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California Real Estate Principles

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CHAPTER 1

THE GOLDEN STATE

Overview

The state of California is approaching 40 million residents. It is, by far, the most populous state in the nation. If California were a separate nation, it would have the fifth largest economy in the world. What is truly shocking about this large state is that the almost 40 million state residents live on only about 5% of California's total land. Much of the state is desert, forests, mountains, and protected state and national parks that do not allow buildings or residents.

Most of the other 95% of land in the state does not have people or residential or commercial property on it. Yet, California is home to some of the most densely populated regions in the nation as well as the entire world in spite of all of this available and unused land.

California History

California has been inhabited for thousands of years. Some of the earliest Native Americans that lived in the region that would later become known as "California" included the Mohave, Yuma, Pomo, Chumash, and Maidu tribes. Many of these tribe members were separated by vast mountain ranges, valleys, and lakes. As a result, there were a number of different types of cultures and languages spoken. The vast majority of these early Native American settlers were peaceful and loving people who fished, hunted, and gathered nuts, fruits, and vegetables for food sources for their tribe members.

Did you know that at least four different types of flags have flown over various parts of the California region over the past several centuries? These include flags from Russia, Spain, Mexico, and the United States. The first big group of settlers in the region that would later become California was the Spanish and Mexicans. They were later followed by Russians in some smaller settlements that were used partly for the

purpose of hunting whales and trapping animals for their fur in areas of Northern California. Yet, these same Russian settlers never attempted to colonize any parts of California.

California's Name

There are at least a few theories out there about the origin of the name “California.” One belief is that it was based upon a romance novel that was first published in 1510 called ***Las Sergas de Esplandian*** that was written by Garci Rodríguez de Montalvo. At the time, the book was quite popular with Spanish explorers who first came to visit parts of the Pacific Coast partly because they were lonely being away from their beloved women back home while sailing the high seas for weeks and months.

The book was about an island paradise near the Indies where a beautiful woman named Queen Califia rules over a nation of beautiful black Amazons with lots of gold and pearls that was located somewhere “east of Asia” just like the real state of California. The fictional island nation in the novel was called *Island of California*.



In 1535, during the early years of Spanish settlement, when the Spaniards landed in the Baja California region of Mexico (“baja” means “low” in Spanish), they thought they had discovered an island because they had also discovered lots of pearls like those featured in the popular romance novel at the time. At a later date, when they ventured along the coast, the Spaniards realized that they were on more of a peninsula along the coastline of California that extended much further north that would later be named “Alta California” (“alta” means “high”).

The fictional main character in the romance novel, named Queen Calafia, was thought to be based on the Spanish word *califa*, which is derived from the Latin word *calipha* that might date back to the oldest Arabic root word - *khalif*. (Definitions include: “a spiritual leader of Islam, claiming succession from Muhammad”; “the title of successors of Muhammad as rulers of the Islamic world”; and “any of the former Muslim rulers of Baghdad up until 1258 and the Ottoman Empire from 1571 to 1924”).

Spanish Settlers

A Portuguese explorer by the name of Juan Rodríguez Cabrillo first guided his ship from the nation of Spain to land in the California region back in 1542. The Spanish settlers had some serious concerns about competing with Native Americans, Russians, Mexicans, and English settlers in the ongoing battle to hopefully colonize portions or the entirety of California over a period of a few hundred years. Some 35 years later, the English explorer named Sir Francis Drake landed his ship near the San Francisco coast in 1579. Because California was thousands of miles away from Spain and Old England, the attempt to create massive European settlements didn't really begin until almost 200 years later.

Spanish Missions

Initially, Spanish priests were sent to California in an attempt to convert the Native Americans to Christianity. It was Spain's intent to make the local California natives become loyal followers of the authority that was obedient to governance from Spain.

The Spanish began to build Catholic mission buildings in the California region in 1769. They built 21 missions along the scenic coastline as a strategy to convert the local Native Americans to Catholicism. Additionally, they built forts for battles and defense of their new territory that were called “presidios” and small towns that were called “pueblos” to house their residents. One of the Spanish presidios built in the southernmost section of their settlement would later become the city of San Diego, while a mission built 100 miles or so north would later evolve into the city of Los Angeles.

Mexico's Independence

Mexico would later gain its formal independence from Spain in 1821. Shortly thereafter, California would become a province of the new independent nation called Mexico. During the reign under Mexico, large farms and cattle ranches were formed to take advantage of all of the natural livestock, fruits, nuts, and vegetables that were plentiful throughout the diverse and rich region. Beaver and California Grizzly Bear furs became quite popular for local hunters and traders from Mexico, England, and other parts of the world as a result of the perceived value of these furs that could be traded for other items.

The Bear Republic

By the early 1840s, more and more settlers were moving out to the warmer California coast from the much cooler East Coast in search of land sites and new opportunities for their families. Many of these new settlers arrived using the Oregon Trail and the California Trail.

Shortly after their arrival, these American settlers began to fight back against the Mexican government for the right to grab their own piece of land in the California region. In 1846, some of the settlers were led by a man named John Fremont in the revolt against the Mexican government, while they declared their own independent nation that was first called the *Bear Flag Republic*.

This short-lived republic didn't last very long because it was in that same year, 1846, that the United States and Mexico declared war on one another in the Mexican-American War. Two years later in 1848, California would officially become a territory of the United States. On September 9, 1850, California was then admitted to the Union as the 31st state.

The California Gold Rush

In the year when the Mexican-American War ended, a massive amount of gold was discovered by James Marshall at Sutter's Mill near the city of Coloma. At the time of the gold discovery, Marshall was building a sawmill for John Sutter prior to finding shiny flakes of gold floating in

the nearby river. Marshall shared the good news with Mr. Sutter, and they tried to keep it a secret. But the word soon got out to the neighbors and fellow townspeople before later spreading across the nation and even to various locations around the world.

Prior to the start of the Gold Rush (or the attraction of hundreds of thousands of new California residents to the Golden State), there were only about 14,000 non-Native Americans living in the region of California. After the word spread of the new gold discovery in 1848, another 6,000 new residents moved to the Gold Rush area. The following year, in 1849, another 90,000 or more residents flocked to the area from places as far away as China, Europe, and Australia. As such, the origin of the phrase “49er” that is associated with many things, like the San Francisco 49ers NFL team, is directly associated with the earliest migration to California in search of a new golden lifestyle, literally and figuratively.



Two of the more popular ways to search for gold was by way of digging or panning. Many of the earliest gold prospectors were making tremendous amounts of money that were equivalent to at least 10 times what they could make each day in another line of work. They would use picks, axes, or small knives to chop or dig through the rocks or soil in search of

gold. The method of “panning for gold” was to stand in the nearby rivers or lakes and put gravel and water in small pans that were then shaken back and forth until the heavier gold settled to the bottom of the pan. That made the gold easier to find for the miners.

Boomtowns and Ghost Towns

Shortly after the discovery of gold in scattered regions throughout California, the hundreds or thousands of new gold miners showed up to once uninhabited regions in need of mining supplies, food, and a place to sleep at night. As a result, small towns sprouted up almost overnight with new businesses that were quickly formed to meet the miners’ needs, such as suppliers of mining pans, shovels, and picks. Of course, the miners also needed bacon, coffee, beans, sugar, flour, tents, lamps, and many other items.

Often, the new business owners would sell these products at prices well above the market value at the time because the demand for their supplies far exceeded the availability of those supplies near these gold rush regions. Since the buyers had newfound wealth after discovering gold, but no basic accounting or financial skills, the miners would pay top prices for these goods being sold in these goldrush areas. Many times, the store and business owners who sold supplies to the miners often became wealthier than the miners themselves due to the peak demand and top prices the miners willingly paid.

These gold rush campsites sometimes stayed small in size, depending upon the discovery of gold adjacent to the mining camps. When gold was plentiful, then these same mining camps would evolve from a few tents here and there to “boomtowns” with newly constructed storefronts, bars, small apartment units, and brothels. These were, much later of course, glorified in old “Western” films and television shows. Sometimes, these small boomtowns that were maybe just 100 yards in length would grow to larger cities over the years, including locations like Columbia and even San Francisco.



When the gold eventually ran dry or wasn't found again in certain areas, the miners would pack up their supplies and head to the next rumored gold-rush area. Once the miners left, then the business and store owners followed them out of town trying to find the next profitable district to sell their goods to newly wealthy miners in other parts of the state. With the people gone from these once boomtown locations, the towns were later referred to as Ghost Towns, since all of the residents seemingly disappeared almost overnight.

Additional Key Gold Rush Facts

- There were only about 1,000 residents in the city of San Francisco at the time when gold was first discovered. Just a few years later after the discovery of gold, the area had well over 30,000 residents.
- As noted earlier, California was admitted as the 31st state of the United States near the peak of the Gold Rush in 1850. Was California rushed to be named a state because of all the potential wealth that the U.S. federal government could attempt to seize at the time?
- Two other well-known “gold rush” locations in the western regions included Pike’s Peak in Colorado and the Klondike Gold Rush in Alaska.
- Historians and gold experts over the years estimated that close to 12 million ounces of gold were mined during the gold rush years. Using current gold price values, it would be equivalent to about \$21.9 billion dollars.

California Geography

From east to west, the greatest distance in the state reaches 560 miles. From north to south (Oregon and Mexican borders), the greatest distance is 1,040 miles. Along the coastline, the distance is closer to 840 miles from south to north. California has the third largest land size of any state after Alaska and Texas, with almost 156,000 square miles and an additional 7,734 square miles that are covered by water, for a grand total size of almost 164,000 square miles.

Highest Point: Mt. Whitney is the highest point in the state at 14,494 feet. It is also the highest point in the contiguous 48 states.

Lowest Point: The lowest point in the state is Death Valley. This region of the state lies 282 feet below sea level and is also the lowest point in the entire nation.

Mean Elevation: California's mean elevation is 2,900 feet above sea level, thanks to the large number of hills and mountains that surround our deserts, forests, lakes, and the Pacific Ocean.

Hottest Temperature: Death Valley is also home to the hottest air temperature ever reached in U.S. history at 134 degrees Fahrenheit on July 10, 1913.

Lowest Temperature: The town of Boca, California in Nevada County, which is right near the California and Nevada border and Truckee, situated 5,528 feet above sea level, once reached an all-time state low temperature of an incredibly frigid **-45 degrees Fahrenheit**.

Major Rivers: Sacramento River, San Joaquin River, Colorado River

Major Lakes: Lake Tahoe, Salton Sea, Owens Lake, Searles Lake

California's contrasting landscape and diverse topography consists of eight main regions throughout the state that include:

Klamath Mountains: Located in the northwest corner of the state, the Klamath Mountains region consists of numerous forest-covered mountain ranges that are anywhere from 6,000 and 8,000 feet above sea level. Deep canyons separate these mountain ranges from one another.

