to use ground water and riparian land owners to use surface water. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

A land owner's use of water in the exercise of their riparian or overlying water rights has *priority* over water rights held by appropriators licensed by the state.

Riparian and overlying water rights are part of the ownership of land, and run with the title to the land when it is sold. Water rights are not personal property which may be assigned or used for the benefit of other property.

Land entitled to water rights

Riparian land is a parcel of real estate located both adjacent to a water source with surface water and within the *watershed* (basin) of the surface water.

A parcel is considered riparian land when it:

- touches the surface water; or
- was part of a larger riparian parcel and retained its riparian rights by reassignment when parceled.

The amount of frontage in actual contact with the surface water of a river or lake does not determine whether a parcel is considered riparian land. For example, a 40-acre tract of land, of which only 250 feet abuts a stream, is considered riparian land. [**Joeger** v. **Mt. Shasta Power Corp.** (1932) 214 C 630]

To constitute riparian land, a property also needs to be located within the watershed surrounding the watercourse. Should a portion of riparian land extend outside the watershed, only the portion within the watershed is entitled to use the water from the watercourse.

Surface water used on land located within its watershed will eventually return to the watercourse, minus the water consumed, in a natural process called **percolation**. Additionally, rain falling on lands within the watershed of a watercourse feeds the watercourse. Thus, a riparian land owner may only divert water to the portion of their land which allows the water to return to the watercourse.

Land lying within the watershed of one stream above the point where the two streams unite, called a **confluence**, is not considered to be riparian to the other. Further, the surface flow (river) below the *confluence* of two streams is a new and entirely different watershed, justifying a new name for the river below the confluence, as is the practice in Mexico to distinguish the watershed. [**Anaheim Union Water Co.** v. **Fuller** (1907) 150 C 327]

Riparian rights are appurtenant

The right to use riparian water is an **appurtenant** (incidental) right attached to and transferred with the ownership of real estate. [Calif. Civil Code §§658, 662]

Each riparian land owner is entitled to a *reasonable use* of the natural flow of stream water running through or adjacent to their land. However, the quantity of the water withdrawn is subject to an upstream riparian land owner's *priority right* to first withdraw water for reasonable use on their upstream riparian land.

Additionally, a riparian land owner may not divert stream water to nonriparian lands, even when they are entitled to use the water on their riparian land, since they are subject to the rules of percolation within the watershed. The land owner's riparian right to use the surface water is appurtenant to the land bordering the stream, not other lands without a border on the stream. [**Gould** v. **Eaton** (1897) 117 C 539]

Reasonable use and domestic priorities

Riparian rights are limited by the requirement that water taken from a stream needs to be put to a **reasonable and beneficial use**. Water is a state resource which, when used under a legal right, needs to be put to reasonable and beneficial use to the fullest extent possible. No one has a protectable interest in the unreasonable use of water. [Calif. Constitution, Article X §2]

QUIZ

1. __________ refer to the rights of a real estate owner to take surface water from a running water source contiguous to their land, such as a river or stream.

   a. Overlying rights

   b. Equitable rights

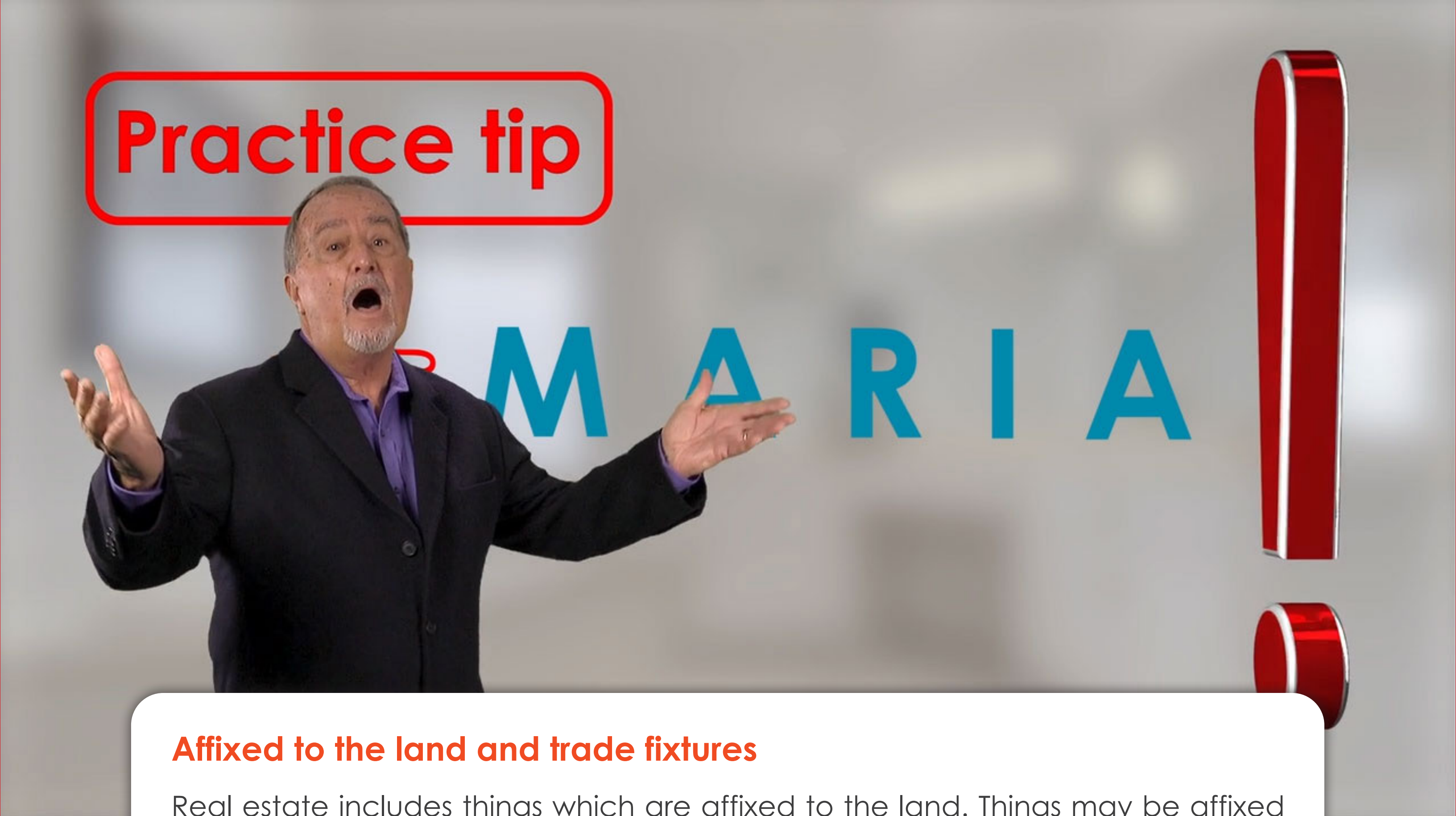
   c. Riparian rights

2. The right to take water may be acquired by __________ when a land owner diverts water from a river or watercourse to their real estate for reasonable use.

   a. prescription

   b. appropriation

   c. confluence



Affixed to the land and trade fixtures

Real estate includes things which are affixed to the land. Things may be affixed to the land by:

- roots (e.g., shrubs and trees);
- embedment (e.g., walls);
- permanently resting (e.g., structures); or
- physically attached (e.g., by cement or nails). [Calif. Civil Code §660]

Things attached to the earth naturally are real estate. Natural fixtures to the land, called **fructus naturales**, include:

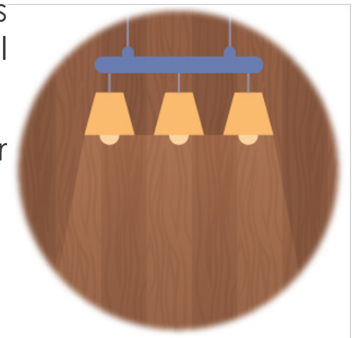
- trees;
- shrubs; and
- grass.

However, natural items planted and cultivated for human consumption and use are fruits of labor, called **fructus industriales**.

Fructus *industriales* include such things as crops and standing timber. Crops and timber are ordinarily considered real estate. However, industrial crops and standing timber sold under a purchase agreement and scheduled to be removed are considered personal property. [Calif. Commercial Code §9102(a)(44)]

Personal property that is permanently attached

A **fixture** is personal property which has become *permanently attached* to real estate. As it is permanently attached, it effectively becomes part of the real estate and is conveyed with it. [Calif. Civil Code §660]



Factors which determine whether an item is a fixture or removable improvement include:

- relationship of the parties;
- agreement between the parties;
- intention of the parties;
- manner of attachment; and
- adaptability of attachment to the real estate's use. [**San Diego Trust & Savings Bank** v. **San Diego County** (1940) 16 C2d 142]

Individuals most likely to dispute whether an item is a fixture include:

- buyers and sellers;
- landlords and tenants;
- a builder and an owner;
- a lender and an owner; and
- the county assessor and an owner.

The most important factor when determining whether an item is a fixture or improvement is the **intent of the parties**.

Intent to make an item a permanent part of the real estate as a fixture is determined by:

- the manner of attachment; and
- the use and purpose of the item in dispute.

For example, when an item is attached to real estate by bolts, screws, cement or the like, the item is a fixture and part of the real estate. An item need not be attached to the real estate in this manner to be a fixture. Items of such weight and size that gravity maintains them in place are sufficient to give the item the character of permanence and affixation to be real estate.

Also, the item may be *constructively attached* when the item is a necessary, integral or working part of improvements on the real estate.

Used to render services or make products

Fixtures which are used to render services or make products for the trade or business of a tenant are called **trade fixtures**.

Trade fixtures are removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord. The removal may not unduly damage the real estate. [Calif. Civil Code §1019]

Thus, trade fixtures are considered *personal property*.

To be considered a trade fixture, a fixture needs to be an essential part of the tenant's business and its removal may not substantially damage the real estate.

In the instance of a beauty salon, trade fixtures include:

- mirrors;
- sink bowls;
- dryers; and
- installed wash stations. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

QUIZ

1. Intent to make an item a permanent part of the real estate as a fixture is determined by:
   a. the manner of attachment
   b. the use and purpose of the item in dispute.
   c. Both a. and b.

2. On the termination of a tenancy, trade fixtures are generally:
   a. removed by the tenant when their removal does not unduly damage the real estate.
   b. removed by the landlord when their removal poses the risk of damage to the real estate.
   c. retained at the property and become the property of the landlord through reversion.

Appurtenant rights

Real estate also includes any **incidental rights** which are not located on the real estate nor reflected on its title, called **appurtenant rights**. *Appurtenant rights* include the right of **ingress and egress** (entry and exit) across adjoining properties. [Calif. Civil Code §662]

An *appurtenant easement* is an interest held by an owner of one parcel of real estate to use adjoining real estate.

Under an appurtenant easement, an owner's **right to use** adjoining real estate is part of their real estate, although it is not reflected on the title to the real estate. This right to use adjoining property *runs with the land* and is automatically conveyed with the real estate when the owner sells it. Appurtenant rights remain with the real estate they benefit and do not transfer from person to person.

Other appurtenant rights to real estate include the right to the *lateral and subjacent support* provided by the existence of adjoining real estate. For example, the owner of real estate may not remove soil from their land if doing so causes the adjoining real estate to subside or collapse.

Appurtenant rights held by an owner of one property are a recorded encumbrance on title to the adjacent property burdened by the appurtenant rights, such as an easement.

QUIZ

1. Incidental rights in a property which are not located on the real estate nor reflected on its title are:

    a. inalienable rights.

    b. assignable rights.

    c. appurtenant rights.

2. Which of the following statements about appurtenant rights is most correct?

    a. Appurtenant rights can include the right to license a specific portion of an adjacent property for a specified use.

    b. Appurtenant rights can include the right of ingress and egress across adjoining properties.

    c. Appurtenant rights can include the right to take private property for public use.

California Construction and Architectural Concepts

Construction concepts

The placement of a house upon the lot is referred to as its **orientation**. *Orientation* is the key determinant of a property's sun exposure. The advantages and disadvantages of a particular orientation will vary depending on geography.

The **floor plan** of a house refers to how its internal space is arranged and allocated. An advantageous *floor plan* allows easy mobility and circulation through the improvements, as well as convenient access to living areas, shared rooms and restrooms.

Some homes are built upon a **foundation**. The *foundation walls*, anchored by footings, are supports typically made of formed concrete, concrete block or masonry on which woodframe houses rest. In some older homes, the foundation walls are made of river rock or stone.

Unreinforced masonry walls used for structural purposes are earthquake hazards. *Unreinforced masonry* walls need to be disclosed by the seller by providing the buyer with a copy of the *The Homeowner's Guide to Earthquake Safety* for pre-1975 residential or commercial buildings. [Government Code §8875.6; see **RPI** Form 316-1]

After the construction site is excavated, the concrete foundation walls are poured into wood forms. Once the concrete has dried, also referred to as *cured*, the wood forms are removed and *dirt backfill* is packed against the walls. Placed directly on top of the foundation wall is the *mud sill*. Wood beams on which the floor of the house rests are called *girders* and *joists*.

A **crawl space** is sometimes left under a home to provide protection against termites and pests and provide a space for ventilation.

Radon gas is a naturally occurring gas resulting from the erosion of uranium in soil. *Radon gas* is harmless in well ventilated areas but can accumulate in confined areas, such as **crawl spaces** and **basements**, posing a health risk to occupants. [See **RPI** Form 316-1]

Other properties are built on a *concrete slab* and anchored by footings. Properties built on a slab are not elevated upon foundation walls, nor do they have a crawl space.

Once the foundation walls or slab have been laid, the **frame** of the house is erected. The *frame* is the skeleton of the house to which interior and exterior walls are attached. Vertical supports within the frame are called **studs**.

The standard spacing for **studs** is *16" on center* (measured from the center of each stud) for load-bearing walls. Some non-load-bearing interior walls, also known as **partition walls**, allow a spacing of 24" on center. *Fire stops* are horizontal pieces of material placed between the studs to block air drafts.

The **exterior walls** consist of sheathing, which may come in the form of structural plywood or oriented strand board (OSB). Outside of the sheathing, the **siding** is placed. *Siding* can be wood, brick, stone, masonry, aluminum, stucco, cement board or other materials.

QUIZ

1. What is the key determinant of a property's sun exposure?
   a. Age.
   b. Orientation.
   c. Height.

2. What is the best description of a property built on a slab?
   a. Properties built on a concrete slab are elevated upon foundation walls.
   b. Properties built on a concrete slab generally have a crawl space.
   c. Properties built on a concrete slab are anchored by footings.

Building regulations

Construction of residential and commercial buildings is regulated by the state of California through **building codes**.

The **State Housing Law** outlines the construction requirements and standards for all buildings in California. The Housing Law dictates the construction and occupancy of dwellings, including:

- single family residences (SFRs);
- apartments;
- hotels; and
- motels.

The **Department of Housing and Community Development (HCD)** *(www.hcd.ca.gov)* is responsible for adopting administrative regulations to carry out the provisions of the Housing Law. The HCD establishes building standards and codes, called the **California Building Standards Code**. [24 Code of Federal Regulations §3280 et seq.]

Local governments can amend building codes to meet the particular needs of its community. Local amendments are typically made based on local climactic, geological or topographical conditions. Though amended, local building codes need to comply with state regulations.

Building codes are enforced by **building inspectors** at the local level. Prior to beginning construction, a *building permit* is obtained from the local building department. Once complete, a building needs to pass inspection and receive a **certificate of occupancy** before allowing occupancy. The *California Department of Public Health* may stop the construction of a property when its water supply, sewage or drainage system is impaired.

Standards for the construction of mobilehomes are governed by the **Department of Housing and Urban Development (HUD)** in Title 24 of the Code of Federal Regulations. [24 CFR §3280 et seq.]

Role of a contractor

A **contractor** is anyone who constructs, alters, repairs, improves or demolishes any building, road, project, development or improvement. [Business and Professions Code §7026]

A *contractor* is to be licensed by the California Department of Consumer Affairs Contractors State Licensing Board *(www.cslb.ca.gov)*. They also need to post a bond or cash deposit. Contracting without a license is a misdemeanor, unless exempt from licensing requirements. [Bus & P C §7028(a)]

Exemptions from the contractor's licensing law include:

- any work performed, including labor and materials, for less than $500 [Bus & P C §7048];
- any work performed by the owner of the property [Bus & P C §7044];
- any work performed by a public utility [Bus & P C §7042];
- oil and gas operations [Bus & P C §7043]; and
- work performed for agricultural purposes.

There are three types of contractor licenses:

- **general engineering**;
- **general building**; or
- **specialty**.

A *general engineering* contractor specializes in engineering, such as irrigation and drainage, flood control, streets and roads and bridges. [Bus & P C §7056]

A *general building* contractor specializes in the construction of any structure designed for occupation by people, animals or personal property. [Bus & P C §7057]

A *specialty* contractor focuses on one particular trade or craft, such as servicing fire extinguisher systems, laying carpet or linoleum, or preparing roadway construction zones. [Bus & P C §7058]

Contractors may hold all three types of licenses concurrently. [Bus & P C §7059]

A contractor's license may be suspended or revoked when the contractor:

- violates safety or building regulations [Bus & P C §7110];
- breaches the construction contract in a material respect [Bus & P C §7109];
- fails to follow the plans or specifications [Bus & P C §7109];
- abandons an incomplete project [Bus & P C §7107]; or
- diverts funds received for the completion for a specific project or fails to substantially account for the use of the funds. [Bus & P C §7108]

QUIZ

1. Prior to beginning construction:
   a. a building permit is obtained from the local building department.
   b. a certificate of occupancy is issued by the California Department of Public Health.
   c. a building inspector is retained to ensure the proposed property will be compliant with local building codes.

Architectural styles: Spanish Mission through Cape Cod

There are numerous *architectural styles* found in California. In this series, we'll analyze the architectural styles you're most likely to encounter in your practice by reviewing each style individually – and with plenty of visual examples.

Spanish style homes are traditionally one story with a light colored stucco exterior and rounded edges. This style is also frequently referred to as **Spanish Mission** architecture.

These *Spanish-style* properties are also distinguished by an orange or tan tile roof, exposed beams, and generally small windows. This simple and rustic architectural style has become a popular choice particularly in Southern California's warmer climate.

Ranch homes are generally one story with a wood or masonry exterior and an attached garage. Ranch properties feature a close-to-the-ground profile, with a wide open and spacious interior.

Ranch-style properties became extremely popular and ubiquitous during the post-World War II boom.

The next architectural style is defined broadly as **contemporary** or **modern**. *Contemporary* or *modern* architecture refers to architecture constructed in mid-20th and 21st century. While no single style is dominant, contemporary or modern architecture is more likely to include open floor plans and unadorned structures with minimal ornamentation or fuss. Think clean, austere lines.

Pueblo properties are traditionally made from adobe bricks, though revival properties employ masonry and stucco to create the same look.

Though built from local materials, the architecture itself is informed by concepts from Spain, and thus also features rounded edges, like with the Spanish property style. However, the pueblo style is also heavily influenced by Indigenous American culture.

Perhaps the most quintessentially American residential property style is the **Colonial**, also called **Cape Cod**.

This style of property traditionally features wood siding and shutters with a steep wood-shingled roof. If you asked a child to draw a picture of a house, it would likely look something like this due to its traditional and easily recognizable look dating back to the 17th century.

QUIZ

1. What best describes a Spanish-style property?
    a. Open floor plans with unadorned exterior structures and minimal ornamental embellishment.
    b. Built from adobe bricks and heavily influenced by Indigenous American culture.
    c. Light colored stucco exterior with rounded edges, and an orange or tan tile roof.

2. What architectural style which became popular after World War II typically features a close-to-the ground profile and spacious interiors?
    a. Ranch.
    b. Cape Cod.
    c. Colonial.

Architectural styles: Dutch Colonial through Craftsman

The **Dutch Colonial**, a style more colloquially known as "*barn house*," traditionally features a **gambrel** roof as well as **dormer** windows. These terms will be illustrated more extensively in later sections.

Mediterranean properties typically feature stucco exteriors, warm tones, and ornamental detailing. These homes are inspired by the Mediterranean region, and are particularly popular in southern California, much like Spanish and Pueblo styles.

Victorian properties have a style which refers to the period in which the United Kingdom's Queen Victoria reigned, from 1837 to 1901. A *Victorian* property is traditionally multiple stories and features ornate wood external decorations and high ceilings. This enhanced degree of ornamentation is fundamental to the Victorian style.

The **town house** or **row house** is a style commonly seen in more densely packed urban areas, such as *San Francisco* and *Los Angeles*. Town houses frequently share one or multiple common walls with the neighboring property, and feature long, narrow lots.

English Tudor homes feature light-colored stucco, which is contrasted against its most distinctive feature, an exterior timber detailing. Many also have brick work. English Tudor homes traditionally feature a steep, **gable roof**.

The **Craftsman** style is an architectural style that became popular in the early 20th century in tandem with the Arts and Crafts movement, which is where it gets its name. These homes prioritize motifs and materials that are inspired by the natural world, placing an emphasis on exposed rocks, naturally toned woodwork, and earthy tones.

QUIZ

1. What architectural style is most likely to feature a gambrel roof and dormer windows?
   a. Town house.
   b. Dutch Colonial.
   c. Victorian house.

2. In what type of house would you most likely encounter materials inspired by the natural world, such as exposed rocks and naturally toned woodwork?
   a. Craftsman.
   b. Mediterranean.
   c. Row house.

Roofing materials and structures

Roofs and roof styles are a fundamental component of real estate.

Rafters form the shape of a roof and act as the ribcage of the roof's structure. Sheathing, made of plywood or a wood product called **oriented strand board**, is placed on top of the *rafters*.

The sheathing serves as a base for the **finishing material**, such as tiles or shingles made of asphalt or wood.

The portion of the roof that extends over the exterior wall of the house is called an **eave**. A gutter runs along the **eave** to catch and direct rain runoff through the *downspout*.

The following are types of roofs found on homes in California.

The **gable roof** is likely the most popular roofing style. A standard gable roof is slanted or pitched, creating flat areas on the front, side or back of a house. This flat area is called a *gable*. A simple triangular gable is the most common.

A **hip roof** is a type of roof that slopes downward from all sides. Second only to the gable roof, it is a ubiquitous style in California. While a gable roof generally consists of *two sloping* sides that join at the top gable ends, a hip roof generally has four *sloping sides*, not always of the same size, with no gable ends.

A **pyramid roof** is a variation on the hip roof. It is a hip roof with triangular sides which converge to form a single peak in the center – simply, a *pyramid*.

Gambrel roofs resemble that of a barn. They usually have two slopes on each side of the roof, the upper slope being shallow and the lower slope being steep. These are associated with the *Dutch colonial style*.

Further, the gambrel is closely associated with the **mansard** roof. Both roofs are multi-sided, though the *mansard* roof is typically confined closer to the top of the house and does not extend as low as a gambrel roof. Mansards roofs are also frequently flat on top.

Mansard roofs are closely associated with French architecture, though are more commonly seen on commercial buildings in California.

Although most **flat roofs** are essentially flat in comparison to other roof styles, the majority have a minimal pitch of ten degrees or less for water drainage. Flat roofs are commonly associated with commercial property, however, certain types of *modern* or *adobe* residential properties feature a flat roof.

A **dormer**, also referred to as a **dormer window**, is a roofing structure which projects from the plane of a sloping roof, such as a *gable* or *gambrel* roof. *Dormers* are generally featured on multi-story homes and are used to provide additional interior space for bedrooms or for expanded living space.

These are the basic architecture and roof styles you can expect to encounter in your daily practice as a California licensee. Geography and climate dictate the prevalence of certain architectural and roof types within our diverse state.

QUIZ

1. A standard __________ is slanted or pitched, creating flat areas on the front, side or back of a house.
   a. hip roof
   b. gable roof
   c. mansard roof

2. What type of roof generally has four sloping sides, not always of the same size, with no gable ends?
   a. Flat roof.
   b. Gable roof.
   c. Hip roof.

Possessory Interests in Real Estate

Ownership interests held in real estate

Real estate, sometimes legally called **real property** or **realty**, consists of:

- the land;
- the improvements and fixtures attached to the land; and
- all rights incidental or belonging to the property. [Calif. Civil Code §658]

A **parcel** of real estate is located by circumscribing its **legal description** on the "face of the earth." Based on the legal description, a surveyor locates and sets the corners and surface boundaries of the parcel. The *legal description* is contained in deeds, subdivision maps or government surveys relating to the property.

All permanent structures, crops and timber are part of the parcel of real estate. The parcel of real estate also includes buildings, fences, trees, watercourses and easements within the parcel's boundaries.

A parcel of real estate is three dimensional. In addition to the surface area within the boundaries, a parcel of real estate consists of:

- the soil below the parcel's surface to the core of the earth, including water and minerals; and
- the air space above it to infinity.

In the case of a statutory condominium unit, the air space enclosed within the walls is the real estate conveyed and held by the fee owner of the unit. The structure, land and air space outside the unit are the property of the *homeowners' association (HOA)*.

The ownership interests a person may hold in real estate are called **estates**. Four types of *estates* exist in real estate:

- **fee estates,** also known as *fee simple estates, inheritance estates, perpetual estates*, or simply, *the fee;*
- **life estates**;
- **leasehold estates**, sometimes called *leaseholds*, or *estates for years*; and
- **estates at will**, also known as *tenancies-at-will*. [CC §761]

In practice, these estates are separated into three categories: *fee estates*, *life estates* and *leasehold estates*. Estates at will are considered part of the leasehold estates category. Leasehold estates are controlled by landlord/tenant law.

Fee estates: unbundling the rights

A person who holds a *fee estate* interest in real estate is a fee owner. In a landlord/tenant context, the fee owner is the landlord.

Editor's note — If a sublease exists on a commercial property, the master tenant is the "landlord" of the subtenant.

A fee owner has the right to possess and control their property indefinitely. A fee owner's possession is exclusive and absolute. Thus, the owner has the right to deny others permission to cross their boundaries. No one can be on the owner's property without their consent, otherwise they are trespassing. The owner may recover any money losses caused by the trespass.

Exclusive right to use and enjoy

A fee owner has the exclusive right to use and enjoy the property. As long as local ordinances such as building codes and zoning regulations are obeyed, a fee owner may do as they please with their property. A fee owner may build new buildings, tear down old ones, plant trees and shrubs, grow crops or simply leave the property unattended.

A fee owner may *occupy, sell, lease* or *encumber* their parcel of real estate, give it away or pass it on to anyone they choose on their death. The fee estate is the interest in real estate transferred in a real estate sales transaction, unless a lesser interest such as an easement or life estate is noted. However, one cannot transfer an interest greater than they received.

A fee owner is entitled to the land's surface and anything permanently located above or below it. [CC §829]

The ownership interests in one parcel may be separated into several fee interests. One person may own the mineral rights beneath the surface, another may own the surface rights, and yet another may own the rights to the air space. Each solely owned interest is held in fee in the same parcel.

In most cases, one or more individuals own the entire fee and lease the rights to extract underground oil or minerals to others. Thus, a fee owner can convey a leasehold estate in the oil and minerals while retaining their fee interest. The drilling rights separated from the fee ownership are called **profit a prendre**. [**Rousselot v. Spanier (1976) 60 C3d 238]**

Profit a prendre is the right to remove profitable materials from property owned and possessed by another. If the profit a prendre is created by a lease agreement, it is a type of easement. [**Gerhard v. Stephens (1968) 68 C2d 864]**

QUIZ

1. A parcel of real estate is most precisely located by circumscribing its __________ on the face of the earth.
   a. property address
   b. legal description
   c. satellite coordinates

2. In the case of a statutory condominium unit, what is the real estate that is conveyed and held by the fee owner of the unit?
   a. The entirety of the property.
   b. The entirety of the property and all shared communal property within the development.
   c. The air space enclosed within the walls.

Life estates and leasehold estates held by tenants

A **life estate** is an interest in a parcel of real estate lasting the lifetime of an individual, usually the *life of the tenant*. *Life estates*, also known as **estates for life**, are granted by a deed entered into by the fee owner, an executor under a will or by a trustee under an inter vivos trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for another person (the life tenant) during that person's lifetime, called the controlling life.

For example, consider the fee owner of a vacation home who has an elderly relative who needs a place to live. The fee owner grants the relative a life estate in the vacation home for the duration of their lifetime. The relative may live there for the rest of their life, even if they outlive the fee owner who granted them the life estate.

Life estates terminate on the death of the controlling life. Life estates may also be terminated by agreement or by merger of different ownership interests in the property. The holder of a life estate may not impair the fee interest. [Calif. Civil Code §818]

Possessory interest conveyed

Leasehold estates, or *tenancies*, are the result of rights conveyed to a tenant by a fee owner (or by the life estate tenant or master lessee) to possess a parcel of real estate.

Tenancies are created when the landlord and the tenant enter into a rental or lease agreement that conveys a possessory interest in the real estate to the tenant.

A lease is for a fixed term, for instance, one year. [See **RPI** Form 550]

A rental agreement concerns a term that is not fixed, but periodic. [See **RPI** Form 551]

Both create a *leasehold estate* held by a tenant. The tenant becomes the owner of a leasehold with the right to possess and use the entire property until the lease expires. The ownership and title to the fee interest in the property remains with the landlord throughout the term of the leasehold. The landlord's fee interest is subject to the tenant's right of possession, which is carved out of the fee by the lease or rental agreement.

In exchange for the right to occupy and use the property, the landlord is entitled to rental income from the tenant during the period of the tenancy.

QUIZ

1. A(n) __________ is an interest in a parcel of real estate lasting the lifetime of an individual.

    a. fee estate
    b. freehold estate
    c. life estate

2. Tenancies are created when the landlord and the tenant enter into a rental or lease agreement that conveys a(n) __________ interest in the real estate to the tenant.

    a. ownership
    b. possessory
    c. fee

Types of leaseholds

Four types of leasehold estates exist and can be held by tenants. The interests are classified by the length of their term:

- a **fixed-term tenancy**, simply known as a lease and legally called an *estate for years*;
- a **periodic tenancy**, usually referred to as a *rental*;
- a **tenancy-at-will**, previously introduced as an *estate at will*; and
- a **tenancy-at-sufferance**, commonly called a *holdover tenancy*.

A *fixed-term tenancy* lasts for a specific length of time as stated in a lease agreement entered into by a landlord and tenant. On expiration of the lease term, the tenant's right of possession automatically terminates unless it is extended or renewed by another agreement, such as an option agreement. [See **RPI** Form 550]

Periodic tenancies also last for a specific length of time, such as a week or a month. Under a periodic tenancy, the landlord and tenant agree to automatic successive rental periods of the same length of time, such as in a month-to-month tenancy, until terminated by notice by either the landlord or the tenant. [See **RPI** Form 551]

In a **tenancy-at-will** (also known as an *estate at will*) the tenant has the right to possess a property with the consent of the fee owner. Tenancies-at-will can be terminated at any time by an advance notice from either the landlord or the tenant or as set by agreement. Tenancies-at-will do not have a fixed duration, are usually not in writing and a rent obligation generally does not exist.

A **tenancy-at-sufferance** occurs when a tenant retains possession of the rented premises after the tenancy granted terminates.

QUIZ

1. An occupancy agreement that is entered into for a specific length of time is most likely a:

    a. rental agreement.

    b. lease agreement.

    c. tenancy-at-will.

2. A(n) __________ occurs when a tenant retains possession of the rented premises after the tenancy granted terminates.

    a. estate at will

    b. tenancy-at-will

    c. tenancy-at-sufferance

Leaseholds conveying special uses

In addition to the typical residential and commercial leases, you will find *special use* leases.

Oil, *gas, water* and *mineral leases* convey the right to use mineral deposits below the earth's surface.

The purpose of an oil lease is to discover and produce oil or gas. The lease is a tool used by the fee owner of the property to develop and realize the wealth of the land. The tenant provides the money and machinery for exploration, development and operations.

The tenant pays the landlord rent, called a **royalty**. The tenant then keeps any profits from the sale of oil or minerals the tenant extracts from beneath the surface of the parcel.

A **ground lease** on a parcel of real estate is granted to a tenant in exchange for the payment of rent. In a *ground lease*, rent is based on the rental value of the land in the parcel, whether the parcel is vacant or improved. Fee owners of vacant, unimproved land use leases to induce others to acquire an interest in the property and develop it.

An original tenant under a ground lease constructs their own improvements. Typically, the tenant encumbers their possessory interest in a ground lease with a trust deed lien to provide security for a construction loan.

Master leases benefit fee owners who want the financial advantages of renting fully improved multi-tenant property, but do not want the day-to-day obligations and risks of managing the property.

For instance, the fee owner of a shopping center and a prospective owner-operator agree to a master lease.

Another type of special-use lease is the **farm lease**, sometimes called a *cropping agreement* or *grazing lease*. Here, the tenant operates the farm and pays the landlord either a flat fee rent or a percentage of the value of the crops or livestock produced on the land.

QUIZ

1. In a(n) _____________, rent is based on the rental value of the land in the parcel, whether the parcel is vacant or improved.

    a. farm lease

    b. fixed-term lease

    c. ground lease

2. Under a(n) ___________, the tenant operates a farm and pays the landlord either a flat fee rent or a percentage of the value of the crops or livestock produced on the land.

    a. land lease

    b. ground lease

    c. farm lease

The rights of others in a property

Easements and **use licenses** are not real estate but they give a holder of the rights a limited and nonexclusive use of someone else's property.

An *easement* is a *right to use* another's property for a specific purpose. An easement is an interest held in someone else's real estate. It grants its holder the right to limit the activities of others on the property burdened by the easement, including the owner of the burdened property. [Calif. Civil Code §§801 et seq.]

For example, a landowner holds an easement allowing them to construct and have access to a pipeline across their neighbor's property. The neighbor's right to develop their own property is limited since the neighbor may do nothing to interfere with the easement owner's access to the pipeline.

A **license** grants its holder a personal privilege to use property, but no possessory right to occupy it to the exclusion of others. Unlike easements, *licenses* are not exclusive rights — an owner may give many licenses to perform the same or different activity in the same area.

Unlike an easement, a license may be revoked at the will of the person who grants it, unless agreed to the contrary or it has become irrevocable.

Rights in another's property

The most common easement is used for ingress and egress. An easement for ingress and egress creates a right of way allowing one property owner to traverse a portion of another's land to access their property.

An easement creates a tenement relationship between two parcels of real estate since it:

- *benefits* one property, referred to as the **dominant tenement**, whose owner is entitled to use the easement; and
- *burdens* another property, referred to as the **servient tenement**, the owner's use of which is subject to the easement.

When an owner whose property is burdened by an easement interferes with the use of the easement by a neighbor whose property benefits from the easement, the neighbor is entitled to have the use of the easement reinstated. The easement is reinstated by either removal, relocation or modification of the interference.

Further, the neighbor who holds the easement is entitled to compensation for their money losses caused by the servient tenement owner's obstruction of the neighbor's use of the easement. [**Moylan** v. **Dykes** (1986) 181 CA3d 561]

Appurtenant or in gross

An easement burdening an owner's property as an encumbrance on their title is classified as either:

- an **appurtenant easement**, meaning the allowed use belongs to and benefits an adjacent property and is said to *run with the land* as an interest the adjacent property holds in the burdened real estate; or
- an **easement in gross**, meaning it belongs to an individual, not land, as their *personal right* to a specified use of the burdened real estate.

An *appurtenant easement* is incidental to the title of the property which benefits from its use. An easement is not reflected as a recorded interest on the title to the parcel of land it benefits. Nor is it a personal right held by a particular individual who may now or have previously owned the parcel benefiting from the easement.

Accordingly, an appurtenant easement is recorded as an **encumbrance** on title to the burdened property. The easement remains on the property's title after a conveyance to new owners of either the benefitting or burdened property. To be enforceable, the easement does not need to be referenced in the grant deed conveying either property to new owners since it runs with the land. [Moylan, *Moylan, supra*]

Conversely, an *easement in gross* benefits a particular person – not the real estate owned by that person. An easement in gross is personally held only by the individual who may use the easement. No parcel of real estate may benefit from an easement in gross since only the individual holding the easement can benefit.

An easement in gross is a personal right that is not transferred with the sale of real estate owned by the holder of the easement. However, the right can be *transferred* by the easement holder to another person by a writing — unless the transfer of the easement in gross is prohibited by a provision in the document creating the easement. [**LeDeit** v. **Ehlert** (1962) 205 CA2d 154]

QUIZ

1. A(n) __________ grants its holder the right to limit the activities of others on the burdened property, including the owner of the burdened property.

   a. encroachment

   b. trespass decree

   c. easement

2. A(n) __________ grants its holder a personal privilege to use property, but no possessory right to occupy it to the exclusion of others.

   a. easement

   b. license

   c. lease

Basics of California Real Estate Law

The English and Spanish influence

Historically, California real estate law has been influenced by two key sources of human conduct:

- the English legal system, or **common law**; and
- the Spanish legal system, or **civil law**.

The *common law* of England has been the predominant influence on California real estate law. This legal framework was officially adopted by California soon after obtaining statehood in 1850. [Calif. Civil Code §22.2]

Under the common law, legal disputes are decided on a case-by-case basis before a judge. Even today, the common law is often called "judge-made" law. When similar legal disputes arise, the judges refer back to the logic of earlier decisions to decide current cases. The reliance on an earlier decision to decide a current case is called **stare decisis**. The earlier case relied on is called **precedent**.

Similarly, the *civil law* of Spain had a significant impact on California real estate law. Civil law establishes statutes to settle legal disputes in advance, rather than on a case-by-case basis.

These legal traditions continue to exist today in the form of:

- statutes, regulations and ordinances; and
- case law.

The role of the U.S. Constitution

The United States Constitution (U.S. Constitution) is the supreme law of the United States. [United States Constitution, Article VI, clause 2]

All powers which the state and federal governments possess are derived from the U.S. Constitution.

The U.S. Constitution lists and explains the powers of the federal government. All other powers not given to the federal government rest with the individual states or **with the people**. [U.S. Const., Amend. X]

The form of government in which individual states share powers with a national or central government is called **federalism**.

Under *federalism*, the individual states remain independent (*sovereign*) to regulate any matters within their own borders which are not already controlled by the federal government.

Each state has its own constitution to regulate state matters remaining under their control. A state may provide more constitutional protection than the federal government if it chooses, but it may not provide less.

Separated powers

Both the federal and state governments created under the U.S. Constitution are separated into three branches:

- the **legislative** [U.S. Const., Art. I];
- the **executive** [U.S. Const., Art. II]; and
- the **judicial**. [U.S. Const., Art. III]

The state and federal *legislatures* enact the *codes and statutes* which regulate most aspects of real estate interests.

The *executive* polices the law and establishes *regulations* to carry out the administration of government as established by the legislature.

The *judiciary* settles disputes and issues *case opinions* regarding the application of the law and regulations.

No branch may exercise a power given to another branch.

QUIZ

1. The common law of England has been the predominant influence on California real estate law. Under the common law, legal disputes:

   a. are settled in advance through a series of statutes, regulations and ordinances.

   b. are decided on a case-by-case basis before a judge.

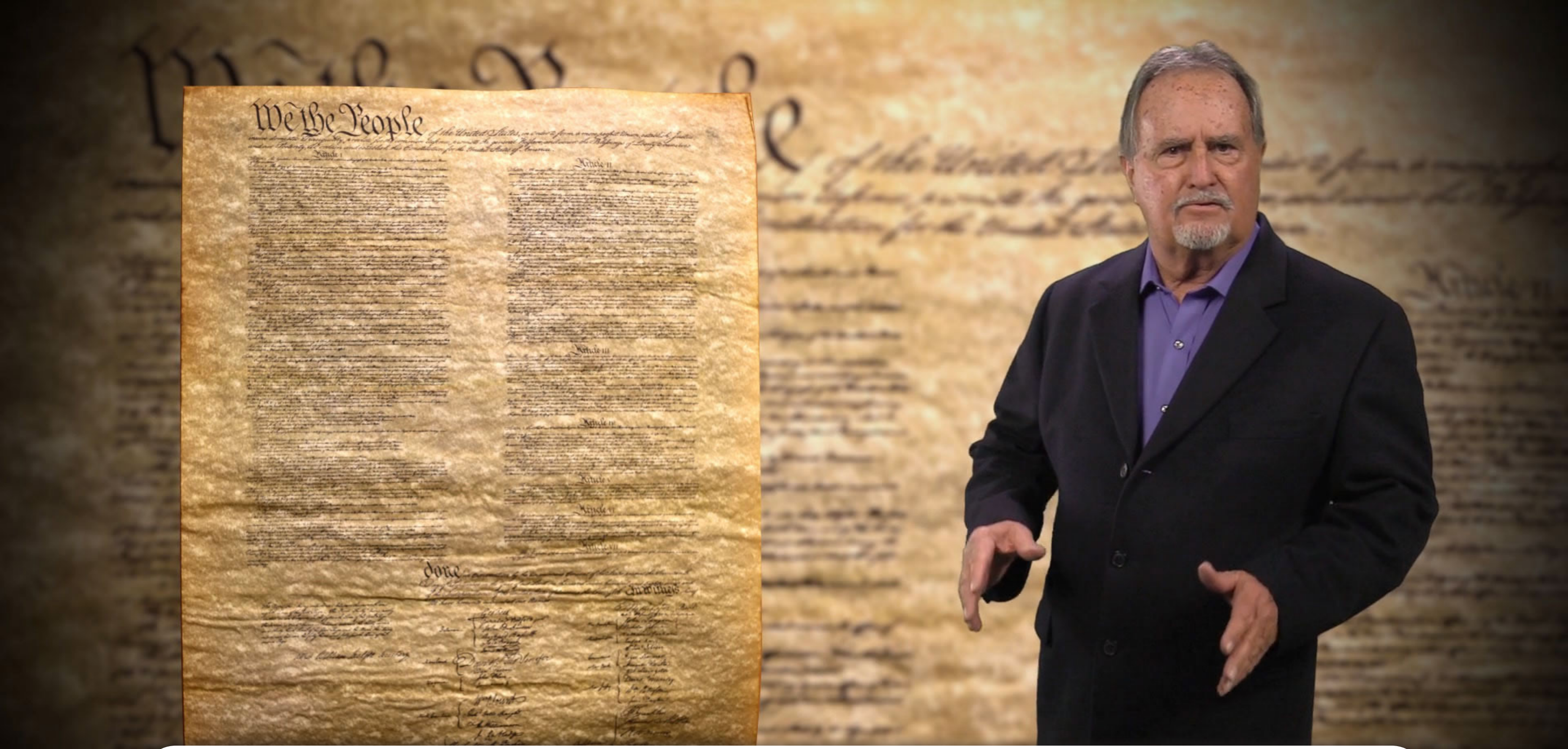
   c. are adjudicated by the third-party mediator who will guide the contesting parties to reach a meeting of the minds.

2. __________ establishes statutes to settle legal disputes in advance, rather than on an individual case-by-case basis.

   a. Spanish civil law

   b. Scandinavian civil law

   c. Portuguese civil law



Authority to legislate

The Mexican-American War ended with the signing of the **Treaty of Guadalupe Hidalgo**. Under the treaty, the United States agreed to acknowledge the existing land grants conveyed by the Spanish and Mexican governments.

The United States set up a **land commission** to document the validity of the land grants.

The land commission established land titles and created the **chain of title** still used for all California real estate today.

After confirmation of a valid land grant, the land was surveyed by the federal government and conveyed to the rightful owner by a United States **patent deed.**

All land not under a valid claim became part of the public domain of the United States.

In 1850, the United States granted part of the unclaimed real estate to the State of California. The balance was retained by the federal government.

The federal and state legislatures as well as local governments enact laws they have been authorized to by the **United States Constitution** or the **California Constitution.**

Four constitutional powers

The authority of the California legislature to enact laws regulating real estate activities comes from four main constitutional powers:

- **police power;**
- **power of eminent domain;**
- **power to tax;** and
- **escheat***,* the reverting of property to the state when the owner dies and there are no capable heirs to inherit it.

These four powers can be memorized using the mnemonic device **PETE**.

The U.S. Constitution confers on California the right to enact laws to protect public health, safety and welfare. [U.S. Const., Amend. X]

The California Constitution confers an equal power to local cities and counties to likewise protect the public good. [California Constitution, Article XI §7]

This power to protect the public well-being is called **police power.** *Police power* is the source of the state or local government's authority to act.

Police power is the basis for laws governing such things as highway construction and maintenance, rent control, zoning and traffic. [**Village of Euclid, Ohio** v. **Ambler Realty Co.** (1926) 272 US 365]

A statute or ordinance passed under the government's constitutional police power and affecting real estate-related activity is valid as long as the law:

- is fair and reasonable;
- addresses a legitimate state interest;
- does not unreasonably burden the flow of interstate commerce; and
- does not conflict with related federal law.

QUIZ

1. The __________ established land titles and created the chain of title still used for all California real estate today.

   a. state legislature

   b. federal legislature

   c. land commission

2. The authority of the California legislature to enact laws regulating real estate activities comes from four main constitutional powers – police power, power of eminent domain, power to tax and:

   a. escheat.

   b. zoning.

   c. code enforcement.

Eminent domain, the power to tax and escheat

The second key power of the state to regulate real estate is the power of **eminent domain**. [Calif. Constitution, Art. 1 §19]

Eminent domain is the right of the government to *take* private property for public use. The process of using the power of eminent domain is called **condemnation**.

However, the government needs to pay the owner the fair market value of the property taken. [**Loretto** v. **Teleprompter Manhattan CATV Corp.** (1982) 458 US 419]

Examples of eminent domain include condemning property to provide highways and roads, establish parks, construct flood control levees and provide land for redevelopment.

The government's exercise of police power may become a **taking** of an owner's real estate by **inverse condemnation** if the government surpasses their power of eminent domain.

The power to tax

State and local governments also regulate the crucial **power to tax** real estate activities to generate revenue and fund state and local governmental functions under their police power. [Calif. Const., Art. XIII D §6]

For example, a city passes an ordinance which imposes an **inspection fee** on all landlords renting residential properties. The fee charged is based on a flat rate per unit, not on current property values.

A landlord subject to the ordinance claims the ordinance is unenforceable since the city must have voter approval before adopting an ordinance which imposes a regulatory fee on property.

The city claims the ordinance is enforceable without voter approval since the fee is imposed on a **use** of the property — renting — not on the mere ownership of the property, which requires voter approval.

Here, the ordinance imposing the inspection fee on landlords based on a flat rate per unit offered for rent is enforceable. Voter approval is only required when fees and taxes are imposed on owners simply because they own real estate. Fees and taxes imposed on the owner's exercise of his uses and rights which come with owning the property do not require voter approval. [**Apartment Association of Los Angeles** v. **City of Los Angeles** (2001) 24 C4th 830]

The power of escheat

The last constitutional power is **escheat**.

Escheat occurs when the owner of a property dies, and they have no heirs to inherit it. When this occurs, ownership of the property reverts automatically to the state.

Escheat also refers to the process of transferring *abandoned* property to the state, whether or not the rightful owner is still alive.

For example, banks possessing an individual's property (read: money) have a duty to return the property to the owner after three years of inactivity. [California Code of Civil Procedure §1513(a)(a)(A)]

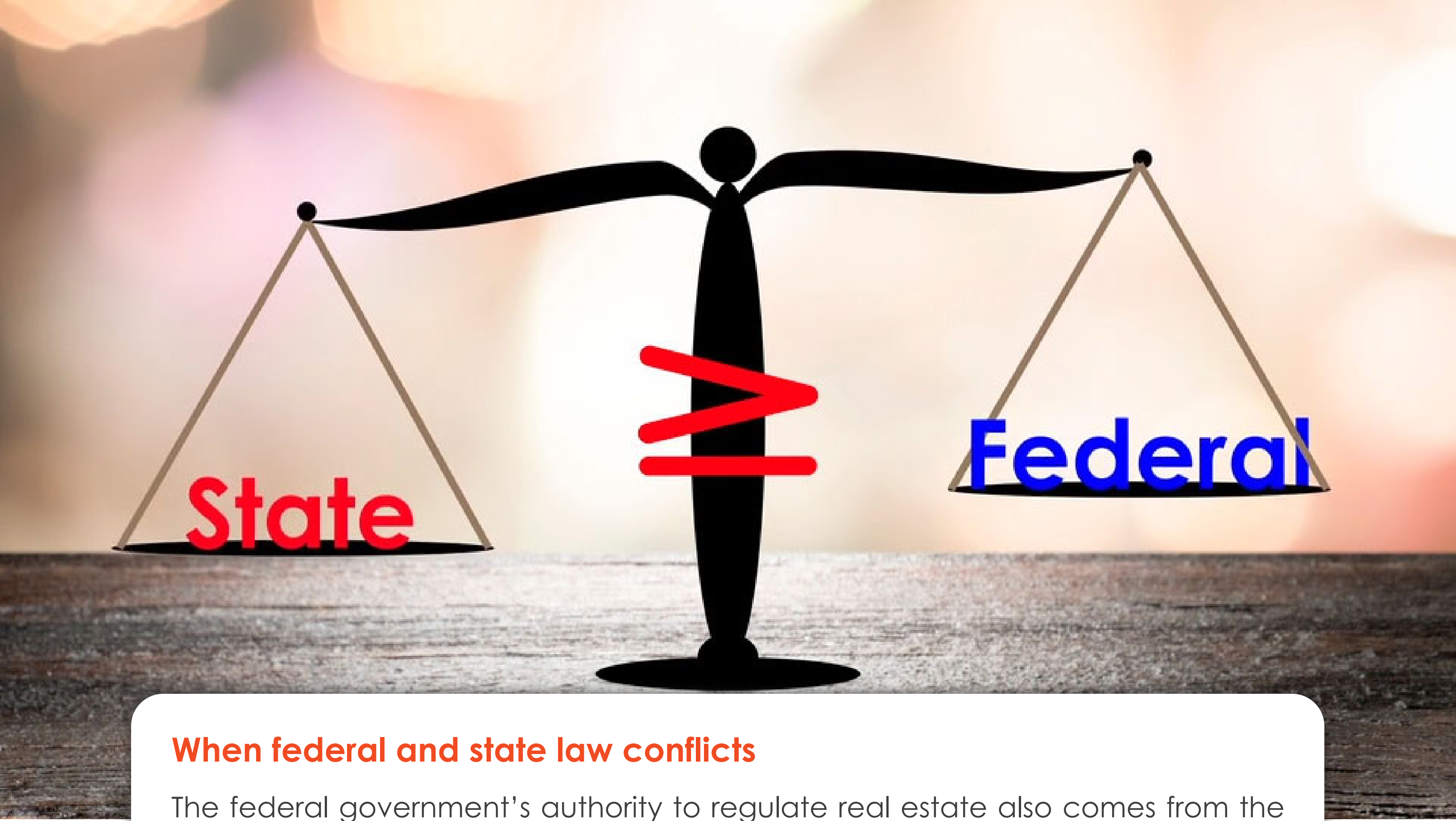
QUIZ

1. Eminent domain is the right of the government to take private property for public use. The process of using the power of eminent domain is called:

   a. reversion.
   b. condemnation.
   c. dedication.

2. An ordinance which imposes a regulatory fee on property is an example of the:

   a. police power.
   b. power of eminent domain.
   c. power to tax.



When federal and state law conflicts

The federal government's authority to regulate real estate also comes from the U.S. Constitution.

Like the state, the federal government has the *power to tax* and the power to *take* private property for public use. [U.S. Const., Amend. XVI; Calif. Const., Art. 1 §19]

However, the federal government has no police power. In its place, the federal government has a powerful clause to regulate areas of national concern, called the **commerce clause**.

The federal government has the right to regulate all commercial enterprises which affect **interstate commerce**.

Originally, the clause was designed to combat attempts by local states to pass protectionist laws under their police powers which would inhibit the flow of goods between states — *interstate commerce*. [**Gibbons** v. **Ogden** (1824) 22 US 1]

Today, the clause also applies to local and intrastate activities which have an indirect effect on the flow of goods, services and people from state to state.

For example, the federal government's interest in the flow of commerce between states outweighs a motel owner's right to exclude specific classes of patrons. The owner's exclusion interferes with the flow of commerce – which includes the mobility of people. [**Heart of Atlanta Motel, Inc.** v. **United States** (1964) 379 US 241]

The federal government's ability to regulate a purely local activity even extends to local real estate brokers' activities within their trade unions.

For example, a broker sues the local board of realtors for federal **antitrust violations**, claiming the association **fixes rates** charged by its members for their services.

The association ostracizes brokers who refuse to comply with the fee-setting policies established by the association based on the maintenance of a minimum acceptable level of income for its union members.

The association claims the federal government may not regulate their activities as their services are purely local and have no effect on interstate commerce.

Do the federal antitrust laws cover local brokerage activities?

Yes! The association's fee-setting of the charges for their members' services affects housing locally, which in turn affects the desire to live in the area, which in turn affects the mobility of people in interstate commerce. [**McLain** v. **Real Estate Board of New Orleans, Inc.** (1980) 444 US 232]

Alternatively, states have the *sovereignty* to regulate within their own borders. At the same time, the federal government has the right to regulate local activities affecting commerce.

What happens when federal and state law conflict? Consider the following example.

An airport is established under the Federal Aviation Act of 1953. The airport expands its number of late-night and early-morning flights. The residents around the airport complain of the noise during late and early hours.

The city where the airport is located passes an ordinance restricting the number of flights between 11 p.m. and 7 a.m.

The airport objects, claiming it was established under the sole jurisdiction of federal law and the Federal Aviation Act of 1953 set forth by the Federal Aviation Administration (FAA) which has no restriction on flights between 11 p.m. and 7 a.m.

Does the federal law **preempt** (supersede) state law?

Yes! The goals of national flight service and the role of the FAA

outweigh local laws inhibiting flight times. [**City of Burbank** v. **Lockheed Air Terminal, Inc.** (1973) 411 US 624]

A federal law will *preempt* state and local statutes and ordinances when:

- federal interests outweigh local interests;
- the federal law is so pervasive as to exclude inconsistent state law; and
- inconsistent treatment nationwide would result if state law controls.

Thus, it is possible for federal and state law to regulate the same real estate activity.

For example, federal and state **fair housing** laws prohibiting discrimination exist. Both the state and federal governments can regulate *fair housing*. The state may provide more, but may not allow less, protection than the federal law. [Calif. Civil Code §51]

QUIZ

1. The federal government has the right to regulate all commercial enterprises which affect:
   a. interstate commerce.
   b. local zoning and planning.
   c. the price of available goods on the open market.

2. Which of the following statements is the most correct concerning the overlap of federal and state law?
   a. Federal law always supersedes state law, unless the law is unique to the state.
   b. The state may provide more, but may not allow less, protection than the federal law.
   c. A federal law will preempt state and local statutes and ordinances when the state interests outweigh federal interests.

Real Estate Licensing

DRE oversight

Real estate law is codified to protect the public in real estate transactions when a real estate licensee or subdivision is involved. [Calif. Business and Professions Code §§10000 et seq.]

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

The chief officer of the DRE is the **Real Estate Commissioner**. The *Real Estate Commissioner's* principal responsibility is to enforce all the real estate laws pertaining to real estate licensing and the **Subdivided Lands Law**. [Bus & P C §§10050; 10051]

The Commissioner ensures that real estate licensees and members of the public dealing with licensees receive maximum protection. [Bus & P C §10050]

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

QUIZ

1. The California Legislature created the __________ to oversee, regulate, administer and enforce the real estate law.

   a. California Association of Realtors (CAR®)

   b. Nationwide Multi-State Licensing System and Registry (NMLS)

   c. Department of Real Estate (DRE)

Who's Who?

To engage in the business of real estate as a real estate **broker or agent**, a person first obtains a real estate license issued by the DRE. [Bus & P C §10130]

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

- negotiating the sale, purchase or exchange of real estate, leases or business opportunities;
- soliciting listings, buyers or sellers;
- leasing or renting, or offering to lease or rent, property on behalf of an owner or tenant;
- collecting rent from real estate or business opportunities;
- assisting in the purchase or lease of property owned by the state or federal government;
- negotiating real property sales contracts or mortgages to be secured directly or collaterally by real estate or business opportunities on behalf of lenders or borrowers; and
- negotiating the sale or purchase of a mobilehome. [Bus & P C §10131]

A **real estate agent** is an individual who, for compensation or in expectation of compensation, is employed by a licensed broker to do one or more of the acts of a licensed broker. [Bus & P C §10132]

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

Delegated supervision, not agency

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

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

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

- transactions requiring a real estate license;
- documents having a material effect upon the rights or obligations of a party to the transaction;
- the filing, storage and maintenance of documents;
- the handling of trust funds;
- advertisement of services that require a license;
- sales agents' knowledge of anti-discrimination laws; and
- reports of the activities of the sales agents. [Calif. Department of Real Estate Regulation §2725]

QUIZ

1. What best describes the relationship between an agent and their employing broker?

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

    b. A sales agent employed by a broker is the agent of the client solicited by the broker. In turn, the broker has no connection to the client, beyond the initial solicitation.

    c. A sales agent employed by a broker is an employee of the client. In turn, the broker is the agent of both the agent and the client.

Agent and broker eligibility requirements and continuing education

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

- be at least 18 years old [DRE Regs. §§2720; 2750];
- be honest and truthful;
- make the application on the proper form prescribed by the DRE;
- complete the mandatory education; and
- pass the qualifying exam.

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

All statutory course requirements for both the agent and the broker license may be waived if the applicant is a member of the state bar. [Bus & P C §§10153.2]

The individual broker license

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

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

Qualifying for a broker license

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

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

The California real estate salesperson and broker examination

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

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

- classes of property
- environmental hazards and regulations
- encumbrances
- types of ownership
- descriptions of property
- government rights in land
- public controls
- special categories of land
- private controls
- water rights
- property characteristics

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

- law, definition and nature of agency relationships, types of agencies, and agents
- creation of agency and agency agreements
- responsibilities of agent to seller/buyer as principal
- disclosure of agency
- disclosure of acting as principal or other interest
- responsibilities of agents to non-client third-parties
- termination of agency

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

- value
- methods of estimating value
- financial analysis

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

- general concepts
- types of loans
- sources of financing
- government programs
- mortgages/deeds of trust/notes
- financing/credit laws
- loan brokerage
- types of loan originators

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

- title insurance
- deeds
- escrow
- tax aspects
- special processes
- types of vesting
- transfer through court supervision

6 — Practice of Real Estate and Disclosures (Includes specialty areas)
Approximately 25% of the sales and broker exam

- trust account management
- fair housing law
- truth in advertising
- record keeping requirements
- agent supervision
- permitted activities of unlicensed sales assistants
- commercial/industrial/income properties
- licensing, continuing education requirements and procedures
- California Real Estate Recovery Fund
- general ethics
- technology
- property management
- DRE jurisdiction and disciplinary actions
- specialty areas
- transfer disclosure statement (TDS)
- natural hazard disclosure (NHD) statements
- disclosure of material facts affecting property value
- need for inspection and obtaining/ verifying information
- reports
- servicing diverse populations

7 — Contracts
Approximately 12% of the sales and broker exam

- general
- listing agreements
- buyer-broker agreements
- offers/purchase contracts
- agreements
- promissory notes/securities
- purchase/lease options
- advanced fees

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

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

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

Agent license

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

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

- real estate principles;
- real estate practice; and
- one elective course in the following subjects:
  - legal aspects of real estate;
  - real estate finance;
  - property management;
  - real estate appraisal;
  - real estate economics or accounting;
  - business law;
  - real estate office administration;
  - escrows;
  - mortgage brokering and lending;

- o common interest developments (CIDs); or
- o computer applications in real estate. [Bus & P C §10153.4]

The applicant has two years from the date the exam application is filed with the DRE to take the exam. [Bus & P C §10153.8]

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

An applicant who fails the agent exam may apply for reexamination. No restriction exists on the number of times the applicant may take the test within the two-year period following the application. [Bus & P C §10153.8]

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

Continuing education requirements

A real estate broker and real estate agent license is valid for *four years* from the date of issuance noted on the license certificate. [Bus & P C §§10153.6; 10153.7]

All real estate brokers and sales agents need to complete at least **45 hours of continuing education (CE)** to renew a license issued by the DRE. [Bus & P C §10170.5]

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

QUIZ

1. Among other qualification requirements, to be eligible for a broker or agent license the applicant needs to:

   a. be at least 18 years old and a member of the real estate trade union.

   b. complete the mandatory education and be a member of the state bar.

   c. pass the qualifying exam and be at least 18 years old.

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

   a. one year

   b. two years

   c. four years

Other classifications

Acts for which a real estate license is required may be performed in the name of a **corporation** if a licensed officer of the corporation qualifies the corporation for a license issued by the DRE. [DRE Reg §2740]

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

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

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

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

Fictitious business name

A licensee may use a **fictitious business name** in any activity for which a real estate license is required, if the license is issued under the fictitious name. [DRE Reg. §2731(a)]

A *fictitious business name* license will only be granted to a broker who has complied with the filing requirements for a fictitious business name, also known as a *d.b.a.* (“*doing business as...*”). [DRE Reg. §2731(b)]

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

- the name is misleading or would constitute false advertisement;
- implies a partnership or corporation exists when one does not;
- includes the name of a real estate agent;
- violates California’s Business and Professions Code on fictitious business name requirements; or
- is the name formerly used by a licensee whose license has been revoked. [DRE Reg. §2731(c)]

Mineral, oil and gas

A real estate broker and agent may solicit and negotiate for the purchase, lease or exchange of mineral, oil and gas property. The licensee may also arrange or negotiate and service loans on mineral, oil and gas property. [Bus & P C §10500]

Finally, the licensee may rent mineral, oil and gas property and collect the rents or royalties from the mineral, oil and gas property. [Bus & P C §10500]

Mortgage loan brokerage

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

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

- one-to-four unit residential properties;
- mobile homes; and
- trailers or houseboats, if they are used as residences. [Bus & P C §10166.01; 12 Code of Federal Regulations §108.103]

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

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

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

QUIZ

1. The officer qualifying the corporation for a corporate broker license is called the:

   a. affiliated officer (AO).

   b. chief executive officer (CEO)

   c. designated officer (DO).

2. A licensee may use a __________ in any activity for which a real estate license is required when the license is issued under that name.

   a. fictitious business name

   b. doing business as (d.b.a)

   c. Both a. and b.

Bulk sales, business opportunities and manufactured homes

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

Common types of *business opportunities* include:

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

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

The sale of a business opportunity consists of two transactions:

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

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

- *bill of sale*;
- *Uniform Commercial Code (UCC)-1 Financing Statement* for the personal property [See RPI Form 436-1]; and

- *a deed* (or assignment of the leasehold and a trust deed) for the transfer of the real property. [See **RPI** Form 404]

Bulk sales

On the sale of a business opportunity, the inventory of the business is transferred to the buyer by a **bill of sale**. The transfer of more than one-half the inventory of a business' materials or goods to a person other than the business' customers is called a **bulk sale**. A *bulk sale* needs to comply with the UCC since it is the transfer of personal property. [Calif. Commercial Code §6102]

The buyer of the inventory gives public notice of the transfer 12 days before the transfer takes place to perfect their interest in the acquisition of the inventory on closing. [Com C §6105]

Manufactured homes

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

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

- at least eight feet in width, 40 feet in length or more than 320 square feet when transported in one or more sections;
- built on a permanent chassis; and
- designed to be used as a dwelling with or without a permanent foundation. [Calif. Health and Safety Code §18007]

A manufactured home that meets the requirements and is attached to a permanent foundation is no longer considered personal property but **real estate**, since it is a permanent fixture or an improvement to real estate. [Health & S C §§18039.1; 18551]

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

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

The government agency responsible for the registration of manufactured homes is the **California Department of Housing and Community Development (HCD)**. Manufactured homes are registered with the *HCD*, unless the manufactured home is considered real estate. [Health & S C §§18206; 18000 et seq.]

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

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

QUIZ

1. The transfer of more than one-half the inventory of a business' materials or goods to a person other than the business' customers is called a:

    a. bulk sale.

    b. §1031 exchange.

    c. liquidation sale.

2. A manufactured home that is attached to a permanent foundation is classified as:

    a. personal property.

    b. real estate.

    c. profit a prendre.

The real estate recovery account

If a client sues a broker for trust account violations and receives a money judgment, the client may satisfy the judgment through the state **Real Estate Recovery Account** if:

- the broker is *insolvent*; and
- the losses are *directly related* to the broker's conduct.

This account is also referred to as the *Real Estate Recovery Fund* and *Consumer Recovery Account*. All refer to the same thing.

The client's recovery is limited to:

- **$50,000** for one transaction; or
- **$250,000** for any one licensee.

The recovery is further limited to the actual losses on the transaction which resulted from the *broker's fraud.* [Bus & P C §§10471 et seq.]

For example, an owner of income-producing real estate enters into a property management agreement with a broker. Under the property management agreement, the broker collects rents from tenants and arranges for maintenance of the real estate.

The owner gives the broker a cash advance to cover maintenance expenses. The broker deposits the cash advance into their **personal account**.

Tenants pay their rents to the broker in cash, which the broker deposits into their personal checking account. The broker then issues a check from their personal account payable to the owner for all funds due the owner.

The check is rejected by the broker's bank due to insufficient funds. The owner demands the broker to either pay the rents collected and return the cash advanced for maintenance, or account for the funds when they have been disbursed. The broker refuses to account to the owner.

The owner sues the broker and is awarded a judgment for:

- three times the amount of *rents collected* by the broker and not paid to the owner;
- three times the amount of the *cash advanced* for maintenance, as no evidence exists showing the broker expended the funds for the benefit of the owner;
- *pre-judgment interest* at the legal rate of 10% on the rents and cash advanced from the date they were received by the broker;
- *post-judgment interest* at 10% until the judgment is satisfied;
- costs; and
- attorney fees.

The owner attempts to collect on the judgment but the broker is insolvent.

Can the owner collect all of their money judgment amounts due from the broker for the misuse of trust funds from the *Real Estate Recovery Account*?

No! The owner can only recover their *actual and direct losses* on the transaction from the Recovery Account, up to the sum of $50,000. Thus, the owner's recovery is limited both by the $50,000 ceiling and the actual amount of their lost rents and the cash advanced for maintenance. The tripled amount cannot be recovered from the Recovery Account since the amount exceeds the actual loss inflicted by the broker. [**Circle Oaks Sales Co.** v. **Real Estate Commissioner** (1971) 16 CA3d 682]

Also, no attorney fees award can be recovered from the Recovery Account since attorney fees are not direct losses. [**Acebo** v. **Real Estate Education, Research and Recovery Fund** (1984) 155 CA3d 907]

However, the owner can recover the interest and court costs awarded in the judgment from the Recovery Account as part of the $50,000 maximum recovery. [**Nordahl** v. **Franzalia** (1975) 48 CA3d 657]

QUIZ

1. When an individual obtains a final-court judgment against a licensee and is unable to recover the judgment from the licensee, the individual may be able to recover the funds through the:

   a. broker's errors and omissions (E&O) insurance policy.

   b. real estate recovery account.

   c. Department of Housing and Urban Development (HUD) embezzlement fund.

2. An individual seeking funds from the real estate recovery account is limited to:

   a. $50,000 for one transaction.

   b. $250,000 for any one licensee.

   c. Both a. and b.

Fair Housing

Federal Fair Housing Laws

Regardless of race, all citizens of the United States have the right to purchase or rent real estate under the federal **Civil Rights Act**. [42 United States Code §1982]

Further, all individuals within the United States are given the same rights to make and enforce contracts, sue, be sued, enjoy the full benefits of the law and be subject to the same punishments, penalties, taxes and licenses, regardless of race or legal status. [42 USC §1981]

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

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

The Federal Fair Housing Act (FFHA)

While the federal Civil Rights Act provides general protection against all prohibited discriminatory activity, the **Federal Fair Housing Act (FFHA)** protections are specifically limited to dwellings, including rental housing. [42 USC §§3601 et seq.]

A **dwelling** includes any building or structure that is occupied, or designed to be occupied, as a residence by one or more families. A *dwelling* also includes vacant land offered for lease for residential dwelling purposes, such as a lot or space made available to hold a mobilehome unit. [42 USC §3602(b)]

The FFHA prohibits discrimination in the following situations:

- the sale, rental or advertisement of a residence;
- offering and performing broker services;
- making loans to buy, build, repair or improve a residence;
- the purchase of real estate loans; or
- appraising real estate. [42 USC §3602]

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

- race or color;
- national origin;
- religion;
- sex;
- familial status; or
- handicap. [42 USC §3602]

Familial status refers to whether a household includes individuals under the age of 18 in the legal custody of a parent or legally designated guardian. [42 USC §3602(k)]

Handicapped persons are individuals who have:

- a physical or mental impairment which substantially limits the individual's life activities; or
- a record of, or are regarded as having, a physical or mental impairment. [42 USC §3602(h)]

Any individual who claims they have been injured by a prohibited discriminatory housing practice under the FFHA or believes they will be injured by such a practice is considered an **aggrieved individual**. [42 USC §3602(i)]

An *aggrieved individual* may file a complaint with the Secretary of Housing and Urban Development (HUD), within one year of the alleged discriminatory housing practice. HUD then attempts to resolve the dispute by having the parties enter into informal negotiations, called **mediation**. [42 USC §3610(a)]

When a real estate broker subjected to a judicial action is found guilty of discriminatory housing practices, HUD is to notify the California Department of Real Estate (DRE) and recommend disciplinary action. [42 USC §3612(g)(5)]

When a court determines discriminatory housing practices have taken place, actual and punitive amounts of money awards may be granted. Also, an order may be issued preventing the landlord or broker from engaging in any future discriminatory housing practice. [42 USC §3613(c)(1)]

Equal Credit Opportunity Act (ECOA)

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

The anti-discrimination rules apply to institutional lenders, mortgage brokers, and others who *make or arrange mortgages*. [15 United States Code §1691a(e)]

Discriminatory practices take many forms, including:

- treating minority mortgage applicants less favorably than non-minority applicants;
- placing additional burdens on minority applicants;
- requiring a spouse's signature on a mortgage application when an applicant qualifies for a mortgage individually; [**Anderson** v. **United Finance Company** (1982) 666 F2d 1274]
- discouraging mortgage applicants based on their race, color, sex, etc.; [12 Code of Federal Regulations §1002.5(b)] and
- making inquiries into the marital status of mortgage applicants. [12 CFR §1002.5(d)]

The lender may not make any inquiries into whether an applicant's income is derived from *alimony* or *child support*. The lender may not inquire whether the applicant intends to bear children. [12 CFR §1002.5(d)]

Further, to deny a mortgage based on an applicant's receipt of income from a public assistance program, such as welfare or social security, is unlawful discrimination. [15 USC §1691(a)(2)]

QUIZ

1. While the federal Civil Rights Act provides general protection against all prohibited discriminatory activity, the __________ protections are specifically limited to dwellings, including rental housing.

   a. Federal Fair Housing Act (FFHA)

   b. Equal Credit Opportunity Act

   c. Unruh Civil Rights Act

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

   a. Unruh Civil Rights Act

   b. Holden Act

   c. Equal Credit Opportunity Act (ECOA)

California prohibitions against discrimination

California prohibits discrimination in the sale or rental of housing accommodations based on an individual's race, color, religion, sex, gender, gender identity, gender expression, sexual orientation, familial status, marital status, disability, genetic information, national origin, source of income, veteran or military status, ancestry, citizenship, primary language, or immigration status. [CC §§51 et. seq.; Calif. Government Code §12955; DRE Reg. §2780 and §2781]

This list of protected individuals under state law is more extensive than all others.

Discriminatory activities and conduct include:

- making a written or oral inquiry into the race, sex, disability, etc. of any individual seeking to rent housing;
- ads or notices for rental of housing which state or imply preferences or limitations based on any of the prohibited discrimination factors;
- a broker refusing to represent an individual in a real estate transaction based on any prohibited factor; and
- any other practice that denies housing to a member of a protected class. [Gov C §12955]

The denial of housing based on the landlord or broker's perception that a prospective buyer or tenant has any of the protected characteristics is absolutely prohibited, whether it was done *explicitly* or *implicitly*. An individual who has been the victim of discriminatory housing practices may recover their money losses. [Gov C §12955(m)]

California Fair Employment and Housing Act (FEHA) and Unruh Civil Rights Act

The **Department of Fair Employment and Housing (Department)** is the California government agency which enforces anti-discrimination law. [Gov C §§12901, 12903, 12930, 12935]

Any individual who feels they have been discriminated against may file a complaint with the *Department*. The Department investigates the complaint to determine any wrongful conduct. When grounds exist, the Department then seeks to resolve the situation through discussions with the individual against whom the complaint is made. [Gov C §12980]

When the dispute cannot be effectively resolved, the Department will file a civil action on behalf of the individual who was discriminated against in the county where the discriminatory conduct is alleged to have occurred. [Gov C §12981]

California's **Unruh Civil Rights Act** prohibits discrimination by a **business establishment** based on numerous status classifications, including: an individual's sex, race, color, religion, ancestry, national origin, disability or medical condition. [Calif. Civil Code §§51; 51.2; 51.3]

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

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

As business establishments, landlords may not boycott, blacklist, refuse to lease or rent because of the race, creed, religion, color, national origin, sex, disability or medical condition of an individual's, or that individual's business partners, members, stockholders, directors, officers, managers, agents, employees, business associates or customers. [CC §51.5]

The Housing Financial Discrimination Act of 1977 (The Holden Act)

To achieve a healthy state economy, all residential housing for sale needs to be available to any homebuyer who is creditworthy and qualifies for **purchase-assist financing**. [Calif. Health and Safety Code §35801(b)]

An efficient real estate market requires the value of housing to be immune from fluctuations caused by lenders who arbitrarily deny financing to qualified homeowners, whether explicitly or implicitly. Thus, the **California Housing Financial**

Discrimination Act of 1977, known as the **Holden Act**, prohibits discriminatory lending practices.

The goal of anti-discrimination law in home financing is to:

- increase the availability of housing to creditworthy buyers; and
- increase lending in communities where lenders have made conventional home mortgages unavailable. [Health & S C §35802]

Under the California Housing Financial Discrimination Act, lenders need to make financing available to *qualified creditworthy mortgage applicants* to:

- buy, build, repair, improve or refinance an existing mortgage on a one-to-four unit, owner-occupied residence; or
- improve one-to-four unit residences which are not owner-occupied. [Health & S C §35805(d)]

Lenders violate public policy when they indicate a **discriminatory preference** by denying or approving financing to creditworthy mortgage applicants based on the applicant's protected status. [Health & S C §35811]

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

- refuse to fund a mortgage based on the **demographics** of that community; or
- appraise real estate in that community at a lower value than comparable real estate in communities predominantly composed of non-minority residents. [Health & S C §§35810, 35812]

Failure to provide financing in certain communities is called **redlining**. *Redlining* is specifically targeted for correction by the law since it adversely affects the health, welfare and safety of California residents. [Health & S C §35801(e)(4)]

Lenders who deny mortgage applications based on the characteristics of the community discourage homeownership in that community. Thus, redlining leads to a decline in the quality and quantity of housing in areas where financing is generally unavailable, perpetuating segregated housing patterns. [Health & S C §35801]

However, a lender can consider *neighborhood conditions* when making a mortgage under certain circumstances. When doing so, the lender is required to demonstrate a mortgage denial is based on neighborhood conditions which render the mortgage unsafe and unsound as a matter of good business practice. [Health & S C §35810(a)]

The California-specific prohibitions and requirements under the Housing Financial

Discrimination Act apply to all institutions which make, arrange or buy mortgages funded to buy, build, repair, improve or refinance one-to-four unit, owner-occupied housing.

This includes mortgage loan originators (MLOs) or lenders offering consumer mortgage services, whether endorsed by the California Department of Real Estate (DRE) or licensed by the Department of Financial Protection and Innovation (DFPI). [Health & S C §35805]

DRE regulation of discrimination

The **Department of Real Estate (DRE)** also enforces numerous regulations prohibiting discriminatory practices by real estate brokers and agents. A broker or agent found guilty of engaging in **discriminatory business practices** may be disciplined by the DRE. [California Department of Real Estate Regulation §2780]

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

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

A broker has a duty to advise their agents and employees of all anti-discrimination rules, including DRE regulations, the Unruh Civil Rights Act, the California Fair Employment and Housing Act, and the FFHA. [DRE Reg. §2725(f)]

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

QUIZ

1. Which legal frameworks features the broadest array of individuals protected from discriminatory activity?

    a. State law.

    b. Federal law.

    c. Both state and federal law equally.

2. Failure to provide financing in certain communities is called:

    a. panic selling.

    b. redlining.

    c. blockbusting.

Agency

Introduction to agency

An **agent** is described as "Someone who is authorized to act for or in place of another; a representative..." [Black's Law Dictionary, Twelfth Edition (2024)]

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

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

Agency in real estate related transactions includes relationships between:

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

The extent of representation owed to a client by the broker and their agents depends on the *scope of authority* the client gives the broker. Authority is given:

- orally;
- in writing; or

- through the client's conduct with the broker.

Agency and *representation* are synonymous in real estate transactions.

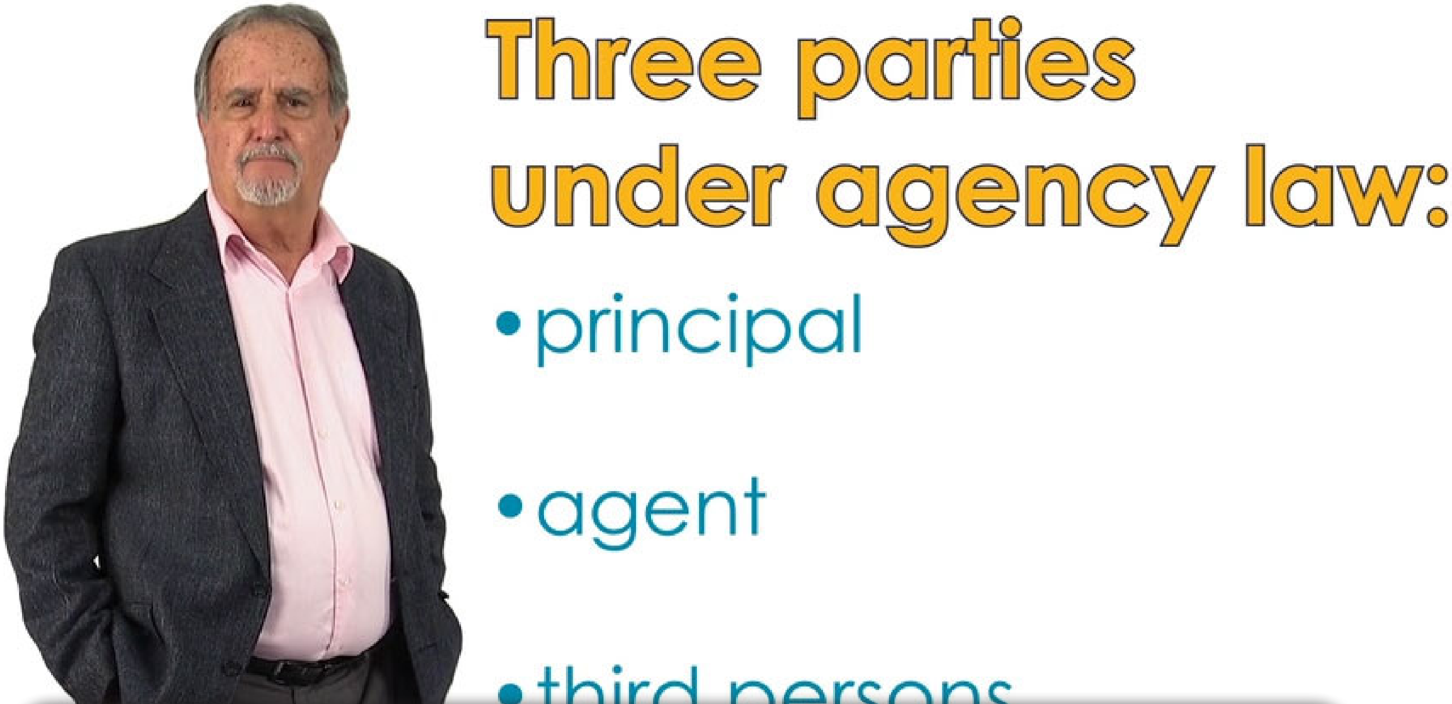
A broker, by accepting an exclusive employment from a client, undertakes the task of aggressively using **due diligence** to represent the client and attain their objectives. Alternatively, an open listing only imposes a *best efforts* standard of representation until a match is located and negotiations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

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

QUIZ

1. Agency and __________ are synonymous in real estate transactions.
   a. independence
   b. representation
   c. self-interest

2. A broker, by accepting an exclusive employment from a client, undertakes the task of using _________ to represent the client and attain their objectives.
   a. due diligence
   b. only the minimal effort needed
   c. due deceit



Who is an agent under agency law?

The representation of others undertaken by a real estate broker is called an agency.

Three parties are referred to in agency law: a principal, an agent and third persons. [Calif. Civil Code §2295]

In real estate transactions:

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

Real estate jargon

Real estate jargon used by brokers and agents tends to create confusion among the public.

When the jargon is used in legislative schemes, it adds statutory chaos, academic discussion and consternation among brokers and agents over the duties of the real estate licensee.

For example, the words "real estate agent," as used in the brokerage industry, mean a *real estate salesperson employed by and representing a real estate broker*. Interestingly, real estate salespersons rarely refer to themselves as *sales agents*; a broker never does. Instead, agents frequently call themselves "broker-associates," or "Realtors," especially if they are affiliated with a local trade union. The public calls licensees "realtors," the generic term for the trade, much like the term "Kleenex."

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

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

QUIZ

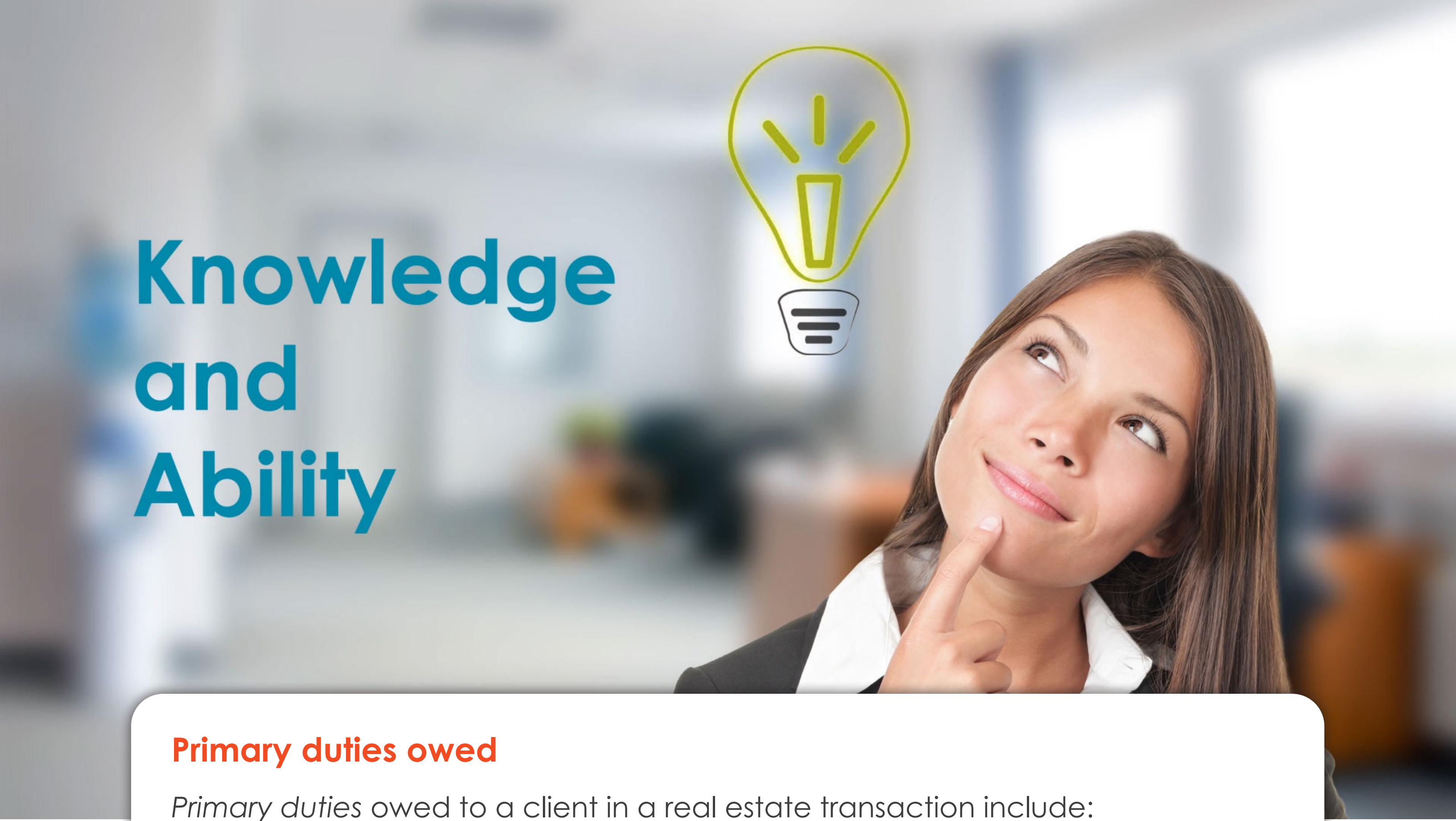
1. A salesperson is legally an agent of:

    a. the client.

    b. the customer.

    c. their broker.

Knowledge and Ability



Primary duties owed

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

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

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

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

Collectively, these are known as **fiduciary duties**. Fiduciary duties are the duties owed by an agent to act in the highest good faith toward the principal and not to obtain any advantage over their principal by the slightest misrepresentation, concealment, duress or undue influence. Again, these are the highest standards owed to the principal the broker represents.

Alternatively, the broker owes a limited, non-client **general duty** to voluntarily provide critical factual information to the opposing party in a transaction.

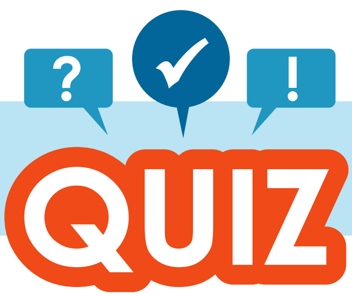
A licensee needs to conduct themselves at or above the minimum acceptable levels of competency to avoid liability to the client or disciplinary action by the DRE.

Creation of the agency relationship

An agency relationship is created in a real estate transaction when a *principal* employs a broker to act on their behalf. [CC §2307]

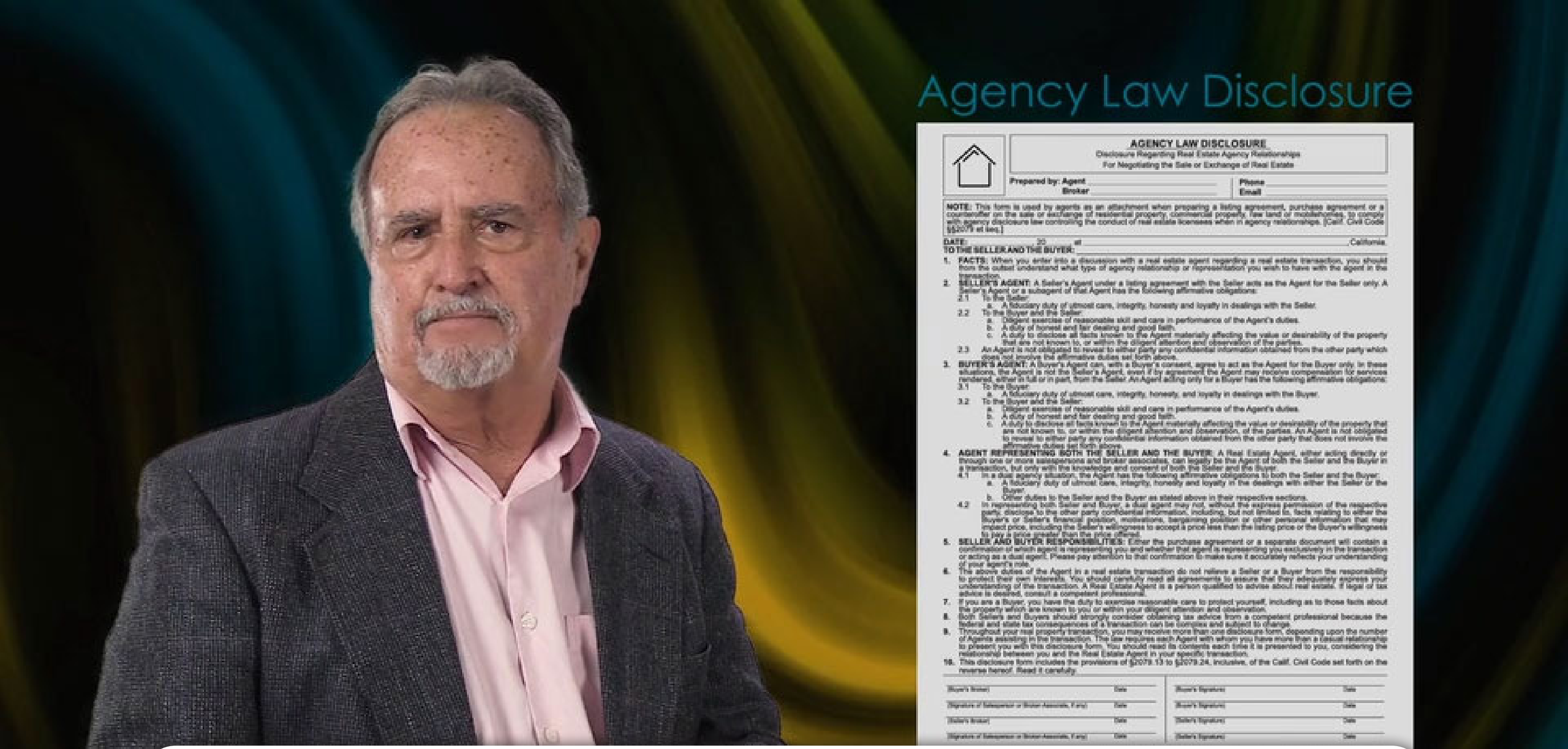
A broker's representation of a client, such as a buyer or seller, is properly undertaken on a written employment agreement signed by both the client and the broker. A written employment agreement is necessary for the broker to have an enforceable *fee agreement*. This employment contract is loosely referred to in the real estate industry as a **representation agreement**, also known as a **listing agreement**. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247] [See **RPI** Forms 102, 103.1and 103.2]

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



1. The primary duties owed to a client in a real estate transaction are collectively known as:
    a. general duties.
    b. fiduciary duties.
    c. limited duties.

2. A written employment agreement is necessary for:
    a. the broker to have an enforceable fee agreement.
    b. a valid agency to be created.
    c. Both a. and b.



Legislated order

As real estate practice matures in California, rules and regulations need to be created to protect society from harm while allowing transactions to be economically beneficial for all involved. However, when professional misconduct of real estate licensees is mishandled by the brokerage community and related trade groups, legislative and judicial forces are compelled to intervene.

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

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

- an **Agency Law Disclosure**, also known as the **Disclosure Regarding Real Estate Agency Relationships**, setting out the "rules of agency" which control the conduct of real estate licensees when dealing with the public in an agency capacity [See **RPI** Forms 305-1 and 550-1]; and
- an **agency confirmation provision**, contained in documents signed by principals used to negotiate the purchase or leasing of real estate and lease agreements with a term exceeding one year, declaring the agency relationships undertaken by each of the brokers with the participants in the transaction. [See **RPI** Form 150]

Editor's note — Two identical versions of the agency disclosure exist for leasing as part of both the "disclosure" and "property management" series of RPI forms. Either *may be used when negotiating a listing, offer/letter of intent (LOI) or agreement for the lease of real estate for a period greater than one year. [See **RPI** Forms 305-1 and 550-2]*

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

This agency law disclosure is presented in a two-page form. The exact wording of its content is dictated by statute. [CC §2079.16] [See **RPI** Forms 305, 305-1 and 550-2]

Targeted by law vs. recommended as best practice

The real estate agency disclosure law previously applied only to one-to-four unit residential sales and leases for greater than one year. It has since been expanded to include more diverse types of property.

The **Agency Law Disclosure** needs to be presented to all parties when listing, selling, buying, exchanging or leasing for a term greater than one year:

- single family residential property;
- multi-unit residential property with more than four dwelling units;
- commercial property;
- vacant land;
- a ground lease coupled with improvements; or
- manufactured homes. [Calif. Civil Code §§2079.13(k), 2079.14]

At its core, the Agency Law Disclosure form is a restatement of pre-existing agency codes and case law on agency relationships in all real estate transactions. [See **RPI** Forms 305, 305-1 and 550-2]

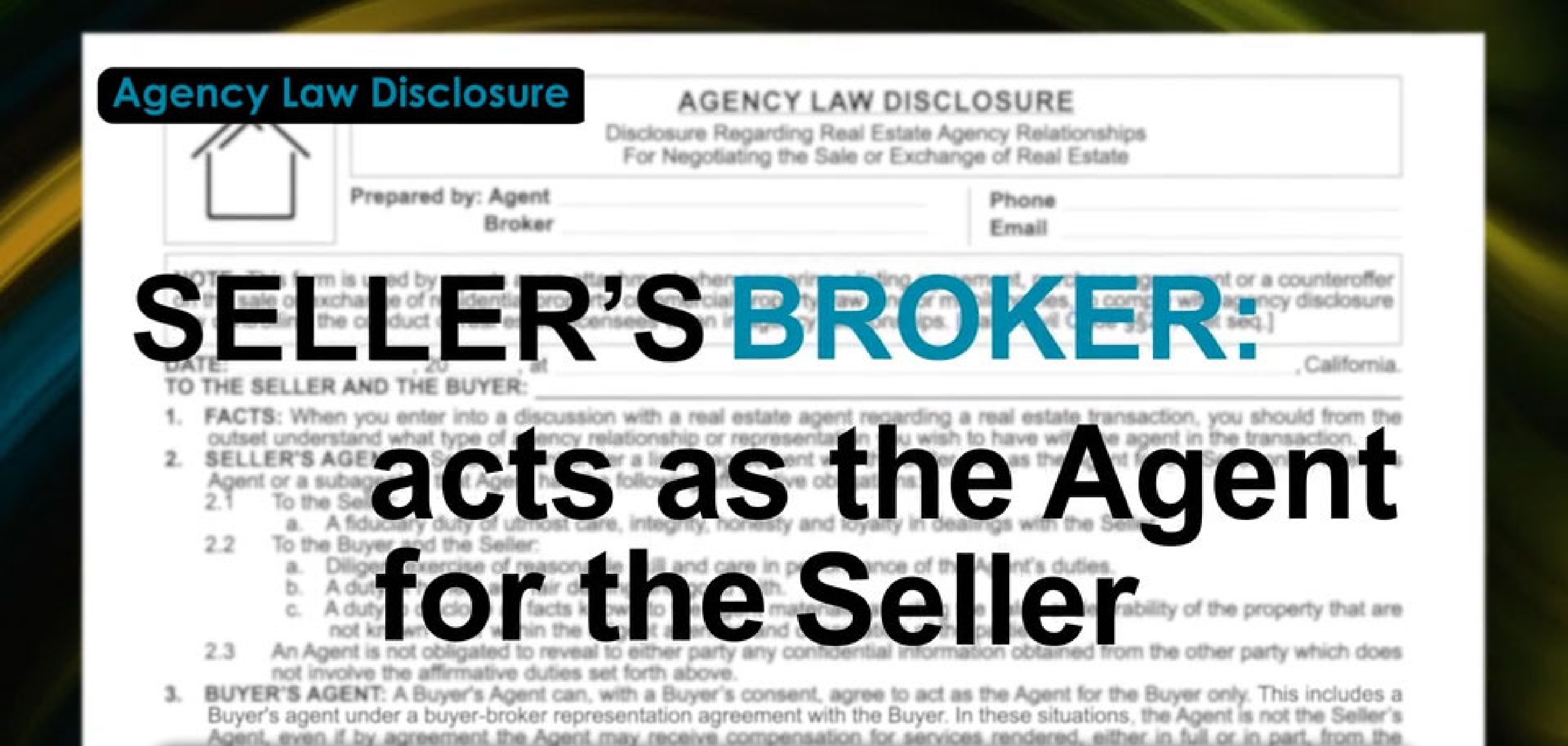
QUIZ

1. Agency Law Disclosure sets out the rules of agency which control the conduct of:

   a. real estate licensees when acting as a principal.

   b. real estate licensees when dealing with the public in an agency capacity.

   c. real estate principals with dealing with licensees.



The uniform jargon and agency law

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

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

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

These industry terms are used to express:

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

A **buyer's agent** and **seller's agent** are mentioned but not defined. Legally, the agent in a real estate transaction is the licensed real estate broker. Thus, the word "agent" used in the disclosure is not a reference to the broker's agents but to the broker, who is always by law an agent when using their license to represent a client and earn a fee. Ironically, a broker rarely refers to themselves as an agent — in practice, the term is used to refer to a broker's employed sales agents.

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

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

Yet, they are selling nothing; they are locating property and negotiating to buy suitable property on behalf of their buyer client.

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

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

QUIZ

1. A seller's agent representing the seller is also known as a(n):

   a. selling agent.
   b. listing agent.
   c. dual agent.

2. An agent who is acting exclusively on behalf of only one party in a transaction is known as a(n):

   a. exclusive agent.
   b. dual agent.
   c. transaction agent.

The participants, their brokers and the duties owed

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

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

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

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

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

The agency confirmation provision discloses each broker's actual agency relationship presently existing with the participants. Further, it memorializes the relationship established by the broker's and their agents' conduct with the principals in a transaction. The agency relationship confirmed is the broker's legal determination of the actual agency created by their prior and present conduct with the parties.

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

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

The agencies to be confirmed by each broker in the purchase agreement are not known at the time of the initial employment when the Agency Law Disclosure is first presented to the principal. For example, the agency in a potential future sales transaction cannot be determined, much less confirmed, at the time the broker firsts presents their seller with the Agency Law Disclosure form. [CC §2079.17(d)]

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

Written disclosures tend to eliminate later disputes over agency duties. Agency conflicts discovered when in escrow often become the basis for cancelling a transaction, the payment of a brokerage fee, or both. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

What is targeted?

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

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

- fee simple estates in real estate or registered ownerships for mobilehomes;
- life estates;
- existing leaseholds with more than one term remaining, such as ground leases coupled with improvements; and
- multi-unit residential property with more than four dwelling units; and
- leases created for more than one year. [CC §2079.13(m)]

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

- a seller's listing [See **RPI** Form 102];
- a Buyer Representation Agreement [See **RPI** Form 103.1 and 103.2];
- a purchase agreement [See **RPI** Form 150 and 151];
- an option to purchase [See **RPI** Form 161 and 161-1]
- an exchange agreement [See **RPI** Form 171];
- a counteroffer, by attachment or by reference, to a purchase agreement containing the disclosure as an attachment [See **RPI** Form 180];
- any letter of intent (LOI) prepared and submitted on behalf of a buyer [See **RPI** Form 185];
- a residential or commercial lease agreement for a term exceeding one year [See **RPI** Form 550 and 552 –552-8]; and
- an offer to lease. [See **RPI** Form 556]

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

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

QUIZ

1. The Agency Law Disclosure is not required on negotiations and agreements concerning:

   a. a month-to-month rental agreement.
   b. a purchase agreement for one-to-four unit residential property.
   c. a residential or commercial lease agreement for a term exceeding one year.

Agency rules for a seller's listing

Consider a seller's listing, open or exclusive, employing a broker and their agents to sell a targeted property. Here, the Agency Law Disclosure is required as an addendum to the seller's listing agreement. [CC §2079.14(a)]

Failure of the seller's agent to provide the seller with the Agency Law Disclosure prior to entering into the listing agreement is a violation of disclosure laws. As a consequence of this upfront failure, the broker will lose the fee on a sale if challenged by the seller. The loss of the fee is not avoided by a later disclosure made as an addendum to a purchase agreement or escrow instructions. [**Huijers** v. **DeMarrais** (1992) 11 CA4th 676]

The **Agency Law Disclosure** is also required when listing and submitting offers on a long-term ground lease on a property coupled with improvements that is being conveyed to a buyer and will be security for any purchase-assist financing. [CC §§2079.13(k), 2079.13(m), 2079.14]

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

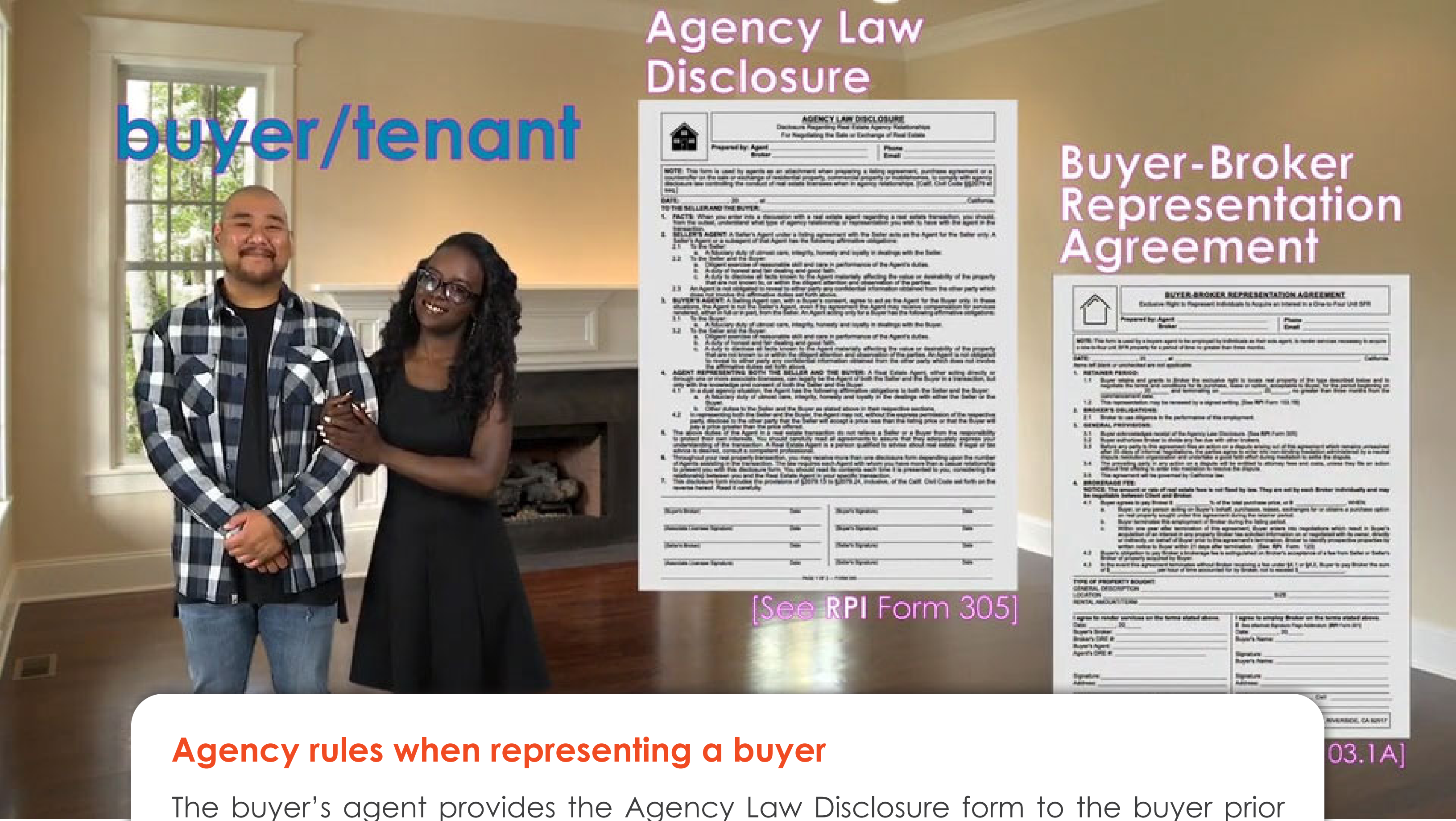
- the listing stage, as an addendum to the listing; and
- on presentation of a buyer's offer, as an addendum to the purchase agreement. [CC §2079.14]

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

Further, when the broker or their sales agent fails to hand the seller the Agency Law Disclosure at the listing stage, the listing, and thus the agency, can be cancelled by the seller at any time. When the Agency Law Disclosure is not delivered up front with the listing, the seller may cancel payment of the fee due their broker after the transaction is in escrow and the brokerage fee has been further agreed to.

QUIZ

1. The seller's signature acknowledges receipt of the Agency Law Disclosure:
    a. at the listing stage as an addendum to the listing.
    b. on presentation of a buyer's offer as an addendum to the purchase agreement.
    c. Both a. and b.



Agency rules when representing a buyer

The buyer's agent provides the Agency Law Disclosure form to the buyer prior to their signing any writing that initiates negotiations contemplating a sale. [CC §2079.13]

For example, the Agency Law Disclosure form is attached when an agent prepares a purchase agreement offer or letter of intent (LOI) to be signed by a prospective buyer for a purchase. As is well understood, an LOI commences negotiations in a transaction between prospective buyers and sellers.

Legislation effective January 1, 2025 requires a buyer's agent — not the seller's agent unless acting as a dual agent — to enter into a written **Buyer Representation Agreement** when their buyer client seeks their assurance to acquire an interest in any type of real estate. [Calif. Civil Code 1670.50(a); see **RPI** Forms 103.1 and 103.2]

The representation agreement provides upfront disclosure of the brokerage fee to be earned by the buyer's agent for acquisition services. Further, the writing establishes the buyer's broker fee will be disbursed by escrow from funds accruing to the seller on the buyer's payment of the purchase price.

Alternatively, the writing also establishes the situations in which the buyer is to pay the broker fee, such as when the representation terminates without the broker otherwise earning a fee.

As a matter of best practices, the Agency Law Disclosure form is provided and signed by the buyer when entering into a Buyer Representation Agreement, as this is the moment affirmative agency duties commence. [See **RPI** Form 103.1, 103.2 and 111]

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

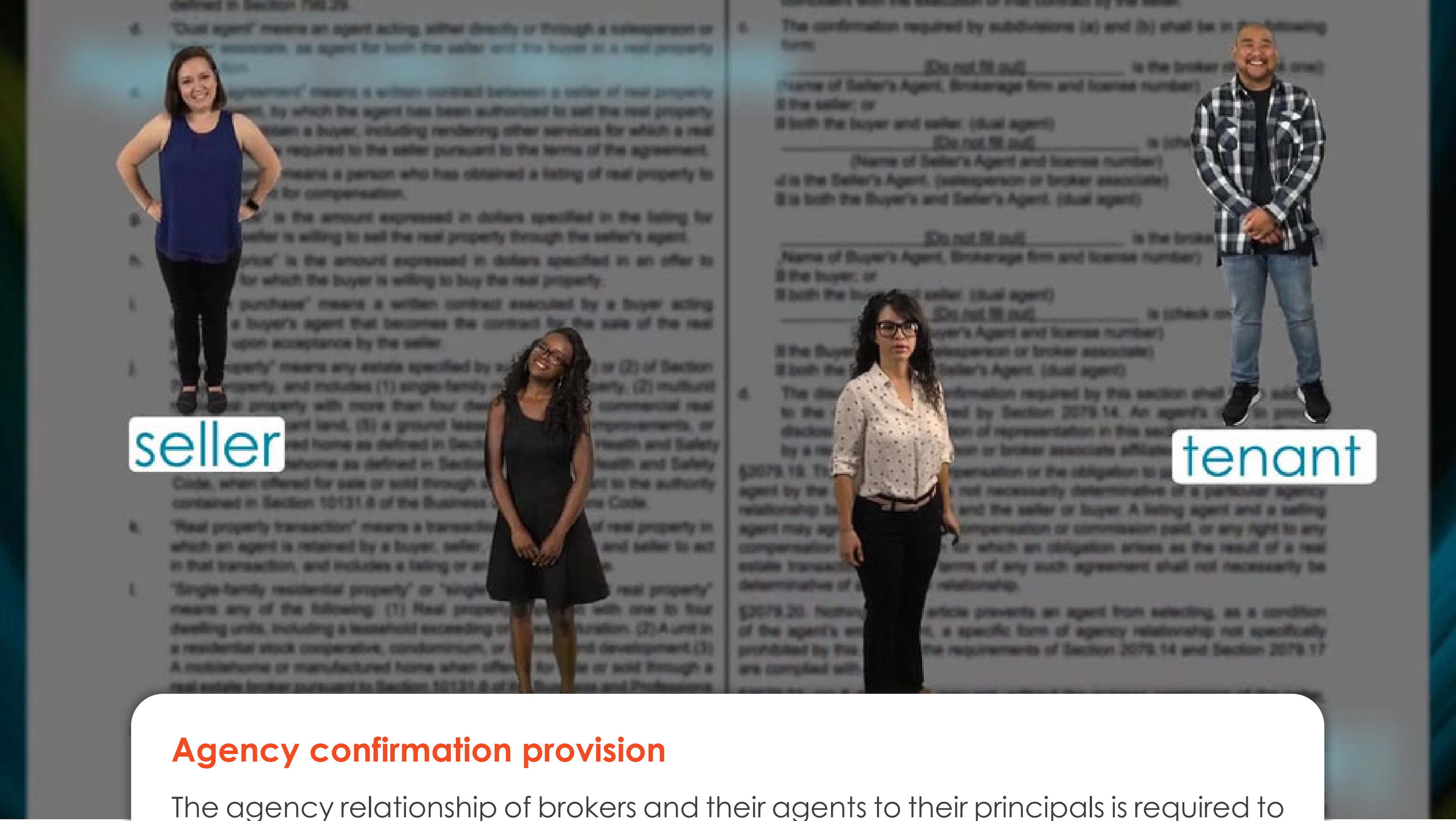
The buyer's broker might erroneously agree to let the seller's broker receive the entire fee from the seller. Under this risky arrangement now prohibited under *antitrust law*, the seller's broker pays the buyer's broker a share of the fee under their separate *fee-sharing agreement*.

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

For the buyer's broker to protect their fee, the seller needs to agree in the body of the purchase agreement that the seller will pay both brokers themselves, as disbursed by escrow from funds accruing to the seller on the buyer's payment of the purchase price.

QUIZ

1. The buyer's agent provides the Agency Law Disclosure form to the buyer:
    a. prior to their signing any writing that initiates negotiations contemplating a sale.
    b. after signing any writing that initiates negotiations contemplating a sale.
    c. anytime as an addendum prior the close of escrow.



Agency confirmation provision

The agency relationship of brokers and their agents to their principals is required to be disclosed to all parties in *targeted transactions*. This includes the sale, exchange or long-term lease of a one-to-four unit residential property, commercial property or mobilehome. [Calif. Civil Code §2079.17(d)]

This relationship is disclosed in the **agency confirmation provision** located in all written negotiations to purchase or lease, and lease agreements. [CC §2079.17]

The *agency confirmation provision* states the existence or nonexistence of each broker's *fiduciary agency* with the various parties to the transaction. Each broker identifies the party they are acting on behalf of as their agent in the transaction. Thus, one broker does not state the agency relationship of any other broker involved in the transaction. For example, the buyer's broker does not include the seller's broker's agency in the agency confirmation and broker identification provisions in the purchase agreement form. [CC §2079.17(a); see **RPI** Form 150]

Further, an *Agency Law Disclosure* is provided each time any broker prepares a purchase agreement. The separate disclosure confirms the broker's specific agency in the transaction, and is attached as a referenced addendum.

The Agency Law Disclosure is an explanation of the duties owed to each party in a transaction by the broker and agents involved. [CC §2079.17(d)]

The Agency Law Disclosure is signed by the buyer, then signed by the seller on an acceptance of the offer or submission of a counteroffer.

Editor's note — This is discussed primarily in the context of an agent representing a buyer or seller. However, the same rules of conduct apply for an agent of a tenant or landlord.

Statutory jargon

The contents of the agency confirmation provision require the broker and their agents to first understand the statutory definitions of:

- agent;
- seller's agent, also referred to as a **listing agent**;
- buyer's agent, also referred to as a **selling agent**;
- subagent; and
- dual agent.