Coastal Ranges: The Coastal Ranges reach from close to the Klamath Mountains in the northern portion of the state all the way south to Santa Barbara, and close to the Pacific Ocean to as far as 30 miles inland. Some of the smaller chains of mountain ranges include Diablo and Santa Cruz Mountains. The valleys that separate some of these ranges include Napa Valley, Santa Clara Valley, and Salinas Valley. The Coastal Range might be best known for being home to the legendary Redwoods in the state as well as being one of the main locations for the San Andreas Fault, which starts up north near Port Arena while running south throughout many parts of the state. The San Andreas fault line is best known for being a root cause of many earthquakes as a result of seismic shifts that are linked to the movement of the earth's crust along the fault line.

The Sierra Nevada: This mountain range located in the northeastern portion of the state runs close to 430 miles from north to south while creating a giant mountain wall that reaches upwards to a high of 14,494 feet above sea level on Mt. Whitney. Hundreds or thousands of years of mountain stream and glacier movement activity formed some spectacular valleys here as best represented by the mesmerizing and incredibly beautiful Yosemite Valley area.



Central Valley: This region of the state lies between the Coastal Range and the Sierra Nevada range while also being home to the San Joaquin River and Sacramento River. It is approximately 450 miles in length from the northeast to the southeast sections. The area comprises about 60% of California's most productive farmland region where various types of fruits and vegetables are grown year-round.

Cascade Mountains: The Cascade Mountains run north from the Sierra Nevada mountain region. This part of the state was once formed by active volcanoes. Even today, the Lassen Peak volcano (10,457 feet above sea level) is still considered to be active. Mt. Shasta, once also an active volcano, is located here as well and rises upwards to 14,162 feet above sea level.

Basin and Range Region: This region of the state consists of the southeastern deserts. The northern sections include a lava plateau, and the southern sections are mostly made up of sandy deserts. The Mojave Desert, Death Valley, and Colorado River regions are included in this area. Due to insufficient levels of consistent water access in many parts of the desert locations, much of these areas are not populated with residents, businesses, or farms. The two main exceptions to lack of farming locations and population centers are the Imperial Valley (near the California and Mexico border, where lettuce, broccoli, cabbage, asparagus, bell peppers, cantaloupes, and watermelons are just some of the main crops), and the Coachella Valley region where over 100 golf courses are located in cities such as Palm Springs, Palm Desert, La Quinta, Rancho Mirage, Bermuda Dunes, Indian Wells, and Indio.



The Los Angeles Ranges: The mountain ranges located within this geographical region include the Santa Ynez, Santa Monica, San Gabriel, and San Bernardino mountains. They run from east to west while surrounding millions of Southern California residents, and are located between Santa Barbara and San Diego counties. Some of the best hiking

trails that are quite popular with Los Angeles County residents are located in these mountain ranges.



The San Diego Ranges: The San Diego Ranges are primarily located in the inland San Diego County in the southwestern portion of the state. Because these mountains are located in the southernmost portion of the state, they tend to be the driest mountain regions with somewhat of a desert feel to them, especially at the lower altitudes. These mountain ranges include Agua Tibia, Laguna, and Vallecito mountains that run south into Baja California in Mexico.



Sources: *The World Almanac of the U.S.A.*, *California* by World Book Online America's Edition, and *The United States Geological Survey*

Urbanization Trends in California and the U.S.

There is well over 80% of the 326 million residents today who live within regions of America that are classified as “urbanized” areas in places like large metropolitan cities, suburbs, or in other population centers with more than 50,000 residents. Around the world, the urban rate is closer to 54%, so Americans really seem to like the most populous areas as compared to people who live in other countries.



The U.S. Census Bureau reported how quickly population trends were changing. These “Components of Population Trend” numbers include the following updated population statistics:

- One birth every 8 seconds
- One death every 11 seconds
- One international net migrant every 32 seconds
- Net gain of one person every 15 seconds

Urban Sectors

In the U.S. Census Bureau report, the definition of “urban” sectors was broken down into two smaller subcategories:

- 1. Urbanized Areas:** Population locations with more than 50,000 residents.
- 2. Urban Clusters:** Areas with somewhere between 2,500 and 50,000 residents.

Per the U.S. Census Bureau: *“The nation’s urban population increased by 12.1% in the past ten years, outpacing the nation’s overall growth rate of 9.7% for the same period.”*

The U.S. Census Bureau report found that there were an estimated 486 urbanized regions (50,000+ residents) and another 3,087 urban clusters (2,500 to 50,000 residents) spread out across the nation.

The top three most densely populated urban areas in America were all located in the state of California. These metropolitan regions include by order of ranking:

- 1. Los Angeles-Long Beach-Anaheim, California:** There are an estimated 7,000 residents per square mile. Since there are 640 acres within a square mile, then this is equivalent to almost 11 people per acre (43,560 square feet).
- 2. San Francisco-Oakland, California:** There were approximately 6,266 residents per square mile in the Bay Area.
- 3. San Jose, California:** There were an estimated 5,820 people per square mile in this high-tech Silicon Valley region.

Even though there is much more raw land without any full-time residents living on the land in the Western U.S. than the Eastern U.S., nine of the 10 most densely populated urban regions were located in the western states. Of those same nine densely populated regions in the west, seven were located in California. The average number of residents for all U.S. urbanized areas was estimated at a much lower 2,534 people per square mile.

By U.S. region, the West has upwards of 89.8% of all residents living within urban population centers. The Northeast sector was second with 85% of residents living in urban locations. The Midwest and South were almost tied, at third and fourth with 75.9% and 75.8%, respectively.

By state, California was number one, by far, as the most urban state in the nation, with 95% of all residents living in urban locations in spite of being such a large state by way of land size. New Jersey was ranked number two with 94.7%.

The Top 3 Metropolitan Regions by Population

1. Newark, New Jersey-New York City, NY:	18,351,295
2. Los Angeles-Long Beach-Anaheim, CA:	12,150,996
3. Chicago, IL:	8,608,208

High Home Prices in California and Other States

The combination of the consistent demand for quality housing in prime metropolitan regions plus the lack of sufficient construction for affordable properties to buy or lease has played a role in some median price regions reaching or surpassing all-time market highs.

According to a market trend study completed by the National Association of Realtors, here are the Top 15 most expensive median price home regions in America (in no particular order):

Metropolitan Area	Median Price
1. San Jose-Sunnyvale-Santa Clara, CA	\$1,265,000
2. San Francisco-Oakland-Hayward, CA	\$988,000
3. Anaheim-Santa Ana-Irvine, CA	\$825,000
4. Urban Honolulu, HI	\$802,500
5. San Diego-Carlsbad, CA	\$645,000
6. Boulder, CO (Metro)	\$618,600
7. Los Angeles-Long Beach-Glendale, CA	\$611,200
8. Nassau County-Suffolk County, NY	\$491,600
9. Naples-Immokalee-Marco Island, FL	\$435,000

10. Seattle-Tacoma-Bellevue, WA	\$524,700
11. Boston-Cambridge-Newton, MA-NH	\$491,900
12. Denver-Aurora-Lakewood, CO	\$462,100
13. New York-Newark-Jersey City, NY-NJ-PA	\$423,900
14. Washington, DC-VA-MD	\$440,900
15. New York- White Plains, NY-NJ	\$386,500

Agenda 21, Sustainable Living, and California Housing Trends

“High Density,” “Sustainable Living,” and “Smart Growth” are just three of the main phrases used in California and many other parts of the United States and the world as it relates to growing population and housing trends. Many people say that California is effectively “ground zero” for the ongoing evolution of Agenda 21 (“Sustainable Living Agenda for the 21st Century”) strategies that will directly and indirectly impact state residents, real estate licensees, investors, and businesses for many years or decades to come.



Urban Sprawl & California Development

The challenges faced by California residents, younger Millennials especially, are fueled partly by much higher development costs to build both apartment projects and new single-family home development tracts as a result of much higher fees that are associated with planning and growth. For example, the home ownership rates for Californians in the Baby Boomer age range (people born between 1946 and 1964) are close to the national average. However, just one in four (25%) of Californians aged 25 to 34 years of age own a home. These low ownership numbers for younger California residents are the third-worst in the nation, per a report entitled *Fading Promise: Millennial Prospects in the Golden State*.

A study sponsored by the nonprofit *California Housing Partnership* found, in addition to the same *Millennial Prospects in the Golden State* study, that the newer, high-density construction costs that are partly due to international Agenda 21 environmental impact guidelines raised construction costs as much as 7.5 times more than the cost of building traditional single-family detached homes. Unlike crowded metropolitan regions like New York City that were designed around efficient public transportation systems, the 25 million plus residents who live in Southern California are more likely to drive to work alone in their car for an average of 30 to 60 minutes each way than to share a subway train with hundreds of fellow passengers.

Several of these studies completed on Millennials and their interests in housing trends revealed that the vast majority of them really do want a suburban-type of “American Dream Home” (i.e., white picket fence, green lawns, three bedrooms or more, friendly neighbors, nearby schools, etc.) as glorified on television and in films over the past several decades, as opposed to living in a high-density apartment unit with less than 500 square feet of livable space that is priced at \$4 to \$7 per square foot to lease or \$2,000 to \$3,500 each month). What is truly tragic about high-density lifestyles being promoted here in California and abroad is that tenants and buyers are actually paying much higher amounts per square foot of space in return for unit sizes that are 25% to 50% the size of a single-family home. Even if many of the younger Millennials do want to live in a brand new high-density apartment or condominium unit that is located walking distance to their job, they cannot necessarily afford the high rents or mortgage payments.

With so much available land here in California, there should be significantly more-affordable building options for developers, especially in the inland regions such as Riverside and San Bernardino counties. A recent *California Department of Finance* study found that the net increase of population in the state still far exceeds the number of new housing units being built for sale or lease. For example, the state had a net increase of 88,562 housing units built, 41,155 of these units were constructed in Los Angeles, Orange, Riverside, and San Bernardino counties. While these construction numbers were up 31% from the previous year, it is still less than half of the estimated 180,000 new housing units that state officials say California needs to keep pace with the annual population growth.

The real estate profession is primarily one in which people are the main products as opposed to homes or commercial properties. Without people, there would be no need for housing, employment centers, or real estate agents waiting patiently to assist them. California's nearly 40 million residents, who represent almost 12% of the national population base, is the driving force between the ongoing sales, development, and leasing trends in the state.

Race Trends in California

California's diverse population includes people born in and out of the state, others who were born in neighboring countries like Mexico and Canada, and many others who originated from Asia, South America, Europe, and Africa. As of July 1, 2014, the number of Hispanic or Latino residents in the state surpassed the number of Caucasians or whites for the first time ever, and they now represent the majority of California residents, per the U.S. Census Bureau. **The numbers were as follows: Latinos - 14.99 million; Caucasians - 14.92 million.**

California became the third state in the nation with a population base that did not have a white majority along with Hawaii and New Mexico. The Latino population numbers across the nation reached 55.4 million, per the Census Bureau study. California and Los Angeles County were ranked number one for the largest Latino numbers of any state or county in the nation.

Back in 1970, there were just 2.4 million Latinos in California, which

represented 12% of the state’s population, while the 15.5 million white residents at the time accounted for more than 75% of the state’s residents. Twenty years later in 1990, the Latino population numbers rapidly increased to 7.7 million, or almost 25% of the total state residents.

Between 2000 and 2015, the nation’s Latino population grew at a staggeringly high 57% pace from the earlier 35.3 million Latino base back in 2000. Of all race classes nationally, Latinos represented the number one segment, per the *Pew Research Center*. And the Latino population in 2020 is 18.5% of the U.S. population, while it is 39.4% of California’s population.

The age differences between Latinos and whites are quite shocking. For Latinos, the median age was reported to be 29 years (Millennial generation age range). For white residents in the state, the median age was closer to 45 years (Generation X age range). The younger Latino residents are much likelier to have more children since they are still near childbearing age ranges as opposed to the much older median-age range for whites. As a result, the future Latino population numbers should grow at a much faster pace than white families.

A recent study released by the California Department of Finance office projects that the state’s population is on track to surpass 50 million by 2049 and 52 million by 2060. The Hispanic population of California is projected to represent upwards of 48% of the entire state’s population base by 2060.

Percentage Breakdown by Race

Year	Population	White	Black	Asian	Hispanic
2010	37,309,382	40%	6%	13%	38%
2020	40,643,643	37%	6%	13%	41%
2030	44,279,354	34%	5%	14%	43%
2040	47,690,186	32%	5%	14%	45%
2050	50,365,074	31%	5%	14%	47%
2060	52,693,583	30%	4%	13%	48%

Source: *California Department of Finance*

Real estate licensees who are fluent in more than one language will become increasingly popular over the next several years due to the fact that Spanish is the dominant language spoken in a high number of California households today. Additionally, some of the wealthiest California property buyers come here from Asia. Local real estate agents who speak and understand one or more Asian languages will have an advantage, to be sure.

Millennials & Other Generations

With the median age for the majority class of Latinos hovering around the age of 29, they are also part of the dominant Millennial generation (age ranges between the late teens and the mid-30s) that now represents the number one group that is both buying and leasing real estate here in California and across the nation. A *Pew Research* released a study, which found that the younger Millennial generation had surpassed 75 million in the U.S. alone. The same study projected that the Millennial group might reach 81 million by 2036 when some of the oldest Millennials will be closer to their mid-50s.

The National Association of Realtors (NAR) reported that Millennials represented approximately 32% of all homebuyers nationally (number one). Baby Boomers (people born between 1946 and 1964) were ranked second with 31% of all homebuyers. These groups were followed by Generation X (born between 1965 and 1984) buyers in third place with 27% of all homebuyers.

As it relates to California homebuyer prospects, the median age for Latinos in the state (29) makes them a part of the number one group of buyers and renters from the Millennial group while Caucasians with a median age of 45 years makes them a part of the number three group of generational buyers and tenants called Generation X. An offsetting factor that might balance these buying and leasing numbers is that some older white California residents may have a higher paying job which helps them qualify for larger mortgage loan amounts than younger California residents of any ethnic background.

To best understand how generational groups influence the real estate profession, let's look more closely at the largest generational groups that make up the population base from the youngest ages to the oldest:

1. Millennials: The youngest and largest generation of Americans today reached an estimated 75 million plus members. They were born sometime between the early 1980s and the early 2000s. Many of these Millennials reached their young adult years back near the turn of the century in 2000 (or “New Millennium” in the 21st century).

2. Generation X: This generational group of Americans was born between 1965 and 1984, per *The Harvard Center*. Please note that the birth years for some or all of these generational groups may vary by a few years or so, depending upon the research or demographics group conducting the study. The *Gen X* members were likely to be somewhere within the 37 to 52 years-of-age range. This group is sometimes referred to as *The Baby Bust* group because their birth rate numbers began declining as compared to the *Baby Boom* group that came before them.

3. The Baby Boom: American *Baby Boomers* were born between the years 1946 and 1964. The age range for most *Baby Boomers* is from 52 to 72 years of age. The birth rates began to skyrocket after the end of World War II (1939 to 1945), beginning in 1946 that started the *Baby Boom* trend. During that period of time, the national U.S. birth rates varied from a low near 2,559,000 in 1940 and a high near 3,104,000 in 1943.



Listed below are the birth rates as reported by the *U.S. Department of Commerce, Bureau of the Census* between the main *Baby Boomer* years of 1946 and 1964:

<u>Year</u>	<u>Babies Born</u>
1946	3,411,000
1947	3,817,000
1948	3,637,000
1949	3,649,000
1950	3,632,000
1951	3,823,000
1952	3,913,000
1953	3,965,000
1954	4,078,000
1955	4,097,000
1956	4,218,000
1957	4,300,000
1958	4,255,000
1959	4,245,000
1960	4,258,000
1961	4,268,000
1962	4,167,000
1963	4,098,000
1964	4,027,000

4. The Greatest Generation: These are the oldest Americans today who were born in 1945 or earlier. As of 2020, the younger members of this generational group reached the age of 75. This group's name was first coined by former NBC news anchor Tom Brokaw, who also wrote a book of the same name, which detailed the trials and tribulations of the brave Americans who fought in World War II and lived through some of the worst economic times during the depths of The Great Depression (1929 - 1939).

However, these same *Greatest Generation* members also experienced the magical exponential growth rates for stocks, real estate, and other types of investments that compounded over many decades just like for many of the younger *Baby Boomers*. As a result, these two older generational groups were most likely to own and control the most valuable assets and

had the highest net worth that they might eventually share with their younger family members and other designated heirs.

The 10 Largest Cities in California

Rank	City	Population
#1	Los Angeles	4,094,764
#2	San Diego	1,376,173
#3	San Jose	1,023,083
#4	San Francisco	856,095
#5	Fresno	502,303
#6	Long Beach	494,709
#7	Sacramento	486,189
#8	Oakland	430,666
#9	Santa Ana	357,754
#10	Anaheim	353,643

Sources: *U.S. Census Bureau* and *California Department of Finance*

Chapter One Summary

- Spanish, Mexican, and Russian occupying settlers lived in the land that later became the state of California in addition to the Native Americans who lived there many years before any of the other groups reached the state's shores.
- The name "California" originates from a story about a fictional island filled with Amazon women, written about in a Spanish romance novel.
- The California Gold Rush that began peaking in 1848 and 1849 helped attract new visitors and residents from many parts of the world.
- California was admitted to the Union as the 31st state on September 9, 1850, partly as a result of the amount of gold that was found near Sutter's Mill and other regions.
- In more modern times, California has almost 40 million residents living on just 5% of the state's available land supply.
- Upwards of 95% of the state's population lives in regions described as "urban"; the state is home to the top three most densely populated urban regions in spite of having so much available land supply.

Chapter One Quiz

1. How many residents now live in California?
 - A. 25 million
 - B. 28 million
 - C. 32 million
 - D. Close to 40 million

2. The vast majority of California residents live on which percentage of the state's land?
 - A. 5%
 - B. 20%
 - C. 50%
 - D. 75%

3. Which foreign occupants once flew their flags on land that later became California?
 - A. Russia
 - B. Spain
 - C. Mexico
 - D. All of the above

4. What is the alleged origin of California's name?
 - A. Indian name
 - B. Mexican flower
 - C. Spanish romance novel
 - D. Greek historical figure

5. Which non-Native American explorer reached land in California first?
 - A. Sir Francis Drake
 - B. Juan Rodríguez Cabrillo
 - C. John Fremont
 - D. James Marshall

6. When was California admitted to the Union as an official state?
 - A. June 7, 1826
 - B. August 1, 1844
 - C. September 9, 1850
 - D. October 11, 1866

7. California was admitted to the Union as the _____.
A. 25th state
B. 28th state
C. 31st state
D. 33rd state
8. Who was the first person to discover large amounts of gold that began the Gold Rush in the region that would later become California?
A. James Marshall
B. John Sutter
C. John Fremont
D. Sir Francis Drake
9. How many ounces of gold were supposedly excavated in the California region during the peak Gold Rush years?
A. 2 million ounces
B. 5 million ounces
C. 8 million ounces
D. 12 million ounces
10. What percentage of Americans live in regions that are designated as “urbanized” areas?
A. 50%
B. 62%
C. 71%
D. 80%

Answer Key:

1. D	7. C
2. A	8. A
3. D	9. D
4. C	10. D
5. B	
6. C	

CHAPTER 2

REAL AND PERSONAL PROPERTY

Overview

Most property falls into just two main categories: **real and personal property**. More people are likely to own personal property than real property, but real property is valued much higher than the vast majority of types of personal property. The simplest way to describe the main difference between the two property classifications is that real property is usually **fixed** and **appurtenant** to the land while personal property is **movable**. In this section of the course, the rights to hold title to both main types of properties will be detailed along with various ways to transfer ownership interests in property.

Personal Property

Household furnishings, jewelry, artwork, clothes, and computer equipment are some of the most common types of personal property that people own. Usually, personal property owners do not maintain official title records other than perhaps a copy of an old payment or credit card receipt to confirm their ownership interests (unlike with real property, as discussed below).

Personal property (also known as “**personalty**” or “**chattel**”) is also classified as **tangible** or **intangible**. Tangible property is property that can be touched or held. Intangible property, which can also be called **incorporeal property** (“*not composed of matter; having no material existence*”), is something of value that a person or entity can have ownership of as well as the legal right to transfer his or her ownership to another party or business entity. Yet it has no physical substance or is not physical in nature. Various types of intangible assets for corporations or other entities can include a copyright, a trademark, goodwill, or brand recognition held by a business. Intangible assets may be challenging to value.

Unlike using sales comparables in real estate to determine the value of a home, personal property assets can be much more difficult to assign a present market value to by an owner or prospective buyer. However, the value of certain types of personal property may be easier to quickly estimate, such as stock, or a Treasury bond investment that might fluctuate in value on a daily basis. The changing values of these investments can be followed on business channels like *CNBC* either on TV or online 24 hours a day.