The statutory definitions of these agency terms and their meanings are oftentimes different from the jargon used among brokers and agents in the multiple listing service (MLS) environment.

For example, by statutory definition, an agent retained by a client is always a broker. This broker is usually represented through the efforts of licensed sales agents employed by the broker. In the jargon of the real estate industry, a sales agent employed by the broker is always called an "agent." In practice, a licensed broker never refers to themselves or other brokers as agents.

By statute, the agent employed by a broker is defined as an **associate licensee** — an *agent of the agent*, not an agent of the client. [CC §2079.13(a), 2079.13(b)]

Only the broker can be an agent of a client. Sales agents are not permitted to have clients. Sales agents are always employees of the *client's agent* — the broker. However, for income tax purposes, agents may be classified in employment contracts with their broker as independent contractors. [Calif. Business and Professions Code §10132] [See **RPI** Form 506]

Use of the agency confirmation provision

Both the agency confirmation provision and the separate Agency Law Disclosure are required to be part of a purchase agreement on all offers and acceptances negotiated by brokers on targeted transactions.

In practice, the buyer's agent is the broker who prepares and presents a purchase agreement to the buyer for their signature.

Thus, the buyer's broker or their agent will:

- attach the Agency Law Disclosure as an addendum to the purchase agreement;

- fill out the buyer's agent's agency confirmation provision in the purchase agreement; and
- obtain the buyer's signature on the agency law disclosure and the purchase agreement.

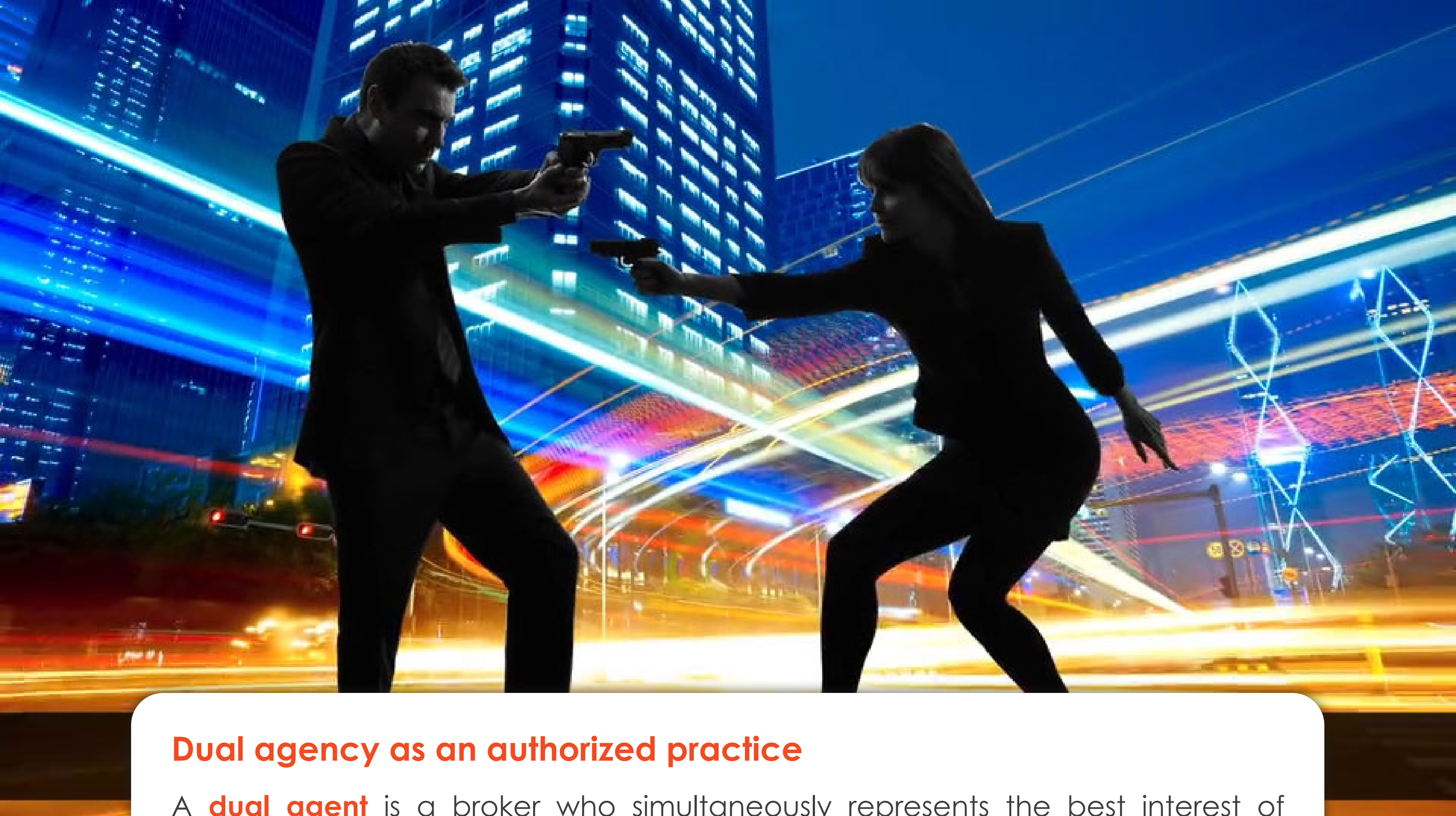
Before submitting the buyer's purchase agreement to the seller, the seller's broker confirms their agency with the seller. The seller's broker does so by filling out the seller's broker confirmation, noting the agency relationship established by their conduct with the seller.

Consider a seller's **counteroffer** which incorporates all the provisions of the buyer's offer, as most do. Here, the seller has signed a writing which includes by reference the confirmation of the broker's agency. All the seller needs to sign is the counteroffer and the Agency Law Disclosure.

QUIZ

1. The agency confirmation provision states the existence or nonexistence of each broker's __________ with the various parties to the transaction.

   a. general agency.
   b. fiduciary agency
   c. subagency status



Dual agency as an authorized practice

A **dual agent** is a broker who simultaneously represents the best interest of *opposing parties* in a transaction, e.g., both the buyer and the seller. [Calif. Civil Code §2079.13(e); see **RPI** Form 117]

Dual agency has always been proper brokerage practice. It is a situation that arises naturally in the course of representing buyers and sellers. However, the existence of a dual agency needs to be promptly disclosed to each client. [CC §2079.17]

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

- the loss of their brokerage fee;
- liability for their principals' money losses; and
- disciplinary action by the California Department of Real Estate (DRE). [Calif. Business and Professions Code §10176(d)]

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

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

Can the broker recover their fee?

No! The broker failed to disclose their dual agency to the seller when it arose, i.e., at the time the broker entered into the listing with the seller. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

Dual agency and conflict of interest

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

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

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

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

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

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

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

QUIZ

1. The agency relationship that results when a broker represents both the buyer and seller in a real estate transaction is known as a:

   a. secret agency.

   b. dual agency.

   c. Either a. or b.

Undisclosed knowledge of confidential pricing information

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

Confidential pricing information needs to remain the undisclosed knowledge of the dual agent, unless authorized to release the information in a writing signed by the principal in question. [CC §2079.21]

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

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

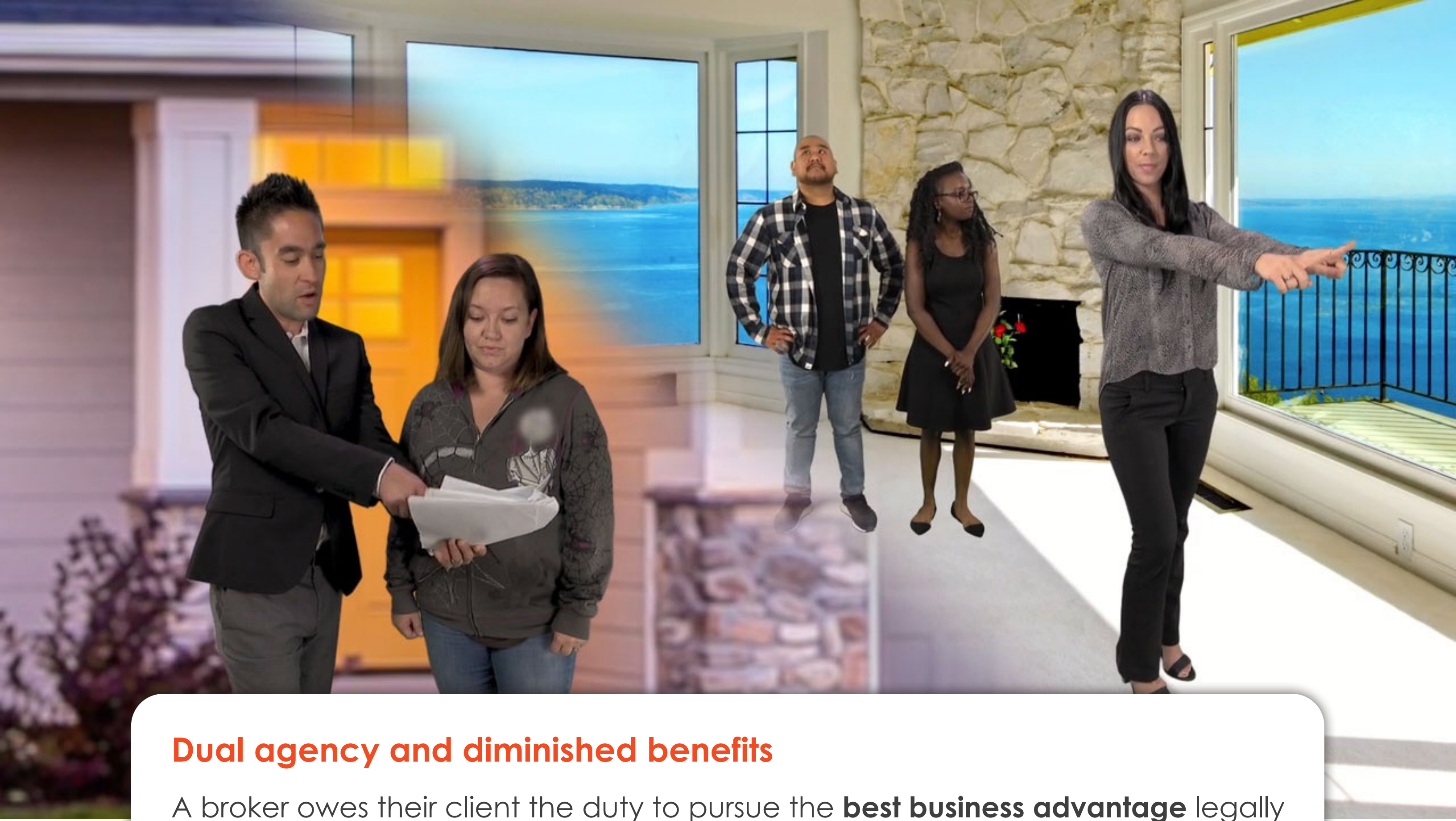
QUIZ

1. When a dual agency is established in a one-to-four unit residential sales transaction and both parties are represented by the same broker, the broker may not:

    a. encourage the seller to hire a home inspector.

    b. discuss general financing options with the buyer.

    c. pass on confidential pricing information to the opposing parties.



Dual agency and diminished benefits

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

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

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

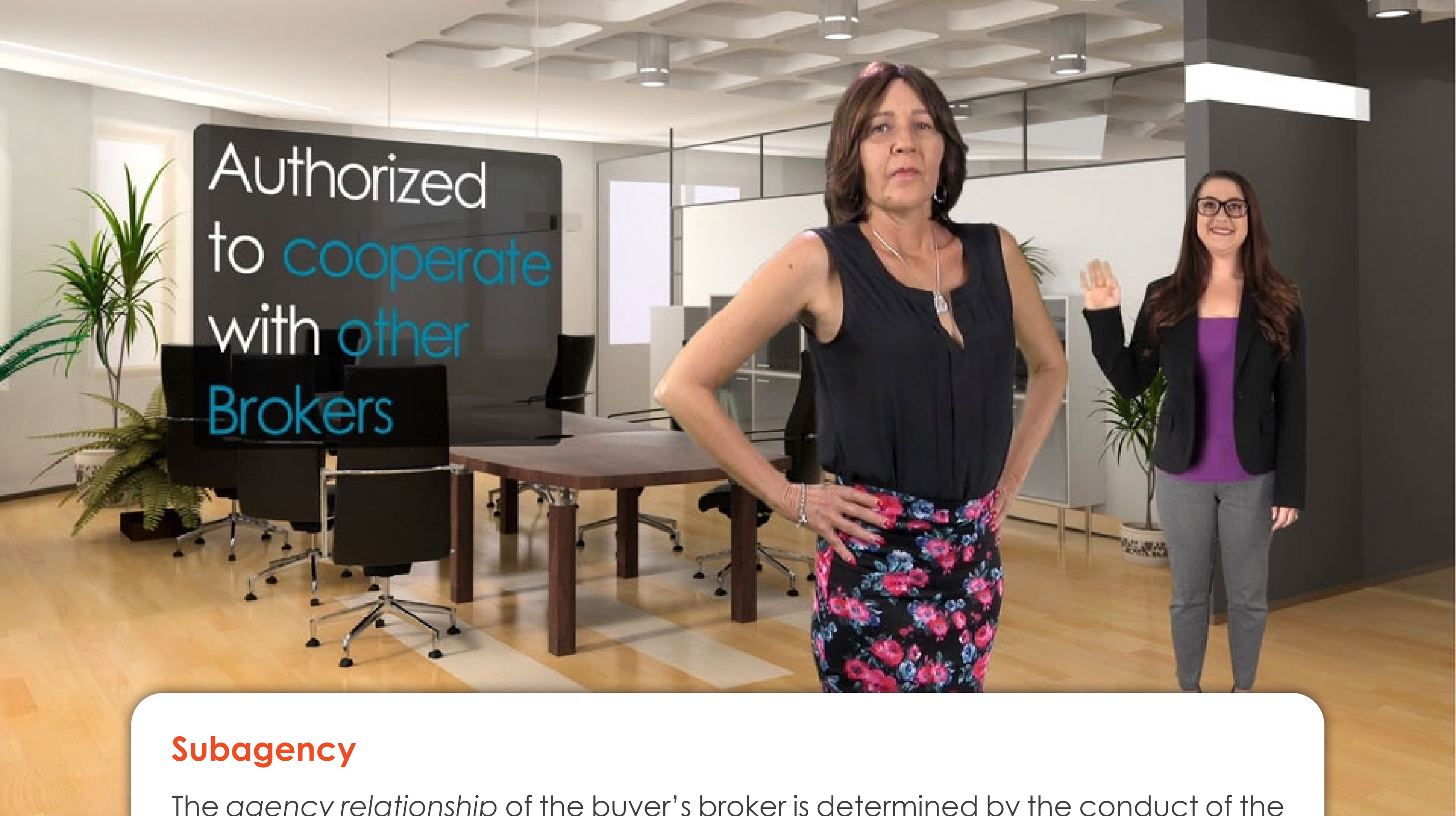
Typically, one agent employed by the broker enters into an exclusive sales listing with a property owner. At the same time, another agent in the broker's employment works separately with a buyer to locate qualifying properties, providing information on properties listed with other brokers.

The broker becomes a *dual agent* the moment this buyer is exposed to a property that is the subject of an in-house listing. However, an improper tendency in transactions involving only one broker and two of their agents is to automatically designate the broker as a dual agent.

However, the buyer may be a party to whom only general duties regarding property disclosures are owed by the broker and their agents. Thus, no specific agency duties are owed the buyer and a dual agency does not arise.

QUIZ

1. Generally, clients of a dual agent:
    a. receive the same degree of benefits available from an exclusive agent.
    b. receive a greater degree of care and protection than those available from an exclusive agent.
    c. do not receive the full range of benefits available from an exclusive agent.



Subagency

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

Thus, neither a **subagency** duty owed the seller, nor a *dual agency* relationship with the buyer and seller, is imposed on the buyer's broker simply because the seller pays the buyer's broker a fee. This fee-agency rule applies whether the seller pays the fee directly to the buyer's broker, or indirectly when the seller's broker initially receives the entire fee. [Calif. Civil Code §2079.19]

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

Subagent vs. fee-sharing buyer's broker

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

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

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

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

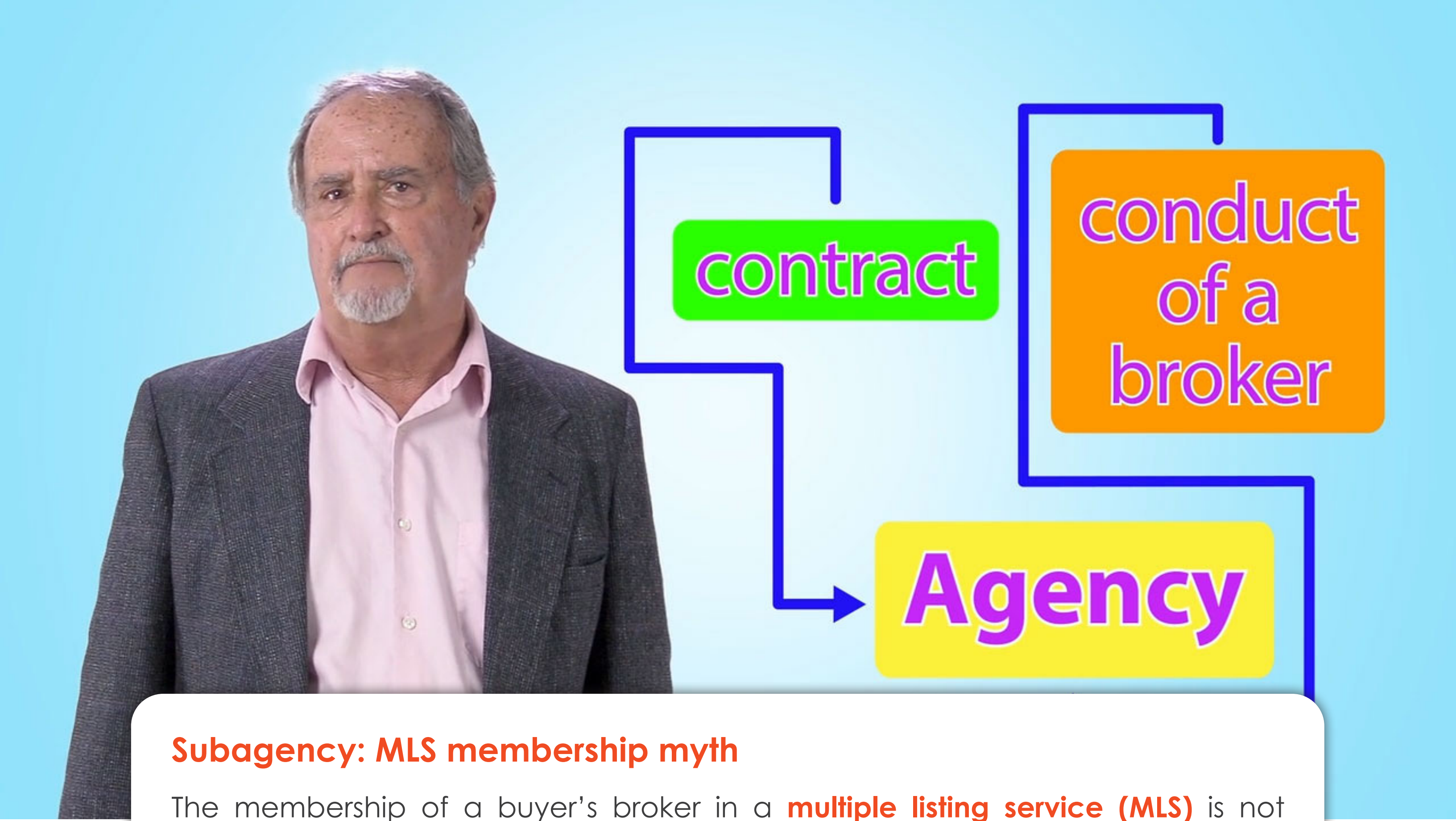
QUIZ

1. An individual who has been delegated agency duties by the primary agent of the client, not the client themselves, is referred to as a(n):

   a. dual agent.

   b. free agent.

   c. subagent.



Subagency: MLS membership myth

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

Agency, whatever the type, is created either by *contract* or by the *conduct* of a broker when interacting with a buyer or seller. Agency is not established by entering into trade memberships or by receipt of a fee paid by the seller. [CC§2307]

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

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

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

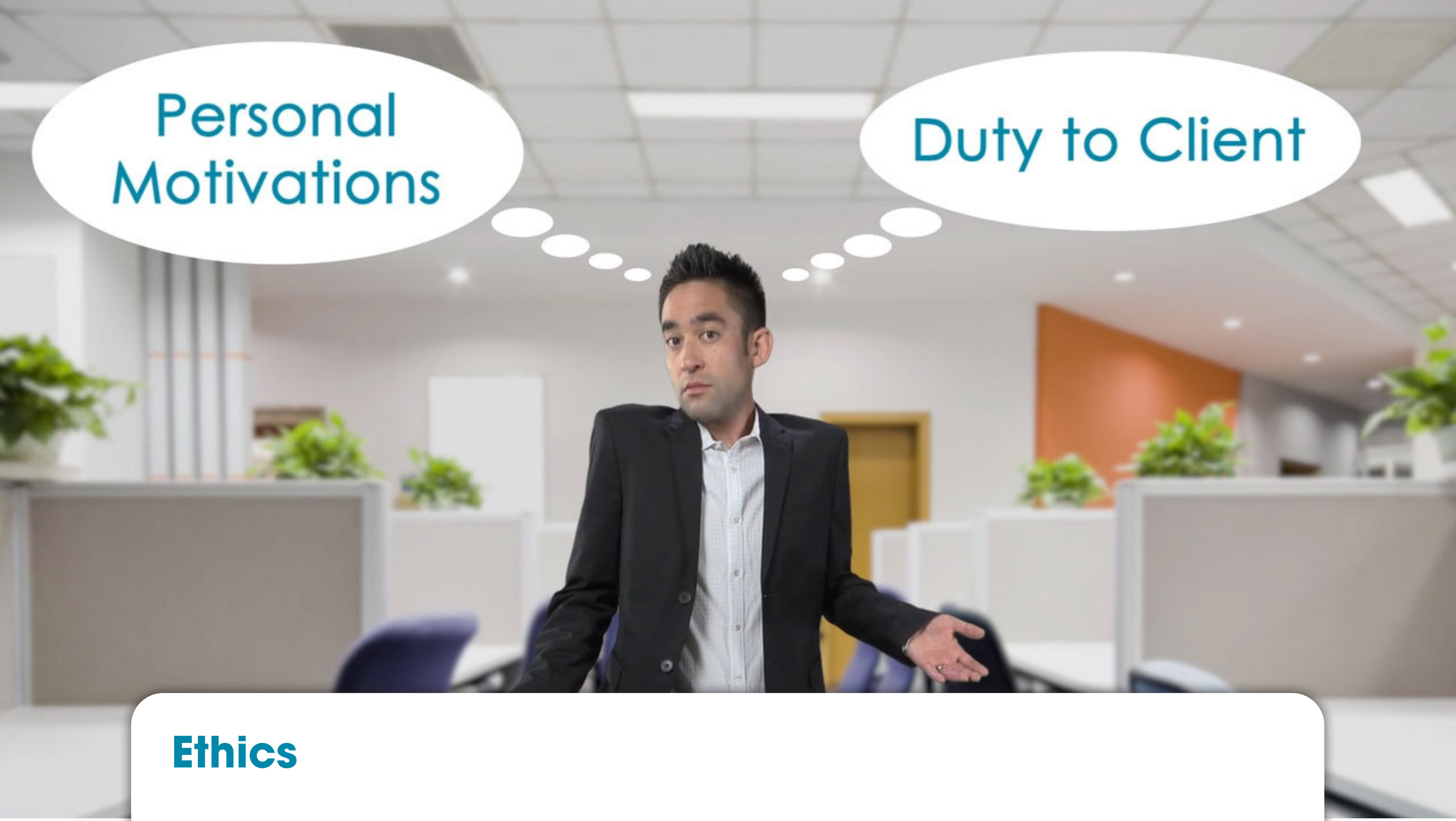
QUIZ

1. Which of the following statements is most correct?

   a. Agency, whatever the type, is most commonly established by entering into trade union memberships.

   b. Agency, whatever the type, is created either by contract or by the conduct of a broker when interacting with a buyer or seller.

   c. Agency, whatever the type, is triggered on receipt of a fee paid by the seller or buyer.



Ethics

Professional relationships compromised

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

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

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

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

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

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

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

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

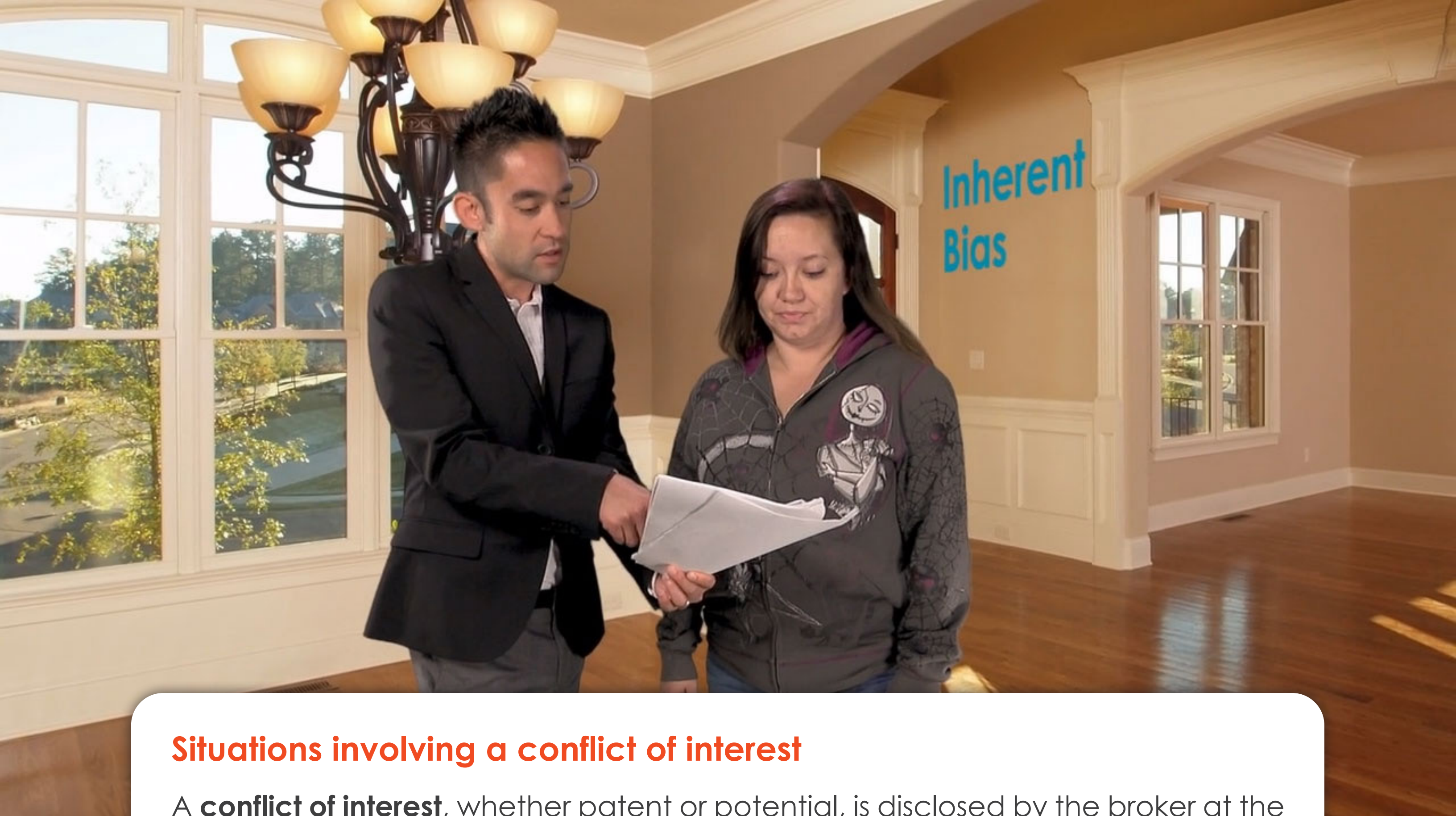
QUIZ

1. A(n) __________ occurs 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.

   a. fiduciary breach
   b. unlawful detainer
   c. conflict of interest

2. A conflict of interest creates a fundamental __________ for brokers.

   a. existential crisis
   b. agency dilemma
   c. moral hazard



Situations involving a conflict of interest

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

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

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

- the broker or their agent holds a direct or indirect *ownership interest* in the real estate, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing, or lending on the property;
- an individual related to the broker or one of their agents by *blood or marriage* holds a direct or indirect ownership interest in the property or is the buyer;
- an individual with whom the broker or a family member has a *special pre-existing* relationship, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold, or security interest in the property or is the buyer;

- the broker's or their agent's concurrent representation of the opposing party, a *dual agency situation*; or
- an *unwillingness* of the broker or their agent to work with the opposing party, or others, or their brokers or agents in a transaction.

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

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

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed. [See **RPI** Form 527]

Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third-parties arise. In practice, brokers, and especially agents, all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk. [Calif. Business and Professions Code §10177(o)]

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

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

QUIZ

1. Timely disclosure of a conflict of interest:
    a. neutralizes the inherent bias itself.
    b. neutralizes the element of deceit which would breach the broker's fiduciary duty if left undisclosed.
    c. invalidates the purchase, sale or lease.

2. Pre-existing relationships which may present a conflict of interest include:
    a. kinship, employment or partnership.
    b. common membership, religious affiliation or civic ties.
    c. Both a. and b.

Relative's participation in a transaction

A seller's broker needs to disclose their acquisition of any direct or indirect interest in the seller's property. Likewise, the broker also needs to disclose whether a family member, a business owned by the broker, or any other person holding a special relationship with the broker will acquire an interest in the seller's property. [See **RPI** Form 527]

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

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

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

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

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

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

A broker cannot act for more than one party in a transaction, including themselves, without disclosing their **dual agency** and obtaining the **client's consent** at the time the conflict arises. [Bus & P C §10176(d); see **RPI** Form 117]

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

Further, failure to disclose a broker's personal interest as a buyer in a transaction when they are also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner. [**Whitehead** v. **Gordon** (1970) 2 CA3d 659]

QUIZ

1. An agent or broker representing a seller needs to disclose whether a family member or a(n) __________will acquire an interest in the seller's property.
   a. a business owned by the broker
   b. any person holding a special relationship with the broker
   c. Both a. and b.

2. Failure to disclose a broker's personal interest as a buyer in a transaction when they are also acting as a broker on behalf of the seller:
   a. is acceptable so long as the broker timely discloses the conflict of interest after the close of escrow.
   b. constitutes grounds for discipline by the Department of Real Estate (DRE).
   c. is an example of implicit bias.

Conflicts of interest when acting as a principal

A broker acting solely as a **principal** in the sale of their own property is not restricted in their conduct by compliance with agency obligations. The broker selling or buying property for their own account acts solely as the *seller* or *buyer*. The licensee has no conflict due to the existence of their license since they are not holding themselves out as a broker or agent acting on behalf of another person in the transaction. [**Robinson** v. **Murphy** (1979) 96 CA3d 763]

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

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

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

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

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

Recovery is received from the *Real Estate Recovery Account* since the broker held themselves out as *acting as a real estate* broker in the transaction by receiving a fee. The broker's license is then suspended. Before the broker can reactivate their license, they need to reimburse the Recovery Account. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

QUIZ

1. When a broker sells their own property and receives a brokerage fee on the sale, the broker:

   a. is acting solely as a principal.

   b. immediately subjects themselves to real estate agency requirements.

   c. Neither a. nor b.

Property related disclosures

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

A broker has a **general duty** to all parties in any type of sales transaction to disclose to buyers at the earliest possible moment their awareness of any property defects. The duty to disclose known conditions on one-to-four unit residential property requires the seller's broker to provide prospective buyers or their agents with the seller's **Transfer Disclosure Statement (TDS)**. [See **RPI** Form 304]

To be effective, property disclosures including the *TDS* are to be provided to the buyer as soon as practicable – meaning as soon as possible – upon the commencement of negotiations and prior to making an offer. [Calif. Civil Code §§1102 et seq.]

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

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

Any attempt to have the buyer of a one-to-four unit residential property waive their right to the mandated property disclosure statement (TDS) is unenforceable. [CC §1102]

Special fiduciary agency duty

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

On locating a prospective buyer, either directly or through a buyer's agent, the seller's agent owes the prospective buyer, and thus also the buyer's agent, a limited, non-client *general duty* to voluntarily provide critical factual information on the listed property, collectively called disclosures of **material facts**.

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

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

Transparency as public policy objective

In California's public policy pursuit of transparency in property information between sellers and buyers, the disclosure obligations of the seller's agent to voluntarily inform prospective buyers about the fundamentals of the listed property act to eliminate asymmetry and power relationships in sales transactions.

The seller's agent may not:

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

QUIZ

1. When property disclosures are not timely made, the buyer may:
   a. cancel the offer on discovery of the broker's failure to disclose known defects prior to the buyer entering into a purchase agreement with the seller.
   b. close escrow on the purchase and seek recovery of the costs to cure the untimely disclosure of known defects.
   c. Either a. or b.

2. Information about a listed property which may affect the property's value or alter a client's decision to purchase or sell the property is classified as:
   a. material facts.
   b. cosmetic factors.
   c. opinions.

The broker's unlawful "as-is" sale

Consider a seller's agent who is aware the seller's residence fails to conform to building regulations. The defect, if known to a buyer, would likely affect the price they are willing to pay. The defect is a material fact.

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

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

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

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

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

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

No! The seller's broker has a *general duty* owed to all parties to a transaction.

The general duty requires the seller's broker to disclose all property conditions affecting the value and marketability of the property which become or ought to become known during the mandated inspection. The duty is not excused by writing an "as-is" disclaimer into the purchase agreement in lieu of making the factual disclosures before an agreement is entered into with the seller. [**Katz v. Department of Real Estate** (1979) 96 CA3d 895]

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

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

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

QUIZ

1. A provision which states the buyer accepts the property without a full disclosure of known conditions is known as a(n):

   a. as-is clause.
   b. liar clause.
   c. conflict of interest disclosure.

2. The seller's agent's general duty to the buyer __________ by writing an "as-is" disclaimer into the purchase agreement in lieu of making the factual disclosures before an agreement is entered into.

   a. is excused
   b. is not excused
   c. is legally avoided

Referral fees between brokerages

Referral fees are allowed between two brokers when the broker receiving the referral fee is not providing another service in the home sales transaction such as financing, insurance, escrow, etc.

Compensation for a referral permitted by or between brokers under **Real Estate Settlement Procedures Act (RESPA)** includes:

- payments to the buyer's broker by the seller's broker, and referral arrangements between real estate agents and brokers;
- payment to any person of a bona fide salary or compensation or other payments of goods or facilities actually furnished or for services actually performed; and
- an employer's payment to its own employees for any referral activities. [Calif. Business & Professions Code §10177.4; 12 USC §2607]

However, brokers and agents need to adhere to specific California Department of Real Estate (DRE) rules and codes when paying or accepting referral fees from other brokers or agents.

Agents are prohibited from accepting a fee or other benefit from *any person other than their employing broker*. Agents are also forbidden from paying a fee to any other broker or agent without first directing the payment through the agent's employing broker. [Bus & P C §10137]

Most importantly, as a *fiduciary* matter, brokers and their agents need to advise their clients of the dollar amount of any compensation received from service providers related to the real estate transaction in which their client is involved. If the compensation (monetary or otherwise) is not disclosed, agents and their employing broker are subject to their client recovering all fees received, as well as license suspension or revocation. [See **RPI** Form 119]

Fees prohibited by RESPA cannot be legalized by disclosure or consent of the client. [Bus & P C §10176(g)]

Bottom line: referral fees are prohibited between brokers and third-party providers with one exception. In order for a broker or agent to receive a referral fee when they are receiving a fee on a home sales transaction, a *tangible service besides the referral* needs to be performed for the business paying the referral fee.

QUIZ

1. Agents are prohibited from accepting a fee or other benefit from any person other than:
    a. their employing broker.
    b. their client.
    c. Either a. or b.

2. Fees prohibited by the Real Estate Settlement Procedures Act (RESPA):
    a. cannot be legalized by disclosure or consent of the client.
    b. can be legalized, so long as the client knowingly consents to the fee in writing.
    c. are only collectable if they are not challenged by the client or the agent's employing broker.

Trust Funds

Introduction to trust funds

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

Trust funds generally include:

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

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

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

transactions, receive funds which are not theirs and are *held in trust* for the owner of the funds. These trust funds include:

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

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

Employees acting on behalf of a broker include:

- sales agents;
- broker-associates;
- resident property managers; and
- office personnel.

QUIZ

1. Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction are referred to as:
    a. monetary funds.
    b. trust funds.
    c. mutual funds.
2. Trust funds may be received by:
    a. a broker.
    b. an employee acting on behalf of the broker.
    c. Either a. or b.

Managing trust funds

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

For example, a buyer enters into a purchase agreement. The buyer's **good faith deposit** is in the form of a bag of gems handed to the broker. The dollar value of the gems will apply toward the purchase price on closing.

Is the broker required to handle the bag of gems as trust funds?

Yes! All items of value received by the broker as part of a transaction, regardless of form, are trust funds subject to special handling — safekeeping and recordkeeping.

Trust funds come in many forms, including:

- checks;
- precious metals/stones;
- stocks/bonds;
- collectibles;
- promissory notes; and
- any other item or evidence of value. [Calif. Business and Professions Code §10145]

Trust funds in practice

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

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

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

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

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

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

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

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

Lastly, by writing a check for the mortgage payment when the broker knew insufficient funds existed in the account to cover the check, the broker misrepresented the availability of immediate funds. This is considered fraud and is grounds for the revocation or suspension of the broker's license. [**Apollo Estates, Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625]

Handling cash and checks

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

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

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

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

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

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

- with the *person or escrow* depository entitled to the funds (as payee or by endorsement); or
- in a *trust account* maintained by the broker at a bank or other state-recognized depository. [Bus & P C §10145; Department of Real Estate Regulation §2832(a)]

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

- deliver the trust funds to the person or the escrow entitled to the funds; or
- deposit the trust funds into the broker's trust account. [Bus & P C §10145(c)]

QUIZ

1. Prior to the end of the third business day after the broker receives negotiable trust funds, the broker must __________ the funds.

   a. invest

   b. deposit

   c. embezzle

2. A(n) __________ is an accounting document or file used to identify the owner of trust funds and the amount held for the owner.

   a. owner’s statement

   b. take sheet

   c. subaccount ledger

Holding checks undeposited

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

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

- the check is made payable to someone other than the broker; or
- the check is made payable to the broker with written instructions, typically from the buyer or tenant, to hold the check undeposited until acceptance of the offer or escrow is opened; and
- the person to whom the offer is submitted, usually the seller or landlord, is informed the check for the good faith deposit is being held by the broker when the offer is submitted. [DRE Reg. §2832(c)]

The instructions to hold the check undeposited until acceptance are included in the terms for receipt of the deposit contained in the offer to purchase or lease.

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

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

- to the payee entitled to the funds, such as a title company or escrow;

- into the broker's trust account at a bank or other state-recognized depository, such as a thrift; or
- to an escrow depository on the broker's endorsement, when the broker is the payee and does not want to deposit and disburse the funds from their trust account to escrow. [DRE Reg. §2832]

QUIZ

1. When a broker negotiates the purchase or lease of real estate, they generally receive a check as a(n):

    a. kickback.

    b. advance on their broker fee.

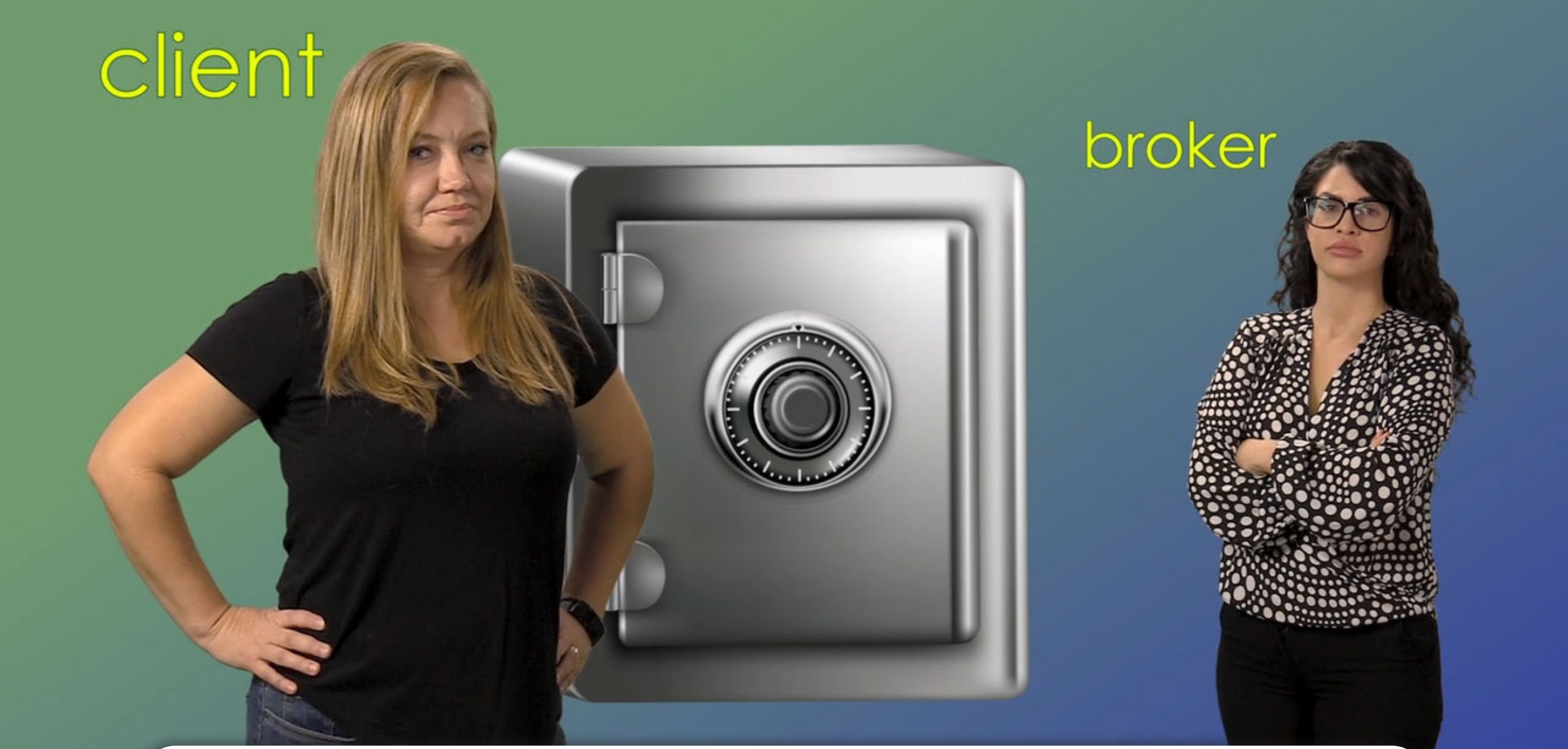
    c. good faith deposit.

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

    a. verbal instructions

    b. written instructions

    c. Either a. or b.



Advance fees are trust funds

Broker fees deposited with the broker before they are earned are called **advance fees**. *Advance fees* will be deposited in the broker's trust account. The funds belong to the client of the broker, not the broker, and cannot be withdrawn by the broker before they are earned and a statement is sent to the client.

In addition to trust fund *accounting requirements*, a broker will send the client a verified accounting for the advance fees:

- no later than at the end of each calendar quarter, and
- at the time the contract between the broker and client is fully performed.

The verified accounting for the advance fees will include:

- the name of the broker;
- the name of the client;
- a description of the services rendered or to be rendered;
- an identification of the trust fund account and where the advance fee is deposited; and
- the amount of the advance fee collected (Department of Real Estate Regulation §2972).

In addition, the verified accounting will include the amount disbursed for each of the following:

- costs for *agreed-to services*;

- *fees* paid to field agents and representatives; and
- *overhead costs* and *profits.* [DRE Reg. §2972(f)]

If an agreed-to service disbursed from the account is made for advertisement, the verified accounting will include:

- a copy of the advertisement;
- the name of the publication in which the advertisement appeared; and
- the number of ads published and the dates they appeared. [DRE Reg. §2972(g)]

Further, if the advance fee is for the arrangement of a mortgage, the verified accounting will include a list of the names and addresses of the persons to whom the information pertaining to the mortgage requirements was submitted, and the dates the information was submitted. [DRE Reg. §2972(h)]

The amounts placed in the trust account may be withdrawn:

- when expended for the *benefit of the client*; or
- on the *fifth day* after the verified accounting is mailed to the client. [Calif. Business and Professions Code §10146]

Approval of advance fee agreements

Before a broker may solicit, advertise for and agree to receive an advance fee, the paperwork material is to be submitted to the Commissioner of the **California Department of Real Estate (DRE)** for approval at least **10 calendar days** prior to use. [DRE Reg. §2970]

If the Commissioner, within 10 calendar days of receipt, determines the material might mislead clients, the Commissioner may order the broker to refrain from using the material. [Bus & P C §10085]

- To be approved by the Commissioner, the *advance fee agreement* and any materials to be used with the agreement will:
- contain the total amount of the advance fee and the date or event the fees will become due and payable;
- list a specific and complete description of the services to be rendered to earn the advance fee;
- give a definite date for full performance of the services described in the advance fee agreement; and
- contain no false, misleading or deceptive representations. [DRE Reg. §2970(b)]

Further, the advance fee agreement may not contain:

- a provision relieving the broker from an obligation to perform verbal agreements made by their employees or agents; or
- a guarantee the transaction involved will be completed. [DRE Reg. §§2970(b)(4), 2970(b)(5)]

QUIZ

1. Broker fees deposited with the broker before they are earned are called:

   a. advance fees.

   b. kickbacks.

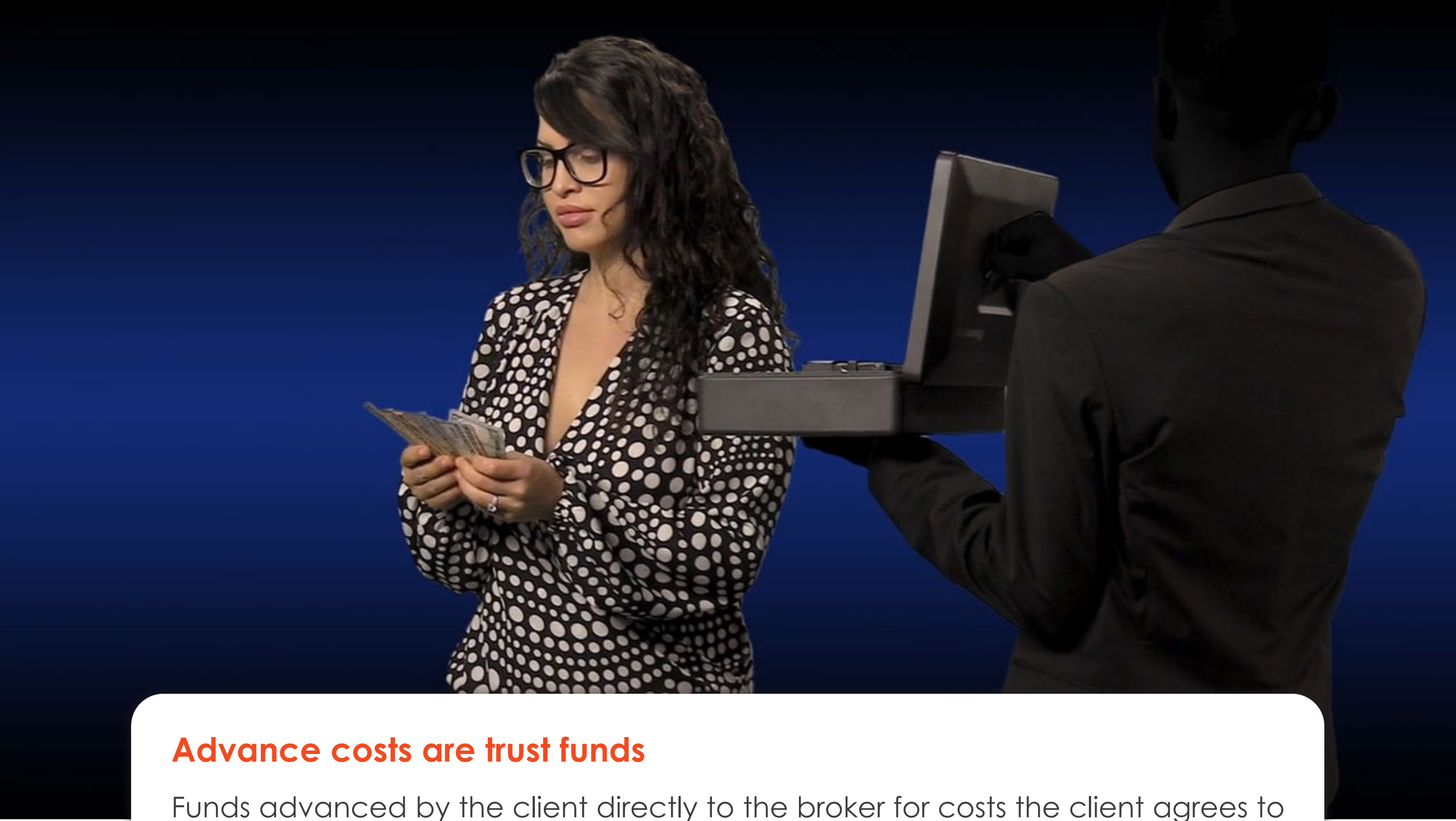
   c. referral fees.

2. Before a broker may solicit for an advance fee, the paperwork needs to be submitted to the California Department of Real Estate (DRE) for approval at least __________ prior to use.

   a. 5 days

   b. 10 days

   c. three months



Advance costs are trust funds

Funds advanced by the client directly to the broker for costs the client agrees to pay belong to the client. Typically, the seller will incur costs for acquiring property reports and marketing the property to prospective buyers.

On receipt of an **advance deposit** from the client for the payment of costs, the broker will place the funds in their trust account since they are trust funds. [Calif. Business and Professions Code §10146]

An **advance cost sheet**, also referred to as a *marketing package cost sheet*, acknowledges the broker's receipt of any deposit towards marketing costs. Further, it authorizes the broker to make disbursement from the funds as the itemized costs are incurred. The *advance cost sheet* is best included as part of the marketing package as an attachment to the listing agreement.

When the listing terminates, the broker is to return all remaining trust funds to the client. The broker may not use trust funds to offset any fees the client may owe them, unless instructed to do so.

An accounting of all funds held in trust will be handed to the client every calendar quarter. However, a monthly accounting by way of a print out of the client's *trust account ledger* creates a better business relationship.

Accounting of funds

A *final accounting* of the funds will be made when the listing agreement expires. When any funds remain, they will be returned to the client with the final accounting.

[Bus & P C §10146]

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

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

Lastly, the broker is to keep all accounting records for at least *three years*. Further, the records will be made available to the California Department of Real Estate (DRE) upon request. [Bus & P C §10148]

A broker who fails to place advance cost deposits in their trust account, or who later fails to deliver proper trust account statements, is presumed guilty of **embezzlement**. [**Burch** v. **Argus Properties, Inc.** (1979) 92 CA3d 128]

For example, a borrower retains a mortgage broker to locate a lender to make a mortgage to fund the acquisition of real estate. The borrower and mortgage broker enter into an *exclusive right-to-borrow listing agreement*.

The listing agreement states the broker will receive a broker fee when the mortgage is funded by the lender the broker locates. [See **RPI** Form 104]

The broker includes an *advance cost sheet* as an attachment to the listing. The advance cost sheet calls for the borrower to advance funds to cover itemized costs which will be incurred by the broker while arranging a mortgage. These costs cover such items as the appraisal of the property securing the mortgage and credit reports. The advance costs are separate and unrelated to the payment of the broker fee.

The borrower issues a check payable to the broker for the amount of the costs to be incurred by the broker while arranging the mortgage.

Can the broker deposit part or all of the funds advanced by the borrower into the broker's *general business account* to cover the costs the broker is to pay on behalf of the borrower?

No! Funds received by the broker to hold and use to pay costs to be incurred in the future on behalf of the borrower are *trust funds*.

Trust funds are deposited by the broker in a *trust account* in the name of the broker as trustee. They are separate from general accounts established to hold the broker's personal or business funds. [Bus & P C §10145]

QUIZ

1. A(n) __________ refers to an itemization of the costs incurred to properly market a property for sale which are to be paid by the owner.

   a. advance cost sheet

   b. advance fee sheet

   c. balance sheet

2. A broker who fails to place advance cost deposits in their trust account is presumed guilty of:

   a. blockbusting.

   b. embezzlement.

   c. eminent domain

non-interest bearing trust account

Trust account management

Checks or cash are frequently made payable and handed to a real estate broker during a transaction. These items are *trust funds* since they do not belong to the broker. Rather, checks payable to the broker and cash are received "in trust" by the broker and held on behalf of the client. These funds will be deposited by the broker into a **non-interest bearing trust account**, unless endorsed and handed to others as instructed by the client.

The *trust account* opened for the deposit of cash and items payable to the broker will be in the name of the broker, as **trustee**, at a bank or a state-recognized depository, such as a *thrift*. [Calif. Business and Professions Code §10145]

Once deposited, the trust funds may only be withdrawn or disbursed as authorized and instructed by the owner of the trust funds. A third party who has an interest in the funds may also be necessary to authorize disbursement, such as a seller who acquires an interest in the buyer's good faith deposit on acceptance of a purchase agreement offer. [Bus & P C §10145(a)(1)]

Withdrawals or disbursements from the trust account in the name of an individual broker will be made under the signature of:

- the broker named as *trustee* on the account;
- a licensed broker or sales agent employed by the named broker under a broker-agent employment agreement [See **RPI** Form 505]; or
- an unlicensed employee of the named broker, provided the unlicensed employee is **bonded or insured** for the total amount of the trust funds the employee can access, and the bond or insurance protects the broker from

intentional wrongful acts committed by the employee. [Department of Real Estate Regulation §2834(a); Bus & P C §10145(a)(2)(c)]

A **signer** is an employee other than the broker who has written authorization from the broker to withdraw or disburse funds from the trust account. This authority is either included in an addendum to the employment agreement or is provided in the agreement itself.

When the trust account is in the name of a **corporate broker** as trustee, withdrawals are made by:

- the **designated officer (DO)** who qualified the corporation as a licensed broker; or
- a licensed or unlicensed employee with the written authorization of the designated officer. [DRE Reg. §2834(b)]

The authorization from the corporation is made as part of the employment agreement with each signatory. [See **RPI** Form 505, 510 or 511]

However, a broker's written delegation to others who are signers on the trust account does not relieve the individual broker or the designated officer of a corporate broker from liability for any loss or misuse of trust funds. [DRE Reg. §2834(c)]

To help prevent an improper withdrawal by an individual signer, the broker may require two signatures on trust account withdrawals. An *insurance policy* for the brokerage business needs to include coverage for theft by employees who have direct or indirect access to trust funds.

QUIZ

1. A trust account opened for the deposit of cash and valuable items payable to the broker will be in the name of the broker as the:

    a. signer.

    b. trustor.

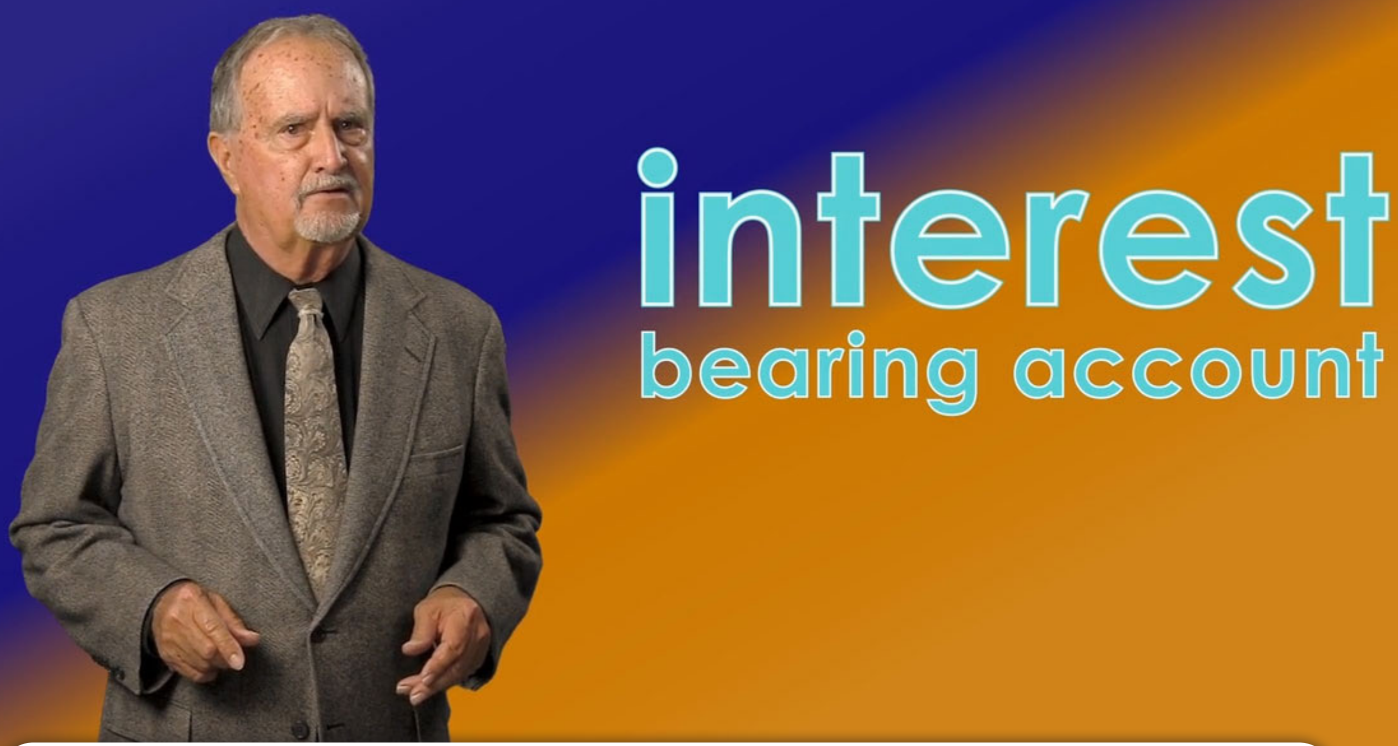
    c. trustee.

2. A ___________ is an employee other than the broker who has written authorization to disburse funds from a trust account.

    a. signer

    b. substitute

    c. dual agent



Interest-bearing accounts

Trust funds may be placed in an **interest-bearing account** if requested by the owner of the funds and agreed to by the broker. [See RPI Form 535]

However, the broker is under no obligation to comply with the owner's request if they notify the owner they will not place the trust funds in an interest-bearing account. [Bus & P C §10145(e)]

If the broker agrees to place the owner's trust funds in an interest-bearing trust account:

- a separate trust account will be established solely to hold the owner's trust funds;
- the trust account will be in the name of the broker as trustee, with the owner named as the specified *beneficiary*;
- the trust account will be insured by the Federal Deposit Insurance Corporation (FDIC); and
- the broker and their agents may not receive any interest earned by the trust account, even if agreed to by the owner of the trust funds. [Bus & P C §10145(d)]

Also, if trust funds are to be placed in an interest-bearing account, the broker is to first disclose:

- how interest is calculated on the account;
- who will receive the interest;

- who will pay bank service charges; and
- any penalties or notice requirements for withdrawal. [Bus & P C §10145(d)(4); see **RPI** Form 535]

QUIZ

1. Trust funds are generally kept in a(n):
   a. interest-bearing account.
   b. non-interest-bearing account.
   c. off-shore account.

Maintaining trust account integrity

If a broker deposits trust funds into an account used to receive and disburse personal or business funds, the broker has **improperly commingled** the funds. Similarly, *improper commingling* occurs when the broker places or leaves personal funds in a trust account. [**Stillman Pond, Inc.** v. **Watson** (1953) 115 CA2d 440]

Except to the limited extent authorized by the California Department of Real Estate (DRE), commingling is always improper.

A broker is only permitted to commingle personal or business funds with trust funds in the following two authorized situations:

1. The broker may maintain a deposit of up to *$200 of their own funds* in the trust account to cover bank service charges on the account; and
2. Fees or reimbursement for costs *due the broker* from the trust funds may remain in the trust account for up to 25 days before being disbursed to the broker. [DRE Reg. §2835]

The improper commingling of trust funds exposes the broker to a complaint and revocation or suspension of their license. [Bus & P C §10176(e)]

For example, a broker prepares a purchase agreement for a buyer. The offer includes the broker's receipt of a check for the buyer's *good faith deposit*. Instructions are not included in the purchase agreement authorizing the broker to hold the check undeposited until acceptance of the offer. [See **RPI** Form 150 through 158]

The buyer signs the offer and issues a check payable to the broker for the good faith deposit. The broker deposits the buyer's check into their trust account.

The offer is not accepted by the seller. The broker then withdraws the buyer's good faith deposit from the trust account and deposits the funds in their personal account. From their personal account, the broker writes checks using the buyer's funds to pay personal expenses.

Is the broker's personal use of the buyer's funds cause for revocation or suspension of their license?

Yes! Not only has the broker violated the rule against commingling trust funds and personal funds, the broker also *converted* the buyer's funds to their own use. Both violations are separate grounds for revocation or suspension of the broker's license. [**Brown** v. **Gordon** (1966) 240 CA2d 659]

Proper recordkeeping

Records maintained by the broker for their trust accounts document and track the broker's **receipt and disbursement** of trust funds. However, recordkeeping alone will not protect the broker against dishonest employees.

The assurance all trust funds are correctly deposited, credited and disbursed is best accomplished by maintaining a *written journal* or *digital accounting system*. However, even the best of accounting procedures do not protect against deliberate diversion of trust funds by others.

The broker named as trustee on a trust fund account is responsible for funds held in the account. The broker is liable even if others sign on the account with authorization to make withdrawals from the account. [DRE Reg. §2834(c)]

Occasionally, it is unfeasible for the broker to personally enter and maintain each accounting transaction and conduct the reconciliation required by the DRE. Banks and other depositories send a monthly statement of the account to each account holder for the purpose of verifying the validity of the deposits, withdrawals and charges on the account. The broker can best protect the trust funds from unauthorized withdrawals by personally receiving and reviewing bank statements before anyone else.

The broker, to maintain the integrity of the trust account, is to make sure the statement is:

- mailed to the broker's office and handed to them unopened;
- held by the bank and personally picked up by the broker; or
- sent to the broker's residence instead of the office.

If unauthorized withdrawals occur, the broker will discover them by reviewing the bank statement and the accompanying deposit tickets and paid checks before anyone else has access to the statement.

In the event the broker discovers an unauthorized withdrawal due to forgeries or improper endorsements, the broker is to notify the bank within 30 days of receiving the statement. The notice of improper payment of checks by the bank will enable the broker to recover the amount of the unauthorized payment. [Calif. Commercial Code §4406]

Any loss from the trust account not covered by the bank will be covered by the broker. Thus, to protect the broker from unrecoverable losses, business insurance is to include coverage for *employee theft*.

QUIZ

1. ___________ occurs when a broker deposits trust funds into an account used to receive and disburse personal or business funds.

   a. Dual agency

   b. Improper commingling

   c. A kickback

2. A broker is permitted to keep up to __________ of their own funds in a client's trust account.

   a. $200

   b. $1,000

   c. $5,000

Penalties for misuse of trust funds

Real estate brokers who handle trust funds need to deposit the funds as instructed by their owner.

Trust fund handling is regulated by a variety of *penalties and consequences*. A broker who misuses trust funds is subject to:

- *civil liability* for money wrongfully converted;
- *disciplinary action* by the California Department of Real Estate (DRE);
- *income tax liability*; and
- *criminal sanctions* for embezzlement.

The penalty depends on the nature of the funds which the broker misuses. For example, penalties for a broker's misuse of **advance fees** held in trust accounts are specifically fixed by statute.

If the broker misuses advance fees, the owner of the funds may recover treble damages plus attorney fees from the broker. A broker who fails to account for advance fees is presumed to be guilty of **embezzlement**. [Calif. Business and Professions Code §10146)]

However, the existence of specific statutory provisions relating to the misuse of advance fees does not mean the misuse of other types of trust funds will go unpunished. Penalties for the misuse of trust funds for other purposes fall under more general statutory schemes.

Violations subject to DRE discipline

If the DRE Commissioner determines a broker violated trust fund accounting rules, the Commissioner may obtain an injunction against the broker to stop or prevent the violation. [Bus & P C §10081.5]

The Commissioner may also include a claim for **restitution** on behalf of clients injured by the broker's misuse of trust funds. [Bus & P C §10081(b)]

If the DRE conducts an audit of the broker's trust account and discovers the broker has **commingled** or **converted** more than $10,000 of trust funds, the broker's license may be suspended pending a formal hearing.

After the hearing, a receiver may be appointed to oversee the broker's business. The receiver is allowed to exercise any power of the broker and may file for bankruptcy on behalf of the broker. [Bus & P C §10081.5]

Commingling of trust funds is grounds for suspension or revocation of the broker's license. [Bus & P C §10176(e)]

Civil liability

A broker who misuses trust funds needs to **reimburse** the owner of the funds the amount wrongfully used. [Calif. Civil Code §3281]

However, a client's right to recover money from a broker is not limited to the amount or value of the funds the broker wrongfully converted. In addition to money losses, the client may be awarded *punitive penalties* based on a breach of the broker's agency relationship with the client.

Also, when a broker uses the client's money for their own benefit, any profits earned by the broker's misuse belong to the client.

Thus, the client is entitled to recover the funds wrongfully converted, *plus any gain* the broker derived from their use. [**Savage** v. **Mayer** (1949) 33 C2d 548]

For example, a seller's broker presents the listed property to a buyer at a price exceeding the seller's listing price. The buyer signs an offer to purchase at the price solicited by the broker and gives the broker a **good faith deposit**.

The broker never communicates the buyer's offer to the seller. Instead, the broker purchases the property from the seller at the seller's lower listed price, then deeds the property to the buyer. The broker keeps the difference between the listed price and the purchase price as a profit.

The buyer seeks to recover from the broker the difference between the prices paid for the property. The broker claims the buyer is not entitled to recover the difference since the property acquired was worth at least what the buyer paid for it.

Is the buyer entitled to the difference in price?

Yes! Further, the buyer's recovery is not limited to actual money losses for overpayment on the price. Since the broker used the buyer's deposit to secretly profit, the buyer is also entitled to recover the profits and fees received by the broker. [**Ward** v. **Taggart** (1959) 51 C2d 736]

Punitive damages

A broker who wrongfully converts trust funds may be liable for **punitive damages**. *Punitive damages*, also called **exemplary damages**, is a money award given to a client when the broker wrongfully obtained assets, such as trust funds, from the client by fraud or with malice. [CC §3294]

Any wrongful use of trust funds is automatically considered *fraudulent*. The broker's breach of their agency duty is defined by statute as *constructive fraud*. [CC §1573]

Thus, any broker misusing trust funds is potentially liable to the principal for punitive damages as well as reimbursement of the trust funds taken or misused. Whether punitive damages will be awarded depends on:

- the severity of the broker's misconduct; and
- the agency relationship undertaken by the broker.

In instances where actual money losses are small, punitive money awards are occasionally awarded as a *deterrent* against future fraudulent activity. [**Esparza** v. **Specht** (1976) 55 CA3d 1]

Embezzlement and income tax reporting

A broker who uses funds in any way not authorized by the owner is guilty of **embezzlement**. [Calif. Penal Code §506]

Whether the broker is merely "borrowing" the funds and intends to return them is of no import. The broker is still guilty of embezzlement. [Pen C §513]

Income taxes to the extent due are paid on all income, from whatever source. This includes income derived from illegal activities such as *embezzlement*. [**James** v. **United States** (1961) 366 US 213]

Thus, brokers who convert trust funds expose themselves to tax penalties when they fail to report the converted funds as income and pay the appropriate taxes on the *illegal income*. [Calif. Revenue and Taxation Code §19701]

Further, embezzled money needs to be reported as income even when it is paid back. Thus, a broker embezzling trust funds cannot escape income tax liability by returning the funds and characterizing the embezzlement as an *unauthorized loan*. [**Buff** v. **Commissioner of Internal Revenue** (1974) 496 F2d 847]

In addition, no deductions of any kind are allowed to offset income derived from illegal activities. The broker is responsible for reporting the full amount of the income they have derived from converting trust funds, undiminished by their related expenses, costs and reimbursements. [Rev & T C §17282]

QUIZ

1. Money damages awarded in excess of actual money losses that are levied in order to deter unlawful actions are known as:

   a. legal fees.

   b. reimbursement.

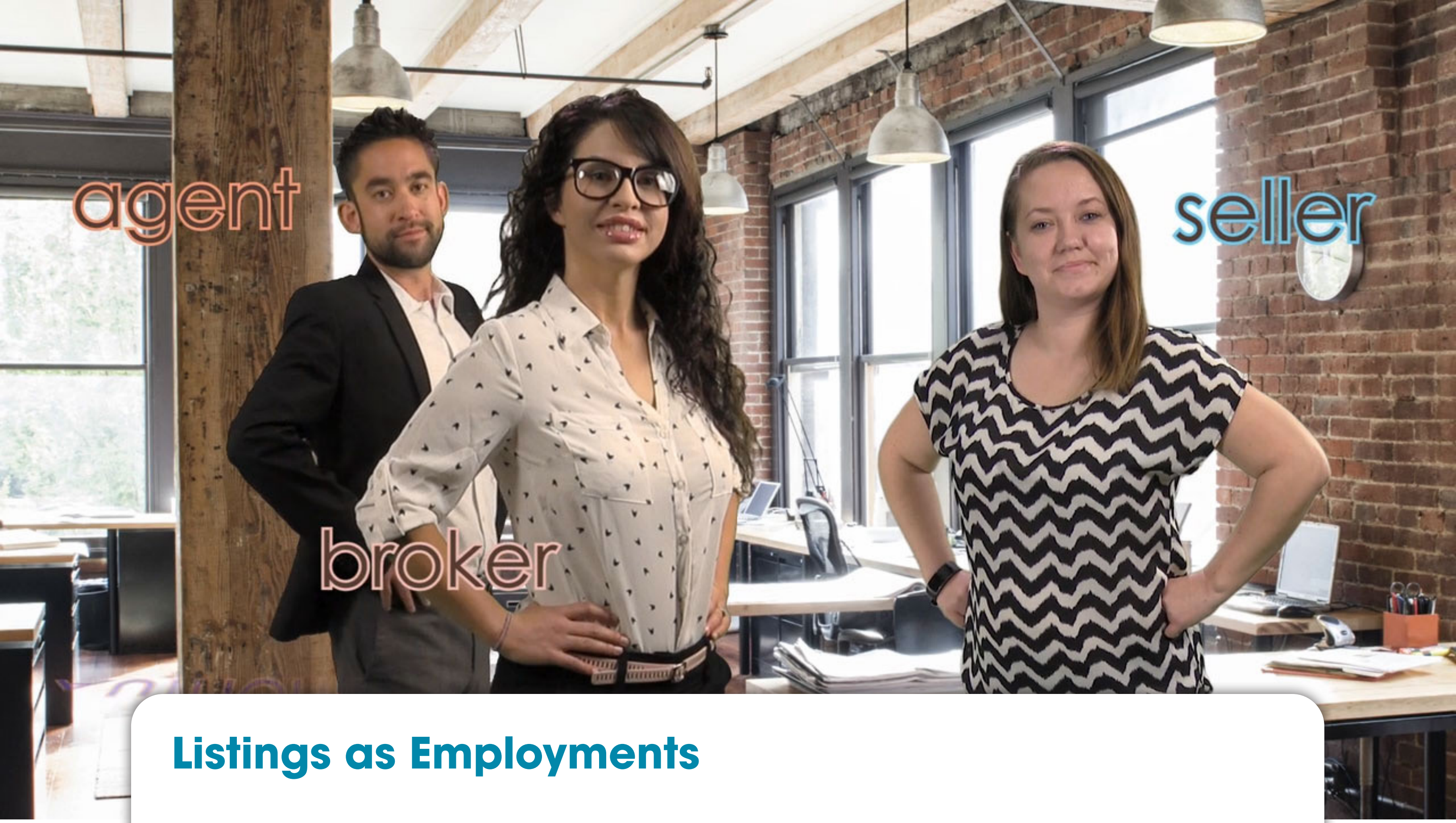
   c. punitive damages.

2. __________ refers to the dishonest act of converting a client's assets for personal use.

   a. Embezzlement

   b. Civil liability

   c. Restitution



Listings as Employments

Authority to act on a client's behalf

A **listing agreement** is a written employment arrangement between a client and a licensed real estate broker regarding real estate services. More recently, a *listing agreement* is also referred to as a **representation agreement**, both referring to the same employment arrangement.

On entering into a listing or *representation agreement*, the broker and their agents are *retained and authorized* to diligently perform real estate related services on behalf of the client in exchange for payment of a fee. [Calif. Civil Code §1086(f); see **RPI** Forms 102-104 and 110-112]

The client retaining a broker may hold an ownership interest in real estate, which the client seeks to:

- *sell* [See **RPI** Forms 102 and 102-1];
- *lease* [See **RPI** Form 110]; or
- *encumber* as collateral for mortgage financing. [See **RPI** Form 104]

Further, the client retaining the services of a broker may be seeking to acquire an interest in real estate as a:

- *buyer* [See **RPI** Forms 103.1, 103.2 and 103-1]; or
- *tenant*. [See **RPI** Form 111]

The person employed by a client to provide real estate services in expectation of a fee is a licensed real estate broker. Likewise, if a dispute arises with a client over the client's failure to pay an agreed-to fee, the broker needs to be employed under a written listing or representation agreement signed by the client to pursue collection.

A real estate agent employed by the broker may obtain a listing, but the agent does so while acting on behalf of the broker. The agent has no independent right to enter into or enforce the listing or representation agreement in their name.

QUIZ

1. On entering into a __________, the broker and their agents are retained and authorized to diligently perform real estate related services on behalf of the client in exchange for payment of a fee.

    a. purchase agreement or lease agreement

    b. listing agreement or representation agreement

    c. finder's fee agreement or loan application

2. The person employed by a client to provide real estate services in expectation of a fee is:

    a. a licensed real estate agent.

    b. a licensed real estate broker.

    c. either a licensed real estate agent or broker.

Agent's right to a fee

The agent of a broker has a *right to a fee* on transactions based on the agent's written employment agreement with the broker, not under the separate listing or representation agreement the broker has with the client. Through the broker-agent employment agreement, the agent is entitled to share in the fees actually received by the broker on transactions in which the agent participates. [See **RPI** Forms 505 and 506]

A licensed agent representing a broker acts as an *agent of the broker*. As the broker's agent, the agent performs on behalf of the broker (as well as the client) all the activities the broker has been retained by the client to provide. Further, an agent providing real estate related services on behalf of a client may not do so independently of their broker. Thus, an agent employed by a broker is referred to as "the agent of the (client's) agent," acting as an agent of their employing broker. [Calif. Civil Code §2079.13(b)]

The listing also authorizes the broker to serve as the client's representative in the negotiation of a real estate transaction with others. The listing or representation also authorizes the broker to serve as the client's representative in the negotiation of a real estate transaction with others.

Further, the listing or representation contains the client's promise to pay a fee to the broker. This promise is given in exchange for the broker's **promise to use diligence** in the broker's efforts to meet the client's objectives, known as their **fiduciary duty**.

Editor's note — The use of diligence is distinguished from a "best efforts" standard for broker performance under an open listing.

QUIZ

1. Through a(n) __________, the agent is entitled to share in the fees actually received by the broker on transactions in which the agent participates.

    a. listing agreement

    b. purchase agreement

    c. broker-agent employment agreement

2. A broker's promise to use diligence in their efforts to meet the client's objectives is known as their:

    a. common law duty.

    b. best efforts duty.

    c. fiduciary duty.

Two legal aspects under a listing agreement

The relationship created between the client and the broker by a *listing or representation agreement* has two distinct legal aspects:

- an **employment relationship**; and
- an **agency relationship.**

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.

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 duty* of loyalty and full disclosure owed by the broker (and their sales agents) to the client. [See **RPI** Form 305]

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*, precedes commencement and survives the termination of the employment relationship. [Calif. Civil Code §2079.16]

Also, an oral agreement to perform brokerage services on behalf of a client imposes an agency law obligation on the broker and agents to act as fiduciaries — no differently than had a writing existed. However, the client's oral promise to pay a fee does not entitle the broker to enforce collection of the fee due from the client – buyer or seller – when working for a client without a written listing or representation agreement.

An agreement employing a broker to purchase or sell real estate, lease a property for over one year or arrange mortgage financing is controlled by *contract law*. For a broker to enforce a promise from a client to pay a fee, the fee agreement needs to be:

- in writing; and
- signed by the client. [CC §1624(a)(4)]

Types of listing or representation agreements

A variety of listing or representation agreements exist, each employing and authorizing a broker to perform real estate related services under different conditions.

The variations usually relate to:

- the extent of the broker's representation;
- the type of services to be performed by the broker and their agents; and
- the events which trigger payment of a fee. [See **RPI** Forms 102-104 and 110-112]

The purpose for most listing agreements is the sale or purchase of single-family residential (SFR) property. Others are for residential-income and commercial-income properties comprising industrial, retail, office, farm and motel/hotel or unimproved parcels.

Likewise, when the agent is representing a buyer seeking to acquire an interest in a property, they use a **Buyer Representation Agreement**. *Buyer-Broker Representation Agreements* come in two forms, distinguished in use by the difference in types of buyer-clients:

- one when the buyer-client is an individual and the retainer period is not greater than three months [See **RPI** Form 103.1]; and
- the other when the buyer-client is an entity. [See **RPI** Form 103.2]

Despite the application of various agreements to the type of property described in the listing, all listings fall into one of two general categories:

- *exclusive;* or
- *open*.

QUIZ

1. An oral agreement to perform brokerage services on behalf of a client:

   a. imposes no agency law obligation on the broker and does not entitle the broker to enforce collection of the fee due from the client.

   b. imposes an agency law obligation on the broker to act as a fiduciary though does not entitle the broker to enforce collection of the fee due from the client.

   c. imposes a contractual employment obligation for the client to pay the broker a fee if the broker performs any of the work agreed to.

2. Listing agreements are divided into one of two general categories:

   a. exclusive or limited.

   b. triple-net or open.

   c. open or exclusive.

Exclusive Right to Sell or Buy

Exclusive listing agreements

Under an *exclusive listing*, a broker receives the sole right to represent:

- an owner by **marketing** a listed property for sale or lease and **locating** a qualified buyer or tenant [See **RPI** Forms 102 and 102-1];
- a tenant by **locating** property [See **RPI** Form 111]; or
- an owner or lender to **mortgage** a property.

Editor's note – This discussion is framed primarily through the context of an agent representing a seller. An agent's representation of a buyer under a Buyer Representation Agreement is covered in a later section.

An *exclusive listing* requires an agent to use diligence in their efforts to fulfill the client's objectives to locate a buyer, tenant or lender for the property. An exclusive listing has a specified period of employment set by a mandated expiration date of the employment, such as 90 or 180 days after its commencement.

If the broker fails to include an expiration date in an exclusive listing, they face disciplinary action by the Department of Real Estate (DRE) on a complaint. [Calif. Business and Professions Code §10176(f)]

Two types of exclusive employment agreements for selling real estate exist:

- an **exclusive agency listing** for a seller or buyer; and
- an **exclusive right-to-sell listing agreement**. [See **RPI** Form 102]

Both types of exclusive listings establish the broker and their agents as the sole licensed real estate representatives of the client. However, these variations are distinguished by whether or not the broker is entitled to a fee when the property is sold or located solely by the efforts of the client.

Under an *exclusive agency listing* fee provision, the broker does not *earn* a fee when the client, acting alone and independently of any other broker or the seller's broker, accomplishes the objective of the employment, i.e., selling the listed property.

Conversely, under the fee provision in an *exclusive right-to-sell/buy agreement*, the broker earns a fee no matter who produces the buyer or locates the property sought under the listing during the listing period.

This is the case whether it is the client, the seller's broker or another broker or representative of the client who produces a buyer. [Calif. Civil Code §1086(f)(1)]

An exclusive employment is an example of a **bilateral contract**. The broker or agent agree to exercise due diligence to fulfill the client's real estate objectives. In exchange, the client promises to pay a fee under various circumstances.

In the context of a contract, it means both parties are bound to act. Stated another way, it's a promise for a promise.

QUIZ

1. Under an exclusive agency listing fee provision:
    a. the broker earns a fee whether or not they accomplish the objective of the employment.
    b. the broker earns a fee when the client accomplishes the objective of the employment.
    c. the broker does not earn a fee when the client accomplishes the objective of the employment.

2. An exclusive employment is an example of a:
    a. unilateral contract.
    b. bilateral contract.
    c. fixed-price contract.

Exclusive right-to-sell listing agreement

An **exclusive right-to-sell listing agreement**, also known as a seller representation agreement, affords a real estate broker the greatest fee protection for their efforts.

This listing employs the broker as the sole agent to act on behalf of the owner to market the property and negotiate any sale with all potential buyers and their agents. The broker is entitled to a fee regardless of who procures the buyer. [See **RPI** Form 102]

Under an *exclusive right-to-sell agreement*, the owner relinquishes their right to list the property with other brokers or defeat the seller's broker's entitlement to compensation by selling the property themselves, as occurs under an *exclusive agency listing* or *open listing*.

An owner of real estate, on entering into an exclusive right-to-sell listing agreement, grants a broker the *right to locate a buyer* for the property prior to the expiration of the period of employment specified in the listing agreement.

The broker is entitled to the fee agreed to in the listing 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. [Calif. Civil Code §1086(f)(1)]

Exclusive right-to-sell listing agreements give a broker and their agents the greatest incentive to fulfill their fiduciary duty and work toward attaining the client's goal of locating a buyer who acquires the property. Here, the seller's broker does not compete with the client to sell the property — they work together to achieve the sale. [See **RPI** Form 102]

Buyer's brokers know that sellers who enter into exclusive right-to-sell listing agreements are fully committed to working with brokers. Also, sellers who retain competent agents are counseled on prices of comparable properties and current market conditions. Thus, the seller of a listed property is more likely to accept a reasonable offer.

In turn, buyer's brokers are comfortable exposing their clients to properties listed exclusively by other brokers.

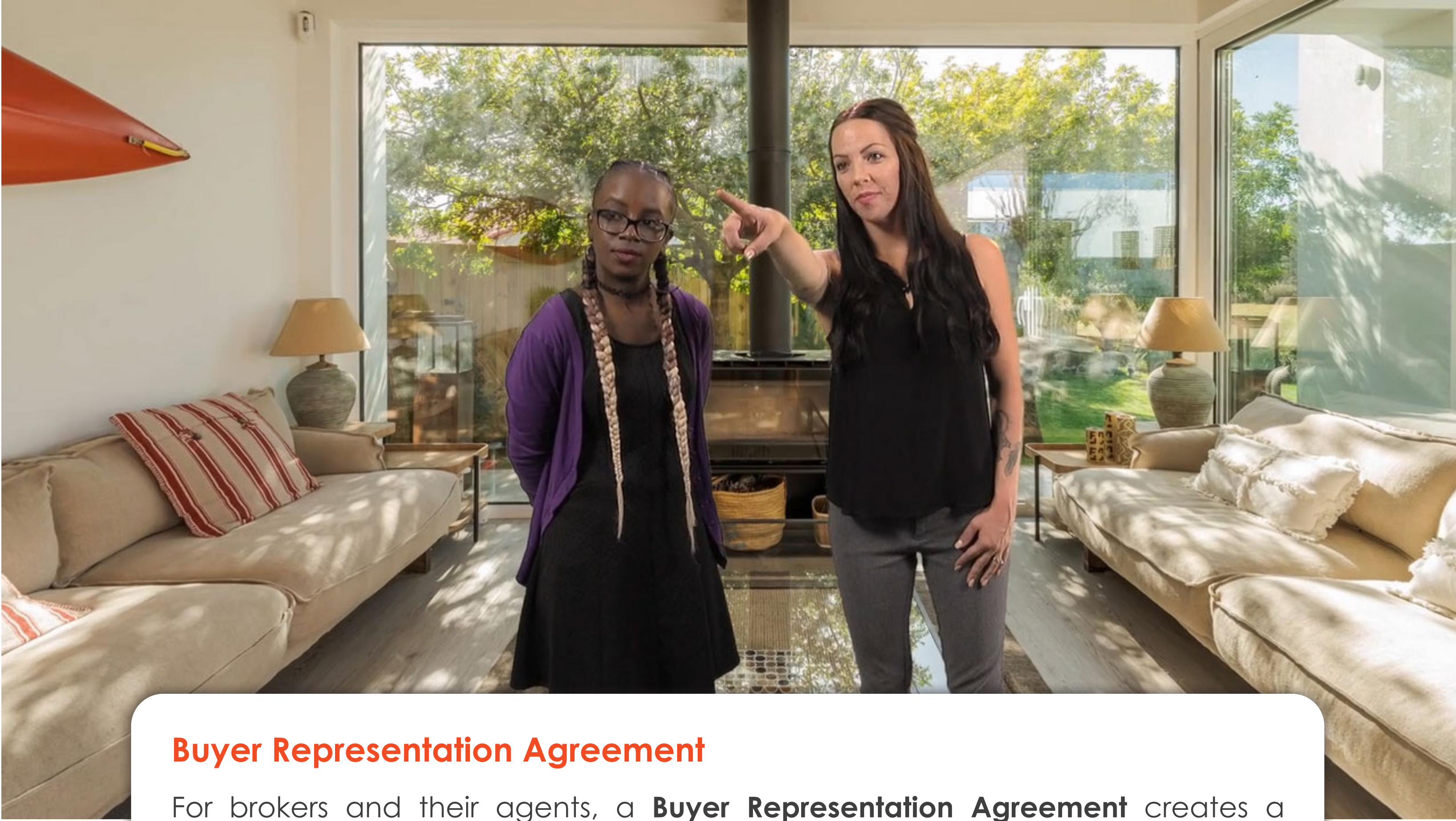
QUIZ

1. An __________ affords a real estate broker the greatest fee protection for their efforts.

   a. exclusive agency listing
   b. exclusive right-to-sell listing agreement
   c. open listing

2. Under an exclusive right-to-sell listing agreement, the owner:

   a. forfeits their right to list the property with other brokers but may sell the property themselves and avoid paying the broker a fee.
   b. may list their property with multiple brokers and only needs to pay a fee to the broker who produces a willing and able buyer but may not avoid payment of a fee by selling the property themselves.
   c. relinquishes their right to list the property with other brokers or defeat the broker's entitlement to compensation by selling the property themselves.



Buyer Representation Agreement

For brokers and their agents, a **Buyer Representation Agreement** creates a contrasting but parallel activity from listing and marketing property for sale. [See **RPI** Form 103.1 and 103.2]

Under a *representation agreement*, a prospective buyer employs a broker to locate qualified properties of the type the buyer seeks to purchase.

As with an exclusive right-to-sell listing, the Buyer Representation Agreement has provisions for a broker fee to be disbursed by escrow from funds accruing to the seller on the buyer's payment of the purchase price when the buyer acquires property during the retainer period of the type described. Here, the seller pays the fee on closing. [See **RPI** form 103.1 and 103.2 §4.2(a)]

In all other situations where the broker is to earn a fee, the buyer pays. [See **RPI** form 103.1 and 103.2 §4.2(b)]

Also, the representation agreement provides greater incentive for brokers and their agents. The exclusive aspect and the due diligence provision imposes a duty to work *diligently and continuously* to meet their buyers' objectives.

The buyer benefits under a representation agreement due to the greater likelihood the broker will find the particular type of property sought. Brokers also act as a safeguard for the buyer since they:

- have continuous access to all available properties;
- investigate and qualify properties as suitable before they are presented to the buyer; and

- advise the buyer on the pros and cons of each property presented.

Importantly, a buyer's broker locating properties listed by other brokers does not become a dual agent or lose their status as the buyer's exclusive agent merely because the buyer's broker works with seller's brokers to obtain information on the listed properties.

Buyer Representation Agreements come in two forms, distinguished in use by the difference in types of buyer-clients:

- one when the buyer-client is an **individual** [See **RPI** Form 103.1]; and
- the other when the buyer-client is an **entity**, such as corporations, real estate investment trusts (REITs), limited liability companies (LLCs) and partnerships. [See **RPI** Form 103.2]

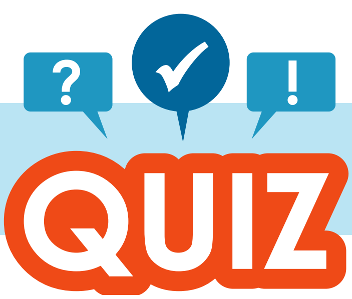
The broker's retainer period for services to be rendered to *individuals* under a representation agreement may initially run no more than **three months** from the date the agreement is signed and received by the broker. [CC §1670.50(d)(1)]

However, when the buyer-client is an *entity*, they may agree to a retainer period for whatever duration the broker and buyer negotiate.

Further, when the buyer is an **individual**, the representation may only be *renewed* for a period no greater than three months from the date the renewal agreement is entered into. [CC §1670.50(d)(2); see **RPI** Form 103.1A]

When the buyer-client is an *entity*:

- the representation period before expiration may be for any duration; and
- the expiration date may be *extended* for whatever duration the broker and buyer negotiate.



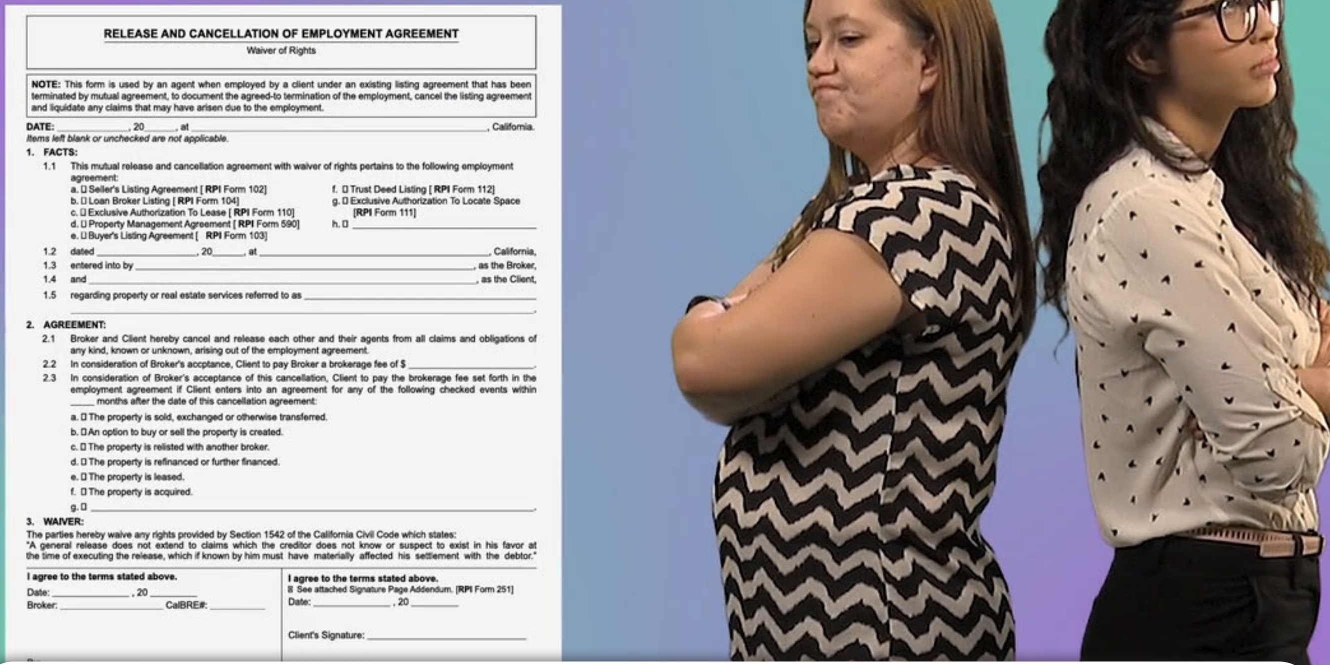
1. Under a Buyer Representation Agreement, a prospective buyer employs a broker to:

   a. market and sell the property subject to the listing.

   b. locate suitable rental property to lease for a term greater than one year.

   c. locate qualified properties of the type the buyer seeks to purchase.

Release and Cancellation of Employment Agreement



RELEASE AND CANCELLATION OF EMPLOYMENT AGREEMENT

Waiver of Rights

NOTE: This form is used by an agent when employed by a client under an existing listing agreement that has been terminated by mutual agreement, to document the agreed-to termination of the employment, cancel the listing agreement and liquidate any claims that may have arisen due to the employment.

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

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This mutual release and cancellation agreement with waiver of rights pertains to the following employment agreement:

a. ☐ Seller's Listing Agreement [**RPI** Form 102]
b. ☐ Loan Broker Listing [**RPI** Form 104]
c. ☐ Exclusive Authorization To Lease [**RPI** Form 110]
d. ☐ Property Management Agreement [**RPI** Form 590]
e. ☐ Buyer's Listing Agreement [**RPI** Form 103]
f. ☐ Trust Deed Listing [**RPI** Form 112]
g. ☐ Exclusive Authorization To Locate Space [**RPI** Form 111]
h. ☐ ____________________

1.2 dated ______________, 20______, at ________________________________, California,

1.3 entered into by ____, as the Broker,

1.4 and ____, as the Client,

1.5 regarding property or real estate services referred to as ____.

2. AGREEMENT:

2.1 Broker and Client hereby cancel and release each other and their agents from all claims and obligations of any kind, known or unknown, arising out of the employment agreement.

2.2 In consideration of Broker's accptance, Client to pay Broker a brokerage fee of $ ______________.

2.3 In consideration of Broker's acceptance of this cancellation, Client to pay the brokerage fee set forth in the employment agreement if Client enters into an agreement for any of the following checked events within _____ months after the date of this cancellation agreement:

a. ☐ The property is sold, exchanged or otherwise transferred.
b. ☐ An option to buy or sell the property is created.
c. ☐ The property is relisted with another broker.
d. ☐ The property is refinanced or further financed.
e. ☐ The property is leased.
f. ☐ The property is acquired.
g. ☐ ____.

3. WAIVER:

The parties hereby waive any rights provided by Section 1542 of the California Civil Code which states:
"A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

I agree to the terms stated above. Date: ______________, 20 ________ Broker: ________________ CalBRE#: __________	**I agree to the terms stated above.** ☐ See attached Signature Page Addendum. [**RPI** Form 251] Date: ______________, 20 ________ Client's Signature: ____________________

Termination-of-agency clause

Consider a seller of real estate who enters into an **exclusive listing agreement** with a broker to sell a property within, say, a three-month period. The fee provision in the listing contains a *termination-of-agency* clause addressing seller interference with the employment. It entitles the broker to a full fee if the seller *terminates* the broker's employment, without good cause, prior to expiration of the listing period. [See **RPI** Form 102 §3.1(c)]

The broker's agent, as agreed in the listing, promptly commences a diligent marketing effort:

- to properly present the property for sale; and
- to locate a buyer who is willing to acquire the property.

However, during the listing period before a buyer is located, the seller terminates the agency by acting to cancel the listing.

The broker makes a demand on the seller for a full listing fee, claiming the termination-of-agency clause in the fee provision of the listing calls for payment of a fee as earned when the seller prematurely terminates the agency. The seller claims the broker is not entitled to a full broker fee, but only to money losses based on an accounting for their time, effort and costs incurred to market the property, called **quantum meruit** – the amount deserved for work completed – since a seller has the right to terminate a broker's agency at any time.

Is the broker entitled to collect a full fee from the seller upon the seller's exercise of their right to terminate the agency at any time?

Yes! It is correct that a seller may terminate the broker's agency at any time. However, the seller cannot both terminate the agency during the listing period and avoid payment of a fee when a termination-of-agency clause exists in the listing agreement the seller entered. The termination-of-agency clause in the listing agreement couples the permissible cancelling of the listing with the obligation to pay a fee.

QUIZ

1. When a termination-of-agency clause exists in the listing agreement, a seller may terminate the broker's agency without good cause at any time during the listing period:

   a. and may avoid payment of a fee if they intend to terminate a broker's employment.

   b. but may not avoid payment of the broker's fee.

   c. but may be liable for up to three times the amount of the broker's typical fee.

Open listings

An **open listing**, sometimes called a nonexclusive listing, allows the owner to market the property themselves while employing brokers to locate buyers and sell the property. The client may enter into *open listings* with as many brokers as they want to without becoming obligated to pay more than one fee, if any.

Thus, the owner under an open listing competes against the seller's brokers to locate buyers. If the owner does locate a buyer, the owner does not become obligated to pay a fee under any open listing. In contrast to other types of listings, an open listing does not grant exclusive rights to the seller's broker and their agents to be the sole representative of the client. This is true whether the client is a buyer, tenant, borrower, seller, landlord or lender.

A broker 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 are 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 will present the offer to the owner *before* the property is sold to some other buyer located by another broker or by the owner directly. Also, the offer will be submitted *before the listing expires* or is revoked by withdrawal of the property from sale or by the termination of the agency. [Calif. Civil Code §1086(f)(3)]

Open listings: a unilateral contract

The broker employed under an open listing is not obligated to use diligence in their efforts to locate a buyer. The broker only has a best-effort obligation since the broker does not "accept" the employment until they produce a buyer for the property.

Thus, an open listing is legally classified as a **unilateral contract**. However, the agency duties of a fiduciary exist at all times under an open listing, Further, on locating a buyer the broker is to perform their *due diligence efforts* to make disclosures and close the transaction.

The first broker to submit an offer during this open listing period from a ready, willing and able buyer to purchase property on the listed terms, or on other terms accepted by the owner, has earned the agreed fee. No other broker holding open listings from the owner are entitled to a fee.

A broker may also represent a buyer to locate property under an open listing agreement. A broker assisting a buyer to locate a suitable property among multiple listing service (MLS) listings held by other brokers at least considers asking the buyer to sign an open listing if the broker chooses not to solicit an exclusive representation with its imposition of due diligence duties.

Further, an open listing does not need to contain an expiration date, unlike an exclusive agency or exclusive right-to-sell/buy listing which require inclusion of an expiration date.

Cancellation of an open listing

The owner revoking an open listing that contains an expiration date owes a fee to the broker if:

- the owner later closes a sale with a prospective buyer located by the broker before the listing is revoked; or
- the owner revokes the listing in an attempt to escape payment of the agreed fee. [**Heffernan** v. **Merrill Estate Co.** (1946) 77 CA2d 106]

Conversely, an open listing *without an expiration date* may be terminated by the owner at any time without becoming obligated to pay a fee. Also, no fee is due under an open listing on:

- the good-faith withdrawal of the property from the market; or
- the premature termination of the employment before the broker has submitted a *full listing offer*. [**Tetrick** v. **Sloan** (1959) 170 CA2d 540]

QUIZ

1. A client may enter into open listings with as many brokers as they choose, but:
    a. they are obligated to pay a fee to all brokers who submit a reasonable offer prior to expiration of the listing.
    b. they need to delegate a managing broker through which all other brokers are to coordinate.
    c. they are not obligated to pay more than one fee to the broker who procures a buyer who presents an offer on the terms sought in the listing.

2. An offer submitted by a broker to a seller with substantially the same terms sought by the seller under the open listing is called a(n):
    a. full listing offer.
    b. option to purchase.
    c. guaranteed offer.

Net listings

A **net listing** is used only with sellers, not buyers. It is structured as either an open or an exclusive type of listing. The *net listing* is distinguishable from all other listing arrangements due to the way a broker's compensation is calculated.

In a net listing, the broker's fee is not based on a percentage of the selling price.

Instead, the seller's net sales price (excluding broker fees and closing costs) to be received by the seller on closing is stated in the listing agreement. The broker's fee equals whatever amount the buyer pays in excess of the seller's net figure and closing costs.

However, the broker discloses to the seller the full sales price paid by the buyer and the amount of the broker's residual fee before the seller accepts an offer on a net listing. Failure to disclose to the client the benefits the broker receives on any transaction leads to loss of the entire fee. [Calif. Business and Professions Code §10176(g)]

For example, if the seller enters into a net listing agreement with a real estate broker for a net sales price of $500,000, the broker will not receive a fee if the seller accepts an offer selling the property for $500,000 or less.

On the other hand, if the property sells for $575,000, the broker's fee is $75,000, minus the seller's other transaction costs.

Net listings tend to be unpopular with the Department of Real Estate (DRE) and consumer protection organizations, and have been outlawed in some states, but not California.

Net listings are particularly prone to claims from buyers and sellers that the broker has been involved in misrepresentations and unfair dealings. These claims are generally based on an improper valuation of the property at the time of the listing or a failure to disclose the fee received by the broker when the property sells.

If the seller thinks the broker's fee is excessive, the seller is likely to complain they were improperly advised about the property's *fair market value (FMV)* when employing the broker.

Thus, net listings are used sparingly, if at all. If a net listing is used, sale documentation is to include complete disclosures stating:

- the property's value;
- the price paid by a buyer; and
- the resulting fee amount.

QUIZ

1. The net listing is distinguishable from all other listing arrangements due to:
    a. duration of employment anticipated under the listing.
    b. inherent dual agency status created by the broker's conduct.
    c. the way a broker's compensation is calculated.

2. In a net listing, the broker's fee:
    a. is based on a percentage of the selling price.
    b. is equal to whatever amount the buyer pays in excess of the seller's net figure and closing costs.
    c. is a pre-established fixed dollar amount based on the extent of the broker's marketing activities and how many buyers submit an offer during the term of the listing.

Option listings

An **option listing** is a variation of the exclusive right-to-sell listing.

Its unique feature is the additional element of a grant to the broker of an **option to buy** the property at a predetermined price, if the property does not sell during the listing period.

The broker wears two hats when holding an option listing: one as an agent, and the other as a principal.

The concurrent status of agent and principal is a **conflict of interest** for the broker. Here, the temptation for *misrepresentation* is apparent.

As a result, the seller's broker may fail to market the property aggressively, with a view toward buying it themselves, then reselling it at a profit. Likewise, the broker may neglect to inform the seller about all inquiries into the listed property by potential buyers.

As always, brokers are required to disclose any outstanding offers or other factors affecting the seller's decision to sell when the broker exercises the option. [**Rattray** v. **Scudder** (1946) 28 C2d 214]

The broker's exercise of a purchase option contained in a listing agreement requires the broker to disclose to the seller the full amount of the broker's earnings (profit). Further, they need to obtain the seller's written consent to the earnings before or at the time the broker exercises the option. [Calif. Business and Professions Code §10176(h)]

A dilemma may arise when market prices rapidly increase after the seller's broker exercises their option to purchase, allowing for a quick resale by the broker at a profit. On discovery, the seller may claim the profit is theirs and demand it be paid to them under the belief they have been cheated by the broker.

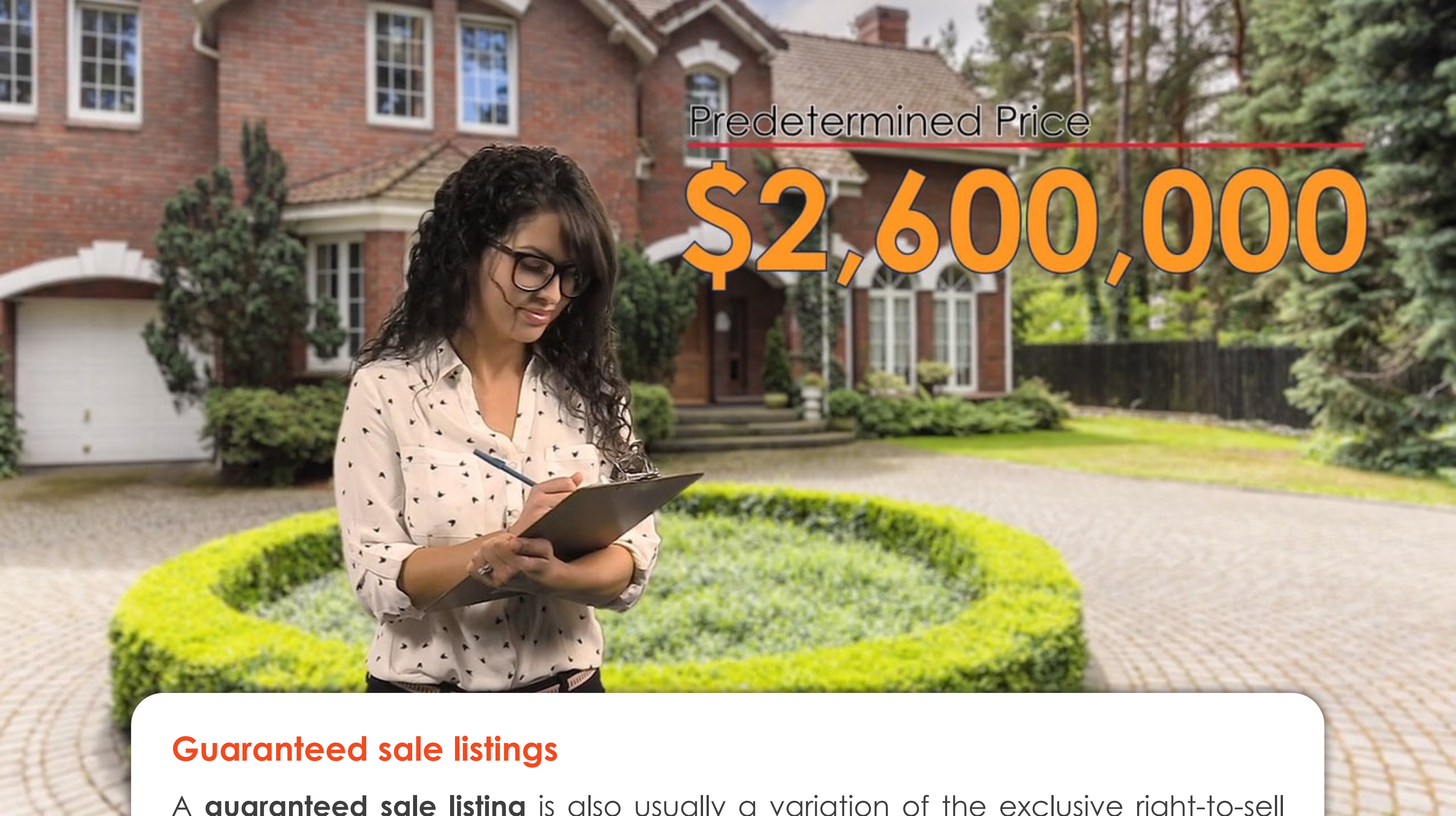
Thus, as with net listings, option listings are to be used with great care, if at all. The option is only exercised after full disclosure by the broker about:

- all material facts relating to the property not known or understood by the seller;
- the identity of all potential buyers and their offers; and
- any market or use conditions relating to the property known to the broker which have a current positive effect on its value.

QUIZ

1. Under an option listing, the broker:
   a. is granted an option to buy the property at a predetermined price if the property does not sell during the listing period.
   b. only has a best-effort obligation to locate a buyer for the property.
   c. grants the seller the option to sell the property to the broker at a predetermined price.

2. The concurrent status of agent and principal under an option listing creates a __________ for the broker.
   a. dual agency situation
   b. conflict of interest
   c. existential crisis



Guaranteed sale listings

A **guaranteed sale listing** is also usually a variation of the exclusive right-to-sell listing. Brokers have been known to use the guarantee feature to boost sales activity during recessionary periods and when inventories of available properties are long.

A *guaranteed sale listing* is distinct from a regular, exclusive right-to-sell listing. Here, the broker grants their seller the option to sell, the broker agreeing to buy, called a *put*. The *seller* is given the right to call on the broker to buy the property at a predetermined price if the property does not sell during the listing period. In this respect, the guaranteed sale listing establishes a reverse role for the seller from the option listing when the property fails to sell during the listing period.

The difference with the guaranteed sale listing is that the seller, not the broker, has the right to exercise the option by accepting the broker's promise to buy the listed property.

The guaranteed sale variation is attractive to sellers who, on account of job transfers, sudden unemployment or other financial factors, are motivated to sell at all costs. The benefit to the seller is the assurance of a back-up, last-resort sale during recessionary periods of market uncertainty — a risk some brokers are willing to take.

As with the option listing, the broker may tend not to work the listing vigorously if the price they have agreed to pay under the guarantee (put option) is much lower than the amount the seller is able to net on a sale at current market prices. Thus, the broker stands to acquire the property at a bargain price if it does not sell during the listing period.

In practice, if a buyer is not produced during the listing period, a desperate seller may have no choice but to sell to the broker. The seller under the exclusive listing has delegated complete control to the broker to locate a buyer.

The broker's advantage, however, is lessened by a DRE regulation which prohibits the inclusion of **advance fee provisions** in a guaranteed sale listing. [Department of Real Estate Regulations §2970(b)(5)]

As always, the broker is required to disclose all offers and the status of potential offers during the listing period and at the time the seller exercises their option to sell to the broker.

QUIZ

1. Under a guaranteed sale listing:

   a. the broker is granted an option to buy the property at a predetermined price if the property does not sell during the listing period.

   b. the seller is given the right to call on the broker to buy the property at a predetermined price if the property does not sell during the listing period.

   c. the amount of the broker's fee is guaranteed to be equal to or greater than a pre-established amount.

2. The guaranteed sale variation is most attractive to sellers who:

   a. would like to sell within one year.

   b. would like to sell within three months.

   c. are motivated to sell at all costs.

Prepared with honesty and in good faith

Condition of Property: the Seller's Disclosures

Mandated on one-to-four residential units

The seller of a one-to-four unit residential property completes and delivers to a prospective buyer a statutory form called a **Transfer Disclosure Statement (TDS)**, more generically called a **Condition of Property Disclosure Statement**. [Calif. Civil Code §§1102(a), 1102.3; see **RPI** Form 304]

The seller's mandated use of the *TDS* requires it be prepared with *honesty and in good faith*, whether or not a seller's agent is retained to review its content. [CC §1102.7]

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

Any conditions known to the seller which might *negatively affect* the value and desirability of the property for a prospective buyer are to be disclosed, even though they may not be an item listed on the TDS. Disclosures to the buyer are not limited to conditions preprinted for comment on the form. [CC §1102.8]

Also, the buyer cannot waive delivery of the statutorily-mandated TDS. Any attempted waiver, such as an "as-is" provision in the purchase agreement, is **void** as against public policy.

Controlled and exempt sellers

Unless a seller is *exempt, sellers of one-to-four unit residential real estate are* *required to fill out and furnish buyers with a statutory TDS when entering into a purchase agreement. [CC §1102]*

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

- by court order, such as probate, eminent domain or bankruptcy;
- by judicial foreclosure or trustee's sale;
- on the resale of real estate owned property acquired by a lender on a deed-in-lieu of foreclosure, or by foreclosure;
- from co-owner to co-owner;
- from parent to child;
- from spouse to spouse, including property settlements resulting from a dissolution of marriage;
- by tax sale;
- by reversion of unclaimed property to the state; and
- from or to any government agency. [CC §1102.2]

The best property disclosure tool for exempt sellers is the preparation and delivery of the statutory TDS form (and a property inspector's report) to prospective buyers or buyer's agents on every type of transaction. If the transaction is exempt or concerns property other than one-to-four residential units, the form as a practical matter needs to be used.

QUIZ

1. The seller of a one-to-four-unit residential property completes and delivers to a prospective buyer a statutory form called a(n) __________, more generically called a Condition of Property Disclosure Statement.

   a. abstract of title

   b. Agency Law Disclosure

   c. Transfer Disclosure Statement (TDS)

2. When preparing the Transfer Disclosure Statement (TDS), the seller discloses:

   a. any property defects known or suspected to exist by the seller.

   b. any conflicts of interest which may alter their dealings with the buyer.

   c. the existence of any financial judgements which may cloud the title to the property.

Delivery of the disclosure statement

While it is the seller who prepares the **Transfer Disclosure Statement (TDS)**, the TDS is delivered to the buyer by the agent who directly receives the purchase agreement offer from the buyer. [See **RPI** Form 304]

The failure of the seller or any of the agents involved to deliver the seller's TDS to the buyer will not invalidate a sales transaction after it has closed. However, the seller and the seller's broker are both liable for the actual monetary losses incurred by the buyer due to an undisclosed defect known to them. [Calif. Civil Code §1102.13]

The TDS is handed to the buyer before the seller accepts a purchase agreement offer submitted by a buyer. If the TDS is delivered to the buyer *after* the seller enters into a purchase agreement, the delivery is untimely in violation of TDS rules, and the buyer may:

- *cancel* the purchase agreement on discovery of undisclosed defects known to the seller or the seller's agent and unknown and unobserved by the buyer or the buyer's agent prior to acceptance; [CC §1102.3]
- *make a demand* on the seller to correct the defects or reduce the price accordingly before escrow closes [See **RPI** Form 150]; or
- *close escrow* and make a demand on the seller for the costs to cure the defects. [**Jue v. Smiser** (1994) 23 CA4th 312]

QUIZ

1. Who prepares the Transfer Disclosure Statement (TDS)?
   a. The seller's agent.
   b. The seller.
   c. The buyer's agent.

2. If the Transfer Disclosure Statement (TDS) is not timely delivered to the buyer:
   a. the closed sale will be invalidated and the buyer and seller returned to their respective positions they held prior to entering into the transaction.
   b. the seller and the seller's broker are both liable for the actual monetary losses incurred by the buyer due to an undisclosed defect known to them.
   c. the seller is liable for three times the amount of the monetary losses incurred by the buyer due to the undisclosed defect, and the seller's broker risks disciplinary action from the Department of Real Estate (DRE).

Include a home inspector

A competent seller's agent will aggressively recommend the seller retain a **home inspector** before they market the property. The inspector hired will conduct a physical examination of the property to determine the condition of its component parts, known as a **home inspection**.

On the home inspector's completion of their examination, a **home inspection report (HIR)** will be prepared on their observations and findings, which is forwarded to the seller's agent.

A **home inspector** often detects and reports property defects overlooked by the seller and not observed during a visual inspection by the seller's agent. Significant defects which remain undisclosed at the time the buyer goes under contract tend to surface during escrow or after closing as claims against the seller's broker for deceit. A home inspector troubleshoots for defects not observed or observable to the seller's agent's eye. [Calif. Business and Professions Code §7195]

To greatly reduce the potential of buyer claims, and eliminate to the extent possible the risk of negligent property improvement disclosures, the HIR is coupled with preparation of the seller's TDS. Both are presented to buyers before the seller accepts an offer.

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.

The inspection and report

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

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

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

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. [Bus & P C §7195(b)]

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. [Bus & P C §7195(a)(1)]

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. [Bus & P C §7195(c)]

QUIZ

1. A home inspector's primary function is to:

   a. inspect a property to arrive at an informed opinion of its fair market value (FMV) which will form the ceiling for what the buyer will offer for the property.

   b. determine whether any natural hazards pose a significant risk to the property, such as flooding or excessive fire risks.

   c. conduct a physical examination of a property to determine the condition of its component parts.

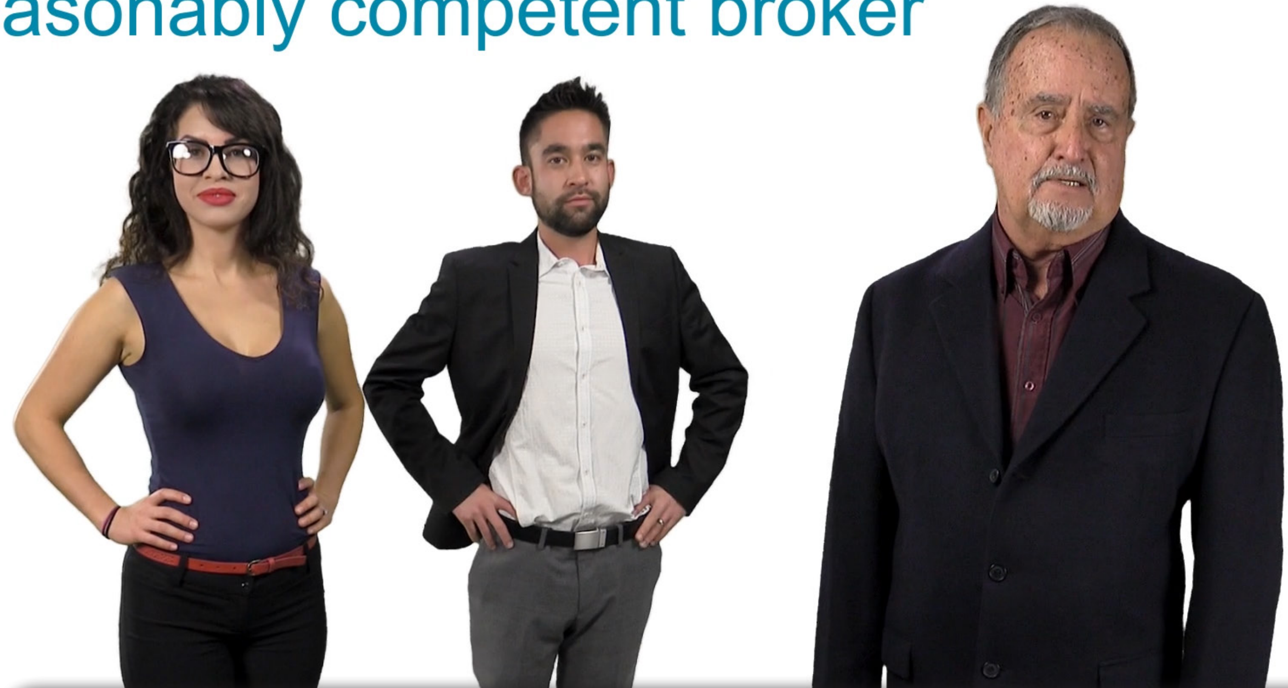
2. On a home inspector's completion of their examination, a(n) __________ is prepared on their observations and findings.

   a. appraisal report

   b. home inspection report (HIR)

   c. Transfer Disclosure Statement (TDS)

reasonably competent broker

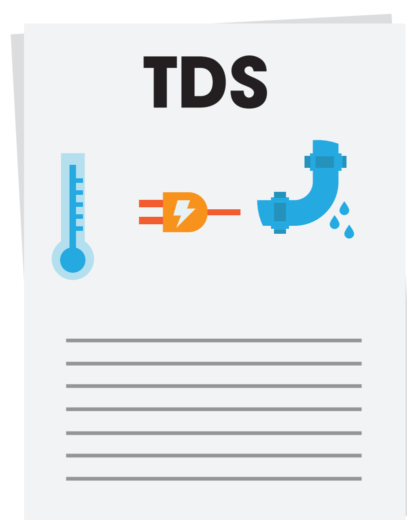


Mandatory inspection by the seller's broker

A seller's agent (or seller's broker) is obligated to personally carry out a competent *visual inspection* of the property. The seller's disclosures and defects noted in the home inspection report (HIR) are entered on the Transfer Disclosure Statement (TDS) and reviewed by the seller's agent for discrepancies. [See **RPI** Form 304]

The seller's agent then adds any information about their knowledge of material defects which have gone undisclosed by the seller (or the home inspector).

A buyer has *two years* from the close of escrow to pursue the seller's broker and agent to recover losses caused by the broker's or agent's *negligent failure* to disclose observable and known defects affecting the property's physical condition and value. Undisclosed and unknown defects permitting recovery are those observable by a **reasonably competent** broker during a visual on-site inspection. A seller's agent is expected to be as competent as their broker in an inspection. [Calif. Civil Code §2079.4]



However, the buyer will be unable to recover their losses from the seller's broker if the seller's broker or agent inspected the property and would not have observed the defect and did not actually know it existed. [CC §1102.4(a)]

Following their mandatory visual inspection, the seller's broker or agent needs to make disclosures on the seller's TDS in full reliance on *specific items* covered in a home inspector's report the seller obtained on the property. If the HIR is relied on after the seller's agent property inspection when preparing the TDS and the TDS is later contested by the buyer as incorrect or inadequate in a claim on the broker, the broker and their agent are entitled to indemnification – held harmless – from the home inspection company issuing the report. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

QUIZ

1. A seller's agent is obligated to personally carry out a(n) __________ of the property they list.

   a. preliminary title search

   b. competent visual inspection of the property

   c. invasive mechanical inspection

2. A buyer has __________ from the close of escrow to pursue the seller's broker to recover losses caused by the broker's negligent failure to disclose observable and known defects affecting the property's physical condition and value.

   a. one year

   b. two years

   c. five years

Ground Transportation Arteries

Environmental Hazards and Annoyances

Noxious man-made hazards

Environmental hazards are noxious or annoying conditions which are **man-made hazards**, not natural hazards. As *environmental hazards*, the conditions are classified as either:

- **injurious** to the health of humans; or
- an **interference** with an individual's sensitivities.

In further analysis, environmental hazards which affect the occupant in **use and enjoyment** of the property are either:

- located on the property; or
- originate from sources located elsewhere.

Hazards on the property

Environmental hazards **located on the property** which pose a direct health threat on occupants due to construction materials, the design of the construction, the soil or its location, include:

- *asbestos-containing* building materials and products used for insulation, fire protection and the strengthening of materials [Calif. Health and Safety Code §§25915 et seq.];
- *formaldehyde* used in the composition of construction materials [Calif. Civil Code §2079.7(a); Calif. Business and Professions Code §10084.1];

- *radon gas* concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium [CC §2079.7(a); Bus & P C §10084.1];
- *hazardous waste* from materials, products or substances which are **toxic**, **corrosive**, **ignitable** or **reactive** [Health & S C §25359.7; Bus & P C §10084.1];
- *toxic mold*; [Health & S C §§26140, 26147]
- *smoke* from the combustion of materials, products, supplies or substances located on or within the building [Health & S C §§13113.7, 13113.8];
- *security bars* which might interfere with an occupant's ability to exit a room in order to avoid another hazard, such as a fire [CC §1102.16; Health & S C §13113.9]; and
- *lead*.

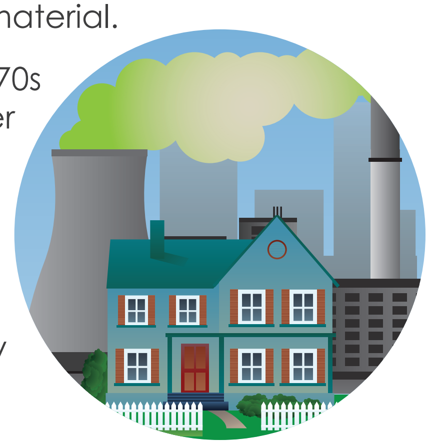
Environmental hazards **located off the property**, but which have an adverse effect on the use of the property due to noise, vibrations, odors or some other ability to inflict harm, include:

- *military ordnance* sites within one mile of the property [CC §1102.15];
- *industrial zoning* in the neighborhood of the property [CC §1102.17];
- *airport influence* areas established by local airport land commissions [CC §§1103.4(c), 1353; Bus & P C §11010(b)(13); see **RPI** Form 308]; and
- *ground transportation* arteries which include train tracks and major highways in close proximity to the property.

Formaldehyde gas emissions

Formaldehyde is a colorless, pungent gas contained in most organic solvents which are used in paints, plastics, resins, pressed-wood fiberboard materials, urea-formaldehyde foam insulation (UFFI), curtains and upholstery textiles. Gas emitted from these materials and products contains *formaldehyde*.

Formaldehyde is a *probable carcinogen* which is likely to cause cancer in humans who inhale the gas emitted by formaldehyde-containing material.



The use of UFFI occurred in construction during the 1970s and was banned in residential property constructed after 1982. However, formaldehyde emissions decrease over time. As a result, properties built during the 1970s and early 1980s with formaldehyde-containing materials give off levels of formaldehyde no greater than newly constructed homes. Over time, emissions decrease to undetectable levels. However, an increase in humidity and temperature will increase the level of emissions.

Radon gas in soil

Radon is a naturally-occurring radioactive gas. It is not visible, cannot be tasted and has no odor. **Radon gas** is located in soils with a concentration of uranium in the rock, e.g., granite or shale, beneath it.

Radon is a known human carcinogen and enters a building from the soil beneath the structure.

Radon is sucked into ground floor residential space by interior heating on cold weather days and the use of exhaust fans in the kitchen and bathrooms since these conditions create a vacuum within the lower area of the structure.

However, California residences rarely experience elevated and harmful levels of radon gas emission. Radon does appear in approximately **one percent of housing** in California. Proper ventilation avoids the buildup of harmful concentrations of radon in a home or other enclosed space, a function of its design and operation.

Hazardous waste on site

Waste is hazardous if it has the potential to harm human health or the environment. **Hazardous waste** is released into the environment, primarily the soil, by the leaking of underground storage tanks, drum containers, poorly contained landfills or ponds, accidental spills or illegal dumping.

Hazardous waste materials include any product, material or substance which is **toxic**, **corrosive**, **ignitable** or **reactive**, such as is generated by oil, gas, petrochemical and electronics industries, and dry cleaner and print shops.

Information is available to prospective buyers on their inquiry into the location and status of hazardous waste sites in the vicinity of a home from the "Cortese list" maintained by the California Environmental Protection Agency (EPA).

Mold: the rogue in vogue

Mold produces spores which become airborne. There are many different kinds of spores, each having differing effects, if any, on humans. Some may be a mere annoyance, irritating the sensitivities of an individual. Others might be a threat to the health of those who inhale them.

The uncertainty of the toxic nature of mold spores has led to a sort of intellectual moratorium on determining just what kinds of molds have an adverse or harmful effect on humans.

It has also spawned a number of lawsuits as the unknown nature of "toxic mold" has been allowed by politicians and lawyers to stir the fears of the general public.

Sellers are under no obligation to investigate whether the improvements contain mold. If it is known the structure does contain mold, the seller has no obligation to determine if the mold is a threat to human health.

The DHS has not yet set any **standards** for disclosures regarding the existence of mold or **guidelines** for the remediation of mold threats. However, the DHS has published multiple **consumer-oriented booklets** on mold on its website at www.cdph.ca.gov.

Until uniform disclosure standards are produced and implemented, the prospective buyer will receive only a generic informational brochure and a writing from the seller and the seller's agent in the form of a TDS advising the buyer of any awareness or knowledge the seller or the seller's agent may have that mold exists on the property. No common knowledge exists for sellers or seller's agents to visually distinguish between harmful and benign molds.

If the seller is aware of mold, regardless of type, the seller is to disclose any awareness of the mold's existence, as well as any other reports or knowledge about the variety of mold which exists.

QUIZ

1. __________ are noxious or annoying conditions which are man-made hazards.
   a. Natural hazards
   b. Environmental hazards
   c. Moral hazards

2. Environmental hazards which may affect an occupant's use and enjoyment of a property:
   a. may be located on the property.
   b. may originate from sources located off the property.
   c. Both a. and b.

Visual inspection and method of disclosure

Environmental hazards have an **adverse effect** on a property's value and desirability. Thus, they are considered defects which, if known, are disclosed as **material facts**: the hazards might affect a prospective buyer's decision to purchase the property.

The disclosure to prospective buyers of environmental hazards related to a property known to a seller and seller's agent is required on the sale, exchange or lease of all types of property.

While the disclosure of an environmental hazard is the obligation of the seller, it is the seller's agent who has the agency duty of care and protection owed to the seller to place them in compliance with the environmental hazard disclosure requirements.

Further, and more critically, the seller's agent also has an additional, more limited duty owed to prospective buyers of the listed property. The seller's agent on taking a listing will personally conduct a *visual inspection* of the property for environmental hazards (as well as physical defects), and do so with a level of competence equal to that of their broker. In turn, the seller's agent uses a **Transfer Disclosure Statement (TDS)** form to advise prospective buyers of their observations (and knowledge) about conditions which constitute environmental hazards. [Calif. Civil Code §2079; see **RPI** Form 304]

Further, a seller's agent uses **RPI** Form 308 to disclose the existence of unique environmental factors or conditions that were not referenced in the boilerplate language of the TDS which may adversely affect the property or its immediate vicinity, such as the close proximity of an industrial use zone. [See **RPI** Form 308]

To conclude the seller's agent's disclosure of environmental hazards and eliminate any further duty to advise the prospective buyer about the environmental hazards, the seller's agent delivers, or confirms the buyer's agent has delivered a copy of the **environmental hazard booklet** approved by the California Department of Health and Safety (DHS) to the buyer. Delivery of the booklet is confirmed in writing through a provision in the purchase agreement. [See **RPI** Form 150 §12.6; See **RPI** Form 316-1]

Included in the booklet is a discussion about the significance of hazardous materials and conditions, and tips for identifying, locating and mitigating the hazards. Also discussed are the symptoms experienced by humans that result from the hazards.

Delivery of the booklet — by hand or digitally — in conjunction with the TDS and its factual disclosures concludes the seller's agent's disclosure of **environmental hazards** and eliminates any further duty they have to advise the prospective buyer about the existence of environmental hazards. [CC §2079.8]

Thus, when a hazardous condition disclosed in the TDS is addressed in the booklet, the disclosure of the condition in the TDS together with the booklet covers the extent to which the seller's agent goes to provide a full disclosure about the existence and nature of that hazardous condition. For the purposes of the seller's side of the transaction, the agent and seller need to say nothing more to the buyer beyond timely providing them the TDS and the booklet to make the disclosures, unless the buyer inquires further — which requires an honest and complete response.

While the timely disclosure of an *environmental hazard* is the obligation of the seller, it is the seller's agent who has the **agency duty** of care and protection owed to their seller to see to it the seller is in compliance with the environmental hazard disclosure requirements.

The buyer's agent's review as their risk mitigation

When the seller or seller's agent have not provided the buyer with the hazards booklet, the buyer's agent may deliver it to the buyer themselves. The preparation and delivery of the TDS are the exclusive domain of the seller, and in turn the seller's agent.

While the seller's agent is required to provide the buyer with the mandatory TDS, the seller's agent has **no duty to discuss** the effect of the hazards with the buyer after the documents have been delivered, unless the buyer inquires.

The buyer's agent reviews the booklet's explanation of the disclosed hazards with the buyer and notes the consequences of the hazards.

On delivery of the TDS by the seller's agent, it becomes the duty of the buyer's agent to point out the hazards disclosed. They then **review** the booklet's explanation of the disclosed hazards with the buyer, noting the consequences of the hazards and counseling the buyer on the alternatives available to mitigate the hazards should they make an offer to acquire the property.

Simply handing the buyer the booklet without directing attention to the specific contents of the booklet that directly relate to the hazard located on the subject property is insufficient.

Further, the buyer's agent's discussion about environmental hazards with the buyer provides the buyer with information necessary for setting the price and terms of any offer the buyer will make to acquire the property.

Method of disclosure

The *TDS* and *environmental hazard booklet* is delivered by the seller's agent at the time a prospective buyer inquires further about a listed property. Alternatively, a counter offer may be needed to make the additional disclosures covered by purchase agreement provisions.

Some environmental hazards are itemized in the TDS, such as a direct reference to hazardous construction materials and waste, window security bars and release mechanisms, and an indirect reference to environmental noise. [See **RPI** Form 304 §§A and C]

All other known environmental hazards are added by separate itemization in the TDS. As for environmental hazards emanating from off-site locations, they are disclosed through provisions in the purchase agreement since they are typically known to buyer's agents who are familiar with the area. [See **RPI** Form 150 §12.7]

*Editor's note — The environmental hazard booklet is not a disclosure of known defects on the property. The booklet merely contains general information on a few environmental hazards, none of which might actually exist on the property. [See **RPI** Form 316-1]*

Regardless of the method of delivery, the seller's agent is to give the environmental hazard disclosures to the prospective buyer as soon as practicable, meaning **as soon as reasonably possible**. As with the disclosure of natural hazards, the legislature intended for the environmental hazard disclosures to be made prior to entry into a purchase agreement. [Attorney General Opinion 01-406 (August 24, 2001)]

QUIZ

1. On delivery of the Transfer Disclosure Statement (TDS) by the seller's agent, it becomes the primary duty of the __________ to point out and discuss the hazards disclosed with the buyer.

    a. buyer's agent

    b. seller's agent

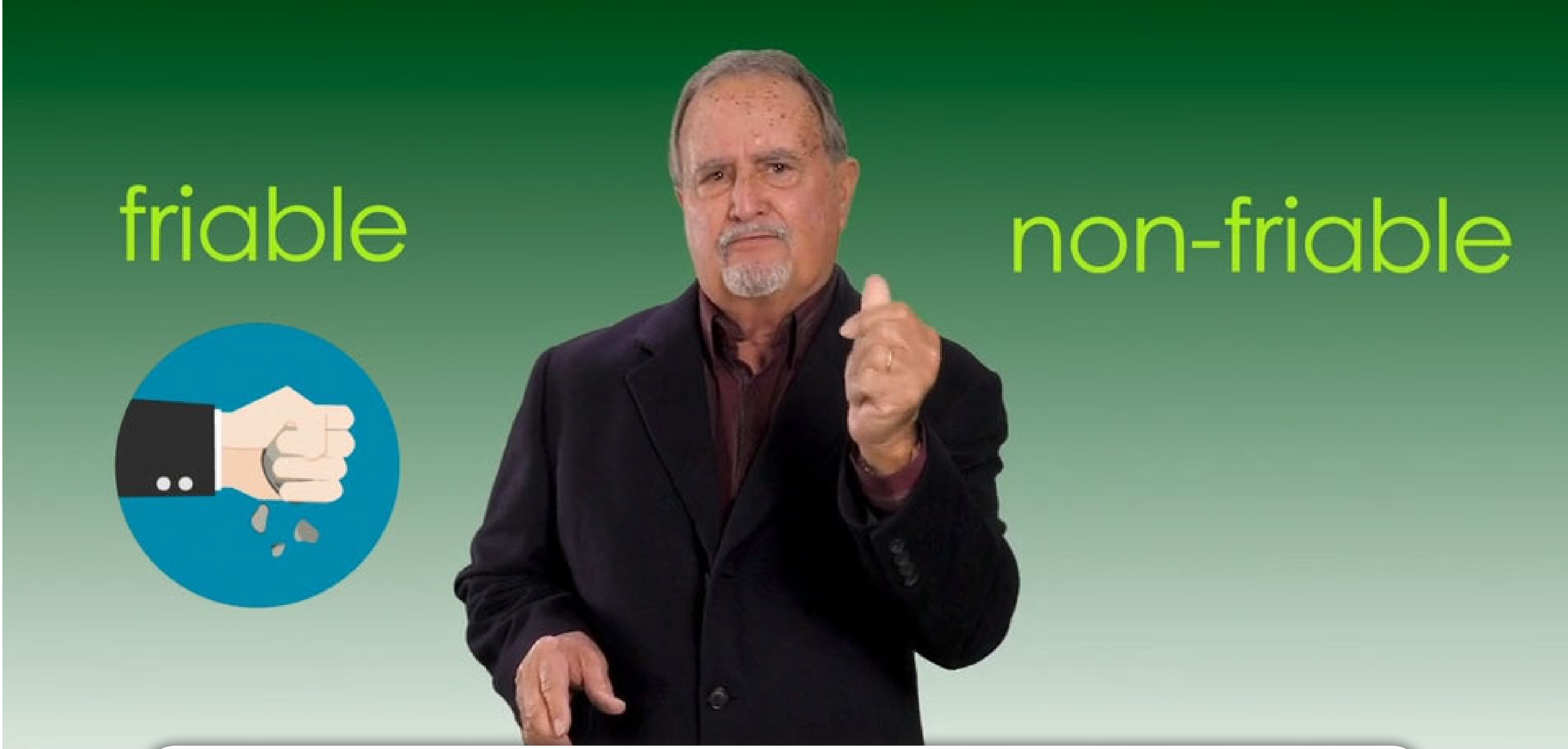
    c. Both a. and b.

2. As a matter of best practices, a seller's agent is to give the environmental hazard disclosures to the prospective buyer:

    a. as soon as practicable after the close of escrow.

    b. after a purchase agreement offer has been submitted to the seller.

    c. as soon as reasonably possible.



Asbestos in construction materials

Asbestos is any of a diverse variety of *fibrous mineral silicates* which are commercially mined from natural deposits in the earth. In the 1940's manufacturers began mixing asbestos fibers with substances commonly used to produce materials for the construction of residential and non-residential real estate improvements. [Health & S C §25925]

However, asbestos is a known **carcinogen**. As an occupant of a building continues to inhale asbestos fiber, they increase their risk of developing negative health conditions.

Construction materials which contain *friable asbestos* are those that can be crumbled, pulverized or reduced to powder by hand pressure when dry.

Construction materials which contain *non-friable* asbestos cannot be crushed by hand pressure. Of course, on the removal of stucco or plaster, the asbestos

may **become friable** since the material is disturbed and broken down for removal, creating particles which may become airborne and inhaled.

The seller of a property constructed with asbestos-containing building materials is under no obligation to investigate or have a survey conducted to determine the existence of asbestos on the property — whether friable or non-friable.

Further, the seller is not obligated to remove or clean up any adverse asbestos condition. However, the condition, if known, **will be disclosed**. As a result, a prospective buyer may well condition the purchase of a property containing friable asbestos on its clean up and removal by the seller.

QUIZ

1. __________ is any of a diverse variety of fibrous mineral silicates and is a known carcinogen which can increase the risk of developing a negative health condition if inhaled.

   a. Formaldehyde

   b. Lead-based paint

   c. Asbestos

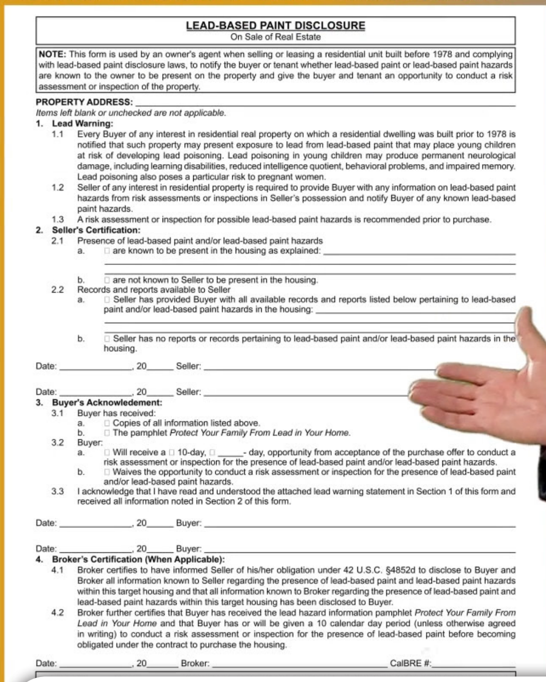
2. The seller of a property constructed with asbestos-containing building materials:

   a. needs to provide the buyer with a list of vendors who can remove or clean up the adverse asbestos condition.

   b. is obligated to mitigate the potential negative health effects caused by friable asbestos, though need not disclose the presence of non-friable asbestos.

   c. is under no obligation to remove or clean up any adverse asbestos condition, though must disclose it.

Lead-Based Paint Disclosure



LEAD-BASED PAINT DISCLOSURE
On Sale of Real Estate

NOTE: This form is used by an owner's agent when selling or leasing a residential unit built before 1978 and complying with lead-based paint disclosure laws, to notify the buyer or tenant whether lead-based paint or lead-based paint hazards are known to the owner to be present on the property and give the buyer and tenant an opportunity to conduct a risk assessment or inspection of the property.

PROPERTY ADDRESS: ________________

Items left blank or unchecked are not applicable.

1. **Lead Warning:**
   1.1 Every Buyer of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women.
   1.2 Seller of any interest in residential property is required to provide Buyer with any information on lead-based paint hazards from risk assessments or inspections in Seller's possession and notify Buyer of any known lead-based paint hazards.
   1.3 A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.
2. **Seller's Certification:**
   2.1 Presence of lead-based paint and/or lead-based paint hazards
      a. ☐ are known to be present in the housing as explained: ________________
      b. ☐ are not known to Seller to be present in the housing.
   2.2 Records and reports available to Seller
      a. ☐ Seller has provided Buyer with all available records and reports listed below pertaining to lead-based paint and/or lead-based paint hazards in the housing: ________________
      b. ☐ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Date: ____________, 20_____ Seller: ________________

Date: ____________, 20_____ Seller: ________________

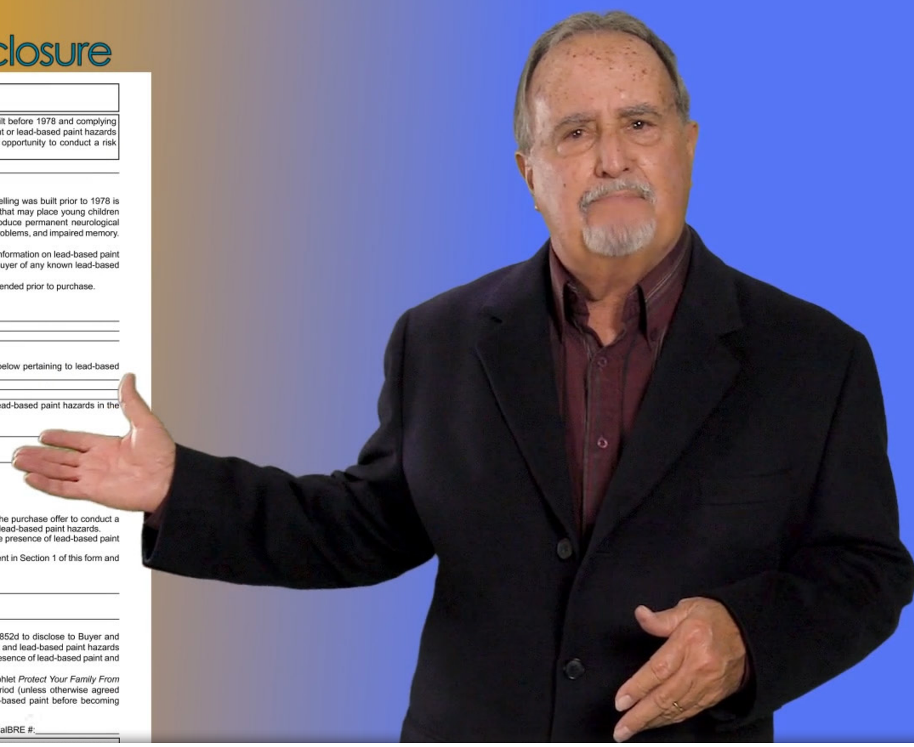
3. **Buyer's Acknowledement:**
   3.1 Buyer has received:
      a. ☐ Copies of all information listed above.
      b. ☐ The pamphlet *Protect Your Family From Lead in Your Home.*
   3.2 Buyer:
      a. ☐ Will receive a ☐ 10-day, ☐ _____- day, opportunity from acceptance of the purchase offer to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.
      b. ☐ Waives the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.
   3.3 I acknowledge that I have read and understood the attached lead warning statement in Section 1 of this form and received all information noted in Section 2 of this form.

Date: ____________, 20_____ Buyer: ________________

Date: ____________, 20_____ Buyer: ________________

4. **Broker's Certification (When Applicable):**
   4.1 Broker certifies to have informed Seller of his/her obligation under 42 U.S.C. §4852d to disclose to Buyer and Broker all information known to Seller regarding the presence of lead-based paint and lead-based paint hazards within this target housing and that all information known to Broker regarding the presence of lead-based paint and lead-based paint hazards within this target housing has been disclosed to Buyer.
   4.2 Broker further certifies that Buyer has received the lead hazard information pamphlet *Protect Your Family From Lead in Your Home* and that Buyer has or will be given a 10 calendar day period (unless otherwise agreed in writing) to conduct a risk assessment or inspection for the presence of lead-based paint before becoming obligated under the contract to purchase the housing.

Date: ____________, 20_____ Broker: ________________ CalBRE #: ________



Lead-based paint hazards

Lead-based paint, defined as any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight, was banned by the Federal Consumer Product Safety Commission in 1978. [24 CFR §35.86; 40 CFR §745.103]

A **lead-based paint hazard** is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [24 CFR §35.86; 40 CFR §745.103]

An agent, prior to meeting with the owner to list an older single family residence (SFR) property for sale, gathers facts about the property, its ownership and its likely market value.

As the first step, the agent pulls a *property profile* on the SFR from a title company website. On receipt of the profile, the agent confirms their suspicion that the structure was built **prior to 1978**. The agent is now aware the property is the target of separate state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of **lead-based paint**.

The agent meets with the owner to review the requisite **listing and marketing** requirements laid down by the agent's broker. To prepare for the meeting, the agent fills out the listing agreement and attaches all the information disclosure forms needed to properly market the property and locate a buyer, called a **listing package**.

Disclosed on two forms

Among other informational forms for this pre-1978 SFR property, the agent includes two forms which address lead-based paint conditions on the property:

- the **Federal Lead-based Paint (LBP) disclosure** [See **RPI** Form 313]; and
- the California **Transfer Disclosure Statement (TDS)**. [See **RPI** Form 304]

On review of the listing agreement with the owner, the agent explains the **owner's legal obligation**, owed to prospective buyers and buyer's agents, to provide them with all the information:

- known to the owner or readily available to the owner's agent on observation or inquiry; and
- which might adversely affect the value of the property.

A full disclosure to the prospective buyer about adverse conditions on the property does not entail a review or explanation by the seller's agent about their effect on the buyer or the property once the facts are disclosed. Application of the facts disclosed and the potential consequences flowing from the facts which may affect the prospective buyer's use, possession or ownership of the property are not among the seller's agent's duties of affirmative disclosure.

Seller's agent insures compliance

However, federal LBP rules do require the seller's agent to advise the owner about the requirements for disclosures to be made to prospective buyers before they enter into a purchase agreement. It is the seller's agent who insures compliance by the owner before entering into a purchase agreement.

*Editor's note — The owner has no obligation to have the property inspected or a report prepared on the presence of lead-based paint or any lead-based paint hazards. Also, the owner need not perform any **corrective work** to clean up or even eliminate the lead-based paint conditions, unless agreed to with the buyer. [24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)]*

Thus, the owner cooperates in the LBP disclosure and their agent's other marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential construction [See **RPI** Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See **RPI** Form 304];
- making a physical home inspection report available to prospective buyers as an attachment to the TDS form; and

- providing the seller's agent with copies of any reports or documents containing information about lead-based paint or lead-based paint hazards on the property.

Opportunity to evaluate risk

A prospective buyer of a residence built prior to 1978 is put on notice of LBP conditions by handing them the disclosure forms before they make an offer. The disclosures advise them they have a *10-day period* after their offer is accepted to evaluate the lead-based paint risks involved. When timely disclosed, the buyer may not later, when under contract, use the existence of lead-based paint as justification for cancellation.

The buyer may agree to a *lesser period* of time or simply waive all their rights to the federally permitted risk evaluation period. However, disclosures about the SFR property cannot be waived by the use of an "as-is" sale provision or otherwise. [40 CFR §745.110(a); see **RPI** Form 313]

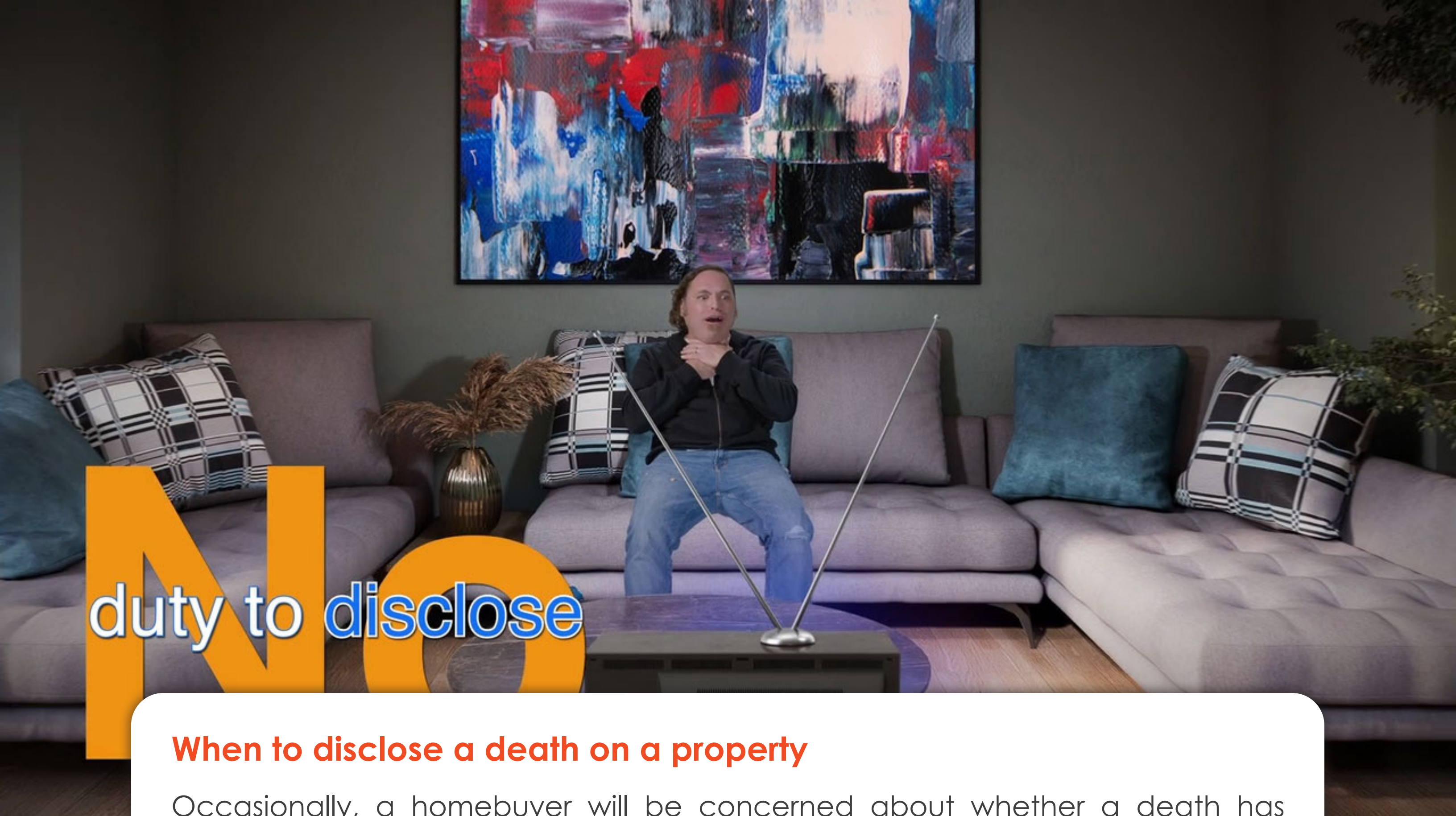
QUIZ

1. A(n) __________ is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects.

   a. lead-based insulation hazard
   b. lead-based paint hazard
   c. natural hazard

2. What is the date which controls whether a property is the target of state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of lead-based paint?

   a. 1968.
   b. 1978.
   c. 1988.



When to disclose a death on a property

Occasionally, a homebuyer will be concerned about whether a death has occurred on the property. To these homebuyers, a death on the property is a **material defect** in the suitability of the property, regardless of when it occurred.

The **manner of death** makes a difference to the property's market value for some homebuyers. Some types of death, such as a murder or suicide, carry heavier stigmas than, say, an elderly occupant who died of natural causes.

A death occurring on a property, and the manner of the death, are always **material facts** to be disclosed to potential homebuyers when:

- the death occurred within three years prior to the date of the homebuyer's offer to purchase; and
- the death affects the property's value or desirability to the homebuyer. [Calif. Civil Code §1710.2]

However, neither the seller nor the agents are required to disclose that an occupant of the property was afflicted with *AIDS*, regardless of when the death occurred. [CC §1710.2(a)]

Thus, for a death occurring on the property more than three years before the date of the homebuyer's offer to purchase, neither agent owes an affirmative duty to voluntarily disclose information regarding a prior occupant whose death, from any cause, occurred on the property.

Consider a seller's agent employed by a seller who locates a buyer for the seller's real estate. Prior to making an offer, the seller's agent hands the buyer the seller's **Transfer Disclosure Statement (TDS)**. The TDS discloses the seller's and agent's knowledge about the present physical condition of the property. [See **RPI** Form 304]

All other mandatory property and transaction disclosures are made.

The buyer does not inquire into any deaths which might have occurred on the property. Ultimately, the buyer acquires and occupies the property.

Later, the buyer is informed a prior occupant died on the property from AIDS more than three years before the buyer submitted their purchase offer. The buyer would not have purchased the property had they known about this event.

The buyer discovers the seller's agent knew of the prior occupant's death on the property resulting from AIDS. The buyer claims the seller's agent breached their agency duties by failing to voluntarily disclose the death to the buyer.

Did the seller's agent breach their general agency duty to the buyer by failing to disclose the death on the property occurring more than three years before the buyer submitted their offer?

No! The seller's agent has **no affirmative duty** to voluntarily disclose information to a potential buyer regarding a prior occupant:

- whose death, from any cause, occurred on the real estate more than three years prior to the purchase offer; or
- who was afflicted with the HIV virus or AIDS. [CC §1710.2(a)]

*Editor's note — Deaths on the property which occurred **within three years** of the offer are treated differently.*

Deaths affecting market value

An agent's duty to disclose material facts known to them is not limited to disclosures of the property's physical condition.

Consider a buyer who enters into a purchase agreement negotiated by an agent, acting either as the buyer's agent or the seller's agent. The offer includes the seller's TDS about the condition of the property. However, the buyer is unaware multiple **gruesome murders** occurred on the property more than *three years* before the buyer's purchase offer.

The agent *conceals their knowledge* of the murders from the buyer. The agent is aware that the notoriety of the murders **adversely affects** the market value of the property, placing its value below the price the buyer is agreeing to pay.

The transaction closes and the buyer occupies the property. After, the buyer learns of the murders and sues the agent to collect their *price-to-value money losses*. The buyer claims the agent had a duty to disclose the deaths since the agent knew the property's market value, due to the stigma surrounding the deaths, was measurably lower than the purchase price paid.

The agent claims they do not have a duty to disclose the deaths since they occurred over three years ago and were not required to be disclosed on the TDS.

Did the agent have an affirmative duty to disclose the deaths?

Yes! The deaths had an *adverse effect* on the property's market value and were **material facts** intentionally concealed from the buyer.

Thus, both the buyers and seller's agent have an affirmative duty to disclose prior deaths when the death might affect the buyer's valuation or desire to own the property. [**Reed** v. **King** (1983) 145 CA3d 261]

Desirability based on events within three years

Consider a buyer's agent who is aware a death occurred on the real estate *within three years* of a buyer's purchase offer.

The value of the property is not adversely affected by the death. Thus, the death is not a material fact about the property which otherwise needs to be disclosed.

The buyer does not ask their agent whether any deaths have occurred on the property. After closing, the buyer learns of the death and is deprived of the pleasurable use and enjoyment of the property. The buyer's attitude about death is an *idiosyncrasy* which was unknown to their agent.

The buyer claims their agent breached their agency duty by failing to disclose the death since it inflicted an intangible harm on the buyer, preventing them from enjoying the real estate.

Should the buyer's agent have disclosed the existence of the death?

Yes! The death occurred *less than three years ago* so the buyer's agent was required to disclose.

Further, and as a matter of prudent practice, the buyer's agent ought to determine when a known death might affect the buyer's decision to purchase the property — regardless of when the death occurred.

Remember, a buyer's agent has a *greater agency duty of care* to protect the buyer than does the seller's agent.

Thus, a buyer's agent discloses any death occurring on the property within three years or otherwise, especially when they believe the death might affect the buyer's decision to make a purchase agreement offer.

It is the buyer's agent's duty to *investigate and disclose* material facts about the property and the transaction. Thus, a greater burden is placed on the buyer's agent to know and understand their client, known colloquially as the **know-your-client** rule.

Conversely, buyers have a duty of care owed to themselves. Buyers themselves have a duty to inquire and discover facts readily available to them or their agent in an effort to protect their own personal interests.

QUIZ

1. A seller's agent has no affirmative duty to voluntarily disclose a prior occupant's death which occurred on the real estate more than __________ prior to the purchase offer.

   a. one year

   b. two years

   c. three years

Natural Hazard Disclosures

Introducing the Natural Hazard Disclosure (NHD) Statement

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

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones. [Calif. Civil Code §1103(c)]

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

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

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

Every agent aspires to be fully employed and working for good clients. Thus, the clients and the agent will both succeed in closing real estate transactions. The client's property and its surrounding environment are the focal point, the hub, from which all broker employment activities emanate.

For every party in any real estate related transaction to do well, it is critical that all data and information about a property cannot be limited in its quality, quantity and timing of release by the listing or leasing agent representing the property owner. A flood of property information is not a hazard in this occupation, but is the beneficial antithesis of stark, reluctant releases of information to interested buyers. Reluctance to disclose upfront is a risk that is inconsistent with all the current and long-term aspirations of an agent providing real estate services as it interferes with closing and invites litigation. Simply put, hoarding property information is *counterproductive* and *wrong*.

Sellers of one-to-four unit residential property and their agents have an affirmative duty to disclose their knowledge about the existence of **natural hazards** to a prospective buyer at the earliest possible opportunity – when the buyer starts asking questions which demonstrate an interest in buying the property.

Natural hazards come with the location of a parcel of real estate, not with the man-made aspects of the property such as those covered in a **transfer disclosure statement (TDS)**. [See **RPI** Form 304]

Man-made hazards are classified as **environmental hazards**.

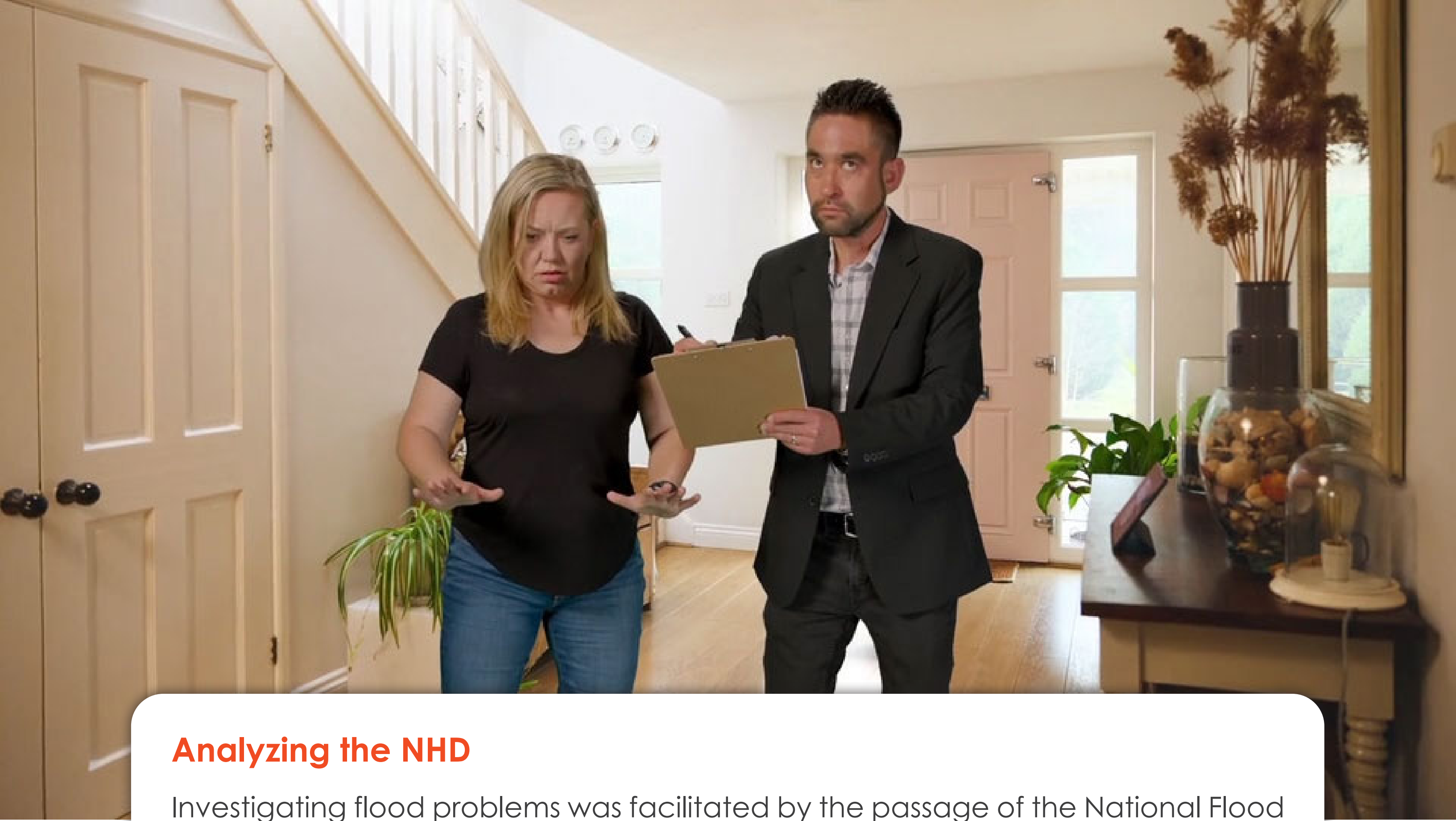
QUIZ

1. Which of the following statements does NOT accurately describe the Natural Hazard Disclosure (NHD) Statement?

    a. The NHD discloses the presence of asbestos-containing building materials and products used for insulation, fire protection and the strengthening of materials.

    b. The statutory NHD form was created by the California legislature to unify and streamline the disclosure of natural hazards by a seller and the seller's agent.

    c. The exact wording of the NHD form is identical regardless of who publishes it, and where in California it is used.



Analyzing the NHD

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP). The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a **special flood hazard area** and is to be disclosed as a natural hazard on the NHD Statement. [See **RPI** Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; and

- the U.S. Corps of Engineers.

Another flooding disclosure which needs to be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See **RPI** Form 314 §2]

An area of potential flooding is a location subject to partial flooding when sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Office of Emergency Services. [Calif. Government Code §8589.5(a)]

Once alerted by the seller's agent to the existence of a flooding condition, the buyer's agent is to inquire further to learn the significance of the disclosure to the buyer.

Disclosure of very high fire hazard severity zones

Areas in the state which are subject to significant fire hazards have been identified as very high fire hazard severity zones. When a property is located in a **very high fire hazard severity zone**, a disclosure needs to be made to the prospective buyer. [See *RPI* Form 314 §3]

The city, county or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction. [Calif. Government Code §51179]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller nor the seller's agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the buyer on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the buyer's agent, when they have an agent.

State Fire Responsibility Area

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a **State Fire Responsibility Area**. [Calif. Public Resources Code §4125(a)]

Notices identifying the location of the map designating *State Fire Responsibility Areas* are posted at the offices of the county recorder, county assessor and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county needs to be posted. [Pub Res C §4125(c)]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller or the seller's agent is to disclose this fact. When the property is located in a wildland area, it requires maintenance by the owner to prevent fires. [Pub Res C §4136(a); see **RPI** Form 314 §4]

In addition, the NHD Statement advises the prospective buyer of a home located in a *wildland area* that the **state has no responsibility** for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or seller's agent. [See **RPI** Form 314 §4]

However, when property disclosures place the property in a wildland area, the buyer's agent has the duty to advise the buyer about the need to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones and seismic hazards

To assist seller's agents in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available which identify special studies zones, called **Alquist-Priolo Maps**. [Calif. Public Resources Code §2622]

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

Also, the NHD Statement requires both the seller and the seller's agent to disclose to a prospective buyer or the buyer's agent whether they have knowledge the property is in a fault zone. [See **RPI** Form 314 §5]

A **Seismic Hazard Zone** map identifies areas which are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides [Pub Res C §2692(a)];
- tsunamis [Pub Res C §2692.1];
- dam failures. [Pub Res C §2692(c)]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the seismic hazard zone disclosure on the NHD Statement is to be marked "Yes."

[See RPI Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show *Alquist-Priolo* Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

If the NHD indicates a seismic hazard, the buyer's agent is to then determine which type of hazard, the level of that hazard and explain the distinction to the buyer, or be certain someone else does. The seller's agent has no such affirmative obligation to explain the impact of the disclosures to the buyer.

QUIZ

1. Areas with a 1% chance of flooding in any given year are disclosed in the Natural Hazard Disclosure (NHD) Statement and are classified as a(n):

   a. area of potential flooding.

   b. special flood hazard area.

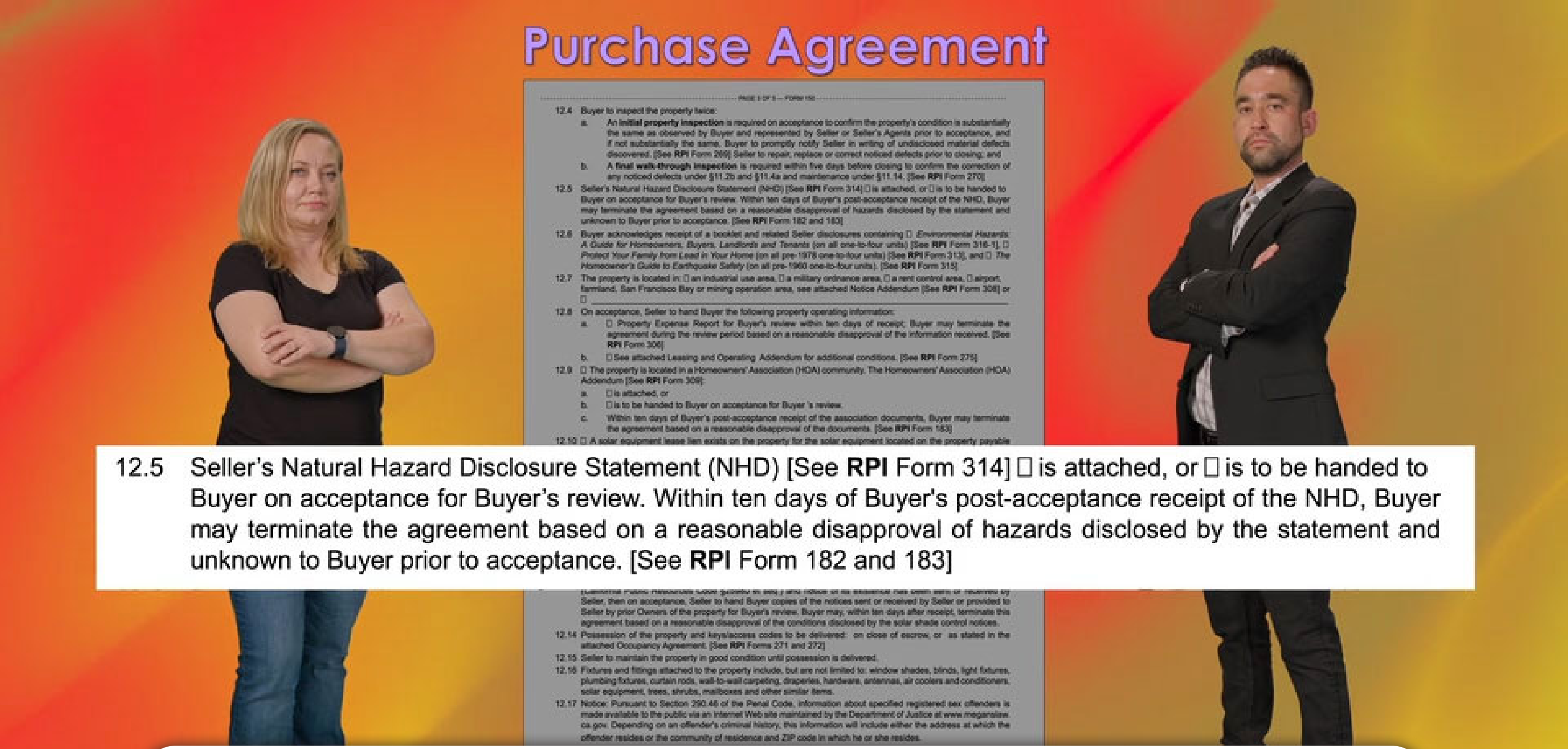
   c. inundation zone.

2. The seismic hazard zone disclosure on the Natural Hazard Disclosure (NHD) Statement is selected when the property for sale is:

   a. susceptible to earthquake hazards.

   b. located within a wildland area exposed to substantial forest fire risks.

   c. subject to damage caused by sudden coastal erosion.



The NHD in your practice

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

The seller and seller's agent prepare the statutory **Natural Hazard Disclosure (NHD) Statement** to disclose their awareness of natural hazards. Alternatively, the NHD form can be prepared by a natural hazard expert, then verified and used by the seller and their agent. [See **RPI** Form 314]

The form is to include information known to the seller and seller's agent (and the NHD expert) and readily available to them as shown on maps in the public records of the local planning department. [Calif. Civil Code §1103.2; see **RPI** Form 314]

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

Editor's note — Any attempt by a seller or seller's agent to use an "as-is" provision or otherwise provide for the buyer to agree to waive their right to receive the seller's NHD statement is void as against public policy. [CC §1103(d)]

However, sellers who are excluded from using the form still need to make the disclosures referenced in the NHD. Use of the NHD form to make property disclosures is not required on:

- court-ordered transfers or sales;
- deed-in-lieu of foreclosures;
- trustee's sales;
- lender resales after foreclosure or a deed-in-lieu;
- estates on death;
- transfers between co-owners;
- transfers to relatives/spouses; or
- transfers to or by governmental entities. [CC §1103.1(a)]

Investigating the existence of a hazard

Natural hazard information is obtained from the **public records**. When not retrieved by someone, the seller and seller's agent cannot make their required disclosures to prospective buyers.

To obtain the natural hazard information, the seller and the seller's agent are required to exercise **ordinary care** in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. When an expert is employed, the expert prepares the NHD form for the seller and the seller's agent to review, add any comments, sign and have ready for delivery to prospective buyers. [Calif. Civil Code §1103.4(a)]

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

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

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

- **request** an NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records;
- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or seller's agent may possess; and
- **sign** the NHD Statement provided by the NHD expert and **deliver** it with the NHD report to prospective buyers or buyer's agents. [CC §1103.2(f)(2)]

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

The buyer's occupancy of property within the influence of an airport facility may be affected by noise and restrictions, now and later, imposed on the buyer's use as set by the airport's land-use commission. [CC §1103.4(c)]

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

Broker uses experts to limit liability

The Natural Hazard Disclosure scheme encourages brokers and their agents to use natural hazard experts to gather and report the information available to all from the local planning department rather than do it themselves. The use of an expert to gather information from the public record and prepare the report **relieves** the seller's agent of any **liability for errors** not known to the agent to exist.

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

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

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with professional licensing and expertise; and
- the seller and seller's agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies and omissions of which they have **actual knowledge**. [CC §§1103.4(a), 1103.4(b)]

Caution: The seller's agent's **dilatory delivery** of an expert's NHD to the buyer or the buyer's agent, after the offer has been accepted, will not protect the broker from *liability* for the buyer's lost property value due to the nondisclosure before acceptance. When the agent **knew or ought to have known** of a natural hazard noted in the readily available planning department's parcel list, the agent is exposed to liability.

Documenting compliance with NHD law

Compliance by the seller and seller's agent to deliver the NHD Statement to the buyer is required to be documented by a provision in the purchase agreement. [See **RPI** Form 150 §12.5; Calif. Civil Code §1103.3(b)]

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

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

- a **three-day right of cancellation** when the NHD Statement was handed to the buyer; or
- a **five-day right of cancellation** when the NHD Statement was mailed to the buyer. [CC §1103.3(c)]

Further, delivery of the NHD after acceptance of an offer imposes liability on the seller and seller's agent, but not the buyer's agent. Liability is based on any money losses (including a reduced property value) inflicted on the buyer by an untimely in-escrow disclosure for those buyers who chose not to exercise their right to cancel and instead proceed with performance of the agreement and close escrow before demanding restitution. [CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312]

QUIZ

1. Which of the following statements is the most correct concerning the use of the Natural Hazard Disclosure (NHD) Statement?

   a. An NHD Statement prepared by the seller and seller's agent is akin to a warranty or guarantee by the seller and seller's agent of the natural hazards known to affect the property.

   b. Use of an NHD expert to gather information and prepare the NHD relieves the seller's agent of any liability for errors known to the agent to exist.

   c. The seller and seller's agent prepare the statutory NHD to disclose their awareness of natural hazards and deliver it to the buyer in writing before the buyer or the seller enter into a purchase agreement.

Risk Management Practices

The reduction of uncertainties for harm

Brokers and agents interact amongst themselves and with members of the public. When acting under their California Department of Real Estate (DRE) licenses, brokers and agents act in the capacity of:

- an *advisor* to an individual who has retained the services of a broker to assist in a real estate related transaction; or
- an *agent* dealing with another broker, their agents or a member of the public in an effort to find a match for the individual they represent regarding ownership, financing or the letting of real estate.

These two relationships contain **risks** as addressed in this section. The risk of causing another person a loss is inherent in all activities conducted in the context of agency relationships.

The risks taken by a broker and their agents expose the broker to liability caused by an:

- error;
- omission; or
- misunderstanding brought about by the activities of the broker or their agents.

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.

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.

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

1. 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.
2. 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.
3. An **evaluation** is undertaken into what sorts of loss the client, others or the broker may experience if the broker or their agents undertake the identified activity, or a modified or alternative version of the activity.
4. 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 provide the level of exposure to liability acceptable to the broker.
5. 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.

Identify activities requiring management

To initiate an analysis for managing the risk of loss, a broker needs to *identify and list* all the activities agents perform which could potentially be the source of a claim of liability against the broker.

Also, the nature of the services offered by brokers varies by whether the activities are classified as:

- the *sale* of single family residences (SFRs), income property or land;
- the *financing* of purchases, construction or equity; or
- the *leasing* or *management* of residential or commercial property.

Other categories of broker activity are based on their duty owed to the client for the performance of services sought by the client. This includes the actions of a

seller's broker, such as:

- advising the seller;
- inspecting the listed property;
- collecting data for disclosures;
- marketing the property; and
- negotiating the terms of a sale.

Likewise included are the actions of a **buyer's broker,** such as:

- selecting qualifying property;
- gathering property information;
- confirming the veracity of seller disclosures;
- evaluating the data collected;
- advising the buyer; and
- negotiating acquisitions.

Mortgage broker and leasing agent activities likewise have categories of duties owed to the participants in their real estate transactions.

Other risks of exposure to liability arise out of losses incurred by clients and others when they rely on information provided by their broker but received by the broker from other sources, such as the property owner or third-party inspectors.

E and O insurance mitigates risk

As a buffer against liability, a broker can purchase negligence insurance, called **errors and omissions (E&O) insurance**. With the payment of a premium, *E&O insurance* protects brokers from the full cost of defending against a **negligence claim** made by a client or others. Similarly, *auto insurance* can be purchased to cover liabilities resulting from the agent's use of their vehicle to conduct activities within the scope of the brokerage activities chosen and authorized by the broker for the agent to undertake.

Through both forms of insurance, the liability exposure for professional negligence and the cost of defense are shifted to corporate insurers willing to take on the financial burden of those uncertainties.

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*.

QUIZ

1. Brokers need to maintain a __________ to keep claims from clients and others under control.

   a. business credit line

   b. risk retention program

   c. risk reduction program

2. As a buffer against liability, a broker can purchase negligence insurance, called:

   a. liability and fraud (L&F) insurance.

   b. theft and auto (T&A) insurance.

   c. errors and omissions (E&O) insurance.

Gathering facts on adverse features

Consider a broker who enters into an exclusive listing with a seller. The broker's efforts to market the property are limited to placing a "For Sale" sign on the property and publishing property information in the *multiple listing service (MLS)*.

The broker refuses to assist or provide additional information to buyers or their agents, except to make the listed property available for inspection through a lock-box arrangement. Phone calls and emails seeking information about the listed property are not responded to.

The seller's broker does not prepare disclosures or provide a **listing package** regarding the condition of the property and operating costs. The agent also does not obtain a property profile, home inspection report, natural hazard disclosure (NHD) report or pest control report. All these items are left to a buyer's agent to obtain or for a buyer to demand in escrow.

The seller's broker employs a **transaction coordinator (TC)** to prepare documents and obtain the seller's signature as needed — at an extra charge to the seller for the TC's services.

None of these limitations on the marketing services provided by the broker are disclosed to the seller, except for the cost of the TC on closing a sale.

No potential buyers are produced by the agent.

The seller, dissatisfied with the broker's marketing efforts, cancels the listing without the broker's consent. Another broker is employed by the seller to market the property. The property is sold under the new listing, but during the listing period remaining on the cancelled listing.

The original seller's broker makes a demand on the seller for a fee, claiming they are due a fee since the property sold during the original listing period. The seller claims the agent's lack of **due diligence** in marketing the property and locating buyers bars the broker from collecting a brokerage fee.

Is the seller's broker entitled to the fee?

No! The efforts of the seller's broker to market the property and locate buyers were insufficient to entitle the broker to a fee on any sale after the seller canceled the listing for good cause.

When employed under an *exclusive listing agreement*, a broker and their agents are obligated:

- to *inform* the seller about the brokerage services to be rendered; and
- to *diligently perform* the agreed-to services in pursuit of buyers who are ready, willing and able to purchase the listed property.

A concerted, continuing effort to sell

Agents fulfill their **agency duty** owed under an exclusive listing by making a *concerted and continuing effort* to locate a buyer, called a **due diligence effort**. All services are to be performed at a level meeting the owner's *reasonable expectations*. Otherwise, the owner has *good cause* to terminate the agency and cancel the employment under the listing without becoming obligated to pay a fee. [**Coleman** v. **Mora** (1968) 263 CA2d 137]

The *diligent effort* of a broker under an exclusive listing is measured by the conduct and actions taken by the broker and their agents, including:

- *analyzing the property* – a responsibility imposed on the broker or their agent to gather readily **available information** and **adverse facts** about the listed property at the earliest opportunity, before marketing begins. This information is included in a **listing package** handed to prospective buyers [**Jue** v. **Smiser** (1994) 23 CA4th 312]; and
- *marketing the property* – which includes advertising in MLSs or other broker-associated publications, making phone calls, putting up "For Sale" signs, distributing fliers, holding open house, broadcasting the property at pitch sessions, etc.

The agent needs proof they exercised *due diligence* in their analysis and marketing of a property. The best evidence of diligence is provided by keeping detailed records. Records avoid unwarranted cancellation of the listing. Records of all solicitations, contacts, money spent, advertisements placed, buyers contacted, etc., are maintained on worksheets in a physical file separately maintained on the listed property. [See **RPI** Form 520 and 525]

Methods for gathering adverse facts

The methods for gathering *adverse facts* about the property's fundamental characteristics, as required on the sale of a one-to-four unit residential property, include:

- conducting a competent **visual inspection** of the property to observe conditions which may adversely affect its market value. Any observations of adverse conditions are noted on the seller's TDS — if not already noted on the TDS by the seller or inconsistent with the seller's disclosures, regardless of whether a home inspector's report has been obtained by the seller [Calif. Civil Code §2079];
- assuring seller compliance with the **seller's duty** to deliver mandated disclosure statements to prospective buyers as soon as possible. These mandated disclosures cover a variety of routine facts 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, condo documents, etc. [See **RPI** Form 304, 314 and 308];
- reviewing and confirming that all the information and data in the disclosure documents received from the seller are consistent with the seller's broker's knowledge, and if not, correct the information and data. Further, if the listing agent has reason to believe information might not be accurate, either investigate and clarify the information, or disclose their 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.). Inspections reduce the seller's and their broker's exposure to claims by a buyer who might discover deficiencies in the property, before or after closing, not known to the seller or the seller's broker; and
- **responding to inquiries** by the prospective buyer or buyer's agent into conditions relating to any aspect of the property. Seller's agents are to respond with a full and fair answer of facts known to them which are or might be detrimental to the value of the property. The inquiry itself makes the subject matter a material fact about which the prospective buyer seeks more information before completing negotiations or acquiring the property. Thus, the response of the seller's agent to the inquiry may not

suppress further investigation or inquiry by the buyer or the buyer's agent. A contingency provision addressing the subject needs to be included in any purchase agreement or counteroffer entered into by the buyer.

These methods are also used to determine those facts which enhance the property's value.

QUIZ

1. __________ refers to the concerted and continuing efforts of an agent employed to meet the objectives of their client in exchange for the client's promise to pay a fee.

   a. Dual agency

   b. Due diligence

   c. General duty

2. Any observations of adverse conditions while conducting a competent visual inspection of the seller's property are to be noted on the:

   a. Transfer Disclosure Statement (TDS).

   b. Agency Law Disclosure.

   c. seller's appraisal report.

Material facts

The pass-through of filtered information from the seller

A seller's agent is required to conduct a **visual inspection** of a property upon taking a listing. The seller's agent's statutory duty owed to prospective buyers to disclose facts about the physical condition of a one-to-four unit residential property is limited to:

- their *knowledge* about the property; and
- their *observations* made while conducting the mandatory *visual inspection*.

To complete the disclosure process, the seller's agent *filters property information* provided by the seller before it is provided to the prospective buyer.

Accordingly, all property information received from the seller is reviewed by the seller's agent for 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 entered on the disclosure forms before the information is used to market the property and induce prospective buyers to purchase, collectively referred to as **fair and honest dealings.**

The extent to which disclosures about the physical condition of the property are to be made is best demonstrated by what the seller's agent is *not obligated to provide*. Everything else adversely affecting value and known to the seller's agent – **material facts** – are to be brought to the attention of prospective buyers as a *matter of law*.

As a minimum effort to be made before handing a prospective buyer 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 their visual inspection of the property which expose the inaccuracies or omissions in the seller's statements; and
- identify the source of the information as the seller.

No duty to provide advice, but must respond fully and fairly

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 any facts unknown to the seller's agent about:

- the property's *title conditions*, consisting of encumbrances such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc.;
- the *operating expenses* and any tenant income the buyer will experience during ownership, such as utilities and property taxes;
- 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 of the property, such as limitations on interest deductions;
- the *suitability of the property* to meet the buyer's objectives in the acquisition; 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 any adverse facts disclosed;
- 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.

Likewise, a seller's agent does not owe a duty to the prospective buyer to explain the consequences of the **customer's failure to further investigate** or analyze adverse facts sufficiently disclosed by the agent to put the buyer on notice of the condition.

However, *when asked* by the prospective buyer or 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 is to include material facts known to the seller's agent about the subject matter of the inquiry and not contain misleading statements.

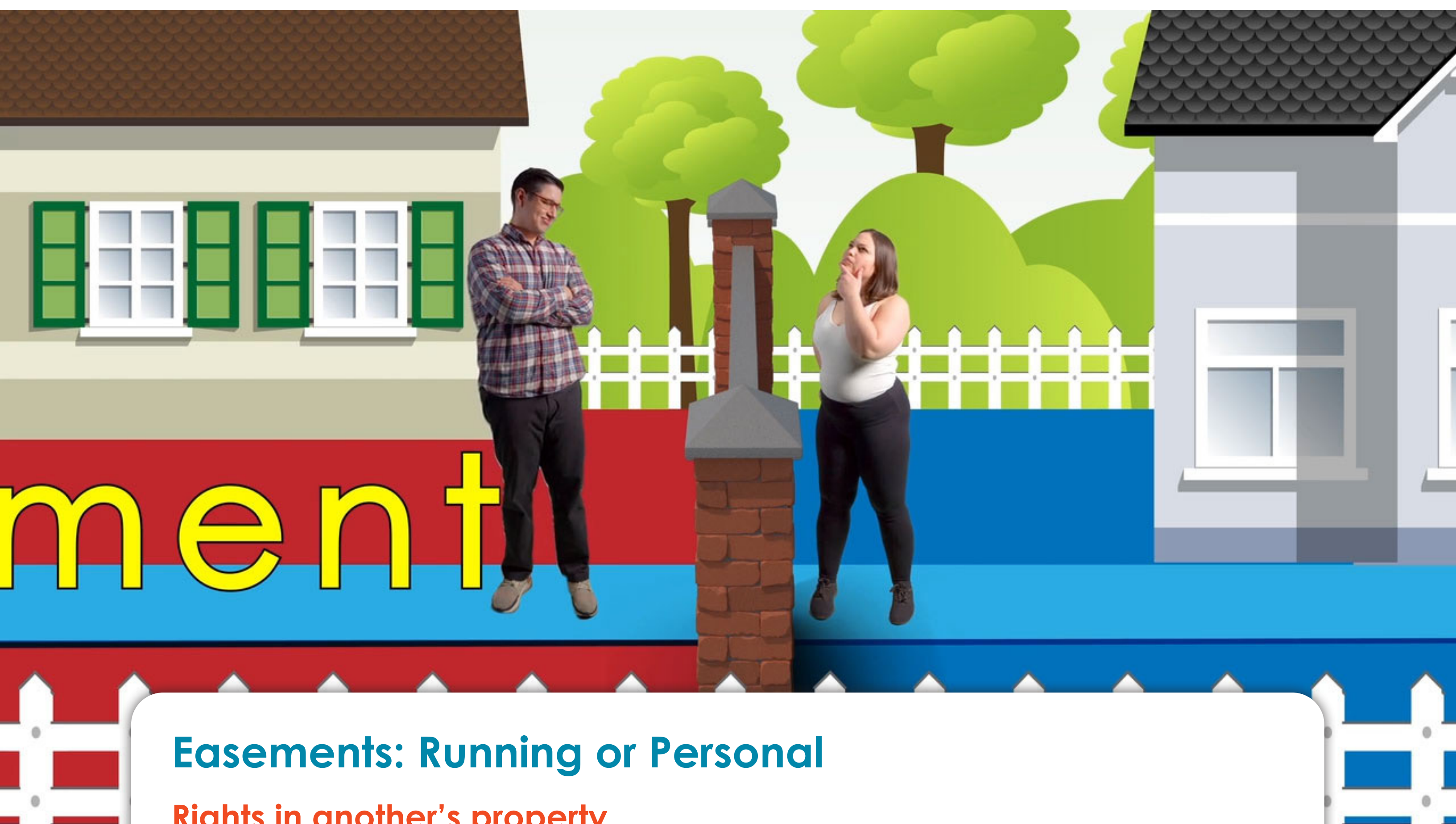
Conversely, it is the buyer or the buyer's agent who has a *duty to care for and protect* the buyer's best interests.

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.

QUIZ

1. A seller's agent needs to:
   a. volunteer information about the income tax aspects of the buyer's acquisition of the property, such as limitations on interest deductions.
   b. make recommendations about the extent of any adverse facts disclosed.
   c. review all property information received from the seller for any inaccuracies or untruthful statements known or suspected to exist.

2. When directly asked by the prospective buyer about any aspect, feature or condition which relates to the property or the transaction, the seller's agent is:
   a. duty-bound to respond fully and fairly to the inquiry.
   b. only required to refer the buyer to the buyer's agent.
   c. not required to provide their working knowledge of the underlying facts.



Easements: Running or Personal

Rights in another's property

An **easement** is the right of one property owner to use the property of another.

"*Easement*" is an Anglo-Norman term coined in the late 14th century. It comes from the Old French word *aisement* meaning "comfort, convenience, use and enjoyment" and from *aisier* meaning "to ease." The current meaning of the word, which is the legal right of one property owner to use the property of another, was first used in the early 15th century.

The most common *easement* is used for **ingress and egress**. An easement for ingress and egress creates a right of way allowing one property owner to traverse a portion of another's land to access their property.

Consider a right-of-way easement which is maintained as a road over an owner's property. The easement provides **access** through the owner's property from a public street to an adjoining neighbor's property.

The owner builds a fence on their entire property line, blocking the neighbor's use of the road and access to the public street in the process.

The neighbor with the property benefitting from the easement claims their easement gives them the right to use the roadway across the owner's property, a use the owner may not interfere with by fencing the perimeter of their property and barring the neighbor's use of the easement.

The neighbor demands the unobstructed use of the road and seeks to recover money losses incurred due to the owner's obstruction.

Is the owner wrongfully blocking the neighbor's use of the road?

Yes! The neighbor in title to the adjacent property holds a valuable **property right** in the owner's property which entitles the neighbor to use the right-of-way easement, classified as an *appurtenance* to the neighbor's property and an encumbrance on the owner's title.

When an owner whose property is burdened by an easement interferes with the use of the easement by a neighbor whose property benefits from the easement, the neighbor is entitled to have the use of the easement reinstated, either by removal, relocation or modification of the interference.

Further, the neighbor who holds the easement is entitled to compensation for their money losses caused by the owner's obstruction of the neighbor's use of the easement. [**Moylan** v. **Dykes** (1986) 181 CA3d 561]

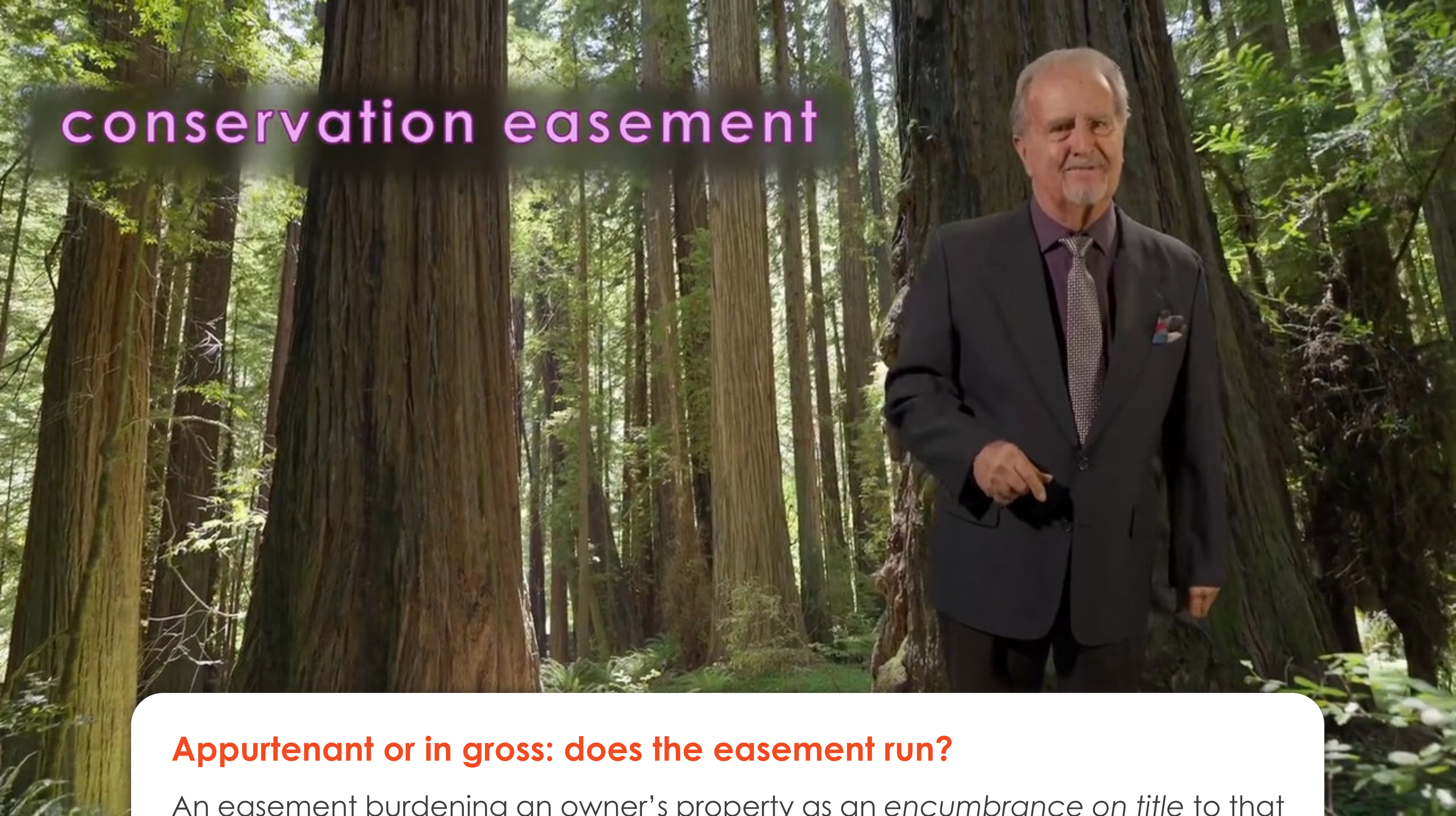
An easement creates a *tenement relationship* between two parcels of real estate since it:

- *benefits* one property, referred to as the **dominant tenement**, whose owner is entitled to use the easement; and
- *burdens* another property, referred to as the **servient tenement**, the owner's use of their property being subject to the easement.

QUIZ

1. The most common easement is used for:
   a. eminent domain.
   b. ingress and egress.
   c. profit a prendre.

2. The property which benefits from the easement and whose owner is entitled to use the easement is referred to as the:
   a. dominant tenement.
   b. servient tenement.
   c. subtenant.



Appurtenant or in gross: does the easement run?

An easement burdening an owner's property as an *encumbrance on title* to that property is classified as either:

- an **appurtenant easement**, since the use allowed belongs to and benefits an adjacent property and *runs with the land* as a property interest held in the burdened real estate; or
- an **easement in gross**, which belongs to an individual, not another parcel of real estate, as their *personal right* in the burdened real estate.

For example, a development company sells parcels in a subdivision, reserving a right-of-way easement over each of the parcels. The deed creating the easement does not state the easement is *appurtenant* to other parcels.

Later, the successor to the developer attempts to build a road on the easement. The owners of the burdened property claim the easement is *in gross*, a benefit held only by the original developer.

Is the easement in gross (personal) since the grant deed does not specify the easement is appurtenant?

No! When the document creating an easement does not indicate whether the easement is appurtenant or in gross, the easement is classified as *appurtenant* if it **benefits a property** other than the burdened property. [**Elliot** v. **McCombs** (1941) 17 C2d 23]

Runs with title to the benefitting property

An *appurtenant easement* is incidental to the title of the property which benefits from its use. However, an easement is not reflected as a recorded interest on the title to the parcel of real estate it benefits. Nor is it a personal right held by a particular individual who may now or have previously owned the parcel benefitting from the easement.

Conversely, an appurtenant easement benefitting one parcel is recorded as an **encumbrance** on title to the burdened property. The easement remains on the burdened property's title after a conveyance to new owners of either the benefitting or burdened property. To be enforceable by a new owner of the benefitting property, the easement does not need to be referenced in the grant deed conveying either property to new owners since it *runs with the land*. [**Moylan** v. **Dykes** (1986) 181 CA3d 561]

Conversely, an *easement in gross* benefits a particular person – not any real estate the person might own. An easement in gross is personally held only by the individual who may use the easement. No parcel of real estate may benefit from an easement in gross since only the individual holding the easement may benefit.

For example, an easement held by a public utility company is an easement in gross. The utility company has the right to enter onto a property to install and maintain its equipment (power lines, gas or water pipes, etc.). In no way does any real estate owned by the utility company benefit from the easement.

While an easement in gross is a **personal right** which is not transferred with the sale of any real estate owned by the holder of the easement, the right may be *transferred* by the easement holder to another person by a writing — unless the transfer of the easement in gross is prohibited by a provision in the document creating the easement. [**LeDeit** v. **Ehlert** (1962) 205 CA2d 154]

Easements for light, air or view

A property owner has no automatic right, and may not acquire a prescriptive right, to air, light or an unaltered view over neighboring properties.

However, a property owner may enforce an easement created by a grant which restricts a neighbor's ability to erect or maintain any improvement which interferes with the owner's right to air, light or view. The easement might be the result of **covenants, conditions and restrictions (CC&Rs)** which blanket several properties with use restrictions, such as restrictions on the height of improvements.

Easements for light, air and view can only be established by *written agreement* between neighboring owners, not by implication or prescription. [Petersen, supra]

Conservation easements

A **conservation easement** is a voluntary conveyance of the right to keep the land in its natural, scenic, historical, agricultural, forested or open-space condition. It is conveyed by an owner of real estate to a conservation organization or government agency. A *conservation easement* is created in the form of an easement or CC&R, by use of a deed, will or other instrument to convey the easement. [CC §815.1]

Conservation easements are *perpetual* in duration and thus are binding on all successive owners of the property burdened by the conservation easement. [CC §§815.1, 815.2(b)]

QUIZ

1. An easement which belongs to an individual, not another parcel of real estate, as their personal right in the burdened real estate is referred to as a(n):
   a. appurtenant easement.
   b. easement in gross.
   c. prescriptive easement.

Created by grant or reservation

The basic method for creating an easement is by a writing. Any document which may be used to convey a legal interest in real estate may be used to create an easement.

An easement is created between the *benefitting* and *burdened* properties in a(n):

- easement agreement;
- will;
- grant deed;
- easement deed;
- quitclaim deed;
- lease;
- order of the court; or
- *covenants, conditions and restrictions (CC&Rs)*.

An easement is created in a conveyance either by:

- **grant**; or
- **reservation**.

For example, the owner of adjacent parcels of real estate may sell one parcel to a buyer and further *grant* the buyer an easement on the parcel retained by the owner.

Alternatively, an owner of adjacent parcels may sell a parcel, and in the grant deed conveying the parcel to the buyer, *reserve* to themselves an easement on the sold parcel for the benefit of the parcel the owner retained.

Easement or fee title conveyed by deed

The terms *"reservation"* and *"exception"* in conveyances of real estate are used to distinguish whether the legally described reservation (easement) or exception (ownership) is:

- created as a burden on the property conveyed for the beneficial use of another property, such as an **easement by reservation**; or
- retained from the parcel conveyed as property of the seller, an *exception for land* which is not transferred on the conveyance of a portion of a larger parcel.

The terms "reservation" and "exception" are often mistakenly and thus improperly used interchangeably. However, their meanings and operative effects are very different.

For example, when a grantor conveys one of two adjoining parcels they own, **reserving** the **right to use** a road on the property conveyed, the grantor has created an *easement by reservation*. Here, the entire parcel was conveyed while imposing a burden on that property in the nature of an easement.

In contrast, when the grantor conveys the parcel noting the description of the portion of the parcel where the road is located is excepted from the conveyance, they have not conveyed title and retains ownership to the portion of the parcel described as the road.

The difference between a reservation and an exception is apparent in the manner title insurance companies write a policy on the transfer of title.

When a parcel is conveyed *reserving* a road, the title insurance policy insures title to the entire parcel, then states the title is subject to — encumbered by — the easement created by the reservation.

Alternatively, when a parcel is conveyed *excepting* the legal description of the road, the portion of the parcel described as the location of the road is not part of the legally described property conveyed and covered by the title insurance policy. The excepted portion did not become the buyer's property. The road did not become an easement burdening the portion of the parcel conveyed since it is located on the property cut out of the parcel by the exception. The seller retains fee ownership of the described portion containing the road since it was an exception from the parcel conveyed.

QUIZ

1. An easement is created in a conveyance either by:
   a. dedication or restriction.
   b. quitclaim or pledge.
   c. grant or reservation.

Conduct creates an implied easement

An easement can be created by conduct without any prior agreement between the owner and the user, called an **implied easement**.

Implied easements exist when the circumstances surrounding an owner's division of their property and sale of a portion of the property imply the owner (grantor) and the buyer (grantee) intended either:

- the grant of an easement on the portion retained by the owner; or
- the reservation of an easement by the owner on the portion sold. [Civil Code §1104; **Palvutzian** v. **Terkanian** (1920) 47 CA 47]

The requirements for establishing an implied easement are:

- a prior *common ownership* of adjoining parcels;
- a *transfer of one* of the adjoining parcels;
- an obvious and apparent *prior use* of one parcel for the benefit of the other parcel during the period of common ownership; and
- a *reasonable necessity* for creating the easement. [**Greene Fickert** (1942) 49 CA2d 511]

Prior common ownership of parcels

A transfer of one of two or more adjoining parcels by a **common owner** is required to create an implied easement.

For example, an implied easement may arise when a **co-ownership** of a property is terminated and the property is divided and parceled out to the individuals who were the co-owners.

Additionally, an implied easement may arise on the distribution of property under a will or trust.

For example, a beneficiary receives a parcel of real estate which is accessible only by a road over an adjoining parcel conveyed to another beneficiary under a will or inter vivos (living) trust which does not provide for an easement.

In this scenario, a **right-of-way easement** is created by implication since the common ownership of the adjoining parcels is the estate or trust. [**Cheda** v. **Bodkin** (1916) 173 C 7]

Division by transfer

An owner of property who uses a portion of their property for the benefit of another portion of the same property does not create an easement on their own property.

An easement is a right to **use another's land** or **prevent anothe**r from a particular use of the owner's land. Thus, an owner cannot hold an easement over their own land. [Calif. Civil Code §805]

Only the division of commonly owned parcels by the transfer of a parcel triggers the creation of an implied easement.

Beneficial use of commonly owned parcels

The prior use of one parcel for the benefit of an adjacent, commonly owned parcel needs to be *obvious* and *permanent* for the new owner on the transfer of one of the parcels to establish the right to an implied easement to use the other parcel.

To establish an implied easement, the **prior use** by the common owner needs to have been:

- either *known* to both the common owner (original grantor) and the buyer (grantee), or so obvious their knowledge may be presumed;
- *regularly used* during the common ownership before the transfer; and
- *intended* to be permanent.

The purpose for creating an implied easement is to establish the right to continue an existing use a buyer and seller intend to permanently maintain, but fail to mention.

Thus, an implied easement is not created when the common owner of adjacent parcels and the buyer of one parcel do not intend for an easement to exist on the adjoining parcels.

Reasonable necessity

For an implied easement to exist, the easement must be *reasonably necessary* for the beneficial use of the parcel whose owner is seeking to establish the easement.

Consider an owner who sells and conveys a parcel containing a driveway. The owner uses the driveway to access an adjoining parcel they own which is improved by their residence. The owner does not reserve an easement for use of the driveway in the conveyance to the buyer.

The owner's residence fronts on a public road. The driveway through the buyer's parcel is the only improved access to the owner's home. The cost of building a road for access to the public road is a reasonable amount for the value of the residence.

On closing, the buyer refuses to allow the owner to use the driveway over the parcel sold to the buyer.

The owner claims they are entitled to an *implied easement* over the parcel sold to the buyer since, prior to the sale, the driveway provided access to the adjoining property they retained.

The buyer claims the owner is not entitled to an implied easement since they can build a new driveway to the public road.

Is the owner entitled to an implied easement to use the buyer's driveway?

No! An implied easement (by reservation) is not reasonably necessary to the owner's beneficial use of the adjacent property they retained since the owner can build a new driveway to the public road at a reasonable cost. [**Leonard** v. **Haydon** (1980) 110 CA3d 263]

Thus, an implied easement is created for the benefit of property only when a *reasonably convenient alternative* is not available to the property and a reasonable necessity for the easement exists.

Implied easement by reference to map

When a landowner records a subdivision map and offers to dedicate the roadways depicted on the map to a public use, a *public easement* is created on the **government's acceptance** of the rights of way legally described on the subdivision map. [Calif. Government Code §§66410 et seq.]

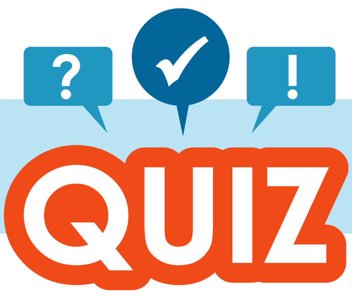
Similarly, when a recorded subdivision map lays out acreage into parcels and streets and sells the lots by reference to the subdivision map, the buyers of the lots have easements in the streets adjoining their lots. [**Danielson** v. **Sykes** (1910) 157 C 686]

An easement implied is another's appurtenance

Regardless of how an implied easement is created, it is always a burden on one parcel of land for the *benefit* of another parcel.

Thus, an implied easement is always an **appurtenance** allowing the owner of the property benefitting from the easement to use the property of another which is burdened by the easement.

Most disputes over implied easements occur after the property burdened by the easement has been deeded out to new owners.



1. Which of the following is NOT a requirement for establishing an implied easement?

   a. A prior common ownership of adjoining parcels.
   b. A signed writing documenting the burdened property owner's acquiescence to the implied easement for a period greater than five years.
   c. An obvious and apparent prior use of one parcel for the benefit of the other parcel during the period of common ownership.

Easements by necessity and prescription

An **easement by necessity** is a variation of an implied easement. The demand for an *easement by necessity* arises when property is **landlocked**. Access to and from a public roadway across all adjacent properties is denied in landlocked property for the lack of the ability to create an easement by agreement or prior conduct.

Since public policy favors the productive use of land, an easement by necessity is created when property is landlocked. [**Reese** v. **Borghi** (1963) 216 CA2d 324]

However, to establish an easement by necessity, the user needs to:

- show **strict necessity**; and
- defend against any claim that the property was intended to be landlocked.

Strict necessity requires the easement to be the only possible means of access. [**Zunino** v. **Gabriel** (1960) 182 CA2d 613]

Additionally, an easement by necessity lasts only as long as the necessity exists. Thus, when a public road is built or an existing adjacent road is dedicated to the public, an easement by necessity is terminated since the *need* is terminated.

No *time limitations* exist for bringing a quiet title action to establish an easement by necessity since the easement legally exists as long as the necessity exists.

Even when an easement is strictly necessary to access landlocked property, an easement will not be created contrary to the intent of the original grantor dividing and transferring the parcel.

Prescription: easement by adverse use

Consider a property owner who has used a roadway on an adjoining property to access their vacation home for over five years. The owner has never received permission from the neighbor to use the roadway.

The neighbor sells their property to a buyer who informs the owner they may no longer use the roadway.

The owner claims their open and continuous use of the road to access their property for more than five years entitles them to a **right-of-way easement** over the adjoining property.

Is the owner entitled to a roadway easement over the adjoining property owned by the buyer?

Yes! A **prescriptive easement** is established by the adverse use of another's property for a period in excess of five years. [**Thomson** v. **Dypvik** (1985) 174 CA3d 329]

An easement created by **prescription** is similar to acquiring land by adverse possession. The difference is prescription establishes the right to **mere use** of another's property, whereas adverse possession is an actual taking of **exclusive possession** under a claim of ownership and the payment of all property taxes.

To meet the legal requirements for acquiring an *easement by prescription*, the adverse use needs to be:

- *obvious* enough to give the owner of the property notice of the use;
- a *continuous* and uninterrupted pattern of use;
- a use *unauthorized* by the owner of the property;
- used under a *claim of right*; and
- used for a period of *five or more* years without the owner acting to terminate the adverse use.

The five-year requirement of uninterrupted use continues with the transfer of the benefitting property to new owner(s) as long as the new owner(s) continue the same unauthorized use of the burdened adjoining property established by the previous owner, called **tacking**. [**Jones** v. **Young** (1957) 147 CA2d 496]

A prescriptive easement does not bar an owner of property burdened by the easement from all use of their land. To obtain the **exclusive use** and possession of real estate, a claim for adverse possession needs to be pursued which, unlike a prescriptive easement, requires the payment of liens and taxes on the property by the adverse possessor.

Easement limited to use

Like all easements, a prescriptive easement is limited in its use to the *parameters of the use* which created the easement.

For example, a neighboring rancher acquires a prescriptive easement for a right of way over an owner's property — an easement benefitting the neighboring ranch.

The rancher only uses the easement for two months each year as the easiest means for accessing their ranch.

Later, the rancher subdivides their property into residential lots. The rancher claims their prescriptive easement allows them to construct a road on the easement for public access to the new development.

The owner claims the rancher may not use the easement for daily residential purposes since the rancher's prescriptive use was occasional and agricultural.

May the owner limit the frequency and purpose of the neighbor's use of the easement to the pre-subdivision usage?

Yes! The use of a prescriptive easement is **limited to the adverse use** which created the easement. [**Cushman** v. **Davis** (1978) 80 CA3d 731]

QUIZ

1. The demand for an easement by necessity arises when property:
   a. contains obsolete features.
   b. needs to be relocated to another location.
   c. is landlocked.

2. A(n) __________ is established by the adverse use of another's property for a period in excess of five years.
   a. implied easement
   b. prescriptive easement
   c. conservation easement

Extinguishing an easement

An existing easement can be **extinguished**. Once extinguished, the easement no longer affects the burdened property as an encumbrance on its title.

Methods used to extinguish an easement include:

- *release* of the easement by a deed from the owner of the property holding the appurtenant right to the easement;
- **merger** by the acquisition of fee title to both the benefitting and burdened properties by the same owner;
- *destruction* of the burdened property which permanently prevents any further use of the easement;
- *forfeiture* due to the easement holder's abuse of their easement rights;
- *prescription* due to the burdened property owner's continuing interference with the easement; and
- *abandonment* by the conduct of the easement holder showing they do not intend to use their easement rights.

Release by deed to burdened property

An owner of property benefitting from the use of an easement may voluntarily terminate it by **releasing the easement** to the owner of the burdened property.

The *release* is accomplished by the use of a *quitclaim* or *grant deed* in favor of the owner of the burdened property, signed by the owner of the property holding the appurtenant right to use the easement.

Merger as an extinguisher

A **merger of legal interests** comprising the *servient* and *dominant* tenement rights and obligations in two properties due to common ownership of both properties extinguishes an easement.

A *merger* occurs when the same person acquires fee title to both the benefitting and burdened properties.

An owner cannot have an easement over their own property for the benefit of their own property. Thus, the easement is automatically extinguished on the **common ownership** of both the properties. [Calif. Civil Code §805]

However, no merger occurs when the owner of burdened property acquires a fractional interest in title to the benefitting property as a co-owner since the owner is not the **sole owner** of both properties. [**Cheda** v. **Bodkin** (1916) 173 C 7]

Additionally, acquiring a lien, such as a trust deed, encumbering either the benefitting or burdened property by the owner of the other property is not a merger of interests.

Extinguished by destruction of property

An easement is terminated by the **destruction** of the burdened property. Nonexistence of the burdened property renders the use of the easement impossible.

Consider an easement to use a stairway in an adjoining building. When the building burns down, the easement is extinguished since the owner is not required to rebuild the stairway. [**Cohen** v. **Adolph Kutner Co.** (1918) 177 C 592]

Forfeiture for exceeding authority

An easement is terminated by **forfeiture** when the easement holder exceeds their authorized use of the easement by placing an *excessive burden* on the property encumbered by the easement.

For example, consider a subdivider who owns land entitling them to use a right-of-way easement over a neighbor's property for access.

Later, the subdivider divides the property into several residential lots. For access, the subdivider constructs a road on the neighbor's property within the legally described easement to a public road. Here, the increased use of the easement constitutes an excessive burden on the property it encumbers, and thus the easement is *extinguished by forfeiture*. [**Crimmins** v. **Gould** (1957) 149 CA2d 383]

The standards for forfeiture are vague and often left to the discretion of the courts to determine, on a case-by-case basis, whether the easement holder's actions create an undue hardship on the owner of the property burdened by the easement.

Prescription creates and destroys

An easement may be established through prescription by the adverse use of another's property. Likewise, an easement may be extinguished by prescription when the burdened property owner's use of the area within the easement which *permanently interferes* with their neighbor's ability to use the easement.

An adverse use which terminates an easement is any act by the burdened property owner which permanently obstructs the beneficial use enjoyed by the holder of the easement.

Abandonment as never to use again

An easement can also be terminated through **abandonment** by the easement holder. The termination of an easement by *abandonment* is not easily established.

The easement holder's actions need to demonstrate a clear intent to *permanently abandon* all future use of the easement, never to use it again.

Consider a subdivider who grants a buyer of a parcel a right-of-way easement over an adjoining parcel owned by the subdivider. The buyer plants trees on their property, blocking their access to their own easement over the adjoining parcel.

The subdivider later builds a fence between the parcels which further bars the buyer's access to the easement. The buyer makes a timely demand on the subdivider to remove the fence. The subdivider claims the easement has been extinguished by the buyer's abandonment of the easement, evidenced by the trees blocking access to the easement.

Has the buyer abandoned their easement by planting trees blocking their access to the right-of-way?

No! Mere **nonuse of an easement** is not sufficient conduct to demonstrate an easement holder's *intent to terminate* an easement by abandonment. The buyer's planting of trees which block access to the easement does not indicate they have decided to never use the easement in the future. [**Tract Development Service, Inc.** v. **Kepler** (1988) 199 CA3d 1374]

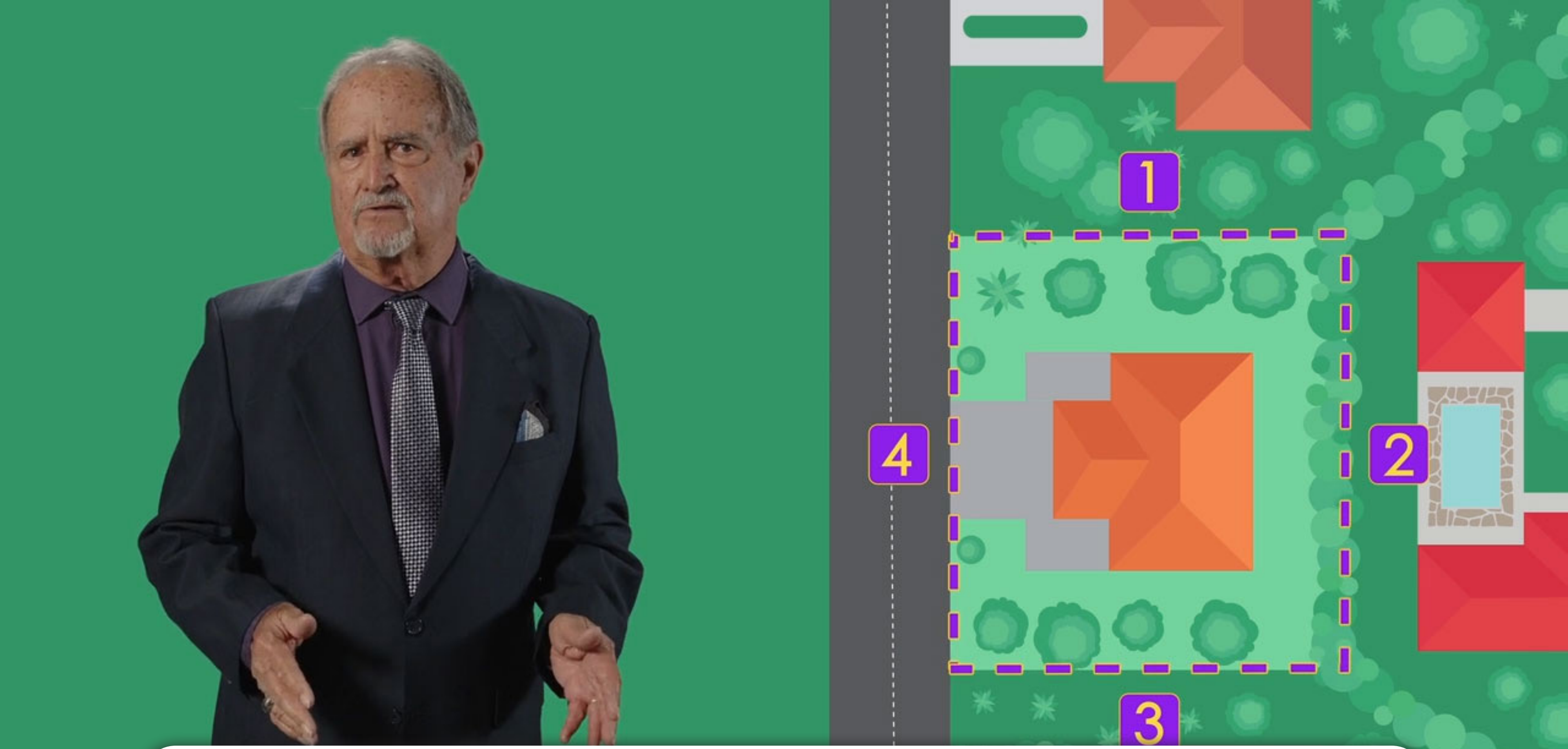
QUIZ

1. Which of the following is NOT a requirement for establishing an implied easement?

   a. A prior common ownership of adjoining parcels.

   b. A signed writing documenting the burdened property owner's acquiescence to the implied easement for a period greater than five years.

   c. An obvious and apparent prior use of one parcel for the benefit of the other parcel during the period of common ownership.



Adjacent Owner Issues

Shared rights and responsibilities

Most properties have three property lines setting the **common boundary** with adjacent properties owned by others. A fourth property line usually sets the frontage on a public right of way, such as a street.

The location of the common property lines might be represented by an improvement which acts as a demarcation of the property line, called a **common boundary improvement**.

A common boundary improvement may be a:

- party wall;
- boundary fence;
- tree line;
- driveway; or
- ditch.

Prospective buyers interested in a property are concerned about:

- the ownership of any **common boundary improvements**; and
- who is responsible for their **maintenance**.

The rights of the adjacent property owners when setting up, maintaining or removing common boundary improvements depend on the type of improvement which exists.

Setting boundaries

Boundaries between parcels of real estate are set out by a survey and recorded as the legal description of each parcel. When the boundary line in a recorded deed is readily ascertainable by a surveyor, the description in the record controls.

However, uncertainty over the exact location of a boundary line may arise in a number of circumstances. For example, where natural markers, such as trees, boulders or a creek, were used to mark a boundary line, the location of the markers may have changed or disappeared over time.

Section posts and other surveyor's monuments which indicate boundary lines are also subject to earth movement, climatic changes and human activity. Additionally, the legal descriptions for parcels of real estate may be conflicting or simply fail to correctly set a boundary line, or may not coincide with another line or boundary.

Doctrine of agreed boundaries

Absent an ascertainable location of a boundary line, the **agreed-boundary doctrine** sets the parameters for the boundary between adjoining parcels.

To establish a boundary line under the *agreed-boundary doctrine*, the following facts need to exist:

- uncertainty as to the boundary's exact location;
- an agreement between the owners to set the boundary line; and
- acquiescence to the boundary line for a period of at least **five years**.

Alternatively, when a substantial loss might be suffered due to a change in the location of the boundary line to the legally described location, a new boundary may be established under the *agreed-boundary doctrine*. [**Ernie** v. **Trinity Lutheran Church** (1959) 51 C2d 702]

Thus, the more practical way to set a boundary line in rural and relatively unpopulated areas was often for owners of adjacent parcels to agree between themselves on the location of a common marker, such as a fence, as the boundary.

Today, surveying techniques are significantly improved. Now, when a deed is clear and a competent surveyor is available, the true boundary line can easily be established and the uncertainty of the boundary's location is eliminated. Thus, the ancient agreed-boundary doctrine has been reduced to the status of a legal last resort.

In the absence of an oral or written agreement between an owner and their neighbor to set the boundary line at some place other than a documented deed line, the boundary line described in their deeds remains as the boundary. [**Armitage** v. **Decker** (1990) 218 CA3d 887]

Agreeing to the boundary

Once owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line, the location they set replaces the legal line provided either:

- a five-year **statute of limitations** has run; or
- a substantial loss might result from the boundary line being moved to the legally described location.

Agreement to make certain

An agreement to mark a boundary line may be oral, written or result from the conduct of neighboring property owners.

Oral or written agreements on the boundary's location are called **express agreements** since they are not implied.

Written agreements are the most effective type of express agreement since they formally document the mutual intentions of both owners. However, they usually exist only in the case of a lot line adjustment map. Unlike the conveyance of real estate, owners do not have to put their boundary agreement in writing for it to be enforceable.

With the setting of an agreed boundary, neither owner is conveying real estate to the other. Instead, the owners are agreeing to what land constitutes their own property. [**Young** v. **Blakeman** (1908) 153 C 477]

QUIZ

1. Which of the following is NOT an example of a common boundary improvement?

    a. Party wall.

    b. Undeveloped land.

    c. Tree line.

2. Absent an ascertainable location of a boundary line, the __________ sets the parameters for the boundary between adjoining parcels.

    a. recorded-boundary principle

    b. mercurial-boundary theory

    c. agreed-boundary doctrine

Party walls and boundary fences

Common boundary improvements, other than trees, located on a property line between adjacent properties are called **party walls**.

A *party wall* may be in the form of a wall, fence or building wall co-owned by the adjacent property owners.

The use and ownership of a party wall is best set forth in a *written agreement* between adjacent property owners. The agreement defines each owner's responsibility for sharing the cost of maintaining the party wall. However, these written agreements rarely exist.

An adjoining property owner may not remove or destroy a party wall without the consent of the other owner since each has an interest in the party wall.

An owner may alter a party wall, such as by installing cosmetic ornamentation on their side. However, they may not injure the wall or interfere with the adjoining property owner's use of the party wall. [**McCarthy** v. **Mutual Relief Ass'n of Petaluma** (1889) 81 C 584]

Boundary fences and cost contributions

For security and privacy purposes, many properties are fenced in by a **boundary fence**. A boundary fence may be a party wall co-owned by the adjacent property owners.

When an owner leaves their land unfenced and later decides to enclose it by using the existing fence as part of the enclosure, they need to compensate the neighbor who built the fence for the pro rata value of the neighbor's fence used by the owner. [Calif. Civil Code §841(b)(2)]

Owners of adjoining properties are presumed to benefit equally from boundary fences. Under this presumption, all adjoining owners are equally responsible for constructing, maintaining and replacing boundary fences. [CC §841(b)(1)]

The responsibility for constructing, maintaining or replacing boundary fences may be altered or removed only by:

- a *written agreement* between all affected owners; or
- an adjoining owner's *judicial petition* to remove or alter their responsibility.

On an owner's petition to a court, factors considered when determining an owner's responsibility for a boundary fence include:

- whether the boundary fence presents a financial burden disproportionate to the owner's benefit;
- the cost of the construction, maintenance or replacement in relation to the value added to the owner's property;
- whether financial responsibility for the boundary fence imposes unjustifiable financial hardship;
- the reasonableness of the construction, maintenance or replacement; and
- any other unequal impact the construction, maintenance or replacement of the boundary fence may have on the owner. [CC §841(b)(3)]

QUIZ

1. The responsibility for constructing, maintaining or replacing boundary fences may be altered or removed by:

   a. a written agreement between all affected owners.

   b. an adjoining owner's judicial petition to remove or alter their responsibility.

   c. Both a. and b.

Line trees: a trunk with common owners

Trees are:

- solely owned;
- government owned; or
- commonly owned.

A tree's ownership is determined by the location of its trunk.

Solely owned trees belong to the owner of the property on which the trunk is growing. [Calif. Civil Code §833]

Trees growing on government-owned parcels, such as a right of way for streets and sidewalks, belong to the local government.

However, shrubbery or trees whose trunks stand partly on the land of two adjacent property owners belong to the adjacent owners as **tenants in common**. These trees are called **line trees** or **common boundary trees**. [CC §834]

Adjacent owners who own boundary trees as tenants in common are jointly responsible for maintaining the trees. [CC §841]

Sharing boundary trees

Co-owners of *boundary trees*, as adjoining property owners, both enjoy the use of the trees.

For example, use of a boundary tree by adjacent property owners includes trimming and maintaining the trees. The co-owner who trims the tree needs to carry away and dispose of the tree trimmings. The co-owner needs also to take care not to damage the tree or interfere with the other co-owner's use of the tree.

The use allowed a co-owner of boundary trees is the same as the use allowed the owner of solely-owned trees, as long as the use does not interfere with the other co-owner's use and enjoyment of the trees.

Remedies

To avoid disputes, adjacent property owners enter into an agreement detailing how they will handle the maintenance of boundary trees.

When a boundary tree injures the *health and safety* of a property owner or prevents them from enjoying their property, the tree may constitute a **nuisance** and be removed. [CC §3479]

A co-owner of a boundary tree might refuse to consent to the removal of a boundary tree. If the tree constitutes a nuisance, an abatement of the nuisance is allowed.