Real Property

Real property is any type of property that is attached, directly or indirectly, to land as well as just the raw land itself. The attachments to land may include both man-made and natural improvements such as a new home structure, mineral deposits and oil. The artificial improvements made to the land may also include sidewalks, fences, and any type of residential or commercial building structure.

Land is legally defined as the real estate, minus the building improvements and equipment that do not occur in a natural way, as well as the natural resources that go along with it such as water, mineral, airspace, and surface rights that extend downward to the earth's center.

In addition to the physical building structures added to the land, real property also includes a **bundle of rights** for the property owner. The bundle of rights gives the owner the right to use, possess, or lease out their property just about any way they see fit, subject to local (public and private), state, and federal zoning and usage laws and rules. As such, **real property** is made up of both physical buildings or objects and **common law rights**, while *real estate* is legally defined as just the property itself.

The ownership of land and any buildings on top of it occurs when a person or entity holds "title" to it. The primary document used to confirm the evidence of title is the deed. When a property seller executes or signs a grant deed to sell or convey his or her interests in the property, the buyer receives the property itself as well as the corresponding bundle of rights accompanying it.

Bundle of Rights: A bundle of rights is a broad term that is used to explain an owner's true property rights. It is comprised of five different rights for the owner: **possess, control, enjoy, exclude, and dispose.**

1. The **right to possess** is the *right to occupy* a specific property while having legal rights to exclude others from living there as well.
2. The **right to control** a property gives the owner the *right to use it* for any lawful purpose, and the right to determine interests and uses for others.
3. The **right to exclude** from a property is the *right to limit who may enter the property*. Keep in mind that easements or a warrant authorizing a search of the property will override the right of exclusion.
4. The **right to enjoy** is the *right to use the property without outside interference*, except for governmental police powers, environmental factors such as floods and fires, and a few other limitations.
5. The **right to dispose** of property is the *right to transfer it by sale, lease agreement, gift, or other assignment options to persons, business entities, charities, or voluntarily to government agencies or groups such as the granting of land for a new public park.*

Water Rights: Water is one of the most valuable commodities on the planet. Properties that are located adjacent to large bodies of water tend to have much higher value than properties located far away from water such as oceans, lakes, rivers, or streams. Water rights, under economic and real estate theories, pertain to the right to use, enjoy, consume, and even sell the water in certain situations.

Water can be located on and below the land's surface. On the surface or underground, moving bodies of water are deemed to be "percolating" on the property. Water that overflows a defined channel is **floodwater**. The three main types of floodwater are **inundations, sheet overflow, and ponding**. Surface water can be confined or somewhat controlled by a channel or basis, or it can be unconfined as uncontrolled floodwaters from recent storms.

There are two types of systems that apply to water rights associated with confined surface water: **riparian** and **appropriative**. Under the riparian doctrine, a property owner has the legal right to divert the water that flows next to or through his or her property for use upon the owner's land.

The owner can take a “reasonable share of flowing waters” as determined by the size of the land owned on the surface above for a “beneficial use” under appropriation rights. Yet, the same landowner cannot utilize the water in such a way that it harms the rights of neighbors and the rest of the general public by harming the flow of water supply. Actions that could harm the flow of water by severely altering the speed, quantity, or quality of the water, include such things as building a small dam or adding chemicals to the water that make it undrinkable or unsafe for swimming.

Water rights are likely to attach to the adjacent property while increasing or decreasing the property's overall value. **Riparian rights** are the rights awarded to property owners with land adjacent to a **river, stream, or lake**. Property owners may use the water as long as their usage does not negatively impact the environment, the water supply, or their nearby neighbors upstream or downstream.



A body of water, such as a canal, river, or lake that is **navigable** is one that is usually quite deep, wide, and slow moving enough for boats, ships, or other types of vessels to travel. The water cannot be too shallow, or have rocks or trees that can damage the water vessels. Any bridges that were built for people to walk over the body of water must be tall enough for most boats or ships to pass under. For a body of water to be considered a **non-navigable waterway**, the owner usually owns the land beneath it all the way to the exact center of the water, such as with a small river or lake.

Littoral rights are rights for owners of properties that are adjacent to large, navigable oceans and lakes as well as non-flowing smaller bodies of water such as a backyard pond. Property owners with these water rights might have almost unrestricted access to the waters. Yet they only own the land to the **median high-water mark** that can fluctuate due to such factors as tide movements, droughts, and floods. The area below the median high-water mark is likely to be owned by the government (local, state, or federal), especially if it is in a protected area.

The water rights are appurtenant to the land, not the owner. Once the property owner sells the beachfront property with littoral rights to a body of water such as the Pacific Ocean, the property and the new buyer takes over the right to use and enjoy the water. The seller therefore relinquishes his or her rights to the use and enjoyment of the property, including the body of water, concurrently with the recordation of the deed of transfer at the time of the sale closing.

Appropriative rights are not dependent upon the ownership of land when it comes to water rights. These rights to use water are available to some people who formally request from a local government body the right to divert public water for their own personal or business benefit. For example, a farmer or rancher might request appropriative rights to water if they are in need of an increased water supply for their crops or livestock.

The property owner may file a permit, and even pay a significant fee, to gain access to the improved water supply for a short or long period of time. If the owner does not use the water in an appropriate or timely manner, the state has the right to revoke the access to these newfound water rights. Often, the state will exercise its own right of appropriation by diverting private and public water supplies for its own good,

regardless of whether these actions harm the value of nearby privately-owned real properties.

Water - Increasing or Decreasing Property Value

In California, the vast majority of the most expensive properties are located adjacent to large bodies of water such as the Pacific Ocean, Lake Tahoe, or near the flowing Colorado River. The **National Oceanic and Atmospheric Administration (NOAA)** has released reports showing that over 50% of all Americans in modern times live in just 10% of America's total land area (excluding Alaska) that is located in shoreline-adjacent counties.

The most-recent numbers released from NOAA included the following key points:

- Over 52% of the U.S. population base lives in coastal adjacent counties.
- Between 1970 and 2014, the U.S. population increased by an estimated 50.9 million residents (40% or more) in coastal counties.
- The population densities are much higher in coastal regions (319 people per square mile) as compared with inland regions (61 people/square mile).



Airspace: The rights to control, occupy, and use the vertical lower air rights or airspace above a person's real property. These rights are limited by the reasonable nearby neighbors and others above such as airplanes and military defense. Just as with mineral and surface rights (discussed below), air rights can be bought, leased, and sold to others such as electrical and telecommunications companies that wish to build new towers on a commercial building rooftop.

Mineral Rights: The ownership of mineral rights (or "mineral interest") is the ownership of an estate in real property. In many ways, it is more of a **mineral estate** than a right in minerals (personal property). The owner is allowed to dig up the minerals found on or below the surface of their land. These minerals may include precious metals such as gold or silver, diamonds, coal, or oil.

An owner of land might have the legal right to sell his or her mineral rights located in subsurface land to another party by way of an easement assignment (subject to local zoning, usage, and environmental laws). The easement allows a third party to excavate minerals from another person's land for a fee such as commonly seen with oil excavation sites in Texas and Oklahoma.

While the minerals are still attached on or below the land's surface, they are considered real property **unless** they are not stationary, are migratory, and are non-solid. Examples of non-stationary minerals include oil and natural gas that are designated as "**fugitive substances**" on property sites. Once these fugitive substances and other minerals are removed from the land, they are likely to become the personal property of whomever removed them.

Improvements / MARIA

Improvements made to land may be considered **permanent** or **temporary** attachments. Permanent improvements to land are generally considered real property, while temporary improvements are usually classified as personal property (e.g., trade fixtures for restaurants, etc.).

Natural attachments to land such as trees, plants, and crops are real property until they are removed from the ground. At that point, they may be considered personal property that can be sold to other parties. Under

the **Doctrine of Emblements**, a leasing farmer with a tenancy that has been terminated through no fault of his own can later re-enter the land to harvest the first crop after the tenancy's termination.

When personal property is **affixed** or attached to land, a home, or a commercial property, it becomes a **fixture** by way of **annexation**. The removal of a fixture from real property at a later date so that it reverts back to personal property is described as the "**severance**" of a fixture.

There are five tests used to determine whether a fixture is temporary personal property or permanent real property. The five tests comprise the acronym "**MARIA**" set out below:

Method of attachment: The first question to ask is exactly how the item is attached to the property. Property that was designed to be permanently attached is considered real property. An example may include a chandelier light fixture wired into the ceiling above the dining room table. Unless this item was specifically excluded in the sales agreement, it will probably be ruled a permanent fixture that remains with the home.

Aadaptability: Was the item created especially for the home? The greater the degree of adaptation results in the higher the probability that the attached item is a permanent fixture that becomes part of the real property. Custom drapes, an old-fashioned soda fountain built for the game room, and an outdoor BBQ built into rocks around the pool are all examples of property additions that are unique to the subject property. If they were later removed at the closing of the sale, the property would probably lose some of its charm and overall value.

Relationship of the parties: In legal disputes when there is no convincing evidence about whether a fixture is temporary or permanent, a judge is likely to look more closely at the relationship between the two main parties in the dispute. It might include a landlord-tenant, lender-borrower, or a buyer-seller as the core relationship in question. More often than not, the court sides with the tenant over the landlord (especially in commercial properties). It sides with the mortgage lender over the borrower (especially in foreclosure situations), and the buyer over the seller, unless the seller clearly identified in writing which items were to be excluded from the sales contract.

Intention: The original intent of the main party who attached the fixture to the property (usually the seller), is a major factor in determining whether the property is personal or real property. The intent may be apparent, either from written documentation or from the seller's actions or the actions of others involved, that the attachment was meant to remain on the property as long as the occupant stays there too. This may be seen with residential and commercial tenants in lease situations (special light fixtures, attached artwork, stereo speakers wired into the walls, etc.). To be safe and to avoid future disputes, a tenant and landlord should inform all parties and put it in writing so that the potential conflict does not later turn into a legal battle.

Agreement of the parties: A clearly written legal agreement that was signed by both sides in a transaction is perhaps the easiest way to determine whether or not the fixture was meant to be temporary or permanent, personal or real property.



Land and Legal Descriptions

In order to hold title to a specific piece of property, it must first have a valid and unique legal description or address which separates it from an adjacent owner's property. This is true whether or not the property is a 10,000-acre raw land site located in the middle of San Bernardino County with no access to utilities or streets for several miles in any direction, or a 50-story commercial office building located in the heart of San Francisco's downtown.

A **legal description** is one in which a unique and separate parcel of land with or without attached buildings on it is sufficient to identify it for legal purposes. A correct and valid legal description of a property is especially important for real estate documents such as a deed. Often, the most effective practice when using the legal description of a property is to review the latest deed to that property.