For example, boundary trees may be a nuisance if their branches or the trees themselves continually fall, threatening the safety of people using the adjacent property or damaging improvements on the adjacent property. [**Parsons** v. **Luhr** (1928) 205 C 193]

QUIZ

1. A tree's ownership is determined by:

   a. the side of the property containing the majority of the branches and foliage.
   b. the location of its trunk.
   c. the location where the majority of the root structure exists.

2. When a boundary tree injures the health and safety of a property owner or prevents them from enjoying their property:

   a. the tree may constitute a nuisance and be removed.
   b. the tree may be classified as an environmental hazard and the burdened owner is entitled to harvest the fruits from the tree.
   c. the tree may be considered a natural hazard and the owner can petition to alter the property line to include the encroaching tree.

injunction

Encroachments: crossing the line

An **encroachment** is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without their consent.

Consider the owner of a parcel of real estate. Shortly after their purchase, the owner discovers the garage on their neighbor's property extends two feet over the boundary line onto the owner's property.

The owner demands the neighbor remove the *encroachment*. When the neighbor refuses, the owner seeks to compel the neighbor's removal of the portion of the garage which encroaches on the owner's property.

The neighbor claims the owner is not entitled to a removal of the improvement due to evidence that:

- the encroachment was unknown and unintentional;
- the square footage of the owner's property affected by the encroachment is minor; and
- the cost to remove the garage far exceeds the monetary loss to the owner if the encroachment were allowed to continue.

May the owner obtain a court order forcing the removal of the encroaching garage, called an **injunction**?

No! The encroachment is unintentional and minor in its effect on the burdened owner. Thus, the burden to the owner does not justify ordering the neighbor to undertake an expensive reconstruction activity.

Instead, the owner is awarded money losses representing the rental value for the lost use of their property, and the neighbor is granted an easement over the owner's property for the life of the garage. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

Further, for the neighbor to be allowed to maintain the encroachment, the neighbor must have acted in **good faith** when building the improvements. This means the neighbor needs to have constructed the improvements *without knowledge* they encroached on the owner's property. If not, the owner is entitled to an injunction forcing the removal of the encroaching structure –no matter how minor the encroachment.

Rights affected

Besides the fee owner of real estate, others may seek to stop an encroachment. Any person holding rights in real estate may protect those rights against outside interference. Thus, the rights affected by an encroachment include:

- *leasehold* interests [**Brown Derby Hollywood Corporation** v. **Hatton** (1964) 61 C2d 855];
- *deed restrictions*, such as limitations on the height of improvements [**Seligman** v. **Tucker** (1970) 6 CA3d 691];
- *setback* requirements;
- *easements* [**City of Dunsmuir** v. **Silva** (1957) 154 CA2d 825]; and
- *prescriptive easements*. [**Warsaw** v. **Chicago Metallic Ceilings, Inc.** (1984) 35 C3d 564]

QUIZ

1. An improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without their consent is best described as a(n):

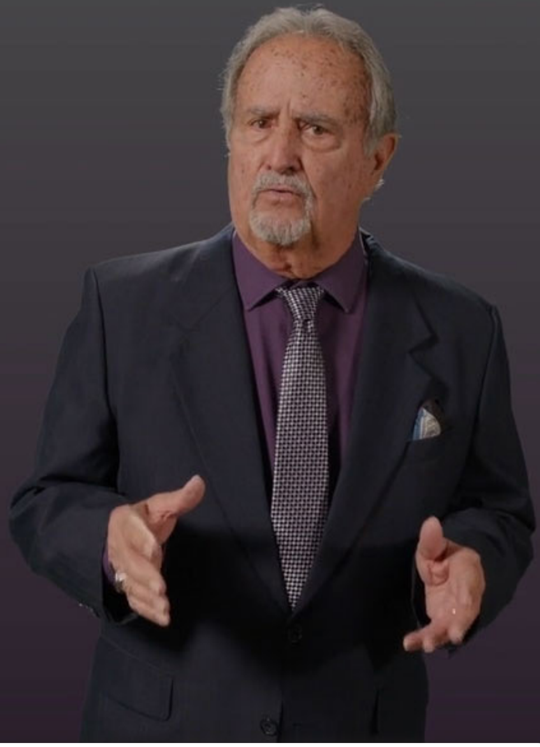
   a. encumbrance.
   b. encroachment.
   c. zoning violation.

encroachment

trespass

nuisance

boundary disputes



Encroachment, trespass and nuisance

An **encroachment** is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without their consent.

Encroachment is closely related to trespass, nuisance and boundary disputes. All involve an interference with another person's property rights.

Any encroachment qualifies as a *nuisance*, be it a **permanent** or **continuing nuisance**, since nuisance is broadly defined as any obstruction of another's use and enjoyment of their real estate.

An encroachment is also a **trespass** when it actually rests on the ground of the neighbor's property.

However, the names used for an interference are unimportant. One way or another, an owner is entitled to recovery for an **unauthorized interference** with their property rights.

Once an encroachment has been discovered, the remedies available to the owner include:

- an **injunction** ordering the removal of the encroaching structure; or
- **money losses** for the diminished value of the property.

Tree encroachments

Trees with trunks which are planted on one side of a boundary line belong solely to the owner of the property on which the trunks grow. [Calif. Civil Code §833]

A solely-owned tree encroaches on a neighboring property when its branches or roots reach past the boundary line, sometimes called the **contiguous line** or **common property line** with the adjacent property.

A property owner confronted with encroaching branches and roots from a neighbor's tree has three potential remedies:

- recover their money losses from the neighbor [**Bonde Bishop** (1952) 112 CA2d 1];
- use self-help to eliminate the encroachment; or
- obtain a mandatory injunction ordering the neighbor to remove the encroachment.

The remedy available depends on the extent of the encroachment.

An encroachment may be either:

- a permanent encroachment; or
- a continuous encroachment. [**Tracy Ferrera** (1956) 144 CA2d 827]

Physical damage caused to the neighbor's property by an encroaching tree is considered a permanent encroachment. The neighbor may recover **money losses** from the adjoining property owner for the cost of repairing the physical damage to their property caused by the encroaching tree. [Bonde, *supra*]

When an encroachment can be abated (discontinued), it is considered a **continuous encroachment**. For example, a tree that does not cause physical damage, but only encroaches on a neighbor's property by its overhanging branches or invading roots, is a continuous encroachment.

A neighbor subjected to a continuous tree encroachment may resort to **self-help** by cutting the offending branches and roots back to the property line. [**Grandona** v. **Lovdal** (1886) 70 C 161]

A neighbor who cuts off overhanging branches from an encroaching tree may keep or discard any firewood or fruit from the overhanging branches. [Grandona, *supra*]

However, a neighbor may not cut the encroaching branches or roots beyond the boundary line, kill the tree or enter the adjoining owner's property without the owner's permission. [**Fick** v. **Nilson** (1950) 98 CA2d 683]

Another type of continuous encroachment is a *nuisance*. A nuisance is any condition which prevents a neighbor's free use or enjoyment of their property or is injurious to their health. [CC §3479]

The mandatory injunction remedy to remove the encroaching branches or roots is only available when the encroachment constitutes a nuisance, such as when tree roots deplete the nutrients in the soil of a neighboring property. [Bonde, *supra*; **Crance** v. **Hems** (1936) 17 CA2d 450]

QUIZ

1. When an encroachment can be abated, it is considered a:
   a. continuous encroachment.
   b. permanent encroachment.
   c. implied encroachment.

Statute of limitations

Normally, an owner seeking to terminate an encroachment or recover money losses is subject to a **three-year statute of limitations** running from the *commencement* of the encroachment. [**Bertram** v. **Orlando** (1951) 102 CA2d 506]

The limitations period for an encroachment is the same as for a *permanent nuisance* since the damage to the owner is complete and certain as soon as the encroachment is created.

The **date** the encroachment was created is the critical date. Whether an owner has knowledge an encroachment exists on their property does not affect application of the statute of limitations to bar their claims for removal or money. The limitations period runs from the creation of the encroachment, not its discovery. [**Castelletto** v. **Bendon** (1961) 193 CA2d 64]

However, in the rare case where damage resulting from an encroachment is **progressive** over time, the three-year statute of limitations does not apply from the date of creation.

For instance, an owner's building is damaged when a neighbor's building leans on it, due to a poorly compacted fill. The degree of the tilt, and the resulting damage, *increases over time*.

More than three years after the damage commences, the owner seeks to recover monetary losses from the neighbor. The neighbor claims the owner is barred from recovering money losses by the running of the three-year limitations period from the date the encroachment first occurred.

However, the intrusion on the owner's building is not only continuous but *progressive* — a further intrusion.

As with a *continuing nuisance*, a new claim accrues each time the loss increases. Thus, while the three-year statute of limitations does apply, it does not begin to run on the commencement of the encroachment, but runs from the date of the last increase in damage from the progressively increasing encroachment. [**Kafka** v. **Bozio** (1923) 191 C 746]

In addition to barring an owner's relief for an encroachment on their property due to the statute of limitations, an action seeking money losses or an injunction against an encroachment may be barred by the equitable doctrine of **laches**, also called **prejudicial delay** or **detrimental reliance**.

A property owner loses their right to enforce a removal of an encroachment or recover money against the encroaching neighbor when the owner *delays* in making the claim, causing the neighbor to rely on the owner's acquiescence to their detriment.

For example, an owner discovers their neighbor is constructing a potential encroachment. However, the owner refrains from saying anything or taking any action until the construction is completed. Here they are barred from enforcing its removal. The encroaching neighbor has relied on the owner's acquiescence in undertaking and completing the construction. [**Rankin** v. **De Bare** (1928) 205 C 639]

Finally, an owner who allows a known encroachment on their property to continue for over five years risks losing property rights through a prescriptive easement or adverse possession since the adverse use of the owner's property by the encroaching neighbor is known to the owner and continuous.

Thus, an owner **needs to act promptly** to enforce their right to remove the encroachment or receive compensation for lost value when a neighbor's improvements encroach on their property.

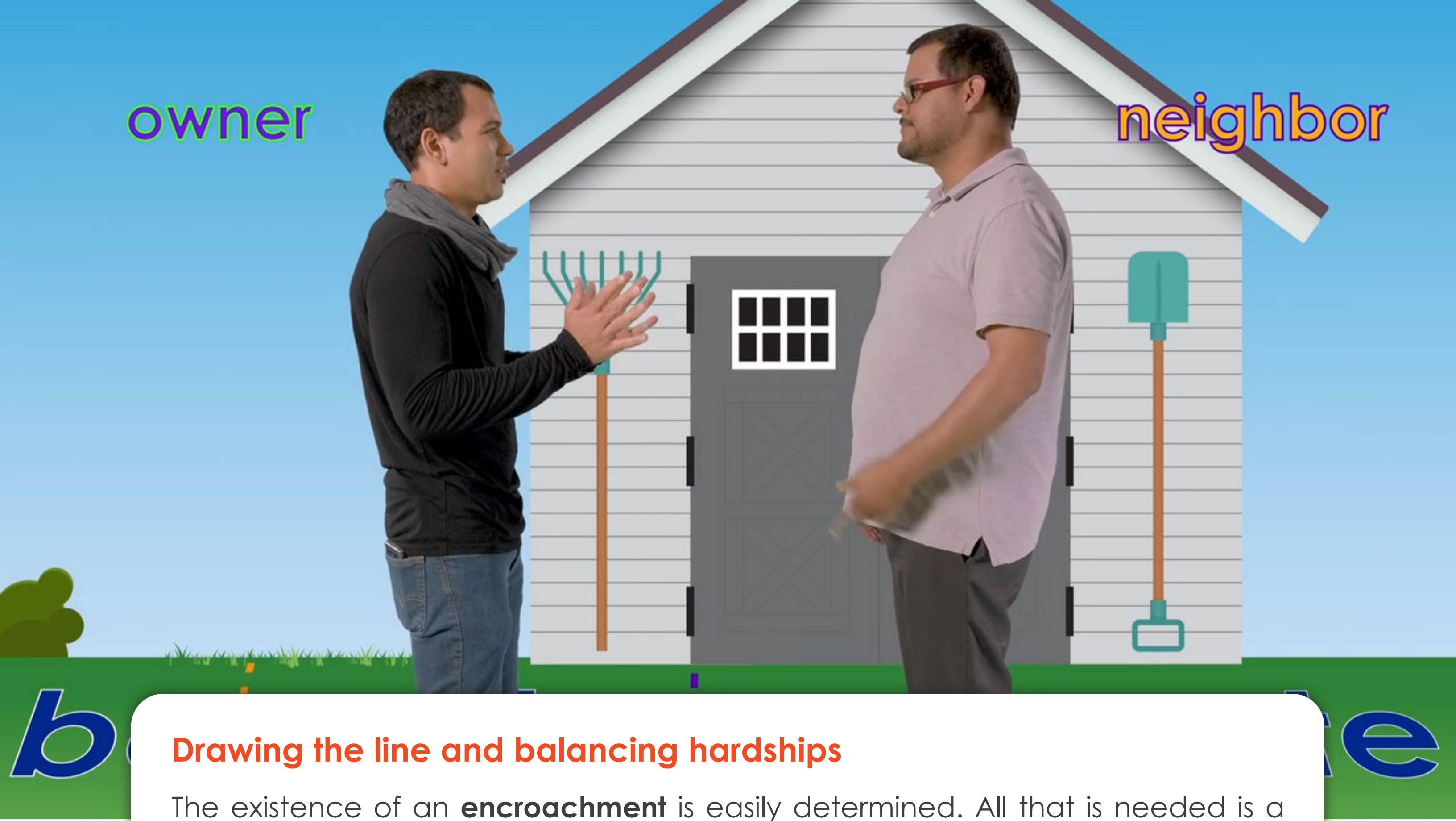
QUIZ

1. An owner seeking to terminate an encroachment or recover money losses is subject to a __________ statute of limitations running from the commencement of the encroachment.

   a. one-year

   b. two-year

   c. three-year



Drawing the line and balancing hardships

The existence of an **encroachment** is easily determined. All that is needed is a survey to locate the property line. When an improvement on one parcel extends over the line onto an adjacent parcel, it is an encroachment.

Occasionally, neighboring owners disputing the existence of an encroachment rely on contradictory surveys to establish the property line. When the owners are not able to agree on the location of the property line, the boundary dispute needs to be resolved before any remedy for the encroachment — when one exists — may be granted.

The resolution of the boundary dispute frequently amounts to no more than a court determining which of the surveys is more accurate. [**Iacovitti** v. **Fardin** (1954) 127 CA2d 348]

However, where the boundary is marked by a physical structure, such as a fence or a row of trees, a survey is not always to be relied on.

For instance, a common boundary line marked by a fence or other structure is not located on the recorded description of the lot line. Both neighbors treat the fence as the boundary for a number of years. The agreed-to location of the property line due to creating the fence is the boundary, regardless of deeds and surveys to the contrary.

Once an **encroachment** has been determined, the remedies available to the owner include:

- an injunction ordering the removal of the encroaching structure; and

- money losses for the diminished value of the property.

Balancing the hardships

An owner is entitled to terminate or prevent an unauthorized intrusion onto their real estate.

However, when a building or other substantial improvement encroaches on an owner's property, the neighbor's cost of removing the encroachment might far exceed the damage inflicted on the owner burdened by the encroachment.

Thus, the encroachment is allowed to continue and the owner is awarded money losses for the lost use of their property, called **balancing hardships** or *balancing equities*.

The conditions for *balancing hardships* — i.e., merely granting money losses and allowing an encroachment to continue — are:

- the owner of the property affected by the encroachment may not suffer an *irreparable injury* due to the continued existence of the encroachment;
- the neighbor who owns the encroaching structure needs to have acted innocently and in *good faith* when constructing the encroaching structure; and
- the **cost** to the neighbor to remove the encroachment needs to greatly exceed the damage done to the value of the property on which it encroaches. [**Christensen v. Tucker** (1952) 114 CA2d 554]

Good faith and innocence

A neighbor who constructs improvements which encroach on the land of another needs to do so innocently and without knowledge of negative effects to someone else, called acting in **good faith**, before any balancing of the hardship of removal or remaining may take place.

The *good faith* requirement prevents an **intentional exploitation** of the balancing hardships rule.

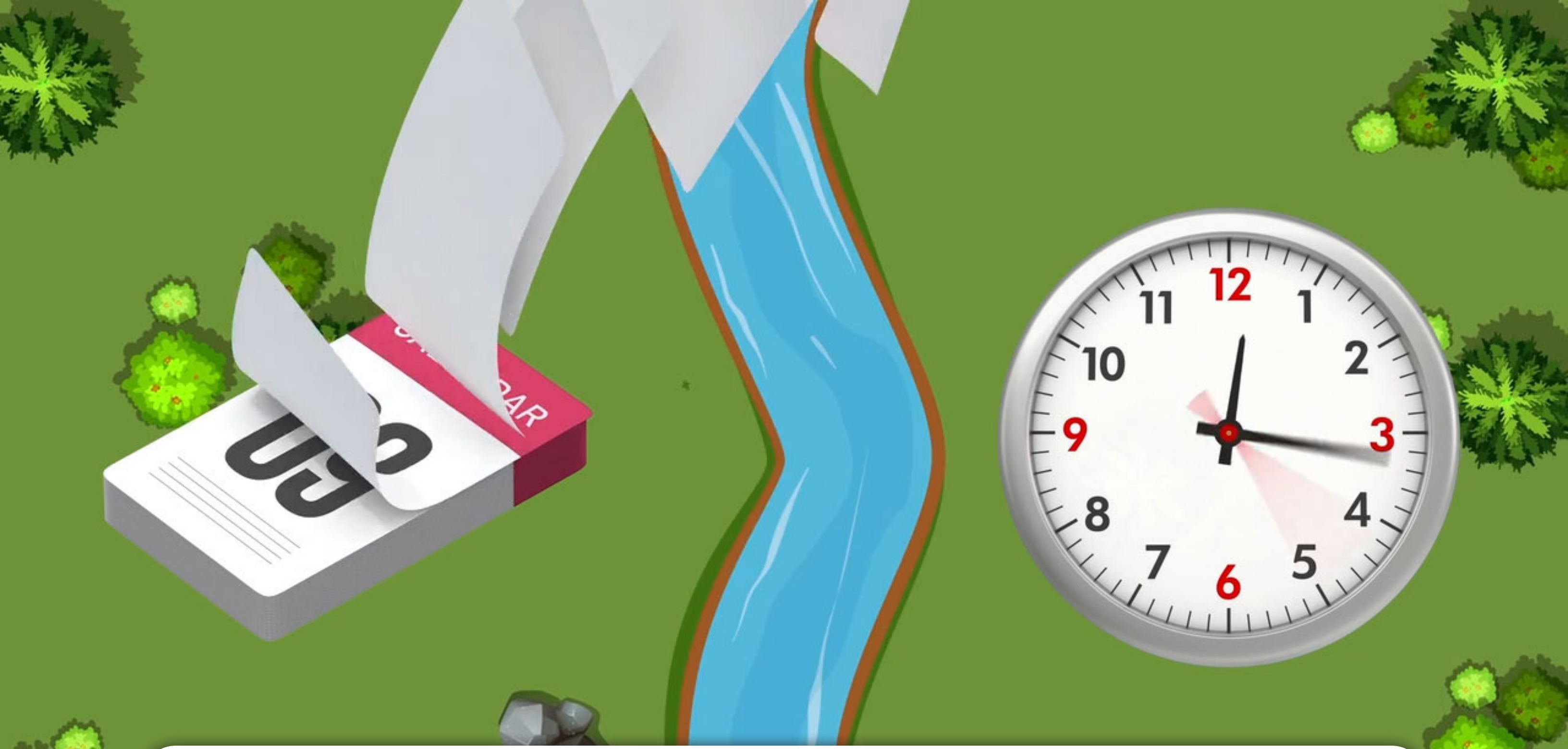
QUIZ

1. Once an encroachment has been determined, the remedies available to the owner include:

   a. an injunction ordering the removal of the encroaching structure.

   b. money losses for the diminished value of the property.

   c. Either a. or b.



Uncertain boundaries

Uncertainty over the exact location of a boundary line may arise in a number of circumstances.

For example, where **natural markers**, such as trees, boulders or a creek, were used to mark a boundary line, the location of the markers may have changed or disappeared over time. Section posts and other surveyor's monuments which indicate boundary lines are also subject to earth movement, climatic changes and human activity.

Also, the legal descriptions for parcels of real estate may be conflicting or simply fail to correctly set a boundary line, or may not coincide with another line or boundary.

An actual *dispute* over a boundary's location need not exist between the owners of adjacent parcels. Instead, owners are to merely be in doubt over the location of the true boundary and agree to the location of the boundary when they set it.

Usually, it is not the original owners who have a dispute over title or possession based on the agreed-to boundary line, it is the later owners.

However, when the boundary line in a recorded deed is readily ascertainable by a surveyor, the description in the record controls, unless the landowner defending the location of the line as the common boundary provides proof the boundary line as located settles an actual, not implied, boundary dispute. [**Bryant** v. **Blevins** (1994) 9 C4th 47]

Agreeing to the boundary

Once owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line, the location they set replaces the legal line provided either:

- a five-year **statute of limitations** has run; or
- a substantial loss would result from the boundary line being moved to the legally described location.

The *statute of limitations* requires the adjacent owners to resolve a dispute within the five-year period. If disputes are not settled within this period, the claims are put to rest. Thus, an owner who fails to object to a boundary dispute during the statute of limitations period is presumed to have agreed to the boundary set by the adjacent property owner.

However, an exception to the five-year rule arises if *substantial loss* will be caused by the movement of the agreed boundary to the true lot line.

The agreed-boundary doctrine has limitations. The doctrine cannot be used to convey property. Further, the agreed-boundary doctrine can only set a boundary, the exact location of which is unknown to the adjacent owners without a survey or litigation.

Any attempt to convey a portion of a lot to the owner of an adjacent property by use of the agreed-boundary doctrine violates the *statute of frauds* which requires a writing documenting the intent to convey land. Thus, the agreed-boundary doctrine cannot be used to make **lot line adjustments** in which adjacent owners move an existing line, the location of which is known to them.

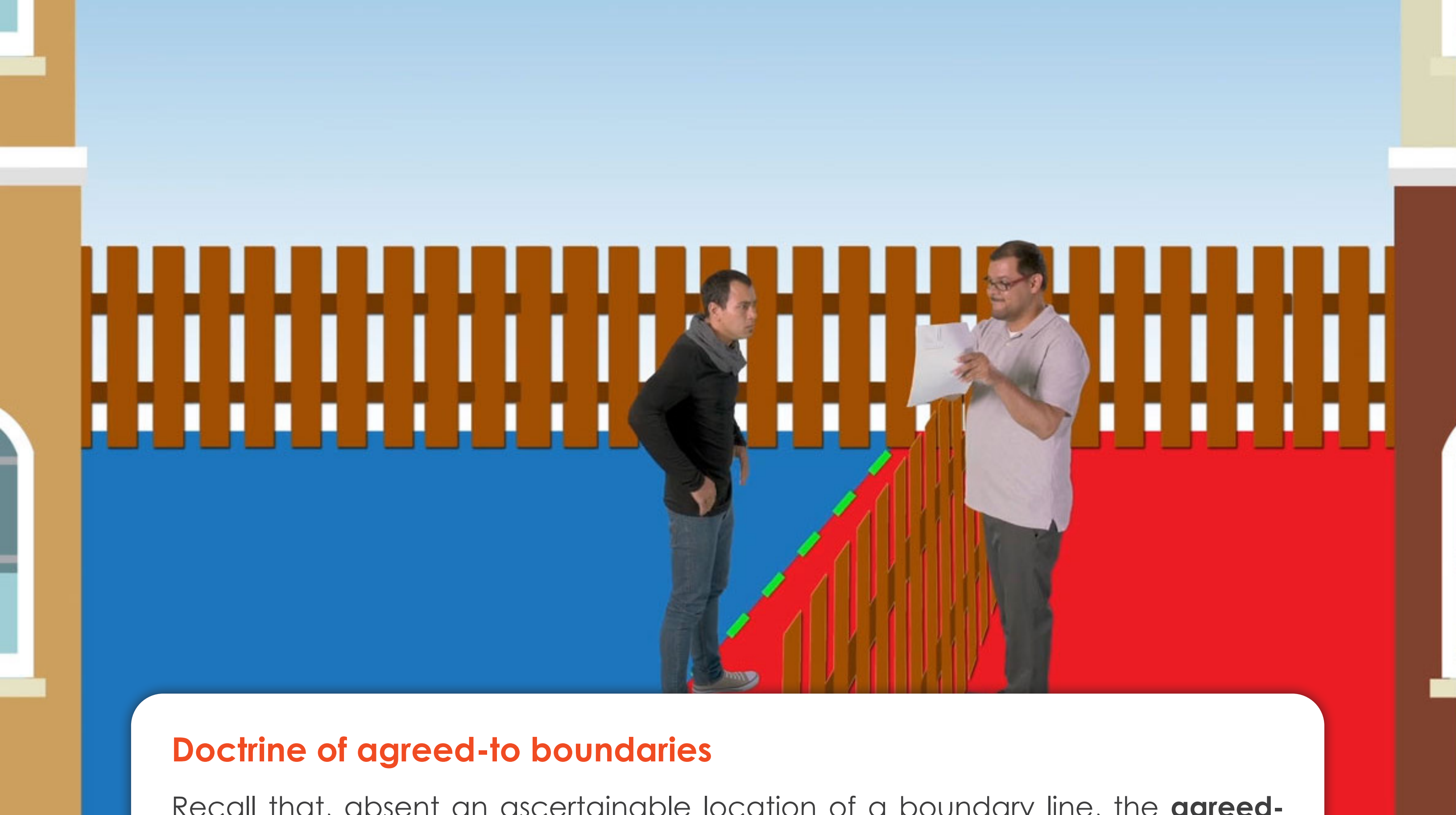
QUIZ

1. Once owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line, the location they set replaces the legal line provided:

   a. a five-year statute of limitations has run.

   b. a substantial loss would result from the boundary line being moved to the legally described location.

   c. Either a. or b.



Doctrine of agreed-to boundaries

Recall that, absent an ascertainable location of a boundary line, the **agreed-boundary doctrine** sets the parameters for the boundary between adjoining parcels.

To establish a boundary line under the *agreed-boundary doctrine*, the following facts need to exist:

- *uncertainty* as to the boundary's exact location;
- an *agreement* between the owners to set the boundary line; and
- *acquiescence* to the boundary line for a period of at least five years.

Alternatively, when a *substantial loss* might be suffered due to a change in the location of the boundary line to the legally described location, a new boundary may be established under the *agreed-boundary doctrine*. [**Ernie** v. **Trinity Lutheran Church** (1959) 51 C2d 702]

The agreed-boundary doctrine was developed during a time when less advanced surveying techniques occasionally made it too difficult or expensive to locate the boundary line described in the deeds.

Thus, the more practical way to set a boundary line in rural and relatively unpopulated areas was often for owners of adjacent parcels to agree between themselves on the location of a common marker, such as a fence, as the boundary.

Today, surveying techniques are significantly improved. Now, when a deed is clear and a competent surveyor is available, the true boundary line can easily be established and the uncertainty of the boundary's location is eliminated. Thus, the ancient agreed-boundary doctrine has been reduced to the status of a legal last resort.

In the absence of an oral or written agreement between an owner and their neighbor to set the boundary line at some place other than a documented deed line, the boundary line described in their deeds remains as the boundary. [**Armitage** v. **Decker** (1990) 218 CA3d 887]

Consider a parcel of real estate divided into two equally sized parcels by a recorded survey. Later, the owners erect a fence between the parcels which is not located on the recorded common boundary line. Thus, one parcel appears to be physically larger than the other.

Multiple years later, the owner of the smaller parcel sells their land. The new owner hires a surveyor to determine the location of the boundary between the properties.

The survey sets the boundary at the location described in recorded documents. The survey shows the fence is not located on the legally described boundary between the adjacent properties. The new owner of the smaller parcel seeks to recover possession of the land between the fence and the boundary.

The neighboring owner of the larger parcel claims the fence is the agreed boundary since it is reasonable to infer the previous owners agreed the location of the fence to be their common boundary.

The owner of the smaller parcel claims the agreed-boundary doctrine does not apply since a recorded legal description of the boundary is available and the true boundary is known and can be located by a survey.

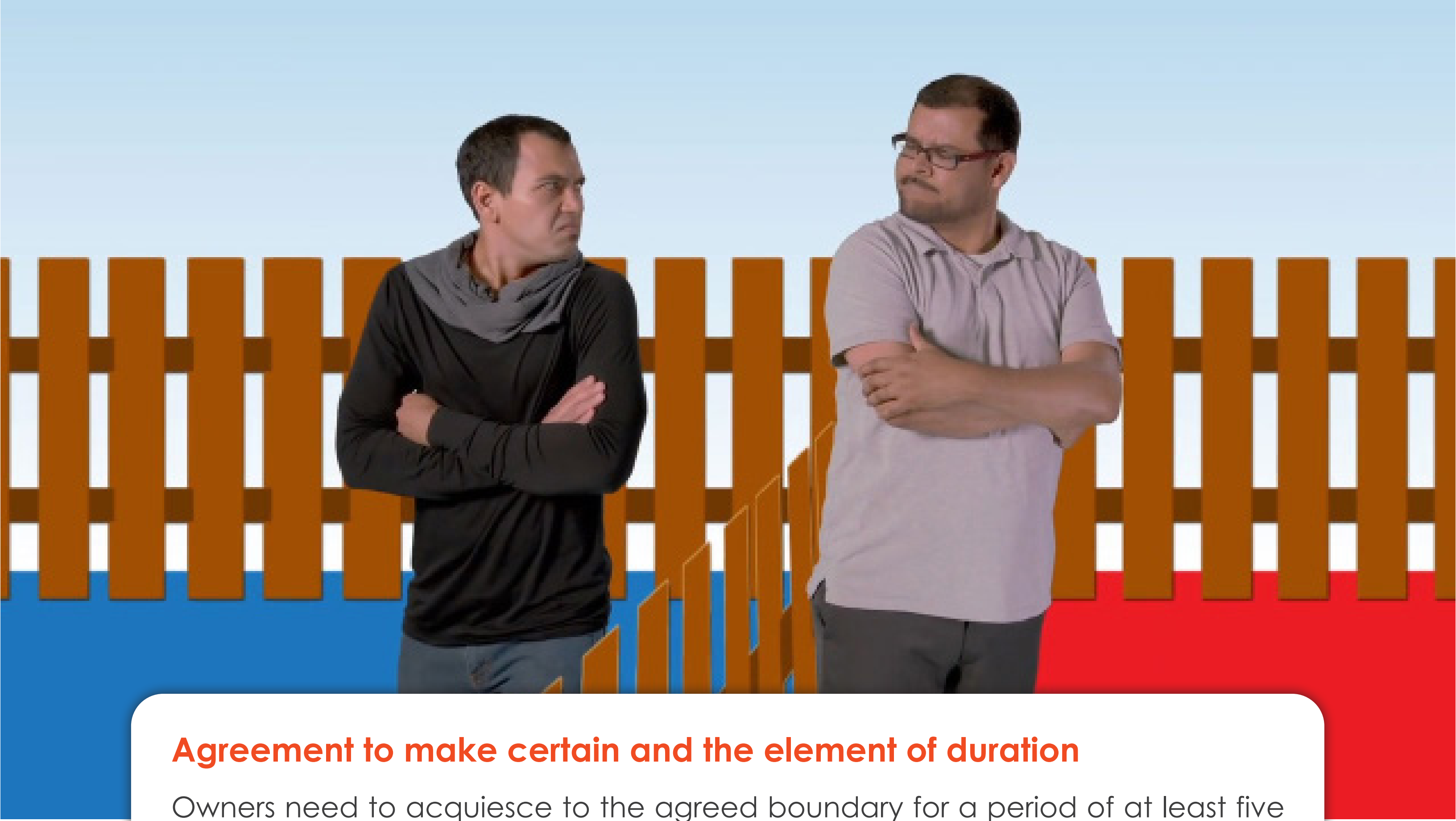
Is the owner of the smaller parcel correct in relying on the **legal description** of the property to establish the actual boundary location?

Yes! The doctrine of title by agreed boundaries does not apply since:

- the exact boundary location can be readily located; and
- the owner of the larger parcel defending the fence as the boundary provided no evidence the prior owners were **uncertain** as to the true boundary description and then, to resolve their uncertainties of location, **agreed** the fence would mark the boundary. [**Bryant Blevins** (1994) 9 C4th 47]

QUIZ

1. Which of the following is NOT required to establish a boundary line under the agreed-boundary doctrine?
   a. Certainty as to the boundary's exact location.
   b. An agreement between the owners to set the boundary line.
   c. Acquiescence to the boundary line for a period of at least five years.



Agreement to make certain and the element of duration

Owners need to acquiesce to the agreed boundary for a period of at least five years. This five-year period is the **statute of limitations** for the recovery of real estate. [Calif. Code of Civil Procedure §318]

The *statute of limitations* requires the adjacent owners to resolve a dispute within the five-year period. When disputes are not settled within this period, the claims are put to rest. Thus, an owner who fails to object to a boundary dispute during the statute of limitations period is presumed to have agreed to the boundary set by the adjacent property owner.

However, an exception to the five-year rule arises when *substantial loss* will be caused by the movement of the agreed boundary to the true lot line.

For example, when an adjacent owner builds improvements near the line established in reliance on an agreement that it is the boundary, the new boundary is allowed without the enforcement of the five-year period. However, the new boundary is only allowed when the adjacent owner can show that moving the boundary will result in substantial loss due to the existence of improvements. [**Roman** v. **Ries** (1968) 259 CA2d 65]

Marking the line

When a writing setting the boundary is not available, subsequent owners need to look to the prior owner's activities for an *implication* that an agreement existed as to the location of the boundary line.

For example, the construction of a fence may imply an agreement to set a boundary. However, in order for the fence to control in an agreed-boundary dispute, the owner relying on the fence as a boundary needs to present evidence to show the fence was erected to resolve a *boundary uncertainty known* to previous owners.

Fences are built for a variety of reasons, one of which is to establish a boundary. Other reasons for erecting fences include controlling animals, aesthetics or to prevent children from wandering off a property.

Further, the location and condition of a fence may be influenced by the topography of the property, the terrain on which it is placed, requirements of an animal enclosure or the loss of lateral and subjacent support. [Bryant, *supra*]

While a fence or wall is evidence of a line for something, a fence does not necessarily set the property boundary.

QUIZ

1. Which of the following is the most correct statement about the agreed-boundary doctrine?
    a. The doctrine can be used to convey property.
    b. The doctrine can be used to make lot line adjustments in which adjacent owners move an existing line, the location of which is known to them.
    c. The doctrine can only set a boundary, the exact location of which is unknown to the adjacent owners without a survey or litigation.

real estate appraiser

Appraisal and Real Estate Valuation

An opinion of value

An **appraisal** is an individual's opinion or estimate of a property's value on a specific date, reduced to writing in an appraisal report.

The *appraisal report contains data collected and analyzed by the appraiser which substantiates the appraiser's opinion of the property's value. The value of a parcel of real estate, given as a dollar amount, is the present worth to an owner of the future flow of net operating income (NOI) generated by the property.*

Similar to a real estate licensee who is licensed by the Department of Real Estate, appraisers are required to hold a license or certification issued by the **California Bureau of Real Estate Appraisers (CalBREA).**

Factors used in the appraisal process to determine a property's value include:

- **demand** – the number of buyers for the property;
- **utility** – the property's possible uses;
- **scarcity** – the availability of similar properties; and
- **transferability** – the seller's ability to transfer good title to a buyer clear of all encumbrances itemized in a title insurance policy.

Collectively, these are known as the **elements of value** and can be memorized with the acronym of DUST.

Further, there are four influences on value, including:

- **physical considerations** – the property's proximity to commercial amenities, access to transportation, the availability of freeways, beaches, lakes, hills, etc;
- **economic considerations** – rents in the area, vacancies and the percentage of homeownership, as well as employment opportunities lost or gained;
- **government considerations** – property taxes, zoning, building codes, and local services such as police and fire protection; and
- **social considerations** – crime rates, school ratings, shopping and recreational opportunities.

These **influences on value** can be memorized with the acronym of **PEGS**.

Factors not used to determine a property's value include the present owner's:

- acquisition cost;
- listing price;
- mortgage financing; and
- equity in the property.

There are many different types of values assigned to a property. In real estate appraisal, the most common type of value used is **market value**, also called **fair market value (FMV)**.

The *FMV* of a property is the highest price on the date of valuation a willing seller and buyer would agree to, both having full knowledge of the property's various uses. [Calif. Code of Civil Procedures §1263.320]

QUIZ

1. Factors used in the appraisal process to determine a property's value include:

   a. demand, utility, scarcity and transferability.

   b. acquisition cost, utility, scarcity and equity in the property.

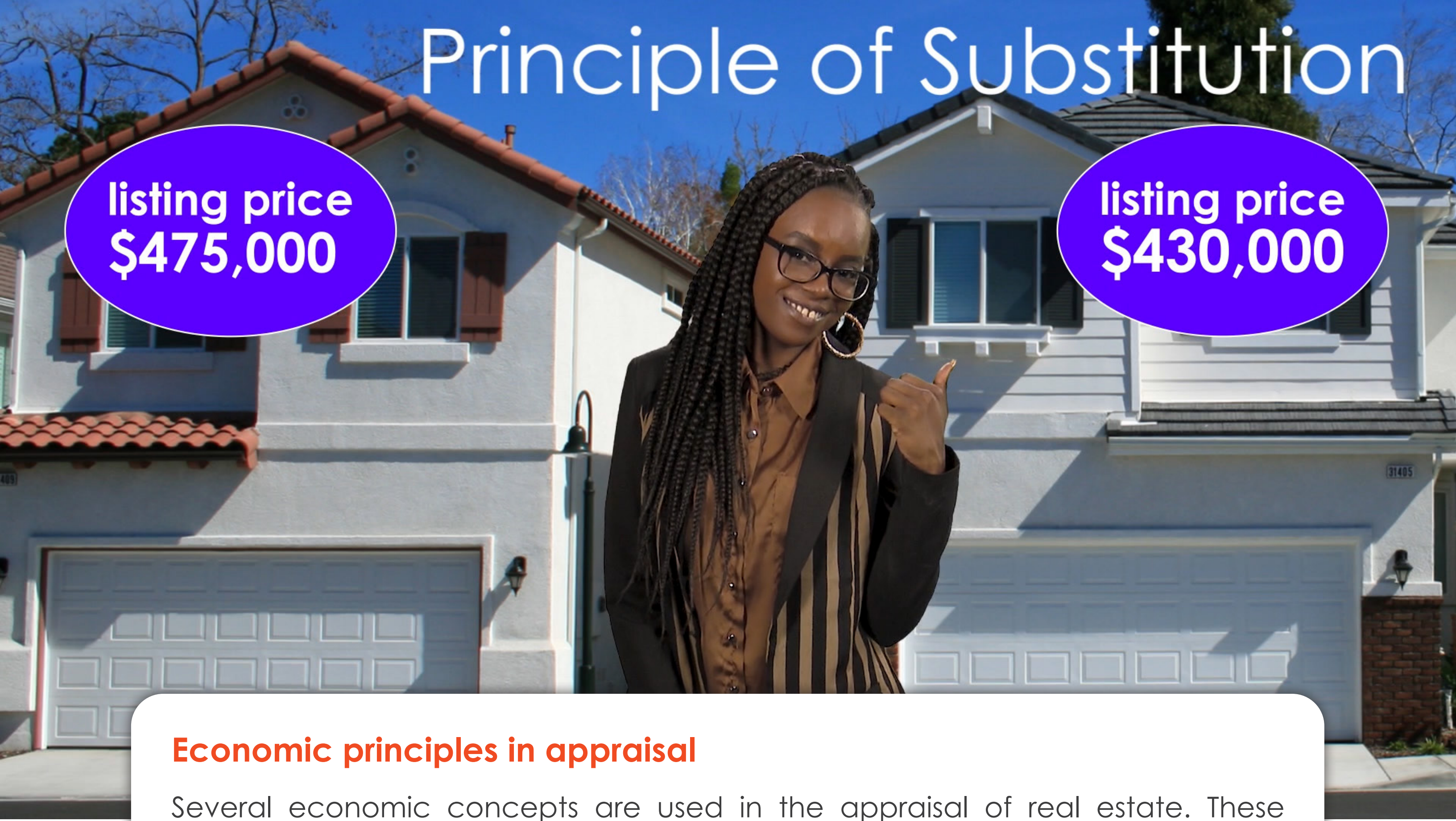
   c. demand, mortgage financing, age and utility.

2. The __________ of a property is the highest price on the date of valuation a willing seller and buyer would agree to, both having full knowledge of the property's various uses.

   a. security value

   b. fair market value

   c. like-kind value



Economic principles in appraisal

Several economic concepts are used in the appraisal of real estate. These principles are referred to as principles of appraisal and are as follows.

The **principle of supply and demand**: For appraisal purposes, the principle of supply and demand holds that once the supply of available homes decreases, the value of homes increase since more people are demanding the decreased supply of available homes. This principle correlates to the density of the population and its level of income, and that of **inventory**.

The **principle of change**: The principle of change holds that property is constantly in a state of change. The change a property experiences is seen in its **life-cycle**. *The life-cycle of a property has four stages:*

- Development of the property includes the subdivision of lots, improvements constructed and the start of a neighborhood community.
- The stability stage of a property, such as a home built within a community, occurs when the property reaches a level of completion where changes are only made to it to maintain an appropriate level of condition.
- The decline stage starts when the oldest buildings begin to deteriorate, lower social or economic groups move into the community and larger homes are converted into multiple family use.
- The revitalization or gentrification stage occurs when the neighborhood is recognized as suitable for renewal. This most often occurs in more urban areas where high-costs force younger and first-time buyers to create value through the renewal process.

The **principle of conformity**: The principle of conformity holds that when similarity of improvements is maintained in a neighborhood, the maximum value of a property can be realized on a sale. **Zoning** regulations and conditions, covenants and restrictions (CC&Rs) tend to protect homeowners by narrowing the uses and excluding nonconforming uses of the property.

The *principle of conformity is further categorized under the principle of:*

- **regression**: The principle of regression holds that the value of the best property in a neighborhood will be adversely affected by the value of other properties in the neighborhood.

  For example, this principle applies to over-improved homes. When an owner makes extensive renovations, such as adding additional rooms and landscaping, and the other neighbors do not, the house is no longer as similar to the others. On the sale of the over-improved home, the owner will not receive the full value of the cost of over-improvements.

- **progression**: The principle of progression is the opposite of the principle of regression, holding that a smaller and lesser maintained property in a well-kept neighborhood will sell for more than if the home were in an area of comparable properties.

The **principle of highest and best use:** The principle of highest and best use holds that the greatest value of the property is realized when its use is maximized. The test for highest and best use requires that the use be physically possible, legally permissible, economically feasible, and achieve the maximum productivity (memorized by the acronym **PLEM**).

On a related note, once improvements have been built, the **consistent-use principle** comes into play. The basic concept is that land and improvements need to be valued on the same basis. When the highest and best use of land as vacant is established, the principle of consistent use holds the improvement is to be valued on that same basis.

Similarly, there's the **principle of balance**. This principle holds that a property's maximum value is realized and sustained when each of the four elements of the factors of production are in economic balance. Thus, the value of a property depends on the balance of land, labor, capital and entrepreneurship.

The **principle of contribution**: The principle of contribution holds that the value of one component (improvement) is measured in terms of its contribution to the value of the whole property rather than its cost. For example, a property's FMV may increase if additions, such as a swimming pool, are added.

The principle of **substitution**: The principle of substitution holds that a buyer will not pay more for a property if it will cost less to buy a similar property of equal desirability. The principle of substitution is the most basic **principle of value** as it is used in each of the three approaches to value.

The principle of anticipation: This principle concerns how the property will benefit the owner over time and into the future. Essentially, it represents the present worth of the rights to all prospective future benefits, both tangible and intangible. In this context, the owner is anticipating the future benefits they will derive from the property.

The principle of anticipation is most commonly used in *commercial* and *income properties*.

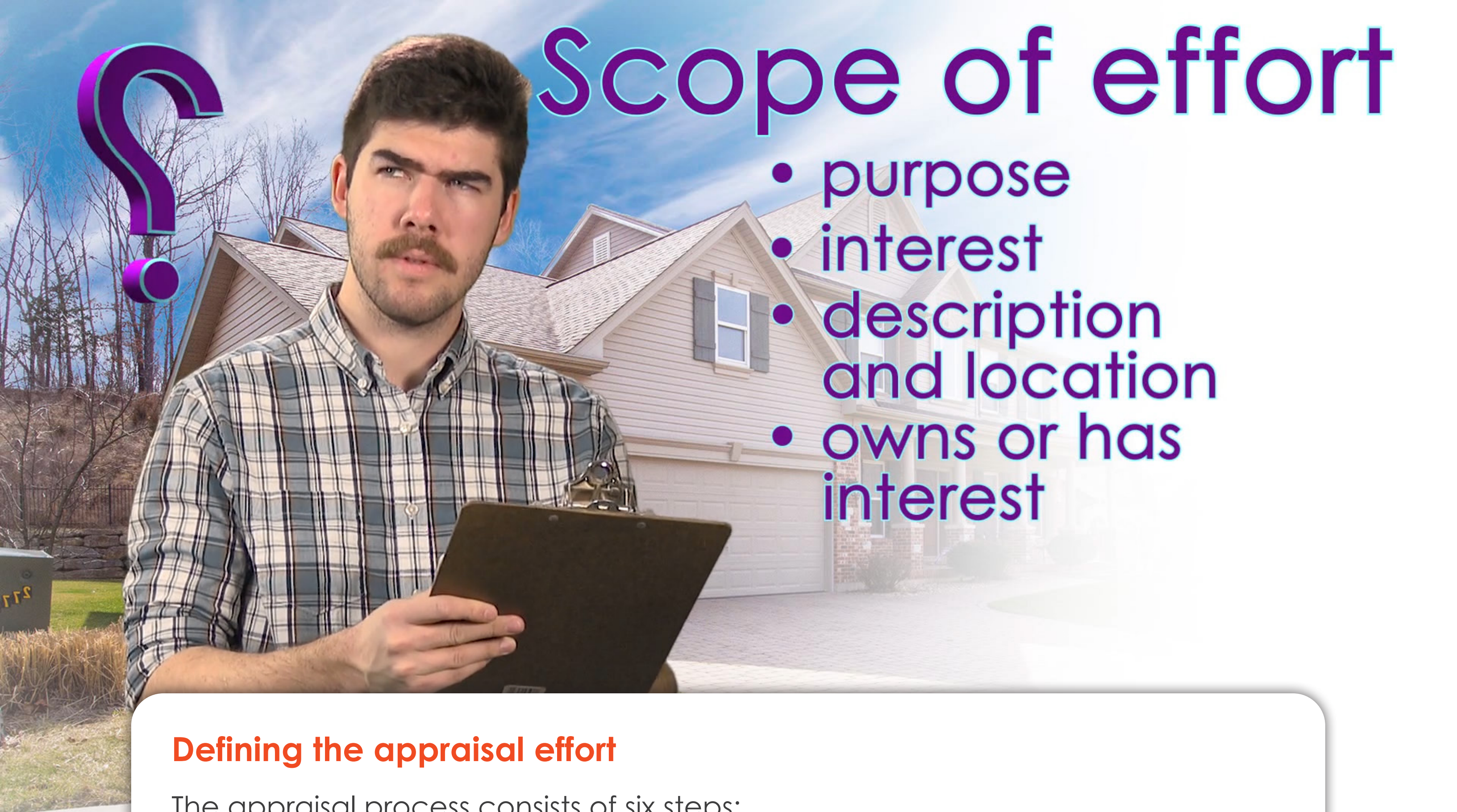
Finally, the **principle of competition**: This principle holds that excessive profits in any line of business will trigger excessive competition— and this excessive competition will, in turn, destroy profits.

Consider a store that opens in a stable area. The store does extremely well and provides a significant return on the investment. Two entrepreneurs separately, and independently, observe the success of the business and open two similar stores in the same neighborhood simultaneously. As a result, the revenue and profits of the original store drops – as does its value. Further, the two new stores don't perform as well as anticipated.

QUIZ

1. The __________ holds that when similarity of improvements is maintained in a neighborhood, the maximum value of a property can be realized on a sale.
   a. principle of change
   b. principle of conformity
   c. principle of highest and best use

2. The __________ holds that a buyer will not pay more for a property if it will cost less to buy a similar property of equal desirability.
   a. principle of substitution
   b. principle of anticipation
   c. principle of competition



Defining the appraisal effort

The appraisal process consists of six steps:

- identifying and defining the appraisal effort to be undertaken by the appraiser;
- data collection;
- analyzing the data;
- applying the three appraisal approaches;
- reconciliation and final valuation of the property; and
- producing the complete report.

Gathering data

The first step in the appraisal process is the identification of the questions to be answered during the appraisal.

The questions to be answered include:

- What is the purpose of the appraisal?
- What interest in the property is being appraised?
- What is the description and location of the property to be appraised?
- Who owns or holds an interest in the property being appraised?
- What is the highest and best use of the property in light of zoning and CC&Rs?
- What encumbrances affect the condition of title to the property?

- Are there any facts that the appraiser needs to clarify?
- What is the appraiser's fee?

The background information gathered on the property to conduct an appraisal is divided into two categories:

- **general data**: Information on the region, city and neighborhood surrounding the property; and
- **specific data**: Information on the location, lot and improvements.

The *general data* gathered are to provide an overview of the property. Data on the local and regional economy are included since it affects property within the local real estate market.

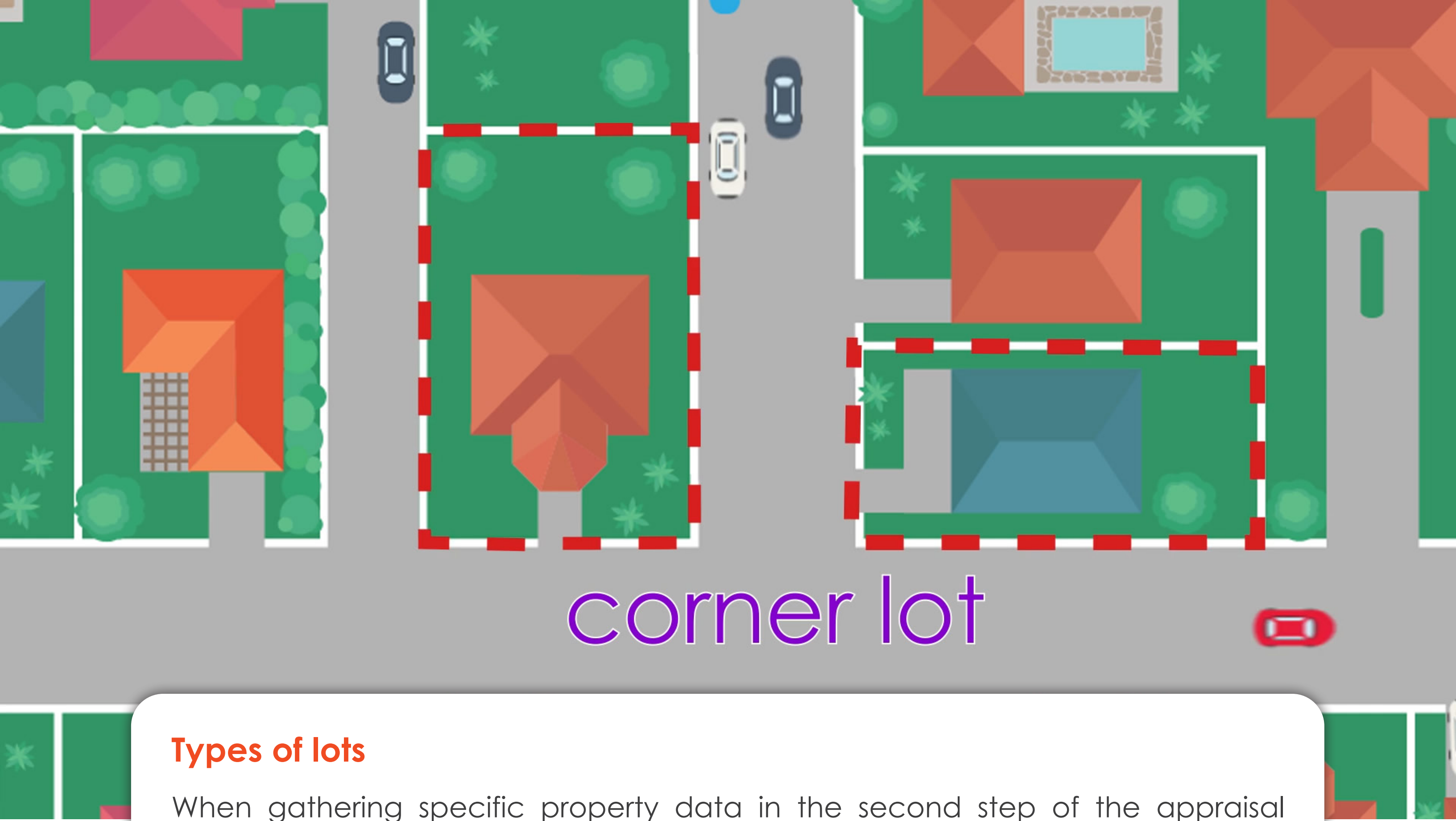
Regional considerations include geography. Also, a growing city or county where jobs are available is desirable. Other features to consider include the quality of school systems and public facilities.

The collection of *specific data* about a property includes information on the size of the parcel, lot type, the improvements on the property and the uses permitted.

QUIZ

1. Which of the following is NOT part of the appraisal process?
   a. Analyzing data about the location, lot and improvements.
   b. Applying the three appraisal approaches and generating a report.
   c. Advising the seller on steps which can be taken to better prepare the property for marketing.

2. The background information gathered on the property to conduct an appraisal is divided into two categories:
   a. macro and micro.
   b. general and specific.
   c. specific and granular.



Types of lots

When gathering specific property data in the second step of the appraisal process, it must be determined what type lot the property is built on.

Lot types include:

- **Cul-de-sac lot:** a lot facing the rounded turn-around portion of a dead-end street. A cul-de-sac property is private since it is not subject to through traffic. Unlike rectangular lots, the cul-de-sac lot has a small front yard which is offset by a larger backyard.
- **Corner lot**: a lot located at the intersection of two streets. A corner lot does not have a great deal of privacy due to traffic on the streets it intersects. However, the corner lot may be more desirable since access to the sideyard and backyard for vehicles is available from the side street.
- **Key lot**: a lot bordered by three or more lots on the sides and the back. The biggest disadvantage of the key lot is the lack of privacy due to numerous neighbors abutting all sides of the lot except the frontage.
- **T-intersection lot:** a lot at the end of a dead-end street. The biggest disadvantage of the T-intersection lot is noise and lack of privacy.
- **Interior lot**: a lot surrounded by lots on all three sides. This is the most common type of lot. An interior lot is usually rectangular in shape with a large backyard. However, privacy is limited since the lot is adjoined on all sides by neighbors.
- **Flag lot**: a lot located behind other lots with a long and narrow access driveway to a public street. Flag lots generally have a reduced value due

to the lack of privacy that results from being surrounded by other homes' backyards. Flag lots also lack curb appeal.

The physical aspects of a lot include:

- size and shape;
- slope, drainage and soil;
- view, exposure to sun and weather; and
- improvements.

Relatedly, **orientation** refers to the placement of a house upon the lot.

Once the general and specific data have been gathered, including information about the lot, the third step in the appraisal process is to analyze the data collected. This is done by carefully studying the information gathered and determining what further research will be necessary.

This analysis phase reflects on what we have learned in the prior section – remember the principles *DUST*, and *PEGS*.

If all the necessary research has been conducted, the appraiser is ready to move on to the fourth step of the process.

QUIZ

1. What type of lot is most likely to have a small front yard offset by a larger backyard?

   a. Cul-de-sac lot.
   b. Interior lot.
   c. T-intersection lot.

2. What is the best term to describe a lot bordered by three or more lots on the sides and the back?

   a. Corner lot.
   b. Flag lot.
   c. Key lot.

Three appraisal approaches: market comparison

After all necessary data have been gathered and analyzed, the appraiser proceeds to the fourth step in the appraisal process. Here, the appraiser considers which of the three appraisal approaches to perform based on the property and the purpose of the appraisal.

The three appraisal approaches are:

- The **market comparison approach,** also known as the *sales comparison approach;*
- The **cost approach,** derived under the *replacement or reproduction method; and*
- The **income approach,** derived under the *gross rent multiplier or capitalization income method.*

The *market comparison approach* is the most commonly used approach to establish the FMV of real estate. Applying the market comparison approach, the appraiser looks at the current selling prices of similar properties to help establish the comparable value of the property appraised. Adjustments are made for any differences in the similar properties, such as their location, obsolescence, lot size and condition.

For example, a property owner's neighbor recently sold their residence for $445,000. The neighbor's house is of a similar age, size and condition as the owner's house, except it has a fireplace worth $5,000 which the owner does not have. Adjusting for the difference in the improvements (the fireplace) between the owner's and neighbor's house would establish the value of the owner's house at $440,000.

To produce a more reliable appraisal, it is better to gather data on **comparable sales**, frequently called "comps."

The appraiser then compares each against the property being appraised for their similarities. Sales information can be obtained from the **multiple listing service (MLS)**, tax records, electronic databases on recordings and title insurance companies.

QUIZ

1. The __________ is the most commonly used approach to establish the fair market value (FMV) of real estate.

    a. income approach

    b. replacement method

    c. market comparison approach

2. When applying the market comparison approach, what would the appraiser be most interested in?

    a. The estimated cost to replace the property if it were to be rebuilt from scratch.

    b. The current list prices of similar properties for sale.

    c. The current selling prices of similar properties.

Three appraisal approaches: cost approach

Appraisers setting value using the *cost approach* calculate the current construction cost to replace the improvements. From the replacement cost, appraisers subtract their estimate of the accrued **depreciation** of the existing improvements due to *obsolescence* and *deterioration* to get the current replacement value of the improvements.

Added to this is the value of the land as though it was vacant. Thus, the appraised market value under the cost approach is the result of totaling the value of the lot plus the cost to replace the improvements minus obsolescence and physical deterioration (depreciation).

The cost approach is best used when valuing *new buildings* and *special* or *unique structures*, such as churches and factories.

Also, an appraiser places more emphasis on the cost approach when recent comparable sales are not sufficient or the property has no income.

Estimating the cost of improvements which would be incurred today to construct the improvements as they exist on the property involves the calculation of **direct** and **indirect** costs.

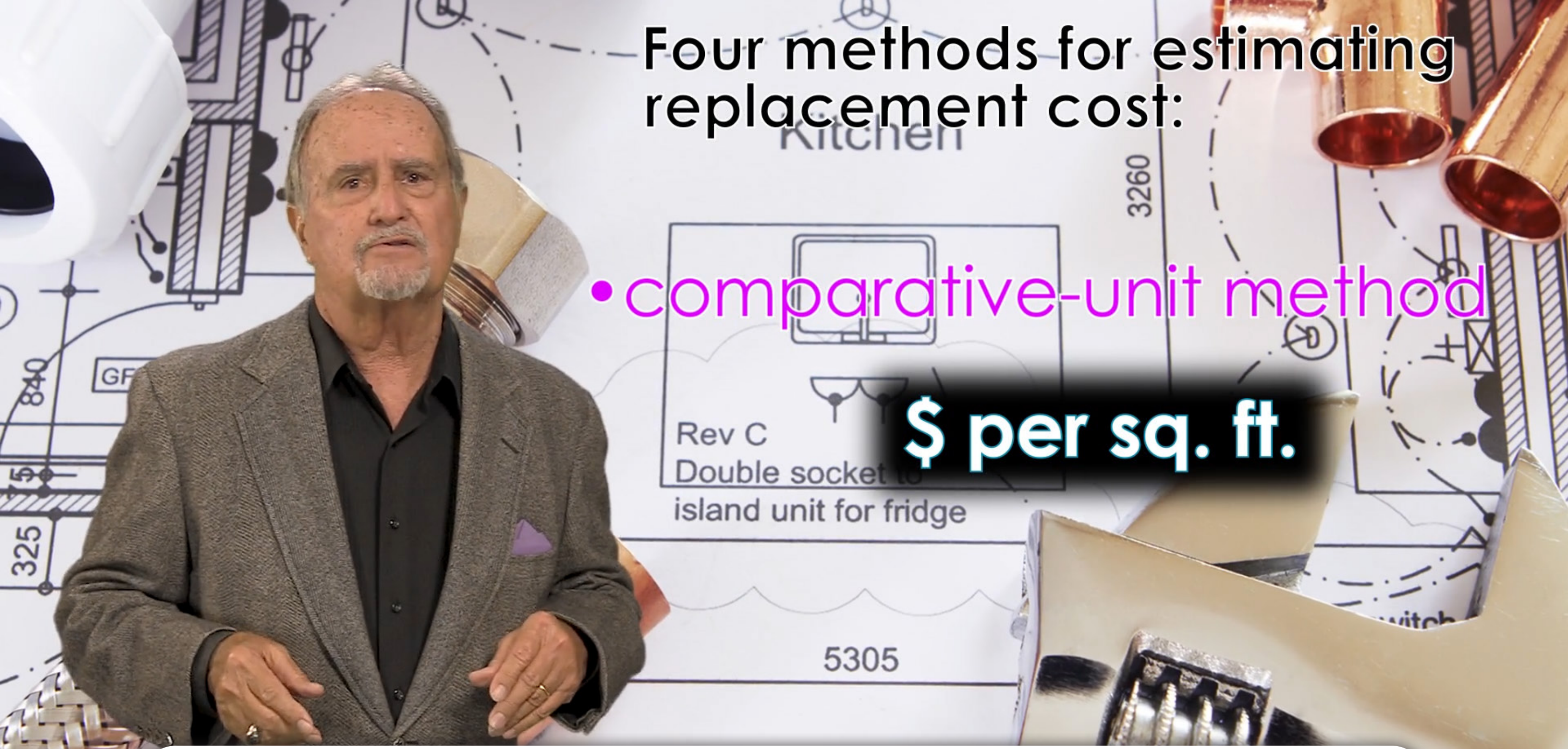
Direct costs include labor and materials used to construct the improvements.

Indirect costs include expenditures other than labor and materials, including permits and other governmental fees, insurance, taxes, administrative costs and financing charges.

QUIZ

1. Appraisers setting value using the cost approach begin by:
   a. calculating the current construction cost to replace the improvements.
   b. estimating of the accrued depreciation.
   c. calculating the value of the land as though it was vacant.

2. The cost approach is best used when valuing:
   a. condominium projects and strip malls.
   b. pre-1978 construction and franchised restaurants.
   c. new buildings and special or unique structures.



Estimated replacement cost under the cost approach

Before discussing the specific methods for estimating **replacement cost** and depreciation, a point of clarification is needed. Replacement cost is the cost to replace a structure with one having the functional equivalent to the structure being appraised, but constructed with modern materials and methods.

A related term is reproduction cost. The reproduction cost is the cost it would take to rebuild a structure as exactly like the original as possible.

For our purposes here, we're going to focus on the more common replacement cost.

The estimated replacement cost of the existing improvements is determined using one of four methods:

- **comparative-unit method**: estimates the cost in terms of dollars per square foot or per cubic foot based on known costs of similar structures, adjusted for physical differences;
- **unit-in-place method**: estimates the unit costs for building components such as foundations, floors, walls, windows and roofs, as well as labor and overhead;
- **quantity survey method**: the most comprehensive and accurate method for estimating the cost of the labor and materials a general contractor would use to build an identical structure, such as lumber, cement, plumbing, electrical, roofing, stucco, glazing, drywall, insulation and labor costs; and
- **index method**: the method designed for use in updating historic costs or

backdating current costs such as in probate valuations where it is required to establish a number at an earlier date.

After the appraiser estimates the replacement costs, the next step is to estimate and deduct **depreciation**.

Depreciation reflects any value-related loss in the property due to use, decay and improvements that have become outdated.

There are three types of depreciation:

- **Physical deterioration** is the loss in the property's value due to wear and tear. Physical deterioration can be curable or incurable. Examples include damage from termites or damage resulting from deferred maintenance and negligent care.
- **Functional obsolescence** is any loss in the property's value due to outdated style or non-usable space. Examples include antique fixtures, a one-car garage or an outdated kitchen.
- **Economic obsolescence** is the loss in property value due to changes in the property's neighborhood. Economic obsolescence is external to the property. For example, a property's value may decrease due to increased noise and traffic if a freeway is built next to it.

QUIZ

1. __________ is the cost to replace a structure with one having the functional equivalent to the structure being appraised, but constructed with modern materials and methods.

   a. Reproduction cost
   b. Replacement cost
   c. Renovation cost

2. Which term best describes any value-related loss in the property due to use, decay and improvements that have become outdated?

   a. Degradation.
   b. Deduction.
   c. Depreciation.

gross rent multiplier (GRM) method

Three appraisal approaches: income approach

There are two methods of calculating the property's value under the **income approach**:

- the **gross rent multiplier (GRM)** method; and
- the **capitalization method**.

Property appraised using the income approach includes:

- apartments;
- offices;
- industrial buildings;
- commercial units; and
- other income-producing property.

The *GRM method* uses the market rent (determined by a survey of similar properties) of the subject property which is then multiplied by a factor, the GRM, to arrive at a value for the subject property. The GRM factor is determined by comparing the subject property to similar properties that have recently been sold.

The *capitalization method* determines the property's value based on the property's future income and operating expenses.

The first step to establish value using the capitalization method is to determine the property's **effective gross income**. A property's *effective gross income* is its gross income minus vacancies and collection losses. [See **RPI** Form 352]

The second step is to deduct **operating expenses** from the effective gross income to determine the property's *net operating income (NOI)*.

Operating expenses include such items as:

- property taxes;
- insurance;
- security;
- management fees;
- utilities; and
- maintenance.

Operating expenses that vary, such as utilities and repairs, are called **variable costs**. Operating costs that remain constant, such as property taxes, security services and insurance, are called **fixed costs**.

Net operating income divided by cap rate

The third step is to mathematically divide the property's NOI by the appropriate **capitalization rate (cap rate)**.

The cap rate is comprised of a prudent investor's expected annual *rate of return* on monies invested in this type of property (adjusted for inflation and risk premiums), and a rate of recovery of their invested monies allocated to the improvements, also called depreciation.

Thus, the FMV of the property is determined by dividing the NOI by the cap rate. For example, if a property's NOI is $100,000 annually, and a cap rate of 10% is used, the property's value under the income approach would be $1,000,000.

The rate of interest paid on mortgages and the amount or terms of mortgage debt on a property have no bearing on a property's market value. The property is viewed as being clear of any monetary encumbrances.

QUIZ

1. The __________ determines the property's value based on the property's future income and operating expenses.

   a. market comparison approach

   b. cost approach

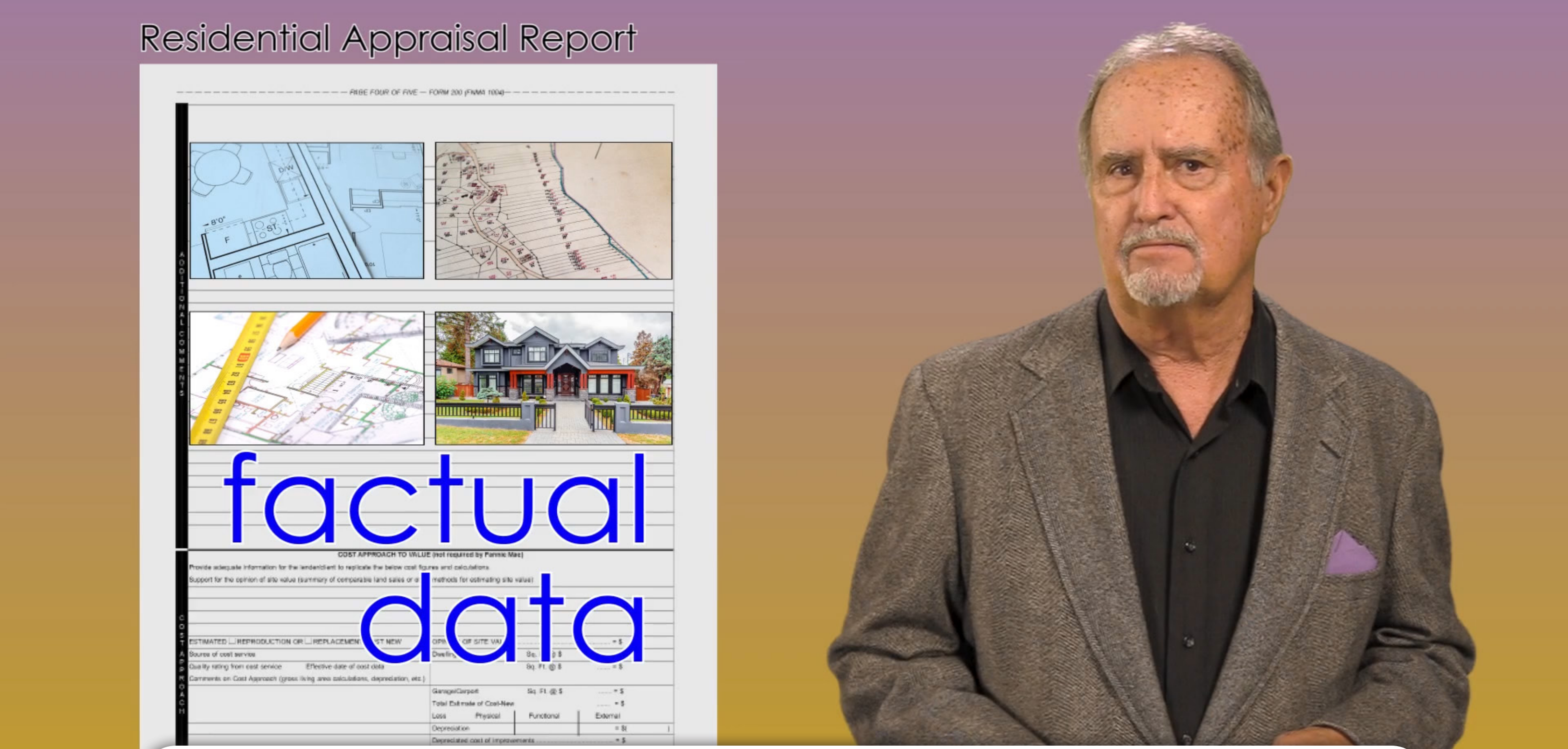
   c. capitalization method

2. The __________ refers to the annual rate of return on invested capital based on net operating income (NOI) produced by the operations of an income property.

   a. capitalization rate (cap rate)

   b. debt-to-income (DTI) ratio

   c. yield spread premium (YSP)



Correlation of values and creation of the appraisal report

The next step in the appraisal process is the correlation or **reconciliation** of the values arrived at under each of the three approaches described previously.

The process selects the most appropriate value from the values arrived at by using the three approaches. For instance, the income approach will NOT be used if the property has no income potential.

The final step in the process is the creation of the complete appraisal report. It is the documentation of the appraiser's findings. The types of appraisal reports include:

- *short summary report* – a filled-in form using checks and explanations;
- *letter form* – a brief written report; and
- *self-contained or narrative* – an extensive written report.

Typically, the appraisal is written up on the **Uniform Residential Appraisal Report** form 1004 produced by Fannie Mae, though other formats for writing up an appraisal such as a narrative report exist. Further, **RPI (Realty Publications, Inc.)** produces a version of this form which replicates the contents of the government form but in an easy-to-use letter format, as opposed to the original version which is formatted for legal-sized paper. [See **RPI** Form 200]

The following information is included in the appraisal report:

- the property's description;
- the purpose and scope of the appraisal;

- description of the neighborhood;
- the date on which the value is estimated;
- qualifying conditions and assumptions;
- factual data, photos and maps with analyses;
- the estimate of value; and
- the name, address, type of license and signature of the appraiser.

QUIZ

1. The process of an appraiser selecting the most appropriate value from the values arrived at using the three approaches is referred to as:

    a. redaction.

    b. ratification.

    c. reconciliation.

2. An appraisal is typically written up on the __________ produced by Fannie Mae.

    a. Uniform Residential Appraisal Report

    b. Standardized Residential Broker Price Opinion

    c. Self-Contained Assessment of Value

Rules controlling appraisals

In order to help preserve appraiser independence and neutrality on the purchase of a one-to-four unit residential property that is financed with a federally-related mortgage, a transaction participant is unable to contact or discuss the price with the third-party appraiser in an attempt to influence their opinion of value.

However, the buyer or interested party is permitted to receive a copy of the appraisal report.

Further, the results of the appraisal may be appealed if the appeal is based on factual information that is found to be in error, such as amenities not considered in the report.

It is unlawful to violate appraisal independence, including:

- coercing, extorting, colluding with, instructing, bribing or intimidating any appraisal professional into appraising property at a value based on any factor other than the independent judgment of the appraiser;
- mischaracterizing the appraised value of a property to secure a mortgage;
- influencing or encouraging an appraiser to meet a targeted value for a property; and
- withholding or threatening to withhold payment for an appraisal report or service. [15 United States Code 1631 §129E]

This does not prohibit anyone with an interest in the transaction from asking an appraiser to:

- consider *additional relevant property information*, including information

regarding comparable properties;
- provide *further explanation* for the valuation;
- *correct errors* in the appraisal report; or
- obtain *multiple valuations* in order to assure reliability in value assessment.

No appraiser or appraisal company may have an interest, financial or otherwise, in the property being appraised.

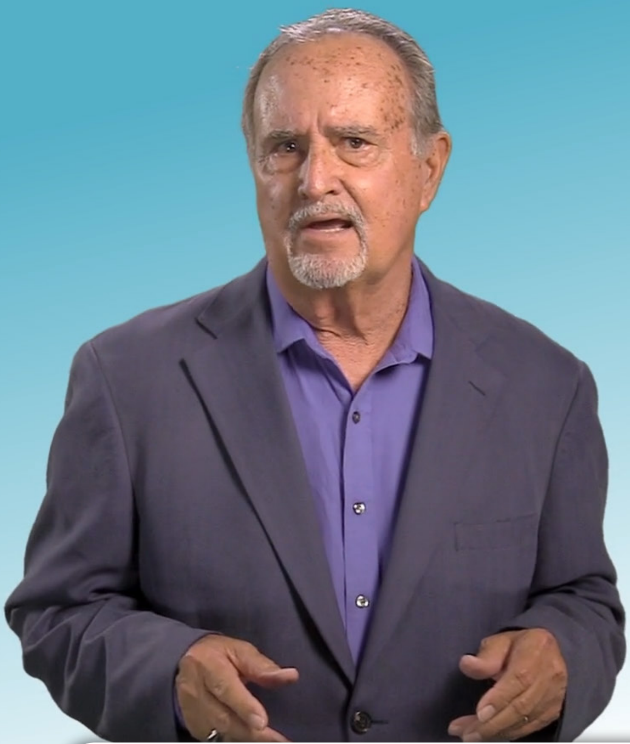
If a lender is aware of a violation of appraisal independence, they are prohibited from using that appraisal report to make a mortgage, unless the lender has confirmed that the appraisal does not misrepresent the value of the property.

Lenders and their agents need to compensate *fee appraisers* at a rate that is reasonable in the market area of the property being appraised. A fee appraiser may charge a fee for complex assignments that reflects the increased time, difficulty and scope of the work performed.

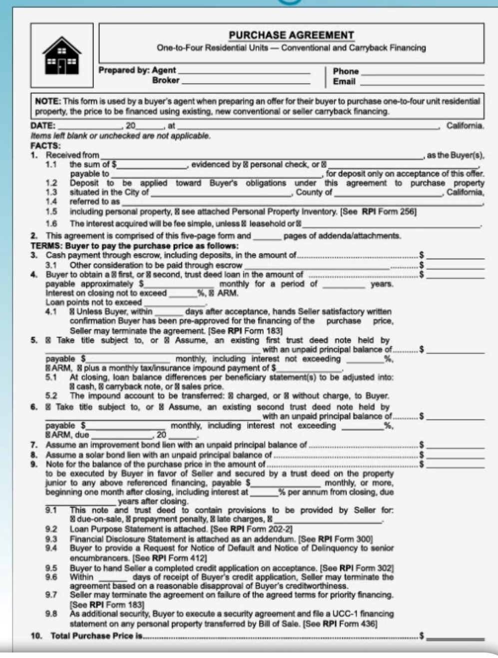
QUIZ

1. The results of an appraisal:
   a. are final and unappealable.
   b. may be appealed if the appeal is based on factual information that is found to be in error.
   c. may be appealed if the appeal is made in an effort to help secure a mortgage.

2. What constitutes an unlawful violation of appraisal independence?
   a. Asking the appraiser to provide further explanation for the valuation or correct errors in the report.
   b. Encouraging the appraiser to meet a targeted value for a property.
   c. Requesting the appraiser to consider additional relevant property information, including information regarding comparable properties.



Purchase Agreement



PURCHASE AGREEMENT

One-to-Four Residential Units — Conventional and Carryback Financing

Prepared by: Agent ______________ **Phone** ______________

Broker ______________ **Email** ______________

NOTE: This form is used by a buyer's agent when preparing an offer for their buyer to purchase one-to-four unit residential property, the price to be financed using existing, new conventional or seller carryback financing.

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

Items left blank or unchecked are not applicable.

FACTS:

1. Received from ______________, as the Buyer(s),
   1.1 the sum of $______________, evidenced by ☐ personal check, or ☐ ______________, payable to ______________, for deposit only on acceptance of this offer.
   1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
   1.3 situated in the City of ______________, County of ______________, California,
   1.4 referred to as ______________,
   1.5 including personal property, ☐ see attached Personal Property Inventory. [See **RPI** Form 256]
   1.6 The interest acquired will be fee simple, unless ☐ leasehold or ☐ ______________.
2. This agreement is comprised of this five-page form and ______ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of .... $ ______
   3.1 Other consideration to be paid through escrow ______________ .... $ ______
4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of .... $ ______
   payable approximately $______________ monthly for a period of ________ years.
   Interest on closing not to exceed ______%, ☐ ARM.
   Loan points not to exceed ______________.
   4.1 ☐ Unless Buyer, within ______ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **RPI** Form 183]
5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by ______________ with an unpaid principal balance of .... $ ______
   payable $______________ monthly, including interest not exceeding ________%, ☐ ARM, ☐ plus a monthly tax/insurance impound payment of $______________.
   5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
   5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.
6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ______________ with an unpaid principal balance of .... $ ______
   payable $______________ monthly, including interest not exceeding ________%, ☐ ARM, due ______________, 20______.
7. Assume an improvement bond lien with an unpaid principal balance of .... $ ______
8. Assume a solar bond lien with an unpaid principal balance of .... $ ______
9. Note for the balance of the purchase price in the amount of .... $ ______
   to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due ______________ years after closing.
   9.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ ______________.
   9.2 Loan Purpose Statement is attached. [See **RPI** Form 202-2]
   9.3 Financial Disclosure Statement is attached as an addendum. [See **RPI** Form 300]
   9.4 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]
   9.5 Buyer to hand Seller a completed credit application on acceptance. [See **RPI** Form 302]
   9.6 Within ______ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.
   9.7 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **RPI** Form 183]
   9.8 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any personal property transferred by Bill of Sale. [See **RPI** Form 436]
10. **Total Purchase Price is** .... $ ______

The Purchase Agreement

Purchase agreement types and variations

A newcomer's entry as a real estate agent into the vocation of soliciting and negotiating real estate transactions typically begins with the marketing and locating of single family residences (SFRs) as a seller's agent or a buyer's agent (also known as *listing agents* or *selling agents*, respectively).

Other properties an agent might work with include:

- one-to-four unit residential properties;
- apartments;
- nonresidential income properties (office buildings, commercial units and industrial space);
- agricultural property; or
- unimproved parcels of land.

For real estate sales conveying ownership of a property, the **primary document** used to negotiate the transaction between a buyer and seller is a **purchase agreement** form. Different types of properties each require a different variety of *purchase agreements*. Various purchase agreements comprise provisions necessary to negotiate the sale of a particular type of property.

Three basic categories of purchase agreements exist for the documentation of real estate sales. The categories are influenced primarily by legislation and court decisions addressing the handling of the disclosures and due diligence investigations in the marketing of properties.

The three *categories of purchase agreements* are for:

- one-to-four unit residential property sales transactions;
- other than one-to-four unit residential property sales transactions, such as for residential and nonresidential income properties and owner-occupied business/farming properties; and
- land acquisition transactions.

Within each category of purchase agreement, several variations exist. The variations cater to the specialized use of some properties, the diverse arrangements for payment of the price and to the specific conditions which affect a property, particularly within the one-to-four unit residential property category.

QUIZ

1. The primary document used to negotiate the transaction between a buyer and seller is a(n):

   a. listing agreement.

   b. mortgage agreement.

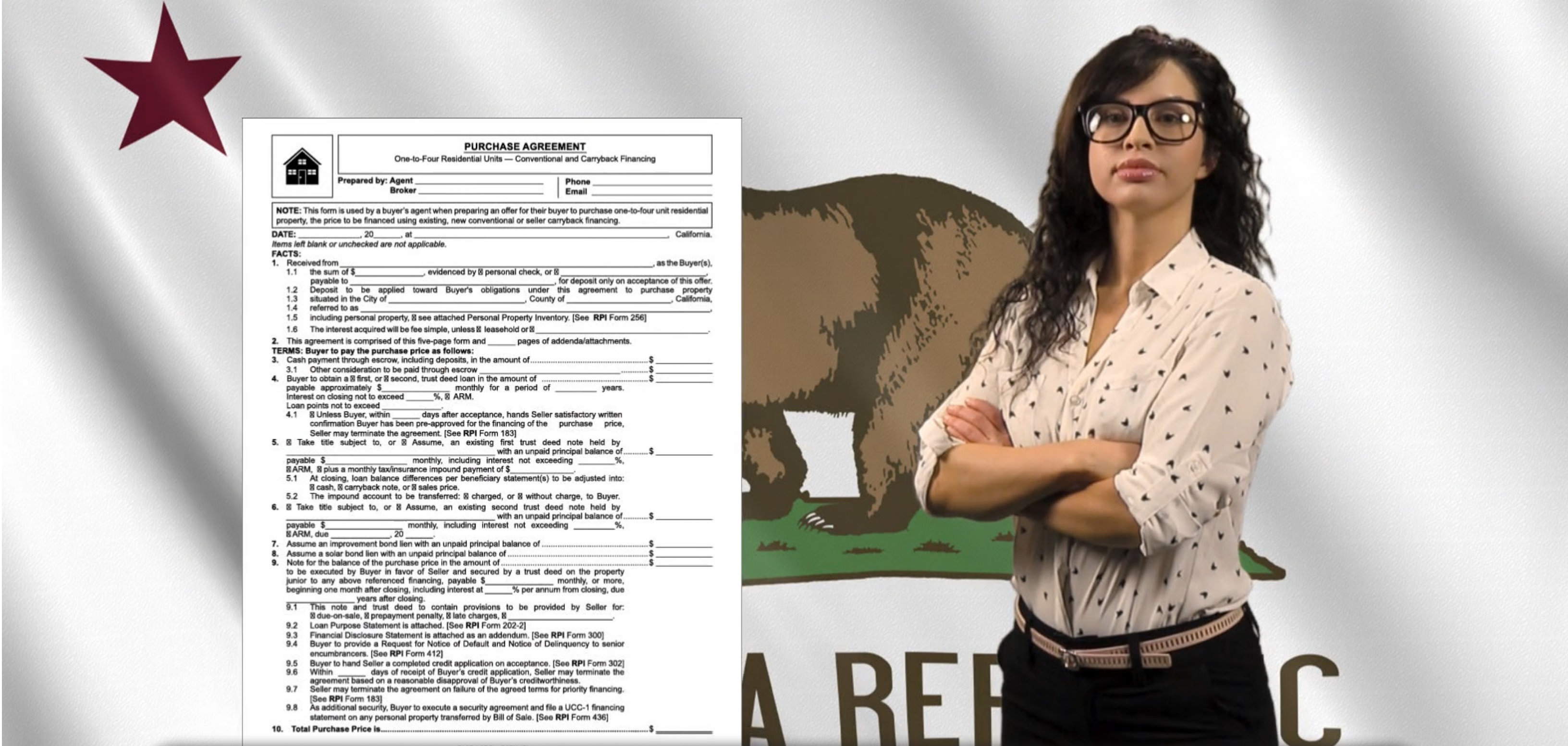
   c. purchase agreement.

2. Office buildings, commercial units and industrial space are examples of:

   a. one-to-four-unit residential properties.

   b. agricultural properties.

   c. nonresidential income properties.



California real estate forms and the freedom of choice

The California real estate industry has an extensive variety of *boilerplate contracts* for practically any contractually negotiated real estate situation. A broker may use any contract they choose. Other brokers, trade union associations, insurers and the multiple listing services (MLSes) may not and do not require a broker to use a particular form.

Though forms published by the California Association of Realtors® (CAR) are ubiquitous, offers and other real estate transaction forms may be written on any number of other legal formats, such as those published by **RPI (Realty Publications, Inc.)** .

The use of printed *commercially-published* forms in lieu of independently-drafted forms to document real estate related transactions and services is justified for two reasons.

First, a **commercially-published** form satisfies the writing requirements mandated by the Statute of Frauds for most real estate transactions. [Calif. Civil Code §1624]

Second, a commercially-published form generally provides clarity of meaning and more uniformity in agreements and disclosures than typically results from **independently-drafted** forms.

However, not all published forms feature the same level of quality, clarity and utility. Nor are they all biased favoring the same side in a transaction.

Commercially-published forms provide a checklist of possible variables in a transaction for everyone to consider, thus decreasing the potential for error.

Published forms limit the task of brokers and their agents to reviewing the provisions and filling in blanks and checking boxes to indicate the provisions included in the agreement or disclosure.

No one approves forms sold by publishers – not the State Bar, the DRE or trade unions. Each publisher is responsible for the content of the forms it publishes.

Forms broadly fit into two categories. Forms are either:

- **mandated for use** by dictate of the state legislature, such as the Agency Law Disclosure – Disclosure Regarding Real Estate Agency Relationships [See **RPI** Form 305], Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **RPI** Form 304] and the Natural Hazard Disclosure Statement [See **RPI** Form 314]; or
- **generic forms**, such as listing agreements, net sheets, costs sheets, etc.

Each form mandated for use by the state must have the same content – no matter who publishes it, and many do. Further, each publisher is responsible for the content of its own generic forms.

RPI is one of the most established publishers in California. **RPI** forms are 100% legal for use in California and are available at no cost to **firsttuesday** students.

Purchase agreement variations

Purchase agreement variations for **one-to-four unit residential sales** transactions include purchase agreements for:

- negotiating the conventional financing of the purchase price [See **RPI** Form 150];
- negotiating a short sale [See **RPI** Form 150-1];
- negotiating a cash to new or existing mortgage, or a seller carryback note [See **RPI** Form 150-2];
- negotiating for separate broker fees paid each broker by their client [See **RPI** Form 151];
- negotiating the government insured financing (FHA/VA) of the purchase price [See **RPI** Forms 152 and 153];
- negotiating the sale of an owner-occupied residence-in-foreclosure to an investor, called an **equity purchase (EP) agreement** [See **RPI** Form 156];
- negotiating an *equity purchase* short sale [See **RPI** Form 156-1];
- direct negotiations between principals (buyers and sellers) without either party being represented by a real estate agent [See **RPI** Form 150-3]; and
- negotiating highly specialized transactions using a "short-form" purchase

agreement which does not contain boilerplate provisions setting forth the terms for payment of the price, which allows the agent to attach specialty addenda to set the terms for payment (a carryback ARM, equity sharing addenda, etc.). [See **RPI** Forms 154, 155-1 and 155-2]

Variations among purchase agreements used in **income property** and **owner-occupied business property** sales transactions include purchase agreements for:

- the conventional financing of the purchase price [See **RPI** Form 151]; and
- the downpayment note financing of the purchase price. [See **RPI** Form 151-1]

Finally, a variation exists for land sales of a parcel of real estate which has no improvements in the form of buildings and for **farm and ranch** sales. [See **RPI** Forms 157, 158 and 158-1 through 158-4]

Attached to all these various purchase agreements are one or more **addenda**, regarding:

- disclosures about the property;
- the financing of the price paid for the property;
- agency relationship law; and
- special provisions called for by the needs of the buyer or seller.

QUIZ

1. Which entity approves real estate forms sold by publishers?
   a. The California State Bar.
   b. The Department of Real Estate (DRE).
   c. No one. Each publisher is responsible for the content of the forms it publishes.

2. Forms mandated for use by dictate of the state legislature:
   a. are highly variable.
   b. must have the same content.
   c. are only available through the Department of Real Estate (DRE).

The purchase agreement in practice

A buyer's agent uses a **purchase agreement** to prepare and submit the buyer's *written offer* to purchase a one-to-four unit residential property. [See **RPI** Form 150]

The pricing and terms for performance are limited to conventional financing, a takeover of existing mortgages, a carryback note or a combination of some of these arrangements.

This *purchase agreement* is also properly used by sellers when confronted with a **counteroffer** situation. The seller's agent prepares an entirely new purchase agreement, then submits it as their fresh offer to sell on terms different from those of an unacceptable purchase offer received from the buyer.

On acceptance, the purchase agreement becomes a binding written contract between the buyer and seller. To be enforceable, the price and terms for performance need to be clear, concise and complete to prevent misunderstandings.

To this end, a comprehensive purchase agreement includes as "boilerplate" all provisions that might be needed in a likely transaction. They are designed to serve as a **checklist** of provisions an **agent** is to consider when preparing an offer. The various conventional financing arrangements and conditions a prudent buyer considers when making an offer to purchase a home are tightly worded for easy selection.

Escrow instructions provide yet another variation on the purchase agreement. For example, a buyer and seller having orally agreed on the terms of a sale, with or without the assistance of an agent, contact an escrow company to handle their deal. Escrow instructions are prepared and signed, without first entering into a real estate purchase agreement. Here, the escrow instructions bind the buyer and seller as though they had entered into a purchase agreement. [See **RPI** Form 401]

QUIZ

1. A buyer's agent uses a purchase agreement to:

    a. note the type of property and location sought by the buyer.

    b. dictate the terms of occupancy the buyer is to abide by for the duration of their tenancy, and what expenses the seller is to provide, such as utilities and trash.

    c. prepare and submit the buyer's written offer to purchase a one-to-four-unit residential property.

2. On acceptance, the purchase agreement becomes a(n) __________ between the buyer and seller. To be enforceable, the price and terms for performance need to be clear, concise and complete to prevent misunderstandings.

    a. enforceable unilateral contract

    b. binding written contract

    c. conditional verbal contract

Analyzing the purchase agreement

Many variations of the purchase agreement exist. Further, different publishers structure their purchase agreements and addenda in a variety of ways. However, many universal characteristics exist.

Nearly all purchase agreements will first identify the parties to the transaction as well as the underlying real estate, then proceed to other sections.

The parts of **RPI's** purchase agreement include:

- *Identification:* the date and place of preparation, the buyer's name, the amount of the good-faith deposit, the description of the real estate, an inventory of personal property included in the transfer and the number of pages contained in the agreement and its addenda (Sections 1 and 2).
- *Price and terms*: variations for payment of the price by conventional purchase-assist financing or a takeover of existing financing (Sections 3 through 10).
- *Acceptance and performance:* aspects of the formation of a contract, excuses for nonperformance and termination of the agreement, such as the time period for acceptance, the broker's authorization to extend performance deadlines, financing of the price as a closing contingency, procedures for cancellation, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract (Section 11).
- *Property Conditions:* the buyer's confirmation of the physical condition of the property as disclosed prior to acceptance by the seller's delivery of reports,

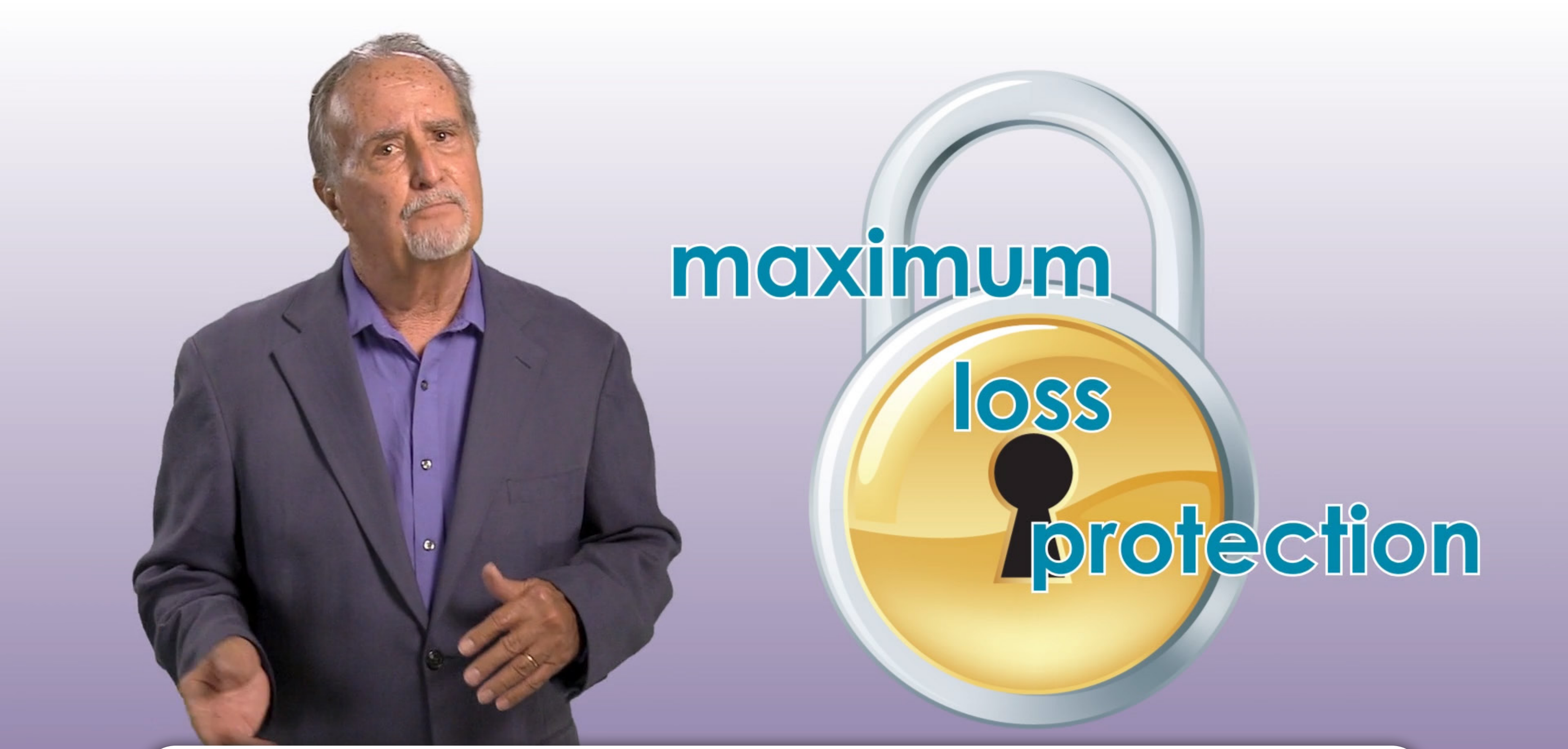
warranty policies, certifications, disclosure statements, an environmental, lead-based paint and earthquake safety booklet, operating cost and income statements, and homeowners' association (HOA) documents not handed to the buyer prior to entry into the purchase agreement, as well as by the buyer's initial inspection, personally or by a home inspector, and final inspection at closing (Section 12).

- *Closing conditions:* the escrow holder, escrow instruction arrangements, closing date, title conditions, title insurance, hazard insurance, prorates and mortgage adjustments (Section 13).
- *Notice of supplemental property tax:* notifies the buyer they will receive supplemental property tax bills they are to pay when the county assessor revalues the property after a change in ownership (Section 14).
- *Notice regarding gas and hazardous liquid pipelines: notifies the buyer of the public availability of information regarding gas and hazardous liquid transmission pipelines via the National Pipeline Mapping System (NPMS) web site (Section 15).*
- *Brokerage and agency:* authorizes the release of sales data on the transaction to trade associations, sets the broker fee, confirms delivery of the agency law disclosure to both buyer and seller and confirms the confirmation of the agency undertaken by the brokers and their agents (Section 16).
- *Signatures:* the seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures (Section 17).

QUIZ

1. Nearly all purchase agreements will first __________ then proceed to other sections.
    a. propose the price and terms of the sale
    b. identify the parties to the transaction as well as the underlying real estate
    c. provide mandated property disclosures and state what each participant needs to do to ensure timely performance

2. What is generally the final section of a purchase agreement?
    a. Signatures.
    b. Closing conditions.
    c. Notice of supplemental property tax.



The RPI purchase agreement – better protection of your fee

Many brokers erroneously believe they are legally compelled to use forms published by their trade union. However, the Department of Real Estate (DRE) clearly states and enforces the policy that seller's agents, under their fiduciary duty owed to the sellers they represent, need to present all offers received regardless of the form on which the offer is written. [See "Being an agent means never having to say you're sorry," DRE Real Estate Bulletin, Fall 2001, Page 12]

Failure to present an offer denies the seller the opportunity to weigh all offers their agent receives and to better understand buyer demand.

This failure to present an offer – written on any form – is essentially an affirmative representation to the seller the offer does not exist. Here, omission becomes deceit, an offense punishable by the DRE.

As a policy of the publisher to provide users of **RPI (Realty Publications, Inc.)** forms with maximum loss reduction protection, the **RPI** purchase agreement does not contain clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker.

Excluded provisions include:

- an **attorney fee provision**, which tends to **promote litigation** and inhibit normal contracting;
- a **time-essence clause**, since future performance (closing) dates are, at best, estimates by the broker and their agents of the time needed to close and are too often **improperly used** by sellers in rising markets to cancel the

transaction before the buyer or broker can reasonably comply with the terms of the purchase agreement; and

- a **liquidated damages provision**, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable.

Many pre-printed brokerage and purchase agreements, such as those published by the California Association of Realtors (CAR), perfunctorily include a boilerplate **arbitration provision.**

The *arbitration provision* included in a purchase agreement, listing or lease agreement *forms a separate contract* between the parties who initial the provision and remains enforceable despite any defects in the underlying agreement containing the provision.

Thus, the arbitration provision in a real estate purchase agreement or listing:

- forms a separate arbitration agreement between the parties who agree to be bound by the provision [Calif. Code of Civil Procedure §1297.71; **Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395]; 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.

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

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

Attorney's fees as a power

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

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

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

Here, the arbitrator exceeded their powers by failing to award attorney fees. The seller, as the prevailing party, was entitled to an award of attorney fees by a provision in the purchase agreement which was the subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator is to award attorney fees to the prevailing party. [**DiMarco** v. **Chaney** (1995) 31 CA4th 1809]

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

QUIZ

1. Under their fiduciary duty owed to the sellers they represent, seller's agents need to:
   a. require the buyer submit their offer on the form most familiar to the seller's agent.
   b. present all offers received which are written on forms published by the trade association.
   c. present all offers received regardless of the form on which the offer is written.

2. The __________ entitles the party who prevails in an action to be awarded attorney fees.
   a. choice-of-law provision
   b. attorney fee provision
   c. arbitration provision

Title Insurance

The preliminary title report, Pt I

A **preliminary title report**, also called a **prelim**, discloses the current vesting and encumbrances which may be reflected on the public record affecting a property's title.

Encumbrances reflected on a *preliminary title* report include:

- general and special taxes;
- assessments and bonds;
- covenants, conditions and restrictions (CC&Rs);
- easements;
- rights of way;
- liens; and
- interests of others.

A preliminary title report is not a representation of the condition of title or a policy of title insurance. Likewise, a prelim cannot be relied on by anyone and imposes no liability on the title company.

A title insurer has no duty to accurately report title defects and encumbrances on the prelim, shown as exceptions in the proposed policy. [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A prelim is no more than an **offer to issue** a title insurance policy based on the contents of the prelim. Further, the offer may be modified by the title company at any time before the policy is issued. [Calif. Insurance Code §12340.11]

The closing of purchase escrows is contingent on the buyer's approval of items in the prelim to set the conditions of title consistent with the expectations of the buyer on entering into a purchase agreement. The buyer, their agent and escrow review the report for defects and encumbrances on title inconsistent with the terms for the seller's delivery of title set in the purchase agreement and escrow instructions. They also look for title conditions which might interfere with any *intended use or change in the use* of the property contemplated by the buyer.

Escrow reliance

Escrow relies in part on items approved and disapproved in the prelim to carry out its instructions to record grant deeds, trust deeds, leaseholds, or options which are to be insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and other encumbrances as agreed and approved in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, advises the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The prelim, and a last-minute **date-down search** of title conditions, are used by escrow and the title insurer to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents when recorded.

The title insurer's *date-down* confirmation of the prelim prior to closing may turn up title defects or encumbrances not included in the prelim. These occur by error on the part of the insurer or by a recording after the preparation of the prelim. In any case, the title company may **withdraw its offer** under the prelim.

The title company then issues a *new prelim*, offering to issue a policy on different terms.

QUIZ

1. Encumbrances reflected on a preliminary title report include:

   a. general and special taxes.

   b. interests of others.

   c. Both a. and b.

2. Which of the following best describes a preliminary title report?

   a. A preliminary title report is an accurate representation of the condition of title and can be relied on by anyone, and therefore imposes liability on the title company.

   b. A preliminary title report discloses the current vesting and encumbrances which may be reflected on the public record affecting a property's title.

   c. Both a. and b.

The preliminary title report, Pt II

Preliminary title reports were once compared to **abstracts of title**.

An *abstract of title* is an accurate, factual representation of title to the property being acquired, encumbered or leased. Thus, an abstract of title may be relied on by those who order them as an absolute representation of the conditions of title. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on the insurer's liability as is set in a policy of title insurance. The content of an abstract is intended by the insurance company to be relied upon as fact. Thus, the insurer is liable for all money losses of the policy holder flowing from a failure to accurately state all conditions of title in the abstract they issue. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

QUIZ

1. A(n) __________ is an accurate, factual representation of title to the property being acquired, encumbered or leased.

   a. preliminary title report

   b. abstract of title

   c. title insurance policy

indemnify the policy holders

Title insurance – a form of indemnity insurance

A policy of **title insurance** is the contract under which a title insurance company reimburses or holds harmless a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance** on title that:

- is not listed in the title insurance policy as an exception to coverage; and
- the insured policy holder was unaware of when the policy was issued. [Calif. Insurance Code §12340.1]

Thus, a policy of *title insurance* is a form of **indemnity insurance**. Title insurance policies are issued on one of several general forms used by the entire title insurance industry in California. The policies are typically issued to:

- *buyers* of real estate;
- *tenants* acquiring long-term leases; and
- *lenders* whose mortgages are secured by real estate.

As an *indemnity* agreement, a title insurance policy is a contract. The terms of coverage in the policy set forth the extent of the title insurance company's obligation to indemnify the policy holder for money losses caused by an encumbrance on title. [Ins C §12340.2]

Encumbrances unknown, undisclosed

Almost all losses due to the reduction in the value of real estate below the policy limits arise out of an *encumbrance*. An encumbrance is any condition which affects the ownership interest of the insured.

The word "encumbrance" is all encompassing. Any right or interest in real estate held by someone other than the owner which **diminishes the value** of the real estate is considered an encumbrance.

Encumbrances on title include:

- covenants, conditions and restrictions (CC&Rs) limiting use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases. [**Evans** v. **Faught** (1965) 231 CA2d 698]

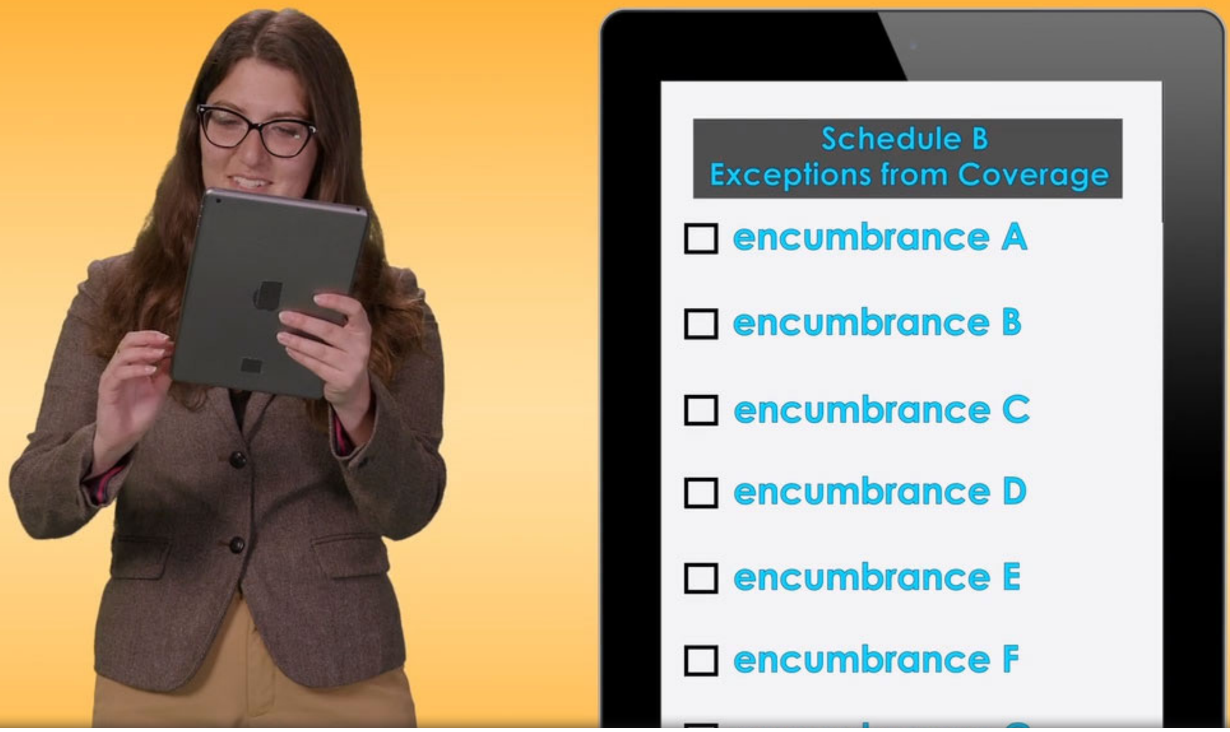
QUIZ

1. A policy of title insurance is a form of:

    a. errors and omissions (E&O) insurance.
    b. homeowners' insurance.
    c. indemnity insurance.

2. An encumbrance is broadly defined as:

    a. any condition which affects the ownership interest of the insured.
    b. any physical defect which impairs the value of the property owned by the insured.
    c. Both a. and b.



Contents of a title insurance policy

Title insurance is purchased to assure real estate buyers, tenants and lenders the interest in title they acquire is what they bargained for.

A policy of title insurance is broken down into six operative sections, including:

- the *risks of loss covered*, called **insuring clauses**, which are based on a completely unencumbered title at the time of transfer;
- the *risks of loss not covered*, comprised of encumbrances arising after the transfer or known to or brought about by the insured, called **exclusions**, which are a boilerplate set of title conditions;
- *identification* of the insured, the property, the vesting, the dollar amount of the coverage, the premium paid and the recording, called **Schedule A**;
- the *recorded interests*, i.e., any encumbrances affecting title and any observable on-site activities which are listed as risks agreed to and assumed by the insured and not covered by the policy, called **exceptions**, which are itemized for all types of coverage in **Schedule B**;
- the *procedures*, called **conditions**, for claims made by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage granted by the insuring clauses; and
- any *endorsements* for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Insuring clauses

Coverage under the broadly worded *insuring clause* of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions and exceptions from coverage

All title insurance policies contain an **exclusions** section.

The exclusions section eliminates from coverage those losses incurred by the insured buyer, tenant or lender due to:

- *use ordinances* or *zoning laws*;
- *unrecorded claims known* to the insured, but not to the title company;
- encumbrances or adverse *claims created after* the date of the policy;
- claims arising out of *bankruptcy* or due to a *fraudulent conveyance* to the insured;
- *police power* and *eminent domain*; and
- *post-closing events* caused by the insured.

Further, all policies of title insurance on *Schedule A* set forth:

- the property interest the insured acquired;
- the legal description of the insured property;
- the date and time coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by *Schedule B* **exceptions** in the policy.

The *exceptions section* contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title.

While the existence of these known encumbrances is insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

You'll notice we're using two very similar terms here – *exceptions* and *exclusions*. There's a critical difference.

Exclusions are the risks of loss not covered. Again, this consists of encumbrances arising after the transfer, or known to, or brought about by, the insured. Exclusions exist *outside* of the policy.

Alternatively, **exceptions** are *carved out* of the policy. Recall that exceptions are recorded interests agreed to and assumed by the insured, and therefore are removed from the policy.

These exceptions are itemized in Schedule B, such as taxes or assessments which are not shown as existing liens in the public records.

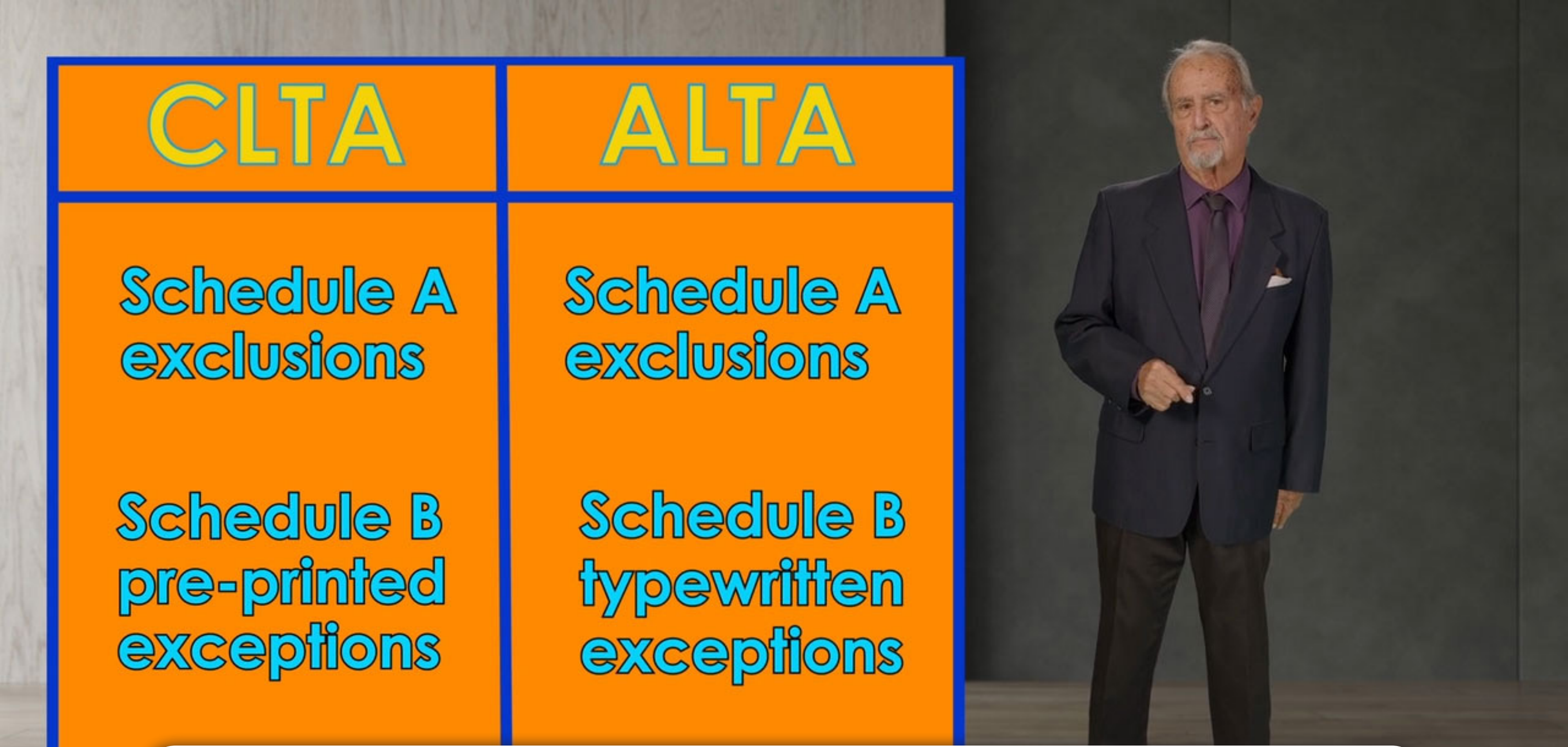
Claims and settlements

Lastly, a policy of title insurance includes a *conditions section*. The conditions section outlines the procedures the insured policy holder needs to follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before paying a claim.