A copy of the property deed can be found by using one or some of the following options:

1. By contacting the appropriate government office such as the local county recorder's or assessor's office where the subject property is located;
2. By contacting a local title insurance company and asking that it conduct some type of informal or formal title search of the records;
3. By reviewing some online real estate information services that may be offered for free or for a small fee; and/or
4. By looking at current or older property tax statements.

For many types of rural properties that have no buildings on them, a physical street address with a description such as "123 Main Street" may not exist at the time. A street address is *not* a true legal description partly since these street address numbers and street names can change, and they were not originally intended to provide an accurate and definitive description for deed preparations or sales activities.

The legal description will probably be the best way to find out the most valid site location. There are usually two main types of legal descriptions:

subdivision or lot and block descriptions and **metes and bounds**. The latter is likely to be used for locations far outside of any existing subdivisions in more rural settings or elsewhere.

Subdivision (Lot and Block)

This type of legal description is much easier to find than those far outside of existing subdivisions or neighborhoods. It may be referred to as the “lot, block, and tract system” or the “subdivision system” or some other similar combination of terms. Developers must file their subdivision or plat map with the local County Recorder that identifies the individual lots in their subdivision before they begin building or selling their homes to the general public.

The name of the subdivision or master-planned community, the lot and block are typically included on legal descriptions such as follows:

“Lot 5, Block 22, Huntington Trails Section 11, according to the plat thereof, as recorded in Plat Book 37, at Page 115 of the Public Records of Orange County, California.”

Public Land Survey System

The earliest legal public survey description systems used in the U.S. date back to those established in 1785 after the Revolutionary War. It was a fairly complex system based upon legal descriptions associated with sections and townships (example: Section 10, Township 6). Later in 1851, the more modern **Public Land Survey System (PLSS)** became prominent across the nation after the General Land Office (now known as the Bureau of Land Management) was created. Today, it is still the main legal public survey description system used for most types of U.S. properties.

The PLSS has been used in most states besides the original 13 states over the past hundred and fifty plus years. The system uses a **prime meridian** line that runs north and south, and a baseline that runs east and west.

Land surveyors were originally sent out by the United States Geological Survey (USGS) to install brass markers on the ground at the corner of each PLSS section being measured at the time. When a brass cap marker was not used to identify each section corner, a stone marker was used instead.

The intent was to place each brass or stone marker in locations that correlated with the map in exact locations that were in the correct spot every square mile. But these markers were not always in their exact desired location that was indicated on the PLSS map, so the measurements were not always in the correct location.



Properties that are irregularly shaped in California and elsewhere might not have completely defined legal descriptions using metes and bounds and can be designated as “unplatted” land without formal complete legal descriptions. Some examples of these land types included rugged

mountain land with no residents anywhere within 30 miles, or desert regions with no access to water or any other utilities.

Before California officially became a state, the land was surveyed with the boundaries of Spanish and Mexican land grants (or “ranchos”) and were described as being only “approximate” at the time. Shortly after California officially became a state in 1850, it began using the Public Land Survey System, which has been used ever since.

The **Rectangular Survey System** is a type of land survey that is approximately 24 miles square. It is bounded by base lines that run east and west, and meridians that run north and south. Within this 24-mile square, it is further divided into Townships that are six miles square.

A **Township** is six miles north or south from the base line, which is the designated parallel. The first line that is six miles south of the designated base line might be described as “T. 1 S” on a map. The east-west area between two parallels is called a **tier** or **township strip**. A tier is identified by its relationship to the base parallel line, and each tier is six miles in width.

Three of the main starting points used as a base or meridian line in the state of California include the following imaginary lines used for property descriptions: 1) The Humboldt baseline and meridian on Mt. Pierre in the northwest region; 2) The Mt. Diablo baseline and meridian in Contra Costa County in the northeastern-central region; and 3) The San Bernardino baseline and meridian in Southern California.

A **Range** measures East or West from the principal meridian line and is usually six miles in size between each range. For example, the first six miles west of the principal meridian line would be described as range one west (R. 1 W).

Originally, Thomas Jefferson proposed that the PLSS system be used for the purpose of delineating or legally identifying farms and ranch properties. **The Homestead Act of 1862** made the PLSS more popular across the United States. This law was helpful to early land settlers who wished to occupy a minimum of 160 acres ($\frac{1}{4}$ of a Section) for the purpose of farming or ranching.

Because the western states like Colorado, Nevada, Montana, and California had much larger land sizes than most states back east, homesteaders out west began to claim much larger land parcels than just 160 acres for their families. Quite often, the western homesteaders would seek claim to a full section of land that was 640 acres in size. Over the past few hundred years, these land sites have been passed down to younger generations while the land values increased and compounded to create some of the wealthiest families in the nation.

A **section** of land is the smallest formally identified and is measured as being one square mile in size (or 640 acres). One **acre** is equal to **43,560 square feet**. There are **36 sections** located within a township. Each **township** in turn, is measured as 6 miles x 6 miles (or 36 square miles). Both the township and the associated range are measured in distance from their closest and most local meridian and baseline.

Metes and Bounds: A description of property by locating it within the PLSS methods. The boundaries of the subject property are described by walking around a parcel of land in sequential order while starting from a *point of beginning*. The very first point of beginning could be a natural landmark such as a big tree or rock, or another point described in the U.S. PLSS.

Below is a sample of a metes and bounds legal description:

“Beginning at a point from which the north quarter corner of Section 3, T. 1 N (township 1 north), R. 66 W (range 66 west) of the 5th PM (the sixth principal meridian, a north-south reference line) in ABC County, California, bears N 46° W 1,380 feet, at which point of beginning an iron stake has been placed; thence south 400 feet to a point also marked by an iron stake; thence N 46° W 200 feet to a large oak tree; thence northeasterly to the point of beginning.”

Metes are defined as a property’s boundary lines that are determined by measuring its **“straight runs”** or a distance between two points. Metes can also be discovered by determining a plot of land’s direction such as a compass point, or the direction that each property point faces north, south, east, or west.

Bounds are described as less of a compass direction like with metes, but more like what types of things, buildings, or public locations are adjacent

to the property site such as a wall, a public street, a railroad track, or some other type of landmark. Bounds are often used to legally define large parcels of land such as farms or ranches.

What can be problematic about the use of the Metes and Bounds legal descriptions is that the main designated landmarks used as the starting or key point on the land survey can erode or be knocked down over time due to extreme weather events or the destructive actions of people on the property. For example, a severe windstorm can blow over a 100-foot tall tree that was used as the main landmark on a 50-acre rural parcel of land, or an adjacent river can change course and dry up completely next to the land site. Yet the compass readings and legal descriptions that identify meridian and base lines should hopefully remain fairly consistent over the years which can be quite beneficial to experienced land surveyors, appraisers, investors, and licensed real estate professionals.



Chapter Two Summary

- Personal property (also referred as “**personalty**” or “**chattel**”) may be described as **tangible** or **intangible**.
- **Real property** is defined as any type of property that is attached, directly or indirectly, to land as well as the raw land itself.
- **Land** is legally defined as the real estate, minus the building improvements and equipment that do not occur in a natural way, as well as the natural resources that go along with it. Examples of rights to natural resources on, below or above land are rights to water, minerals, airspace, and the surface that extends downward to the earth’s center.
- A **bundle of rights** includes five different rights: **possess, control, enjoy, exclude, and dispose**.
- There are two types of systems that apply to water rights associated with confined surface water: **riparian** and **appropriative**. Owners have rights to divert and use some of the water that is adjacent to their property for “beneficial use.”
- **Littoral rights** are rights of owners of properties that are adjacent to large, navigable oceans and lakes and non-flowing smaller backyard ponds.
- Defining the method of attachment and whether the item is personal or real property under the **MARIA** acronym: 1) Method of Attachment; 2) Adaptability; 3) Relationship of the parties; 4) Intention; and 5) Agreement between the parties (the most important method).
- A valid **legal description** of property is one in which a unique and separate parcel of land with or without attached buildings on it is sufficient to identify it for legal purposes. There are two main types of legal descriptions: **subdivision or lot and block descriptions** and **metes and bounds**.

- The **Public Land Survey System (PLSS)** is the main legal definition system used for most types of U.S. properties.
- The **Rectangular Survey System** is a type of land survey that is approximately 24 miles square. It is bound by base lines that run east and west, and meridians that run north and south.
- A **Township** is six miles north or south from the base line, which is the designated parallel.
- **Metes** are a property's boundary lines that are determined by measuring its **"straight runs"** or a distance between two points. **Bounds** are descriptions based on landmarks, or what types of things, buildings, or public locations are adjacent to the property site such as a wall, a street, or a railroad track.

Chapter Two Quiz

1. Another name for personal property is _____.
 - A. Real property
 - B. Personalty
 - C. Chattel
 - D. Both B and C
2. Personal property that is tangible is _____.
 - A. Always taxable
 - B. Touchable
 - C. Voidable
 - D. Fluid
3. An example of intangible property is _____.
 - A. Home
 - B. Water
 - C. Corporate stock
 - D. Land

4. The right to encumber is known as the right to _____.
 - A. Lease
 - B. Buy
 - C. Sell
 - D. Borrow money against
5. Real property may be defined as _____.
 - A. Chattel
 - B. Land
 - C. Beneficial
 - D. Tenancy
6. Personal property may be:
 - A. Movable
 - B. Touchable
 - C. Intangible
 - D. All of the above
7. Which of these is **not** part of the “bundle of rights”?
 - A. The right to occupy and use
 - B. The right to encumber or borrow against
 - C. The right for the government to tax
 - D. The right to sell
8. The most important test under the acronym “MARIA” for determining whether an attachment is a fixture is:
 - A. Method of attachment
 - B. Adaptability of the fixture
 - C. Relationship of the parties
 - D. Agreement among the parties
9. The riparian doctrine is about which type of property issue?
 - A. Leasehold interests
 - B. Pest control
 - C. Encumbrances
 - D. Water rights

10. The doctrine of emblements allows a farmer whose tenancy has been terminated due to no fault of his own to:
- A. Re-enter the land to harvest his next crop
 - B. Must give all of his harvested crop to the leaseholder
 - C. May not go back on the property
 - D. All of the above
11. Which of these is not a valid type of raw land description?
- A. Street address
 - B. Lot and block
 - C. Rectangular survey system
 - D. Metes and bounds
12. A baseline is ____.
- A. Used to measure land location
 - B. Horizontal
 - C. Vertical
 - D. Both A and B

Answer Key:

1. D	7. C
2. B	8. D
3. C	9. D
4. D	10. A
5. B	11. A
6. D	12. D

CHAPTER 3

OWNERSHIP INTERESTS IN PROPERTIES

Overview

In this chapter, readers will learn about the many different types of ownership and leasehold interests available to buyers, sellers, tenants, and landlords. The ownership interests in properties may vary in a number of ways. Without clear title and valid ownership interests in a real estate property, the owner may have reduced or even no true valid ownership and leasehold claims to the property. Properties may be purchased or leased by individuals, partners, corporations, Limited Liability Companies (LLCs), trusts, or some other form of vested ownership interests. Principals and agents should investigate the multiple options available to determine the best property interests for their unique situation. They may do this by seeking out legal, accounting, estate planning, and real estate assistance before finalizing a transaction.