QUIZ

1. In a title insurance policy, the identification of the insured, the property, the vesting, the dollar amount of the coverage, and the premium paid and the recording is most likely to be contained in:
   a. Schedule A.
   b. Schedule B.
   c. the conditions section.

2. Exceptions in a title insurance policy are most likely to be contained in:
   a. Schedule A.
   b. Schedule B.
   c. the identification section.



CLTA versus ALTA

There are two primary types of title insurance coverage available in California:

- a **California Land Title Association (CLTA)** standard policy; and
- an **American Land Title Association (ALTA)** owner's extended coverage policy.

The *CLTA standard policy* is purchased solely by buyers, carryback sellers and private lenders.

The CLTA standard policy insures against all encumbrances affecting title which can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an inspection or survey, is not covered due to the CLTA policy exclusions and standard exceptions.

Additionally, the CLTA standard policy as well as the ALTA policy protects the insured against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

All title insurance policies provide coverage forever after the date and time the policy is issued. Coverage is limited to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the exclusions, exceptions and conditions on claims.

Policy exclusions and exceptions

Both the CLTA standard policy as well as the ALTA policy contain **Schedule A** exclusions to coverage.

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called *standard exceptions* or *regional exceptions*. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a "*standard*" policy.

Critically, an ALTA owner's policy does not contain pre-printed exceptions, only the **typewritten exceptions** listing the encumbrances which are known to the title company and affect title to the property.

The pre-printed standard exceptions in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which would have been discovered by the buyer on an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not recorded and indexed by the county recorder;
- unrecorded encroachments or boundary line disputes which a survey would have disclosed; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a *lower level of risk* for indemnified losses due to the CLTA pre-printed exceptions, as compared to the extended risks covered by the more expensive ALTA owner's policy.

The ALTA owner's policy and survey

The ALTA owner's policy provides greater coverage than the CLTA policy. When the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

As the ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy, prior to issuance of a policy, the title company may require:

- the parcel to be surveyed; and

- those in possession of the property to be interviewed or estopped.

The exclusions section of an ALTA owner's policy is identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to secured creditors.

Variations on the ALTA policy exist which provide different levels of coverage, such as:

- an **ALTA residential (ALTA-R) policy**; and
- an **ALTA homeowner's** policy.

QUIZ

1. Which title insurance policy provides greater coverage?
   a. California Land Title Association (CLTA) standard policy.
   b. American Land Title Association (ALTA) owner's extended coverage policy.
   c. Alameda County Title Association (ACTA) default policy.

Escrow – the Way to Perform

Introduction to escrow

Escrow is a process employing an independent agent, typically a licensed escrow company, to manage and coordinate the closing of a real estate transaction.

The escrow company does so by handling the exchange of documents and money which is to take place between two persons, such as a buyer and seller. Escrow activities are typically based on a primary agreement, such as a written purchase agreement, though one need not exist. [Calif. Financial Code §17003(a); see **RPI** Form 150]

In mortgage servicing situations, the word escrow has a different application for an arrangement called **impounds**. The mortgage holder manages their receipt and disbursement of funds received from the property owner as an escrow account, also called an **impound account**.

The funds are used for payment of annual property taxes and insurance premiums (TI) owed by the owner of the secured property. Typically, these funds are collected monthly with the regular principal and interest (PI) payment. Collectively, the *mortgage principal, interest, property taxes and insurance premiums* are referred to as **PITI**.

Escrow activity to close a real estate transaction consists of:

- *one person*, such as a seller or buyer of real estate, who delivers written documents or money, collectively called **instruments**, to an escrow company for the purpose of fully performing their *obligations owed another person* under a verbal or written agreement previously entered into for a sale, a mortgage origination or lease of real estate; and

- *the escrow company*, which receives and delivers documents and money *to another person* (e.g. the buyer, seller or third parties) on the occurrence of a specified event or the performance of prescribed conditions, such as the receipt of reports, further approvals or the issuance of a title insurance policy. [Fin C §17003(a)]

QUIZ

1. __________ refers to a process which employs an independent agent to manage and coordinate the closing of a real estate transaction.

    a. Escheat

    b. Estoppel

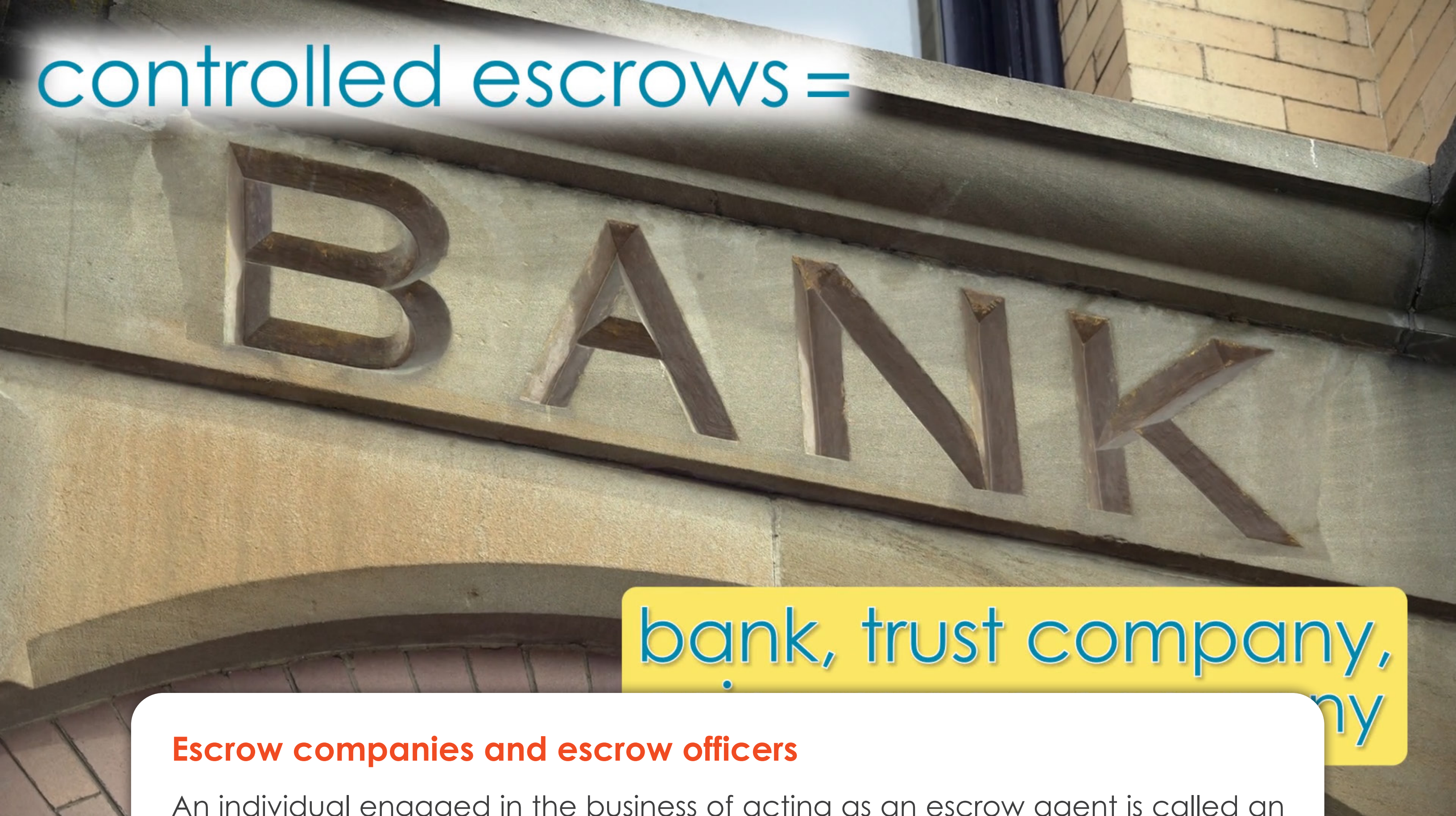
    c. Escrow

2. A money reserve funded monthly by the property owner and maintained by the mortgage holder to pay annual recurring ownership obligations is referred to as a(n):

    a. nontraditional credit account.

    b. impound account.

    c. trust account.



Escrow companies and escrow officers

An individual engaged in the business of acting as an escrow agent is called an **escrow officer**. The *escrow officer* is employed by an **escrow company**. Both the officer and the company are licensed by the California Department of Financial Protection and Innovation (DFPI), unless exempt. [Calif. Financial Code §17200]

Individuals exempt from escrow licensing requirements are called **controlled escrows**. *Controlled escrows* include:

- a licensed real estate broker, either individual or corporate, who represents a person in a real estate transaction in which the broker will also perform escrow services;
- a licensed attorney who does not hold themselves out as an escrow agent;
- a bank, trust company, savings and mortgage association or insurance company; and
- a title insurance company whose principal business is preparing abstracts or making searches of title used for issuing title insurance policies. [Fin C §17006]

The services rendered by an *escrow officer* typically include:

- receiving funds and collecting necessary documents, such as property reports, disclosure statements and title reports called for in the **escrow instructions** [See **RPI** Form 401];
- preparing documents necessary for conveyancing and mortgaging a property required for escrow to close;

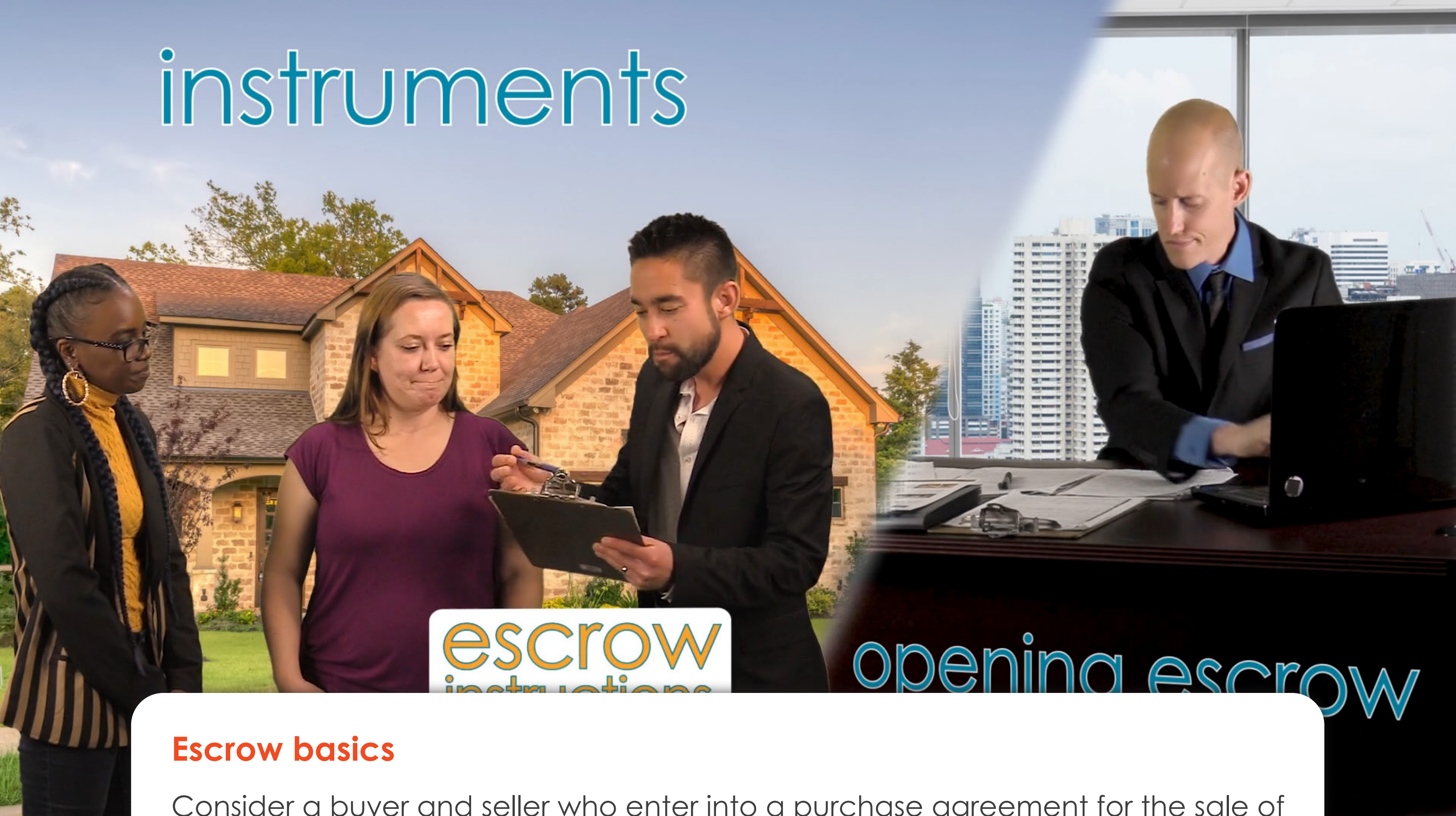
- calculating prorations and adjustments; and disbursing funds and transferring documents when all conditions for their release have been met. [Fin C §17003(a)]

The specific duties of the escrow officer, outlined in the *escrow instructions,* vary according to expectations commonly held in local real estate transactions.

QUIZ

1. Which is NOT classified as a controlled escrow?
   a. An escrow officer employed by an escrow company.
   b. A licensed real estate broker who represents a person in a real estate transaction in which the broker will also perform escrow services.
   c. A bank, trust company, savings and mortgage association or insurance company.

2. The specific duties of an escrow officer are outlined in the escrow instructions and:
   a. are nonnegotiable by any of the transaction participants.
   b. vary according to expectations commonly held in local real estate transactions.
   c. are dictated by statute and may not be altered without legislative intervention.



Escrow basics

Consider a buyer and seller who enter into a purchase agreement for the sale of the seller's one-to-four unit residence. As provided in the purchase agreement, escrow is opened to handle the closing of the transaction. [See **RPI** Form 150 §13.1]

In modern real estate practice, *opening escrow* simply means establishing a depository for the **instruments** (deeds, money and other items) with accompanying instructions controlling their use. Escrow instructions are signed by all necessary persons (the buyer and seller), each authorizing escrow to transfer or hand their instruments to the other person or third parties on closing. [**Montgomery** v. **Bank of America National Trust & Savings Association** (1948) 85 CA2d 550]

Before accepting any instruments as an escrow holder for a transaction, an agent of the buyer or seller *dictates instructions* to the escrow officer. The purpose for this communication is to establish precisely when and under what circumstances the documents and monies deposited with escrow are to change hands.

When receiving instructions from an agent, the escrow officer prepares a **"take sheet."** On it, the officer notes all the tasks they are to undertake to process and close escrow. When drafting escrow instructions, the officer relies on the *take sheet* as a checklist to determine the contents of the instructions.

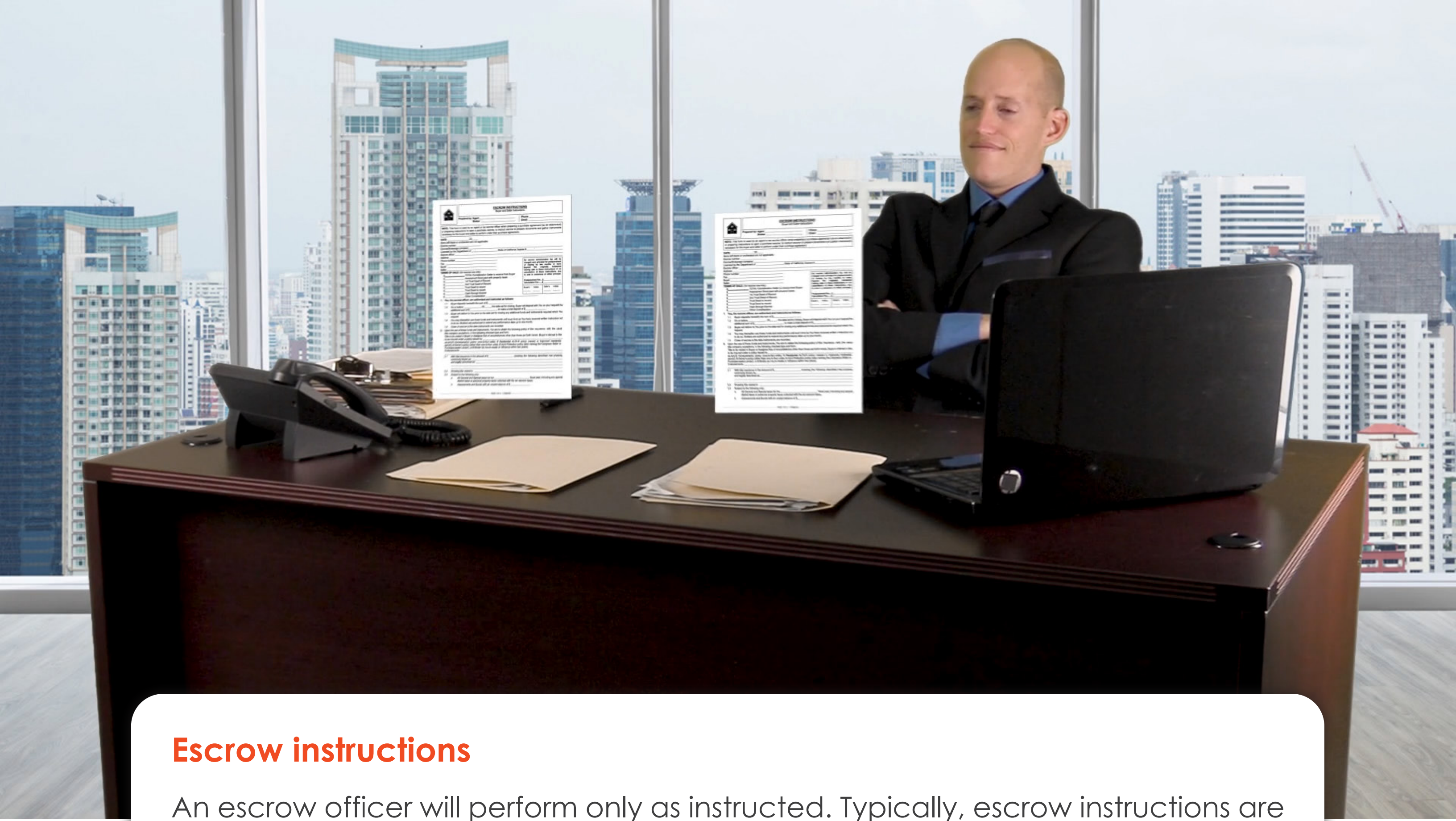
Increasingly, agents simply email a copy of the purchase agreement to the named escrow company. The escrow officer then drafts escrow instructions as needed for the buyer and seller to state their obligations to be performed to close the transaction created by the purchase agreement. When prepared, the officer sends the written instructions to the agent to verify they conform to the intent of the persons in the transaction.

A checklist is used by an agent for "going to escrow." As a worksheet, it guides the buyer's agent's collection and organization of facts and supporting papers the escrow officer needs to draw instructions, clear title conditions and close escrow. [See **RPI** Form 403]

QUIZ

1. The expression "opening escrow" most closely means:
   a. entering into a signed and binding purchase agreement between a buyer and seller, whether or not the participants are represented by an agent.
   b. meeting with a mortgage lender and submitting a loan application to fund the acquisition of the property.
   c. establishing a depository for the transaction instruments with accompanying instructions controlling their use.

2. When receiving instructions from an agent, the escrow officer frequently prepares a(n) __________ to note all the tasks they are to undertake to process and close escrow.
   a. balance sheet
   b. take sheet
   c. advance cost sheet



Escrow instructions

An escrow officer will perform only as instructed. Typically, escrow instructions are prepared by the escrow officer based on information received from the seller's or buyer's agent about the transaction. However, agents, like many builders, may include instructions they prepare as an addendum to a purchase agreement. [**Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847; see **RPI** Form 401]

In practice, the escrow officer prepares the instructions on forms they have adopted for this purpose. Once completed, the instructions are forwarded to the agents of the persons in the transaction for their signatures and return to escrow. Escrow is considered open for each person who signed and returned the instructions.

Types of escrow instructions

Two types of escrow instructions are used in California:

- **bilateral***; and*
- **unilateral instructions.**

Most escrow instructions used in a California real estate sales transaction are bilateral in nature. As bilateral escrow instructions, they are entered into by both the buyer and seller. Each signs a copy of the same instructions and hands them to escrow (which is why an agent can prepare them as an addendum to a purchase agreement).

In some areas of Northern California, separate sets of unilateral escrow instructions are prepared, usually waiting until the transaction is ready to close to be prepared and signed. Each set of instructions contains only the activities to be performed by or on behalf of one person — one set is the buyer's instructions, the other set is the seller's instructions.

When an escrow officer operating under conditions of unilateral instructions determines they have all documents necessary to call for funding and closing the transaction, the officer prepares the separate instructions for signatures of the respective buyers and sellers.

Analyzing and preparing the escrow worksheet

In practice, the *Sales Escrow Worksheet* is used by an agent when preparing to dictate instructions for opening a sales escrow, to organize and collect supporting documents the escrow officer will need to efficiently prepare escrow instructions, clear conditions and close escrow. [See **RPI** Form 403]

As with all checklists, the sales escrow worksheet is designed to address activities which are to be considered, but may or may not be applicable to the transaction at hand. Since it is a checklist, the form is not to be used to create an agreement between the buyer and seller. Also, the worksheet serves as the agent's personal control sheet (or that of their transaction coordinator) and is to be maintained in the client's file to act as a reminder of those activities yet to be completed to close the transaction.

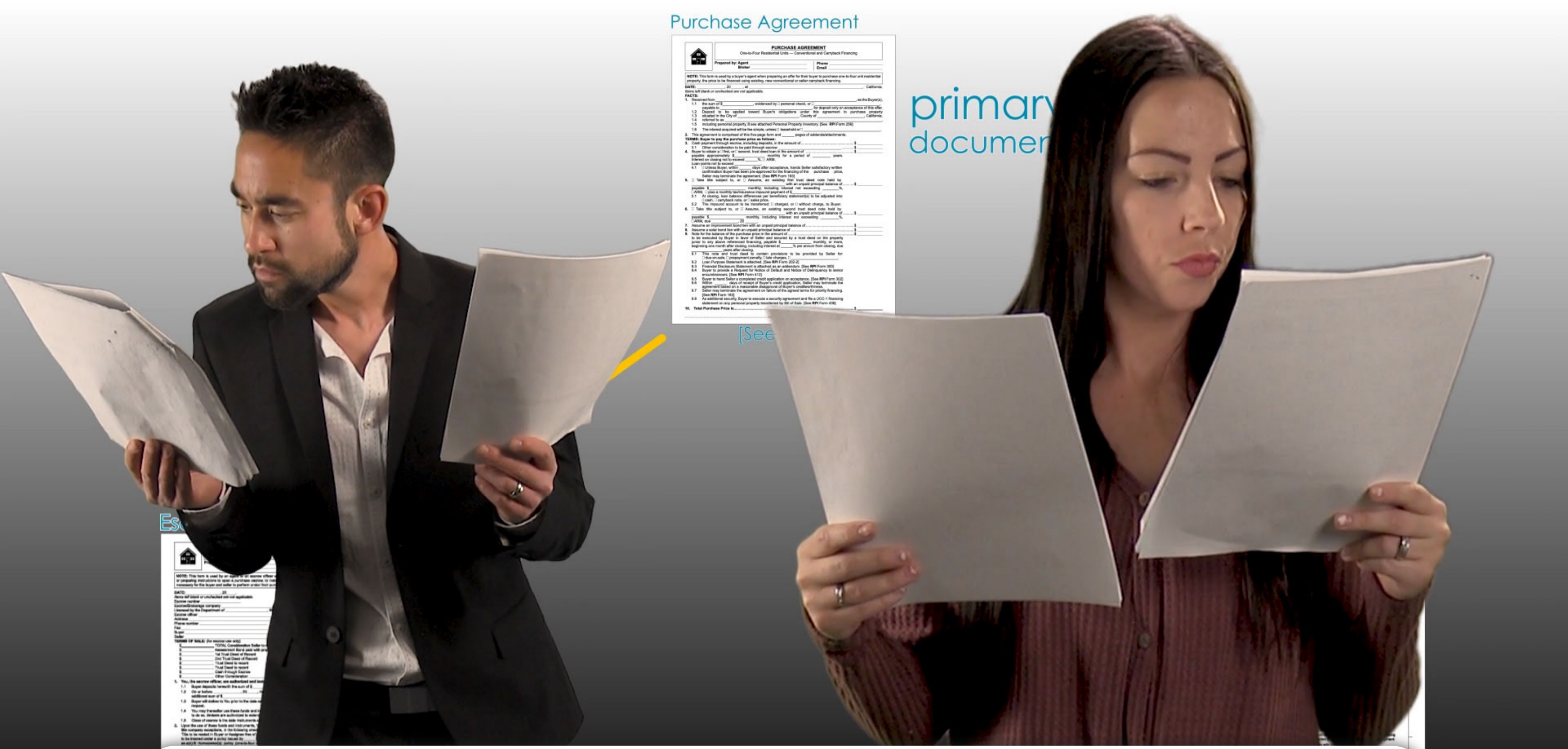
QUIZ

1. Escrow is considered __________ for each person who signed and returned the instructions.

    a. open
    b. closed
    c. consummated

2. Most escrow instructions used in a California real estate sales transaction are:

    a. unilateral.
    b. bilateral.
    c. ratified.



The Documents work together

Most modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction. Thus, the trend needs to be toward the agent preparing both at the same time as separate agreements, one attached to the other — saving time and massive amounts of energy. [See **RPI** Form 150 §13.1(a), (b)]

Both the purchase agreement and the escrow instructions are *contracts* regarding interests in real estate. Both documents need to be in writing to be enforceable under the **Statute of Frauds**. [Calif. Civil Code §1624]

A *purchase agreement* sets forth the:

- sales price;
- terms of payment; and
- conditions to be met before closing. [See **RPI** Form 150]

Escrow instructions constitute an *additional* agreement entered into by the buyer and seller with an escrow company (or the office of one of the brokers involved negotiating the transaction). Under the instructions, escrow facilitates the completion of the performance required of the buyer and seller to disburse monies and use documents needed to perform their purchase agreement.

Escrow instructions do not replace the purchase agreement. Instead, instructions function separately but in conjunction with purchase agreements, as directives an escrow officer undertakes to coordinate a closing expressed by the terms of the purchase agreement. [**Claussen** v. **First American Title Guaranty Co.** (1986)

186 CA3d 429]

Escrow instructions occasionally add exactness and completeness, providing the enforceability sometimes lacking in purchase agreements defectively prepared by brokers or their agents.

Purchase agreement is primary

A **written and signed purchase agreement** typically is the primary underlying document in a real estate sales transaction. All further agreements, including the escrow instructions, need to conform to the primary document, unless the parties *intend to modify the terms of that original agreement to clarify their intent for the transaction. The document making the change needs to note a modification is involved.*

The agents negotiating a transaction are responsible for ensuring the escrow instructions conform to the purchase agreement. Thus, the escrow instructions are reviewed by the both agents prior to submitting them to their clients for their review and signatures.

In some instances, the buyer and seller orally negotiate the sale and go directly to escrow, without first memorializing their understandings in a written purchase agreement. In this instance, an underlying written purchase agreement has not been prepared and escrow is opened.

Here, the buyer and seller intend the escrow instructions to function as the binding agreement documenting the sale (which becomes an enforceable contract when all contingencies are removed). In this situation, in addition to providing closing instructions, the escrow instructions constitute the binding contract between the buyer and seller needed to satisfy the **Statute of Frauds**. [**Amen** v. **Merced County Title Co.** (1962) 58 C2d 528]

Escrow worksheet ensures a timely closing

To set the stage for a timely closing, the agent dictating instructions collects and hands to the escrow officer all of the information necessary to prepare the instructions and documents for the transaction.

Less diligent agents leave the job of tracking down documents (and learning more about the deal) to the escrow officer, limiting the agent's involvement to simply forwarding a copy of the purchase agreement to the named escrow company. However, to enhance the likelihood of a successful closing without surprises, the agent prepares a *worksheet* of the items and information they need to gather and give to the escrow officer, as discussed in the prior section.

Typically, the agents in a transaction know more about potential issues which may interfere with closing than the escrow officer at the time instructions are dictated. Thus, a discussion with the officer when delivering information further facilitates a smooth closing.

Also to be considered by agents, an escrow officer has no duty to notify the buyer or seller of any suspicious fact or circumstance observed by the officer before the close of escrow, unless the *fact affects closing* as instructed.

An agent best serves their client by selecting escrow officers who promptly alert the agent to potential problems outside the escrow instructions which become known to the escrow officer. [**Lee** v. **Title Insurance and Trust Company** (1968) 264 CA2d 160]

QUIZ

1. Most modern real estate sales transactions depend on both the escrow instructions and the __________ working in tandem to close a transaction.

   a. listing agreement

   b. purchase agreement

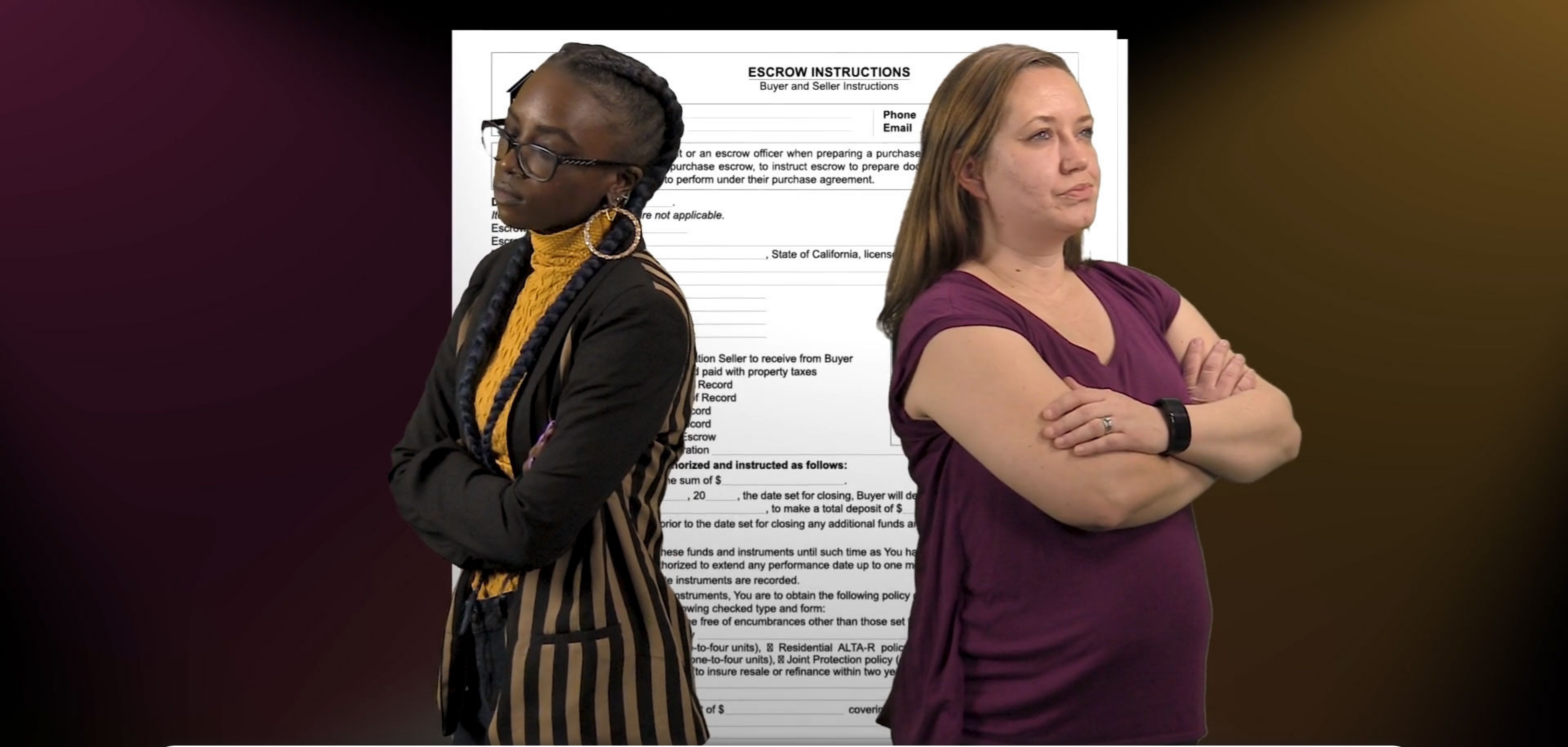
   c. loan application

2. Generally, escrow instructions function __________ the underlying purchase agreement.

   a. in stark contrast with

   b. separately but in conjunction with

   c. entirely independent from



Modifying escrow instructions

Disputes occasionally arise between the buyer and seller over a point not addressed in the purchase agreement or escrow instructions. Disputes impose a need on the agents to mediate an agreeable solution.

The negotiated resolution then needs to be added to the escrow instructions by amendment and signed by the buyer and the seller. Signed amended instructions bind the buyer and seller to the terms agreed to in the amended instructions as part of their contractual obligations in the transaction. [**U.S. Hertz, Inc.** v. **Niobrara Farms** (1974) 41 CA3d 68]

Escrow instructions which modify the intentions stated or implied in the purchase agreement need to be *written*, *signed* and *returned* to escrow by both the buyer and seller. Proposed modifications signed by some but not all parties are not binding on a party who has not agreed to the modifications. [**Louisan** v. **Vohanan** (1981) 117 CA3d 258]

Need for clarification

The purchase agreement and escrow instructions work together to ensure the original expectations of the buyer and seller are met when the transaction closes.

Before closing escrow, an agent may discover an aspect of the escrow instructions which conflict with the purchase agreement or the expectations of the buyer or seller. Here, the agent is duty-bound to immediately bring these discrepancies to the attention of the escrow officer and their client for resolution between the parties. [**Claussen** v. **First American Title Guaranty Co.** (1986) 186 CA3d 429]

On notification of an error in the instructions or a need for clarification, the escrow officer holds up the close of escrow until the discrepancy is clarified and corrected escrow instructions have been prepared, signed by the buyer and seller, and returned to escrow. [**Diaz** v. **United California Bank** (1977) 71 CA3d 161]

The **amended instructions** reference the purchase agreement as being modified. Once the buyer and seller agree on the terms, escrow can proceed toward closing.

QUIZ

1. Escrow instructions which modify the intentions stated or implied in the purchase agreement need to be:

    a. written and returned to escrow by both the buyer and seller.

    b. written, signed and returned to escrow by both the buyer and seller.

    c. signed and returned to escrow by the party which initiated the modification.

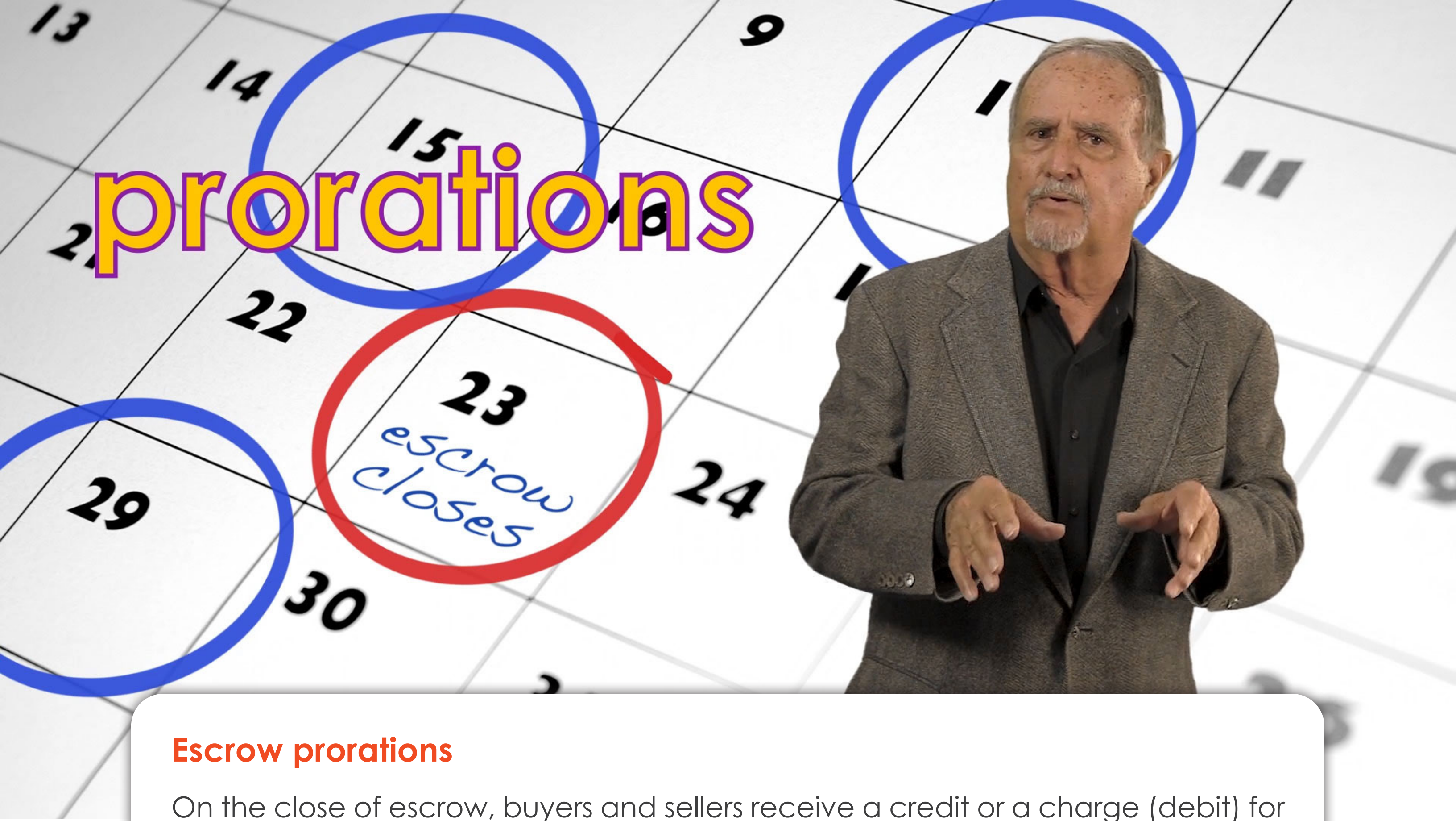
2. Escrow has a duty to advise the buyer in writing of the __________, unless the seller certifies they are exempt.

    a. the final points and fees the buyer will pay on the mortgage upon closing

    b. the residency status of the seller if they will be moving out of state after closing

    c. Franchise Tax Board (FTB) requirements for withholding 3 1/3% of the price paid the seller

prorations



Escrow prorations

On the close of escrow, buyers and sellers receive a credit or a charge (debit) for their proportionate share of past due or prepaid income or expenses involved in the ownership or operations of the property being conveyed, called **prorations**.

Prorations are usually calculated based on the date escrow closes. However, they may be set based on any date agreed to by the buyer and seller. For calculating prorations based on the date of closing, the entire day of closing is the first day of the buyer's ownership, unless the escrow instructions specify otherwise.

Items which the buyer takes over and are prorated include:

- property taxes;
- interest on mortgages/bonds assumed;
- rent; and
- service contracts assumed by the buyer.

Time periods for prorations

Items to be prorated are initially agreed to in the purchase agreement. Proration provisions entitle the seller to a credit for the portion of prepaid sums which have not fully accrued on the day before closing on items the buyer takes over or receives on the sale.

Conversely, the buyer receives a credit for unpaid amounts assumed by the buyer which accrued through the day prior to the close of escrow. [See **RPI** Form 150 §13.6]

For example, property taxes are levied for the fiscal year which begins July 1st and ends June 30th of the following calendar year. To prorate property taxes, the beginning of the fiscal year – July 1st – is the starting point for accrual.

Prorations are based on a 30-day month or a 360-day year.

Property taxes are paid in one or two installments. The first installment is payable no later than December 10th for the first half of the fiscal year. The second payment is due no later than April 10th for the second half of the fiscal year.

For interest on mortgages, improvement district/solar panel bonds or other debts assumed by the buyer, the seller is charged and the buyer receives a credit for the interest accrued and unpaid during the seller's ownership of the property through the day before the close of escrow.

Prorations on the purchase of income property

On the purchase of income property, the investor-buyer is entitled to a credit for the **prepaid rents** collected by the seller which have not accrued for the remaining days of the month beginning with the day of the close of escrow.

All **security deposits** held by the seller are credited to the buyer as a lump sum adjustment, not a proration. After closing, the buyer is responsible to account to the tenants for the deposits on termination of their tenancies, on proper notice handled by the seller's agent. [See **RPI** Form 585]

The seller is credited for any delinquent unpaid rents which have accrued prior to closing and are to be collected by the buyer, unless otherwise agreed in the purchase agreement and escrow is so instructed.

QUIZ

1. Prorations are usually calculated based on:
   a. the date the purchase agreement is signed.
   b. the date escrow closes.
   c. the date the property taxes become due.

2. Prorations are generally based on a(n):
   a. 29-day month or a 362-day year.
   b. 30-day month or a 360-day year.
   c. 31-day month or a 365-day year.

Funds held in escrow on cancellation

When escrow fails to close, a buyer's **good faith deposit** toward the payment of the purchase price of a one-to-four unit residential property is disbursed within 30 days after the person entitled to the funds demands them. [Calif. Civil Code §1057.3]

A good faith deposit is more commonly known as **earnest money**.

When disputed by the other party, the issue becomes *who has the right* to receive the funds deposited in escrow.

A seller or buyer who wrongfully refuses to release the buyer's good faith escrow deposit is liable for a money penalty of three times the amount wrongfully withheld, called **treble damages**. *Treble damages* will be greater than $100 but less than $1,000, plus attorney's fees. [CC §1057.3]

Usually the dispute arises on the seller's claim they are entitled to the deposit under *forfeiture-of-deposit* provisions contained in outdated purchase agreements. However, the seller is not entitled to any of the buyer's funds unless the seller has suffered **out-of-pocket money losses** due to a breach by the buyer, much different from forfeiture.

Thus, the fully performing seller needs to release the escrowed deposit to a breaching buyer, less any out-of-pocket money losses the seller actually incurred due to the buyer's breach.

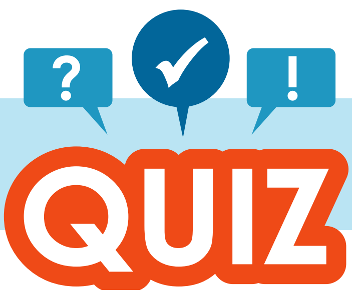
Unless escrow receives mutual instructions to disburse the funds held in escrow when escrow fails to close, the escrow company merely deposits the funds with the court. This relieves escrow of any further responsibility to account for the funds, called an **interpleader**. Thus, escrow can close out its trust account on this escrow file. [Calif. Code of Civil Procedure §386; **Security Trust & Savings Bank** v. **Carlsen** (1928) 205 C 309]

Good faith dispute over deposits

Release of deposited funds is not required when a legitimate **good faith dispute** exists between the buyer and the seller over entitlement to the funds. [CC §1057.3(f)(2)]

Neither the buyer nor seller will be entitled to any penalty or statutory attorney's fees on resolution of a *good faith dispute*.

However, the good faith standard for an individual's refusal to release escrowed funds requires a *reasonable belief* by the individual of their right to the funds. [CC §1057.3(c)]



1. When escrow fails to close, a buyer's good faith deposit toward the purchase price is to be disbursed __________ after the person entitled to the funds demands them.

   a. within 3 days

   b. within two weeks

   c. within 30 days

2. A seller or buyer who wrongfully refuses to release the buyer's good faith escrow deposit is liable for:

   a. a money penalty equal to 50% of the amount wrongfully withheld.

   b. a money penalty equal to the amount wrongfully withheld.

   c. a money penalty of three times the amount wrongfully withheld.

Vesting

What is vesting?

A **vesting** is a method of holding title to real estate. Differences in the types of title vestings present different consequences for persons who have interests in property.

Title to real estate in California is held in one of four basic vestings:

- **joint tenancy** — Ownership of fractional interests in real estate by two or more individuals each holding an equal share with the right of survivorship. When a joint tenant dies, their interest is eliminated and the surviving joint tenants share the remaining ownership equally. Joint tenants take title together on the same deed, at the same time, hold equal shares in the ownership of the property, and each has the right to possess the entire property, known as the **four unities**.
- **tenancy in common** — Tenants in common may have varying percentages of ownership in a property, may take title at different times, and have centralized rights of possession. When a joint tenant conveys their interest in the property to another person, that person takes title as a tenant in common. A tenant in common may will their interest in the property to others on their death since a tenancy in common interest carries no right of survivorship with it.
- **community property** — All property acquired by a married couple in California during a marriage is presumed to be community property, unless

acquired as the separate property of either spouse. Under the community property vesting, the ownership interests are equal.

- **community property with right of survivorship** — Identical to the community property vesting but with the inclusion of words creating the right of survivorship. On the death of a spouse, the surviving spouse automatically becomes the sole owner of the property.

Next we'll illustrate the different types of vestings in application.

QUIZ

1. What type of vesting allows for varying percentages of ownership in a property, and the owners to take title at different times and have centralized rights of possession?

   a. Joint tenancy.

   b. Tenancy in common.

   c. Community property.

Vesting reflects estate planning

Consider a married couple who, with the assistance of their agent, locate real estate they intend to purchase. They will use monies accumulated during their marriage and a new purchase-assist mortgage to pay the purchase price.

The agent, as part of their *due diligence* on any property acquisition, asks the couple how they want to take title on the close of escrow. The couple wants the property to be vested in both of their names, as a married couple, with the **right of survivorship**.

On the death of a spouse, the couple wants the *surviving spouse* to automatically become the sole owner of the property, avoiding probate procedures.

Recognizing the **community property** aspect of their funds accumulated during marriage, the agent advises the couple they need to take title as:

- "*a married couple as community property with right of survivorship*"; or
- "*a married couple as joint tenants.*"

The agent explains the two vestings are identical for future conveyancing since:

- both vestings may be **severed** before death by either spouse to provide for an alternative distribution of each spouse's ownership interest to others by will, a trust agreement or another vesting of their interest; and
- on death the title is cleared of the deceased spouse's interest by the surviving spouse recording an **affidavit** declaring the death of the deceased spouse and attaching a certificate of death. [See **RPI** Form 460; see **RPI** Form 461]

However, mindful of the *tax consequences* for the surviving spouse, the agent recommends the couple vest title to the property as community property with right of survivorship. Like the tax consequences of a joint tenancy vesting by spouses, the surviving spouse is assured a fully **stepped-up cost basis** for the community property.

In this example, the agent's advice to vest the property as "community property with right of survivorship" satisfies the couple's estate planning needs for holding title to the property. Likewise, since the property was acquired during the marriage, it is considered *community property* even when the couple vested the property in their names as joint tenants.

Additionally, the couple intends to avoid probate procedures on the death of a spouse. Both right of survivorship vestings avoid enforcement of any contrary provisions in the will of the deceased since no interest remains under either vesting to be transferred by will or otherwise after death.

Community property with right of survivorship

For the surviving spouse, a **community property** vesting with right of survivorship is superior to a simple community property vesting. This is the case even though a simple community property vesting without the right of survivorship also transfers the property to the surviving spouse when the deceased dies **intestate** (with no will) or **testate** (with a will) stating the surviving spouse takes the property.

On a simple community property vesting, when no one contests the surviving spouse's right to become the sole owner of the deceased spouse's interest in the property, the surviving spouse needs to wait 40 days following the death before the property can be sold, leased or encumbered.

After 40 days, an **affidavit** by the surviving spouse is recorded to clear title by declaring the death and attaching a death certificate. [See **RPI** Form 461]

A joint tenancy recommendation by the agent produces the same transferability and tax results as does the community property vesting with right of survivorship. They function identically before and after death.

However, joint tenancy provides spouses with more flexibility by allowing for avoidance of some *community debts* during the marriage and on death. This avoidance of debts incurred solely by one spouse is not available under either community property vesting.

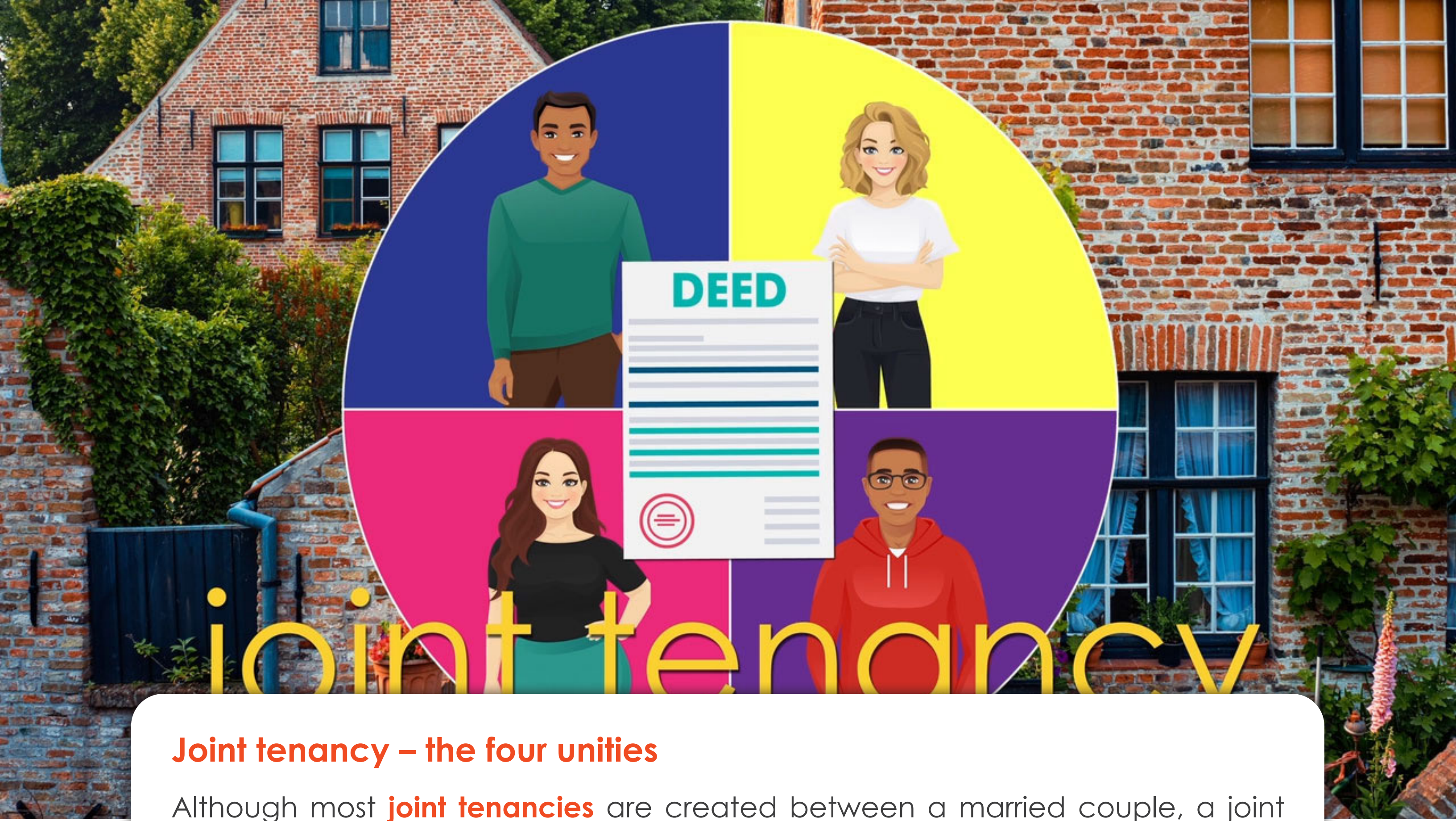
QUIZ

1. When a couple who jointly owns property wants the surviving spouse to automatically become the sole owner of the property on the death of the other spouse, what language do they include in the vesting?

   a. Power of attorney.

   b. Right of first refusal.

   c. Right of survivorship.



Joint tenancy – the four unities

Although most **joint tenancies** are created between a married couple, a joint tenancy can exist between non-married persons. Conversely, community property vestings are only available to married couples or registered domestic partners.

Additionally, the number of joint tenants is not limited to two, as is a married couple's ownership of community property interests. Using one deed, any number of co-owners can take title to real estate as joint tenants. The only ownership condition is that the joint tenants take **equal ownership interests** in the property.

Traditionally, the creation of a **joint tenancy** requires the conveyance of *four unities*:

- **unity of title**, meaning the joint tenants take title to the real estate through the same instrument, such as a single grant deed or court order;
- **unity of time**, meaning the joint tenants receive their interest in title at the same time;
- **unity of interest**, meaning the joint tenants own equal shares in the ownership of the property; and
- **unity of possession**, meaning each joint tenant has the right to possess the entire property.

Today, a joint tenancy vesting is loosely based on these four unities. For example, a joint tenancy is currently defined as ownership **in equal shares** by two or more persons. Thus, the joint tenancy co-ownership incorporates the *unity of interest* into its statutory definition.

Similarly, a joint tenancy needs to be created by a **single transfer** to all the co-owners who are to become joint tenants. Thus, the historic *unity of title* (same deed) and *unity of time* (simultaneous transfers) required under common law have been retained in one event. Typically, this is accomplished by the recording of a conveyance transferring title to all the joint tenants.

QUIZ

1. A joint tenancy can exist between:

   a. married couple.

   b. non-married persons.

   c. Either a. or b.

2. Traditionally, the creation of a joint tenancy requires the conveyance of four unities. What are the four unities?

   a. Title, transfer, interest and participation.

   b. Time, totality, inflation and parity.

   c. Title, time, interest and possession.

Creating a joint tenancy and a joint tenant's right of survivorship

A joint tenancy ownership in real estate may be created by any of the following transfers when the conveyance states the co-owners take title "as joint tenants":

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to themselves and others;
- a transfer from co-owners vested as tenants-in-common to themselves; or
- a transfer from a married couple holding title as community property, tenants-in-common or separately, to themselves.

For the small percentage of joint tenants who are not a married couple, typically family members or life-long friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional ownership interest** in the property.

Their actual fraction of ownership, when severed or transferred to others, is a function of the number of individuals who took title as joint tenants. For example, five co-owners as joint tenants each hold a one-fifth or 20% fractional ownership interest.

A joint tenancy vesting adds nothing to the legal aspects of the ownership interest held in real estate by each co-owner. Whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest.

However, the **necessary incident** of a joint tenancy vesting is the *right of survivorship*, legally referred to as *jus accrescendi*. The right of survivorship is a case law doctrine which is triggered by the death of one joint tenant.

Thus, the joint tenancy vesting, by the incident of its right of survivorship, becomes operative only on the death of a joint tenant, at which point the right of survivorship **extinguishes the deceased's interest** and leaves the remaining joint tenant(s) with the entire ownership interest they held as joint tenants. The right of survivorship is a mere **expectancy** held by each co-owner and is not a property right.

Ultimately, on the death of all other joint tenants, the last survivor becomes the sole owner of the interest in the property originally owned by all the joint tenants.

QUIZ

1. On the death of all other joint tenants, the last survivor becomes the ___________ of the interest in the property originally owned by all the joint tenants.

   a. surviving heir

   b. successor owner

   c. sole owner

Conveying community property

On a *dissolution* of the marriage, all property acquired jointly by a married couple during the marriage, no matter how vested, is **presumed** to be community property for purposes of division.

Further, the community property presumption for married couples does not only come into play when a couple divorces. All property acquired by a couple or by either spouse during marriage is considered community property, unless the couple clearly states their contrary intention to own their individual interests in the real estate as separate property.

As community real estate, both spouses need to consent to a sale, a lease of more than one year or an encumbrance regardless of how it is vested.

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either **ratify** the transaction or have it **set aside**.

The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to *set aside* the transaction.

Encumbering and leasing joint tenancy property

When real estate held in a joint tenancy vesting is **separate property** — as when the joint tenants are not a married couple, or when a married couple, in writing, agree their interests are separate property — each joint tenant can sell or encumber their interest in the real estate without the consent of the other joint tenant(s).

Additionally, when the joint tenancy in real estate represents **separate property**, a joint tenant may lease out the entire property since a lease is a transfer of possession, and each joint tenant has the right to possession of the entire property.

However, consider a married couple who owns **community property real estate** as joint tenants. One spouse enters into an agreement to lease the property for a term over one year, which the other spouse does not sign.

Under the joint tenancy rule, either joint tenant alone may lease the property. However, under the community property rule (which applies to property acquired during marriage), **both spouses** need to execute a long-term lease agreement with a term greater than one year.

QUIZ

1. On the dissolution of a marriage, all property acquired jointly by a married couple during the marriage is presumed to be __________ for purposes of division, no matter how the property was vested.

   a. community property

   b. separate property

   c. collateral property

Severing right-of-survivorship vestings

Every co-owner vested as a joint tenant or as community property with the right of survivorship has the right to **unilaterally sever** the right of survivorship. The severance by a co-owner *terminates* the right of survivorship in that co-owner's interest.

The separate or community property nature of the co-owner's interest in the property remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner *unilaterally severing* their right of survivorship is not required to first give notice or seek consent from the other co-owner(s).

To sever the vesting, the co-owner prepares and signs a deed from themselves "as a joint tenant" or "as community property with right of survivorship" back to themselves. On recording the deed, the right of survivorship is severed by having merely revested the co-owner's interest. The deed revesting title is to include a statement noting the transfer is intended to sever the prior vesting.

Recording requirement for severance

Recording is necessary to terminate another joint tenant's right of survivorship.

The **unilateral severance** of a joint tenant's interest needs to either be:

- recorded in the county where the property is located before the death of the severing joint tenant; or
- recorded within seven days after the joint tenant's death when executed

and notarized within three days before the joint tenant's death.

Additionally, the joint tenancy may be severed by agreement of the joint tenants. When a written agreement to sever the joint tenancy is signed by all the joint tenants, recording or notarization is not required.

All the preceding rules for recording a severance apply fully to the severance deed of a spouse seeking to terminate the right of survivorship held under the community property vesting.

The unilateral severance of a joint tenancy terminates the right of survivorship. Without the existence of the right of survivorship, each co-owner disposes of their interest in the property on death as they wish, such as by *will* or *inter vivos trust*, or by the severance itself.

Although the sale of a joint tenant's separate property interest in real estate severs the joint tenancy, a lease or encumbrance of the property by a joint tenant does not.

All the procedures for severing a joint tenancy are fully available for a married couple to sever the community property vesting which includes the right of survivorship.

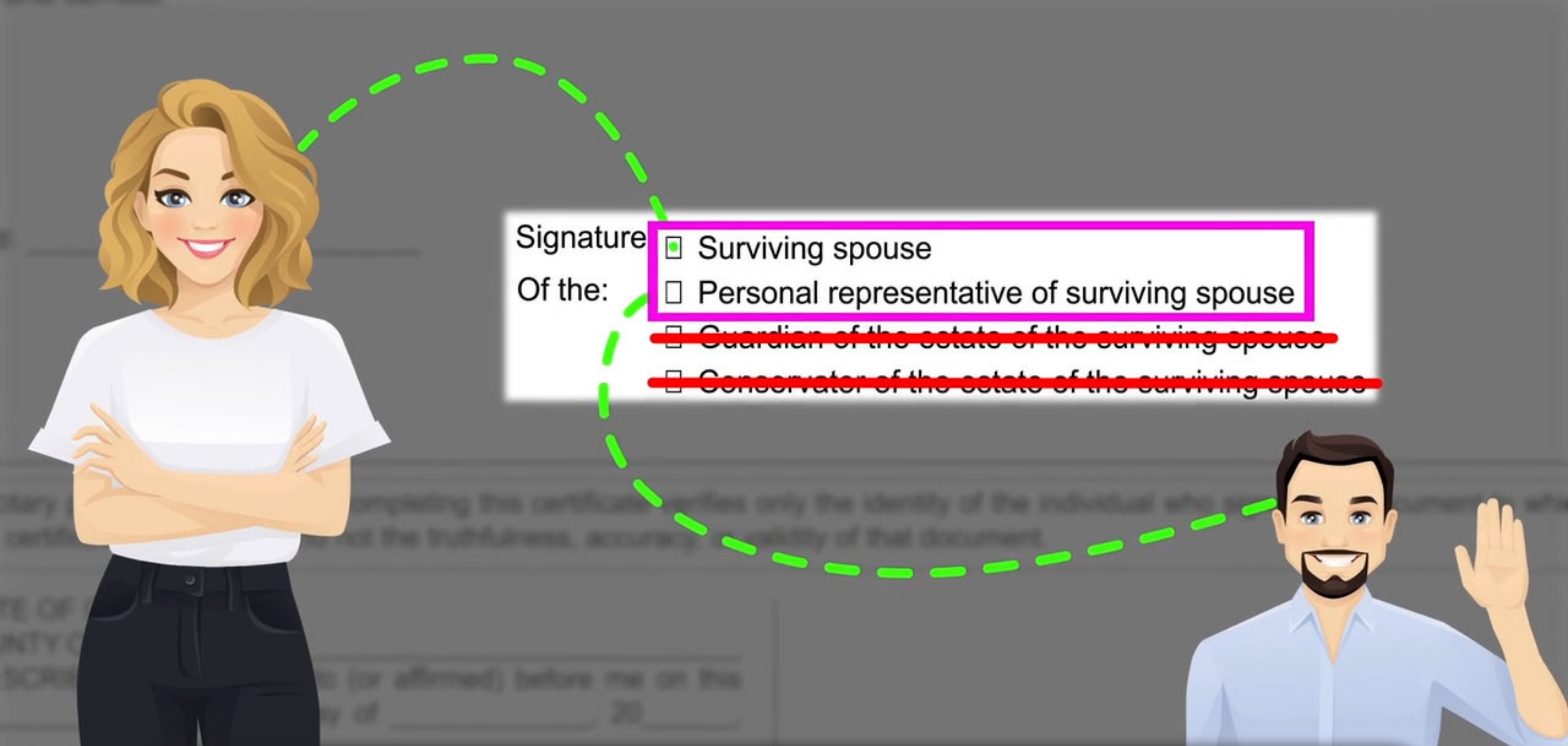
QUIZ

1. Which of the following statements is true concerning the severance of a right-of-survivorship vesting?

    a. A co-owner unilaterally severing their right of survivorship is required to first give notice or seek consent from the other co-owner(s).

    b. Recording is necessary to terminate another joint tenant's right of survivorship.

    c. Both a. and b.



Clear title on death by affidavit

When co-ownership of property is vested as a joint tenancy, the death of a joint tenant *automatically extinguishes* the deceased joint tenant's interest in the real estate. This leaves the surviving joint tenant(s) as the sole owner(s).

However, the deceased joint tenant's interest in the property needs to be cleared from the title before the surviving joint tenant(s) will be able to sell, lease or encumber the property as the sole owner.

The new ownership interest of the surviving joint tenant(s) is documented by simply recording an **affidavit**, signed by anyone, declaring the death of a joint tenant who was a co-owner of the described real estate.

The interest in the property held by the deceased spouse as community property with right of survivorship is extinguished by the same *affidavit* procedure used to eliminate the interest of a joint tenant, except the surviving spouse or their representative is the only one authorized to make the declaration. [See **RPI** Form 461]

Once the affidavit is **notarized, recorded and indexed**, anyone conducting a title search on the property will have notice of the joint tenant's death since the deceased joint tenant is indexed as a grantor. Thus, the surviving joint tenant becomes the **sole owner** of the property due to the right of survivorship.

QUIZ

1. Before a surviving joint tenant(s) will be able to sell, lease or encumber the property as the sole owner, what is the process by which the deceased joint tenant's interest in the property is cleared from the title?

   a. The new ownership interest of the surviving joint tenant(s) is documented by recording an affidavit declaring the death of a joint tenant who was a co-owner of the described real estate.

   b. The deceased joint tenant's interest is cleared from title through lengthy probate procedures.

   c. The new ownership interest of the surviving joint tenant(s) is automatically established by operation of law and no other action is needed.

Controlling the vesting of one-half

A spouse can unilaterally sever the joint tenancy and community property with right of survivorship vestings by:

- executing and delivering a deed that conveys legal title to a **third party**;
- executing a deed to **themselves**;
- executing a written **severance of joint tenancy**; or
- executing a written instrument that **evidences an intent to sever**.

Additionally, the community property interest of a spouse who executes a deed to themselves to sever the title and eliminate the right of survivorship remains community property. Community property cannot be transmuted to separate property without the consent of both spouses or a court order.

A **severance deed** to oneself terminating the right of survivorship is not sufficient by itself to avoid passing the property to the surviving spouse on death for community property vested as either community property with right of survivorship or in joint tenancy.

A will needs to also be prepared or a living trust established naming the person intended to receive the spouse's community property interest on death.

Otherwise, since it is community property, the property will pass by intestate succession to the surviving spouse as though the severance of the vesting had never occurred.

QUIZ

1. A severance deed to oneself terminating the right of survivorship is not sufficient by itself to avoid passing the property to the surviving spouse on death for community property vested as either community property with right of survivorship or in joint tenancy. What else needs to occur?

   a. The severance deed needs to be posted on a conspicuous location on the property for a minimum of 21 days.

   b. A will needs to be prepared or a living trust established naming the person intended to receive the spouse's community property interest on death.

   c. Both a. and b.

A Deed as a Transfer

A deed by any name is a grant

Real estate is conveyed when title is transferred from one individual to another. [Calif. Civil Code §1039]

The transfer of an interest in title to real estate contained in a writing is called a grant or conveyance, no matter the form of writing. [CC §1053]

A **deed** is itself the grant which transfers title to property. [Hamilton v. Hubbard (1901) 134 C 603]

Title by deed passes either:

- *voluntarily* by agreement with the owner, such as in a sale in the open market or *foreclosure* on a trust deed; or
- *involuntarily* without agreement, such as the enforcement of a creditor's judgment or tax lien.

No matter the form of writing, the individual conveying real estate is called the **grantor**. The individual acquiring title is called the **grantee**.

Ownership of *possessory interests* in real estate includes:

- a **fee estate**, also known as *fee simple ownership*;
- a life estate;
- a leasehold estate; and
- an estate at will.

A fee estate is presumed to pass by a grant of real estate, unless a lesser possessory interest is stated, such as an *easement, life estate* or *leasehold interest*. [CC §1105]

A *fee estate* in real estate is an indefinite, exclusive and absolute legal ownership interest in a parcel of real estate.

Creating a valid deed for conveyancing

To be valid, a deed needs to:

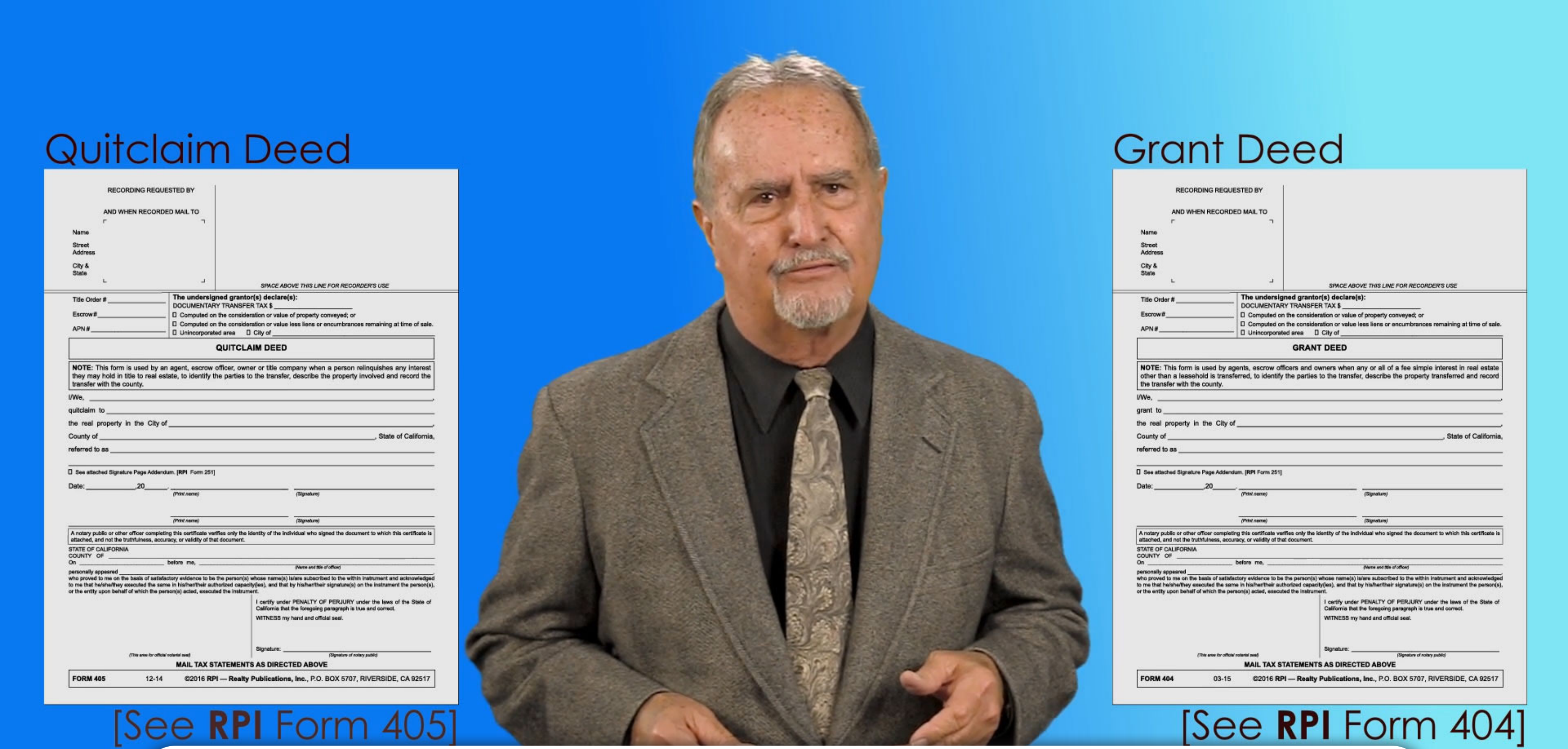
- be in writing;
- identify the grantor and the grantee;
- contain a granting clause stating the grantor's intention to convey;
- adequately describe the real estate involved;
- be signed by the grantor; and
- be handed to and accepted by the grantee.

Form deeds used in real estate transactions conform to these validity requirements by containing words of conveyance, and contain provisions for the identification of the parties and a description of the real estate. They are of suitable size and format to also permit the document to be notarized and recorded. [See **RPI** Form 404 and 405]

QUIZ

1. The transfer of an interest in title to real estate contained in a writing is called a __________ no matter the form of writing.
   a. conveyance
   b. grant
   c. Either a. or b.

2. A(n) __________ is presumed to pass by a grant of real estate, unless a lesser possessory interest is stated.
   a. fee estate
   b. estate at will
   c. leasehold estate



A deed in writing, with exceptions

To be valid, the *transfer of an ownership interest in real estate needs to be in writing, except for:*

- an estate at will or a lease for a term not exceeding one year [Calif. Civil Code §1091];
- adverse possession; or
- an *executed (partially or fully performed) oral agreement* under which the buyer takes possession of the property and makes payments toward the purchase price or makes valuable improvements on the property.

An *executed oral agreement* for the transfer of real estate ownership is enforced either under the doctrines of **specific performance** or **estoppel**. The application of both doctrines is unaffected by whether the property is sold under an oral agreement to a buyer for consideration, or given to a *donee* by gift.

Enforcing an oral promise to convey

Consider a buyer and seller who enter into an oral *land sales contract*. The buyer agrees to pay the purchase price by taking over payments on the mortgage of record and making an additional monthly payment to the seller. [See **RPI** Form 168]

The seller agrees to convey title to the buyer when the buyer has fully paid the purchase price by final payoff of the mortgage and the seller's remaining equity balance in the land sales agreement.

The buyer takes possession of the property. The buyer eventually completes payment of all amounts due. Having fully performed the oral agreement, the buyer makes a demand on the seller to convey title to the property.

The seller refuses, claiming the oral land sales contract is unenforceable since the **statute of frauds** requires an agreement for the sale of real estate to be in writing to be enforceable.

Is the buyer entitled to the specific performance of the oral land sales contract and conveyance of title to the property?

Yes! The buyer's **possession** of the property and **full or partial performance** of the oral land sales contract collectively acts as a substitute for the prerequisite signed writing required by the *statute of frauds* for enforcement of a sale of real estate.

However, *partial payment* of the purchase price under an oral agreement when the buyer is not given possession is insufficient to overcome the statute of frauds writing requirement.

The buyer needs to be given possession of the property for the oral purchase agreement to be enforceable on a partial payment of the price. The buyer's **open and notorious** possession indicates a claim of ownership in the property which is inconsistent with the seller's claim of ownership when a verbal agreement for payment of the agreed-to price has been acted upon. [**Francis** v. **Colendich** (1961) 193 CA2d 128]

Additionally, the buyer's possession of the property is inconsistent with record title. Any purchaser obtaining title from the seller after the buyer takes possession is on constructive notice to further inquire into the interest of the buyer-in-possession of the property. Thus, the subsequent purchaser is not an innocent buyer who is without notice of the buyer-in-possession's interest, called a **bona fide purchaser (BFP)**. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

QUIZ

1. Which of the following transfer of an ownership interest in real estate needs to be in writing?

   a. An estate at will.

   b. A lease for a term exceeding one year.

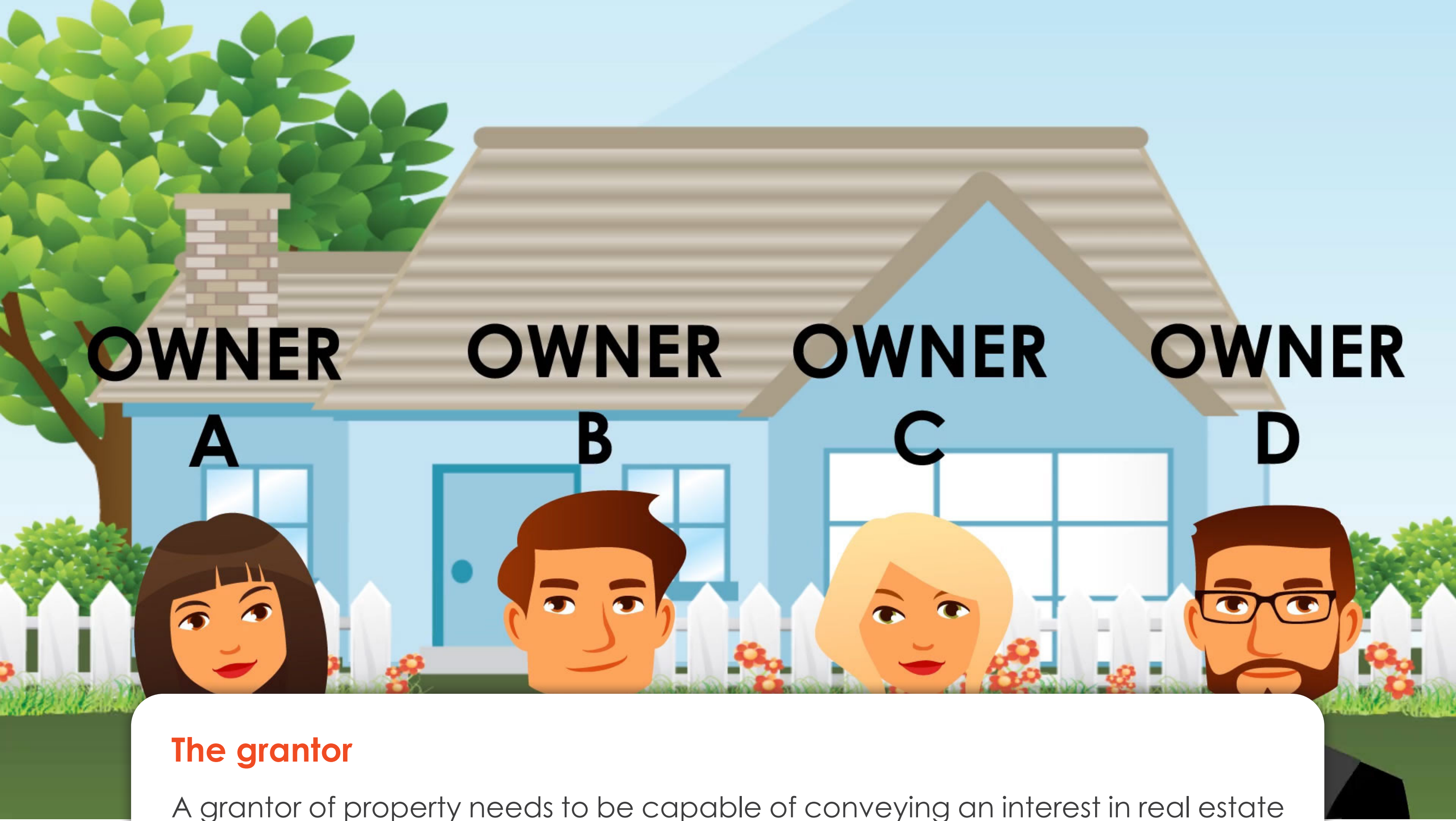
   c. A lease for a term not exceeding one year.

2. An executed oral agreement for the transfer of real estate ownership is enforced under the doctrine of:

   a. estoppel.

   b. specific performance.

   c. Either a. or b.



The grantor

A grantor of property needs to be capable of conveying an interest in real estate at the time the deed is signed for the deed to be an enforceable conveyance. [Calif. Civil Code §38; Calif. Family Code §6701]

To be *capable*, the grantor at the time the deed is signed needs to:

- be of *sound mind;*
- *possess their civil rights; and*
- be an adult at least 18 years of age. [CC §1556]

However, an exception exists to the "18 or over" age qualification. An **emancipated minor** is considered an adult capable of transferring an interest in real estate. [Fam C §7050(e)(3)]

An individual under the age of 18 is an *emancipated minor when the individual:*

- has entered into a valid marriage, even if the marriage is now dissolved;
- is on active duty with the United States Armed Forces; or
- has received a declaration of emancipation from the court. [Fam C §7002]

A **temporary conservator** may be appointed by the court to manage the affairs of a property owner who is deemed incapable of conveying an interest they hold in real estate.

To put the public on **notice of a conservatorship**, a notice of conservatorship is recorded in the county where the property is located. Unless the notice is recorded, the owner's conveyance to an individual who does not have **actual knowledge** of the conservatorship is valid. [Calif. Probate Code §1875]

However, while the deed may be valid, the failure to record a notice of conservatorship does not eliminate the *rules of equity* when the incapable owner has conveyed property. A conveyance to a buyer who does not have actual or constructive knowledge of the conservatorship may be *rescinded* (set aside) as **voidable** by the owner when the owner did not understand the nature and consequences of the sales transaction they entered into. [Prob C §§1875, 1876]

Further, when a court not only decrees an owner to be **incompetent** but appoints a guardian as well, any later conveyance of real estate by the owner is **void** as having transferred nothing, not merely voidable. When the owner has been adjudicated as entirely incompetent and is appointed a guardian, a later conveyance by the owner may be set aside as never having been effective, even when the grantee is a *bona fide purchaser (BFP)* for lack of actual or recorded notice of the guardianship.

The appointment of a guardian and decree of incompetency, even unrecorded, are considered notice to all individuals of the owner's legal incapacity to convey real estate under any circumstances.

Unlike a conservator, a guardian does not need to record a notice of the appointment to put buyers and lenders on notice. A court's determination of the owner's incompetence and appointment of a guardian constitutes *notice to the world* that the deed is void since the owner lacks all legal capacity to convey property. [**Hellman Commercial Trust & Savings Bank** v. **Alden** (1929) 206 C 592]

Grantor identification in deed

The **grant provision** in a deed needs to identify each person who is conveying an interest in the property in the grant provision of the deed. When a conveyance such as a deed is signed by a person who is not named as the **grantor**, the deed does not convey that person's interest in the property.

The identity of the grantor in the provision containing words of conveyance needs to be stated by name, determined by an examination of the entire deed, not just the signatures. [**Childs** v. **Newfield** (1934) 136 CA 217]

For example, a deed identifies several individuals by name as grantors in the grant provision and the document contains their signatures. However, the list of grantors named in the deed's grant provision is incomplete to convey 100% of the title. Several unnamed individuals also have an ownership interest in the property.

Further, the signatures on the grant deed include all the individuals who are co-owners of the property — even though some are not named as grantors in the grant provision.

In this instance, the deed transfers only the ownership and title held by those owners named as grantors in the grant provision in the deed. The deed by its wording does not show the necessary intent to convey title by the unnamed owners who were not listed as grantors and also signed the deed. [**Roberts** v. **Abbott** (1920) 48 CA 779]

On recording, the county recorder will only index as grantors those persons listed in the grant provisions since only they by their signatures conveyed their interests in the real estate. This creates a **cloud on title**.

Grantor's vesting in the chain of title

The name of the grantor on a deed needs to match the name of the grantee named in the previous deed which conveyed title to them. Otherwise, a **break in the chain of title** occurs.

For example, an unmarried woman takes title in her maiden name "as an unmarried woman."

Later, the woman marries and takes her husband's last name as her own.

If the woman then conveys the property using her newly-acquired married name to identify herself as the grantor, it will cause a *break in the chain of title*. When a different name is used as the grantor from the name used to receive title under a prior deed, the new name cannot be located in the county recorder's grantor-grantee index as the grantee who previously received and holds title to the property being conveyed. The title remains in her maiden name as no one is on notice (by the record) of her conveyance.

With a *break in title* between deeds due to the grantor's name change after taking title as a grantee, a buyer receives an unmarketable title. In this example, the grantor received title in her maiden name as an unmarried woman and conveyed the property in her married name, causing a break in the chain of title. [**Benson** v. **Shotwell** (1890) 87 C 49]

Any person conveying property whose name has changed after becoming vested in title needs to enter as grantor on the deed both:

- the name in which they previously received title to the real estate as a grantee; and
- the name by which they are acting as the grantor on the conveyance. [CC §1096]

When a deed does not identify the grantor by the precise name and spelling under which the grantor previously took title, the deed does not give constructive notice to later buyers or encumbrancers of the property that the grantor has already conveyed their interest. However, the deed with the reference to the incorrect name of the grantor is valid and enforceable between the parties to the deed and those who have notice of the true identity of the grantor. [CC §1096]

Further, **possession** of real estate by the grantee is **constructive notice** to others that the defective deed exists. Possession places future buyers, lenders and tenants on notice to ask the grantee-in-possession what interest they hold in the property.

QUIZ

1. To be considered capable at the time the deed is signed, the grantor needs to be of sound mind, possess their civil rights and:
    a. be an adult at least 16 years of age.
    b. be an adult at least 18 years of age.
    c. be an adult at least 21 years of age.

2. An emancipated minor is considered an adult capable of transferring an interest in real estate. Which of the following, in and of itself, does not constitute an emancipated minor?
    a. An individual who has entered into a valid marriage, even if the marriage is now dissolved.
    b. An individual who is on active duty with the United States Armed Forces.
    c. An individual who holds steady employment and a valid driver's license.

The grantee

While the grantor needs to have the capacity to convey title, any existing person (individual or entity) may take and hold title to real estate as the **grantee**. [Calif. Civil Code §671]

A child or an incompetent person has the *capacity to receive* and hold title as a grantee even though that person does not have the legal capacity to convey the same property. [**Turner** v. **Turner** (1916) 173 C 782]

Unless a deed *identifies* the grantee, the deed is **void**. The identity of the grantee needs to be sufficient to identify with certainty the individual to whom the seller intends title to be passed. [**Tumansky** v. **Woodruff** (1936) 14 CA2d 279]

Consider a seller who places their grant deed in escrow (a third party) without naming a grantee or instructing escrow to enter a grantee's name.

Later, the escrow agent inserts the name of the buyer in the deed as the grantee on the assumption the deed was to be used to convey title to the buyer. The buyer's name is inserted without the seller being present or the seller's written authority.

Is the deed enforceable after escrow inserted the buyer's name in the deed without receiving the seller's authority?

No! If a seller/grantor is not present when a buyer's/grantee's name is inserted in the grant deed, or if the name of the grantee is inserted by a person without the grantor's written authority to do so, the deed is *void*. [**Tannahill** v. **Greening** (1927) 85 CA 714]

Further, a deed is considered valid when the individual identified as the grantee takes title under a **fictitious name** by which they are also known or have assumed for the purpose of receiving title.

However, when the *fictitious name* is used to defraud the grantor, the grantor may set aside the deed as **voidable**.

Sometimes an unintentional error **misnames the grantee** in a recorded deed, such as by misspelling the grantee's name. A deed with a misnamed grantee is still a valid conveyance of the real estate.

Another deed from the same grantor to the grantee named with the correct spelling of the grantee's name will not correct the error, nor will re-recording the original deed with an amendment containing the grantee's correct name. The recording of a corrective deed falls outside the *chain of title* in the grantor-grantee index since the grantor no longer has any interest to convey. The grantor has already conveyed their title, albeit to a grantee with an erroneously spelled name. [**Walters** v. **Mitchell** (1907) 6 CA 410]

However, the buyer may petition a court to establish the identity of a seller when a discrepancy with the seller's name exists in the chain of title. [Calif. Code of Civil Procedures §§770.010 et seq.]

Editor's note — Title companies are only concerned the grantor on a deed is the same person who took title under an incorrect name. Title companies will generally accept a deed conveying title which identifies the grantor by both their correct name and the incorrect (misspelled) name under which they originally took title as a grantee.

QUIZ

1. Any existing person, individual or entity may take and hold title to real estate as the:

   a. grantor.

   b. grantee.

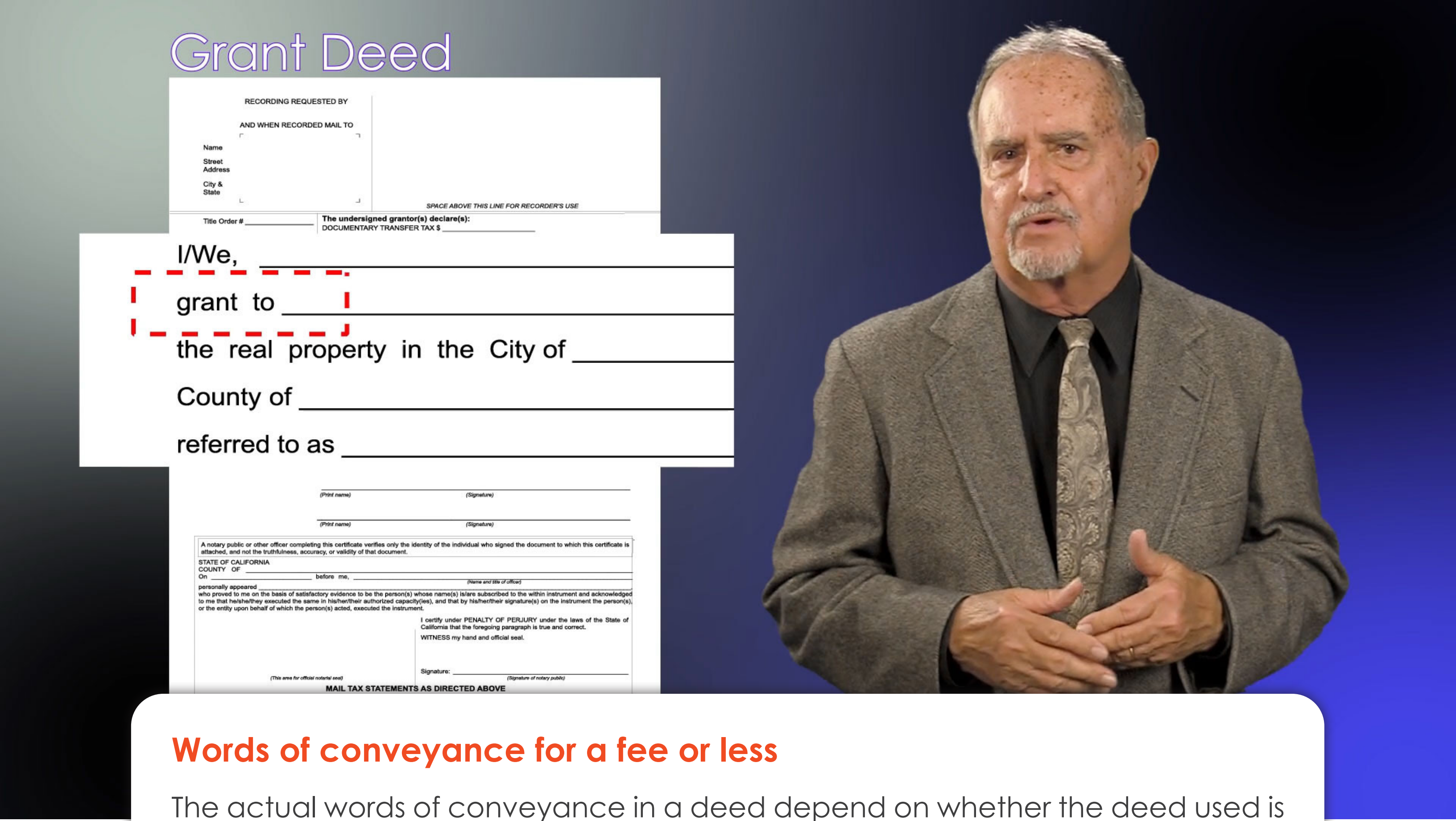
   c. guarantor.

2. The identity of the grantee needs to be __________ the individual to whom the seller intends title to be passed.

   a. reasonably clear to identify with hesitation

   b. sufficiently clear to identify with certainty

   c. logically clear to identify with implication



Words of conveyance for a fee or less

The actual words of conveyance in a deed depend on whether the deed used is a **grant deed** or a **quitclaim deed**.

A grant deed is used to pass a fee estate from the grantor to another individual, unless a lesser interest is stated in the deed.

While no precise words of conveyance are necessary, use of the word "grant" in the granting clause, without noting a lesser interest in the description of the property, indicates the conveyance of a fee simple interest in the described property. [See **RPI** Form 404]

Alternatively, a *quitclaim deed* is intended to convey whatever interest, if any, the grantor may hold in the real estate. The words of conveyance historically used in a quitclaim deed are "remise, release and otherwise quitclaim."

However, only the word "quitclaim" is required as the word of conveyance. The word "grant" is not used in a quitclaim deed since no implied warranties are included with a conveyance under a quitclaim deed. Yet, the parties to a quitclaim deed are referred to as the "grantor" and the "grantee." [See **RPI** Form 405]

The covenants (warranties) implied in a grant deed include:

- the interest conveyed in the real estate has not been *previously conveyed* to another, except as disclosed in the grant deed; and
- the grantor has not *further encumbered* the real estate, except as disclosed

in the grant deed. [Calif. Civil Code §1113]

Grant deed covenants are **implied.** Thus, they are not separately bargained for as provisions to be included in the grant deed conveyance.

If a grant deed covenant is breached by a seller (grantor), the buyer (grantee) may recover their money losses from the seller for the breach of the implied covenant, as though the covenant had been written into the grant deed. [CC §1113]

Quitclaim deeds: you have what I had if I had it

A **quitclaim deed** terminates any interest in the real estate described in the deed which may be held by the named person (grantor) signing and delivering the quitclaim deed.

Unlike a grant deed, a *quitclaim deed* operates to **release to the grantee all interest** the grantor may hold in the property. [**Platner** v. **Vincent** (1924) 194 C 436]

A quitclaim deed passes whatever title, legal or equitable, the grantor possessed on execution (signing and delivering) of the quitclaim deed.

While a quitclaim deed is not intended to assure the conveyance transfers a fee simple ownership, the named grantor who holds fee title and signs and delivers a quitclaim deed conveys fee simple ownership of the property, and all the benefits of holding fee simple title. [**Spaulding** v. **Bradley** (1889) 79 C 449]

Unlike a grant deed, a quitclaim deed does not also pass the grantor's after-acquired title to the real estate described in the quitclaim deed. The quitclaim deed is a *release* of the grantor's interest in the real estate at the time it is signed and delivered.

The individual signing and delivering a quitclaim deed does not promise to convey an interest in the real estate, much less agree they received it and have not previously conveyed or encumbered it.

However, after-acquired title will pass to a buyer named in a previous quitclaim deed if:

- the seller sold by use of a quitclaim deed an *unperfected right* in the property which will later ripen into ownership, called an *inchoate right*, such as the interest held by a beneficiary under a will or inter vivos (living) trust prior to the death of the property owner [**Soares** v. **Steidtmann** (1955) 130 CA2d 401]; or
- the seller is *estopped* (barred) by their sales agreement or their conduct from claiming the after-acquired title does not pass to the buyer.

The seller may not claim the after-acquired title does not pass when:

- the quitclaim deed contains recitals or covenants, such as an *assignment clause*, showing the seller's intention was not to limit the interest conveyed to only the interest the seller had at the time the quitclaim deed was executed; or
- the seller has affirmed, or their conduct has implied, they actually had an interest in the property which was to be conveyed. [**In re Wilson's Estate** (1940) 40 CA2d 229]

QUIZ

1. A __________ is used to pass a fee estate with implied warranties from the grantor to another individual, unless a lesser interest is stated in the deed.

    a. grant deed

    b. quitclaim deed

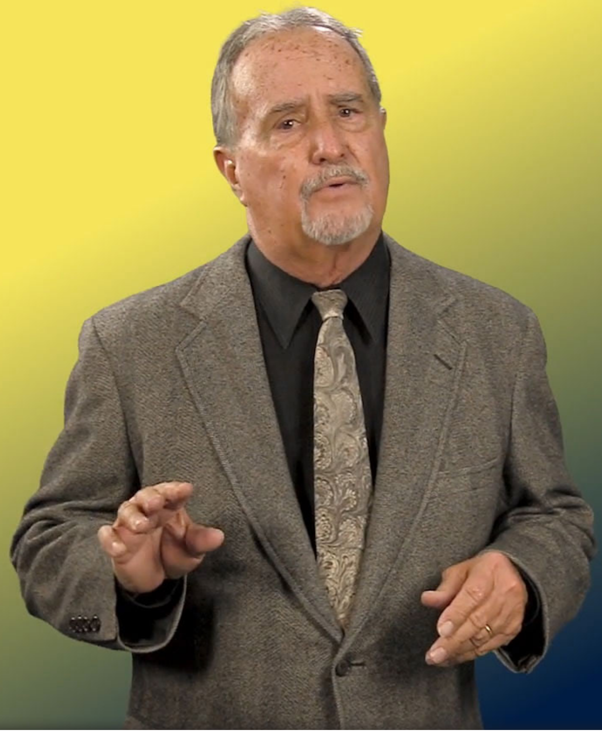
    c. Either a. or b.

2. Which type of deed would most likely be used to pass whatever title, legal or equitable, the grantor possesses on execution?

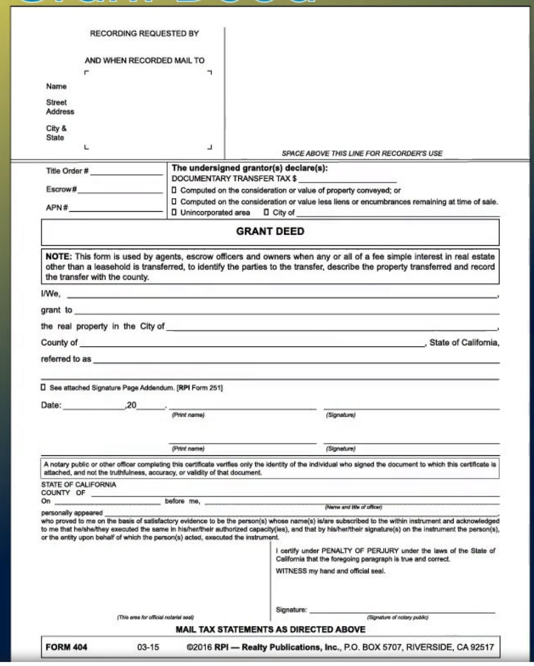
    a. Grant deed.

    b. Quitclaim deed.

    c. Trust deed.



Grant Deed



RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

Title Order # ____

Escrow# ____

APN # ____

The undersigned grantor(s) declare(s):
DOCUMENTARY TRANSFER TAX $ ____
☐ Computed on the consideration or value of property conveyed; or
☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.
☐ Unincorporated area ☐ City of ____

GRANT DEED

NOTE: This form is used by agents, escrow officers and owners when any or all of a fee simple interest in real estate other than a leasehold is transferred, to identify the parties to the transfer, describe the property transferred and record the transfer with the county.

I/We, ____,

grant to ____

the real property in the City of ____,

County of ____, State of California,

referred to as ____

☐ See attached Signature Page Addendum. [**RPI** Form 251]

Date: ____, 20____. ____ *(Print name)* ____ *(Signature)*

____ *(Print name)* ____ *(Signature)*

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF ____
On ____ before me, ____ *(Name and title of officer)*
personally appeared ____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: ____ *(Signature of notary public)*

(This area for official notarial seal)

MAIL TAX STATEMENTS AS DIRECTED ABOVE

FORM 404 03-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Describing the property conveyed

A deed conveying property needs to sufficiently *describe* the property being conveyed. The description in the deed is necessary so the property may be reasonably located. When the property cannot be located from the description, the conveyance is void. [**Scott** v. **Woodworth** (1917) 34 CA 400]

The description of a parcel in a deed needs to be sufficient to allow the real estate conveyed to be identified and located with reasonable certainty by a surveyor. [Best v. Wohlford (1904) 144 C 733]

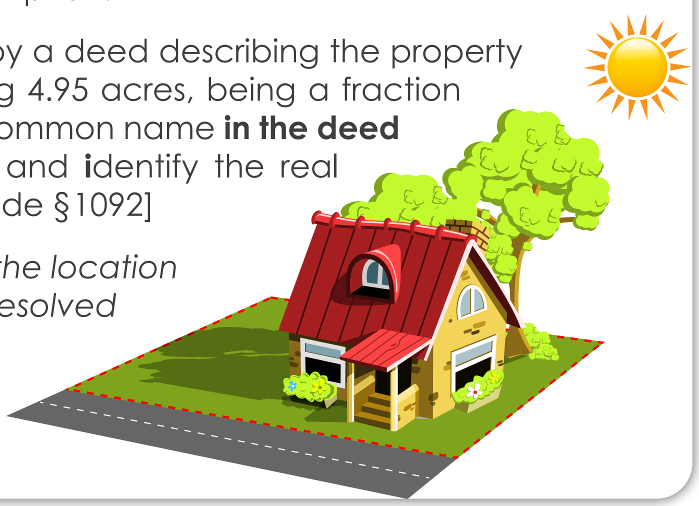
Facts not stated in the deed, known as extrinsic evidence, may only be used when an ambiguity arises as to the description of the property conveyed.

Conversely, *extrinsic evidence* may not be used to supply the deed with a missing description or correct a defective description.

For example, real estate is conveyed by a deed describing the property as the "Occidental Mill Site, containing 4.95 acres, being a fraction of lot 2..." The use of the real estate's common name **in the deed** is sufficient to locate the boundaries and **i**dentify the real estate being conveyed. [Calif. Civil Code §1092]

Editor's note — Any dispute regarding the location of the 4.95 acres on lot 2 needs to be resolved as a boundary dispute.

Additionally, a deed which describes



real estate by its street address, such as “123 Riverside Avenue, Riverside, CA 92507,” will be considered sufficient to identify the real estate located at the street address, sometimes called a **common description** or **common address**. [**Brudvig** v. **Renner** (1959) 172 CA2d 522]

However, the best method of ensuring certainty of the parcel being conveyed is to include the property’s **legal description** or a map designation, such as a parcel or lot number.

This would also contain the **metes and bounds** description which sets forth all the boundary lines together with their terminal points and angles.

Thus, the real estate may be described by reference to other documents, such as a subdivision map as it contains the metes and bounds description of the parcel conveyed. The subdivision document referenced in a deed is incorporated into the deed as the source of the metes and bounds description of the property conveyed. [**Edwards** v. **Lewis** (1938) 25 CA2d 168]

QUIZ

1. The best method of ensuring certainty of the parcel being conveyed is to include the property’s:

   a. common description.

   b. common address.

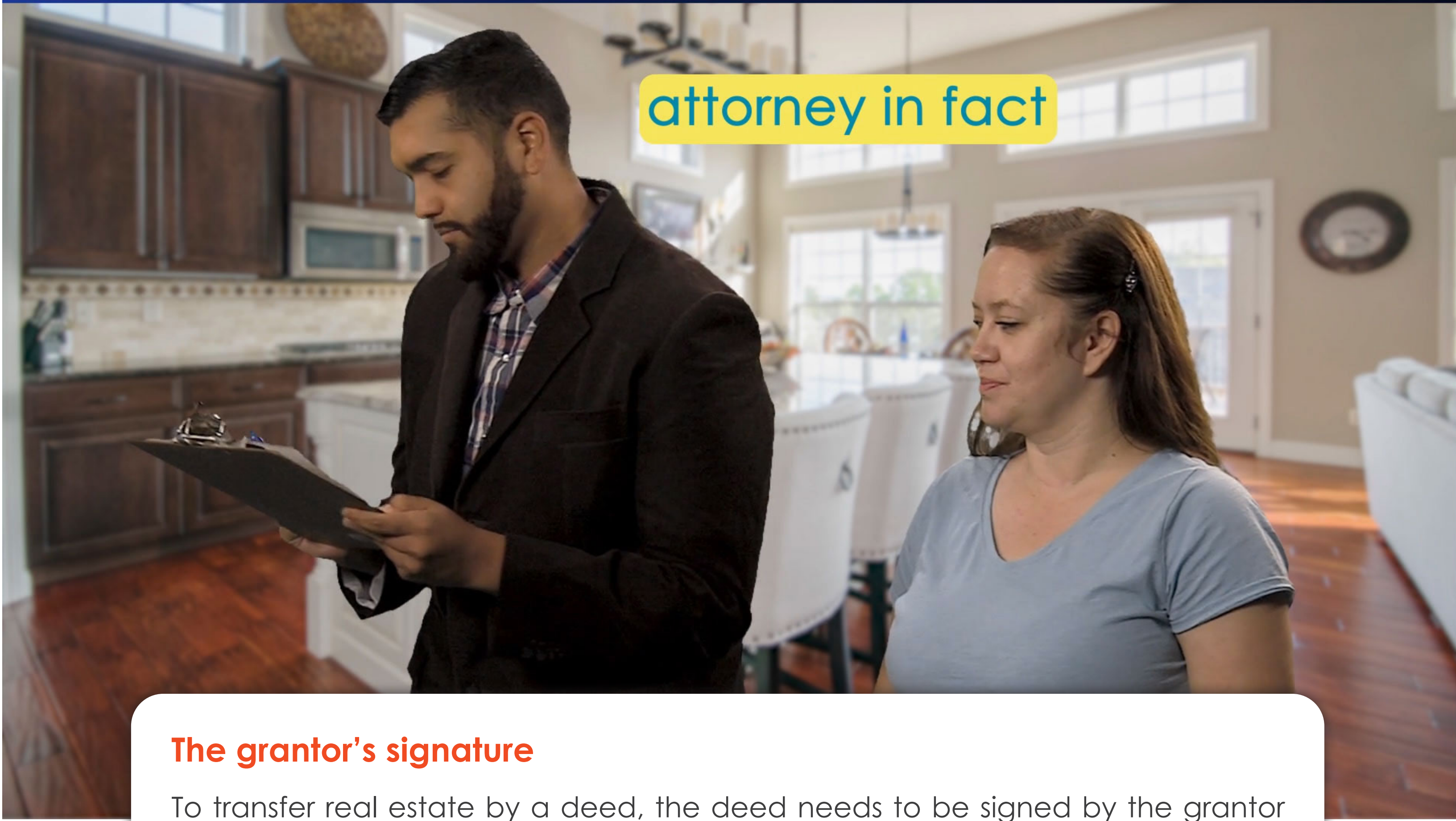
   c. legal description or a map designation.

2. Which method of property description sets forth all the boundary lines together with their terminal points and angles?

   a. Legal description.

   b. Metes and bounds description.

   c. Map designation.



The grantor's signature

To transfer real estate by a deed, the deed needs to be signed by the grantor named in the deed. [Calif. Civil Code §1091]

The grantor's agent may also sign a deed on behalf of the grantor when the agent is authorized in writing to convey the property on the grantor's behalf. The agent is called an **attorney in fact** and is operating under a written *power of attorney*. [CC §1091; see **RPI** Form 447]

Additionally, a deed may be signed in the name of the grantor by an **amanuensis** acting on oral instructions from the grantor. An *amanuensis* is an individual who has the oral authority of the grantor to sign the grantor's name on a grant deed by their own hand on behalf of the grantor.

Unlike an attorney in fact, who is an agent with *discretionary authority* to determine whether they are to enter into a deed without prior approval from the grantor, an amanuensis has a purely ministerial duty. The amanuensis signs a document as instructed by the grantor whose name they sign without exercising personal discretion or judgment.

QUIZ

1. To transfer real estate by a grant deed:

    a. the grantee needs to be over the age of 18.

    b. the deed needs to be signed by the grantor named in the deed.

    c. the deed needs to contain the words “release” or “remise.”

2. A(n) __________ is authorized by another to perform certain acts for them under a power of attorney.

    a. traveling notary

    b. special advisor

    c. attorney in fact

Title by claims of adverse possession

A signed writing is not always needed to transfer an interest in real estate. Title to property may also be acquired not through the use of a grant deed or quitclaim deed, but through **adverse possession.**

Adverse possession is the only means by which the law will take 100% of an individual's legal or equitable ownership interest in a parcel of real estate and give it to another individual without compensation.

The doctrine of adverse possession is based on a social and economic rationale suggesting real estate is not to lie idle. An individual who puts another's land to use without interference or compensation and pays taxes imposed on the property — *ad valorem* — is allowed in time to enjoy the benefits of continued long-term possession, namely **ownership**.

The "use it or lose it" rationale has remained unchanged since its inception, when the doctrine of adverse possession was established to dispossess medieval lords of their stranglehold on fertile farmland in England.

Any person claiming title to property through adverse possession needs to satisfy specific criteria to *perfect their claim* of ownership. If the adverse possessor fails to meet any criterion, their claim to ownership fails as it has not been perfected.

The criteria for **perfecting ownership** by an adverse possession claim are:

- a color of title or claim of right to title;
- actual, notorious and open possession;
- hostile, adverse and exclusive use;

- continuous and uninterrupted possession for five years; and
- payment of current and delinquent real estate taxes and assessments. [**Gilardi** v. **Hallam** (1981) 30 C3d 317]

Adverse possession under a color of title

Two distinct types of adverse possession claims exist:

- a claim of ownership based on a written instrument, called a **color of title claim** [Calif. Code of Civil Procedure §322]; or
- a claim of ownership made without any documentation, except possession and payment of taxes, called a **claim of right**. [CCP §324]

The *color of title* claim is used to defend the claim of ownership held by the individual in possession of the property. This defense is used against the person who holds recorded title and seeks to:

- wrest possession of the property from the occupant, called an **adverse possessor**; and
- clear title of the cloud created by the document which supports the adverse possessor's color of title claim.

To perfect a color of title claim, the adverse possessor presents written documentation demonstrating they are the owner of the property. This documentation need not be valid to support a color of title claim. Typically, title held by the adverse possessor is defective and unenforceable. However, the adverse possessor only needs to show they have a good faith belief they are the owner of the property to fulfill this criteria for adverse possession.

For example, real estate is conveyed by a recorded grant deed to an individual on the distribution of a deceased relative's estate. The individual takes possession of the property and exercises the rights and responsibilities of ownership.

Later, it is discovered the deceased relative in fact was only a lessee, not the record owner of the property, and had no legal title to convey. However, the individual has an adverse possession claim to the property based on the color of title since they had a good faith belief the deed they received was valid. [**Helvey** v. **Lillis** (1934) 136 CA 644]

Adverse possession under a claim of right

Conversely, adverse possession by *claim of right* attacks the title held by the recorded owner and takes possession of the property with the intent to interfere with that title.

A person whose adverse possession is based on a claim of right is merely a *trespasser or intruder* who has taken possession of a property without any belief they are the owner.

Additionally, an individual who has a mistaken but good faith belief they have an ownership interest in a property, but no documents to validate their ownership, establishes their adverse possession claim against the owner under a claim of right. [**California Maryland Funding, Inc.** v. **Lowe** (1995) 37 CA4th 1798]

An adverse possessor's claim to ownership is based upon their willingness and ability to defend their possession of the property against others who may claim title, including the owner of record. [**Brown** v. **Berman** (1962) 203 CA2d 327]

Proving ownership by adverse possession based on a claim of right is more difficult than by color of title which relies on title documentation. Evidence of five years of continuous adverse and hostile possession and use by the adverse possessor and the payment of property taxes is required to prove ownership under a claim of right. [**Thomson** v. **Dypvik** (1985) 174 CA3d 329]

Actual, notorious and open possession

An adverse possessor needs to show they have been in *actual possession* of the property they claim they own. [**Howell** v. **Slauson** (1890) 83 C 539]

Actual possession is occupancy by the adverse possessor or by a tenant who rents the property from the adverse possessor. [**Palin** v. **Sweitzer** (1937) 8 C2d 329]

When the adverse possession claim is made under a *claim of right*, the adverse possessor needs to demonstrate their actual possession of the property by either:

- surrounding the property with a substantial, protective enclosure;
- cultivating the property; or
- improving the property. [CCP §325]

An adverse possessor occupying property under *color of title* may show possession through one of the claim of right methods, or they may show they used the land similarly to the usage of like properties in the area. [CCP §323]

Additionally, the owner of the property against which an adverse possession claim is made needs to be *on notice* of the possessor's adverse activity regarding the property. This notice may be either **actual** or **constructive**.

Actual notice means the owner is personally aware of the occupancy or the adverse possessor's claim against the owner's land.

However, the owner has constructive notice when, upon viewing the property, a reasonable person understands the adverse possessor appears to hold some interest in the property due to their occupancy. [**Myran** v. **Smith** (1931) 117 CA 355]

Hostile and adverse use

When an individual claims ownership under color of title — the existence of a document which purports to vest title in the individual in conflict with the true ownership — satisfies the *hostile and adverse possession* requirements.

For possession under a claim of right to qualify as hostile and adverse the possession needs to be without any permission or consent from the legal owner of record and without regard to any rights of the true owner.

A possessor's exclusive use of a property is required to perfect any adverse possession claim, whether based on color of title or claim of right. When another person concurrently or intermittently uses the property without consent from the adverse possessor, the possessor's claim is defeated.

Continuous and uninterrupted use

An adverse possessor needs to have occupied a property for at least **five years** before they are able to acquire title through adverse possession. [CCP §325]

Any interruption in the adverse possessor's possession of the property, such as use by another not authorized by the possessor, negates the continuity of the five-year period, barring an adverse possession claim. [**Laubisch** v. **Roberdo** (1954) 43 C2d 702]

However, the adverse possessor need not be in **continuous possession** of the property to satisfy the *continuous possession* requirement. Exceptions to the continuous possession requirement include:

- vacancies between tenants of rental property [**Montgomery & Mullen Lumber Co.** v. **Quimby** (1912) 164 C 250];
- vacancies of homes built on subdivided property and not immediately sold [**Blume** v. **MacGregor** (1944) 64 CA2d 244]; and
- off-season vacancies of property used for agriculture or grazing. [**Park** v. **Powers** (1935) 2 C2d 590]

Continuous possession by an adverse possessor acting under a claim of right needs to encompass a constant, definable portion of the property. The claim-of-right possessor's use of different portions of a property at different times for a total of five years does not satisfy the continuity requirement.