Options for Estates

There are generally two main types of estates as it pertains to interests in real properties: **Freehold Estates** and **Leasehold Estates (less-than-freehold)**.

Freehold Estates: This is an estate of indefinite duration that later may be freely sold, gifted, or granted to designated heirs by way of wills, family trusts, family limited partnerships, or other types of family planning or inheritance structures. Another name for this type of estate is an **estate of inheritance**. The holder of the freehold estate is more likely to be referred to as the property **owner**.

Freehold estates can be broken down into several types of estate and life estate interests that include:

A. Fee Simple Estates: Also referred to as a **fee simple**, it is a freehold ownership or estate in land held by property owners. A **fee simple absolute** is the highest possible ownership interest claim for real property held in common law nations like the United States and Great Britain. The ownership interests in the property held under fee simple absolute are without any severe qualifications, limitations, or restrictions. This includes certain types of private deed restrictions once created by the former owner or seller of the property or by adjacent neighbors in the same community. Yet some local, state, and national rules, laws, or zoning and usage codes do apply and may serve to limit the seemingly unlimited freedom to do what the owner pleases with the subject property.

B. Fee Simple Qualified (Defeasible): These are properties owned with a few limitations or restrictions to usage of the property such as those that may be set out in a private deed. Concurrently with the transfer of the property in a sale from the seller to the buyer, these restrictions or limitations must clearly be disclosed and defined by the seller, agents, title and escrow companies, and any other third party inspectors who were hired to research and disclose these restrictions.

C. Life Estates: This is an interest in a property that can be created by will or deed for as long as one designated individual is still alive. It is still a freehold estate interest in the property that ends at the death of that individual prior to the property reverting back to the original owner, or it may pass onward to another person who was originally identified in the life estate paperwork.

Life estate holders must still pay the property taxes and any other fees required to maintain or manage the property during the contract term. Should the property be rented to others during the life estate period, the designated person with the interests at the time shall be able to collect the rents and profits associated with the named property during the period of the life estate.

The person who first granted the property to another individual also has the right to nominate yet another person to receive the same interests in the designated property at the time of his or her death. This other person might be a spouse, a child, or a grandchild, for example, who will receive the full interests in the property at the time of the grantor's passing. Those interests are known as an **estate in remainder**. Should the same

property be designated to be returned by the heir back to the original life estate owner, the original owner will then have an **estate in reversion**. Both estates in remainder and estates in reversion are known as “future interests” in property.

Reserving a life estate is a property transfer scenario where the owner sells her home, but specifically retains the full right to live in it until her death, at which time it is transferred to the buyer. For example, an owner sells her home to a nearby real estate developer who has plans to later demolish the property before building a new custom home or lot that is part of a much larger new housing subdivision. The property has, in fact, sold to the developer and the title has formally transferred from the seller to the home builder, but the selling individual retains the full right to live in the home up until her death. It is only after the passing of the seller’s life that the developer is able to gain full possession of the home and then tear it down, rebuild, rent it out, or sell it to another buyer.

In a life estate situation, the person who has the right to maintain possession of the home until he or she dies is referred to as the **life tenant**. The life tenant must not cause any damage to the property which may harm the potential interests in the reversionary or remainder estate. If the life tenant causes damage, he or she may be held financially responsible. For example, the life tenant may not burn down the home during a bonfire party in their backyard without being financially at risk for all of the damage to the property as the home’s value goes from \$500,000 (home plus lot) to \$50,000 (lot value only) when the entire home is destroyed by the fire due to the life tenant’s negligence. In this type of situation, the life tenant had better hope that he or she has sufficient insurance to financially and legally protect them, or he or she may end up being sued by the life estate owner of the property for all damages.

Life Estates and Deeds - A Closer Look

Ownership interests in properties are usually transferred from one party to another by way of various types of deeds - a quitclaim deed, warranty deed, grant deed, trust deed, gift deed, or a life estate deed. There are benefits and risks associated with each of these deed choices.

For example, a general warranty deed provides more guarantees or assurances that the seller does, in fact, have the legal right to transfer clear title to the new buyer. With a quitclaim deed, on the other hand, the seller does not guarantee that he or she has valid and clear ownership interests in the property being transferred, but does agree to transfer whatever ownership interests or rights he or she holds in the property to the new buyer.



Life Estate Deed

A life estate deed is similar to a sale-leaseback type of transaction typically without the selling occupant having to make rental payments to the named recipient on the deed. It can also be a clever way to avoid probate court at a later date after the occupant passes away.

The life estate deed is created between two or more parties when the owner of the home (the grantor or assignor) formally transfers his or her ownership interests and rights in a clearly defined property to be used by another person during the life of one designated person. Within the life estate deed, the details will include the fact that the occupant of the home is allowed to possess and use the property for the remainder of his or her life. In most cases, the grantor of the life estate deed and subject property and the **“life tenant”** are the same person. Yet there can be

several other life estate deed transfer scenarios where the grantor and life tenant are not the same person in more complex life estate deed transfers.

In most cases, the deed that creates a life estate will also include a unique **remainderman** named in the document. A remainderman is the party with future beneficial or profitable interests who will later end up with full legal ownership after the life tenant dies. However, the remainderman does not usually occupy the property or financially gain from the usage of the property as long as the life tenant is living.

Life Tenant Example: Sally's husband, Ken, passed away several years earlier. Both Sally and her husband lived in their \$2 million dollar home that is located directly across the street from a popular beach in Southern California. Back in the late 1960's when they first purchased it together, the price they paid for the home was \$30,000. 20 years into paying the mortgage payments on time on their 30-year mortgage, the property became free and clear with no mortgage debt. Thanks to the magical powers of compounded inflation growth, the property value increased from \$30,000 to \$2,000,000 in present day value.

Since Ken passed away, Sally has struggled with her own health issues partly related to her sadness over Ken's death. Sally has lived off of the combination of Ken's life insurance settlement funds paid out after his passing, some pension income from Ken's retirement accounts that have also compounded and grown over the past several decades, and Sally's monthly Social Security checks.

After Sally and her one grown child, Roger, (a single man who was never married and has no children of his own) met with their estate planning advisor, it was decided that it would be in their best interests if they created a life estate deed transfer as a way to reduce estate taxes owed as well as to avoid the additional expenses and risks associated with having to go through probate upon Sally's passing.

Sally's doctors have advised her that she may not live another two years due to her ongoing health complications and advancing age. Roger is attending medical school in Northern California for the next few years while sharing a small apartment unit with a fellow student. Roger drives or flies back and forth every month to see his frail and ailing mother who also has an in-home nurse by her side taking care of her. It was

important to Sally that Roger finishes his studies to become a doctor as their family had dreamed for him for many years. Therefore, Sally effectively ordered Roger to continue medical school as opposed to dropping out and moving in with her during her final years.

The solution offered by the estate planner for Sally and Roger was as follows:

- An estate attorney is to create a life estate deed on behalf of Sally.
- Roger is named as the primary 100% recipient of the property and other assets upon Sally's passing.
- When Sally dies, the property automatically transfers to Roger as his sole and separate property with 100% ownership interests.

Freehold Estate Title Examples

There are a number of ways to hold ownership of title to real property by way of freehold estate interests. It is imperative that new and experienced agents and brokers learn how to prepare and share the required documentation for each type of freehold estate transaction possibility. This is true as it relates to the signing of all documents to purchase a property with the correctly designated vesting or ownership. It is also true as it relates to the preparation of listing agreements and the deed for the subsequent property transfer, concurrently with the recordation of the title. ***Note that agents should refrain from offering any legal advice about simple or complex ownership vestings, and should consider suggesting their clients seek competent assistance from a legal and/or accounting expert with a specialization in these fields.***

Listed below are some of the more popular selections for freehold estate interests in properties in both California and in most parts of the nation:

Estate (Ownership) in Severalty

When just one person owns a life or fee estate alone, this type of

ownership is called an estate (ownership) in severalty. Other descriptive names for this type of ownership include tenancy in severalty and sole ownership. The use of the word “severalty” (a derivative of words like sever, separate, or divide) in this freehold estate is because the sole owner does in fact own an undivided 100% interest in the property that is not shared with any other person. The sole owner can be a person or a separate legal entity such as a corporation or an LLC with several shareholders or members.

Even though a married couple is likely to combine and share their assets, one spouse in the marriage may retain ownership in one or more pieces of real property that were either owned before the marriage or purchased during the marriage as **separate property** in spite of being part of a married union. The title might be held under separate legal entities like trust or corporate agreements, or held as **“a married person as sole and separate property”** on the vested deed.

In tenant situations, the estate of a deceased tenant in severalty then later passes the real property on to his or her heirs or beneficiaries, who were likely designated in a will or trust agreement. If he or she has a will, this is accomplished through probate.

Shared Forms of Ownership:

Marital Properties

California, like some other states, is a **community property** ownership state. Other community property states over the years have included Arizona, Nevada, Washington, New Mexico, and Texas.



Real and personal property interests are classified as and divided under community property law into two distinct types of property ownership: **separate** and **community** property. With respect to separate property, the ownership interests belong to just one spouse. Under community property, the ownership interests are shared equally by both spouses.

Separate property examples may include:

1. Properties owned by either spouse before the marriage.
2. Properties acquired during the marriage (in certain circumstances, such as when it is purchased with one spouse's separate funds).
3. Property inherited or gifted from other family members or friends before or during the marriage.

4. Property purchased with separate property classified funds that may be set out in a prenuptial or postnuptial marital and asset agreement.
5. Income collected from interests in separate properties such as rent, or the sale of real property held separately for cash or other types of assets.

Property that is owned separately by one spouse free and clear or with an existing mortgage on it, can be freely transferred, sold, gifted, or encumbered with more mortgage debt without the other spouse's signature in most cases. At the time of death of the spouse who held title to the separate property while married, their ownership interests in the property will likely pass on to their designated heirs by will or laws of descent. This primary named heir may include the other surviving spouse, their children, a friend, or a charity. These separate interests do *not* automatically pass 100% to the surviving spouse even if they were happily married for 50 years. The wishes of the spouse regarding the assignment of the ownership interests in the property must be clearly defined by way of some type of legal document prior to their passing.

Community property example:

All real and personal property assets acquired during the marriage by one or both spouses is community property, unless these assets were clearly designated to be owned and used separately.

Real properties held under community property vested ownership cannot be sold or encumbered with mortgage debt without the signatures of both spouses. At the passing or death of one spouse in the marriage, his half or 50% interest in the property will probably transfer automatically to his surviving spouse unless other arrangements have been made and mutually agreed to by both spouses. They may have agreed to his half of the community property being gifted to a charity or other designated assignees, for example. Again, any transfer of 50% interests in property held as community property must be agreed to by both spouses for it to be legal and valid in most circumstances. Upon the passing of the second spouse, the 100% interests in the property will pass on to their descendant heirs.

Unmarried Ownership Interests

Co-owners in property can be friends, business partners, strangers with a shared interest in acquiring the property, and family members as long as they are not legally married to one another. For two or more parties with ownership interests in real property, the co-owners can also be referred to as **co-tenants**.

Tenancy in Common

These co-owners may hold vested interests by way of a **tenancy in common** or **estate in common**. This form of shared ownership interest between two or more parties or entities is the most common form of co-ownership for parties who are not married to one another.

Each **tenant in common** may hold a specified and undivided interest in the property that does not need to be balanced 50/50. For example, one party may own and control 75% of the property because they originally invested more funds to buy it while the other shared investor put up a smaller share of capital and now holds a smaller 25% ownership share. These unequal or equal ownership amounts will be clearly listed and explained on the deed to the property. Each tenant in common has the legal right to sell or pass their own interests in the property to other named heirs through their estate, will, or trust agreements set up in place without first getting permission of the other co-tenant(s) involved in the transaction.

Some of the other key characteristics involved with tenancy in common ownership include:

- A minimum of two or more owners with no limitation on the total number of owners
- No right of survivorship (or automatic transfer of interests to the surviving co-owner upon the passing of one co-owner)
- Identical property rights
- No special wording required to create the title, vesting, and deed paperwork

- Partial, undivided ownership interests are allowed (e.g., 10%/90% for two owners or 25%/25%/25%/25% for four co-owners)
- Equal rights to possess (“unity of possession”) and occupy the property, if applicable
- Unrestricted right to transfer interests to others without the requirement to obtain permission from the other co-tenants (including leaving interests in the property to heirs or even selling it to a person, a corporation, or other entity)
- Distinct and separable ownership interests that may include separate deeds
- Right to partition (this is more likely with land ownership in that the co-tenants might work toward splitting up the land parcel into two or more separate land sites so that it is easier to sell or build on for individuals)

Joint Tenancy

The type of vested ownership interest in real property called **joint tenancy** has many of the same shared characteristics as tenants in common estates as well as some key differences. First, there must be at least two parties involved with joint tenancy. The property shall be collectively owned as if there were only a single person involved. The joint tenants’ interests and rights in the property are equal and indivisible, and **cannot** be divided up or sold, gifted, or assigned to others like heirs, as joint tenancy interests.

Key Point: The interests in a joint tenancy property may be assigned to others under a tenancy in common arrangement where the new owners will take title under tenancy in common interests as opposed to joint tenancy interests with the original owners. But all of the joint tenants must agree to this.

One of the main differences between joint tenancy and tenancy in common is that with joint tenancy, there is a **“right of survivorship”** involved where the surviving partners will automatically be assigned the interests of the joint tenant who passed away. In other words, with two joint tenants, the surviving one will wind up with 100% ownership upon

the passing of the co-joint tenant. With three owners, the surviving two co-owners will each end up with a 50% ownership interest instead of the previous 33.33% when all three joint tenants were alive.

The interests between the parties in joint tenancy vestings are equal in the vast majority of property situations, excluding some sort of legal issue adversely affecting the ownership interests of one or more parties, such as a tax lien or personal judgment from an unrelated lawsuit.

When there is a lone surviving joint tenant owner, he or she will then own his or her interest in the property as an estate in severalty or sole ownership and the joint tenancy is then officially terminated. The sole ownership interests will later be probated through a will, or pass through a trust, or other agreements or court decisions upon the last surviving owner's death.

The acronym “**TTIP**” (time, title, interest, and possession) is a quick way to remember the four core elements involved with joint tenancy. They stand for the “four unities”: The property must be acquired at the exact same **time** (unity of time); by the two or more joint tenants while using the same deed or **title** (unity of title); with equal **interests** (unity of interest); and they must take **possession** together simultaneously (unity of possession).

Right to partition: Under joint tenancy arrangements, a partition suit may be filed in court to divide or partition the property physically, as requested by the claiming owner's rights and interests in the property. These types of situations might occur if two or more co-owners in a joint tenancy property can't agree to sell the property, and one of the partners needs his or her funds out sooner rather than later.

Two of the main types of legal partitions include **partition in kind** and **partition by sale**. With 100-acre land parcels out in Riverside County, it will be easier for the courts to agree to split up the site in equal amounts for the joint tenants (50 acres each) using a partition-in-kind legal method. Many times, however, the property cannot be easily divided such as a single-family home on a 7000-square foot lot. Then the assets are divided up equally upon sale of the property in a partition by sale.

A partition suit can formally terminate both a joint tenancy and a tenancy- in-common agreement. Bankruptcy, foreclosure, and judgment

liens from unrelated creditors are other ways that joint tenancy and tenancy-in-common arrangements can be voided.

Ownership by Legal Entities

Besides individuals, there are various types of legal entities that can also hold title to property as an owner or tenant. These entities may include:

Tenancy in Partnership: A property is owned by two or more persons for business purposes. Each partner has equal possession rights. In the event of the death of one of the partners, the partnership will end or dissolve unless otherwise noted in a prior written agreement. If so, the surviving partners will share equally the remaining rights of possession in the property. Often, the partner who passed away has heirs who may be entitled to the deceased partner's profits from the property, but they usually do not have any rights over the property itself unless otherwise spelled out in writing between all original partners.

Sole Proprietorships: This is one single owner who conducts business operations under a specific trade name (e.g., Ralph's Painting) and is also vested on the title of the building for the company's business headquarters or some other type of property. There may or may not be employees working for this type of sole business and property owner.

Corporations: The owners of corporate stock in a company who purchase shares of stock (aka "securities") as an investment are called *shareholders*. The shareholders are usually the primary owners of a corporation. A corporation is legally defined as an "artificial person" that can own or lease estates or other assets, sign contracts, and take on new debts and liabilities.

General Partnerships: A general partnership is a business association formed by contract when two or more persons decide to conduct business and/or invest together for profit. Each partner may incur unlimited liability for the debts of the entire partnership. The authorized acts of one partner are binding on the partnership and individual partners or principals. Any real property acquired by the partnership is the property of the partnership as opposed to the individual partners who are not co-owners in the property (e.g., ABC General Partnership is on the deed of trust as the 100% owner).

Limited Partnership (LP): Limited partnership investors can have both limited risk and opportunities in profits as compared with general partnerships. One of the main reasons why investors choose these types of partnership arrangements is to minimize their personal financial liabilities in the event of future litigation from outside parties. Usually, limited partners do **not** act with any real authority in management decisions related to the business operations or the management of the real estate assets.

Limited Liability Companies (LLCs): These legal entities are somewhat akin to a hybrid between a corporation and a partnership. An LLC is created by filing articles of organization with the California Secretary of State. The tax structure of an LLC provides the single-level tax benefits seen with partnerships. Often, the LLC members are passive, and do not assist with the management of the LLC unless they were appointed to play key management roles by the other members. A key benefit for LLC members is that individual members do not typically have personal liability for the company's financial obligations or losses. As such, LLCs are quite popular with investors who buy "fix and flip" properties and other types of "high risk/high opportunity" investments with several of their business associates, friends, or family.

Trusts: Trusts are legal documents that have one or more trustees (or neutral administrators) who work on behalf of one or more beneficiaries (or entities or people who hope to receive financial benefits). A trust document defines the powers of the trustee and the interests of the beneficiaries as well as the rights and interests of any trustors (borrowers) involved in the trust agreement associated with the property.

Real Estate Investment Trusts (REIT): A REIT is a more sophisticated type of business ownership trust. REITs are regulated by the Division of Corporations and their governing agency called the Department of Business Oversight, and possibly other federal agencies such as the Securities and Exchange Commission (SEC). REITs must have at least 100 shareholders. They may own or offer types of mortgage financing for properties such as office buildings, retail shopping malls, multifamily apartment buildings, and packages of single-family homes. The investors are usually passive and do *not* act with any management capacity. Rather, they collect income streams from the assets over several years while paying income taxes on these dividends.

Which legal entities are the most effective for investment properties held both short term and over the long term?

Both new and experienced real estate licensees in California will likely be asked at some point by at least one or more of their clients about the best legal entities to use when acquiring real estate as an investor or owner-occupant. The safest answer that a licensee can respond with when asked these questions is to suggest that they ask a qualified legal and accounting specialist instead. Yet, it is also important for agents to understand the basics involved with legal entity options when dealing with their clients or prospective customers partly as a way to most effectively assist them with the purchase or sale of one or more properties.

There can be different types of tax and legal consequences for properties held in title for as little as a month or two in a “fix-and-flip” investment scenario as compared with properties held long term in an investment portfolio. Let’s take a closer look below at some of the most popular legal entity choices for investors who acquire and hold property for various time periods.

S Corporation

Many real estate investors, contractors or developers, and other types of business professionals such as real estate brokers, accountants, and attorneys managing small or large-sized firms. They can provide incredible tax savings benefits as well as additional layers of asset protection. Additionally, the S Corporation can help to reduce self-employment taxes for business professionals who had previously filed as independent, self-employed professionals, sole proprietors, or primary LLC members before later converting to an S Corporation classification.

The long-term ownership of rental properties held under an S Corporation can provide some attractive benefits to shareholders. The corporate body can collect rent, pay expenses, and reduce personal liability obligations in the event that the tenant later gets hurt on the property.

Owning properties under a corporate umbrella may also reduce liability risks for individual shareholders from legal claims that are unrelated to

the investment properties held by the corporation because their personal name is not on the title to the property. Often, private investigators or civil litigants may do a thorough asset search by way of researching public records in an attempt to find assets to grab in various types of civil court cases associated with car accidents, divorce, or business disputes.

An S Corporation can also assist owners with the avoidance of double taxation that is seen with a C Corporation (as discussed below). An S Corporation allows the profits earned through the corporate entity to be passed on to the individual shareholders. Each of these profits is then taxed on the individual shareholder's personal returns instead being taxed twice (first at the corporate level and second at the personal individual return level).

The S corporation is defined by the Internal Revenue Service as:

... [C]orporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level.