For example, an adverse possessor relying on a claim of right who uses part of a property for two years, then uses a different part of the property for three years, has not satisfied the five-year requirement. [**Zimmer** v. **Dykstra** (1974) 39 CA3d 422]

Payment of taxes

An adverse possessor needs to provide a certified record of tax payments from the county tax collector to prove they have paid the property taxes during each year of their five-year qualifying occupation. [CCP §325]

Additionally, the adverse possessor needs to pay any **back taxes** owed on the property at the time they took possession. [**City of Los Angeles** v. **Coffey** (1966) 243 CA2d 121]

In a situation where the taxes are assessed to both the true owner and the adverse possessor, the requirement will be satisfied when the adverse possessor pays the taxes which are assessed in their name, without regard to the payment of taxes by the true owner also. [**Cummings** v. **Laughlin** (1916) 173 C 561]

When the taxes are assessed only to the owner, the adverse possessor needs to pay the taxes before the owner pays them. Paying taxes after they are paid by the owner does not satisfy the payment of taxes requirement, and the possessor will not be able to obtain legal title through adverse possession. [**Carpenter** v. **Lewis** (1897) 119 C 18]

QUIZ

1. A method of acquiring title to real estate owned by another by openly maintaining exclusive possession of the property for a period of five years and paying all property taxes is referred to as:
   a. quiet title action.
   b. chose in action
   c. adverse possession.

2. As a requisite for perfecting ownership by an adverse possession claim, the possessor needs to maintain continuous and uninterrupted possession for:
   a. at least one year.
   b. at least three years.
   c. as least five years.

The Owner's Homestead Exemption

The owner's homestead interest in title

A **homestead** is the dollar amount of equity in a homeowner's dwelling the homeowner qualifies to exempt from creditor seizure.

The dollar amount of the homestead held by the homeowner in the equity in their home has priority on title over most judgment liens and most government liens.

Two types of *homestead* procedures are available to California homeowners:

- the **declaration of homestead**, which is recorded [Calif. Code of Civil Procedure §704.920; see **RPI** Form 465]; and
- the **automatic homestead**, also called a statutory homestead exemption, which is not recorded. [CCP §704.720]

Both homestead arrangements provide the same dollar amount of home-equity protection in California. However, a homeowner needs to record a **declaration of homestead** to receive all the benefits available under the homestead laws.

These benefits allow homeowners the right to sell, receive the net sales proceeds up to the dollar amount of the homestead and reinvest the funds in another home. [See **RPI** Form 465]

Neither the declared nor the automatic homestead interfere with:

- **voluntary liens** previously or later placed on title to the property by the homeowner, such as trust deeds; and
- **involuntary liens** given priority to the homestead exemption under public policy legislation; or
- the homeowner's credit ratings or title conditions.

Some *involuntary liens* and encumbrances are given priority by statute and are enforced as senior to the amount of the homestead exemption, including:

- mechanic's (contractor's) and vendor's (seller's) liens;
- homeowners' association (HOA) assessments;
- judgments for alimony or child support;
- real estate property taxes; and
- Internal Revenue Service (IRS) liens.

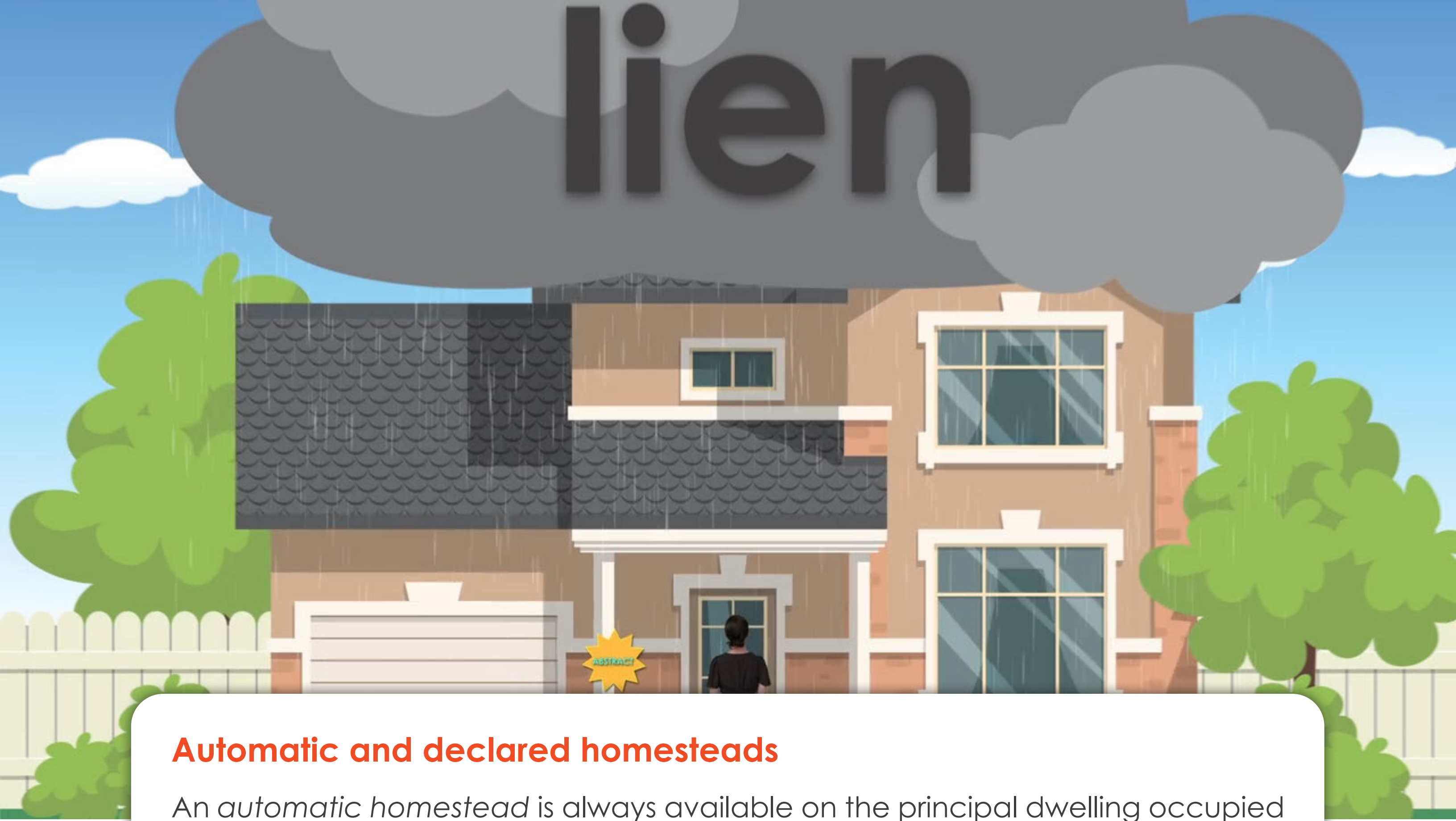
Involuntary liens that are subordinate and junior to the homestead amount include:

- Franchise Tax Board personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

QUIZ

1. Which homestead arrangement provides the greater dollar amount of home-equity protection in California?
   a. Declaration of homestead.
   b. Automatic homestead.
   c. Both homestead arrangements provide the same dollar amount of protection.

2. Which of the following involuntary lien or encumbrance is subordinate and junior to the homestead amount?
   a. Mechanic's liens.
   b. Homeowners' association (HOA) assessments.
   c. Judgment creditor's liens.



Automatic and declared homesteads

An *automatic homestead* is always available on the principal dwelling occupied by the homeowner or their spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead. [CCP §704.710(c)]

The *automatic homestead exemption* applies to the equity in:

- a real estate dwelling (and its outbuildings);
- a mobilehome;
- a condominium;
- a planned development;
- a stock cooperative;
- a community apartment project together with the land it rests on; or
- a houseboat or other waterborne vessel used as a dwelling. [CCP §704.710(a)]

Conversely, a *recorded declaration of homestead* applies only to real estate dwellings. Thus, mobilehomes which are not established as real estate on the property tax records and houseboats are not protected by a recorded homestead.

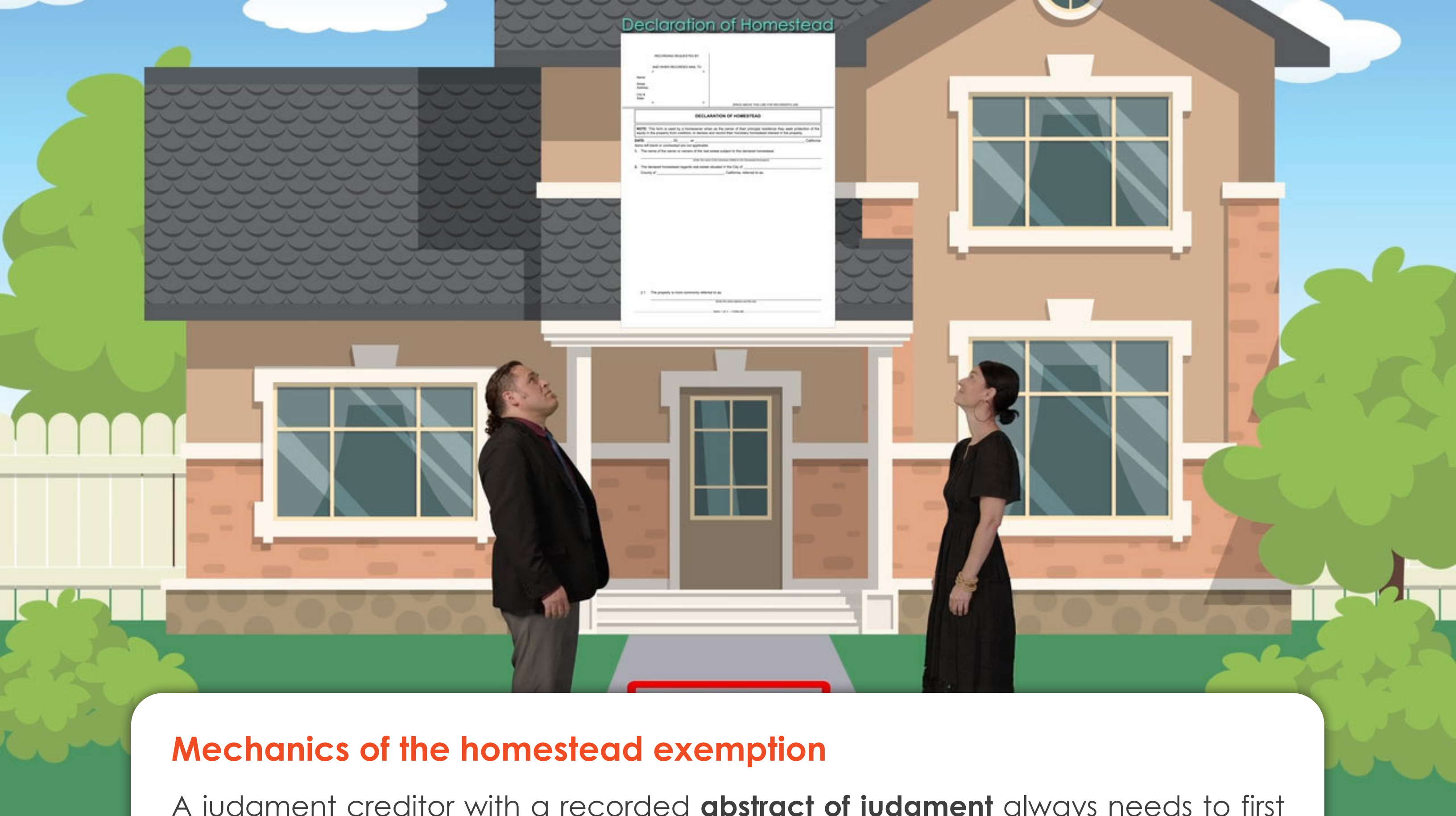
To qualify a property for the homestead exemption, the homeowner needs to use the homesteaded property as the **principal residence** for themselves and their family.

The dollar amount of home equity protection a homeowner qualifies to preserve is the same under either the automatic homestead or a recorded declaration of homestead.

California homeowners qualify for a net equity homestead protection of up to $300,000 or the median sale price for a single family residence (SFR) in their county in the calendar year prior to the year in which the exemption is claimed, not to exceed $600,000. This dollar threshold is adjusted annually for inflation. [CCP §704.730]

QUIZ

1. To qualify a property for the homestead exemption:
    a. the homeowner needs to have invested at least $100,000 into the property in renovations and repairs.
    b. the homeowner needs to use the homesteaded property as the principal residence for themselves and their family.
    c. the homeowner may not own any other properties in California.



Mechanics of the homestead exemption

A judgment creditor with a recorded **abstract of judgment** always needs to first petition a court for authorization to sell a homesteaded property and collect on a money judgment. The court then determines whether the owner's *net sales equity* in their home is a dollar amount greater than the amount of the owner's homestead exemption. If it is, the creditor may proceed to judicial foreclosure on their judgment lien by an **execution sale**. [CCP §704.740(a)]

A home with a net equity less than the homestead amount leaves nothing for the creditor to sell and receive to apply to the debt owed under the judgment. However, the sale of a homesteaded dwelling can be forced by a creditor if a net equity exists beyond the amount of the homestead the homeowner holds in the property.

If the homeowner has not recorded a declaration of homestead on the property, they need to prove their residency in the dwelling qualifies the property for the automatic homestead exemption. [CCP §704.780(a)(1)]

Automatic homestead is a shield

A creditor may be permitted by the court to force the sale of the debtor's home. However, the court will first exclude the dollar amount of the automatic homestead from the anticipated net sales proceeds to determine if any funds remain to apply on the judgment. If so, the dollar amount of the homestead received by the homeowner on the sale is protected from the creditor's attachment during a **six-month reinvestment period** following the sale.

Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds. [CCP §704.720(b)]

However, if the replacement home acquired is in the same county where the judgment lien is recorded, the lien will attach to the new residence (subject to the owner's homestead exemption) the instant title is transferred into the homeowner's name.

A homeowner who *voluntarily* sells their residence when title is subject to a creditor's lien cannot use the automatic homestead exemption to protect the sales proceeds from being taken by the judgment creditor.

In contrast, a *declaration of homestead* recorded prior to the recording of the judgment lien allows the homeowner who voluntarily sells their home to first withdraw their homestead amount from the net sales proceeds before the judgment creditor receives any funds.

Although an insufficient net equity may exist barring the judgment creditor from forcing a sale of the home, the homeowner claiming only an automatic homestead exemption may not use a **quiet title action** to remove the lien and sell the home, unlike what is accomplished under a declared homestead.

QUIZ

1. A(n) __________ allows the homeowner who voluntarily sells their home to first withdraw their homestead amount from the net sales proceeds before the judgment creditor receives any funds.
   a. automatic homestead proven to be the qualified residence of the homeowner
   b. declaration of homestead recorded prior to the recording of the judgment lien
   c. Either a. or b.

Mortgage Financing and Brokerage

The buyer's agent becomes the transaction agent

The ability of a buyer or an owner to obtain **financing** is an integral component of most real estate transactions. This type of financing is generically called a **mortgage**.

The submission of a **mortgage application** to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.

The *buyer's agent* owes their buyer the duty to ensure their buyer negotiates the best financial advantage available among mortgage lenders. As viewed and identified by lenders, the buyer's agent is called a **transaction agent (TA)**.

The principles of agency law impose a duty on the transaction agent to represent the best interests of their client. These duties include:

- helping the buyer locate the most advantageous mortgage terms available in the market;
- oversight of the mortgage application submission; and
- policing the lender's mortgage packaging process and funding conditions.

These transaction agent activities ensure all documents needed to comply with the lender's requests and closing instructions are in order. If not, funding cannot take place and closing the sales escrow is *jeopardized*.

The transaction agent neither arranges nor makes a mortgage. Further, they are barred from receiving any compensation for referring the buyer to service providers or policing lender activity.

Events related to the transaction serviced by the transaction agent are covered solely by the broker fee negotiated on the sales transaction.

Sources of conventional financing

Consumer mortgages are either:

- **conventional mortgages**; or
- **government-related mortgages**.

A *conventional mortgage* is any mortgage that is not made, insured or guaranteed by the federal government.

A government-related mortgage is a mortgage insured by the **Federal Housing Administration (FHA)**, guaranteed by the U.S. Department of Veterans Affairs (VA) or guaranteed or funded by the U.S. Department of Agriculture (USDA).

The terms of a conventional mortgage are set by the:

- investor who purchases the mortgage;
- private mortgage insurer, if the loan-to-value ratio (LTV) exceeds 80%; and
- lender originating the mortgage.

In contrast, the terms of a government-related mortgage are set by the:

- FHA, VA or USDA; and
- lender.

The majority of conventional mortgages are sold to **Fannie Mae** or Freddie Mac after origination. Collectively, these entities are known as **government-sponsored enterprises (GSEs)**.

To be eligible for sale to Fannie Mae or Freddie Mac, a mortgage needs to meet minimum mortgage standards set by Fannie Mae or Freddie Mac. As the bulk of consumer mortgages are sold after origination, Fannie Mae and Freddie Mac guidelines effectively dictate the minimum features of conventional mortgages.

When applying for a *conventional mortgage*, a buyer has several types of lenders to choose from, including:

- portfolio lenders, such as *banks, thrifts* and *credit unions*;
- institutional lenders, such as insurance *companies* and *trade association pensions*; and
- warehousing lenders, such as *mortgage bankers* who resell the mortgage in the **secondary mortgage market**.

While portfolio and institutional lenders typically service their own mortgages, they often originate mortgages for immediate sale in a process called **warehousing**.

The business of servicing mortgages is also bought and sold. This causes the mortgage to appear to be changing hands. Typically, the originating lender continues to service the mortgage when they sell the mortgage to an investor.

Government financing programs at a glance

A variety of state and federal loan programs exist, offering down payment assistance for low- to moderate-income buyers and first-time buyers, mortgage refinance or modification programs to distressed owners, and special programs for veterans.

Federal programs:

Federal Housing Administration (FHA)-insured mortgage: The FHA insures lenders against loss for the full amount of a mortgage. FHA-insured mortgages permit small cash down payments and higher loan-to-value ratio (LTV) requirements than mortgages originated by conventional lenders.

U.S. Department of Veterans Affairs (VA) mortgage guarantee: The VA mortgage guarantee program assists qualified veterans or their surviving spouses to buy a home with zero down payment.

Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) and Government National Mortgage Association (Ginnie Mae): Fannie Mae, Freddie Mac and Ginnie Mae are government-sponsored enterprises (GSEs) designed to help facilitate home purchases for low- to moderate-income buyers. Fannie Mae and Freddie Mac do not provide home mortgages directly. Instead, they purchase and package pools (tranches) of qualifying single family residence (SFR) mortgages originated by mortgage bankers, known as conforming mortgages, as mortgage-backed bonds (MBBs). They then sell the MBBs to Wall Street Bankers on the secondary mortgage market.

State programs:

California Housing Finance Agency (CalHFA): CalHFA administers several first-time homebuyer assistance programs, offering 30-year fixed rate mortgages with interest rates and fees typically lower than conventional financing.

California Department of Veterans Affairs (CalVet): CalVet provides a veteran with an ARM mortgage at a rate generally below market, low monthly payments and flexible credit standards, as compared to conventional financing or mortgages insured by the FHA or guaranteed by the VA.

California Department of Housing and Community Development (HCD): HCD programs fund local public agencies and private entities which produce affordable housing for rental or ownership.

Diametrically opposed interests

A lender's objectives and goals are diametrically opposed to those of the buyer – a debtor versus creditor relationship.

On the advice from their agents, buyers need to understand that the lender's product – money – is always unpriced until the closing has taken place. This truth exists in spite of the **Loan Estimate** and interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the mortgage application. [See **RPI** Form 204-5]

The buyer needs to understand the *Loan Estimate* is not a commitment to lend and is not a guarantee a mortgage on substantially the same terms will be funded. A lender at any time may change the mortgage terms then simply provide another, refreshed **Loan Estimate**. [See **RPI** Form 204-5]

QUIZ

1. The submission of a(n) __________ to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.

   a. listing agreement

   b. mortgage application

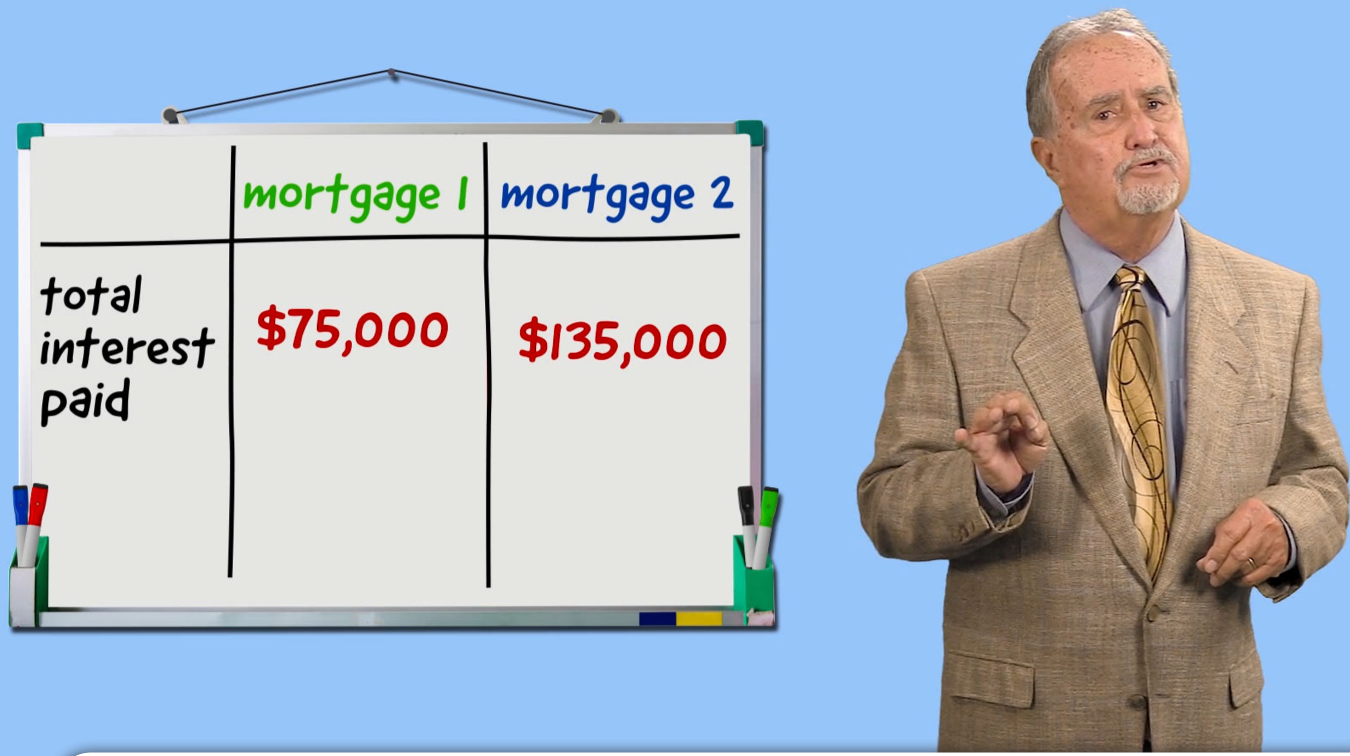
   c. appraisal report

2. Under the principles of agency law which impose a duty on the transaction agent to represent the best interests of their client, the transaction agent:

   a. helps their buyer locate the most advantageous mortgage terms available in the market.

   b. arranges and funds a mortgage for the buyer.

   c. receives a fee for referring the buyer to a reputable service provider known to the agent.



Preparing for meeting with a lender

As part of the **transaction agent's (TA's)** advice and guidance in the mortgage application process, the TA instructs the buyer regarding:

- the *expectations held* and the *role* of each servicer or affiliate involved in the mortgage transaction, such as the lender's mortgage representative, an appraiser, any mortgage broker involved, credit agencies, creditors of the buyer, etc.;
- *what is going to take place* during the application process, such as lender disclosures, payment of lender costs, funding requirements, etc.; and
- *what to guard ag*ainst, such as excuses and claims usually made by the lender to justify an increase in rates at the time of closing.

Documents the buyer needs to gather and submit to the lender to process the mortgage include:

- *W-2s* or other tax documents for the self-employed;
- recent bank statements; and
- recent pay-stubs to evidence the employment information represented by the buyer in section four of the mortgage application. [See **RPI** Form 202 (FNMA 1003)]

Lenders also verify other information in the application by requesting and reviewing:

- an appraisal report to establish the value of the property serving as security;
- verification of deposit or tax returns to establish the buyer's income and assets; and

- a credit report to establish the buyer's liabilities and propensity to repay the mortgage. [See **RPI** Form 202 (FNMA 1003)]

To best protect the buyer, applications are to be submitted to at least **two lenders**. The second application is insurance against lenders' last minute changes to the rates and terms at the time of closing.

Without a backup application processed by another lender, the buyer is left with no opportunity to reject the lender's changes.

You gotta shop around – it's a big deal

One might imagine the majority of prospective homebuyers would spend a great deal of time considering the **financing** needed to fund the purchase of their biggest asset — their home. But that is not the case. Studies show Americans spend nearly twice as long shopping for and researching their car purchase — at one tenth the price — as they do for a mortgage they need to fund the purchase of a home.

The different types of mortgages, rates and lender fees all play a critical role in the sum of money a homebuyer will ultimately pay to finance their purchase. The difference between one lender's offer and another's can easily equate to tens of thousands of dollars over the life of a mortgage.

Remember, an adversarial relationship exists between a lender and homebuyer. The lender is selling a product — a **mortgage** — to potential borrowers. Consequently, homebuyers have the liberty to accept or reject a lender's offer. If the homebuyer does not accept the lender's terms, they are free to walk away from the lender's proposal without cost. More should, for their financial well-being.

Thus, homebuyers are to inform themselves by soliciting mortgage quotes from multiple lenders. Armed with this information, the homebuyer and their agent compare the alternative mortgages arrangements and mortgage costs available. Equally as responsible for this comparison shopping taking place is the **buyer's agent**. No one else is duty bound to protect the homebuyer's financial interests. [See **RPI** Form 312]

Balancing deceitful information asymmetry

Agents and brokers are the **gatekeepers** standing between the consuming population and entry into the real estate marketplace. For most, entry includes mortgages as part of the calculus.

Critically, the buyer's agent owes a fiduciary duty to their homebuyers to assist them with acquiring the information needed to make an educated choice.

Without mortgage information, a homebuyer cannot make a well-informed decision as to which mortgage offers the most advantageous terms.

Confusion exists in the trade-offs between costs and rates and fees and terms, and these are the variables lenders have learned to manipulate to their advantage in order to increase their earnings. Agents, well-versed in real estate fundamentals and lender conduct, are the only ones available to walk their homebuyers though this intentional chaos.

Thus, buyer's agents are obligated to shepherd their homebuyers through the **asymmetry of information** created by the buyer's ignorance and the lender's silence about the real estate mortgage market and available mortgage options.

Added costs for submitting multiple mortgage applications will be incurred, and properly so. However, this cost is to be viewed as a "premium" paid to ensure the homebuyer they will receive a mortgage at the time of closing that is arranged on the best possible terms and at the least cost.

Editor's note — Obtaining mortgage pre-approvals and submitting applications to multiple lenders will not have an adverse impact on a homebuyer's credit score, provided the homebuyer conducts all of their mortgage inquiries for comparisons within a 45-day period.

QUIZ

1. Which of the following is a lender least likely to verify when reviewing a mortgage application?

   a. an appraisal report to establish the value of the property serving as security.
   b. a credit report to establish the buyer's liabilities and propensity to repay the mortgage.
   c. a birth certificate to ensure the buyer is a United States resident.

2. To best protect the financial interests of a buyer, it is recommended that a mortgage application is submitted to:

   a. only local lenders.
   b. no more than one lender.
   c. at least two lenders.

Fundamentals of the uniform residential loan application

The **Uniform Residential Loan Application (URLA)** is prepared by the buyer with the assistance of their transaction agent (TA).

This generic Loan Application is published by *Fannie Mae*, form number 1003. However, **RPI** also replicates the content as part of our series of mortgage lending forms. **RPI's** Uniform Residential Loan application is **RPI** number 202. [See **RPI** Form 202]

Home sales transactions are typically contingent on the buyer-occupant obtaining a purchase-assist mortgage, known as a **consumer mortgage**. With it, they fund the price they will pay to buy the residence they intend to occupy. Further, a consumer mortgage may also be needed by:

- an owner of vacant land to construct their home;
- a homeowner to improve or renovate the home they currently occupy;
- a homeowner to refinance an existing consumer mortgage; or
- a residential tenant on a long-term lease who makes significant **tenant improvements (TIs) to their residence.**

After shopping lenders and selecting one as their primary lender, the buyer authorizes the lender to start the *mortgage packaging process* by preparing and submitting a URLA with the assistance of their buyer's agent, called a **transaction agent (TA)** by lenders. [See **RPI** Form 202]

Typically, the lender who will fund the mortgage is the loan processor, but not always. In some cases the loan processor who receives the loan application is a broker with a **mortgage loan originator (MLO)** endorsement. If the buyer's broker is affiliated with the lender, whether it is an in-house or independent lender sharing in profits, proper business affiliation disclosures are required since the buyer's broker will share in any profits of the lending operation.

The URLA provides the lender with necessary information about:

- the buyer who is taking out the mortgage; and
- the residence to be encumbered by the mortgage.

The title of the *URLA* implies it is intended to be used to apply for mortgages secured by residential properties, such as:

- a one-to-four unit residential property;
- condominiums (attached or detached); or
- rental property of any size which is exclusively residential.

However, the URLA is a generic mortgage application for arranging or making all types of mortgage originations. Thus, it is used by all MLOs and mortgage loan brokers (MLBs) when taking an application for a mortgage funding any purpose, consumer or business/investment/agriculture, secured by any type of property.

The URLA contains all the information required for arranging mortgages secured by any type of real estate. The type of property intended to be purchased or improved by use of the mortgage funds is the property described in the mortgage application.

QUIZ

1. Which of the following is NOT an example of a consumer mortgage?
    a. A mortgage taken out to purchase vacant land on which to construct a home.
    b. A mortgage taken out to improve or renovate a home currently occupied by the owner.
    c. A personal loan from a commercial bank, usually unsecured and short term, for other than mortgage purposes.

2. An individual who receives fees to arrange a consumer mortgage is referred to as a(n):
    a. underwriter.
    b. investment banker.
    c. mortgage loan originator (MLO).

Section 1: borrower information

The first component of the **Uniform Residential Loan Application (URLA)** is titled *Section 1: Borrower Information***.**

This section calls for the borrower to enter their *personal identifying* information and information concerning income from employment and other sources the borrower intends to use to qualify for the mortgage.

Information identifying the borrower, such as their name, alternate names, *social security number* and date of birth is entered towards the top. Also noted is their citizenship status.

Space is left to insert any co-borrower information if the income, assets and liabilities of a co-borrower are to be considered for mortgage qualification purposes. Thus, the borrower is asked to indicate whether they are applying for individual credit, or joint credit with a co-borrower.

The marital status, number of dependents and contact information of the borrower are called for next. This is followed by the borrower's address and a question of whether they or a spouse served or are or currently serving in the US armed forces.

The borrower's, and any co-borrower's, employment information necessary to identify their source of income is entered in the next section of the loan application.

Employment information includes:

- the employment currently held by the borrower;
- the borrower's job title; and

- years spent at that specific job and within that profession.

If the borrower is self-employed, they indicate this by checking the self-employed box.

Additional space is provided for the borrower to enter further or previous employment information, if applicable. They may also note whether they receive income from other sources.

A separate form is used to disclose to the lender the borrower's assets and liabilities if:

- the assets and liabilities result from separate property owned by a co-borrower;
- the co-borrower is part of the transaction when the property to be encumbered is considered community property; or
- the co-borrower is to be a co-signer of the note as a primary borrower.

QUIZ

1. The first component of the Uniform Residential Loan Application (URLA) is:
   a. Financial Information.
   b. Borrower Information.
   c. Loan and Property Information.

2. What is the borrower most likely to enter in the first component of the Uniform Residential Loan Application (URLA)?
   a. Identifying information and information concerning income from employment and other sources the borrower intends to use to qualify for the mortgage.
   b. Information concerning the purpose of the loan and the property they intend to purchase.
   c. The existence of any gifts or grants the borrower has been given or will receive that will be applied to the loan.

Section 2 & 3: financial information

The next component of the loan application is titled Section 2: Financial Information – Assets and Liabilities.

Here, the borrower, with the help of their transaction agent (TA), enters information about the things they own that are worth money which qualify them for the loan. In a word: assets.

The borrower will also enter information about the liabilities and debts they pay each month, such as credit cards, student debt and alimony.

This information is pertinent since the borrower's liabilities affect their ability to repay the mortgage.

However, the borrower may not want to disclose all their assets when filling out this form with the TA. A balance needs to be struck between maintaining financial privacy and disclosing enough assets to get creditworthiness clearance so the mortgage will be funded.

The next component of the loan application is titled *Section 3: Financial Information – Real Estate*.

In this section, the borrower lists all the properties they currently own, and their financial obligation on these properties.

If this is the borrower's first property, they will check the box stating, "I do not own any real estate."

The information called for on this page includes:

- the property address;
- property value; and
- mortgage loans which encumber the property, including the monthly payment and outstanding balance.

If the borrower owns multiple properties, space is provided for the entry of this parallel real estate data.

The borrower and co-borrower need to prepare a **balance sheet** when their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower prepares a separate asset and liabilities balance sheet for individual consideration by the lender. [See **RPI** Form 209-3]

The borrower also completes a **statement of information**. The statement of information discloses confidential information used by the title company to search the general index (GI) for conditions affecting title when held in the name of the borrower. Title companies search for information on the borrower and any co-borrower regarding judgments and other legal conditions that might interfere with the property's title. [See **RPI** Form 401-4]

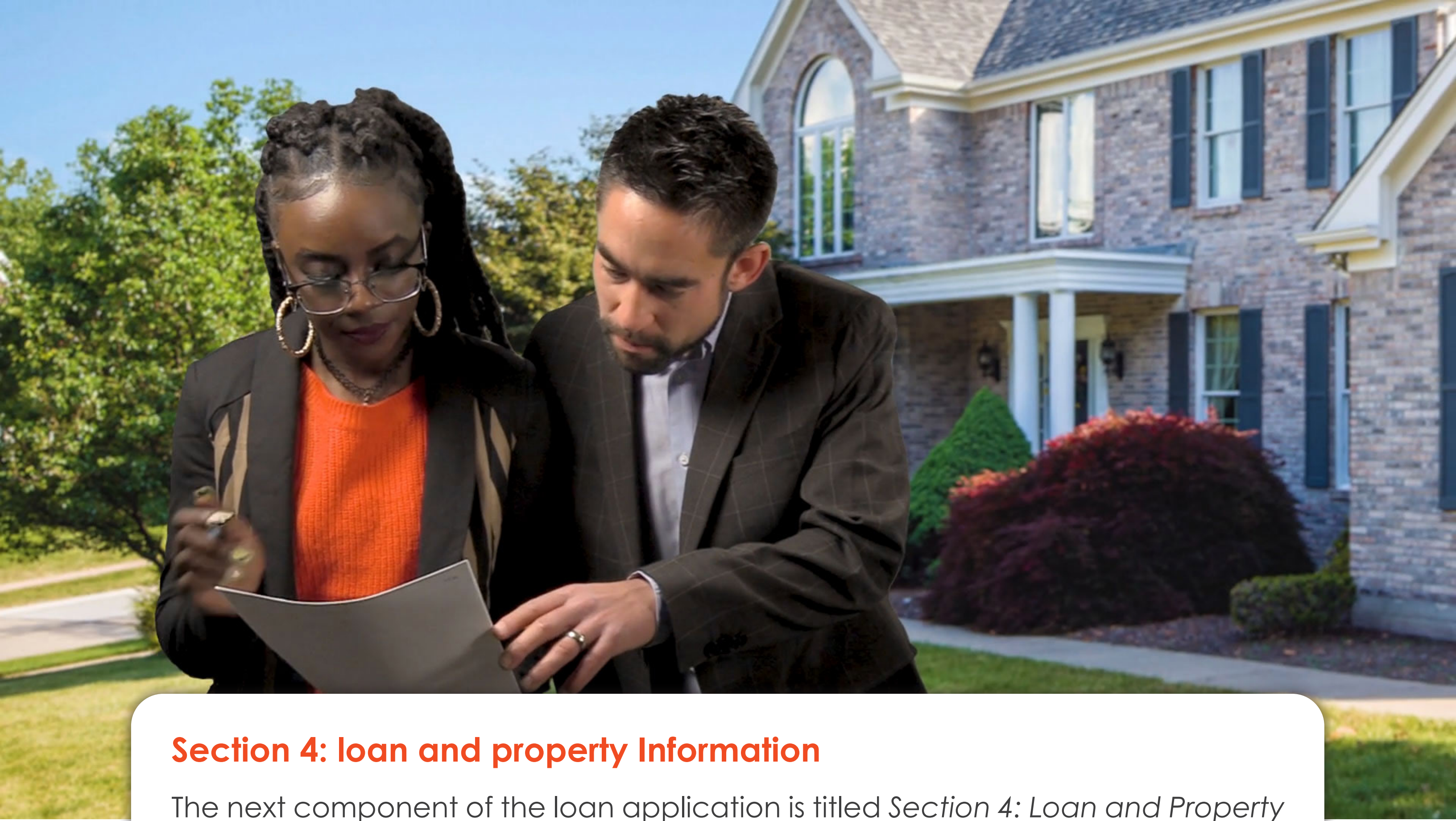
QUIZ

1. What is the borrower most likely to enter in the second component of the Uniform Residential Loan Application (URLA)?

    a. A declaration of any debt enforcement or debt avoidance activities the borrower has experienced.
    b. Information concerning all the properties they currently own and their financial obligation on these properties.
    c. A disclosure of the borrower's ethnicity, sex and race.

2. A(n)__________ is prepared by the borrower to list their assets and liabilities.

    a. statement of information
    b. Transfer Disclosure Statement (TDS)
    c. balance sheet



Section 4: loan and property Information

The next component of the loan application is titled *Section 4: Loan and Property Information*.

Here, the borrower enters information about the *purpose of the loan*, and the property they intend to purchase or refinance with the funds.

In Section 4, the buyer indicates:

- the total dollar amount of the mortgage requested;
- the purpose of the loan, whether it's a purchase, refinance or something else;
- the property's address;
- the property's value; and
- the intended occupancy of the home, be it a primary residence, second home, investment property, or FHA secondary residence.

If applicable, in this section the borrower will also enter other information concerning:

- other new mortgage loans the buyer will obtain for the purchase or refinance of the property;
- expected monthly rental income the property is expected to generate, if the property or part of it is to be rented out for investment purposes; and
- gifts or grants the borrower has been given or will receive that will be applied to the loan.

QUIZ

1. What is the borrower most likely to enter in the fourth component of the Uniform Residential Loan Application (URLA)?

   a. Information concerning their legal obligations which are created when they sign and submit the application.

   b. Whether they are applying for individual credit, or joint credit with a co-borrower.

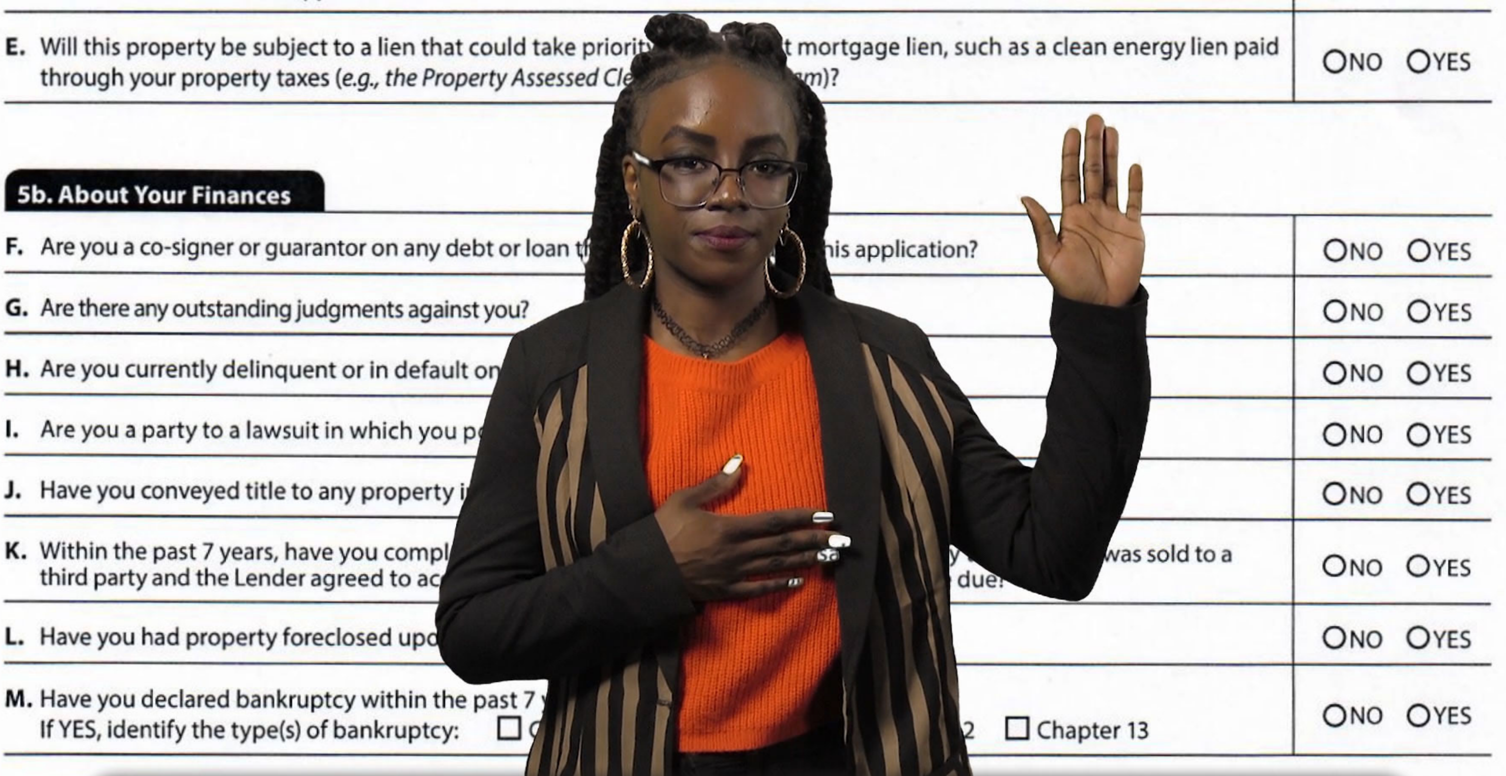
   c. Information about the purpose of the loan, and the property they intend to purchase or refinance with the funds.

2. If the property or part of it is to be rented out for investment purposes, the borrower is asked to enter the:

   a. expected monthly rental income the property is expected to generate.

   b. name and employment history of the tenant.

   c. terms of the existing rental or lease agreement.



Additional components of the application

The next component of the loan application is titled *Section 5: Declarations*.

Here, the borrower answers specific questions about their past financial history, the property that is involved in the transaction and the funding sought. This includes debt enforcement or debt avoidance the buyer has experienced.

Of course, the borrower is to answer these questions truthfully and honestly.

In *Section 6: Acknowledgments and Agreements*, the borrower learns of their legal obligations which are created when they sign and submit the application.

Next, the borrower signs the application, along with any co-borrower, to acknowledge and agree to the numerous conditions.

These conditions and acknowledgments include:

- the property will be occupied as represented in the application;
- the buyer will amend the application and resubmit it to the lender if the facts originally stated substantially change;
- the lender may report information about the borrower's account to credit bureaus; and
- the lender is authorized to verify all aspects of the mortgage application as represented by the buyer.

When the borrower, or their deceased spouse, is currently serving or has ever served in the United States Armed Forces, the borrower will confirm their service in

Section 7: Military Service. If the borrower, or their deceased spouse, did not serve, they are still required to confirm that they did not serve.

The borrower then completes *Section 8: Demographic Information* which concerns the borrower's ethnicity, sex and race.

Note that the borrower may choose not to provide answers to some or all of the demographic questions – that's not a problem. They only have to answer whatever they're comfortable with.

Finally, the Uniform Residential Loan Application concludes with *Section 9: Loan Originator Information*, where the **mortgage loan originator (MLO)** supplies their name, Nationwide Mortgage Licensing System and Registry (NMLS)-ID number and other identifying information.

QUIZ

1. After the entry of loan and property information, the fifth component of the Uniform Residential Loan Application (URLA) is:
   a. Acknowledgments and Agreements.
   b. Loan Originator Information.
   c. Declarations.

2. In what section of the Uniform Residential Loan Application (URLA) does the borrower learn of their legal obligations which are created when they sign and submit the application?
   a. Section 5: Declarations.
   b. Section 6: Acknowledgments and Agreements.
   c. Section 7: Demographic Information.

The borrower's debt-to-income ratio and ability to repay

A lender evaluating a mortgage package considers a buyer's *willingness* and *capacity* to pay. To comply, buyer/owners applying for a *consumer mortgage* are evaluated by the lender for their **ability-to-repay (ATR)**, part of **Regulation Z (Reg Z)**, which implements the **Truth in Lending Act (TILA)**. [12 Code of Federal Regulations §§1026.43 et seq.]

Generally, the **debt-to-income ratios (DTI)** for conventional mortgages, also called the **debt-to-income standards**, limit the buyer's:

- monthly payments for the maximum purchase-assist mortgage, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and
- monthly payments on long-term debt to a maximum of 41% of the buyer's gross monthly income. [See **RPI** Form 229-1, 229-2 and 230]

Lenders use the *DTI* to evaluate the buyer's ability to make timely mortgage payments. This is referred to as **buyer mortgage capacity**. [See **RPI** Form 230]

The buyer's willingness to make mortgage payments is evidenced by the **credit report**. The credit history demonstrates to the lender whether or not the buyer has sufficient propensity to pay, called **creditworthiness**.

The DTIs can be increased by the lender depending on one or more *compensating factors*, including whether the buyer has:

- ample cash reserves;

- a low LTV; or
- spent more than five years at the same place of employment.

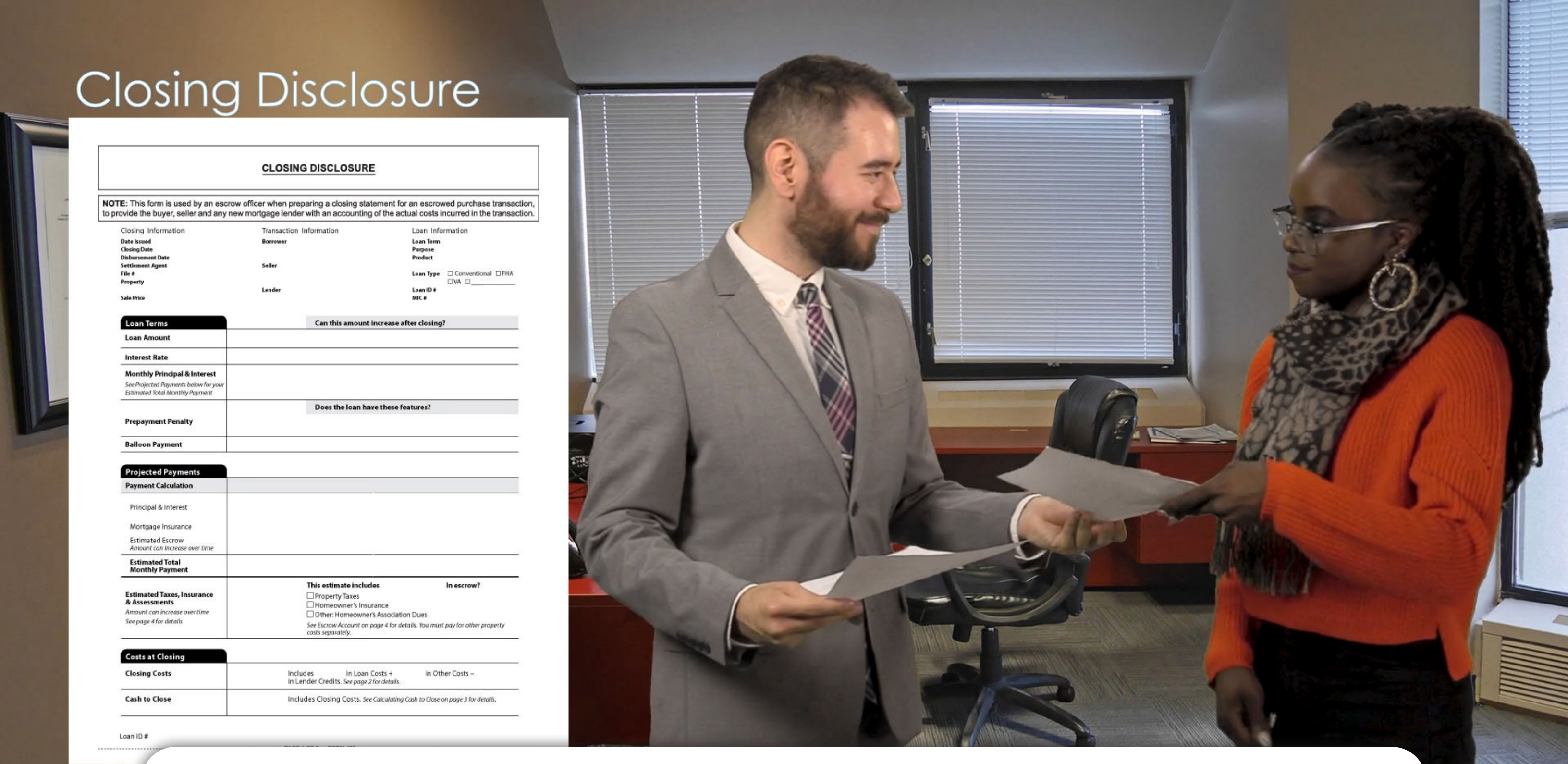
QUIZ

1. ______ is a federal regulation implementing the Truth in Lending Act (TILA).

   a. Real Estate Settlement Procedures Act (RESPA)
   b. Regulation X (Reg X)
   c. Regulation Z (Reg Z)

2. Lenders use the __________ to evaluate a buyer's ability to make timely mortgage payments.

   a. capitalization rate (cap rate)
   b. debt-to-income ratio (DTI)
   c. profit-to-loss statement



RESPA disclosures

Mortgage lenders active in the secondary mortgage market disclose all **mortgage related charges** on mortgages used to purchase, refinance or improve one-to-four unit residential properties, a mandate of the **Real Estate Settlement Procedures Act (RESPA)**.

Mortgage related charges include:

- origination fees;
- credit report fees;
- insurance costs; and
- prepaid interest.

RESPA is administered and enforced by the **Consumer Financial Protection Bureau (CFPB)**. The result is a marked improvement in consumer protection action than previously provided by the politically controlled U.S. Department of Housing and Urban Development (HUD).

When the buyer takes out an ARM containing an interest rate that changes periodically, the lender informs the buyer not only of the interest rate, but also the:

- index the rate changes are tied to;
- the lender's margin; and
- any payment and interest rate adjustment floors and caps. [See **RPI** Form 320-1]

Since a consumer mortgage lender is considered a RESPA lender, within three business days of the lender's receipt of the buyer's mortgage application, they also provide the buyer with:

- a **Loan Estimate** of all mortgage terms quoted by the lender (this replaced the old *good faith estimate of costs* and initial Regulation Z (Reg Z) disclosure form previously required) [12 Code of Federal Regulations §1026.37]; and
- a **special information booklet** published by the CFPB to help the buyer understand the nature and scope of real estate settlement costs. [12 CFR §1026.19(g)]

When the buyer arranges financing through a mortgage broker, the broker (not the lender) provides a copy of the *special information booklet* to the buyer. [12 CFR §1024.6(a)(1)]

However, the booklet does not need to be given to the buyer when the mortgage funds:

- the refinance of an existing mortgage;
- a closed-end mortgage in which the lender takes a subordinate lien;
- a reverse mortgage; and
- any consumer mortgage used to fund the purchase of other than a one-to-four unit residential property. [12 CFR §1024.6(a)(3)]

Also, at least three days before the consumer closes on the mortgage, the lender needs to provide:

- a **Closing Disclosure**, which summarizes the "final" mortgage terms and details [12 CFR §1026.19(f)(ii)]; and
- a list of **homeownership counseling** organizations. [12 CFR §1024.20]

Editor's note — A list of homeownership counseling organizations approved by HUD can be found on the CFPB's website, www.consumerfinance.gov

Buyers are not required to take part in the counseling. Homeownership counseling is only compulsory if the mortgage is a Section 32 high-cost mortgage or allows for negative amortization. [78 Federal Register 6964-6966]

QUIZ

1. The __________ requires mortgage lenders active in the secondary mortgage market disclose all mortgage related charges on mortgages used to purchase, refinance or improve one-to-four unit residential properties.

   a. Truth in Lending Act (TILA)

   b. Real Estate Settlement Procedures Act (RESPA)

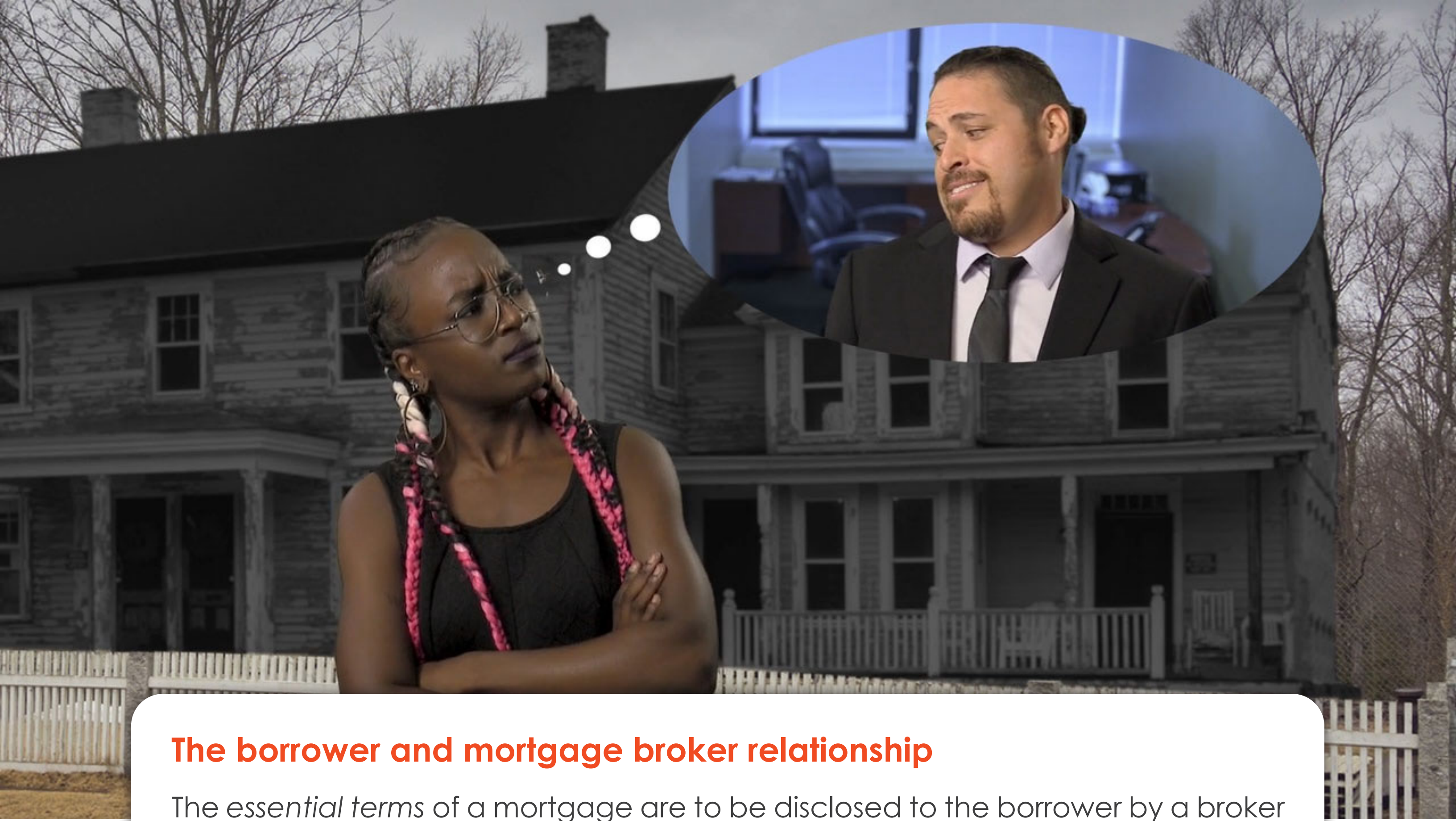
   c. Civil Rights Act

2. Within three business days of the lender's receipt of the buyer's mortgage application, the lender needs to provide the buyer with:

   a. a Loan Estimate of all mortgage terms quoted by the lender.

   b. a Closing Statement providing an accounting of all funds actually made to the buyer.

   c. Both a. and b.



The borrower and mortgage broker relationship

The *essential terms* of a mortgage are to be disclosed to the borrower by a broker soliciting or arranging a mortgage.

For example, consider a real estate broker who advertises they can arrange mortgages with a low monthly payment schedule — a "bait and switch" advertising trick, as mortgages of the type advertised are not really available. A borrower, seeking a mortgage with the low payment schedule advertised by the broker, retains the broker to perform these services.

The borrower asks specific questions of the broker concerning the interest rate, late charges, due date, the final balloon payment and mortgage closing costs.

The broker tells the borrower the balloon payment will be "small." The broker further misrepresents the probable interest rate and the day of the month on which late charges are incurred. The broker provides the borrower with "approximations" of the closing costs that are significantly lower than the actual closing costs. The broker also fails to accurately disclose other important mortgage aspects, such as that the monthly payments are interest only, or that late charges are equal in amount to the monthly interest payment.

Further, the **financial disclosure** statement the broker prepares and hands to the borrower is lengthy and contains complex wording. Rather than reading the disclosure statement, the borrower relies on the broker's oral representations and signs the mortgage documents.

On closing, the borrower ends up with a mortgage with less favorable terms than verbally represented by the broker. The borrower incurs additional and unexpected expenses, such as high late charges, an early due date and graduated monthly payments. The additional expenses ultimately create an excessive financial burden for the borrower. The borrower defaults on the mortgage and the secured property is sold at a foreclosure sale.

Later, the borrower discovers the broker was aware of the actual mortgage terms and costs for origination before the borrower signed the mortgage documents.

Here, the broker's failure to disclose the actual interest rate, the exact amount of the late charge, the size of the balloon payment and the actual closing costs breached the broker's **agency duty** owed to the borrower.

The borrower can recover all their money losses caused by the broker's misrepresentation and for failing to discuss important provisions in the mortgage documents. [**Wyatt** v. **Union Mortgage Company** (1979) 24 C3d 773]

As the borrower's broker arranging a mortgage, a licensee needs to fully and accurately disclose all **essential facts** of the mortgage transaction which may affect the borrower's decision to participate in the transaction. [Calif. Business and Professions Code §§10130, 10131(d), 10176(a), 10176(i)]

The broker's duty to disclose, and their obligation to deal fairly with borrowers, commences on their first contact with prospective borrowers to solicit employment. Thus, the broker will disclose essential facts before entering into a listing agreement. [**Realty Projects Inc.** v. **Smith** (1973) 32 CA3d 204]

Even after the broker is employed as the agent of the borrower, their duty to disclose and provide accurate representation is not completely fulfilled by merely providing the mortgage documents to the borrower. The provisions in the documents need to be *discussed with the client* to ensure the client has an understanding sufficient to make a well-informed decision regarding the mortgage. [Bus & P C §10241]

QUIZ

1. A mortgage broker needs to fully and accurately disclose __________ of a mortgage transaction which may affect the borrower's decision to participate in the transaction.

   a. only minimal details

   b. only the most critical elements

   c. all essential facts

Kickbacks as a RESPA violation

When property prices rise, **kickbacks** in real estate sales become infectious.

Although kickbacks, often in the form of **referral fees**, were banned by the *Real Estate Settlement Procedures Act (RESPA)* in 1974, they remain under the radar in many forms and for many reasons. In fact, they continue to be one of the most pervasive RESPA violations.

Referral fees become unlawful kickbacks when received by a broker or agent who negotiated a fee-generating home sale when that broker or agent renders no service to the other provider in exchange for the referral fee beyond the referral. Referral fees of the kickback variety are improper and attack the efficiency of the real estate market. Worse, kickbacks increase the *cost of doing business*, the cost of which is always passed on to buyers and sellers in the sales transactions.

Kickbacks absolutely result in the elimination of better and cheaper competition. Instead of being directed by agents to legitimate lenders, escrows, title insurers or other types of third-party service providers, buyers are referred to those businesses providing kickbacks to the broker or agent.

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

Any person who violates RESPA may be fined up to *$10,000 or imprisoned* for up to one year, or both.

RESPA violators are liable, to the person charged for the settlement service, for three times the amount paid for the settlement service. In addition, RESPA violations are often combined with other private lawsuit claims such as antitrust violations, exposing violators to additional civil liability. [12 United States Code §2607(d)]

QUIZ

1. Kickbacks were prohibited in 1974 under the:

   a. Real Estate Settlement Procedures Act (RESPA).

   b. Equal Credit Opportunity Act.

   c. The Housing Financial Discrimination Act.

2. A(n) __________ is a fee paid to an agent who renders no service in exchange for a referral fee beyond the referral itself when the agent is already providing another service for a fee.

   a. discount

   b. refund

   c. kickback

RESPA controls indirect kickbacks

The mere *referral-steering* of a client is not a **service** rendered in exchange for a kickback, but is already a service owed the client to care for, protect and give them advice in the sales transaction.

Any payment between brokers or agents and third-party service providers, over and above the fee received from the seller on the sales transaction, may only be received in exchange for performing a *significant portion* of the services rendered by the provider paying the agent an additional fee. However, brokers and agents rarely perform services on behalf of service providers beyond the referral (which was done on behalf of the client, not the provider), and therefore cannot receive a referral fee – the **kickback**.

Referral fees are not the only form of kickback which violate RESPA.

Indirect kickbacks commonly provided by third-party services in exchange for referrals from brokers and agents include:

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

However, promotional and educational activities are allowed when:

- they are not conditioned on the referral of business; and
- they do not involve the payment of expenses (rent, IT services, supplies, equipment, etc.) incurred by a broker or agent in a position to refer business. [12 Code of Federal Regulations §1024.14(g)(vi)]

Another classic example of kickbacks is found in so called "*closed offices*," where brokers ban third-party service providers from competing legitimately for business with their one chosen service provider – their "preferred" lender or title insurer.

In addition, lenders may not pay a fee to a real estate broker representing a principal in the sale the lender is to finance, unless the broker has performed a significant service on behalf of the lender. For instance, a broker may receive a second fee, the so-called *referral fee*, if they render significant mortgage origination services.

QUIZ

1. Indirect kickbacks commonly provided by third-party services in exchange for referrals from brokers and agents include:

   a. throwing a party for anyone who referred business.

   b. paying for real estate listing advertising.

   c. Both a. and b.

Property appraisal and mortgage approval

On the lender's receipt of a mortgage application, the property is **appraised**. [See **RPI** Form 207]

The *appraisal* determines whether the property is of sufficient value to function as adequate security for recovery of the mortgage amount in the event of a default. Thus, the property needs to support the amount of financing the buyer requests. The lender uses the appraisal to gauge whether the **loan-to-value ratio (LTV)** meets the lender's standards.

Generally, an acceptable *LTV* for conventional mortgages is 80% of the property's value. An LTV of 80% requires the buyer to make a minimum 20% down payment. When permitted, the buyer might make a lesser down payment using a piggyback mortgage to fund the remainder of the 20% equity beyond the first mortgage amount. A greater LTV than 80% compels the lender to require the buyer to obtain **private mortgage insurance (PMI)**.

The 80% LTV ceiling is used to limit mortgage amounts originated during downturns in the market value of real estate, rather than during a rapidly rising market. Thus, swings in values throughout an economic cycle are exacerbated by the volatile conduct of lenders, including their financial accelerator activity.

Regulations setting parameters for mortgage lending are designed to narrow the cyclical swings and thus eliminate the economic damage brought on by unregulated lender conduct.

Once a lender approves a property as security for a mortgage amount based on an appraisal, the lender or MLO processing the application assembles a **mortgage package** and sends it to their mortgage underwriter for review.

The *mortgage package* prepared by the lender or MLO includes:

- the Uniform Residential Loan Application;
- the property appraisal report [See **RPI** Form 200];
- a credit report on the buyer;
- the lender's verification of the information provided on the mortgage application [See **RPI** Form 210];
- the purchase agreement, escrow instructions and condition of property disclosure statement handed to the buyer by the seller and seller's broker [See **RPI** Form 150, 304 and 401]; and
- other documentation needed to support the buyer's request, including operation balance sheets, tax returns, IRS Form 4506, title reports and bank statements.

Mortgage approval

A **mortgage approval** issued by a lender is often conditioned on a buyer providing more information or taking corrective actions. For example:

- the *physical condition* of the property may need correction;
- *title* may need to be cleared of defects;
- *derogatory entries* on the buyer's credit report may need to be eliminated; or
- the buyer's *long- or short-term debt* needs to be reduced.

Once conditions for funding are met and verified by the lender, the mortgage is classified as *approved*. Escrow calls on the lender or MLO for mortgage documents and funds, and on receipt of the funds, the sales transaction is closed.

Transaction agents working with buyers need to remind themselves that the degree of risk each lender finds acceptable is different. More often than not, a lender in the stable real estate market does exist who will make a mortgage of some amount under some conditions to nearly *any buyer*. Remember: it is the business of lenders to lend.

QUIZ

1. Prior to funding a mortgage, a lender has a property appraised to gauge whether the property's __________ meets the lender's standards.
   a. operating expenses
   b. loan-to-value ratio (LTV)
   c. debt overhang

2. A lender originating a mortgage takes on the risk they might lose on their investment in the mortgage if the buyer defaults. To shift this risk, __________ coverage is taken out to indemnify the mortgage lender in case of a loss.
   a. private mortgage insurance (PMI)
   b. title insurance
   c. federal deposit insurance

Notes and their Provisions

Evidence of the debt

Most real estate sales hinge on financing some portion of the purchase price, stated as a contingency to the buyer's closing of escrow. In these *purchase-assist* mortgage financing arrangements, a lender funds the buyer's purchase price.

In exchange for receiving the mortgage, the buyer promises to pay a sum of money to the lender either in:

- installments; or
- a single payment at a future time.

In an installment sale, the buyer makes payments to the seller under a **carryback financing arrangement** negotiated in a purchase agreement.

In either arrangement, the promise to pay the debt created by the funds advanced or property conveyed is set out in a written document called a **promissory note**, or more simply, just **note**. A *promissory note* is a document given as evidence of a debt owed by one person to another. [Calif. Code of Civil Procedure §1933]

To be enforceable, the promissory note needs to be signed by the buyer, also known as the **borrower, debtor** or **payor**. On closing the sale, the buyer's note is delivered to the lender or carryback seller, called the **payee**.

A note may be **secured** or **unsecured**. A secured note is a note evidencing debt which is backed by an asset, known as the **security**, also called **collateral**. The note is attached to property as a lien on title through the use of a *security device*.

If the note is secured by real estate, the security device used is a **trust deed**, commonly called a **mortgage**. When secured, the debt evidenced by the note becomes a voluntary lien on real estate described in the *trust deed* that references the note.

Satisfaction of the debt

When a debt secured by a trust deed lien on real estate has been fully paid, the lien is removed from title.

To release the lender's trust deed lien from the real estate, a process called **reconveyance**, the trustee under the trust deed needs to:

- obtain the original note from the lender; and
- complete a request for *reconveyance*. [Calif. Civil Code §2941]

If the lender or the trustee fails to reconvey the security interest after full payment, either may be subject to:

- a criminal fine of $400; and/or
- six months' imprisonment. [CC §2941.5]

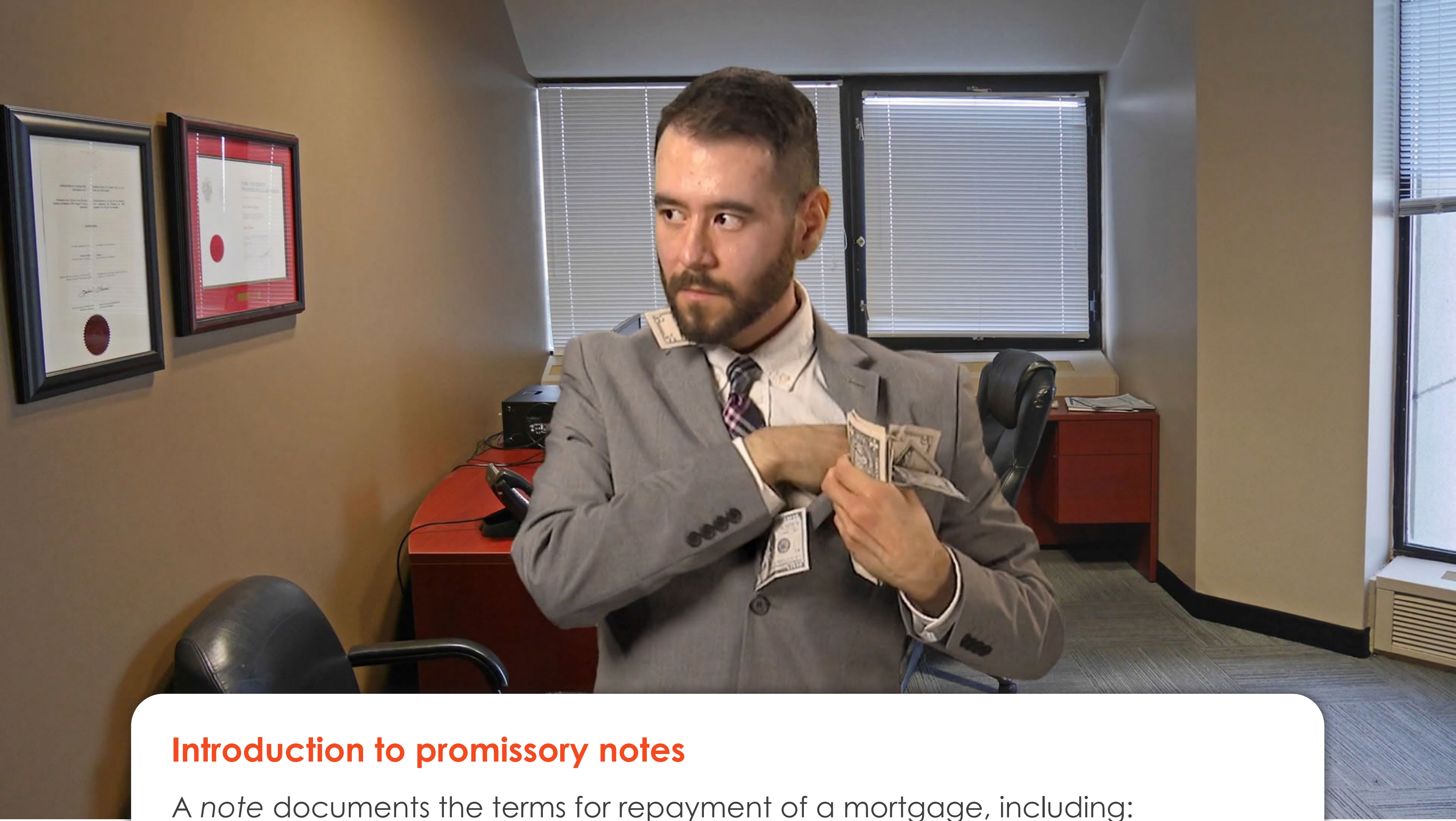
QUIZ

1. A__________ is a document given as evidence of a debt owed by one person to another.

   a. trust deed
   b. promissory note
   c. bill of sale

2. When a debt secured by a trust deed lien on real estate has been fully paid, the lien is removed from title in a process called:

   a. reconveyance.
   b. ratification.
   c. reconciliation.



Introduction to promissory notes

A *note* documents the terms for repayment of a mortgage, including:

- the amount of the principal to be paid;
- the interest rate charged on the remaining principal;
- the periodic payment schedule; and
- any due date.

Notes are categorized by the method for repayment of the debt. Thus, they are either:

- **installment notes**; or
- **straight notes**.

An *installment note* calls for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a balloon payment.

The two major variations of the installment note are the:

- **interest-included notes**; and
- **interest-extra notes**.

A note with a fixed interest rate, commonly called a **fixed rate mortgage (FRM**), provides the classic method for calculating interest that accrues on principal. With an FRM, the interest rate remains fixed for the life of the mortgage.

However, variations on the interest rate and repayment schedules contained in the installment and straight notes are available to meet the special needs of the lender and borrower. Variations include the:

- **adjustable rate mortgage (ARM)**;
- **graduated payment mortgage (GPM)**;
- **all-inclusive trust deed (AITD) note**; and
- **shared appreciation mortgage (SAM)**.

For carryback mortgages involved in **seller financing**, the dollar amount of the note depends on whether the carryback is evidenced by:

- an **all-inclusive trust deed (AITD) note**; or
- a regular note.

Using an AITD note to evidence a carryback debt always results in a greater face value than structuring the carryback using a regular note. The AITD note includes the principal amount remaining unpaid on the existing mortgage encumbering the property and the amount remaining unpaid on the seller's equity in the property after the down payment.

In contrast, a regular note in the same scenario is for the amount of the unpaid portion of the purchase price remaining after deducting the down payment and the principal remaining unpaid on the mortgage taken over by the buyer.

Usury: interest rate limitations on mortgages

For *consumer mortgages* made by a lender or non-exempt carryback seller, federal ability-to-repay (ATR) rules require establishment of the borrower's ability to repay the mortgage. While setting the payment amount does not impose interest rate limitations, the ATR rules set the maximum monthly payment the borrower is qualified to pay on the consumer mortgage based on their **debt-to-income (DTI) ratio.** In turn, when the maximum qualifying payment is coupled with the interest rate charged, the result sets the limit for the amount of principal debt the borrower may incur in the transaction. [12 Code of Federal Regulations §1026.43(a)]

In addition, California's **usury law** limits the interest rate on *non-exempt* real estate loans to the greater of:

- 10%; or
- the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%. [Calif. Constitution, Article XV]

Usury laws apply only to a **loan of money** or the **forbearance of payment** on a money loan. [Calif. Const. Art. XV §1]

Seller carryback notes are not money loans. Rather, they are installment sales that extend credit for payment of the price on a sale. Thus, they are not covered by usury law. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

A loan, if not exempt, is usurious if the note rate exceeds the ceiling rate on the day the note is entered into. Further, other benefits received by the lender may make a loan usurious when the terms on the face of the note are not usurious.

Importantly, real estate loans *made or arranged* by a real estate broker are exempt from the state usury restriction.

Penalties for usury

The most common penalty imposed on a non-exempt 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. [**Bayne** v. **Jolley** (1964) 227 CA2d 630]

The lender may also have to pay a usury penalty of **treble damages.** [CC §1916.3]

Treble damages are computed at three times the total interest paid by the borrower during the one year period immediately preceding their filing of a suit and during the period of litigation until the judgment is awarded.

An award of treble damages is typically reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower. [**White** v. **Seitzman** (1964) 230 CA2d 756]

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.

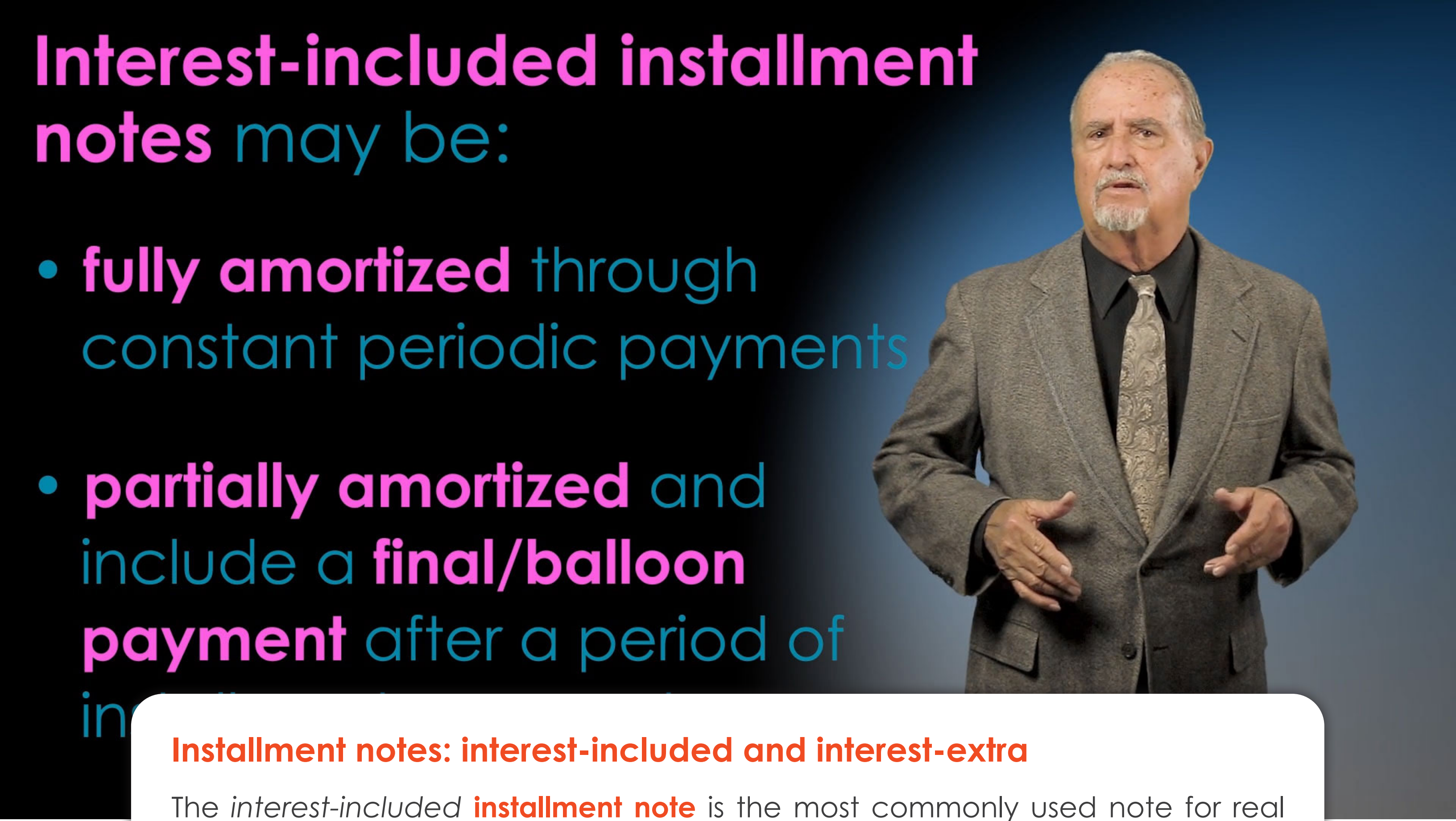
QUIZ

1. A(n) __________calls for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a balloon payment.

    a. installment note
    b. straight note
    c. forbearance note

2. __________ refers to a limit on a lender's interest rate yield on non-exempt real estate mortgages.

    a. Unconscionable advantage
    b. Upcharging
    c. Usury



Installment notes: interest-included and interest-extra

The *interest-included* **installment note** is the most commonly used note for real estate financing. Interest-included installments notes are the standard for consumer mortgage financing.

An interest-included installment note produces a schedule of constant periodic payments which amortize the principal. In doing so, the constant amount of scheduled payments contains diametrically varying amounts of principal and interest from payment to payment. With each payment, the amount of principal reduction increases and the amount of interest paid decreases. [See **RPI** Form 420]

Each payment is applied first to the interest accrued on the remaining principal balance during the period between payments, typically a month. The portion of the payment remaining is applied to reduce the principal balance. Interest accrues on this reduced principal amount for the next payment.

Interest-included installment notes are paid off through:

- constant periodic payments of principal reduction until the principal has been fully repaid, a process called **amortization**; or
- a period of constant installment payments followed by a final lump sum payment of principal, called a balloon payment, on a due date specified in the note.

However, balloon payments on consumer mortgages are only allowed under the general ability-to-repay (ATR) rules or small creditor balloon qualified mortgage (QM) rules.

Installment notes, interest extra

Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid separately, typically together with payment of the principal installment. [See **RPI** Form 422]

The principal payments remain constant until the periodic principal reductions fully pay the principal or a *due date* calls for a final/balloon payoff of principal. After each payment of principal, future interest is calculated as accruing on the remaining balance, decreasing the interest payment.

Thus, unlike an interest-included note with constant periodic payments, the amount of each scheduled payment of principal and interest on an interest-extra note declines in amount from payment to payment.

For example, the first payment of interest is based on the entire original unpaid balance of the interest-extra note. The second interest payment will be on the principal amount remaining after the principal reduction resulting from the first payment. To set the amount of each periodic payment, the accrued interest due to be paid with each principal payment is recalculated for each payment until the principal is paid off. This type of payment schedule is typically used in *land sales transactions*.

QUIZ

1. __________ are the standard for consumer mortgage financing.
   a. Interest-extra installment notes
   b. Interest-included installment notes
   c. Straight notes

2. Under an interest-included installment note, each payment is applied first to:
   a. reduce the principal balance with each monthly payment.
   b. the interest accrued on the remaining principal balance during the period between payments.
   c. discounting the points which were paid to originate the mortgage.

Straight notes

A **straight note** calls for the entire amount of its principal together with accrued interest to be paid in a single lump sum when the principal is due. Unlike in the installment note variations, a *straight note* does not include periodic payments of principal. [See **RPI** Form 423]

Interest usually accrues unpaid and is due with the lump sum principal installment. Thus, this form of real estate financing is sometimes referred to as a **sleeper trust deed**. Occasionally, the accruing interest is paid periodically during the term of a straight note when principal is not due for a year or two.

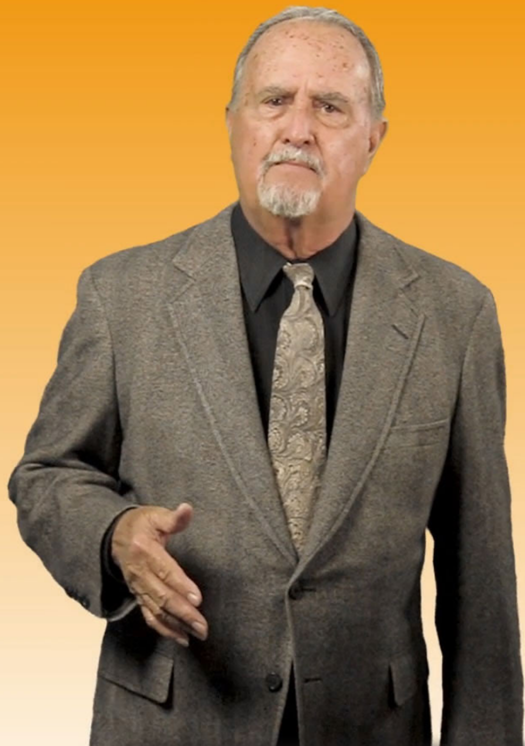
The straight note is typically used by lenders or carryback sellers to evidence short-term debt. Straight notes are rare in real estate transactions since most mortgages are long-term debts. However, straight notes are used to evidence short-term real estate obligations, like **bridge loans** used to purchase a property when the buyer's funds needed for closing will not be available until later. [See **RPI** Form 423]

Even if a bridge loan is a consumer mortgage secured by a one-to-four unit residential property, it is not subject to *ability-to-repay (ATR)* rules if the term is 12 months or less. [12 Code of Federal Regulations §1026.43(a)(3)(ii)]

QUIZ

1. A note which calls for the entire amount of its principal together with accrued interest to be paid in a single lump sum when the principal is due is a(n):
   a. Interest-included installment note.
   b. Seller carryback note.
   c. Straight note.

2. Straight notes are typically used by lenders or carryback sellers to evidence:
   a. short-term debt.
   b. medium-term debt.
   c. long-term debt.



Repayment schedule variations:

- adjustable rate mortgage
- graduated payment mortgage
- all-inclusive trust deed
- shared appreciation

Repayment variations: adjustable rate mortgage

The **adjustable rate mortgage (ARM)**, as opposed to a **fixed-rate mortgage (FRM)**, calls for periodic adjustments to the interest rate.

In turn, the amount of the scheduled payments fluctuates with each interest rate adjustment based on the original amortization period of the note. The interest rate adjusts based on movement in an agreed-to index, such as the *Cost of Funds Index (COFI)* for the *11th District Federal Home Loan Bank*.

The ARM interest rate formula delivers greater revenue to the mortgage holder when short-term interest rates trend upward above the initial note rate on origination. With an FRM, the lender's yield (and the borrower's monthly payment) is constant for the full term of the mortgage.

When an interest rate adjustment occurs, the note's repayment provisions call for an increase or decrease in the monthly payment to maintain the original amortization period. In the interest rate cycle of rising short-term rates, if the amount of the original monthly payment is not adjusted to reflect an increase in the amount of interest due at the adjusted rate, one of two things happens:

- the amortization period is extended; or
- the principal balance owed increases when the amount of interest accruing exceeds the monthly payment, called **negative amortization**.

Adjustable rate mortgages typically feature an introductory interest rate that is applicable for a short period of time, say several months. This is known as a **teaser rate** or **qualifying rate**.

For consumer mortgages, *negative amortization* is only allowed under the general *ability-to-repay (ATR)* rules, and is not allowed under *qualified mortgage (QM)* rules.

All ARMs contain five components:

- an introductory interest rate;
- a ceiling and a floor rate;
- an index figure;
- an operating margin; and
- adjustment intervals for rates and payments.

QUIZ

1. A mortgage which calls for periodic adjustments to the interest rate is an example of a(n):

   a. fixed-rate mortgage (FRM).

   b. adjustable rate mortgage (ARM).

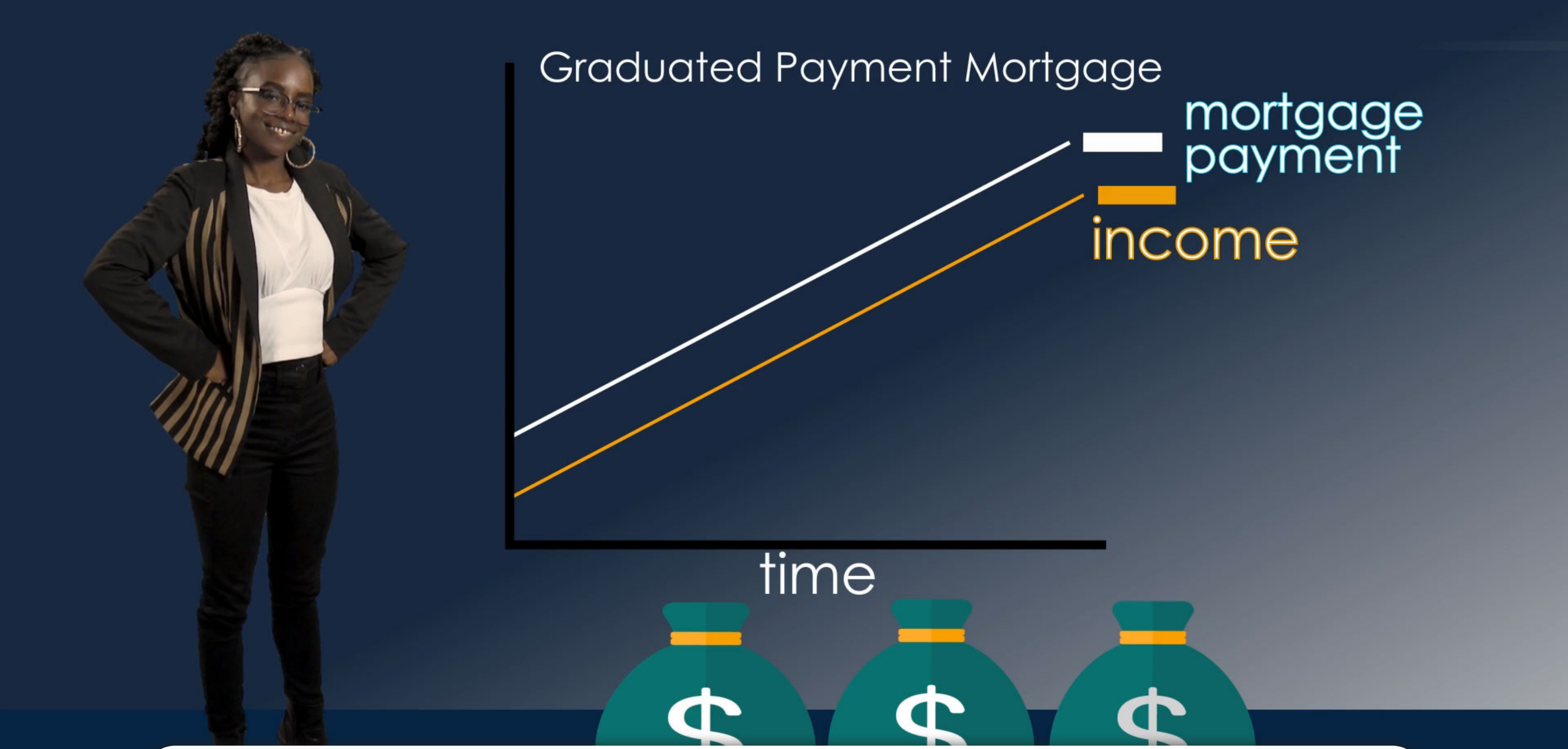
   c. blanket mortgage.

2. Adjustable rate mortgages (ARMs) typically feature an introductory interest rate that is applicable for a short period of time known as a:

   a. teaser rate.

   b. qualifying rate.

   c. Both a. and b.



Repayment variations: graduated payment mortgage

With a **graduated payment mortgage (GPM)**, payments increase periodically by predetermined amounts until the payment fully amortizes the principal over the remaining life of the mortgage without a further increase in payments, the interest rate on the note being fixed.

GPMs are in demand when interest rates or home prices rise too quickly and ARMs are disfavored by the buyer. The graduated payment schedule allows buyers time for their income to increase and cover mortgage payments when they reach the level that will fully amortize the principal without a further graduation in payments.

For example, a borrower takes out a GPM. The initial low monthly payments on origination are less than the interest that accrues on the principal balance. The payments are gradually increased over the first three to five years of the mortgage until the payment amortizes the principal over the remaining term.

Consider a buyer who is unable to currently afford a fully amortized monthly all-inclusive trust deed (AITD) payment of $2,000. Here, the buyer may offer to pay $1,400 monthly for the first year. With the mutual agreement of the buyer and seller, the monthly payments will increase $300 annually, until the full $2,000 amount needed to amortize the AITD is reached.

However, the monthly interest accrued and remaining unpaid each month is added to the principal balance. This results in **negative amortization** since the principal is increasing rather than decreasing with each payment. Thus, the negative amortization causes the unpaid interest to bear interest as principal, called **compounding**.

QUIZ

1. Graduated payment mortgages (GPMs) are in the most demand when:

   a. home prices are flat to down and underwriting requirements are lax.

   b. interest rates are rapidly decreasing and fixed-rate mortgages (FRMs) are increasingly scarce.

   c. interest rates or home prices rise too quickly and adjustable-rate mortgages (ARMs) are disfavored by the buyer.

2. __________ occurs when negative amortization causes unpaid interest to bear interest as principal.

   a. Capitalization

   b. Compounding

   c. Compaction

Repayment variations: all-inclusive trust deed

As a *debt instrument* and *security device* for the carryback sale of mortgaged real estate, the **all-inclusive trust deed (AITD)** and note provides agents, sellers and buyers with the flexibility needed to finance the **balance of a sales price** remaining to be paid after a down payment. AITDs become more common during periods of tightened availability of mortgage funds.

For a buyer with a down payment, the *AITD* carried back by a seller is all the financing needed to acquire mortgaged real estate.

The principal amount of the AITD includes:

- the **unpaid balance** on the existing mortgage which will remain of record, called the *wrapped mortgage* or *underlying mortgage*; and
- the **seller's equity** in the property remaining to be paid after the buyer's down payment.

Through the use of an *AITD*, the buyer makes monthly payments to the seller as negotiated in the all-inclusive note. In turn, the seller continues to make monthly payments to the mortgage holder on the underlying mortgage.

The advantages of an AITD over a regular second mortgage are experienced primarily by the seller. However, the buyer and underlying mortgage holder benefit as well since the arrangement allows the underlying mortgage holder and the buyer to avoid the assumption process.

For the benefit of the seller, the AITD:

- **allows a greater yield** than ordinarily can be negotiated for the note rate on a regular second mortgage, a financial advantage generated by the **overriding interest rate** feature available by use of an all-inclusive note;
- **eliminates the risk of loss** due to a default on the underlying mortgage since the seller remains responsible for its payment;
- **defers profit tax liability** for a greater percentage of the transaction's profit since an all-inclusive note increases the percentage of profit allocated to the principal in the carryback mortgage;
- **supports the price** sought by the seller by providing non-institutional financing; and
- **provides for a trustee's foreclosure** on the buyer's default, unlike other wraparound security devices, such as land sales contracts and purchase/lease-option agreements which require a judicial foreclosure (unless they contain a power-of-sale provision).

AITD concepts

An AITD is always a **junior mortgage**, usually a second, subordinate to a pre-existing, underlying first mortgage. Legally, the AITD has the same function as a regular trust deed.

The AITD form used is a regular trust deed form with the addition of an AITD addendum. The AITD addendum covers the disclosures and accounting for the financial aspects unique to an AITD. [See **RPI** Form 442, 443 and 450]

Like the AITD, land sales contracts and lease-option sales are also all-inclusive security devices which exhibit the same wraparound debtor/creditor features.

Under all three, the seller has sold the property yet remains responsible for payments on the underlying mortgage while receiving installments from the buyer. Additionally, income and property tax results for each device are treated the same by all government agencies.

The terms negotiated for payment of the sales price when the seller carries back an AITD include five variables:

- the down payment;
- the principal amount of the AITD;
- the interest rate;
- the periodic (monthly) payments; and
- the due date.

Down payment

The down payment in an AITD transaction is handled no differently than on any other method of carryback or conventional financing, such as a:

- regular first or second trust deed;
- **land sales contract**; or
- lease-option sale.

The amount of the down payment is fully negotiable between a buyer and seller. It may range from zero to the seller's entire **equity** in the mortgaged property.

The prudent carryback seller will require a down payment of no less than 10% to 20% of the sales price, depending on whether the property sold is intended as:

- a buyer-occupied residence; or
- an income-producing property.

The smaller the down payment, the greater the risk of loss for the seller if the buyer defaults on the mortgage and the property is foreclosed on. The risk of loss created by a low down payment is covered financially by:

- an increase in the price or interest rate, or both;
- guarantee by a person other than a signer of the note;
- cross-collateralization by a lien on other property owned by the buyer; or
- the bifurcation of the carryback debt into separate secured and unsecured debts.

The amount of the AITD

The distinguishing characteristic of the all-inclusive note is its **face amount**. The *face amount* of the all-inclusive note is the entire balance of the sales price remaining after the down payment. [See **RPI** Form 421]

At first glance, the total dollar amount of the debts secured by the underlying mortgage and the AITD appear to over-encumber the property.

However, the amount of the AITD **wraps around** and is **inclusive** of the underlying mortgage balance. Thus, the separate trust deed balances cannot be added together to determine the total dollar amount of encumbrances on the property. The amount of the AITD is often the total of the amounts owed on *all* encumbrances.

For example, property encumbered by a $600,000 first mortgage is sold for $1,000,000 with a $300,000 down payment. An AITD is carried back for $700,000, the amount remaining unpaid on the purchase price. The buyer does not assume or otherwise agree to pay the first mortgage. Collectively, the amounts secured by the two trust deeds total $1,300,000, yet the amount required to clear title of both trust deeds is controlled by provisions in the AITD addendum and is only $700,000, the amount of the AITD. [See **RPI** Form 442 and 443]

Conversely, a **regular** trust deed carried back as a second mortgage for the balance of the seller's equity (after the down payment) is in this case $100,000 with the buyer assuming the $600,000 first mortgage for an aggregate debt of $700,000.

The interest in an override

The seller's offering and use of an AITD makes financing for buyers during periods of high interest rates more attractive by offering a **below-market rate**, whether or not the rate on the underlying mortgage is below market.

For the seller, the interest rate on the AITD will ideally be equal to or exceed the rate on the underlying mortgage, although this is not always the case.

In this respect, the AITD's rate is said to **override** the rate on the underlying mortgage. The *override* is the difference between the interest rate on the underlying mortgage and the higher rate negotiated on the AITD.

For example, an AITD with an 8% interest rate which wraps a first mortgage at 5% gives the seller a 3% interest override on the underlying mortgage balance in excess of the interest on the first mortgage.

The override is the financial advantage available to the carryback seller when using an AITD. Use of the AITD greatly increases the yield on their equity in the AITD.

Equity burn-off dilemma

Alternatively, if the interest rate on the underlying mortgage exceeds the interest rate on the AITD, the seller's equity in the AITD is said to **burn-off** bit by bit. Here, the seller's equity shrinks daily as interest accrues in dissimilar amounts on both the underlying and the carryback mortgages.

In addition to reducing the seller's equity in the AITD, this principal *burn-off* reduces the AITD balance faster than the balance on the underlying mortgage. In turn, this converts the cash received as principal payments on the AITD into interest paid on the wrapped mortgage.

To avoid having the balance on the AITD drop below the balance on the underlying mortgage, a due date on the AITD is set for payoff before the balance on the AITD sinks below the balance on the wrapped mortgage, a moment in time called a **crossover**.

AITD documentation

The AITD transaction is best documented:

- between a buyer and seller in a purchase agreement, escrow instructions, grant deed, trust deed with all-inclusive addendum, and all-inclusive note;
- between a seller and the underlying mortgage holder in a written due-on waiver with any modification of the underlying note agreed-to with the mortgage holder for consent; and
- through escrow, by the buyer depositing the down payment funds and the AITD, and the seller depositing their grant deed.

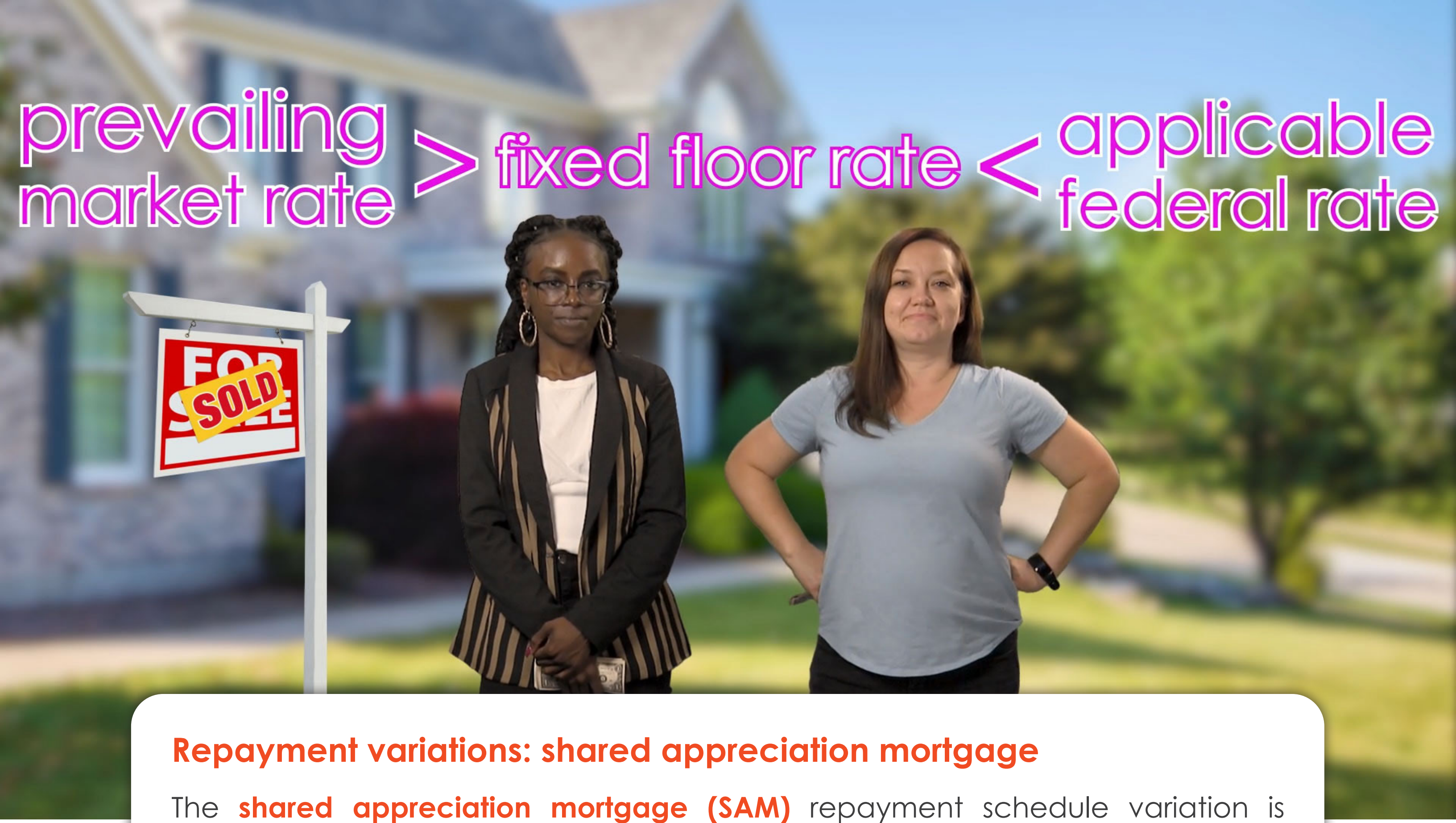
Agents involved in any carryback transaction need to make full disclosure to the buyer and the seller about the terms of the carryback and the underlying financing. Disclosure is accomplished in part by use of the AITD addendum.

Further, a **carryback disclosure statement** with statutorily mandated content is to be used on carryback sales of one-to-four unit residential property and, as good practice, on the carryback sale of all other types of property. [See **RPI** Form 300]

QUIZ

1. When a buyer and seller agree to enter into an all-inclusive trust deed (AITD), the buyer:
   a. may be able to obtain lower than market mortgage interest rates.
   b. is able to acquire the mortgaged real estate with a down payment.
   c. assumes the seller's repayment schedule of mortgaged real estate.

2. The principal amount of the all-inclusive trust deed (AITD) includes:
   a. the unpaid balance on the existing mortgage which will remain of record.
   b. the seller's equity in the property remaining to be paid after the buyer's down payment.
   c. Both a. and b.



Repayment variations: shared appreciation mortgage

The **shared appreciation mortgage (SAM)** repayment schedule variation is designed to help carryback sellers attract buyers at lower prices during times of tightening mortgage money conditions.

The SAM, a type of **split-rate note**, calls for the buyer to periodically pay interim interest at a fixed rate, then when the principal balance is due, to further pay the mortgage holder additional interest calculated as a fraction of the property's increased net value since origination. [See **RPI** Form 430]

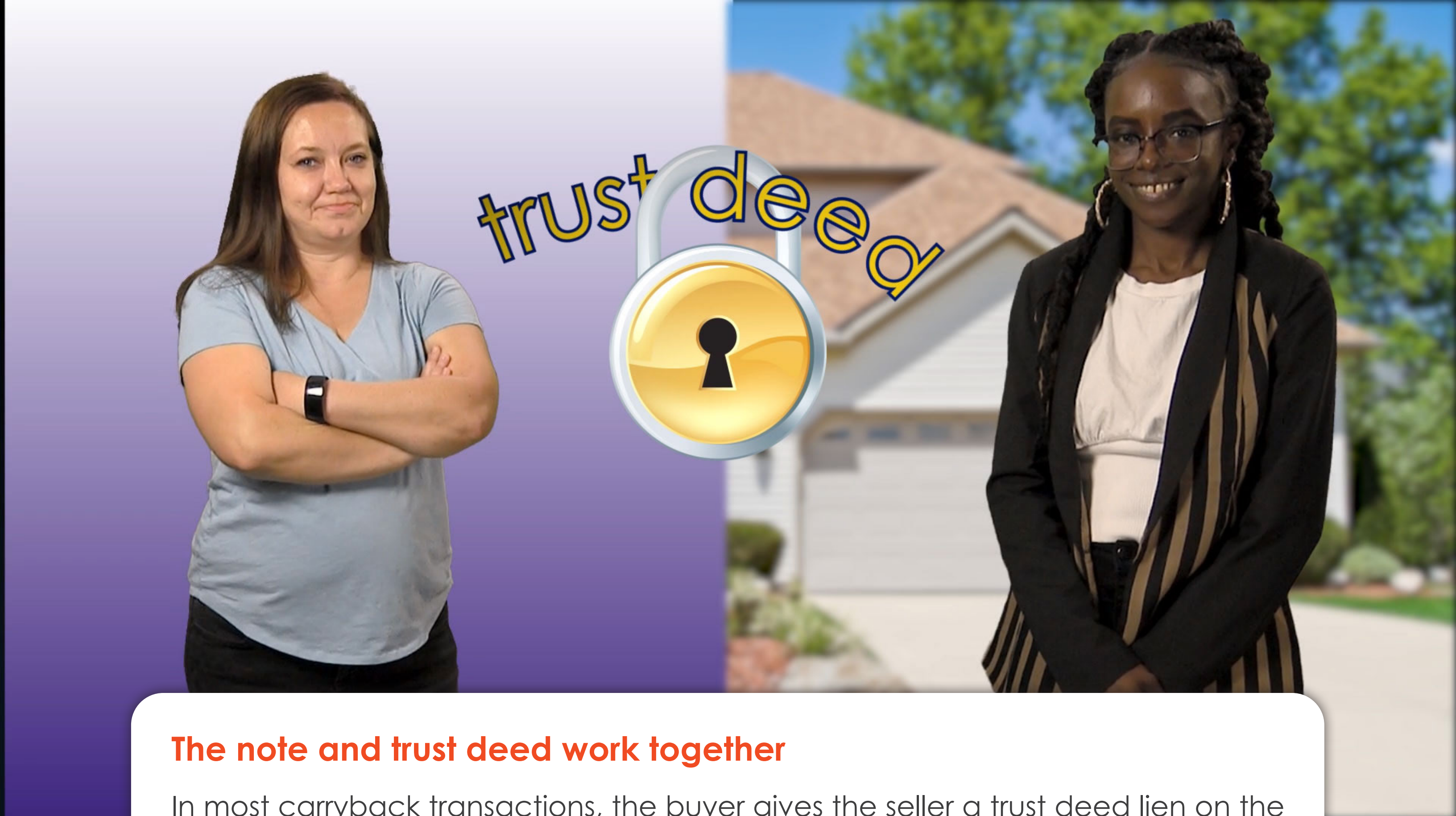
Under a SAM note, the buyer pays an initial fixed interest rate, called a **floor** or **minimum rate**. The floor rate charged is typically two-thirds to three-fourths of the prevailing market rate, but not less than the **Applicable Federal Rate (AFR)** for reporting imputed interest.

In return, the carryback seller receives part of the property's appreciated value as additional interest, called **contingent interest**, when the property is sold or the carryback SAM is due.

QUIZ

1. The initial fixed interest rate the buyer pays under a shared appreciation mortgage (SAM) is referred to as the:
    a. floor rate.
    b. minimum rate.
    c. Either a. or b.

2. What benefit does a carryback seller receive under a shared appreciation mortgage (SAM)?
    a. The carryback seller holds a super-priority lien on the property which is senior to all prior recorded encumbrances.
    b. The carryback seller receives part of the property's appreciated value as additional interest, called contingent interest.
    c. The carryback seller is better able to attract tenants to rent the property since they will also receive part of the property's appreciated value.



The note and trust deed work together

In most carryback transactions, the buyer gives the seller a trust deed lien on the real estate sold as security for payment of the portion of the price left to be paid.

The trust deed is **recorded** to give public notice and establish priority of the seller's security interest in the property. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

A trust deed without a monetary debt is worthless since it secures nothing as a lien to the property described. Although the note and trust deed executed by a buyer in favor of a lender or seller are separate documents, a trust deed is only effective when it provides security for an existing promise to pay or perform any lawful act that has a *monetary value*. [**Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543]

Though they are separate documents, the note and trust deed for the same transaction are considered one contract to be read together. [Calif. Civil Code §1642]

A **note** contains a borrower's *promise to pay* the lender or carryback seller — the mortgage holder – the principal amount of the debt entered into, plus any interest. The note is not the debt itself, but *evidence of the existence* of a debt created in an underlying transaction.

The schedule and conditions for payment of principal and interest are also contained in the *note*.

In contrast, provisions in a **trust deed**, besides referencing the note and describing the real estate liened to secure payment of the debt, primarily address the maintenance and preservation of the mortgage holder's *security interest* in the real estate.

Together, the note and trust deed are called a **mortgage**.

QUIZ

1. What is the primary reason for recording a trust deed?

    a. To keep the country appraised of the vesting on the property and maintain a proper chain of title.

    b. To notify the public of the date, time and place of the scheduled foreclosure sale.

    c. To give the public notice and establish priority of the seller's security interest in the property.

2. Collectively, a note and trust deed are commonly called a(n):

    a. impound account.

    b. mortgage.

    c. cloud on title.

Default and Foreclosure

The power-of-sale provision

A mortgage holder or carryback seller holding a note secured by a trust deed in **default** has two foreclosure methods available to enforce collection of the mortgage debt. These two foreclosure methods are:

- a **judicial foreclosure** sale, also called a *sheriff's sale* [Calif. Code of Civil Procedure §726]; or
- a **nonjudicial foreclosure** sale, also called a *trustee's sale*. [Calif. Civil Code §2924]

The key to the mortgage holder's ability to *nonjudicially foreclose* by a trustee's sale on the mortgaged real estate is the power-of-sale provision contained in the mortgage, also called a *trust deed*.

Other security devices used to create a lien on real estate to secure a debt which may also contain a **power-of-sale provision** include:

- a lease-option sale [See **RPI** Form 163 §19];
- a homeowners' association (HOA)'s conditions, covenants and restrictions (CC&Rs) regarding assessment liens;
- bonded improvement assessments;
- a UCC-1 financing statement [**Lovelady v. Bryson Escrow, Inc.** (1994) 27 CA4th 25; see **RPI** Form 436-1]; or
- a land sale contract. [**Petersen v. Hartell** (1985) 40 C3d 102; see **RPI** Form 168]

The grant of the power-of-sale by the owner of a property provides a private contract remedy for the **recovery of money** by a creditor, typically a mortgage holder. The power-of-sale is voluntarily agreed to by the owner of the mortgaged property, authorizing the mortgage holder on a default to hold a nonjudicial foreclosure sale of the property by public auction. [CC §2924]

If the note evidences a **recourse debt** with a remaining balance exceeding the *fair price* of the mortgage holder's security position in real estate, the mortgage holder may want to choose a *judicial foreclosure*. A judicial foreclosure action allows the mortgage holder to seek a money judgment for any deficiency in the property's value to satisfy the debt.

However, by foreclosing under the power-of-sale provision, the mortgage holder avoids a costly (and potentially time-consuming) court action for judicial foreclosure.

Further, when a mortgage holder completes a nonjudicial foreclosure, it cannot later obtain a deficiency judgment against the owner of the mortgaged real estate. Alternatively, the owner cannot redeem the property after the mortgage holder's trustee's sale as they can after a judicial foreclosure sale.

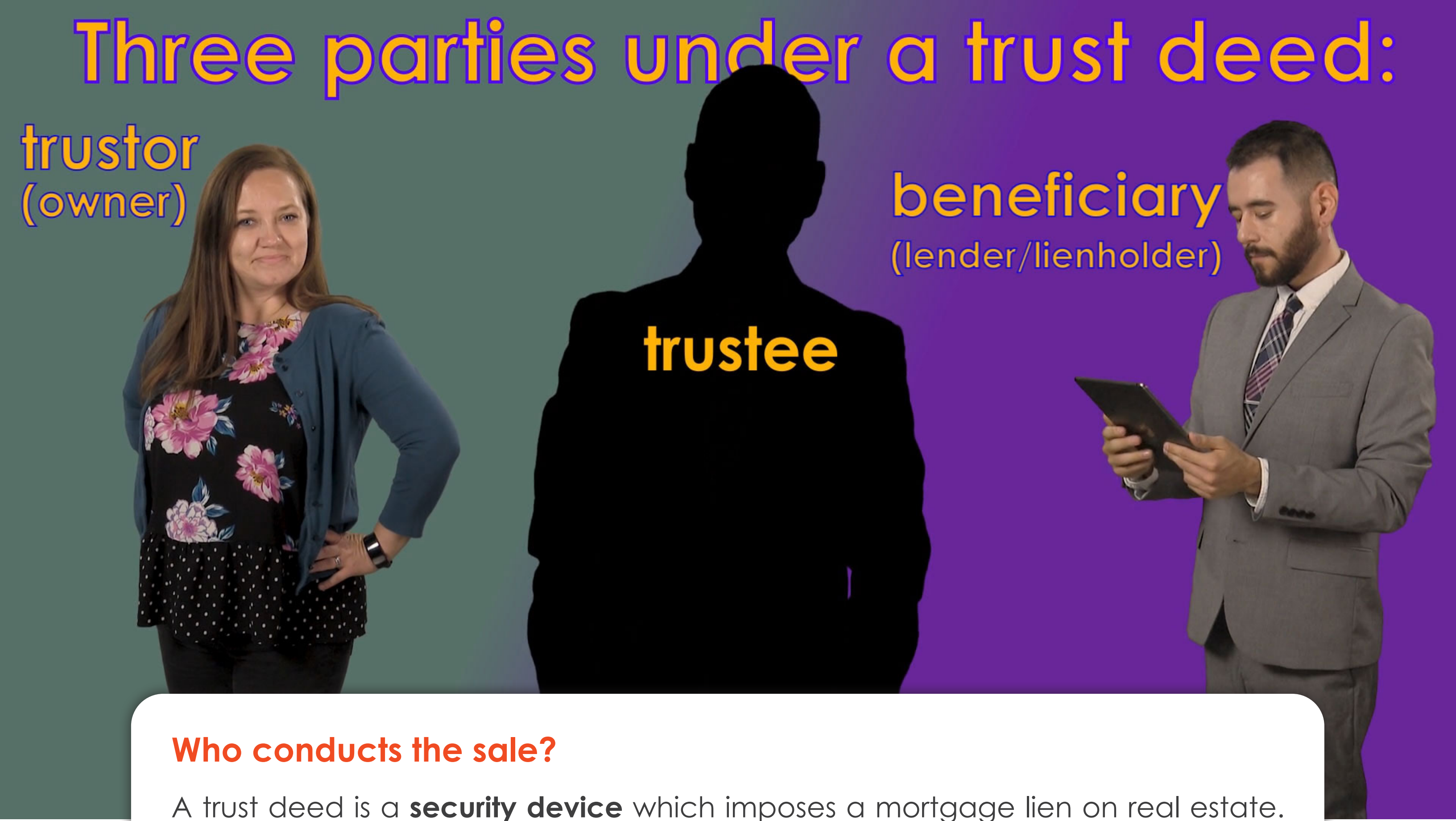
QUIZ

1. The key to the mortgage holder's ability to nonjudicially foreclose by a trustee's sale on the mortgaged real estate is the __________ contained in the trust deed.

    a. sheriff's sale provision
    b. power-of-sale provision
    c. judicial sale provision

2. Why would a mortgage holder choose to foreclosure nonjudicially?

    a. A nonjudicial foreclosure allows the mortgage holder to seek a money judgment for any deficiency in the property's value to satisfy the debt.
    b. A nonjudicial foreclosure is generally less costly and time-consuming than a court action.
    c. The foreclosed owner waives their right to redeem their property under a nonjudicial foreclosure.



Who conducts the sale?

A trust deed is a **security device** which imposes a mortgage lien on real estate. The mortgage wording purports to create a *fictional trust* which is said to "hold title" to the mortgaged real estate for the benefit of the mortgage holder. As you will observe, the trustee holds no interest in the property and has no duty owed to anyone, until they voluntarily undertake to reconvey or foreclose on a declaration by the mortgage holder.

Thus, a mortgage has three parties:

- at least one **trustor** (the owner(s) of the mortgaged real estate);
- a **trustee** who need not be named; and
- at least one **beneficiary** (a lender, carryback seller, HOA, bonded assessment or other lienholder with a trustee's sale provision).

The trustee's sale is conducted by the trustee who is either:

- named in the mortgage; or
- appointed by the *beneficiary* of the mortgage at the time the beneficiary initiates the foreclosure process.

A broker, attorney, mortgage servicer, subsidiary of the mortgage holder, or the mortgage holder itself may be appointed at any time as the trustee.

Generally, trust deed forms are prepared and distributed by title or escrow companies naming their corporation as the trustee. However, a trust deed or other security device does not need to name the trustee at all. The mortgage holder later simply appoints a trustee to handle the *NOD* or reconveyance. [See **RPI** Form 450]

Also, the mortgage holder may appoint a substitute trustee to replace the trustee named in the trust deed.

QUIZ

1. The trustee's sale is conducted by the:

   a. trustor.

   b. trustee.

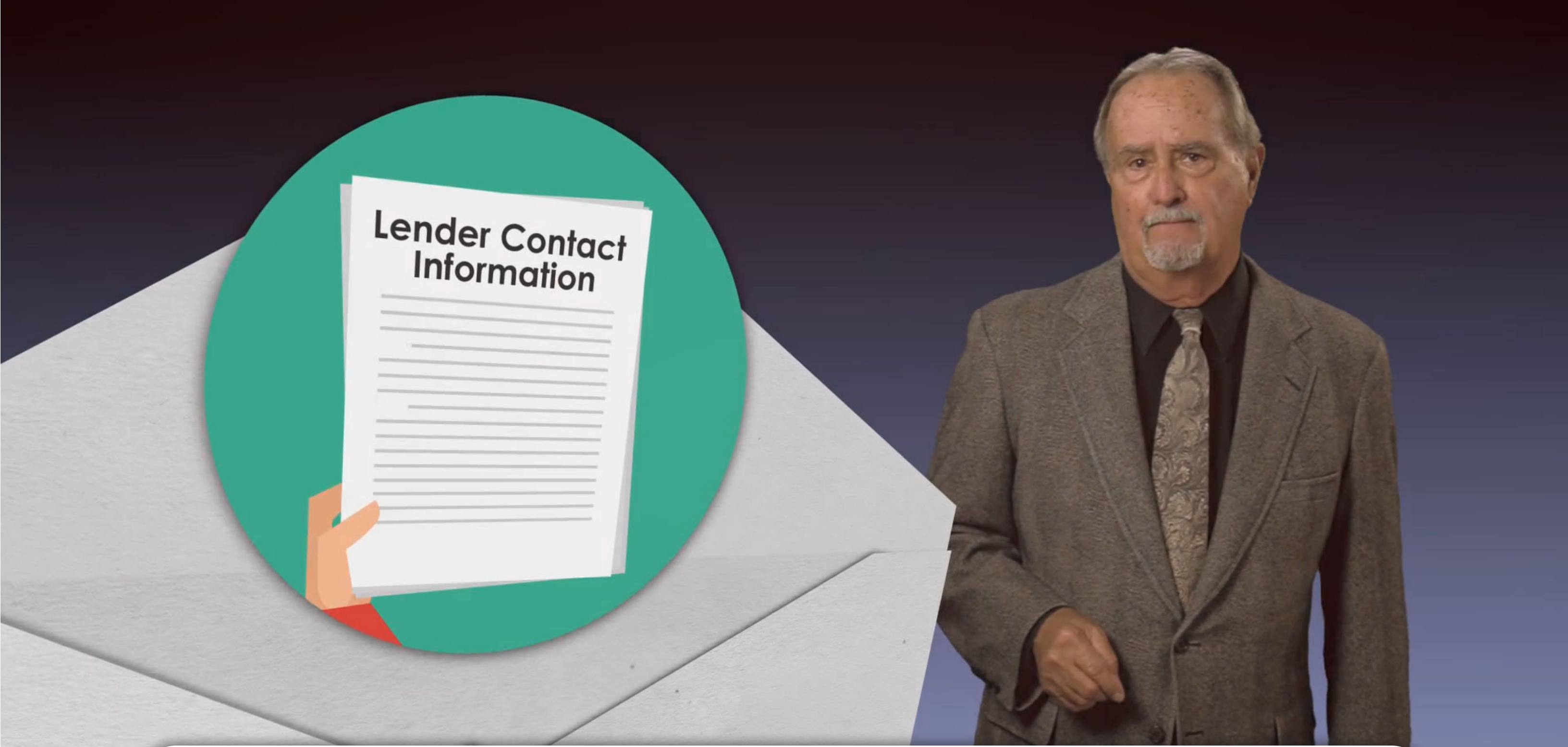
   c. beneficiary.

2. Who is authorized to function as a trustee?

   a. A broker, attorney, mortgage servicer or subsidiary of the mortgage holder.

   b. The mortgage holder itself.

   c. Both a. and b.



Pre-foreclosure workout prior to NOD

The trustee begins the nonjudicial foreclosure process by recording a **notice of default (NOD)**. The trustee ends the process on delivery of the trustee's deed and disbursement of any sales proceeds. [**Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194; see **RPI** Form 471]

However, before recording an *NOD* on a first lien mortgage securing a purchase-assist loan on a *principal residence*, a mortgage holder needs to conduct a **pre-foreclosure workout** with the homeowner.

At least 30 days prior to recording an NOD, the mortgage holder needs to contact the homeowner to:

- assess the homeowner's financial situation;
- explore options for the homeowner to avoid foreclosure;
- advise the homeowner of their right to an additional meeting within 14 days to discuss their financial options; and
- provide homeowners with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency. [Calif. Civil Code §2923.5(a)]

Further, after attempting the initial contact, the servicer must send a written statement to the owner informing the owner of their right to:

- additional protections and services if they are a service member or a dependent of a service member; and
- request the note, trust deed, assignment and payment history. [CC §2923.55]

If the mortgage holder is unable to make contact with the homeowner, the mortgage holder:

- sends the homeowner a first-class letter containing a toll-free number for a housing counselor certified by the *HUD; and*
- calls the homeowner by the primary telephone number on file at least three times at different hours on different days. [CC §2923.5(e)]

The mortgage holder may record an NOD on a mortgage without complying with any of these 30-day pre-foreclosure requirements when the homeowner has:

- surrendered the property to the mortgage holder either by a letter confirming the surrender or by delivery of the keys to the mortgage holder;
- contracted with a person who facilitates a homeowner's decision to leave their home by extending the foreclosure process and avoiding the mortgage holder's enforcement of the loan; or
- filed a bankruptcy petition which is pending. [CC §2920.5(c)(2)]

QUIZ

1. Before recording a notice of default (NOD) on a first lien mortgage securing a purchase-assist loan on a principal residence, a mortgage holder needs to:

   a. post and record a Notice of Trustee's Sale (NOTS).

   b. place a stay on any collection efforts with the homeowner.

   c. conduct a pre-foreclosure workout with the homeowner.

2. A mortgage holder needs to conduct a pre-foreclosure workout with the homeowner:

   a. at least 30 days prior to recording a notice of default (NOD).

   b. at least three months prior to the scheduled sale date.

   c. no later than the second month the owner missed a mortgage payment.

The stages of foreclosure, reinstatement and redemption

To successfully complete a trustee's foreclosure sale under a power-of-sale provision, the trustee and mortgage holder need to adhere to the procedures detailed in the California foreclosure statutes for handling a trustee's sale. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268]

The nonjudicial foreclosure process has three stages:

- the **notice of default (NOD)** is recorded and mailed;
- the **notice of trustee's sale (NOTS)** is recorded, posted and mailed; and
- the **trustee's sale** of the real estate by auction occurs, followed by the execution of the trustee's deed and distribution of sales proceeds.

Editor's note — Mortgage servicers are required to wait until a mortgage is at least 120 days delinquent before commencing foreclosure on a first lien mortgage secured by an owner's principal residence. [12 Code of Federal Regulations §1024.41(f)(1)]

While the trustee is concerned about the three stages for processing the foreclosure, the owner of the real estate and the mortgage holder are concerned primarily with two different periods of time which control payment of the debt:

- the **reinstatement period**, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and
- the **redemption period**, which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property.

Reinstatement

A mortgage on which the trustee has recorded an NOD initiating foreclosure is reinstated when the mortgage holder receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes and insurance (collectively known as PITI), assessments and advances;
- installments that become due and remain unpaid after the recording of the NOD;
- any future advances made by the mortgage holder after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums and to eliminate any other impairment of the security; and
- costs and expenses incurred by the mortgage holder to enforce the trust deed, including statutorily limited trustees fee's (or attorney fees). [Calif. Civil Code §2924c(a)(1)]

After an NOD is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the **reinstatement period**. When the sale is postponed, the *reinstatement period* is extended, ending the day before the fifth business day prior to the postponed sale date. [CC §2924c(e)]

Until the trustee records an NOD, the mortgage holder is compelled to accept the tender of all delinquent amounts.

After recording the NOD, the trustee allows **three months** to pass before advertising and posting notice of the date of the trustee's sale. [CC §2924]

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

Thus, the very last day to reinstate the mortgage is on Thursday, the day before the five business days and, in this example, eight calendar days before the trustee's sale.

The mortgage holder's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the mortgage holder may enforce payment of any omitted defaults by recording another, separate NOD. [CC §2924]

On reinstatement of the mortgage debt, the trustee rescinds the NOD, removing the recorded default from title to the property. [CC §2924c(a)(2)]

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

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

Redemption

An owner's failure to cure a default before the reinstatement period expires allows the mortgage holder to require the owner — who intends to retain ownership of the property — to **redeem** the property prior to completion of the trustee's sale by:

- paying all sums due on the mortgage debt; and
- reimbursing the costs of foreclosure.

The owner's right of redemption runs until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property (such as a tenant with a leasehold estate) may satisfy the debt and redeem the property prior to the completion of the trustee's sale. [CC §2903]

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

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

Unless all unpaid amounts due on the mortgage debt are paid in full during the redemption period, the owner loses ownership of the property at the trustee's foreclosure sale.

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

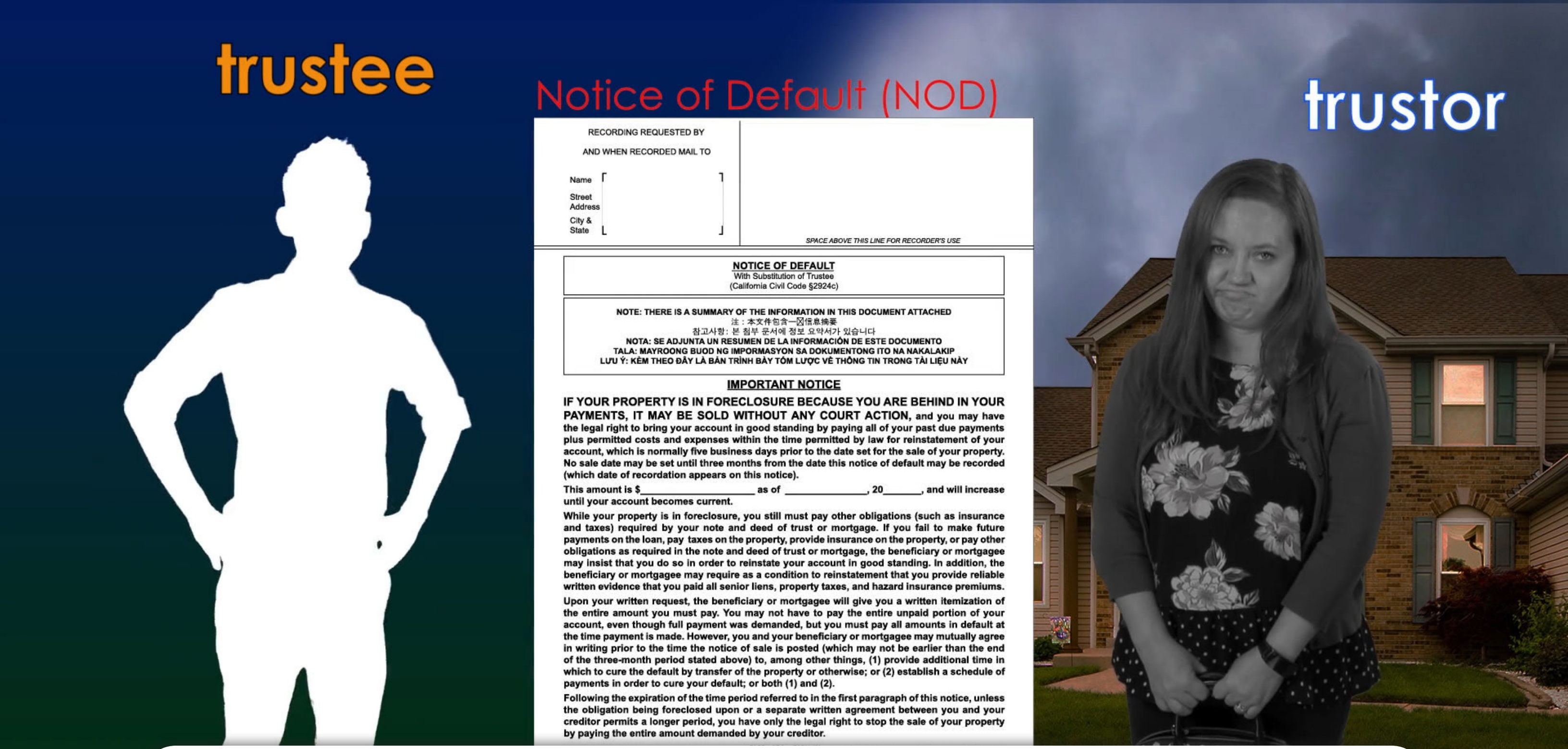
- a breach of a due-on clause;
- a breach of a waste provision; or
- a violation of law provision in the use of the property.

Editor's note – The owner of a unit in a ***common interest development (CID)*** *has 90 days after the trustee's foreclosure sale on an HOA assessment lien to redeem the unit. This is distinct from the standard redemption period applicable to non-HOA units which expires five business days before the trustee's sale. This HOA-specific legislation was adopted to stymie the efforts of an HOA attempting to initiate foreclosure to collect overdue HOA assessments of minimal value. [Calif. Code of Civil Procedures §2924.1]*

QUIZ

1. What is the order of the three stages of the nonjudicial foreclosure process?
   a. notice of trustee's sale (NOTS), notice of default (NOD), trustee's sale by auction
   b. notice of default (NOD), notice of trustee's sale (NOTS), trustee's sale by auction
   c. trustee's sale by auction, notice of trustee's sale (NOTS), notice of default (NOD),

2. After a notice of default (NOD) is recorded, an owner or junior lienholder may bring current any curable monetary default stated in the NOD prior to five business days before the trustee's sale, called the:
   a. reinstatement period.
   b. redemption period.
   c. ratification period.



The notice of default

When a mortgage is in default and the mortgage holder has chosen to foreclose, the mortgage holder hands a **declaration of default and demand for sale** to the trustee.

The declaration contains instructions directing the trustee to initiate foreclosure on the mortgaged property as authorized under the power-of-sale provision contained in the mortgage.

Even though the trustee may have received the mortgage holder's declaration of default, the trustee's foreclosure process and the periods imposing rights and obligations do not begin until the trustee or mortgage holder records a **notice of default (NOD)**. [**System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137]

Once the NOD is recorded, the trustee is required to strictly comply with statutory notice requirements. To be assured the required notices are served on all the proper persons, the trustee orders a **trustee's sale guarantee** from a title company before or at the time the NOD is recorded.

The *trustee's sale guarantee* provides coverage to the trustee for failure to serve notices on any party due to an omission of that person's identity in the guarantee.

The trustee's sale guarantee contains:

- the name and address of each person who has recorded a request for a copy of the NOD;
- the name and address of each party with a recorded interest in the real estate securing the obligation in default;

- any junior (later recorded) easements and to whom the easements were granted;
- the property's legal description;
- a plat map locating the property; and
- the names of the newspapers in general circulation in which the NOTS, and the NOD if necessary, are to be published.

The notice of default and election to sell

When ordering a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to record the NOD in the office of the county recorder in the county where the real estate is located. [Calif. Civil Code §2924(a)(1)]

The NOD contains statutorily mandated statements which set forth the monetary default on the note or other obligation secured by the mortgage. [CC §2924c(b)(1); CC § 2924(a)(1)]

The monetary default statement informs the owner:

- they need to continue to pay other obligations required of them by the mortgage, such as hazard insurance premiums and property taxes; and
- if they do not make future payments on the obligations in default, the owner is required to make the payments to reinstate the loan.

The NOD does not need to state the actual amounts of the monetary defaults on the recurring obligations. However, the NOD needs to state the nature of the *present defaults* on the mortgage. [CC §2924c(a)(1)(B); CC §2924c(a)(1)(C)]

For one-to-four unit residential property, a summary of key information contained in the NOD needs to be attached to the NOD. The summaries do not have to be published or recorded. [CC §2923.3(c); see **RPI** Form 471-1]

Further, if the mortgage was originally negotiated in one of five languages other than English, the summary is to be provided in that language. These languages are:

- Chinese;
- Korean;
- Spanish;
- Tagalog; or
- Vietnamese. [CC §2923.3(a); see **RPI** Form 474-1 through 474-6]

To determine the amount needed to cure the default, the NOD directs the owner seeking to *reinstate* the mortgage or *redeem* the property to contact the trustee. Thus, the trustee insulates the mortgage holder from all direct contact with the owner or junior mortgage holder after the date the NOD is recorded until cancelled or a trustee's sale occurs.

If the NOD does not list a default known to the mortgage holder at the time of recording, the unnamed default does not need to be cured for the loan to be reinstated. [**In re Peters** (9th Cir. BAP 1995) 184 BR 799]

However, the mortgage holder may later record a separate NOD to notice the omitted default, and pursue a separate foreclosure based on the omitted default. [CC §2924(e)]

Delivering the NOD

Within **ten business days** after recording a NOD, two copies of the NOD are mailed to:

- the owner of the property;
- the administrator of a deceased owner's estate; and
- each person who has recorded a request to receive a copy of the NOD. [**Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)]

One copy of the NOD is sent by registered or certified mail, the other copy is sent by first-class mail. [CC §2924b(b)(1), (e)]

Within **one month** after recording the NOD, the trustee sends a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the mortgaged property, including:

- the owner's successor-in-interest;
- any junior mortgage holder;
- the assignee of a junior mortgage;
- a buyer on a land sales contract;
- a lessee on a lease; and
- the state Office of the Controller, if a *Notice of Lien for Postponed Property Taxes* is recorded against the property. [CC §2924b(c)]

Any other person interested in obtaining a copy of the NOD records a **request for NOD**. The request for NOD assures the interested person they will be notified of the default. [See **RPI** Form 412]

A trustee or person depositing the NOD into the mail to give notice to others prepares a *proof of service* and includes a copy of the form with the NOD in each mailing. [CC §2924b(e)]

No address for trustor

The trustee must send a copy of the notice of default (NOD) to:

- the trustor's address as noted in the trust deed; and
- the address given by the trustor in a recorded request for NOD. [Calif. Civil Code §2924b(b)(3)]

If the trust deed does not contain a request for NOD, or contains a request for NOD but no address for the trustor, the trustee can do one of the following within 10 business days after recording the NOD:

- publish the NOD in a newspaper of general circulation in the county in which the property is located (the trustee's sale guarantee issued by the title company advises which newspaper to use), and continue publishing once a week for at least four weeks;
- personally serve the NOD on the trustor; or
- post the NOD in a conspicuous place on the secured property and mail the notice to the last known address of the trustor. [CC §2924b(d)]

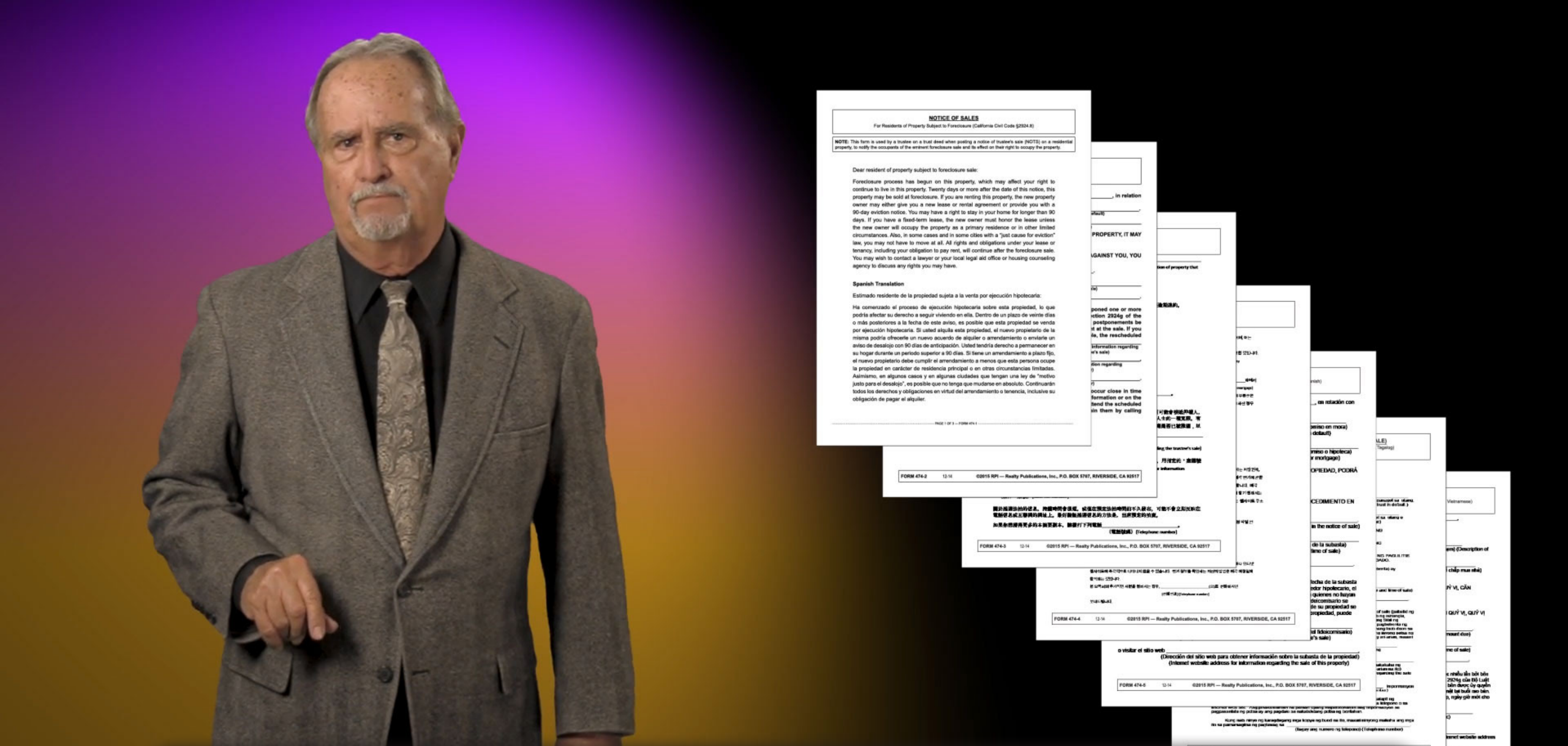
A trustee is not required to discover a trustor's address if the current address is not actually known to the trustee. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]

Unless the trustee has actual knowledge of the trustor's last known physical address, which does not include the use of an email address, the trustee is not liable if the trustor does not receive a copy of the NOD. [CC §2924b(b)(3)

QUIZ

1. The notice of default (NOD) needs to state:
   a. the nature of the present defaults on the mortgage.
   b. the actual amounts of the monetary defaults on the recurring obligations.
   c. the calendar year the property was acquired by the owner.

2. Within ten business days after recording a notice of default (NOD), two copies of the NOD are mailed to:
   a. the owner of the property.
   b. each person who has recorded a request to receive a copy of the NOD.
   c. Both a. and b.



The notice of trustee's sale

A trustee or mortgage holder may begin noticing the date set for the sale of a property on the day following **three months after** the NOD is recorded. [Calif. Civil Code §2924(a)(3)]

After noticing the date set for the sale, at least **20 calendar** days need to pass before the date of the sale. The trustee may sell the property no sooner than the twenty-first day after advertising begins and the posting of notice occurs. [CC §2924f(b)]

Thus, the owner or junior lienholder has approximately 103 to 105 days after recording the NOD to cure the default and reinstate the mortgage debt. Doing so avoids a full payoff or foreclosure of the property.

At least 20 calendar days before the trustee's sale, the trustee sends two copies of the NOTS to each party who previously received the NOD. [CC §2924b(c)(3)]

As with the NOD, one copy of the NOTS is sent by registered or certified mail, while the other is sent by first-class mail. [CC §2924b(b)(2), (e)]

The date of the sale may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m. [CC §2924g(a)]

In general practice, a **date down** of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or on the day the title company records the NOTS.

The *date down* notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded. [CC §2924b(c)(1)]

The trustee prepares an NOTS which contains:

- the trustee's name or their agent's name, street address and telephone number (or toll-free number if located out of state);
- the street address or common designation of the mortgaged property;
- the county assessor's parcel number of the mortgaged property;
- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner they are in default. [CC §2924f]

If the billing address of the defaulting owner is different from the mortgaged property's address, an additional notice needs to be posted on the property concurrent with the NOTS. The notice states in English and five other mandated languages that any tenant has the right to a 90-day notice to vacate the property. A copy of the tenant's rights is also to be mailed at the time of posting to the "Resident of property subject to foreclosure sale." [CC §2924.8(a); see **RPI** Form 474-1]

Like the NOD, the NOTS needs to contain a summary of key information in the language the mortgage was originally negotiated in. [CC §2923.3; see **RPI** Form 474-2]

If the mortgage was negotiated in Spanish, the mortgage may contain a request for a Spanish-language NOD. The trustee is then obligated to serve the owner an NOD in Spanish. [CC §2924c(b)(1)]

Delivering the NOTS

To ensure the sale at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee performs all of the following at least 20 calendar days prior to the sale:

- **post a copy** of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;
- **post a copy** of the NOTS in a conspicuous place on the property to be sold; and

- **start publishing a copy** of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located. [CC §2924f(b)(1)]

The location of the sale

A trustee's sale is held in the county where the mortgaged real estate is located. [CC §2924g(a)]

If the property or properties being foreclosed are located in two or more counties, the trustee's sale may take place in any one of the counties.

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the mortgage holder or by the trustee at their discretion. [CC §2924g(c)(1)]

QUIZ

1. After noticing the date set for the trustee's sale, at least _________ need to pass before the date of the sale.

   a. seven business days

   b. 20 calendar days

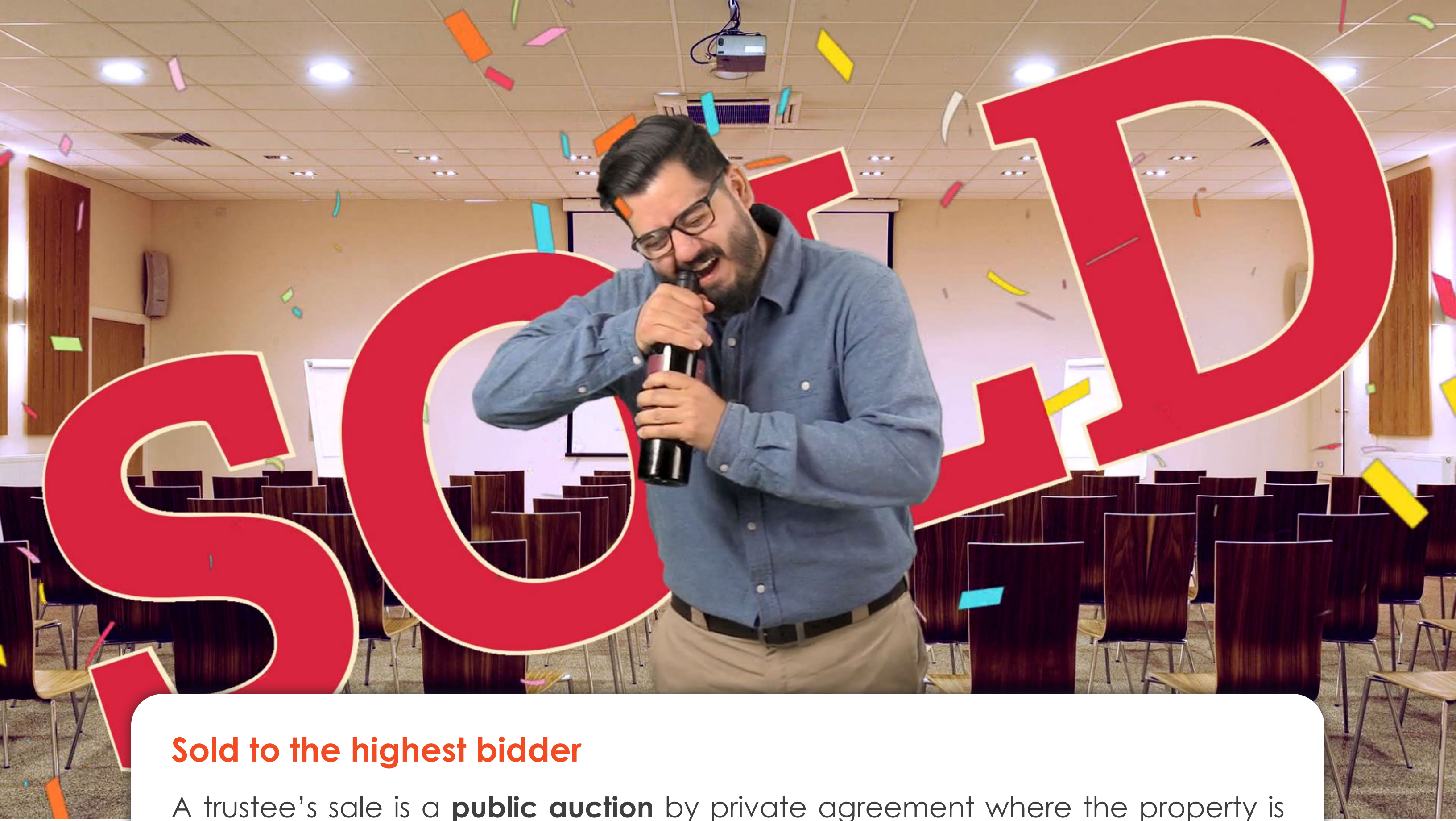
   c. three months

2. An owner or junior lienholder has approximately __________ after recording the notice of default (NOD) to cure the default and reinstate the mortgage debt.

   a. 20 to 23 days

   b. 45 to 48

   c. 103 to 105 days



Sold to the highest bidder

A trustee's sale is a **public auction** by private agreement where the property is sold to the highest bidder. [Calif. Civil Code §2924h]

Before the auction begins, the trustee may:

- demand all prospective bidders show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid. [CC §2924h(b)(1)]

A bidder at auction can tender their bid amount in U.S. dollars in the form of:

- cash;
- a cashier's check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings bank or credit union; or
- a cash equivalent designated by the trustee in the NOTS, such as a money order. [CC §2924h(b)(1)]

Each bid made at a trustee's sale is an irrevocable offer to purchase the property. However, any subsequent higher bid cancels a prior bid. [CC §2924h(a)]

The trustee's sale is considered final on the trustee's acceptance of the last and highest bid. [CC §2924h(c)]

Once the highest bid has been accepted by the trustee, the trustee may require the successful bidder to immediately deposit the full amount of the final bid with the trustee. [CC §2924h(b)(2)]

If the successful bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available. [CC §2924h(c)]

Failure to deliver payment of a bid

If a successful bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the successful bidder a notice of *rescission for failure* of consideration. [CC §2924h(c)]

To hold a new trustee's sale auction, the trustee sets a new trustee's sale date and records, serves and publishes a new NOTS. The new NOTS follows all the same statutory requirements as the original NOTS.

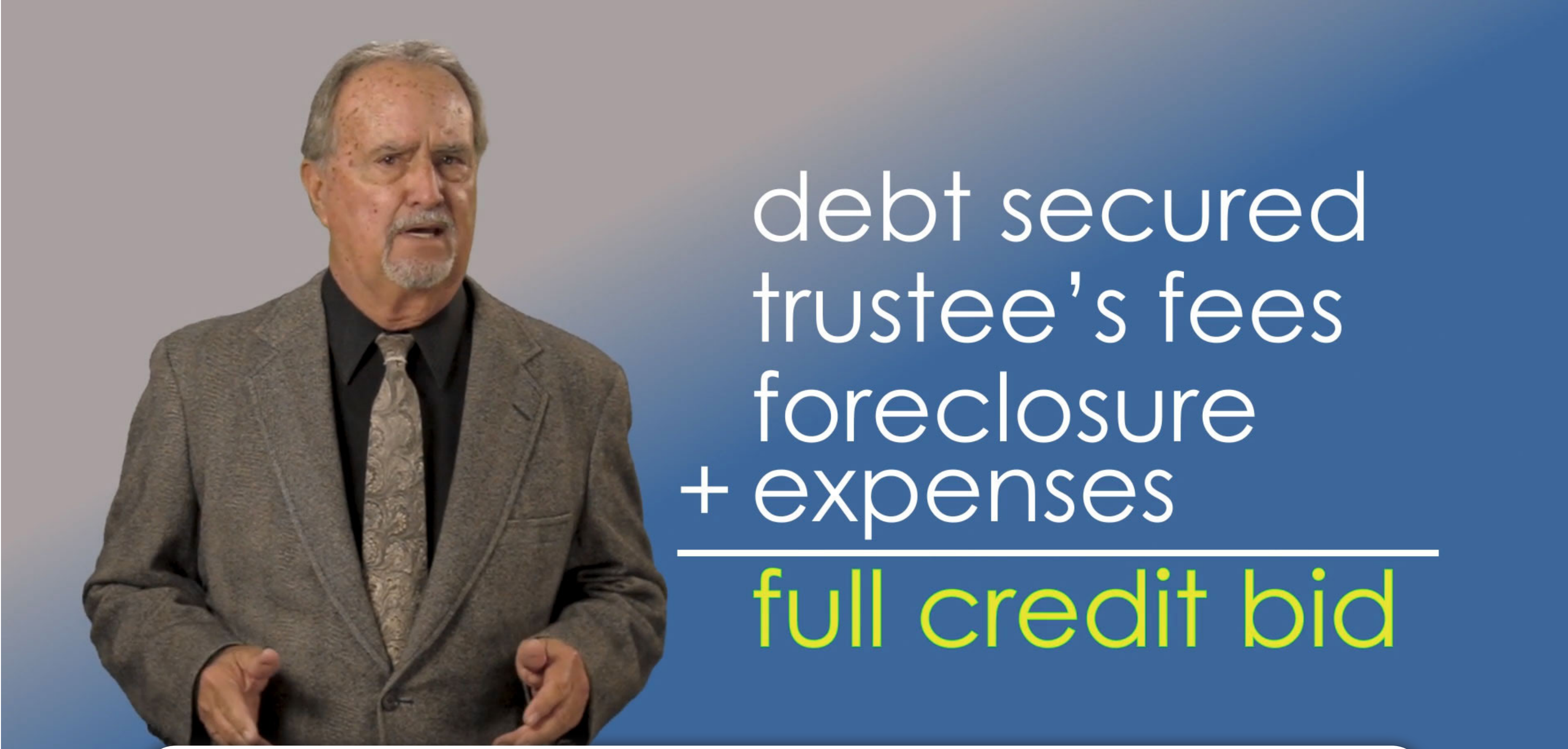
The successful bidder who fails to tender payment when demanded is liable to the trustee for all resulting damages, including:

- court costs;
- reasonable attorney fees; and
- the costs for recording and serving the new NOTS. [CC §2924h(d)]

QUIZ

1. Before the auction begins, the trustee may:
    a. demand all prospective bidders show evidence of their financial ability to pay as a precondition to recognizing their bids.
    b. hold the prospective bidders' amounts to be bid.
    c. Either a. or b.

2. Each bid made at a trustee's sale is a(n) __________ to purchase the property. However, any subsequent higher bid __________ a prior bid.
    a. irrevocable offer; cancels
    b. tentative offer; doubles
    c. revocable offer; legitimizes



Conveyance by a trustee's deed

The mortgage holder is frequently the only bidder at the trustee's sale. Thus, the mortgage holder automatically becomes the successful bidder.

The mortgage holder may bid without tendering funds up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses. This amount is called a **full credit bid**. [CC §2924h(b)(2)]

If the mortgage holder is the successful bidder under a full credit bid, the trustee retains possession of the mortgage holder's note (or other evidence of the mortgaged debt) in exchange for the trustee's deed to the property.

The mortgage holder is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The mortgage holder can bid an amount below the full amount of the debt, called an **underbid**.

On the completion of a trustee's sale, the trustee uses a **trustee's deed** to transfer title to the property on to the successful bidder at the auction.

When a buyer other than the mortgage holder purchases the property for value and without notice of title or trustee's sale defects, the buyer is considered a **bona fide purchaser (BFP)**.

The BFP's interest in the property sold is perfected as of 8 a.m. on the date of the trustee's sale, if the trustee's deed conveying the property to the BFP is recorded:

- within 15 calendar days after the date of the trustee's sale; or

- the next business day following the 15th day after the sale if the county recorder is closed on the 15th day. [CC §2924h(c)]

The title received by the third-party BFP is clear of any interest claimed by the owner, mortgage holders or tenants whose interests are junior to the foreclosed mortgage. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

However, upon completion of the trustee's sale, the new owner needs to honor an existing residential lease if it has a fixed-term. If the home is to be occupied as a principal residence, the new owner may serve the tenant with a *90-day eviction notice*. [CC §2924.8(a)(1); see **RPI** Form 573]

More importantly, title is taken clear of any unrecorded *prior interests* or **claims** in the property held by others not in possession of the real estate. However, to take clear title free of claims, the BFP needs to have no *constructive notice* or actual knowledge of any existing priority claims when acquiring title to the property at the trustee's sale. [CC §§1107, 1214]

A **lis pendens** recorded against the real estate prior to the trustee's sale places bidders on constructive notice of a lawsuit involving a claim to a right in title or to possession of the real estate. If the claim has priority to the foreclosed mortgage, the *lis pendens* destroys the BFP status of the successful bidder.

Surplus funds

Occasionally, the price paid for property by the successful bidder at a trustee's sale exceeds the amount of debt and costs due under the foreclosed mortgage. The excess amounts are called **surplus funds**. [See **RPI** Form 479]

The trustee has a duty to distribute the *surplus funds* to the junior mortgage holders and the owner(s).

The gross proceeds from the trustee's sale are distributed in the following order:

- to pay the costs and expenses of the trustee's sale, including trustee's fees or attorney fees;
- to pay the indebtedness secured by the property in default, including advances made by the mortgage holder;
- to satisfy the outstanding balance of junior mortgage holders of the property, distributed in the order of their priority; and
- to the owner, the owner's successor-in-interest or the vested owner of record at the time of the trustee's sale. [CC §2924k(a)]

QUIZ

1. A bid made by a foreclosing mortgage holder equal to the debt secured by the property being sold plus trustee's fees and foreclosure expenses is referred to as a:

   a. fair market bid.
   b. underbid.
   c. full credit bid.

2. On the completion of a trustee's sale, the trustee uses a _________ to transfer title to the property on to the successful bidder at the auction.

   a. grant deed
   b. sheriff's deed
   c. trustee's deed

Judicial foreclosure and pursuit of the deficiency

When a loan is in default, the mortgage holder's *collection efforts* are limited to judicial or nonjudicial activities, both of which are very structured. If the note evidences a **recourse debt**, the mortgage holder may recover against both the property and the owner as the named borrower, but only if a judicial foreclosure sale takes place.

To initiate a collection effort, the mortgage holder needs to first **exhaust the security** by foreclosing on the security, i.e., the real estate. The mortgage holder's security interest in a property is exhausted when the mortgage holder completes a foreclosure sale on the property. Alternatively, the mortgage holder's security interest may have been wiped out — exhausted — by a senior trust deed holder's foreclosure sale. Thus, the note is now unsecured and the noteholder unable foreclose.

Only when the note evidences a *recourse debt* may the mortgage holder pursue a **money judgment** against the property owner for any deficiency in the property's value to fully satisfy the debt. To obtain a *money judgment*, the holder of a recourse mortgage is limited to using the judicial foreclosure process, or if their security interest has otherwise been exhausted suing directly on the now unsecured recourse note. [Calif. Code of Civil Procedure §726(b)]

A mortgage holder may foreclose on a property and sell it to exhaust their security interest in one of two ways:

- **judicial foreclosure**, under mortgage law, also called a **sheriff's sale** [CCP §725a]; or

- **nonjudicial foreclosure**, under the power-of-sale provision in the trust deed or other security device, also called a **trustee's sale**. [Calif. Civil Code §2924]

Judicial foreclosure is the court-ordered sale by public auction of the secured property. It can take eight months to multiple years to complete a judicial foreclosure.

Alternatively, when a mortgage holder nonjudicially forecloses by a trustee's sale, the property is sold as authorized by the trust deed provisions at a public auction, called a **trustee's sale.** *Trustee's sales* can be completed on property other than a one-to-four unit residential property within four months after a property owner defaults. On average, it takes approximately nine months to nonjudicially foreclose on a one-to-four unit residential property.

Unlike a judicial foreclosure sale, the completion of a trustee's sale bars the foreclosing mortgage holder from obtaining a money judgment for any unpaid balance remaining after the foreclosure sale due to *insufficient value* in the secured property. [CCP §580d]

Trustee's sales are considerably less expensive and quicker than judicial foreclosures. Alternatively, a judicial sale requires the filing of a lawsuit, which includes:

- litigation expenses;
- appraisals; and
- attorney fees.

However, when the value of a mortgaged property drops below the balance owed on a recourse debt, the mortgage holder may elect to foreclose by judicial action. A judicial foreclosure sale allows the holder of a recourse mortgage to obtain a money judgment against the property owner for any deficiency in the value of the mortgaged property at the time of the sale to fully satisfy the recourse debt. [CCP §580d]

QUIZ

1. If a note evidences a(n) __________, the mortgage holder may recover against both the property and the owner as the named borrower under a judicial foreclosure sale.

   a. recourse debt

   b. nonrecourse debt

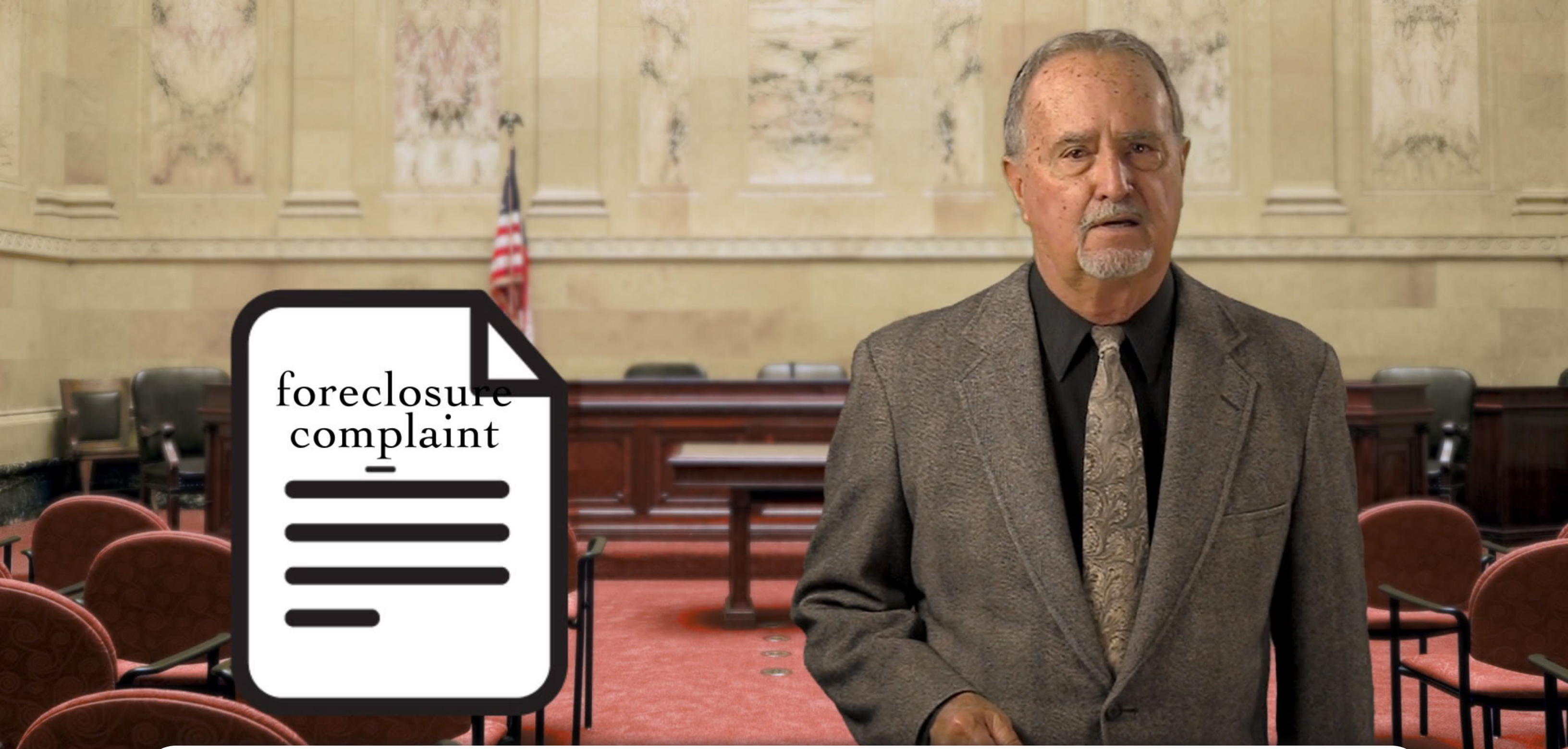
   c. Either a. or b.

2. To initiate a collection effort under a judicial foreclosure, the mortgage holder needs to first:

   a. pursue the borrower for the deficiency through a private court action.

   b. contact all junior mortgage holders to determine whether they'd like to collectively pay off the outstanding debt.

   c. exhaust the security by foreclosing on the real estate.



Suing to foreclose

The first step in the judicial foreclosure process is to file a complaint in the Superior Court of the county where the property is located.

The foreclosure complaint names as defendants the original borrowers named in the mortgage as the trustors. The complaint also names anyone else holding a recorded interest in the secured property junior to the foreclosing mortgage holder's security interest in the property.

The trustee named in the mortgage is not involved in the lawsuit and is not named. A trustee under a mortgage has no interest in the property.

The mortgage holder foreclosing judicially needs to obtain a **litigation guarantee** of title insurance. The *litigation guarantee* lists all parties with a recorded interest in the property and their addresses of record. The guarantee further ensures that persons with a recorded junior interest to the foreclosing mortgage holder in the property are named and served. Thus, when noticed, their junior interest is also eliminated from title by the judicial foreclosure sale.

If a person holding an interest in the property junior to the mortgage holder's trust deed is not named as a defendant, their lien or ownership interest:

- is not affected by the outcome of the foreclosure proceedings; and
- remains of record. [Calif. Code of Civil Procedures §726(c)]

Additionally, when the foreclosing mortgage holder intends to seek a deficiency judgment, the original borrowers need to be named as defendants, whether or not they still hold an interest in the property. [**Hutchison** v. **Barr** (1920) 183 C 182]

At the time the lawsuit is filed, the foreclosing mortgage holder records a **notice of pending action** against title to the mortgaged property, also called a **lis pendens**.

The *lis pendens* places a *cloud on the title* of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests to the results of the litigation.

QUIZ

1. The first step in the judicial foreclosure process is to:

   a. publish as record a notice of default (NOD).

   b. publish, record and serve a notice of public auction (NPA).

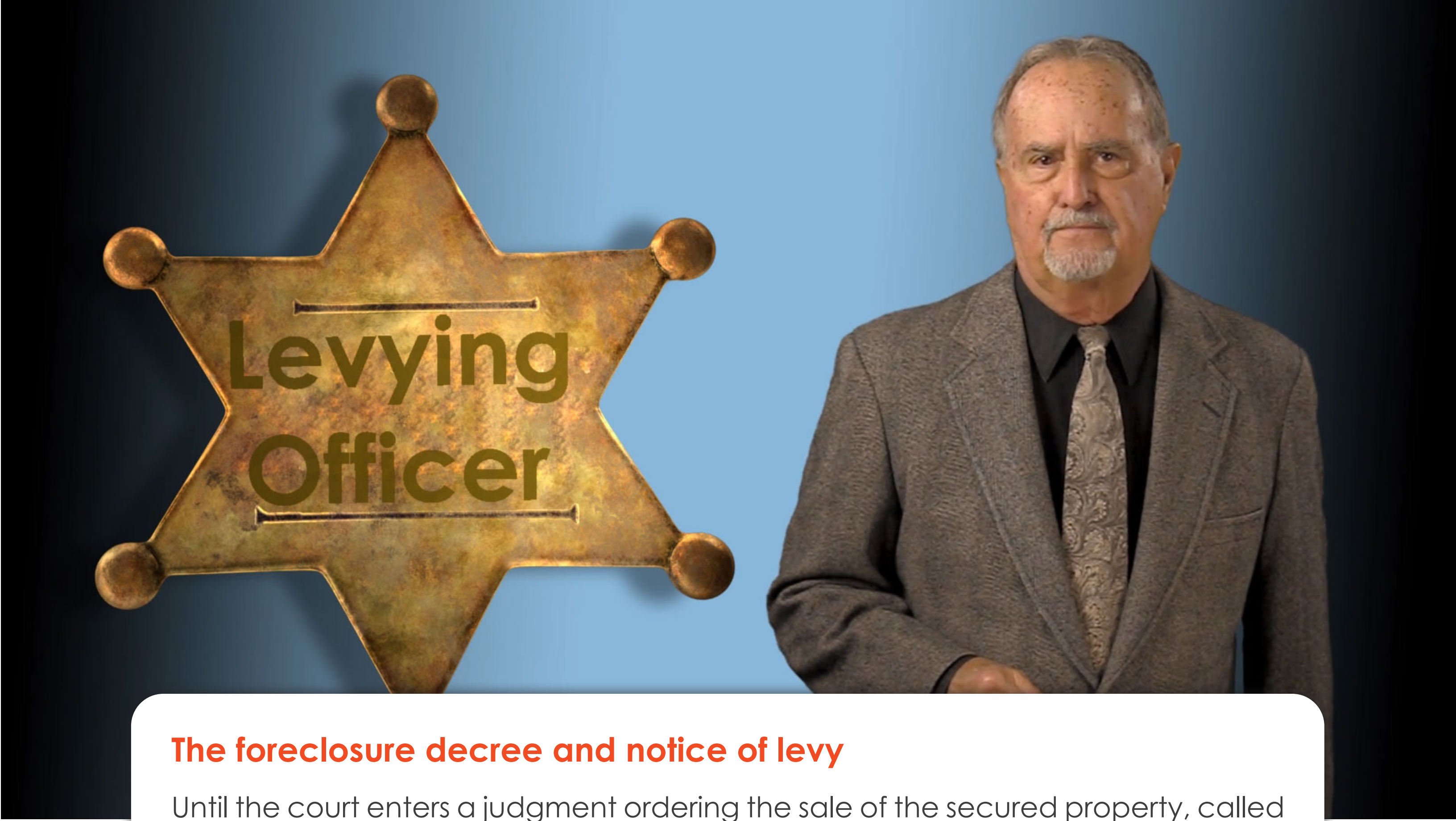
   c. file a complaint in the Superior Court of the county where the property is located.

2. A __________ lists all parties with a recorded interest in the property and their addresses of record, and further ensures that persons with a recorded junior interest to the foreclosing mortgage holder in the property are named and served.

   a. litigation guarantee

   b. trustee's sale guarantee

   c. sheriff's guarantee



The foreclosure decree and notice of levy

Until the court enters a judgment ordering the sale of the secured property, called a **foreclosure decree**, the property owner has the right to bring the delinquencies current, called **reinstatement**. A *foreclosure decree* ends the reinstatement period.

A foreclosure decree orders the sale of the real estate to satisfy:

- the outstanding debt; and
- cover foreclosure-related expenses incurred by the mortgage holder. [Calif. Code of Civil Procedures §726(a), (b)]

The foreclosure decree also states whether the property owner will be held personally liable for any deficiency in the property's **fair market value (FMV)** to satisfy the debt owed. [CCP §726(b)]

Importantly, FMV is never determined by the amount of the high bid at the judicial foreclosure sale.

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a **levying officer**.

After the court decree authorizing the judicial foreclosure sale, the foreclosing mortgage holder is issued a **writ of sale** by the court clerk. In turn, the *writ of sale* authorizes the receiver or sheriff to record a **notice of levy**. Both describe the property to be sold and state the levy is against the security interest the mortgage holder holds in title to the property under its mortgage lien. [CCP §712.010]

The levying officer **records** the writ of sale and the notice of levy in the county where the property is located. They also mail the writ of sale and the notice of levy to the owner and any occupant of the property. [CCP §700.010]

The junior mortgage holder

Before entry of a judicial foreclosure decree, a junior trust deed holder or other mortgage holder also have the right to **reinstate** the note by paying the trust deed delinquencies and foreclosure costs, bringing the trust deed note current.

After entry of a foreclosure decree ordering the property to be sold, the **junior mortgage** holder has until the time the property is sold to the highest bidder at the foreclosure sale to redeem the property by paying all amounts owed on the debt and foreclosure costs. [Calif. Civil Code §2903 et seq.]

Once a property is sold at a judicial foreclosure sale, any liens subordinate to the foreclosing mortgage holder's trust deed are wiped out and eliminated from the title. [Calif. Code of Civil Procedure §§701.630; 729.080(e)]

If the junior mortgage holder does not reinstate the note or purchase the property at the judicial foreclosure sale, and the owner later **redeems the property**, the junior mortgage holder will then be able to recover the amount of their lien, plus interest. [CCP §729.060(b)(5)]

A creditor holding an unrecorded lien not actually known to the foreclosing lender does not need to be named or notified of the judicial foreclosure action to have the unrecorded lien extinguished on completion of a recorded mortgage holder's judicial foreclosure sale. [CCP §726(c)]

If the junior mortgage holder of record is unnamed or unserved in a judicial foreclosure action by the senior trust deed holder, the junior trust deed holder still has an enforceable trust deed after completion of a senior trust deed lender's judicial foreclosure sale.

If the senior mortgage holder is time barred from filing another judicial foreclosure action, a junior trust deed holder of record who was not given notice of the judicial foreclosure action may initiate their own judicial or trustee's foreclosure proceedings to enforce their trust deed. The junior trust deed holder's interest is now senior to the interest of the high bidder at the first mortgage holder's judicial foreclosure sale. [**Little** v. **Community Bank** (1991) 234 CA3d 355]

QUIZ

1. What ends the reinstatement period under a judicial foreclosure?
   a. The court's issuance of a foreclosure decree.
   b. The appointment of a levying officer.
   c. Three months have run from the completion of the foreclosure sale.

2. Once a property is sold at a judicial foreclosure sale, any liens subordinate to the foreclosing mortgage holder's trust deed:
   a. are wiped out and eliminated from the title.
   b. may be reinstated by the owner or any of the junior lienholders during the redemption period.
   c. Either a. or b.

The notice of judicial sale

Similar to the notice of trustee's sale (NOTS) recorded in a nonjudicial foreclosure, the receiver's or sheriff's **notice of judicial sale** states the necessary details of the auction, such as the:

- date;
- time; and
- location of the sale. [Calif. Code of Civil Procedures §701.540(a)]

When a deficiency judgment is sought by the foreclosing mortgage holder, the notice of judicial sale also states:

- the property is being sold subject to the property owner's right of redemption; and
- the amount of the secured debt, plus accrued interest and foreclosure-related costs. [CCP §729.010(b)(1)]

If a money judgment for any deficiency is barred, as occurs with a *nonrecourse debt*, the receiver or sheriff waits at least 120 days after service of the notice of levy before proceeding to notice the judicial sale. [CCP §701.545]

However, if the mortgage holder seeks a deficiency judgment on a *recourse debt*, no waiting period applies before noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the clerk of the court issues the writ of sale. [CCP §729.010(b)(2), (3)] At least **20 days** before the sale, the notice of judicial sale is:

- served on the property owner personally or by mail [CCP §701.540(c)];
- mailed to any person who has recorded a request for a notice of judicial sale [CCP §701.550(a)];
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published once a week for three successive weeks in a local newspaper of general circulation. [CCP §701.540(g)]

Loss mitigation efforts on a consumer mortgage

When a **consumer mortgage** is being foreclosed, the mortgage holder is required to comply with federal mortgage rules under any type of foreclosure proceeding. A property owner subject to foreclosure under a consumer mortgage has the right to submit a complete **loss mitigation application** to the mortgage holder prior to 37 days before a scheduled judicial or nonjudicial foreclosure sale. On receipt of the application, the mortgage holder can't move forward with the foreclosure sale until the following criteria are met:

- the loan servicer sends the property owner a notice informing them they are not eligible for loss mitigation; and
- the property owner either is not eligible to appeal, has not requested to appeal within the time period allowed, or their appeal has been denied; or
- the property owner rejects all loss mitigation possibilities the servicer offers; or
- the property owner did not perform under an agreement on a previously agreed to loss mitigation option. [12 Code of Federal Regulations 1024.41(g)]

QUIZ

1. A __________ states the necessary details of the judicial foreclosure auction, such as the date, time and location of the sale.

   a. notice of trustee's sale (NOTS)

   b. notice of judicial sale

   c. notice of levy

2. If the mortgage holder seeks a deficiency judgment on a recourse debt:

   a. the owner is given a statutory three month extension of the reinstatement period.

   b. the receiver or sheriff needs to wait at least 120 days after service of the notice of levy before proceeding to notice the judicial sale.

   c. the receiver or sheriff may notice the judicial sale immediately after the clerk of the court issues the writ of sale.

Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an auction. The property is sold to the highest bidder. [Calif. Code of Civil Procedures §701.570(b)]

The foreclosing mortgage holder is entitled to make a credit bid up to the full amount of the debt owed to acquire the property at the foreclosure sale. Payment by a successful bidder other than the mortgage holder is made at the time of the public sale:

- in cash;
- by certified check; or
- by a credit transaction as long as the amount is over $5,000, in which case the greater of $5,000 or 10% of the amount bid is due at the time of sale, with the remaining balance plus applicable costs and interest due within ten days after the sale. [CCP §701.590(a), (c)]

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for their failure to pay their bid. [CCP §701.600]

The foreclosing mortgage holder is often the highest — or only — bidder at a judicial sale. When intending to seek a **deficiency judgment**, the mortgage holder needs to **bid no less** than an amount it believes the court will set as the *FMV* of the property.

Any successful bids for less than the property's FMV on the date of the sale will generate an uncollectible loss on the mortgage holder. The loss from a **below market bid** is the spread between the high bid when the owner redeems and the greater FMV. [**Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

A **certificate of sale** is issued to the successful bidder on the completion of a judicial foreclosure sale.

Although the bidder purchased the property at the public auction, they will not become the owner of the property or be able to take possession of it until the applicable **redemption period** expires. [CCP §729.090]

The *certificate of sale* reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder. [CCP §729.020]

QUIZ

1. When intending to seek a deficiency judgment in a judicial foreclosure action, the mortgage holder needs to bid:
    a. the original amount of the principal balance on origination.
    b. no less than an amount it believes the court will set as the fair market value (FMV) of the property.
    c. greater than the amount it believes the court will set as the FMV of the property to create collectable loss.

2. A__________ is issued to the successful bidder on the completion of a judicial foreclosure sale.
    a. trustee's deed
    b. bill of sale
    c. certificate of sale

Redemption follows foreclosure

On a judicial foreclosure of a purchase-assist mortgage secured by a buyer-occupied one-to-four unit residential property, or a seller carryback note secured solely by the property sold no matter its use, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt [Calif. Code of Civil Procedure §580b]; and
- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs. [CCP §729.030(a)]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property. [CCP §729.030(b)]

The property can only be redeemed by the owner or the owner's **successor-in-interest** since all junior mortgage holders are wiped out, leaving no remaining rights in the property.

Successors-in-interest to the owner include any person who acquires the owner's interest in the property by deed prior to the judicial foreclosure sale. [CCP §729.020;]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bidder at the judicial foreclosure sale (even if the amount is less than the property's FMV on that date);
- taxes, assessments, insurance premiums, upkeep, repair or improvements

to the property paid by the successful bidder; and

- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full. [CCP §729.060]

On redemption, the owner (or successor) is entitled to:

- an offset for any net rents collected by the mortgage holder under an assignment of *rents provision* in the mortgage; and
- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale. [CCP §§729.060, 729.090]

If the owner or successor does not redeem the property within the redemption period, the sale is final and the high bidder is entitled to possession. [CCP §729.080]

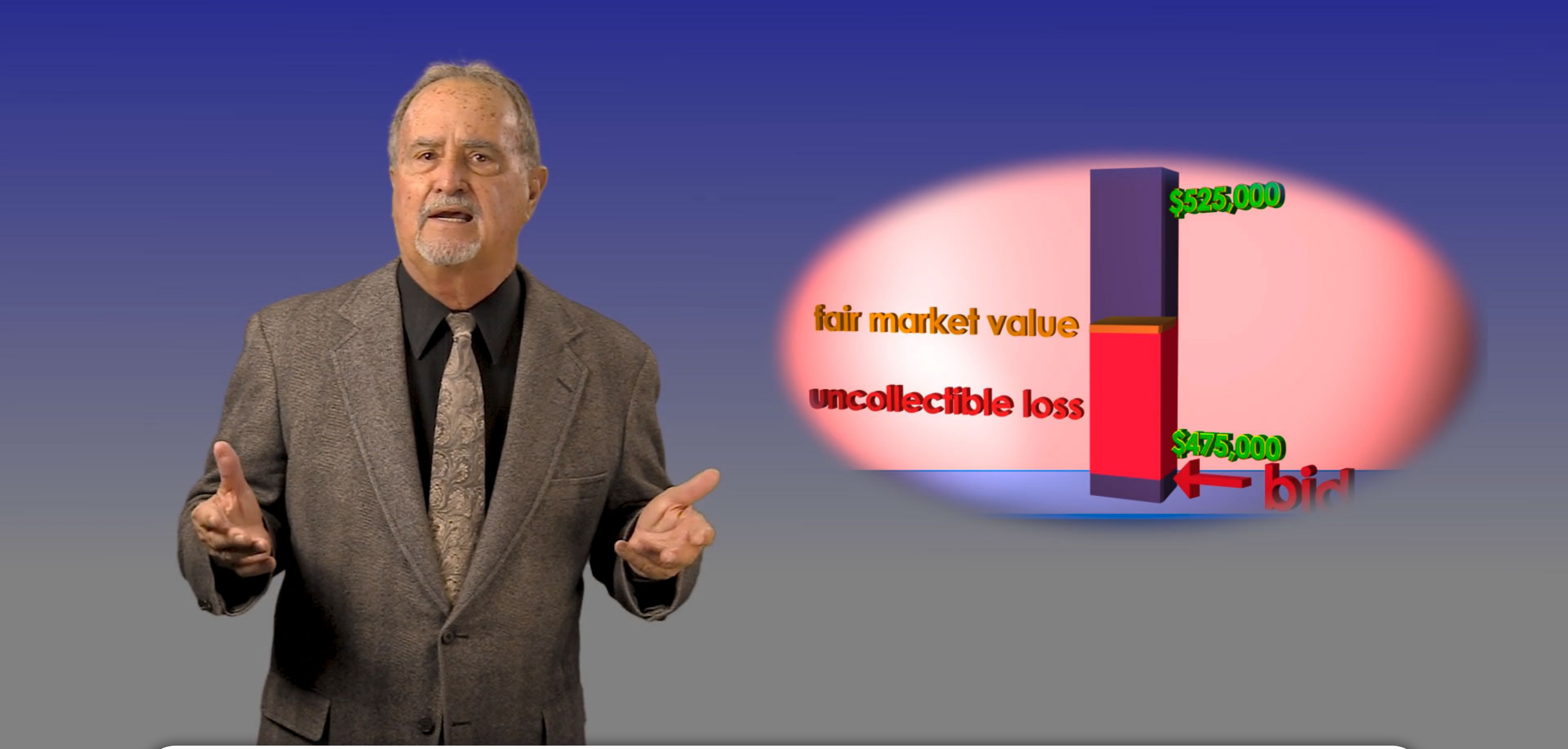
QUIZ

1. If an owner is liable for a deficiency in the property's value on a recourse debt and the mortgage forecloses judicially, the owner has up to ___________ after the judicial sale to redeem the property.

   a. 20 days
   b. three months
   c. one year

2. The redemption price for the owner or successor to recover the property sold at a judicial foreclosure sale is the total of the price paid for the property by the highest bidder at the judicial foreclosure sale plus:

   a. taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder.
   b. interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full.
   c. Both a. and b.



Obtaining a deficiency judgment

The remaining balance owed on a mortgage may be greater than the *fair price* of the mortgage holder's security interest in the real estate. The spread when the fair price is lower than the balance due is the *deficiency* in the value of the property to cover the debt.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by **anti-deficiency** statutes as a nonrecourse debt. This is referred to as a **deficiency judgment**.

The mortgage holder holding a recourse mortgage will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At a **fair value hearing**, noticed within three months after the foreclosure sale, the amount of the deficiency is set by the court. [Calif. Code of Civil Procedures §§580a, 726(b)]

The amount awarded as a deficiency judgment is based on the debt owed on the date of the judicial foreclosure sale, and the greater of:

- the fair market value (FMV) of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the mortgage being foreclosed, the result setting the *fair price* of the mortgage holder's security interest in the property; or
- the amount bid for the property at the judicial foreclosure sale. [CCP §580a]

The mortgage holder is awarded a money judgment for the portion of the debt not covered by the fair price of the mortgage holder's secured position on title, or the price bid at the sale if it is higher.

The mortgage holder and property owner present evidence at the fair value hearing to establish the property's FMV on the date of the foreclosure sale. The court may appoint an appraiser, called a **probate referee**, to advise the court on the property's FMV. [CCP §§580a, 726(b)]

QUIZ

1. A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes as a nonrecourse debt. This is referred to as a(n):

   a. abstract of judgment.

   b. confession of judgment.

   c. deficiency judgment.

2. Within three months after the foreclosure sale, the amount of the deficiency is set by the court in a(n):

   a. sheriff's valuation decision.

   b. fair value hearing.

   c. Either a. or b.

The Tenancies in Real Estate

Tenancies as leasehold estates

Different types of tenancies and properties trigger different termination procedures for the landlord, and different rights and obligations for the tenant.

Leasehold estates, or tenancies, are possessory interests in real estate. Four types of **tenancies** exist:

- *fixed-term tenancies;*
- *periodic tenancies;*
- *tenancies-at-will*; and
- *tenancies-at-sufferance*, also called *holdover tenancies.*

To initially establish a tenancy, a landlord transfers to the tenant the right to occupy the real estate. This right is conveyed either in a writing, orally or by the landlord's conduct, called a grant. If the landlord does not transfer by grant the right to occupy, the person who takes possession as the occupant is a **trespasser**.

Fixed-term tenancies, periodic tenancies and tenancies at will have agreed-to termination dates, or can be terminated by notice.

A *holdover tenancy* occurs when a tenant continues in possession of the property after their right to occupy has expired. This holdover of possession without a contractual right is called an unlawful detainer (UD).

A landlord needs to file a judicial *UD* action to have a **holdover tenant** evicted. To be evicted, a tenant's right of possession under the tenancy granted is to first be terminated either by service of the proper notice or expiration of the lease. Plainly speaking, the tenant needs to unlawfully retain possession of the property before the tenant can be evicted for unlawful detainer.

The type of notice required to terminate a tenancy, other than a fixed-term lease, depends on the period of the tenancy, length of the occupancy and location of the property (e.g., rent control). [**Colyear** v. **Tobriner** (1936) 7 C2d 735]

QUIZ

1. When a landlord does not transfer the right to occupy a property to a person by grant, the person who takes possession as the occupant is classified as a(n):

   a. short-term tenant.

   b. trespasser.

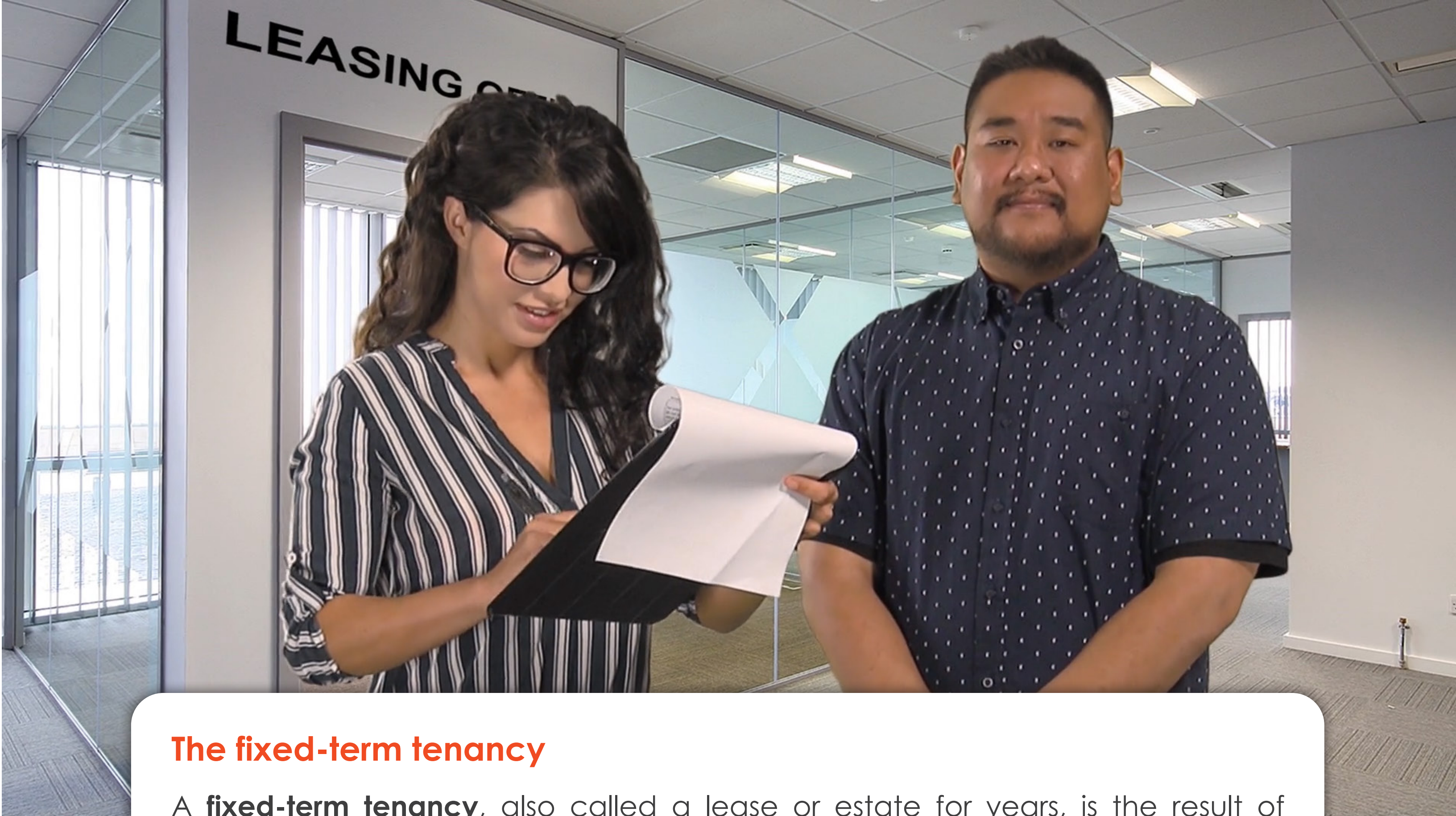
   c. subtenant.

2. A holdover of possession of real estate without a contractual right to do so is most accurately called a(n):

   a. trespass.

   b. nuisance.

   c. unlawful detainer (UD).



The fixed-term tenancy

A **fixed-term tenancy**, also called a lease or estate for years, is the result of an agreement between the landlord and the tenant for a fixed rental period, also called the lease term. If the rental period is longer than one year, the lease arrangement is required to be in writing and signed by the tenant to be enforceable under the Statute of Frauds.

The written document which sets the terms for rent and conditions for occupancy creating a fixed-term tenancy is called a **lease agreement**. **[**See **RPI** Form 550]

A *lease agreement* is required to have a commencement date and an expiration date. [Calif. Civil Code §§761, 1624]

During the term of the lease, the tenancy can only be terminated and the tenant evicted for good cause. Even then, service of a three-day notice to vacate the property (or if curable to cure the breach) is required. [See **RPI** Form 576]

Editor's note – Different eviction rules apply if the property is subject to Just Cause eviction requirements. This content will be covered in a subsequent section.

Without the tenant's exercise of any option to renew or extend, a fixed-term tenancy automatically terminates on the expiration date, no notice required. [Calif. Code of Civil Procedures §1161(1)]

If a renewal or extension option exists, the lease is renewed or extended by the tenant's exercise of the option or the landlord's acceptance of rent called for in the option. [CC §1945]

A fixed-term tenancy provides a tenant with several advantages:

- the right to occupy for the fixed term;
- a predetermined rental amount; and
- limitations on termination or modification.

However, a fixed-term tenancy also has disadvantages for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (less rent paid by any replacement tenant located by the landlord to mitigate losses);
- the tenant may not vacate prior to expiration of the rental period; and
- the tenant may not assign or sublet the premises to a new tenant if prohibited by provisions in the lease agreement.

QUIZ

1. A lease agreement is required to have:

   a. a commencement date.

   b. an expiration date.

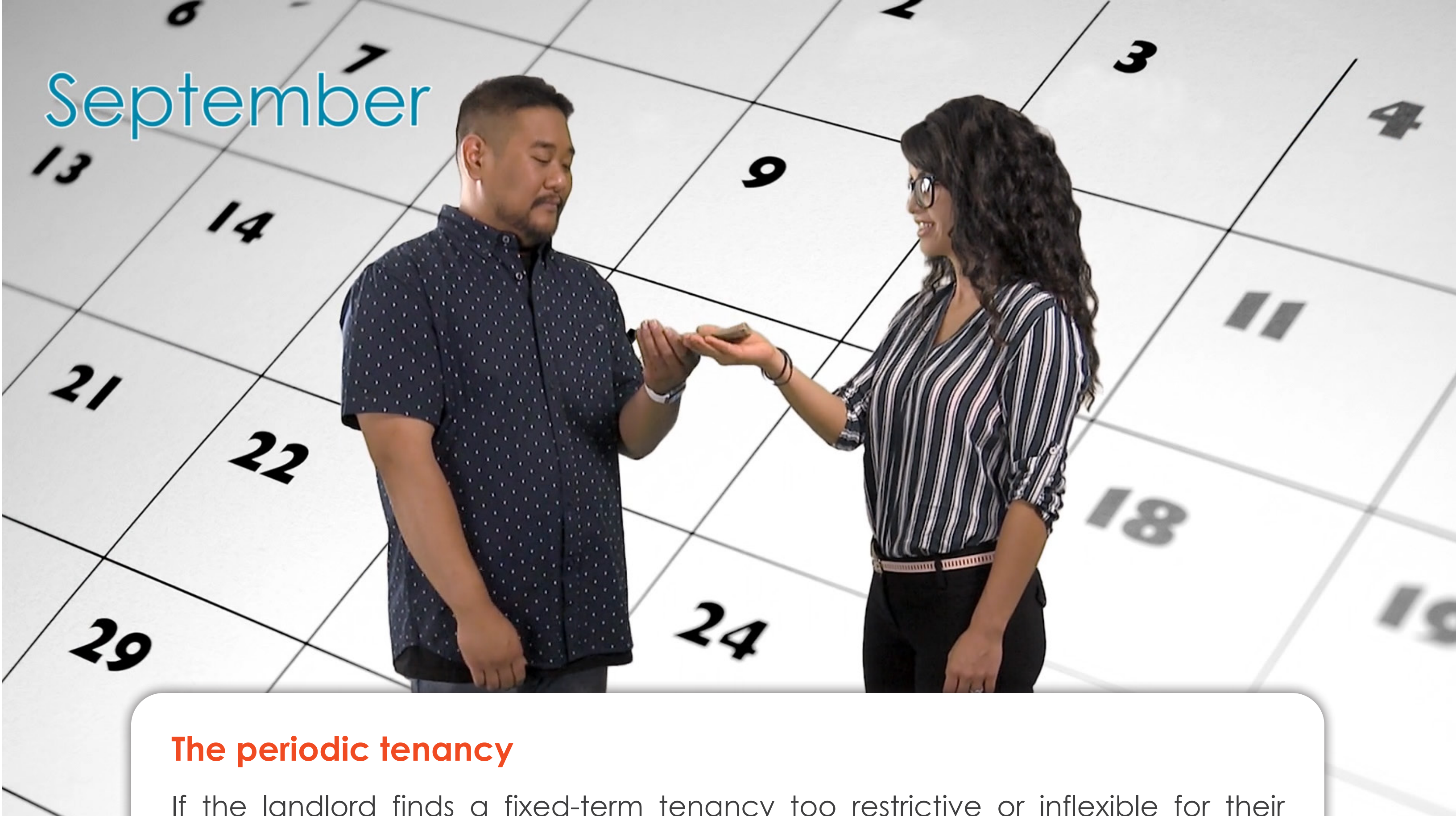
   c. Both a. and b.

2. Without the tenant's exercise of any option to renew or extend, a fixed-term tenancy:

   a. automatically terminates on the expiration date, no notice required.

   b. terminates on the tenant's service of a 30-day notice to vacate in advance of the expiration date.

   c. terminates on the landlord's service of a 60-day notice to vacate in advance of the expiration date.



The periodic tenancy

If the landlord finds a fixed-term tenancy too restrictive or inflexible for their requirements, a **periodic tenancy** may be more suitable.

A periodic tenancy is automatically extended for equal, successive periods of time, such as a week or a month, until terminated by notice. The length of each successive period of time is determined by the interval between scheduled rental payments.

Examples of periodic payment intervals include:

- **annual** rental payments, indicating a year-to-year tenancy;
- **monthly** rental payments, indicating a month-to-month tenancy; and
- **weekly** rental payments, indicating a week-to-week tenancy.

A periodic tenancy is intentionally created by a landlord and tenant entering into a *rental agreement*. A rental agreement is the agreement which sets the terms for payment of rent and conditions for possession under a periodic tenancy. [See RPI Form 551]

A periodic tenancy can also result due to possession under a defective lease agreement. A tenant who takes possession under an unenforceable lease agreement (e.g., oral, or unsigned) and pays rent in monthly intervals that the landlord accepts has entered into a month-to-month periodic rental agreement.

A periodic tenancy continues until terminated by a notice to vacate. This right to terminate a month-to-month tenancy by either the landlord or the tenant giving the other a notice to vacate makes a periodic tenancy flexible. [**Kingston** v. **Colburn** (1956) 139 CA2d 623; Calif. Civil Code §1946]

To terminate a periodic tenancy, the notice period is to be at least as long as the interval between scheduled rental payments, but need not exceed 30 days. A residential property exception exists: a 60-day notice is required to terminate a periodic tenancy in a dwelling if the tenant has occupied the property for more than 12 months. [CC §1946.1; see **RPI** Form 569-1]

On a material breach of the rental agreement, a three-day notice to vacate can also be used to terminate a periodic tenancy. [See **RPI** Form 577]

*Editor's note – Additional rules for terminating a tenancy may apply if the property is subject to "just cause" eviction requirements under the **Tenant Protect Act**. This will be covered in a later section.*

QUIZ

1. A periodic tenancy:
    a. needs to be in writing to be enforceable under the Statute of Frauds.
    b. is automatically terminated on the expiration date, no notice required.
    c. is automatically extended for equal, successive periods of time until terminated by notice.

2. To terminate a periodic tenancy, the notice period initiated by either the landlord or tenant is to be:
    a. at least 30 days.
    b. at least 60 days.
    c. at least as long as the interval between scheduled rental payments.

A closer look at a tenancy-at-will

Fixed-term and periodic tenancies are the most common type of leasehold estates. But there are others, such as a **tenancy-at-will**, also known as an **estate at will**.

The characteristics of a *tenancy-at-will* include:

- the tenant possesses the property with the landlord's knowledge and consent, frequently after the termination of a lease;
- possession is provided for an indefinite and unspecified period of time;
- there is no underlying rental or lease agreement, or the agreement has expired; and
- there is no provision for the payment of rent.

A common example of a *tenancy-at-will* is when a family member allows another family member to live in their property without any type of agreement whatsoever and without paying any rent.

This meets all the criteria: possession is mutually agreed to, possession is indefinite, there is no underlying agreement documenting the arrangement, and the family member does not pay rent to the other family member.

Situations giving rise to a tenancy-at-will include:

- when a tenant is granted the right to indefinitely occupy the property in exchange for services rendered [**Covina Manor Inc.** v. **Hatch** (1955) 133 CA2d Supp. 790; see **RPI** Form 591];

- when a tenant is given possession of property under an unenforceable lease agreement (e.g., a written lease not signed by either party or on terms orally agreed to) — unless rent is accepted which creates a periodic tenancy [**Psihozios** v. **Humberg** (1947) 80 CA2d 215]; or
- when a tenant is given possession of the property while lease negotiations regarding the rent amount are still in progress and rent is not accepted. [**Miller** v. **Smith** (1960) 179 CA2d 114]

For a tenancy-at-will, a written three-day notice to pay rent or quit is all that is required to implement any change in the right to continue to occupy the premises – for instance, change it to a different kind of tenancy or terminate the tenancy. Contrast this with the more onerous notice requirements for terminating a periodic tenancy.

Relatedly, a *tenancy-at-will* situation often presents itself in the context of a **resident manager** whose right to occupy a property is granted in exchange for providing property management services.

QUIZ

1. A common example of a(n) __________ is when a family member allows another family member to live in their property without any type of agreement whatsoever and without paying any rent.

   a. holdover tenancy
   b. tenancy-at-sufferance
   c. tenancy-at-will

2. Under a tenancy-at-will:

   a. possession is not agreed to in advance, the tenancy is documented by an expired lease agreement and the tenant holds no option to renew or extend the duration of the possession.
   b. the tenant's use has to be open, hostile and uninterrupted for a period greater than five years.
   c. possession is mutually agreed to, possession is indefinite and there is no underlying agreement documenting the arrangement.

The holdover tenancy

When a fixed-term or periodic tenancy terminates by prior agreement or notice, the tenant who remains in possession unlawfully detains the property from the landlord. Likewise, a tenant-at-will who receives the appropriate notice to vacate and who remains in possession of the property also unlawfully detains the property. These scenarios create a tenancy-at-sufferance, commonly referred to as a **holdover tenancy**.

A holdover tenancy also arises on termination of a resident manager when the resident manager's compensation includes the right to occupy a unit rent-free. When the landlord terminates the employment and the resident manager fails to vacate immediately, the resident manager unlawfully detains the premises as a holdover tenant. [**Karz** v. **Mecham** (1981) 120 CA3d Supp. 1; see **RPI** Form 591]

A **holdover tenant** retains possession of the premises without any contractual right to do so. Their tenancy has been terminated. Thus, the landlord is not required to provide a holdover tenant with any additional notice prior to commencing **eviction** proceedings. [Calif. Code of Civil Procedures §1161]

A *holdover tenant* no longer owes rent under the expired lease or terminated rental agreement since they no longer have the right of possession. However, the rental or lease agreement usually includes a **holdover rent** provision which calls for a penalty rate of daily rent owed for each day the tenant holds over.

If the rental or lease agreement does not contain a *holdover rent* provision, the tenant owes the landlord the reasonable rental value of the property. This is a daily rate owed for each day the tenant holds over. [See **RPI** Form 550]

Holdover rent is not due and is not to be collected by the landlord until the tenant vacates or is evicted under an **unlawful detainer (UD)** action. On vacating, the holdover period is known and the amount owed can be determined, demanded and collected. If it is not paid on demand, rent can be collected by deducting it from any security deposit or obtaining a money judgment.

But a caution to landlords: acceptance of any holdover rent prior to a tenant vacating or being evicted by a UD action has unintended consequences.

QUIZ

1. Which scenario creates a tenancy-at-sufferance?

   a. When a fixed-term tenancy terminates by prior agreement and the tenant remains in possession without the consent of the landlord.

   b. When a tenant-at-will receives the appropriate notice to vacate and remains in possession without the consent of the landlord.

   c. Both a. and b.

2. Most rental or lease agreements include a(n) __________ which calls for a penalty rate of daily rent owed for each day the tenant holds over.

   a. holdover rent provision

   b. liquidated damages provision

   c. attornment clause

Changing the type of tenancy

A landlord, by using a proper notice, can create a different tenancy relationship from the one they initially conveyed to the tenant. A tenant's possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice;
- expiration of a lease; or
- by conduct.

A classic example involves a change in the type of tenancy which arises when a holdover tenant becomes a month-to-month (periodic) tenant.

A landlord who accepts any rent from a holdover tenant under an expired lease has elected by their conduct to treat the continued occupancy as a periodic tenancy. [**Peter Kiewit Sons Co.** v. **Richmond Redevelopment Agency** (1986) 178 CA3d 435]

Thus, the prerequisite to a UD eviction is the service of a proper notice to vacate on the holdover tenant who paid rent for the continued occupancy, rent the landlord accepted to create a periodic tenancy. [**Colyear v. Tobriner (1936) 7 C2d 735]**

If a landlord accepts rent from a holdover tenant after a fixed-term tenancy expires, the expired lease agreement is renewed on the same terms except for the period of occupancy, which is now periodic. [Calif. Civil Code §1945]

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not renew the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — hence, one month if rent is paid monthly. [Calif. Civil Code §1945]

A landlord who wants to terminate a periodic tenancy they created by accepting rent after expiration of a lease needs to serve the tenant with the proper notice to vacate and let it expire. On expiration of the notice, the tenant who remains in possession of the premises is unlawfully detaining the premises and the landlord may file a UD action to evict them.

Transient occupants and their removal

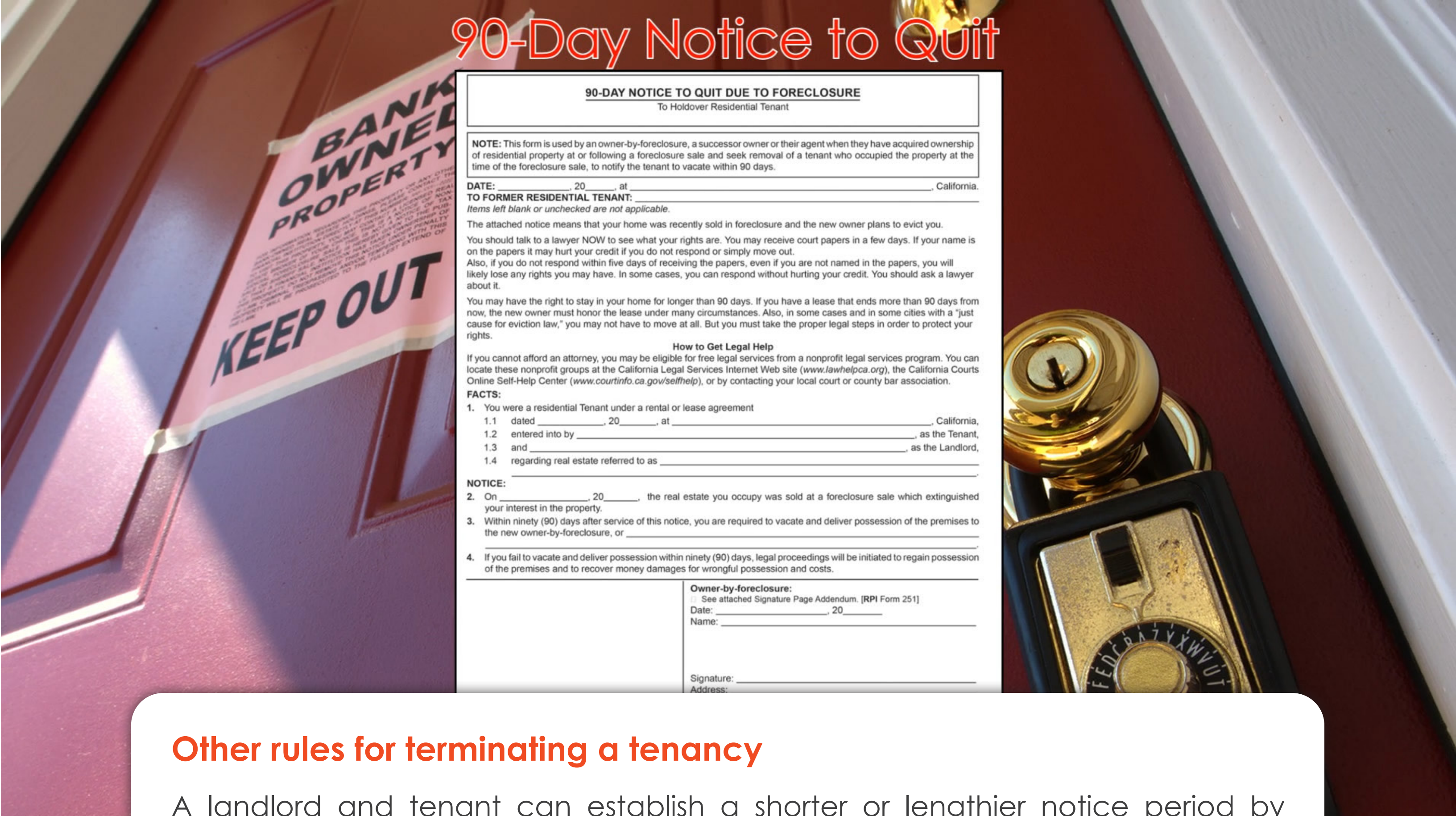
Another type of occupancy is to be differentiated from the leasehold interests discussed in this course. **Transient occupancy** is the occupancy of a vacation property, hotel, motel, inn, boarding house, lodging house, tourist home or similar sleeping accommodation for a period of 30 days or less. This type of occupant is classified as a *guest*, also called a *transient occupant*.

A transient occupant occupies property known as lodging, accommodation or unit, not space or premises. The property is not called a rental. The term "rental" implies a landlord/tenant relationship exists. Further, landlord/tenant law does not control *transient occupancy*.

QUIZ

1. A landlord who accepts any rent from a holdover tenant under an expired lease has elected by their conduct to treat the continued occupancy:
   a. as an unlawful holdover.
   b. as a periodic tenancy.
   c. as a fixed-term lease which runs for one year commencing on the date the landlord accepts payment.

2. On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments:
   a. renews the tenancy for another term equal to the term of the original lease.
   b. does not renew the tenancy for another term equal to the term of the original lease.
   c. creates an automatic holdover tenancy which may only be corrected by an unlawful detainer (UD) action.



Other rules for terminating a tenancy

A landlord and tenant can establish a shorter or lengthier notice period by agreement. However, the notice period cannot be less than seven days.

Other specialized rules exist for different types of properties and situations. For example, in a rent-controlled tenancy, terminating the right of possession is restricted by local ordinances.

In a tenancy-at-will in a mobile home park, the tenant needs to be given a 60-day written notice. [Calif. Civil Code §798.55(b)]

Industrial and commercial tenants typically require three months minimum notice due to the time spent receiving and responding to a notice since it goes through multiple tiers of corporate management before a decision can be made. [CC §1946]

In some instances, an extended 90-day notice is required to terminate residential tenancies in foreclosed properties.

Terminating a tenancy under the Tenant Protection Act (ACT)

The **Tenant Protection Act (TPA) of 2019** made several significant changes to the rights of landlords and tenants of targeted properties including:

- **capping annual rent increases** at 5% plus the rate of inflation for much of California multi-unit residential properties; and
- requiring **"just cause" to evict** tenants in place for 12 months or more.

Requiring a just cause for eviction makes it harder for landlords to evict tenants in order to rent out their properties to new tenants at a higher rate. Further, if a tenant is being evicted at no fault of their own, the landlord may also be required to provide modest financial **relocation assistance**.

The changes enacted will be effective until they are repealed on January 1, 2030. [Calif. Civil Code §1946.2(j)]

The applicability of the TPA is comprehensive, covering most multi-unit residential real estate housing in California and **single family residential (SFR)** units owned by a real estate investment trust (REIT), a corporation or a limited liability company (LLC) in which at least one member is a corporation. However, there are numerous, sizable exemptions for multi-family units and conditions for SFRs to be excluded.

Multi-unit residential real estate **exempt** from "just cause" eviction procedures include:

- residential units that have been issued a certificate of occupancy within the previous 15 years;
- a duplex of which the owner occupied one of the units as their principal residence at the beginning of the tenancy and remains in occupancy;
- units restricted as affordable housing for households of very low or moderate income, or subject to an agreement that provides subsidies for affordable housing for households of very low, low, or moderate income;
- dormitories constructed and maintained in connection with any higher education institution in California;
- units subject to rent or price control that restricts annual increases in the rental rate to an amount less than that set by the TPA;
- multi-unit transient occupancy housing like hotels and motels;
- accommodations in which the tenant shares kitchen or bathroom facilities with an SFR owner-occupant;
- SFR real estate that can be sold and conveyed separate from the title to any other dwelling unit, like in an SFR subdivision or condominium project, provided:
    - the owner is not one of the following:
        - a real estate investment trust (REIT);
        - a corporation; or
        - a limited liability company (LLC) in which at least one member is a corporation; and
    - the tenant has been given written notice stating the rental

property is exempt from the rent increase caps under the TPA. [CC §1947.12(d); CC §1946.2(e); see **RPI** Form 550, 551 and 550-3]

To notify the tenant of the property's exempt status from the TPA, the landlord uses a **checkbox** in the rental or lease agreement to indicate whether the property is subject to just cause eviction requirements.

When a residential property or tenancy does not meet any of the criteria for exemption, the landlord is to abide by the TPA limiting their ability to increase the rent or evict a tenant to regain possession.

QUIZ

1. Though a landlord and tenant can establish a shorter or lengthier notice period by agreement, the notice period cannot be less than:

   a. 30 days.

   b. two weeks.

   c. seven days.

2. A(n) __________ is required to terminate residential tenancies in foreclosed properties.

   a. 30-day notice

   b. 60-day notice

   c. 90-day notice

Tenant improvements

Tenant Leasehold Improvements

Ownership rights when a tenant vacates

Tenant improvements are improvements made to a leased property to meet the needs of the occupying tenant.

Consider a retail business owner who enters into a commercial lease agreement to occupy commercial space as a tenant. The leased premises do not contain **tenant improvements (TIs)** since the building is nothing more than a shell. [See **RPI** Form 552 through 552-4]

The tenant agrees to make all the tenant improvements needed to occupy the premises and operate a retail business (i.e., interior walls, flooring, ceilings, air conditioning, electrical outlets and lighting, plumbing, sprinklers, telephone and electronic wiring, etc.).

The lease agreement provides for the property to be delivered to the landlord on expiration of the lease "in the condition the tenant received it," less normal wear and tear. However, no lease provision addresses whether, on expiration of the lease, the TIs will remain with the property or the property is to be restored by the tenant to its original condition before the addition of the tenant improvements.

On expiration of the lease, the tenant strips the premises of all of the tenant improvements they placed on the property and vacates. The building is returned to the landlord in the condition it was found by the tenant: an empty shell, less wear and tear. To relet the space, the landlord replaces nearly all the tenant improvements that were removed.

Is the tenant liable for the landlord's costs to replace the tenant improvements removed by the tenant on vacating?

Yes! Improvements made by a tenant that are permanently affixed to real estate become part of the real estate to which they are attached. Improvements remain with the property on expiration of the tenancy, unless the lease agreement provides for the tenant to remove the improvements and restore the property to its original condition. [Calif. Civil Code §1013]

However, the landlord's right to improvements added to the property and paid for by the tenant depends upon whether:

- the tenant improvements are permanent (built-in) or temporary (free-standing); and
- the lease agreement requires the tenant to remove improvements and restore the premises.

All improvements attached to the building become part of the real estate, except for trade fixtures as discussed in a later section. [CC §660]

Examples of improvements that become part of the real estate include:

- **built-ins** (i.e., central air conditioning and heating, cabinets and stairwells);
- **fixtures** (i.e., electrical and plumbing);
- **walls, doors and dropped ceilings**; and
- **attached flooring** (i.e., carpeting, tile or linoleum).

In most circumstances, improvements attached to the building become part of the real estate. However, there are critical exceptions.

Improvements that are unique to the operation of the tenant's business are called **trade fixtures**. Trade fixtures are retained by the tenant on expiration of the lease. They are also known as **trade improvements**.

QUIZ

1. In most circumstances, improvements attached to the building:

   a. become part of the real estate, except for fixtures.

   b. become part of the real estate, except for trade fixtures.

   c. do not become part of the real estate and are to be taken by the tenant when they vacate.

2. Which of the following improvements would not become part of the real estate on expiration of a lease?

   a. central air conditioning and heating, cabinets and stairwells.

   b. hair washing stations, mirrors and salon chairs.

   c. walls, doors and dropped ceilings.

Leasehold improvement provisions and promises

Commercial lease agreements typically contain a **further-improvements provision** allowing the landlord to either:

- retain tenant improvements and alterations made by the tenant; or
- require restoration of the property to its original condition on expiration of the lease. [See **RPI** Form 552]

Further-improvement provisions usually include clauses stating:

- who will make the construction of improvements (landlord or tenant);
- who will pay for the construction of the improvements (landlord or tenant);
- the landlord's consent is required before the tenant makes improvements;
- any *mechanic's liens* due to improvements contracted by the tenant will be removed by the tenant;
- the condition of the premises on expiration of the lease; and
- whether and on what conditions the improvements are to remain or be removed on expiration of the lease.

Improvements promised

A landlord under a lease agreement who agrees to make improvements to the rented premises is required to complete the improvements in a timely manner. If the landlord fails to make timely improvements, the tenant may cancel the lease agreement. [See **RPI** Form 552 §10]

Conversely, lease agreement provisions can obligate a tenant to construct or install improvements on the property. The time period for commencement and completion is agreed to in the lease agreement. If not agreed to, a reasonable period of time is allowed. [Calif. Civil Code §1657]

Further-improvement provisions typically call for the landlord to approve the planned improvements before construction is commenced. Alternatively, some lease agreement provisions allow a tenant to make necessary improvements without the landlord's further consent. These improvements are not specifically mandated, or required to be completed in exchange for a reduction in rent. This non-mandatory type of improvement is called a **permissive improvement**.

Surrender of improvements

All tenant improvements are to remain with the leased property on termination of a lease unless the lease agreement permits or mandates their removal by the tenant as a restoration of the premises.

Most lease agreements merely provide for the property to be returned in *good condition*, minus ordinary wear and tear for the years of the tenant's occupancy. Thus, the tenant is not required to restore the property to its actual condition when they took possession since tenant improvements are part of the real estate.

A provision calling for the tenant's *ordinary care* of the premises does not also require the tenant to remove their improvements or renovate the premises to eliminate deterioration, obsolescence or normal wear and tear caused by the tenant's permitted use of the property. [**Kanner v. Globe Bottling Co. (1969) 273 CA2d 559**]

If a lease does not require the tenant to restore the property to the condition it was in when received, the tenant may only remove their personal improvements, called **trade improvements** or **trade fixtures**.

QUIZ

1. Non-mandatory improvements which are not specifically required to be completed in exchange for a reduction in rent are an example of a(n):
   a. permissive improvement.
   b. mandatory improvement.
   c. compulsory improvement.

2. The majority of lease agreements provide for a property to be returned:
   a. in perfect condition, with all evidence of the tenant's use for the duration of their occupancy corrected.
   b. in good condition, minus ordinary wear and tear for the years of the tenant's occupancy.
   c. in any condition, minus defects which render the property uninhabitable for future tenants.

Real estate fixtures vs. trade fixtures

Two types of fixtures exist distinguishing improvements installed in a building:

- **real estate fixtures**; and
- **trade fixtures**.

A real estate fixture is personal property that is attached to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property. [Calif. Civil Code §§660; 1013]

For example, if a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall, the bookshelves become part of the improvements located on the real estate.

When the lease expires, real estate fixtures become the landlord's property. The landlord takes possession of the real estate fixtures as part of the real estate forfeited or surrendered to the landlord, unless the lease agreement provides for restoration or permits removal by the tenant. The conveyance of real estate fixtures from tenant to landlord on expiration of the lease is called **reversion**. [**City of Beverly Hills v. Albright (1960) 184 CA2d 562]**

Conversely, *trade fixtures* do not revert to the landlord on expiration of the lease. A trade fixture is an improvement that is attached to the real estate by the tenant and is unique to the operation of the tenant's business, not the use of the building.

Consider a tenant who leases property to operate a beauty salon. The tenant moves in work-related furnishings (i.e., mirrors, salon chairs, wash stations and dryers), necessary to run the business. The items are attached to the floor, walls, plumbing and electrical leads.

On expiration of the lease, the tenant removes the fixtures that were used to render the services offered by the business. The landlord claims the fixtures are improvements to the property and cannot be removed since they became part of the real estate when installed.

However, furnishings unique to the operation of a business are considered trade fixtures even though the furnishings are attached and built into the structure. Trade fixtures are removable by the tenant.

A tenant may, at the end of or anytime during the lease term, remove any fixture used for trade purposes if the removal can be done without damaging the premises. [**Beebe v. Richards (1953) 115 CA2d 589]**

Fixtures that have become an integral part of the building's structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures which cannot be removed include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings. [CC §1019]

Trade fixtures as security

Lease agreements often contain a default provision prohibiting the tenant from removing the trade fixtures when the agreement is breached. The tenant (and their unsecured creditors) no longer has a right to the trade fixtures under a default provision.

Consider a tenant who signs a commercial lease agreement to use the premises to operate a frozen packaging plant. The lease agreement states all fixtures, trade or leasehold, belong to the landlord if the lease is terminated due to a breach by the tenant.

The tenant later encumbers the existing trade fixtures by borrowing money against them. The tenant then defaults on their lease payments. While in default on the lease, the tenant surrenders the property to the landlord, including all trade fixtures.

Does the lender on the mortgage secured by the trade fixtures have a right to repossess them?

No! The tenant lost their ownership right to remove the trade fixtures under the terms of the lease agreement that was entered into before they encumbered the trade fixtures. Any right to the fixtures held by the secured lender is similarly lost since the lender is junior in time and thus subordinate to the landlord's interest in the fixtures under the lease agreement.

Further, if the trade fixtures installed by the tenant are owned by a third party, or if a third party had a lien on them at the time of their installation, the landlord has no more right to them than the tenant. [**Goldie** v. **Bauchet Properties** (1975) 15 C3d 307]

QUIZ

1. Bookshelves built into a wall which have become part of the improvements located on the real estate are best classified as:

   a. fixtures.

   b. trade fixtures.

   c. business ornamentations.

2. The conveyance of real estate fixtures from tenant to landlord on expiration of the lease is called:

   a. ratification.

   b. reversion.

   c. restoration.

Notice of Nonresponsibility protects against a mechanic's lien

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any **mechanic's lien** by a contractor for nonpayment initially attaches to the tenant's leasehold interest in the property. [Calif. Civil Code §8442(a)]

However, the mechanic's lien for unpaid labor and materials may also attach to the fee simple interest held by the landlord if the landlord or the landlord's property manager:

- acquires knowledge the construction is taking place; and
- fails to post and record a **Notice of Nonresponsibility**. [See **RPI** Form 597]

A *Notice of Nonresponsibility* is a written notice which needs to be:

- posted in a conspicuous place on the premises within ten days after the landlord or their property manager first has knowledge of the construction; and
- recorded with the county recorder's office within the same ten-day period. [CC §8444]

However, the landlord who becomes aware of the construction and fails to post and record the Notice of Nonresponsibility is not personally liable to the contractor. Rather, the contractor can only lien the landlord's interest in the real estate and foreclose on their mechanic's lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant. [**Peterson** v. **Freiermuth** (1911) 17 CA 609]

Further, if the lease requires the tenant to make *mandatory improvements,* a mechanic's lien attaches to the landlord's interest even when the landlord has posted and recorded a Notice of Nonresponsibility.

QUIZ

1. A lien entitling a contractor or subcontractor to foreclose on a job site property to recover the amount due and unpaid for labor and materials they used is referred to as a(n):

    a. judgment lien.

    b. mechanic's lien.

    c. contractor's easement.

2. A Notice of Nonresponsibility needs to be:

    a. posted in a conspicuous place on the premises within ten days after the landlord or their property manager first has knowledge of the construction.

    b. recorded with the county recorder's office within ten days after the landlord or their property manager first has knowledge of the construction.

    c. Both a. and b.

Residential Rental and Lease Agreements

A review of periodic vs. fixed-term tenancies

In this series, we're going to take a close look at the similarities and differences between residential occupancy agreements.

Residential landlords and tenants typically enter into either a **fixed-term lease agreement** or a **periodic rental agreement**. [See **RPI** Form 550 and 551]

Residential periodic tenancies frequently take the form of *month-to-month rental agreements*. [See **RPI** Form 551]

Residential rental and lease agreements both grant the tenant the right to possession. Both impose the same rights and obligations regarding maintenance of the property on the landlord and tenant.

If they both do these same fundamental things, how are they different?

The tenant's expectation of **continued occupancy** and their obligation to **pay future rent** differs between a **rental agreement** and a lease agreement.

A *month-to-month rental agreement* runs for an indefinite period of time. It automatically renews monthly, and on the same terms, until modified or terminated by notice. It keeps going and going (and going). [See **RPI** Form 551 §3]

Periodic tenancies can be terminated by either the tenant or landlord on 30 days' written notice. However, a landlord needs to give the tenant at least 60 days' written notice when the tenant's occupancy has exceeded one year.

What about a **lease agreement**?

A **lease agreement** is *finite*. A lease agreement creates a tenancy that continues for a **fixed** period. [See **RPI** Form 550]

At the end of the fixed-period, both the lease agreement and the tenant's right of possession expire. The terms of the lease set the expiration date, and no further notice is required.

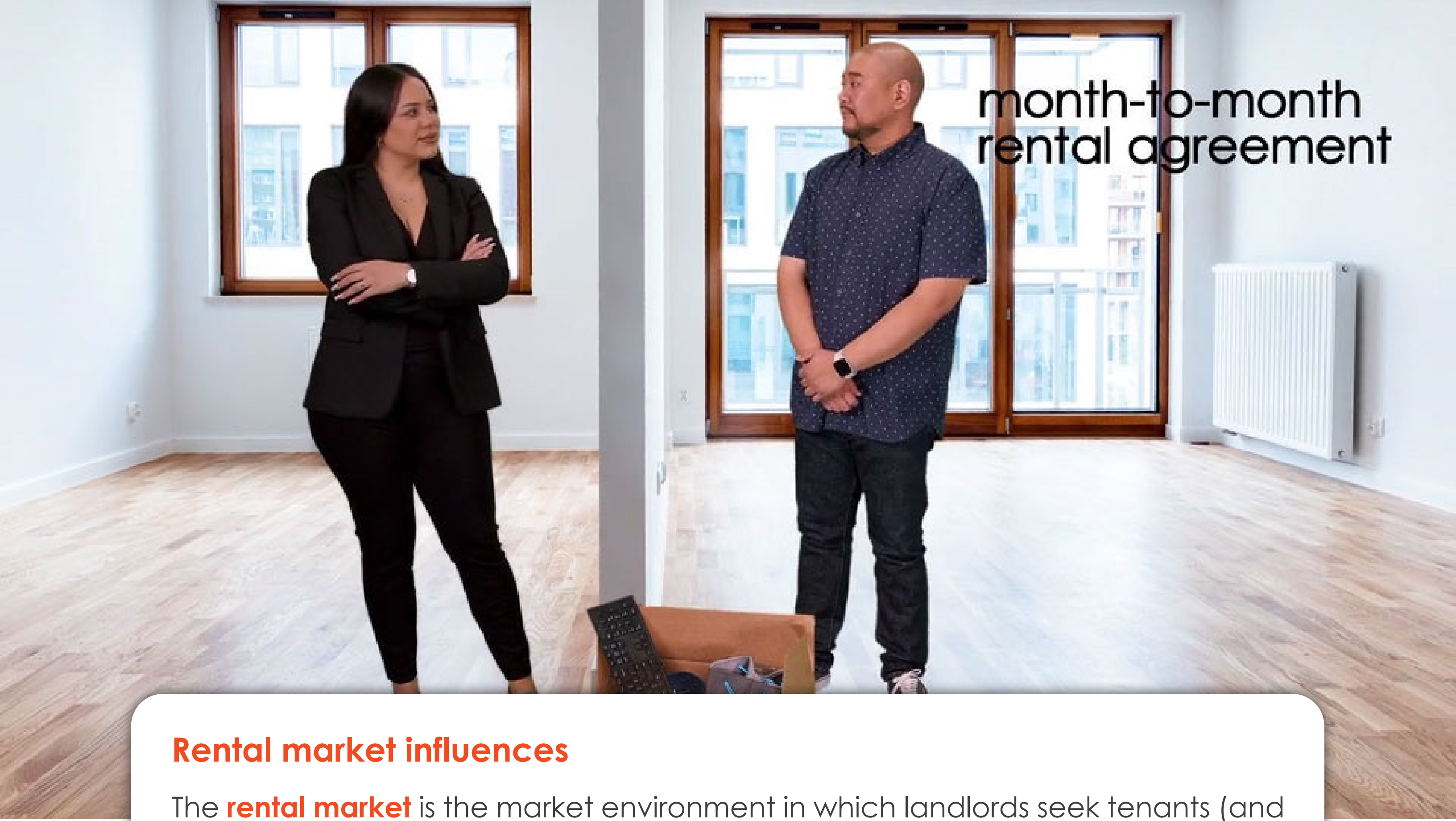
Unlike a periodic tenancy, the lease agreement does not automatically renew, unless an option to renew or extend has been written into the lease agreement and timely exercised. [See **RPI** Form 565]

In the rest of this series, we'll go over your professional use of residential rental and lease agreements, and related addenda.

QUIZ

1. What is/are the primary difference(s) between a rental agreement and a lease agreement?
   a. The allocation of responsibility to maintain the premises between the landlord and tenant.
   b. The tenant's expectation of continued occupancy and their obligation to pay future rent.
   c. Whether the subject property is intended for residential or commercial use.

2. What type of occupancy agreement creates a tenancy that continues for a fixed period of time?
   a. Rental agreement.
   b. Lease agreement.
   c. Month-to-month periodic tenancy agreement.



Rental market influences

The **rental market** is the market environment in which landlords seek tenants (and vice versa). The condition of the *rental market* is determined by:

- the population of tenants;
- the number of properties competing for these tenants; and
- the comparative position of the property and its amenities in relation to competing properties.

The *rental market* sets the amount of rent a landlord is able to charge on any given day to solicit and induce prospective tenants to enter into rental or lease agreements.

Generally, tenants on month-to-month rental agreements pay higher amounts of monthly rent for a unit than do tenants with lease agreements. Month-to-month tenants pay a premium for the privilege of being able to vacate the premises on 30 days' notice, without liability exposure for future rents. This privilege held by the tenant contributes to the landlord's uncertainty about their income and costs of tenant turnover, hence the rent *premium* to cover the risks.

Tenants typically pay *lower rents* when they enter into a lease agreement. In stable rental markets, the longer the lease period the lower the rent.

Rent may, however, be subject to adjustments for future price inflation, local appreciation and management decisions. During *weak market periods* of generally high vacancy rates, price-competitive landlords may favor using month-to-month rental agreements rather than lease agreements. When rents begin to rise, landlords adjust rents to market by serving notice of a change in rent rates.

Lease negotiations on expiration

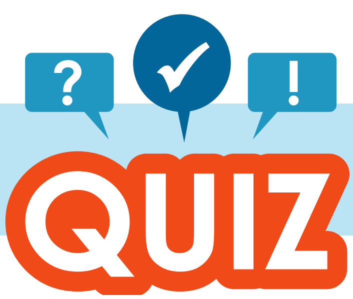
A landlord may not alter the terms of a lease agreement during the life of the lease without consideration and the tenant's consent.

To extend a soon-to-expire lease agreement, the landlord may contact the tenant and offer to:

- enter into another lease agreement [See **RPI** Form 550]; or
- a month-to-month rental agreement. [See **RPI** Form 551]

When the tenant desires to remain in possession when their lease expires, the amount of rent a landlord may demand is limited only by negotiations and economic forces in the rental market, with the exception of rent control vicinities.

As an alternative, a landlord proactively negotiates and grants **options to renew or extend** when initially entering into lease agreements. The right to extend the occupancy may be all that is needed to induce the tenant to remain a tenant on expiration of the lease. [See **RPI** Form 565]

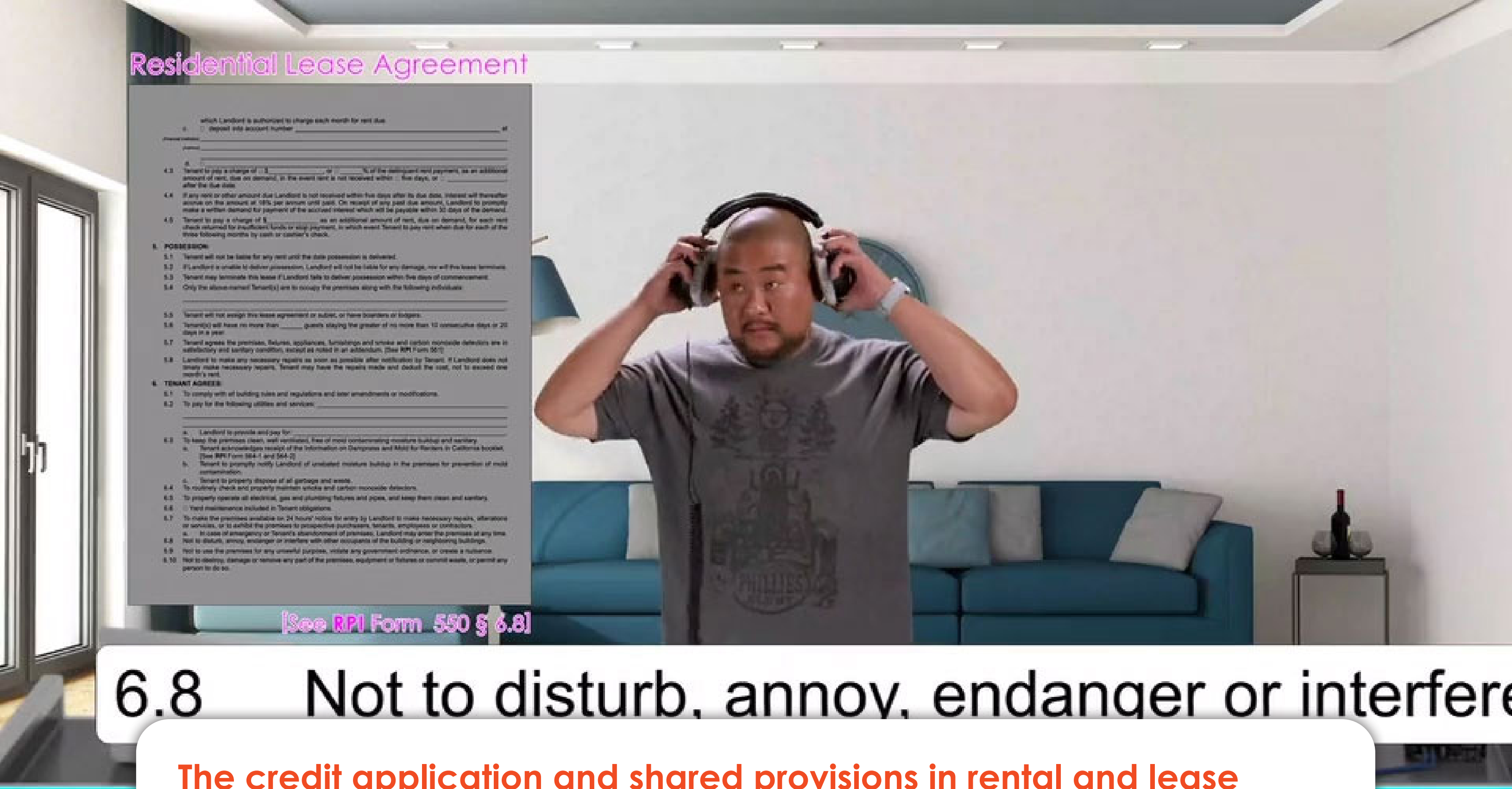


1. The condition of the rental market is determined by the population of tenants and:

   a. the number of properties competing for these tenants.

   b. the comparative position of the property and its amenities in relation to competing properties.

   c. Both a. and b.



The credit application and shared provisions in rental and lease agreements

On locating a prospective tenant for a residential unit, the landlord establishes the prospect's **creditworthiness** before entering into either a rental or lease agreement. This is accomplished by requiring the tenant to fill out a **credit application**. [See **RPI** Form 302]

The *credit application* is referenced and attached as an addendum to any rental or lease agreement entered into by the landlord and tenant. The application is part of the leasing process which persuades the landlord to accept the applicant as a tenant.

Initially, the landlord uses the authorization provided by the tenant on the application to verify the tenant's rental history, employment, credit standing and check-writing history.

If a prospective tenant has a poor credit rating or no credit rating at all, yet meets the landlord's income requirements, the landlord may seek assurances in addition to the maximum security deposit allowed. These assurances include:

- a *co-signer* on the lease; or
- a *guarantee agreement* signed by a creditworthy person. [See **RPI** Form 553-1]

With third-party assurances, the landlord will receive full performance on the lease agreement from others when the tenant defaults on their rent or otherwise causes the landlord to incur a loss exceeding the security deposit. On a default by the tenant, the landlord may hold the co-signer liable, or collect their losses from the guarantor.

Critical provisions in residential rental and lease agreements

In return for the use and possession of the premises, the tenant pays the landlord *rent* until expiration of the lease, or periodic tenancy. The tenant agrees to pay a late charge when rent is not paid on the due date, or within the established *grace period*. [See **RPI** Form 551 §4 and Form 550 §4]

Also, the number of guests the tenant may have in their unit and the period of time over which their guests may visit is limited. [See **RPI** Form 551 §5.6 and Form 550 §5.6]

The tenant agrees to comply with all building or project rules and regulations established by any existing *covenants, conditions and restrictions (CC&Rs)* or the landlord. [See **RPI** Form 551 §6.1 and Form 550 §6.1]

The landlord and tenant agree who will pay or how they will share the financial responsibility for the unit's utilities. Landlords of apartment buildings or complexes often retain the responsibility of providing water to the units. [See **RPI** Form 551 §6.2 and Form 550 §6.2]

In both rental and lease agreements, the tenant agrees to hold the landlord harmless from all liability for damages caused by the tenant or their guests. [See **RPI** Form 551 §7.1 and Form 550 §7.1]

Residential rental and lease agreements often contain provisions that restate the landlord's and tenant's statutory rights and duties.

For example, the rental agreement reiterates the landlord's statutory obligation to furnish a tenant with:

- a security deposit refund;
- a notice of the tenant's right to a joint pre-expiration inspection of the unit and delivery of an itemized statement of repairs/cleaning [Civil Code §1950.5(f)]; and
- a statement of security deposit accounting and an itemization of any deductions. [CC 1950.5(g)(1); see **RPI** Form 551 §2.4 and Form 550 §2.4]

Also, rental and lease agreements often advise tenants of their limited statutory right to make necessary repairs to the premises and deduct the cost from the rent when the landlord fails to make the repairs the tenant has brought to the landlord's attention. [CC 1942; see **RPI** Form 551 §6.2 and Form 550 §6.2]

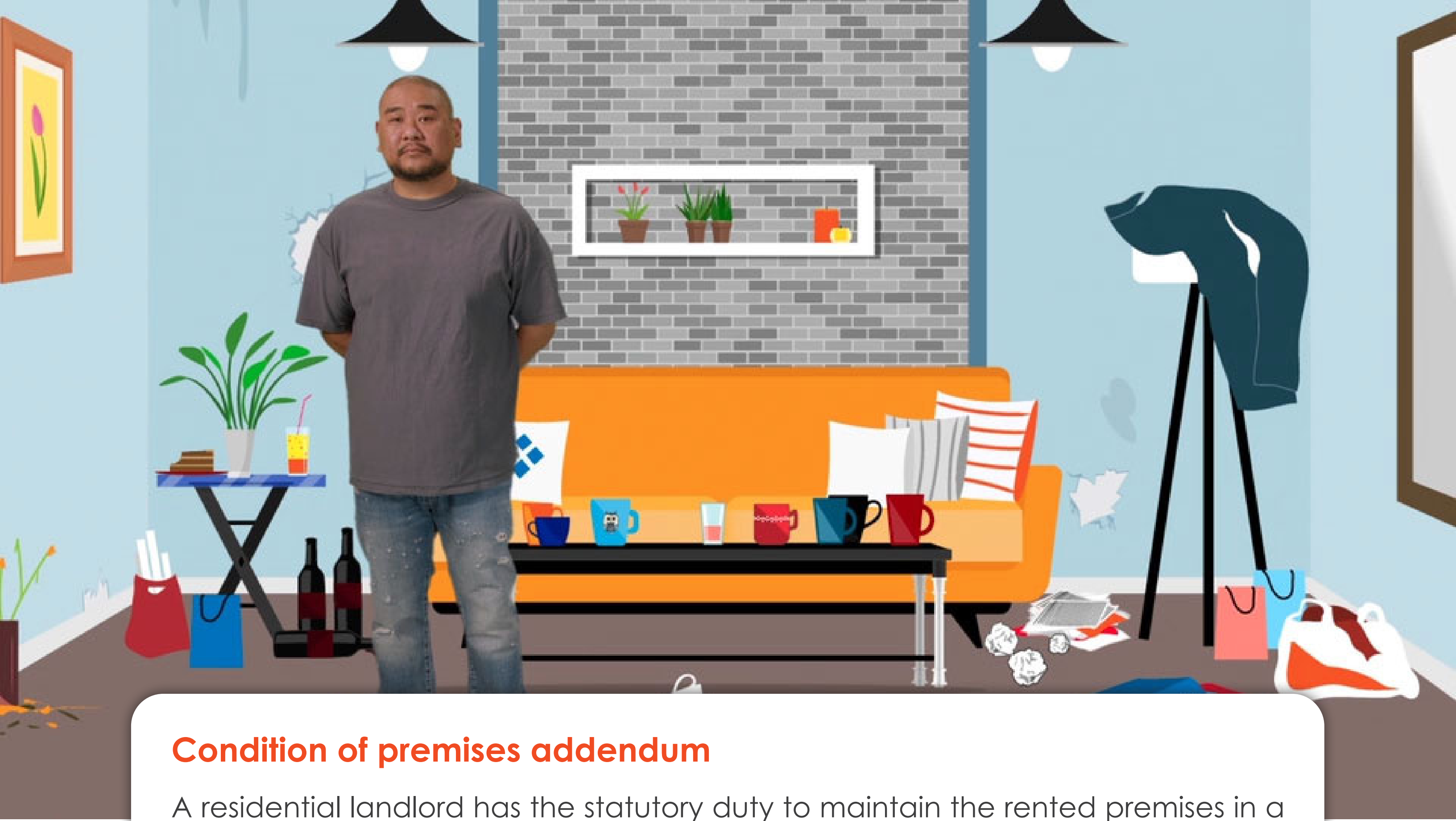
A rental or lease agreement prohibits a tenant from:

- using the premises for an unlawful purpose;
- creating a *nuisance*; and
- committing *waste*. [See **RPI** Form 551 §6.7, §6.8 and Form 550 §6.7, §6.8]

QUIZ

1. What document is generally completed first?
   a. Lease agreement.
   b. Pre-expiration inspection worksheet.
   c. Credit application.

2. The tenant agrees to pay a __________ when rent is not paid on the due date or within the established __________.
   a. late charge; grace period
   b. security deposit; delinquency period
   c. tenant screening fee; acceleration period



Condition of premises addendum

A residential landlord has the statutory duty to maintain the rented premises in a **habitable condition** at all times.

Similarly, a tenant has the statutory duty to refrain from *damaging the premises* and advising the landlord of adverse conditions which come about during the tenancy. [Calif. Civil Code §§1941; 1941.2]

To avoid disputes over who is responsible for any damage to the premises, the residential landlord and tenant complete and sign a **condition of premises addendum** before the tenant is given possession. [See **RPI** Form 560]

Before a tenant takes possession, the landlord or their property manager needs to inspect the unit with the tenant, known as a **walk-through**.

Together, the landlord and the tenant will use a condition of premises addendum to note:

- the premises are in satisfactory condition;
- any existing damage to the premises; and
- any repairs the landlord is to make to the premises.

When the unit is furnished, the landlord and tenant complete and sign an additional form on their walk-through called a **condition of furnishings addendum**.

The *condition of furnishings addendum* notes:

- the inventory of furnishings located in the unit;

- the current condition of the furnishings; and
- the tenant's acceptance of the furnishings. [See **RPI** Form 561]

Within thirty days before the end of a residential tenancy, the condition of premises addendum is reviewed during the **pre-expiration inspection** to help establish tenant responsibility for excess wear and tear to the unit rented. [See **RPI** Form 567-3]

The public policy purpose served by a residential landlord or property manager conducting a joint *pre-expiration inspection* is to timely advise a vacating tenant of the repairs and cleaning the tenant needs to correct or cure to avoid deductions from the **security deposit**.

QUIZ

1. A residential landlord has the statutory duty to:

   a. add amenities to the rented premises as requested by new and existing tenants.

   b. provide on-site workout facilities containing at least one functional treadmill.

   c. maintain the rented premises in a habitable condition at all times.

2. The public policy purpose served by a residential landlord or property manager conducting a joint pre-expiration inspection is to:

   a. timely advise a vacating tenant of the repairs and cleaning the tenant needs to correct or cure to avoid deductions from the security deposit.

   b. give the tenant sufficient notice of the condition of the property and amenities prior to taking occupancy of a rented unit.

   c. note the condition of any shared amenities located on the property.

Rental and lease agreement addenda

Any provisions agreed to but not included in the boilerplate provisions of pre-printed lease or rental agreements are included in an **addendum** to the rental or lease agreement. The additional or conflicting provisions are entered on the *addendum*. The addendum is then referenced in the body of the rental or lease agreement as attached. [See **RPI** Form 550-1]

One such addendum is the **pet addendum**. When a landlord allows pets, they often:

- impose restrictions on the type or size of the pet; and
- require the landlord's written consent to keep the pet on the premises. [See **RPI** Form 551 §6.9 and Form 550 §6.9]

The landlord and tenant may sign and attach a pet addendum that states:

- the type of pet and its name;
- the security deposit to be charged for the pet (but limited as part of the maximum security deposit allowed); and
- the tenant's agreement to hold the landlord harmless for any damage caused by the pet. [See **RPI** Form 563]

Note that a landlord may not prohibit a disabled person from keeping a *specially trained guide dog* on the premises. [Calif. Civil Code §54.1(b)(5)]

Additionally, a landlord who allows pets may not:

- favor declawed or devocalized animals in any advertisement;

- refuse to rent or negotiate for rent to a tenant because their pet has not been declawed or devocalized; or
- require tenants' pets to be declawed or devocalized as a condition of renting the property. [CC §1942.7]

Editor's note — Although landlords may not favor declawed or devocalized pets, they may still protect against property damage or noise by including a lease provision barring specific pet behavior or prohibiting pets altogether.

Non-smoking addendum

Every landlord has a duty to ensure the residential housing they rent is **safe and sanitary** throughout the tenant's occupancy. Additionally, a landlord has a duty to protect their tenants from *foreseeable* dangers.

Since *environmental tobacco smoke (ETS)* poses a legislatively recognized danger to tenants, a wise landlord takes steps to avoid claims. [**Stoiber** v. **Honeychuck** (1980) 101 CA3d 903; Calif. Code of Civil Procedure §1174.2]

A landlord may do any of the following risk avoidance activities to alleviate the burden of future ETS disputes:

- relocate smokers so they will not affect non-smokers;
- relocate non-smokers so they are not affected by the ETS of smoking tenants; or
- refuse to rent to persons who will not agree to the non-smoking provisions made a part of the rental or lease agreement.

Alternatively, the landlord may:

- designate all of the property as **smoke-free**, with the exception of any clearly defined areas where smoking will not affect others, by amending existing rental agreements or expired lease agreements; [See **RPI** Form 563-1] and
- enforce no smoking as part of the rules and policies of occupancy of the property through a "*property policies*" provision in the rental or lease agreement, then serve tenants who breach the no-smoking rule with a three-day notice to perform (do not smoke) or quit (vacate). [See **RPI** Form 550 §6.12; see **RPI** Form 576-1]

The above policies may be **agreed upon** by the landlord and tenant by the use of a **Non-Smoking Addendum** when entering into a rental or lease agreement. The *Non-Smoking Addendum* either prohibits smoking on the entire premises, or notes the specific location on the property where smoking is permitted. [See **RPI** Form 563-1 §3]

Other addenda

Other addenda which may be incorporated into a residential rental or lease agreement include:

- house or building rules; and
- any *rent control* disclosures required by local rent control ordinances.

A residential landlord seeking to sell a property may also grant the tenant an option to purchase the property. [See **RPI** Form 161]

However, no portion of any option money or the rent may be applied to the purchase price. When the terms of the lease agreement or option agreement provide for any credit to be applied toward the purchase price, or to a down payment on the purchase price, the tenant has acquired an *equitable ownership* interest in the property and cannot be evicted.

This is called a **lease-option sale**, and is a masked sale of the property typically entered into in violation of all the single family residence (SFR) disclosures to the buyer/tenant, mortgage lender and county assessor. The *lease-option sale* also lacks the protective formalities and fees involved in an escrowed grant deed transfer of ownership.

QUIZ

1. Which of the following statements is correct?

   a. A landlord who allows pets may require tenants' pets to be declawed or devocalized as a condition of renting the property.

   b. A landlord who does not allow pets may not prohibit a disabled person from keeping a specially trained guide dog on the premises.

   c. A landlord who allows pets may favor declawed or devocalized animals in their advertisements.

Property Management

Property management – licensing and responsibilities

Consider an individual who owns and operates income-producing real estate. As the owner-operator, they locate and qualify tenants, prepare and sign occupancy agreements, deliver possession, contract for property maintenance, collect rent, pay expenses and mortgages, serve any notices and file any *unlawful detainer (UD) actions* to evict tenants.

Does the owner-operator need a **Department of Real Estate (DRE)** broker license to perform these activities?

No! The owner of income-producing real estate does not need a real estate broker license to operate as a *principal*. The owner-operator is not acting on behalf of *someone else* as an agent when managing their own property. [Calif. Business and Professions Code §10131(b)]

On the other hand, if the owner-operator decides to hire an individual to take over the general management of the apartment complex, the individual employed to act as a **property manager** needs to under most circumstances be licensed by the DRE as a California real estate broker.

A broker has the authority to act as a *property manager* by virtue of their DRE license alone. There is no special "property management" license or endorsement required under California law.

Performance of services in exchange for a fee requires a license

An individual or corporation is to hold a broker license if they perform or offer to perform any of the following services on behalf of another in exchange for a fee:

- listing real estate for rent or lease;
- marketing the property to locate prospective tenants;
- listing prospective tenants for the rental or lease of real estate;
- locating property to rent or lease;
- selling, buying or exchanging existing leasehold interests in real estate;
- managing income-producing properties; or
- collecting rents from tenants of real estate. [Bus & P C §10131(b)]

An individual employed by a broker to perform any of the above services under their supervision needs to also be licensed by the DRE, either as a broker or sales agent, unless exempt.

A person is not required to have a real estate broker license when they are acting:

- as an **attorney** performing management as part of their legal services [Bus & P C §10133(a)(3)]; or
- under **court appointment**, such as a receiver or bankruptcy trustee. [Bus & P C §10133(a)(4)]

These exceptions are usually short-term and refer to specific properties.

A person whose business is advertised or held out as including property management for others needs to comply with the licensing laws. Individuals managing property without a license and without qualifying for an exemption will not be able to enforce collection of the fee they were to receive. [Bus & P C §10137]

Also exempt from licensing is an individual who has been given authority to act as an "attorney in fact" under a **power of attorney** to *temporarily manage* a landlord's property. [Bus & P C §10133(a)(2); see **RPI** Form 447]

However, a *power of attorney* may not be used as authority to continuously manage real estate and does not substitute for a broker license.

QUIZ

1. Under most circumstances, in order to perform the general management of an apartment complex, the individual employed to act as a property manager needs to:

   a. hold a Certified Property Manager (CPM) membership with the Institute of Real Estate Management (IREM).

   b. be licensed by the Department of Real Estate (DRE) as a California real estate salesperson.

   c. be licensed by the Department of Real Estate (DRE) as a California real estate broker.

Licensed vs. unlicensed property management activities

An employee hired to assist the broker in the rental and leasing of residential complexes, other than single family units, may be either:

- **licensed** by the Department of Real Estate (DRE); or
- **unlicensed**.

Under the constant supervision of the broker, *unlicensed employees* may perform **tenant-related negotiations** in apartment and vacation rentals, such as:

- showing rental units and facilities to prospective tenants;
- providing prospective tenants with information about rent rates and rental and lease agreement provisions;
- providing prospective tenants with rental application forms and answering questions regarding their completion;
- accepting tenant screening fees;
- accepting signed lease and rental agreements from tenants; and
- accepting rents and security deposits. [Bus & P C §10131.01(a)(1)]

Further, administrative and non-discretionary duties performed by an employee of a broker who manages transient housing or apartment complexes are *exempt* from real estate licensing requirements while the employee is under the broker's supervision and control. [Calif. Business and Professions Code §10131.01(a)]

Licensed employees may perform any and all of the activities unlicensed employees perform.

However, licensed employees are additionally able to perform activities relating to *contacts with the landlord*, as opposed to the tenant, about the leasing, care of the property and accounting.

Activities which only licensed employees may perform include:

- landlord-related solicitations;
- entering into property management or leasing agent agreements with the landlord;
- listings and rental or lease negotiations;
- care and maintenance of the property;
- marketing of the listed space; and
- accounting.

*Editor's note – Apartment building management has special licensing rules distinguishing **resident managers** from nonresident property managers.*

A resident manager is employed by either the landlord or the broker who manages the apartment building or complex. The resident manager lives on the premises as a requirement of their employment. A resident manager and their employees do not need a real estate license to manage the apartment complex. [Bus & P C §10131.01(a)(1)]

Contingent fees and bonus awards

When a landlord is a corporation, limited liability company (LLC) or partnership, any officer of the entity may manage the entity's property without a broker license. [Bus & P C §10133(a)(1)]

However, the unlicensed officer may not receive any **contingency fees** or **extra compensation** based on activities that require a license. They are to be salaried or on wages.

A common "licensing" misconception

It is a widely held misconception that property managers are required to hold a **Certified Property Manager (CPM)** membership with the Institute of Real Estate Management (IREM) to perform property management activities.

The CPM designation is a non-required unofficial designation bestowed by a private non-regulatory organization. Brokers and agents may earn them by completing private coursework and submitting proof of a certain number of years of property management experience.

Other non-required third-party property management designations include:

- the *certified apartment manager (CAM)* designation;
- the *accredited resident manager (ARM)* designation;
- the *registered in apartment management (RAM)* designation; and
- the *certified apartment supervisor (CAPS)*

Like the certified CID manager designation, the CPM designation is not required to be employed. Unlike the CID manager designation, the criteria for obtaining these designations are entirely determined by private organizations.

The designations are often costly, and do not guarantee employment in property management. Some employers may favor such designations, while others may not recognize them at all.

QUIZ

1. Which of the following activities may only be performed by a licensed employee working for a property manager?

   a. Showing rental units and facilities to prospective tenants.

   b. Accepting signed lease and rental agreements from tenants.

   c. Landlord-related solicitations.

Resident managers

A **resident manager** is an individual employed by the property manager or landlord to live on-site at the managed complex and see to its daily operations. A *resident manager's* duties may include:

- screening tenants and negotiating leases;
- cleaning vacated units;
- supervising landscaping, maintenance and repairs;
- serving notices; or
- attending to tenant inquiries.

Both residential income property and commercial property may have resident managers. However, apartment buildings with **16 or more units** are required to have a landlord, resident manager or responsible caretaker living on the premises to manage the property. [25 Calif. Code of Regulations §42]

Resident managers do not need to be licensed as a real estate broker or agent to negotiate leases or collect rents. However, when a nonresident property manager is not the landlord, the nonresident property manager needs to be licensed by the Department of Real Estate (DRE) as a real estate broker. [Calif. Business and Professions Code §10131.01]

Hiring a resident manager

A property manager who employs a resident manager is responsible for the following brokerage activities:

- selecting and hiring the resident manager;
- maintaining worker's compensation, liability insurance and any bonding requirements of the landlord or property manager;
- keeping payroll records, including information about withholding and employer contributions;
- supervising the resident manager; and
- terminating the resident manager's employment.

The resident manager's status as an employee is established in an employment agreement called the **resident manager agreement**. [See **RPI** Form 591]

Family members who live with the resident manager are listed in the *resident manager agreement*. Further, a statement noting these family members are not tenants is to be included. Thus, the family members' right to occupy the property terminates with the resident manager's right to occupy the property (e.g., the termination of the resident manager's employment).

Payment for services, withholding, benefits

Depending on the size of the complex, the resident manager may receive occupancy of a unit in the complex as compensation for their services based on:

- a rent reduction given in exchange for the dollar value of the resident manager's services;
- no rent charge, the rental value given in exchange for services; or
- no rent charge, plus an additional monthly salary paid in further exchange for services.

The resident manager agreement states the salary paid to the resident manager is a monthly amount. The fair rental value of the resident manager's unit is deducted from their salary. After the rent deduction, the resident manager is paid any balance of their salary. Utilities may also be included as part payment for the resident manager's services or treated separately from the agreed-to salary. [See **RPI** Form 591 §4]

As an employer, the property manager or landlord is responsible for withholding and forwarding federal and state income taxes. The property manager also makes all required payments for social security, unemployment insurance and disability insurance. [Calif. Unemployment Insurance Code §13020]

The property manager or landlord is required to carry *workers' compensation insurance* to cover resident manager injuries on the job. Providing workers' compensation coverage is imperative for any persons who employ individuals other than for casual labor.

The degree of control the property manager or landlord retains over a resident manager classifies the resident manager as an employee.

Minimum wage requirements apply

A resident manager's employment is subject to **minimum wage laws** even though the portion of the wages paid by a reduction or elimination of rent is not taxable as personal income. [Calif. Labor Code §1182.8]

Even though the rent-free compensation is not taxed as income, the rent credit is included and considered when determining the resident manager's pay for minimum wage requirements. The rent credit is used as all or part of the wages received per hour of work performed by a resident manager, limited by caps on the rent credit.

Two "caps" limit minimum wage calculations to control the amount of the rent credit. [8 CCR §11050(10)(C); Labor C §1182.13]

To keep wages per hour from dropping below the minimum dollar amount capped by the government, the property manager requires the resident manager to:

- prepare time cards;
- limit the number of hours per week the resident manager may work so wages per hour do not drop below the minimum dollar amount; and
- make provisions for the payment of any overtime permitted.

Terminating a resident manager's occupancy

The *resident manager agreement* controls the resident manager's right to occupy their unit as an employee. No separate lease or rental agreement is entered into or required (unless the property manager or landlord specifically intend to create a tenancy).

The resident manager agreement also controls when that right to occupy the unit is terminated. When a resident manager agreement requires the resident manager to surrender their unit upon termination of employment, the resident manager is not entitled to any notice to quit. The termination of employment is sufficient to terminate the resident manager's occupancy.

If the terminated resident manager remains in possession of the property after their employment is terminated, they are unlawfully detaining the property and may be evicted.

To avoid creating a tenancy that continues on termination of the resident manager's employment, the resident manager agreement will state:

- possession is incidental to employment;
- possession automatically ends concurrent with termination of employment; and
- failure to perform managerial duties constitutes a breach of the resident manager agreement and is grounds for immediate termination and eviction.

However, a caution: a property manager or landlord's conduct can change the resident manager's right of occupancy.

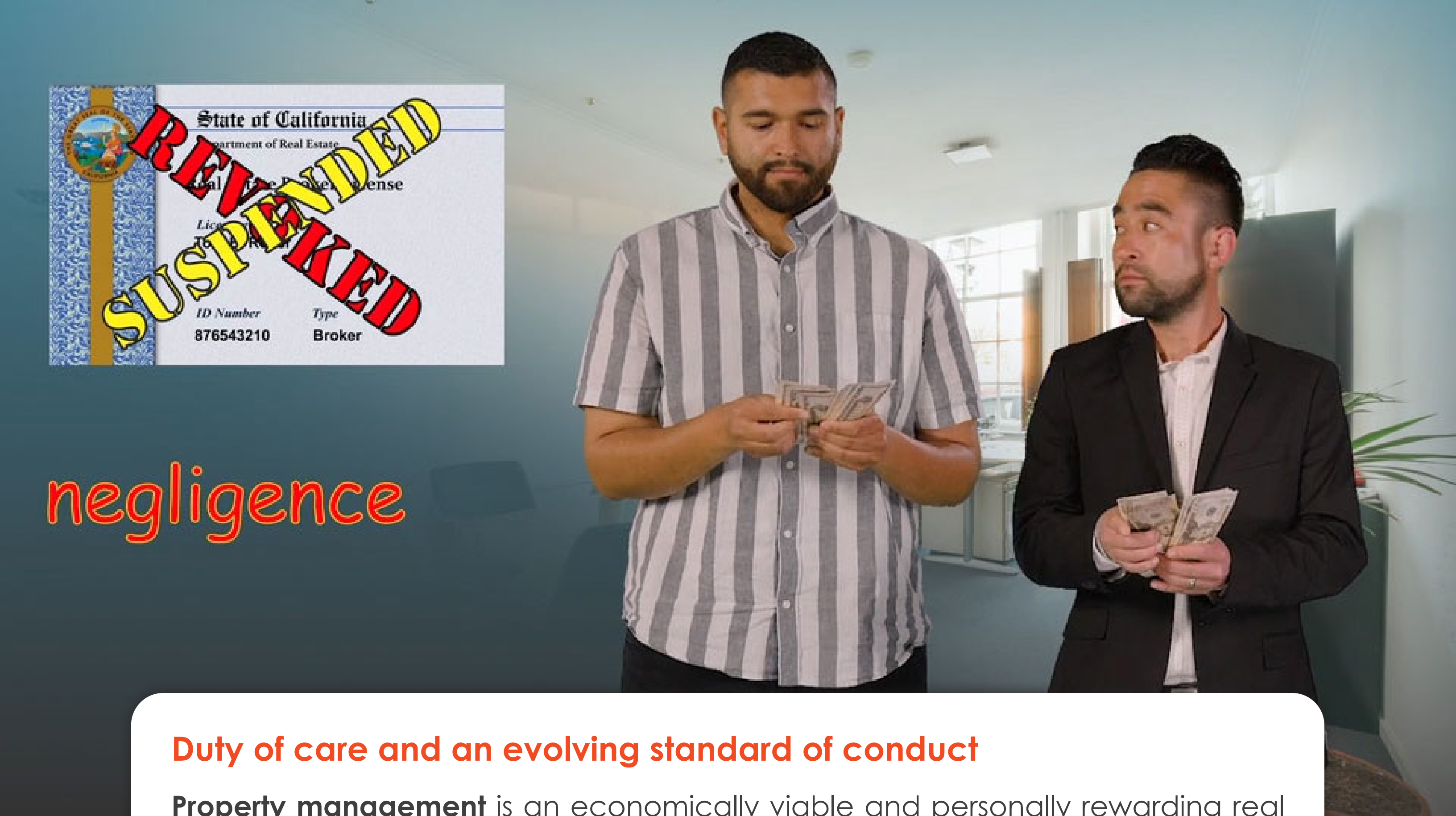
QUIZ

1. Apartment buildings with __________ are required to have a landlord, resident manager or responsible caretaker living on the premises to manage the property.

    a. 12 or more units

    b. 16 or more units

    c. 24 or more units



Duty of care and 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 operating a rental property is to:

- fill vacancies with suitable tenants;
- collect rent;
- incur and pay expenses; and
- account to the landlord.

Thus, a property manager needs to have spent time *accumulating experience* by actively overseeing and operating like-type rental properties before being 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 Department of Real Estate (DRE) broker license. Any licensed agent or broker associate employed by the broker acts on behalf of their broker, not independent of their broker. [Calif. Business and Professions Code §§10130, 10131(b)]

The *duty of care* a property manager owes a landlord is the *same duty of care* and protection a broker in real estate sales owes their sellers and buyers. As a property manager, the broker is an agent acting in capacity of a trustee on behalf of the landlord. Agents acting on behalf of the broker perform property management services as authorized by the broker.

A property manager's real estate broker license may be revoked or suspended when the property manager demonstrates negligence or incompetence in performing their management tasks. This includes negligent supervision of their employees, be they licensed or unlicensed employees. [Bus & P C §§10177(g), 10177(h)]

To be successful in the property management field, a broker initially acquires the minimum knowledge and experience through training sufficient to adequately perform their tasks.

A broker acquires property management expertise through:

- courses required to qualify for and maintain a real estate license [Bus & P C §§10153.2, 10170.5];
- 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 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 responsive staff who will perform to the landlord's expectations.

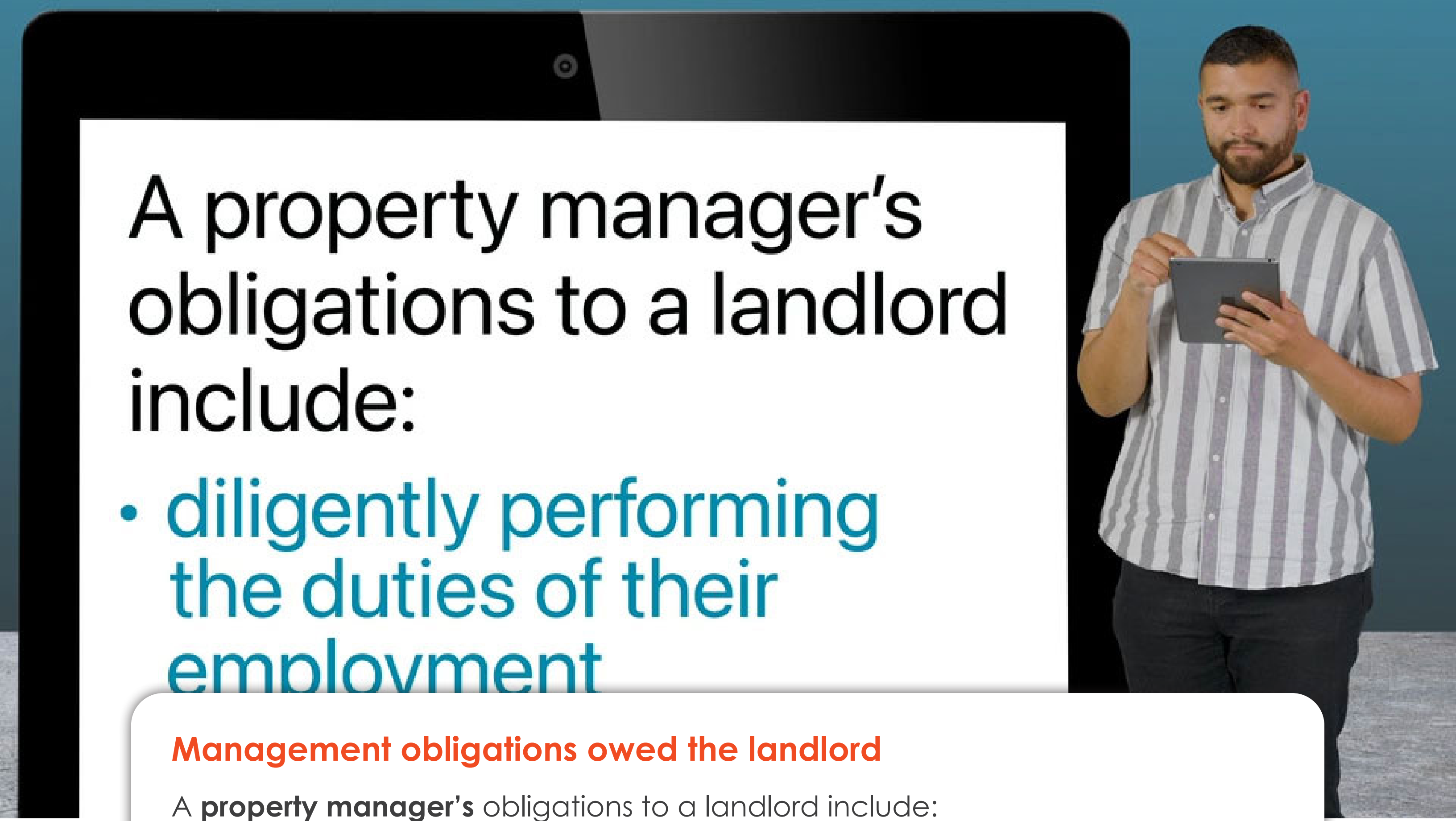
Other indicators that a property manager will successfully handle rental property include:

- 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.

QUIZ

1. The duty of care a property manager owes a landlord:
   a. is the same duty of care and protection a broker in real estate sales owes the opposing parties in a transition.
   b. is the same duty of care and protection a broker in real estate sales owes the sellers and buyers they represent.
   c. is the same duty of care a finder owes a prospective buyer of property.

2. Which of the following characteristic is less indicative that a property manager will successfully handle rental property?
   a. Prior experience handling and reporting trust account activities.
   b. Ownership of a luxury car as a symbol of success.
   c. A competent staff to perform office and field duties and to quickly respond to both the landlord's and the tenants' needs.



Management obligations owed the landlord

A **property manager's** obligations to a landlord include:

- holding a broker license;
- diligently performing the duties of their employment;
- sufficient oversight of the broker's employees acting on behalf of the landlord;
- handling and accounting for all income and expenses produced by the property;
- contracting for services, repairs and maintenance on the property as authorized;
- monitoring utility services provided by the landlord;
- advertising for prospective tenants;
- showing the property and qualifying tenants;
- 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:

- confirms the existence of or obtains general liability and workers' compensation insurance sufficient to protect the landlord, naming the property manager as an additionally insured;
- obligates the landlord to only those agreements authorized by the landlord;
- maintains the property's earning power, called **goodwill**;
- hires and fires resident managers and other on-site employees as needed;
- complies with all applicable codes affecting the property; and
- notifies the landlord of any potentially hazardous conditions or criminal activities affecting the health and safety of individuals on or about the property.

A property manager has a duty to employ a higher standard of conduct regarding the operation of a property than a typical landlord might apply. This standard is called the **prudent investor standard**.

A *prudent investor* is a person who has the knowledge and expertise to determine the wisest conduct for reasonably managing a property. The *prudent investor standard* is the minimum level of competency expected of a property manager by a landlord, whether or not the landlord is familiar with it.

In contrast, the expectations of resident and non-resident landlords 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. Often they are not 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 their primary occupation, one in which they have developed an 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 a reasonable vacancy rate.

Thus, the property manager bases decisions on the need to generate the maximum income from the property and incur only those expenses necessary to maintain the property's good will and preserve the safety, security and habitability of the property.

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.

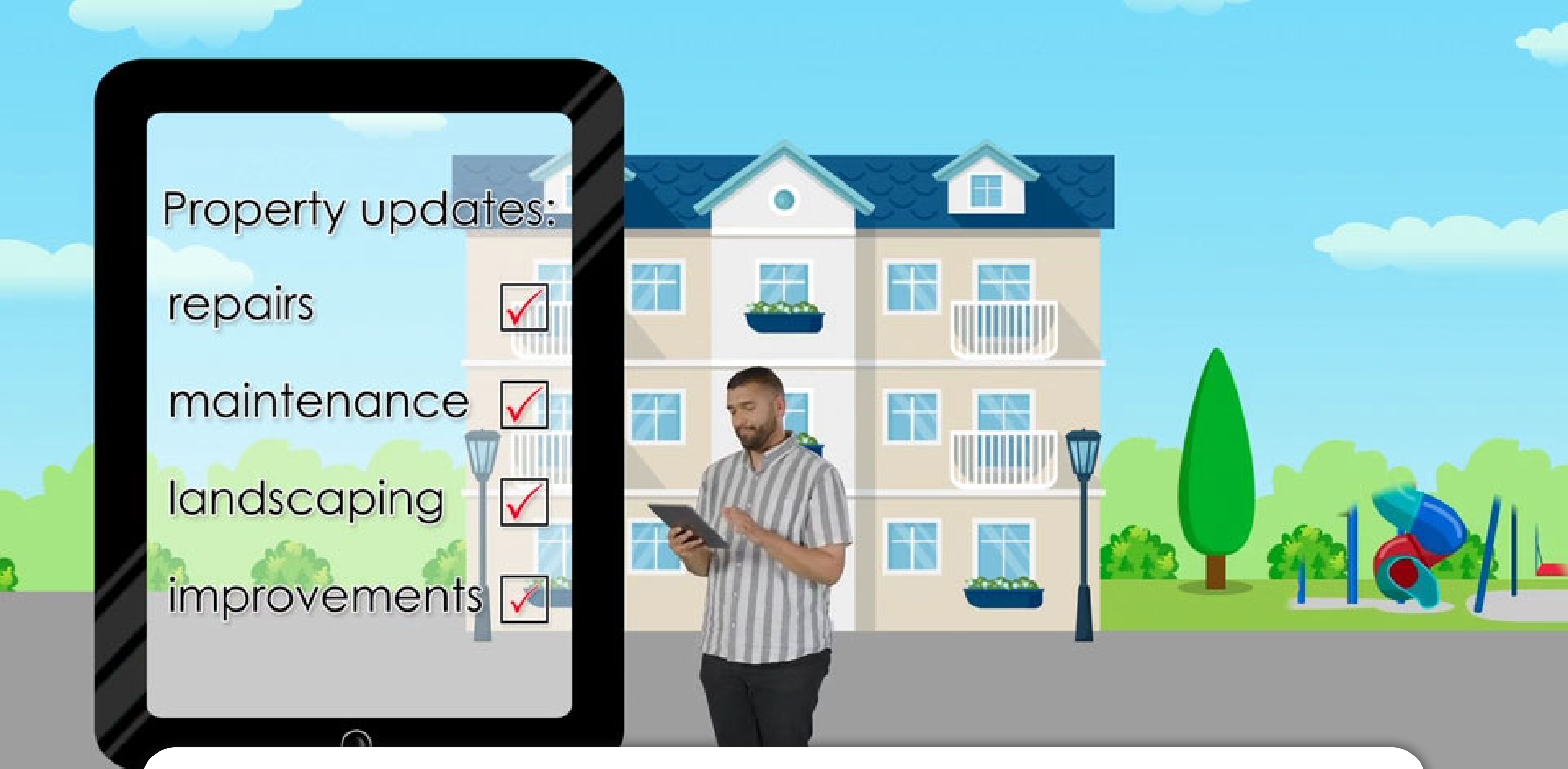
QUIZ

1. A property manager's obligations to a landlord include:

    a. showing the property and qualifying tenants, and responding in a timely manner to the needs of the tenants.

    b. diligently performing the duties of their employment, and negotiating and executing rental and lease agreements.

    c. Both a. and b.



Critical curb appeal and title profile analysis

The manager's ability to locate tenants willing and able to pay the rent rate sought by the landlord depends on the competition in the area of the property.

For example, when more tenants seek space than there are units available to rent, the property manager may be able to increase the rent (excluding units covered by rent control ordinances) and still maintain occupancy levels.

Conversely, when 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 (particularly **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 are able to determine the amount of cost involved for any 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 exterior finish 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 reviews the status of 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 sufficient rents to produce a positive cash flow after mortgage payments. Worse yet, in some cases mortgage 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 in the mortgage market to refinance the property with more advantageously structured financing. The property manager may 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 when 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 information for the area.

Any discrepancy between information provided by the landlord and a property profile report is resolved with the landlord prior to taking over management of the property.

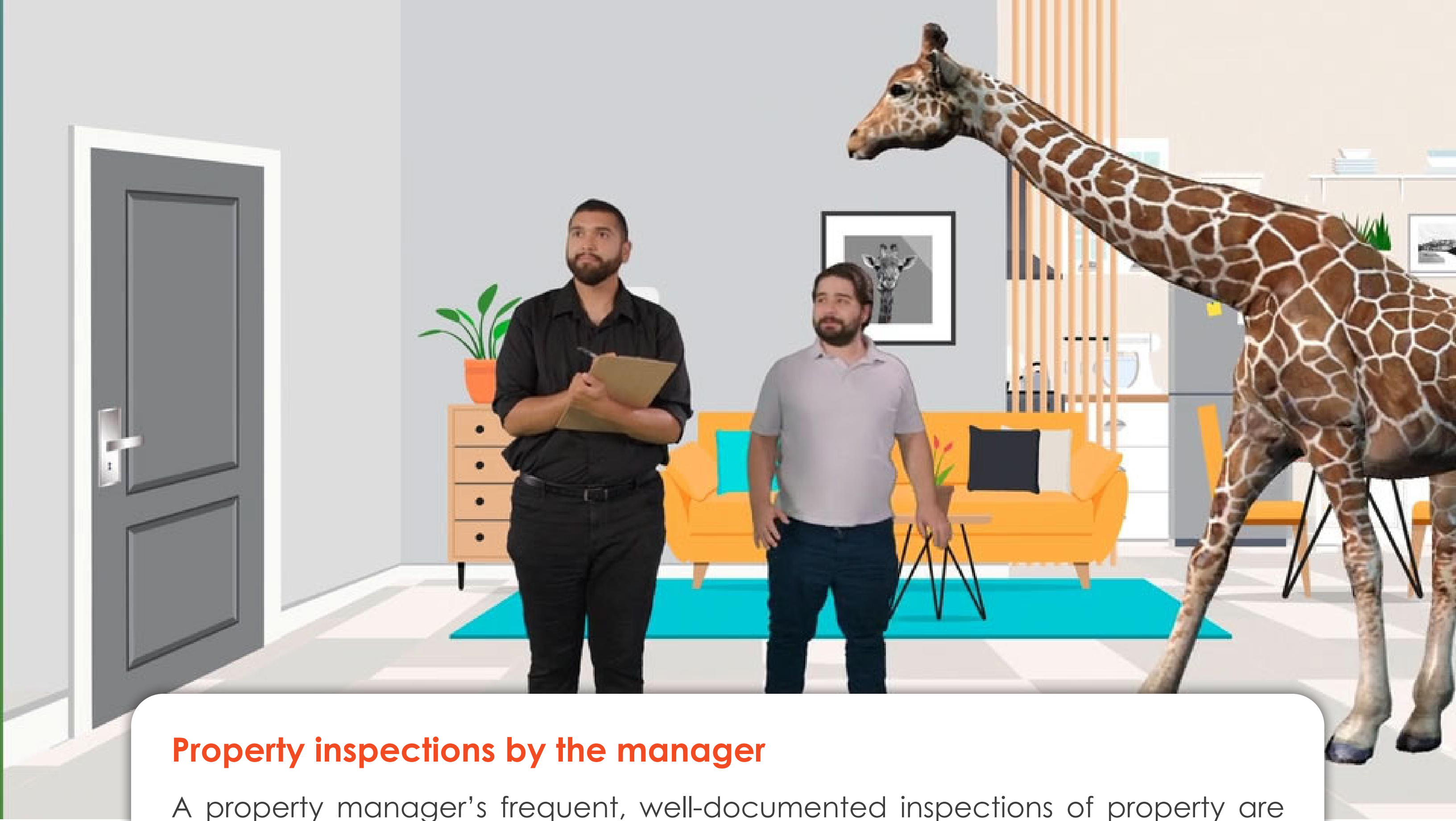
QUIZ

1. The current physical condition of a property reflects the attitude of the ownership towards tenants. What expression most closely relates to this concept?

   a. Fiduciary duty.

   b. Functional obsolescence.

   c. Curb appeal.



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. Property inspections by the property manager determine the:

- physical condition of the property;
- availability of habitable units or commercial space; and
- use of the leased premises by existing tenants.

When a property manager conducts an inspection of the property, they do so for one of several key situations:

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." However, conditions which might endanger the health and safety of tenants and their guests may not 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 a residential tenant vacating*. Residential property is inspected prior to termination of possession when the tenant requests a **joint pre-expiration inspection** on receipt of the mandatory notice of right to a wear and tear analysis to be sent by the landlord or the property manager. [See **RPI** Form 567-1]
5. *When the tenant vacates*. The property's condition is compared against its condition documented when first occupied by the tenant. Based on any differences in the property's condition, a reasonable amount may be deducted from the tenant's security deposit for the cost of corrective repairs. Cost 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.

Inspections that coincide with key events help establish who is responsible for any deferred maintenance and upkeep or any damage to the property.

Joint pre-expiration inspections – a closer look

A residential landlord or property manager 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. [See **RPI** Form 567-1 §5]*

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 purpose for the *joint pre-expiration inspection*, also called an **initial inspection**, is to require residential landlords and property managers to advise tenants of the repairs or conditions the tenant needs to perform or maintain to avoid deductions from the **security deposit**.

When a residential tenant requests the pre-expiration inspection in response to the notice, the *joint pre-expiration inspection* is to be completed no earlier than two weeks before the expiration date of:

- the lease term; or
- a 30-day notice to vacate initiated by either the landlord or the tenant. [Civil Code §1950.5(f)(1)]

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. Further, 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.

Notice of entry and statement of deficiencies

When the landlord or property manager 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.

When the landlord and tenant cannot agree to the date and time of the inspection, the landlord may set the time. However, when 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 or property manager and tenant.

When the waiver is signed, the landlord or property manager may proceed with the inspection. [CC §1950.5(f)(1); see **RPI** Form 567-2]

Following service on the tenant of the 48-hour notice, the landlord or property manager 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 or property manager gives the tenant an itemized **statement of deficiencies**. In it, the landlord or property manager specifies any repairs or cleaning which need to be completed by the tenant to avoid deductions from the security deposit.

Also, the itemized *statement of deficiencies* is to contain the contents of subdivisions (b) and (d) of Calif. Civil Code §1950.5. [See **RPI** Form 567-3]

The landlord's pre-expiration inspection statement is prepared at the time of the inspection and delivered to the tenant by either:

- handing the statement directly to the tenant when they are present at the inspection; or
- leaving the statement inside the premises at the time of the inspection when the tenant is not present. [CC §1950.5(f)(2)]

When the tenant chooses to withdraw their request for an inspection after submitting it, the landlord or property manager 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 or property manager does not bar the landlord or property manager 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. [CC §1950.5(f)]*

QUIZ

1. A residential landlord or property manager is to notify a tenant __________ of the tenant's right to request a joint pre-expiration inspection of their unit prior to the tenant vacating the unit.

   a. verbally
   b. in writing
   c. Either a. or b.

2. On completion of the joint pre-expiration inspection, the landlord or property manager gives the tenant a(n) __________ which specifies any repairs or cleaning which need to be completed by the tenant to avoid deductions from the security deposit.

   a. notice of right to a pre-expiration inspection
   b. notice to vacate
   c. itemized statement of deficiencies

Property manager is responsible for all maintenance

Periodic review of leases and property maintenance

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. [See **RPI** Form 590]

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 tenant demands and available units/spaces as future trends, the more protection the landlord's investment will 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. Possibly, this includes the elimination of *physical obsolescence* brought on by ageing.

The property manager is responsible for all the maintenance and repairs on the property while employed by the landlord. This responsibility still exists when the property manager delegates the maintenance of the units to the tenants in lease agreements.

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 property under a net lease agreement will perform all maintenance and upkeep of the property. [See **RPI** Form 552-2 and 552-3]

The broker, as the property manager, then has a greatly reduced role in the care and maintenance of the property under a net lease agreement. The property manager simply oversees the tenant to confirm they are caring for the property and otherwise fully performing the terms of the lease agreement.

QUIZ

1. Periodic evaluations by the property manager of existing leases and rental agreements are undertaken to:

   a. minimize curb appeal and maximize vacancies.

   b. maximize expenses and minimize rental income.

   c. minimize expenses and maximize rental income.

Goodwill is value maintained or lost

The way a property is operated develops a level of **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 constantly increasing the intangible image — goodwill — of the property.

Goodwill is maintained, and 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."

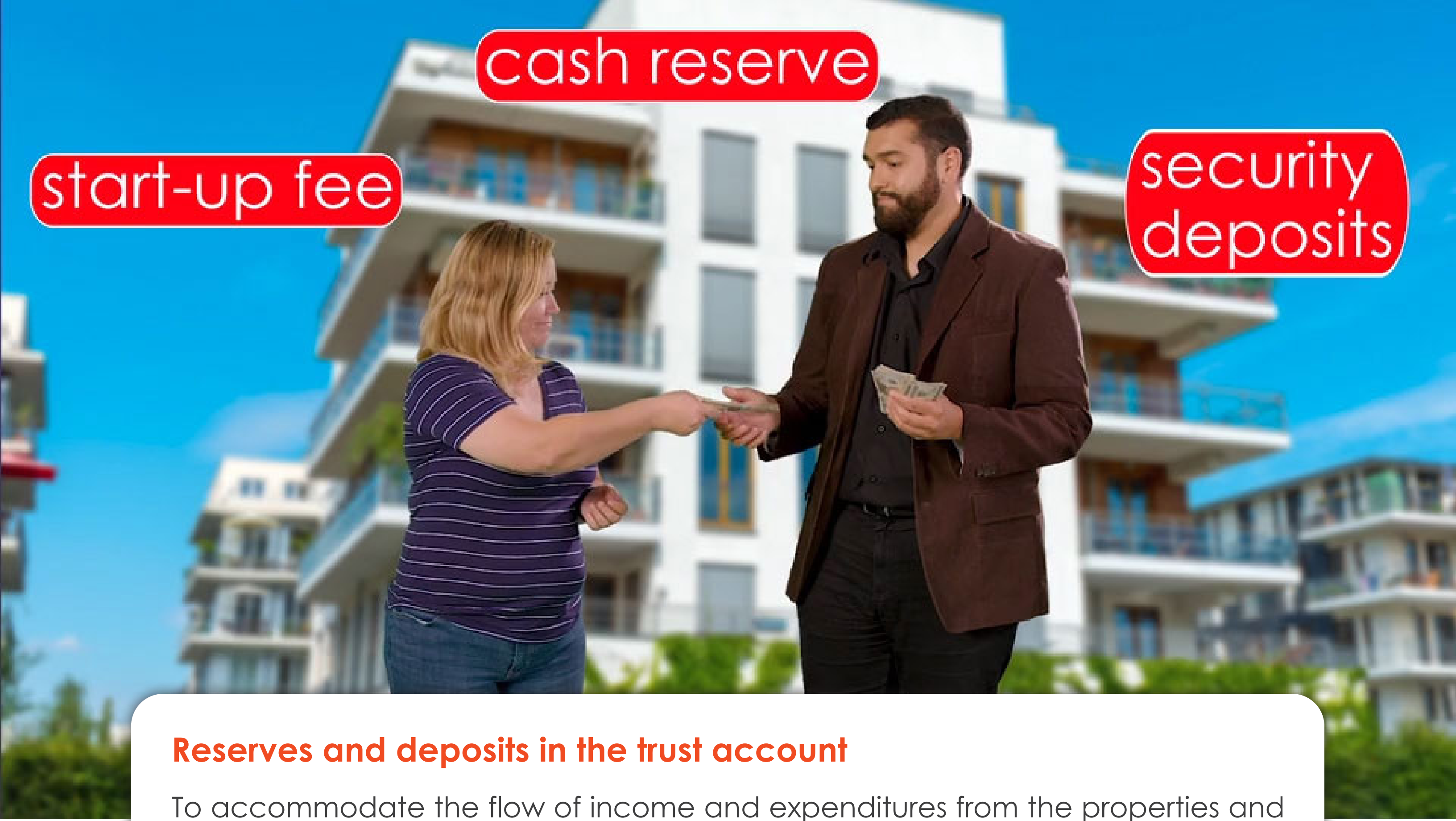
The manager who fails to promptly complete necessary repairs or correctly maintain the property may be impairing the property's goodwill built up with tenants and the public.

Allowing the property or the tenancies to deteriorate will expose the property manager to liability for the decline in revenue.

QUIZ

1. The concept of goodwill most closely equates with:

    a. the earning power of the property.
    b. the functional utility of the property.
    c. the location of the property.



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. [Calif. Code of Regulations §2830]

Generally, a property manager receives a cash deposit as a reserve balance from the landlord. The sum of money includes a **start-up fee**, a cash reserve for costs and the tenants' security deposits.

A *start-up fee* is usually a flat, one-time management fee charged by the property manager to become sufficiently familiar with the property and its operations to commence management activities.

The cash reserve is a set amount of cash the landlord agrees to maintain as a minimum balance in the broker's trust account. The cash reserve is used to pay costs incurred when costs and mortgage payments exceed rental income receipts. Security deposit amounts are separate from the client's cash reserves.

The prudent property manager insists that all security deposits previously collected from existing tenants are deposited into the property manager's trust account.

The security deposits need to be accounted for separately from other client funds in the trust account, though this separation of a client's funds is not required. Security deposits belong to the tenant, though the landlord and the property manager have no obligation to handle them differently than funds owned by the landlord.

On a tenant vacating, their deposit is returned, less reasonable deductions. For a residential tenant, an accounting is mailed within 21 days of the tenant's departure. For commercial properties, the security deposit accounting is mailed 30 days after a commercial tenant's departure. [Calif. Civil Code §1950.5(g)(1); 1950.7(c)(1)]

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. [Calif. Business and Professions Code §10145(a); California Department of Real Estate Regulations §2832]

Separate ledger for each landlord

Trust accounts are to be maintained in accordance with standard accounting procedures. These standards are best met by using computer software designed for property management. [DRE Reg. §2831]

Also, withdrawals from the trust fund account may not be made by the landlord, only by the property manager.

However, a property manager may give written consent to allow a licensed employee or an unlicensed employee who is bonded to make withdrawals from the trust account. [DRE Reg. §2834(a)]

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. [DRE Reg. §2834(c)]

The property manager's bookkeeping records for each trust account maintained at a bank or thrift include entries of the:

- amount, date of receipt and source of all trust funds deposited;
- date the trust funds were deposited in the trust account;
- date and check number for disbursements of trust funds previously deposited in the trust account; and
- daily balance of the trust account. [DRE Reg. §2831(a)]

Entries in the general ledger for the overall trust account are kept in chronological order and in a column format. Ledgers may be maintained in a written journal or one generated by a computer software program. [DRE Reg. §2831(c)]

QUIZ

1. To accommodate the flow of income and expenditures from the properties and monies they manage, the property manager maintains a(n) __________ in their name, as trustee, at a bank or financial institution.

   a. overseas

   b. trust account

   c. checking account

2. Trust funds collected by a property manager include:

   a. cash reserves and start-up fees.

   b. security deposits and rents.

   c. Both a. and b.

Manager’s trust account supervision and accounting

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 mishandling of the trust account, the property manager:

- deposits the funds received, whether in cash, check or other form of payment, within *three business days* [Department of Real Estate Regulations §2832];
- keeps trust fund account records for *three years* after the transaction [Calif. Business and Professions Code §10148];
- keeps a separate ledger or record of deposits and expenditures itemized by each transaction and for each landlord [DRE Reg. §2831.1]; and
- keeps accurate trust account records for all receipts and disbursements. [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 of any 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 hands the landlord 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 when 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 avoids the receipt of **advance fees**. Accounting for the collection of advance fees requires a DRE-approved form. [Bus & P C §10146]

Failure to account for funds

A property manager on the receipt of monies while acting on behalf of the landlord places them into a *trust account*. As trust funds, these monies need to be diligently managed to avoid claims of mishandling, misappropriation or the **commingling** of the landlord's funds with the property manager's personal funds.

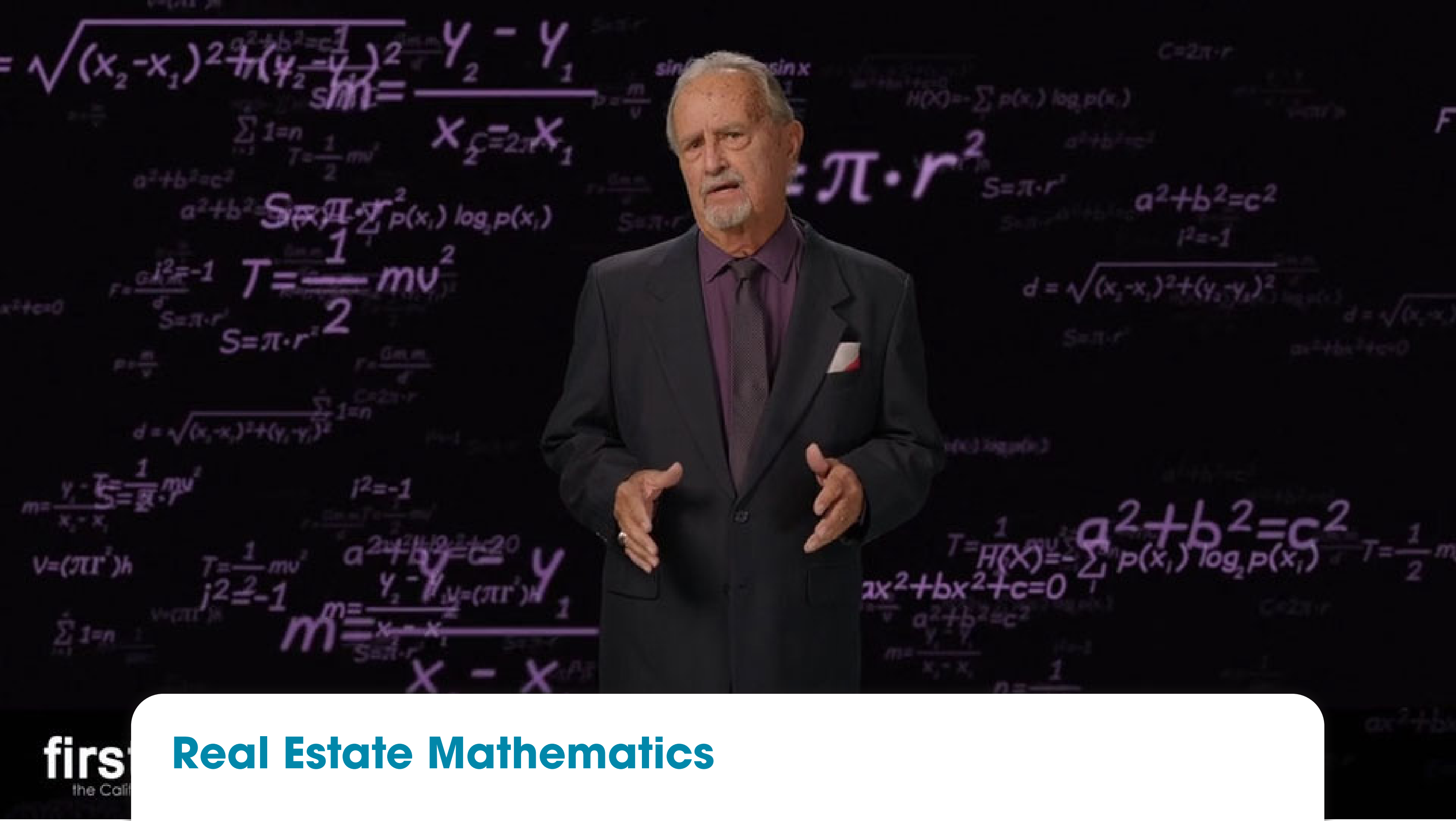
QUIZ

1. Any discrepancy or failure by the property manager to properly account for the trust funds:

    a. will be resolved against them and in favor of the landlord.

    b. will be resolved in favor of the property manager only on the first occurrence.

    c. will always be settled under the terms of an arbitration agreement.



Real Estate Mathematics

The mathematical tools you need

As a requisite for entry into the real estate profession, a thorough understanding of the formulas commonly used in the real estate industry is necessary.

Once the basic formulas and logic behind them are mastered, most math issues in mortgages, income property, property management and investment are solved with a basic, nonprogrammable calculator.

Editor's note – Once an individual is licensed, a financial calculator is a wise investment in the real estate industry. Frequently used formulas are pre-programmed into the financial calculator, such as amortization schedules, making it an invaluable asset.

Only a very small proportion of the salesperson and broker licensing examination consist of math questions. Of these, no questions require a calculator, just memorized figures. An examinee could miss or skip the few number of math question and still successfully pass the exam.

However, these math concepts are important in the context of actual practice nonetheless.

When you're in the field, a grasp of mathematical basics is critical when dealing with a myriad of real estate concepts. To name a few:

- land measurements;

- percentages;
- fractions;
- area;
- fees/commissions;
- loans;
- investments/cost analysis; and
- capitalization (cap) rates.

Basic units of measurement in real estate

Below is a review of basic units of land measurement:

- **Township** = 36 square miles broken up into 36 sections;
- **Section** = 640 acres and 1 square mile;
- **Half section** = 320 acres, a quarter section = 160 acres, and a quarter of a quarter = 40 acres;
- **Acre** = 43,560 sq. ft;
- **Mile** = 5,280 ft;
- **Square mile** = 27,878,400 sq. ft (5,280 ft x 5,280 ft) or 640 acres (27,878,400 sq. ft / 43,560 sq ft);
- **Square acre** = approximately 209 ft x 209 ft;
- **1 yard** = 3 ft;
- **1 square yard** = 9 sq. ft (3 ft x 3 ft);
- **1 mile** = 320 rods; 5,280 ft; and
- **1 rod** = 16.5 ft or 5.5 yards (16.5 ft x 3 ft).

Editor's note – Some variation of these land measurements has an extremely high likelihood of appearing on the state licensing exam.

QUIZ

1. The salesperson and broker licensing exam administered by the Department of Real Estate (DRE):

   a. places a heavy emphasis on math questions.

   b. contains only a handful of math questions requiring a financial calculator.

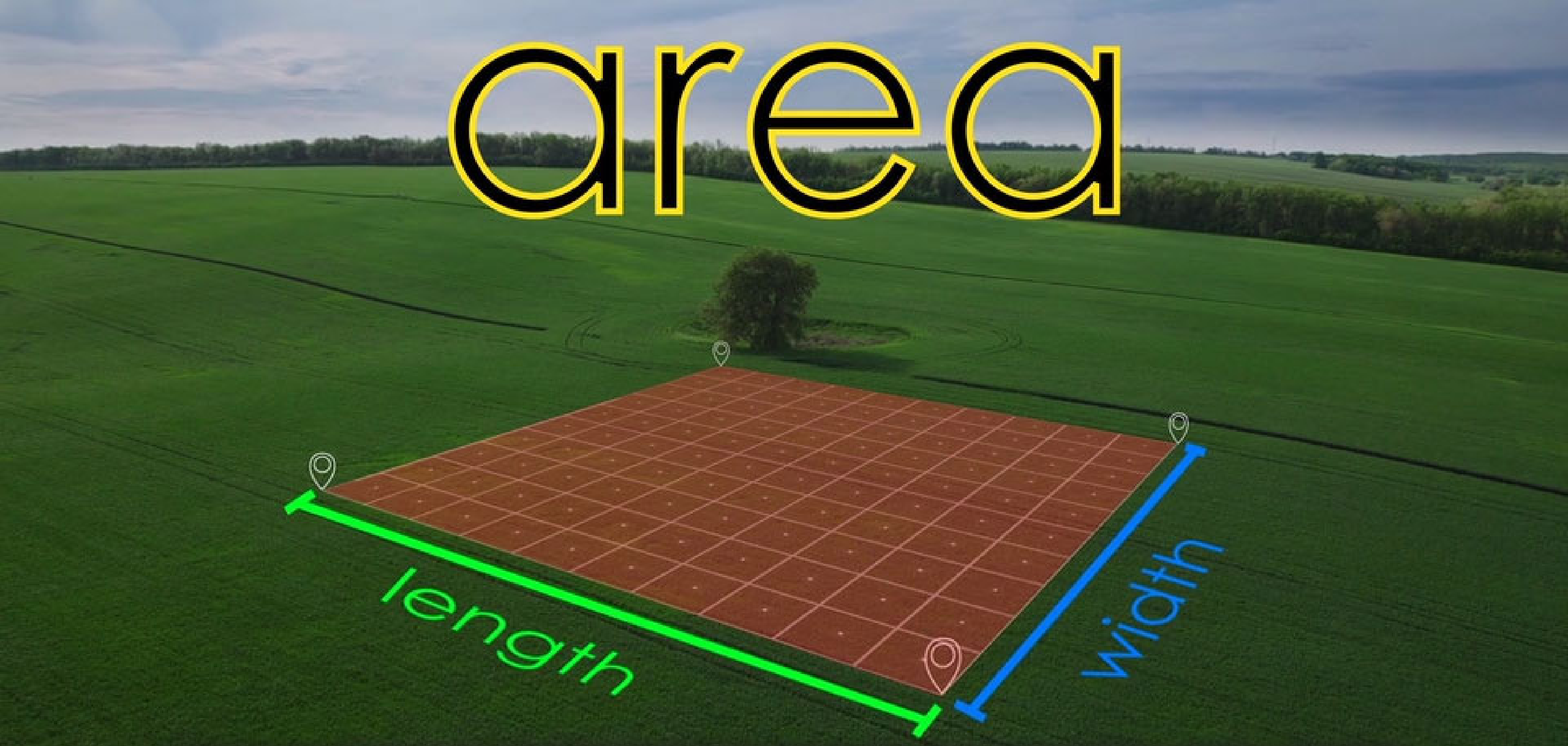
   c. does not contain any computational math questions which require a calculator.

2. How many square miles are in one township?

   a. 12.

   b. 24.

   c. 36



Percentages, fractions and calculating the area of a property

A **percentage** needs to be converted to a decimal before any mathematical computations can be completed. This is a conversion financial calculators are preprogrammed to make.

When converting percentages to decimals, the basic rule to follow is to move the decimal point two spaces to the left.

Examples:

50% = 0.5

3% = 0.03

115% = 1.15

Alternatively, to convert a decimal to a percentage, move the decimal point two spaces to the right.

Examples:

1.43 = 143%

0.03 = 3%

0.5 = 50%

Fractions converted

It is beneficial to convert all fractions to decimals and then use a calculator to complete the computations.

A **fraction** is composed of a *numerator* and a *denominator*. The number on the top of the fraction is the numerator and the number on the bottom is the denominator.

When converting a fraction into a decimal, divide the numerator (the number on top) by the denominator (the number on the bottom).

Examples:

4/5 = 0.8

1/2 = 0.5

3/4 = 0.75

3/100 = 0.03

667/100 = 6.67

Basic formulas for area

The formula for an **area** of a rectangle is most often used in *land measurement*. The area of a rectangle equals *length* multiplied by *width*, the result being the number of square feet within the parcel.

A = L x W

Examples: area of a rectangular lot

Example 1

A rectangular lot is 1,230 ft by 2,340 ft. What is the area of the lot in acres?

Area = 1,230' x 2,340' (2,878,200 sq. ft).

Conversion of square feet to acres. (One acre equals 43,560 sq. ft.)
2,878,200 / 43,560 = **66 acres**.

Solution: 66 acres.

Example 2

A rectangular lot is comprised of 10 acres. If the length of the lot is 500 feet, what is its width?

10 acres = 10 x 43,560 sq. ft (435,600 sq. ft).

435,600 sq. ft / 500 ft = **871.2 ft.**

Solution: 871.2 ft.

Example 3

A rectangular lot is comprised of a quarter of a quarter (1/16) of a section of a township. The width of the lot is 800 feet. What is the length of the lot in yards?

A quarter of a quarter of a section is equal to 40 acres. (One section of a township equals 640 acres and 1/16 of a section (1/4 x 1/4) is 40 acres.)

40 acres = 40 x 43,560 sq. ft (1,742,400 sq. ft).

1,742,400 sq. ft / 800 ft = 2,178 ft.

2,178 ft / 3 = **726 yards.**

Solution: 726 yards.

Example 4

A rectangular lot measures 1,652 ft by 2,430 ft. The cost per acre for the lot is $120. How much would the lot cost to purchase? (Round to the nearest whole acre.)

The lot area = 1,652 ft x 2,430 ft. (4,014,360 sq. ft).

4,014,360 sq. ft = 92 acres (4,014,360 / 43,560).

92 acres x $120 = **$11,040.**

Solution: $11,040.

Another critical formula is the area of a triangle. This formula is used when determining the area of a triangular shaped lot.

The area of a triangle equals its base multiplied by its height divided by two.

A = (B x H) / 2

Examples: area of a triangular lot

Example 1

A triangular lot features a 200 ft base and a height of 150 ft. How many square feet are contained in the triangular lot?

The lot area = (200 ft x 150 ft) / 2.

30,000 ft / 2 = **15,000 sq. ft.**

Solution: 15,000 sq. ft.

Percentage formula

The *percentage formula* is a basic calculation used in real estate mathematics. It is typically used to determine the amount of a **broker's fee** on a transaction.

As compensation for services, a broker is entitled to a *broker's fee* typically stated as a percentage of the:

- sales price;
- loan amount; or
- total rents.

The percentage formula is easily converted to suit a variety of situations. On the state licensing exam, usually two of the three variables will be known, leaving the third to be determined.

Understanding the basic formula makes solving problems a question of mechanics.

The percentage formula is as follows:

Fee = Percent (%) x Principal

Percent (%) = the rate charged.

Principal (P) = the dollar amount of the price, loan or rents.

Given the basic formula and two of the three variables, solutions are determined as follows:

- To determine the fee, multiply the principal by the rate **(P x %)**.
- To determine the rate, divide the fee by the principal **(Fee / P)**.
- To determine the principal, divide the fee by the rate **(Fee / %)**.

Examples: percentages

Example 1

A broker earns a 3% fee on the sale of a $1,000,000 home. How much will the broker earn?

Consider what we know:

% = 3%

P = $1,000,000

Using the percentage formula: Fee = % x P

Fee = 3% x $1,000,000

Fee = 0.03 x $1,000,000

Fee = $30,000

Thus, the broker earns a fee of $30,000.

Solution: $30,000

Example 2

An agent shares in the broker's fee based on 40% of the 3% fee the broker is paid on a transaction. The home sells for $945,000.

Editor's note — Alternatively, the purchase price is analogous to the total loan amount in a mortgage loan brokerage situation, or the total amount of all rents due during the initial term of a lease agreement in a leasing agent situation.

How much will the agent earn?

Start with what we know to determine the broker's fee:

% = 3%

P = $945,000

Using the percentage formula:

Fee = 3% x $945,000

Fee = 0.03 x $945,000

Fee = $28,350

Thus, the broker will earn **$28,350**. The sales person will then receive 40% of $28,350.

Using the percentage formula:

Fee = 40% x $28,350

Fee = 0.4 x $28,350

Fee = $11,340

The agent receives **$11,340** on the close of the transaction.

Solution: $11,340

Example 3

A real estate transaction involves both a seller's broker and a buyer's broker. Under the terms of the seller's listing agreement, the seller is to pay the seller's broker 3% of the purchase price. Under the separately negotiated Buyer Representation Agreement, the buyer's broker is to receive 2% of the funds accruing to the seller on the buyer's price paid.

If the home sells for $1,000,000, what are the total broker fees itemized as a transactional cost on the seller's net sheet?

First, compute the total fee to be received by the seller's broker:

Seller's broker's fee = 3% x $1,000,000

Seller's broker's fee = 0.03 x $1,000,000

Seller's broker's fee = $30,000

Thus, the total brokerage fee to be paid to the seller's broker is **$30,000**.

Second, calculate the buyer's broker's fee as established under the Buyer Representation Agreement:

Buyer's broker's fee = 2% x $1,000,000

Buyer's broker's fee = 0.2 x $20,000

Buyer's broker's fee = $20,000

$20,000 is the amount the buyer's broker will receive on the close of the transaction.

Finally, add both fees to calculate the total broker fees.

Seller's broker's fee = $30,000

Buyer's broker's fee = $20,000

Total broker fees = $50,000

The total broker fees itemized as a transactional cost on the seller's net sheet is **$50,000**.

Solution: $50,000

Mortgage calculation

The percentage formula can also be used when calculating mortgage arrangements.

Cost of using the lender's money = *Cost*

Interest rate = *Percent*

Principal amount of the loan = *Principal*

When calculating simple interest, the interest rate is the rate of interest over one year.

Interest can be further broken down into months by dividing the annual interest rate by 12, and into days by dividing the interest rate by 360 (months are uniformly considered to be 30 days to avoid awkward numbers).

Financial calculators and **amortization tables** make interest calculations easier. An *amortization table* is a schedule of monthly loan payments which show the amount of principal and the amount of interest which comprises each constant payment until it is paid in full by the end of the term.

Early in the amortization schedule, a majority of the monthly payment is applied to interest. However, towards the end of the schedule, most of the monthly payment is applied towards the diminishing *principal balance*.

In loan problems, **time** is an important factor and is part of the percentage formula. Thus, the percentage formula is modified slightly for loan problems as follows:

Cost of borrowing money (C) = Interest Rate (%) x Time (T) x Principal (P)

C = % x T x P

When dealing with interest rates for different periods, remember the following:

- for *annual interest*, the interest rate is the percent given;
- for *monthly interest*, the interest rate is equal to the interest rate given divided by 12 (for the 12 months in the year); and
- for *daily interest*, the interest rate is equal to the interest rate given divided by 360.

QUIZ

1. The formula for an area of a rectangle is most often used in:
   a. calculating annual property taxes.
   b. land measurement.
   c. fee split negotiations.

2. The percentage formula is most likely to be used to:
   a. calculate the area of a triangular lot.
   b. calculate county transfer taxes to be paid on the close of escrow.
   c. determine the amount of a broker's fee on a transaction.

California real estate mathematics applied to taxes

Proposition 13 (Prop 13), also known as the *People's Initiative to Limit Property Taxation*, was voted into California's Constitution in 1978. It caps the amount property taxes may increase each year.

Prop 13 limits property taxes to 1% of the property's *assessed value*. The property's assessed value equals the property's **base value** (the property's value at the time of purchase), plus an inflation factor determined by California's consumer price index (CPI). When the same owner has held the property since Prop 13 was adopted, then their home is taxed based on its assessed value in *1975*.

The property's assessed value may increase a maximum 2% each year, to compensate for annual **inflation**. However, it may change upon a reassessment by the county assessor. A reassessment only occurs upon *transfer of title*, even when the property's actual **fair market value (FMV)** is substantially higher than its assessed value.

On the other hand, the property's assessed value may not be more than the current FMV. Thus, during a recessionary period of price decline, when a property's assessed value is higher than its market value the assessed value is reduced to its *reappraised value*. The property is to be reappraised annually until the value exceeds its original assessed value, at which point the original assessment rules apply. [Calif. Revenue and Taxation Code §51(e)]

Consider a property purchased for $700,000.

After the purchase, the new owner installs a swimming pool which adds $50,000 to the assessed value.

The next year, the tax assessor raises the value 2% as allowed by Prop 13. To calculate the current assessed value, first determine the base value by adding the sales price, $700,000, and the improvement, $50,000.

Then, multiply this amount by the 2%, the increase allowed under Prop 13. Convert the percentage to a decimal by moving the decimal two places to the left. Thus, the current assessed value is $765,000.

County transfer tax

The basic county **transfer tax** rate is $0.55 per $500 of valuation.

For values over $500 but less than $1,000, the amount of the *transfer tax* is rounded up. Several counties and communities charge additional fees.

The transfer tax is a one-time fee paid at the time title is transferred and recorded.

Let's frame this as an example.

Consider a buyer who purchases a home for $650,000.

The terms of the sale state the buyer will make a down payment of $200,000 and assume an existing first trust deed for the balance of the purchase price.

At a basic rate of $0.55 per $500, how much will the transfer tax be?

First, understand that transfer taxes are charges against **new money** only. Since the transaction included the assumption of a $450,000 existing mortgage, the only tax charged is against the $200,000 down payment.

The transfer tax rate in the county where the property is located is $0.55 per $500, which equals $1.10 per $1,000.

Therefore, multiply $1.10 by 200, totaling **$220** in transfer taxes paid on the sale.

QUIZ

1. Proposition 13 limits property taxes to __________ of the property's assessed value.
   a. 1%
   b. 3%
   c. 5%

2. The basic county transfer tax rate is:
   a. $0.55 per $100 of valuation.
   b. $0.55 per $500 of valuation.
   c. $0.75 per $1,000 of valuation.

Glossary

A

abandonment: The termination of an easement when the easement holder's actions demonstrate a clear intent to permanently abandon all future use of the easement.

abstract of title: A representation issued by a title company as a guarantee to the named person, not an insurance policy, listing all recorded conveyances and encumbrances affecting title to the described real estate.

Addenda: An attachment to a contract, rental or lease agreement for incorporating any provision agreed to but not included in the boilerplate provisions of the agreement. Further, an existing contract may be amended with the mutual consent of both parties.

adjustable rate mortgage (ARM): A variable interest rate note, often starting out with an introductory teaser rate, only to reset at a much higher rate in a few months or years based on a particular index. In turn, the amount of the scheduled payments fluctuates with each interest rate adjustment based on movement in the agreed-to index.

advance cost sheet: An itemization of the costs incurred to properly market a property for sale which are to be paid by the owner.

advance fee: Broker fees deposited with the broker before they are earned.

adverse possession: A method of acquiring title to real property by a person other than the owner of record through open possession of the property for a five-year statutory period and payment of property taxes.

affiliated business arrangement: A business arrangement in which a broker may lawfully profit from referring a client to a service provider the broker owns; requires the broker to make a disclosure of their ownership interest to the client.

affirmative duty: An agent's obligation to voluntarily undertake an advisory activity when in a fiduciary relationship.

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

Agency Law Disclosure: Restatement of agency codes and cases which establish the conduct of real estate licensees. It is delivered to all parties in targeted sales and leasing transactions.

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

agreed-boundary doctrine: When owners of adjacent properties uncertain over the true boundary agree to establish the location of their common lot line and acquiesce to the boundary line for at least five years.

amortization: The constant periodic payment of mortgage principal until the principal balance has been fully repaid, generally on an installment basis.

Applicable Federal Rate (AFR): Every debt that is the result of an extension of credit on a sale, such as a note carried back by a seller, has an Applicable Federal Rate (AFR) of interest. The note's AFR sets the minimum rate of interest the seller will report over the life of the carryback note. The rate of interest reported is fixed and does not vary.

appraisal: An appraisal is an individual's opinion or estimate of a property's value on a specific date, reduced to writing in an appraisal report, or delivered orally. The appraisal report contains data collected and analyzed by the appraiser which substantiates the appraiser's opinion of the property's value.

appropriation: The action of taking something for one's own use. Most commonly, you'll see this framed in the context of water.

appurtenant easement: An easement located on one parcel is incidental and belongs to the ownership of another parcel which benefits from its use.

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.

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

associate licensee: A sales agent employed by a broker.

attorney fee provision: A provision in an agreement permitting the prevailing party to a dispute to receive attorney fees when litigation arises due to the agreement.

attorney in fact: One who is authorized by another to perform certain acts for another under a power-of-attorney. A power-of-attorney may be limited to a specific act or acts, or be more general in its application.

B

balancing hardships: The awarding of money to an owner to compensate for lost use of their property burdened with an encroachment.

balloon payment: Any final payment on a note which is greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the final/balloon payment.

beneficiary: The holder of a note secured by a trust deed and entitled to the performance of the provisions in the trust deed, such as a lender or carryback seller. Beneficiary also refers to an individual entitled to the benefits of a trust or from an estate, the title of which is vested in a trustee.

bilateral contract: A contract in which a promise by one party is given in exchange for a promise made by the other party. It is a promise given in exchange for a promise, both parties being required to perform.

bona fide purchaser: A buyer who lacks knowledge that the property they are buying is the subject of a sale to another buyer and purchases the property for valuable consideration. The expression "bona fide purchaser" indicates a participant is acting in good faith, without awareness of other claims or improprieties.

building inspectors: Individuals employed by municipalities to ensure properties comply with local building codes, ordinances, zoning regulations and contract specifications.

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

bundle of rights: All of the legal rights incident to the ownership of property.

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

buyer's agent: An agent representing the buyer. Also known as a selling agent.

C

capitalization method: An appraisal method used by an appraiser to arrive at a property's value based on the present worth of a property's future net operating income.

capitalization rate (cap rate): The annual rate of return on investment produced by the operations of an income property or sought by an investor on the investment of capital.

certificate of sale: A certificate issued to the successful bidder on the completion of a judicial sale of a property.

civil law: Spanish civil law attempts to settle legal disputes by establishing elaborate statutes to address the issues in advance of the disputes, rather than on a case-by-case basis.

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

chain of title: A history of conveyances and encumbrances affecting the title from the time the original patent was granted in 1870, or as far back as records are available, used to determine how title came to be vested in the current owner.

cloud on title: A claim, encumbrance or condition which impairs the title to real property until disproved or eliminated by a quiet title action, use of a quitclaim deed, or other action.

color of title: Title that has the appearance of validity but has a fatal defect and is ineffective.

commingling: The mixing of personal funds with client or third-party funds held in trust.

common boundary improvement: An improvement which acts as a demarcation of the property line.

common law: An English legal system in which disputes are decided by a judge on a case-by-case basis applying precedent set in prior cases and statutes.

community property: All property acquired by husband or wife during a marriage when not acquired as the separate property of either spouse.

comparable sales (comps): comparable sales: Sales of properties recently sold which have similar characteristics as the subject property being evaluated and are used for analysis in the appraisal of the subject property.

condemnation: The act of taking private property for public use by the government with payment to the owner to compensate for the taking. The process of using the power of eminent domain is called condemnation.

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.

conservation easement: A voluntary conveyance of the right to keep land in its natural or historical condition to a conservation organization or government agency.

constructive notice: To be charged with knowledge of the observable or recorded conditions which exist on a property.

Consumer Financial Protection Bureau (CFPB): An independent federal agency responsible for regulating consumer protection in the financial services and products market.

consumer mortgage: Consumer mortgages are either conventional mortgages or government-related mortgages. A conventional mortgage is any mortgage that is not made, insured or guaranteed by the federal government. Alternatively, a government-related mortgage is a mortgage insured by the FHA, guaranteed by the VA or guaranteed or funded by the USDA.

continuing nuisance: An ongoing nuisance that can be entirely eliminated by those adversely affected by the activity or condition.

contractor: Anyone who constructs, alters, repairs, improves or demolishes any building, road, project, development or improvement.

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

counteroffer: An alternative response to an offer received consisting of terms different from those of the offer rejected.

credit application: A document prepared by a prospective tenant which includes a provision authorizing the investigation and receipt of information on the applicant's creditworthiness.

D

date-down search: A further search of the public records performed by a title insurer after preparing a preliminary title report and immediately prior to issuance of a policy of title insurance.

debt-to-income ratio: Percentage of monthly gross income that goes towards paying debt.

declaration of homestead: A document signed by a homeowner and filed with the county recorder's office to shield the owner-occupant's homestead equity from seizure by creditors.

deed: A written instrument which when signed and delivered conveys title to real property from one person — the grantor — to another — the grantee.

default: Failure to fulfill a duty or promise or to discharge an obligation. You will likely hear this framed in the context of a default on a mortgage.

deficiency judgment: A judgment awarded by a court in a judicial foreclosure when the value of mortgaged property on the borrower's default is insufficient to pay off the mortgage debt.

Department of Fair Employment and Housing: The state agency designated to protect Californians from discrimination in housing, employment, and public accommodations.

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

depreciation: Depreciation reflects any value-related loss in the property due to use, decay and improvements that have become outdated.

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

dominant tenement: The property benefitting from an easement on a servient tenement.

dual agent: A broker who represents both parties in a real estate transaction.

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

E

earnest money: The down payment or partial payment made by a purchaser of real estate as evidence of their good faith intent to buy. Earnest money is also known as a good faith deposit.

easement: The right of the owner of one parcel to use an adjacent parcel owned by another for a specific purpose.

easement by necessity: An easement providing access to a landlocked property.

elements of value: Value is impacted by numerous factors, known as the elements of value. These elements can be easily memorized using the acronym "DUST." The elements of value are demand, utility, scarcity and transferability.

embezzlement: The dishonest act of converting a client's assets for personal use.

eminent domain: The right of government to take private property for public use.

encroachment: An improvement on a parcel of real estate, such as a building, fence, driveway or tree, which extends into an adjacent parcel belonging to another person without their consent.

encumbrance: A claim or lien on title to a parcel of real estate, such as property taxes, assessment bonds, trust deeds, easements and covenants, conditions and restrictions (CC&Rs).

environmental hazards: Noxious or annoying man-made conditions which are injurious to health or interfere with an individual's sensitivities.

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

equity: The interest or value an owner has in real estate over and above the liens or encumbrances against it.

errors and omissions (E&O) insurance: An insurance policy protecting brokers and agents from negligent conduct when acting as a licensee.

escheat: The reverting of property to the State when heirs capable of inheriting are lacking. There is no compensation and only the state government may acquire property through escheat, never an individual or other government agency.

escrow: The depository process employed to facilitate the gathering of instruments and funds for use to transfer real estate interests between two persons.

estates: The ownership interests a person may hold in real estate. Four types of estates exist.

estate for life: A freehold estate in land held by a person who is entitled to the use of the property for the duration of their life or the life of another. An estate for life is also called a life estate. It terminates and is eliminated on death of the controlling life.

estoppel: A legal theory barring a person from later asserting or denying a condition based on the person's previous acts or statements.

eviction: An unlawful detainer action to physically remove a tenant from a property they wrongfully possess.

exception: Any encumbrances affecting title and any observable on-site activities which are listed as risks assumed by the insured and not covered by a policy of title insurance under Schedule B.

exclusion: Risks of loss not covered under a policy of title insurance, comprised of encumbrances arising after the transfer or known to or brought about by the insured.

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

exclusive agency listing: An agreement employing a broker as the sole agent for the seller of real property in which the seller promises to pay the broker a fee if the property is sold, unless the sale is by the owner acting without the services of any agent.

exclusive right-to-sell/buy agreement: Two types of exclusive employment agreements for buying and selling real estate exist: an exclusive agency agreement for a seller or buyer, and an exclusive right-to-sell or right-to-buy listing agreement. During the listing period under an exclusive right-to-sell or buy agreement's fee provision, the broker earns a fee no matter who produces the buyer or locates the property sought, be it the client or another broker.

F

fair market value (FMV): Value is the present worth of the future benefits arising out of the ownership of a property. Fair market value is the price a reasonable, unpressured buyer and seller would agree to for both having reasonable knowledge of the relevant facts.

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

Fannie Mae: A government-sponsored enterprise buying, owning and selling mortgages in the secondary mortgage market.

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

fee estate: A person who holds a fee estate interest in real estate is a fee owner. A fee owner has the right to possess and control their property indefinitely. A fee owner's possession is exclusive and absolute.

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

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

fixed-term tenancy: A leasehold interest held by the tenant, running for the specific lease period as set in a lease agreement. A lease agreement is required to have a commencement date and an expiration date. A fixed-term tenancy automatically terminates at the end of the lease period. Further, when the rental period is longer than one year, the lease arrangement is required to be in writing.

fixture: Personal property which has become permanently attached to real estate. As it is permanently attached, it effectively becomes part of the real estate and is conveyed with it.

G

gable roof: A pitched roof with sloping sides.

gambrel roof: A curb roof, having a steep lower slope with a flatter upper slope above.

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

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

goodwill: The intangible image or opinion held about a property which affects its earning power.

graduated payment mortgage (GPM): A mortgage providing for installment payments to be periodically increased by predetermined amounts to accelerate the payoff of principal.

grant deed: A document used to pass a fee simple interest in real estate from the grantor to another individual, unless a lesser interest is stated, such as an easement, life estate or leasehold interest.

ground lease: A ground lease on a parcel of real estate is granted to a tenant in exchange for the payment of rent, which is based on the rental value of the land in the parcel, whether vacant or improved. Fee owners of vacant, unimproved land use leases to induce others to acquire an interest in the property and develop it.

H

habitable condition: The minimum acceptable level of safety, utility and sanitation permitted in a residential rental. Related, the implied warranty of habitability is an unwritten provision, included by statute, in all residential lease agreements requiring the landlord to provide safe and sanitary conditions in the rental unit.

hazardous waste: Waste is hazardous if it has the potential to harm human health or the environment. Hazardous waste materials include any product, material or substance which is toxic, corrosive, ignitable or reactive, as is generated by the oil, gas and electronics industries, and dry cleaner and print shops.

highest and best use: An appraisal phrase addressing the use of a property which is most likely to produce the greatest net return on the land and/or buildings over a given period of time.

hip roof: The roof of a property that slopes on all four sides.

holdover tenant: A tenant who retains possession of the rented premises after their right of possession has been terminated.

holdover tenancy: A holdover tenancy occurs when a tenant continues in possession of the property after their right to occupy has expired. This holdover of possession without a contractual right is called an unlawful detainer.

homestead: The dollar amount of equity in a homeowner's principal dwelling the homeowner qualifies to shield as exempt from creditor seizure.

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

I

implied easement: An easement created by the conduct of parties without prior agreement.

impound account: Funds received and held by a mortgage holder to pay the owner's annual obligations owed for property taxes, hazard insurance premiums, assessment liens and improvement bonds. An impound account is also called an escrow account.

income approach: One of three approaches of the appraisal process applied to income-producing property to develop the appraiser's opinion of value. There are two methods of calculating the property's value under the income approach: the gross rent multiplier method (GRM), and the capitalization method.

inflation: The price change in consumer goods and services, stated in the consumer price index (CPI) as a figure which is reported as a percentage change over one year ago.

influences on value: There are four major influences on value which are constantly changing. These influences on value are: physical, economic, government and social. Taken together, the influences on value can be easily memorized using the acronym "PEGS."

ingress and egress: Access to a property by its owner directly from publicly dedicated streets or by using their right to traverse a portion of another's land using an easement.

installment note: A note calling for periodic payments of principal and interest, or interest only, until the principal is paid in full by amortization or a final/balloon payment.

instrument: A document which formally expresses the rights of the parties for the purpose of creating, modifying or terminating a right, or the items deposited in escrow associated with a transaction.

inventory: Properties available on the market for sale or lease published through a multiple listing service (MLS) or made available by for-sale-by-owner (FSBO) sellers. Inventory is synonymous with supply.

J

joint tenancy: An ownership interest in property concurrently received by two or more individuals who share equally and have the right of survivorship.

judicial foreclosure: The court-ordered sale by public auction of the mortgaged property. A judicial foreclosure is also known as a sheriff's sale. Contrast this with a nonjudicial foreclosure under the power-of-sale provision in the trust deed or other security device, also called a trustee's sale.

junior mortgage: A junior mortgage, also known as a junior lien or second mortgage, is the second or subsequent loan on a property in a lesser, subordinate position.

K

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

L

land sales contract: Under a land sales contract, a buyer and seller enter into a contract for the sale of property. The buyer takes possession of the property and makes payments according to the terms of the contract. However, title does not formally pass to the buyer by grant deed until the buyer pays the seller in full.

lead-based paint hazard: Any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. If a property was built prior to 1978, the buyer or tenant must receive a copy of the Federal Lead-Based Paint disclosure.

lease agreement: The written document which sets the terms of a fixed-term tenancy.

legal description: The description used to locate and set boundaries for a parcel of real estate. Using the property's legal description, a surveyor locates and sets the corners and horizontal boundaries of the parcel.

lien: A monetary encumbrance on a property securing the payment of a debt or performance of an obligation.

listing: A written employment contract between a client and a licensed real estate broker. On entering into a listing agreement, the broker and their staff are retained and authorized to perform real estate-related services on behalf of the client in exchange for a fee.

liquidated damages: A provision in a purchase agreement specifying the amount of money the seller will receive from the buyer if the buyer breaches the agreement.

loan application: The Uniform Residential Loan Application (URLA) is the standardized mortgage application prepared by the buyer and submitted to the lender. The URLA contains all the information required for arranging mortgages secured by any type of real estate.

loan-to-value ratio (LTV): A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value.

lot line adjustment: When adjacent property owners move an existing property line.

M

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

material fact: Information about a listed property which may affect the property's value or alter a client's decision to purchase or sell the property and, thus, needs to be disclosed.

merger: The termination of an easement when one owner acquires fee title to both the property benefitting from and the property burdened by an easement.

metes and bounds: A term used in describing the boundary lines of land, setting forth all the boundary lines together with their terminal points and angles.

mechanic's lien: A lien created by statute which exists against real property in favor of individuals who have performed work or furnished materials for the improvement of the real property.

mortgage: A security device by which real estate is hypothecated to secure the payment of a debt. In literal practice in California, this term actually refers to a note secured by a deed of trust.

mortgage loan originator (MLO): A DRE-licensed broker or sales agent who solicits or accepts a consumer mortgage application or arranges a consumer mortgage in expectation of a fee is classified as an MLO.

multiple listing service (MLS): A database of property held out for sale or rent, pooled and published by real estate agents.

N

natural hazards: Natural hazards come with the location of a parcel of real estate, not with the man-made aspects of the property. The existence of a hazard due to the geographic location of a property affects its desirability, and thus its value to prospective buyers. To unify and streamline the disclosure of natural hazards by a seller, the California legislature created a statutory form entitled the Natural Hazard Disclosure Statement.

negative amortization: Negative amortization occurs when monthly installment payments are insufficient to pay the interest accruing on the principal balance, requiring the unpaid interest to be added to the principal balance.

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

nonjudicial foreclosure: When property is sold at a public auction by a trustee as authorized under the power-of-sale provision in a trust deed.

note: A document, often secured by a trust deed on real estate, evidencing an obligation to pay money to a creditor, usually a lender or carryback seller. A note is also known as a promissory note.

notice of default (NOD): The notice recorded to begin the nonjudicial foreclosure process.

nuisance: An action which is injurious to health, offensive to the senses, or obstructs the use and enjoyment of surrounding parcels.

O

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 is legally classified as a unilateral contract.

operating expenses: The total annual costs incurred to maintain and operate a property for one year.

option listing: A variation of the exclusive right-to-sell listing in which the seller grants the broker an option to buy the property at a predetermined price, if the property does not sell during the listing period.

orientation: The placement of a house upon the lot is referred to as its orientation. Orientation is the key determinant of a property's sun exposure.

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

P

party wall: A common boundary improvement located on a property line between adjacent properties, such as a wall, fence or building co-owned by the adjacent property owners.

patent: The conveyance to a citizen of title to a property owned by the government, initially issued by the Bureau of Land Management.

periodic tenancy: A leasehold interest which continues automatically for successive rental periods each for the same length of time such as in a month-to-month tenancy, terminating upon notice from either party.

personal property: Moveable property which is not classified as real estate, such as trade fixtures and furnishings.

police power: The constitutional source of the state or local government's authority to act.

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

prepayment penalty: A provision in a note giving a lender the right to levy a charge against a borrower who pays off the outstanding principal balance on a loan prior to expiration of the prepayment provision.

prescription: A process for acquiring property rights to use another's property, such as an easement, through adverse use hostile to the rights of the owner.

prescriptive easement: The right to use another's property established by the adverse use of the property for a period in excess of five years without a claim of ownership.

prescriptive right: Prescriptive rights to the use of water may be established when a person appropriates nonsurplus water openly and adversely for an uninterrupted period of five years, and does so without documentation or evidence of a legal right, called a claim of right.

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

principles of value: The application of several appraisal principles to arrive at a final value.

private mortgage insurance (PMI): Default mortgage insurance coverage provided to a mortgage holder by private insurers on conventional mortgages with loan-to-value ratios (LTVs) higher than 80%.

profit a prendre: The right to remove minerals from another's real estate.

pro rata: A Latin term used to describe a proportionate allocation relating to a percentage or proportion of a whole.

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

prudent investor standard: A property management standard reflecting the expectations of a well-informed investor for efficient and effective management of rental income and expenses.

punitive damages: Monies awarded in excess of actual money losses in order to deter unlawful actions.

purchase agreement: The primary document used as a checklist to negotiate a real estate sales transaction between a buyer and seller.

Q

quitclaim deed: A document used to convey whatever interest, if any, the grantor may hold in the real estate.

R

radon gas: Radon gas is a naturally occurring gas resulting from the erosion of uranium in soil. Radon gas is harmless in well ventilated areas but can accumulate in confined areas, such as crawl spaces and basements, posing a health risk to occupants.

ratify: The later adoption or approval of an act performed on behalf of a person when the act was not previously authorized.

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

Real Estate Recovery Account: Funds available to individuals who have obtained a final-court judgment against a licensee and are unable to recover the judgment from the licensee. The Real Estate Recovery Fund is also known as the Consumer Recovery Account. The threshold is $50,000 for one transaction and $250,000 for any one licensee.

Real Estate Settlement Procedures Act (RESPA): Legislation prohibiting brokers from giving or accepting referral fees if the broker or their agent is already acting as a transaction agent in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally related consumer mortgage.

reconciliation: The second to last step in the appraisal process is the correlation or reconciliation of the values arrived at under each of the three appraisal approaches.

reconveyance: A document executed by a trustee named in a trust deed to release the trust deed lien from title to real estate when the secured debt is fully paid.

recording: The process of placing a document on file with a designated public official known as the County Recorder. All documents filed with the County Recorder put the general public of that county on notice of the contents of the document.

recourse: A debt for which a debtor may be personally liable if a sale of the secured property does not fully satisfy the debt on a default.

redlining: The practice of denying mortgages and under-appraising properties in minority communities based on demographics, outlawed in California by Housing Financial Discrimination Act of 1977.

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

regression: A real estate valuation theory which holds the worth of a greater valued property is negatively affected by the close proximity of numerous lesser valued comparable properties.

Regulation Z: A component of the Truth-in-Lending Act (TILA) requiring consumer mortgage lenders to timely disclose a loan's annual percentage rate and all associated costs to potential borrowers, enabling borrowers to competitively shop for loans.

rental agreement: The written document which sets the terms and conditions of a periodic tenancy.

rental market: The market environment in which landlords seek tenants and tenants seek landlords for the occupancy of property. The rental market sets the amount of rent a property will command on any given day.

replacement cost: The cost to replace a structure with one having utility equivalent to that being appraised, but constructed with modern materials and according to current standards, design and layout.

reservation: A right retained by a grantor in conveying property.

resident manager: An individual employed by the property manager or landlord to live onsite at the managed property and handle its daily operations.

restitution: A money award given to restore an injured party to the condition they held before being damaged.

reversion: The interest which a person has in land or other property which is received on termination of the preceding estate. For example, when a lease expires, real estate fixtures are the landlord's property, not the tenant who installed them. The conveyance of these fixtures from the tenant to the landlord on expiration of the lease is a reversion.

right of first refusal: A pre-emptive right held by another person to buy a property if the owner decides to sell.

right of survivorship: The right of surviving joint tenants or a spouse to succeed to the entire interest of the deceased co-owner.

right-of-way easement: A privilege under an easement granted by the owner of property giving the owner of another property the right to pass over their property.

S

Schedule A: Identification of the property interest insured, the legal description of the insured property, the date and time coverage began, the premium paid for the policy and the total dollar amount to be paid for all claims settled.

Schedule B: Exceptions from coverage, both standard and itemized, by the title insurance policy.

secondary mortgage market: A market for the sale of bonds collaterally secured by a pool of mortgages. Warehoused mortgages are sold on the secondary mortgage market to investment pools, such as Fannie Mae, Freddie Mac and Ginnie Mae.

security deposit: 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.

seller's agent: An agent representing the seller. Also known as a listing agent.

seller financing: A note and trust deed executed by a buyer of real estate in favor of the seller for the unpaid portion of the sales price on closing.

servient tenement: A property burdened by a license or easement.

set aside: To annul by court order a document transferring an interest in real estate.

shared appreciation mortgage (SAM): A type of split-rate note calling for the property owner to periodically pay interim interest at a fixed rate, and when the balance is due, to further pay the holder of the note as additional interest an agreed fraction of the property's increased value.

signer: An employee who has written authorization from the broker to withdraw or disburse funds from the trust account.

statute of limitations: The commonly used identifying term for various statutes which require that a legal action be commenced within a prescribed time after the accrual of the right to seek legal relief.

stepped-up cost basis: The tax basis of community property a surviving spouse receives on the death of a spouse is stepped up to the property's fair market value on the date of death.

straight note: A note calling for the entire amount of its principal to be paid together with accrued interest in a single lump sum when the principal is due.

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

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

Subdivided Lands Law: Government regulations that empower the Real Estate Commissioner to approve a public report for the sale of property divided and developed by the land owners.

T

teaser rate: A temporary, low introductory interest rate found in adjustable rate mortgages (ARMs).

tenancy-at-sufferance: A leasehold interest held by a tenant who retains possession of the rented premises after their right of possession has been terminated.

tenancy-at-will: A leasehold interest granted to a tenant with no fixed duration or rent owed.

tenant improvements: Improvements made to a leased property to meet the needs of the occupying tenant. All tenant improvements are to remain with the leased property on termination of a lease unless the lease agreement permits or mandates their removal by the tenant as a restoration of the premises.

title insurance: A form of indemnity insurance issued by a title insurance company which holds harmless the named insureds against monetary loss caused by an encumbrance not listed in Schedule B of the policy and not known by the insured when the policy was issued.

trade fixtures: Fixtures which are used to render services or make products for the trade or business of a tenant. Trade fixtures are considered personal property are to be removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord.

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. The TDS is more generically called a Condition of Property Disclosure Statement. The state mandated disclosure form requires the seller to state all known material facts affecting the property's value and desirability.

trespass: A trespass is any wrongful and unauthorized entry onto real estate in the possession of another. Trespass is distinct from any interference with title or an ownership interest.

trust account: An account separate and apart and physically segregated from a broker's own funds, in which the broker is required by law to deposit all funds received for clients.

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

Truth in Lending Act (TILA): A federal law designed to protect borrowers applying for a consumer mortgage with a lender which requires lenders to make upfront disclosure of mortgage rates and charges.

U

unlawful detainer (UD): The unlawful possession of a property. A landlord needs to file a judicial unlawful detainer (UD) action to have a holdover tenant evicted. Plainly speaking, the tenant needs to unlawfully retain possession of the property before the tenant can be evicted for unlawful detainer.

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

U.S. Department of Veterans Affairs mortgage guarantee: A federal program that assists qualified veterans or their surviving spouses to finance their purchase of a home with zero down payment.

usury: A limit on the lender's interest rate yield on nonexempt real estate loans.

V

vesting: A method of holding title to real estate, including tenancy in common, joint tenancy, community property and community property with the right of survivorship.

visual inspection: An inspection of a listed property performed by the seller's agent and undertaken to observe defects to be noted on a condition of property disclosure called the Transfer Disclosure Statement (TDS).

void: Void and voidable are contract terms which are similar but are distinguishable by the date they affect the validity of a contract, and thus, the rights of those who relied on the contract. Void contracts are unenforceable. A voidable contract is a contract that is valid and enforceable after delivery until it is challenged due to a defect and a court order declares the contract to be invalid.

Z

zoning: Building and land use restrictions enacted by local policy makers to ensure a consistent flow of new improvements to meet the demand of population growth.

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