To qualify for S corporation status, the corporation must meet the following requirements:

- *Be a domestic corporation.*
- *Have only allowable shareholders*
 - *May be individuals, certain trusts, and estates*
 - *But may not be partnerships, corporations or non-resident alien shareholders.*
- *Have no more than 100 shareholders*
- *Have only one class of stock*
- *Not be an ineligible corporation (e.g. certain financial institutions, insurance companies, and domestic international sales corporations).*

Source:

<https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations>

C Corporation

A C Corporation is a business and tax term that is used to distinguish this separate legal entity from other entities or individuals. The profits earned within a C Corporation are taxed separately from its owners under subchapter C of the Internal Revenue Code.

A high percentage of investors and business professionals seem to appreciate the fact that a C Corporation can limit individual shareholders' personal liability. This is true partly since shareholders do not typically have unlimited personal liability for the debts incurred by the corporate body. As such, they are not as likely to be sued individually for corporate wrongdoings, subject to some legal and financial exceptions.

Shareholders are the primary owners of a C Corporation. These shareholders must unite and mutually agree to elect a board of directors that will make business and investment decisions for them while filing the required paperwork with the appropriate state, federal, and tax agencies. Because these corporate structures are treated more like an independent entity, the C Corporation doesn't cease to exist when its shareholders or stock owners change or die.

Some other major benefits associated with a C Corporation include the following:

- As compared to a sole proprietorship or an LLC designation, corporations (both C and S) are usually at a much lower risk for government or tax audits.
- There may be more business deduction opportunities for corporations than for individuals or LLC members which can greatly reduce tax obligations for shareholders.
- The corporate profit might be split in ways where the corporation pays a tax rate generally lower than individual tax rates which can thus save shareholders some money.
- There can be an unlimited number of shareholders in a C Corporation (subject to change). This may allow the corporate structure to raise much larger amounts of capital from hundreds or thousands of shareholders that can be pooled together to acquire

or build much more expensive real estate projects such as retail shopping centers or 100+ unit apartment buildings. The investors may also include wealthier foreign investors.

- The owner or majority shareholder of a C Corporation has the option of issuing a few types of “classes” of stocks to many different shareholders. Two of the main stock investment options for shareholder investors typically include **common stock** and **preferred stock**.

There are many benefits associated with both S and C Corporations for investors and numerous types of business professionals. However, there are some potential drawbacks for certain types of real estate investors that are partly based upon the length of time the investor holds ownership.



Selling or Refinancing Corporate Assets

The challenges for the ownership of real property under an S Corporation in particular can have some negative consequences when the property is later sold or refinanced in another name. There are some banks that will not refinance properties held by an S Corporation. Other banks may agree to finance or refinance a property if the title is in the primary shareholder's personal name.

Another common reason that investors might decide to transfer title to a property from their S Corporation into their own personal name is in situations where they are planning to convert their rental home into their primary home. Let's review below a (fictional) example of an investor attempting to change his rental property to an owner-occupied property in order to take advantage of the capital gain tax exclusions offered to homeowners across the nation.

Converting Rental Properties to Owner Occupied Properties

A Case Study (S Corp. to Individual)

Janet Smith and her husband, Mark Smith, purchased a rental home (Main Street) in Ventura County for \$200,000 over a decade ago. She added another \$25,000 in upgrades to the property, and consistently rented the home to two different families over a period of 10 years. Today's market value of the home is \$600,000, according to sales comparables provided by their local real estate agent.

During this time, their primary home (First Street) was located just a mile away. Janet and Mark's primary home appreciated from \$300,000 to \$700,000 over a period of close to 15 years. Under **IRS Code Section 121 (capital gain exclusion on primary residential property)**, an individual or married couple who lives in their main residence for at least two of the past five years before the sale of their primary property is entitled to an exemption of up to \$250,000 for a single person and up to \$500,000 for a married couple. As a result of this tax benefit for owner-occupied married couple owners, they were able to *not* pay any tax on the \$400,000 appreciation gain.

Now, Janet and Mark needed a new place to live after selling their beloved home on First Street where they spent the past 15 years raising

their children. The most obvious choice to Janet and Mark was to move into their nearby rental on Main Street, fix it up, live there just two years, and sell that property while trying to also avoid the capital gains taxes for up to \$500,000 in profit as well.

But there was one problem with Janet and Mark's plan to convert their rental property into their main home. The biggest challenge was that the rental property on Main Street was held by Janet and Mark's S Corporation, "123 Main Street Corporation." Because Janet and Mark did *not* research the potential serious tax issues associated with changing ownership of a property from their corporation to individuals after they signed the deed as corporate officers from 123 Main Street Corporation to Janet and Mark Smith, a married couple, they were later shocked to learn about the tax consequences associated with the title or ownership transfer.

Here was the main tax issue that Janet and Mark learned about when they later received their tax bill from the IRS and Franchise Tax Board:

Once Janet and Mark changed the deed from 123 Main Street Corporation (S Corp.) to "Janet and Mark Smith," the IRS considered it as a sale, which also triggered a tax on the \$375,000 gains (less depreciation, additional upgrades over the years, and other deductions) that was determined by subtracting from the estimated current market value of \$600,000, the original \$200,000 purchase price plus \$25,000 in upgrades. In this tax scenario, there was no actual sale to an unrelated party for a true net cash gain, it was just related to the ownership change on the deed from an S Corporation to the couple's personal names.

Two years later, Janet and Mark might be able to sell the Main Street property for a much higher price that would be based upon an original purchase price under their married couple names of \$600,000 instead of their original \$200,000 purchase price many years ago.

Shared Property Types

Both condominiums and co-ops ("cooperative") offer individual and shared co-ownership features.

Condominiums: With condominium units, the owner of an individual unit owns the airspace located within the walls of their specific unit. But they share equal interests in the common area amenities such as access to the community pool and clubhouse in fractional ownership percentages that are equal to the number of units in the condominium complex (50 units = 1/50th ownership).

Typically, owners will have to pay a monthly Homeowner's Association (HOA) fee as well as closely follow the community rules outlined in the CC&R's (Covenants, Conditions, and Restrictions). Sometimes, older apartment buildings are converted by the owner/developer into modified condominium buildings so that the individual units can be sold at a much higher price through the legal process of **conversion**. Conversion has been quite popular for many developers in places like Orange and Los Angeles Counties over the past few decades due to the skyrocketing prices being paid for metropolitan and coastal regions.

Cooperative ("Co-op") Units: A cooperative, or "co-op" unit is a more complex type of shared ownership interest in a building that typically looks like a high-rise apartment or condominium unit building as seen in metropolitan regions like Los Angeles, San Francisco, and New York City. The named owner on the deed to the entire building is a corporation. The individual "co-op owner" owns stock in the same corporation that owns the entire building as well as proprietary rights to occupy a specific unit within the building. A co-op owner's number of shares in the corporation that owns the cooperative property is based upon the size of the unit and building as well as the common area amenities.

Each co-op unit owner will likely pay a monthly "maintenance" fee payment that is similar to an HOA payment found in condominium units. In some of the priciest co-op buildings, the monthly fees might range from \$500 to \$1,000+ per month in addition to their monthly mortgage payment (principal and interest), plus property taxes and insurance. There are some mortgage lenders that will not provide financing options for property owners with co-op interests as they would for other types of shared interests on deeds or properties like condominium complexes due to the perceived risks of these investments. Licensees would be wise to check the public records for a co-op building that interests their clients in order to find out which lenders have provided mortgage loans for current or past co-op unit owners.

Leasehold Estate

Individuals who rent or lease residential or commercial properties or hold a leasehold estate interest from a landlord are usually referred to as tenants. The non-freehold estate held by a tenant can also be described as a leasehold, an estate of tenancy, or a “chattel real” (chattel is typically associated with movable personal property).

The leasehold interest is first created with a lease agreement. In most situations, the lease is an express or written contract as opposed to an implied or verbal agreement, especially if the lease term lasts more than 12 months. The lease agreement formally creates the relationship between the owner or landlord (lessor) and the tenant (lessee). The tenant has a clearly defined and specific amount of time spelled out in the contract to possess and use the real property. At the end of this term, the tenant must then move out or work on renewing the lease agreement for a longer period of time if the landlord agrees to it.

Interests in properties that are considered “less-than-freehold” are usually ones in which the rights of usage and the interests are much less and more limited than freehold interests and are of a typically shorter duration. People or entities like corporations or partnerships that hold leasehold estate interests in properties are usually referred to as a **tenant**.

Both freehold estate and leasehold estate interests in properties can exist simultaneously for the same property site by tenants and owners. On each side of the transaction, both parties have certain rights and claims for the property based upon the terms of the written agreement or contract between the two parties (tenant and landlord). When there are two or more parties with interests in the same property, it is called **privity**.

An **habendum clause** in a deed or lease agreement will define the type of interest and rights that can be enjoyed by the grantee or lessee. Often, the clause will begin with the words “to have and to hold” as it relates to an owner’s or tenant’s rights to use, occupy, and enjoy.

Let’s take a closer look at common ways to hold ownership or leasehold interests in a property.

Leasehold Estate Types

Term Tenancy: A term tenancy is a tenancy for a fixed period of time that may also be called “estate for years” by agents or principals. Many lease agreements have an end date for the lease term in months or years. This type of lease agreement will automatically end or terminate at a specific future date. The term tenancy can end before this end date if the tenant does not pay their rent on time, the landlord refuses to maintain the property in the conditions outlined in the lease agreement, or if both the tenant and landlord mutually agree to break the lease (a/k/a a **surrender** of the lease contract).

Periodic Tenancy: The most common type of lease agreement is the periodic tenancy arrangement that is structured as month-to-month or year-to-year. In this type of agreement, at least one party (tenant or landlord) must officially notify the other side before terminating the periodic tenancy. Otherwise, the periodic tenancy will continue automatically until one side wishes to end it and gives notice to the other.



Tenancy at Will: A tenancy at will is a lease arrangement that typically has no formal written lease contract between the landlord and tenant. It

is more of a verbal or implied contract and may not be assigned to any other parties. As long as the tenant pays his or her rent on time and the landlord continues to accept it, the tenancy at will arrangement may continue. To end this type of verbal lease, one side must give the other side at least a 30-day notice in California.

Tenancy at Sufferance: A tenancy at sufferance is somewhat of a hybrid between an express (written) and implied (verbal) arrangement. At first, there is a written lease contract with a specific end date. Once the contract period ends, if the tenant continues to remain on the premises paying the same amount of rent to the landlord and the landlord willingly accepts the payments at the original lease terms, the tenant legally becomes known as a **holdover tenant**. Should the landlord eventually want the tenant to vacate the property even if he or she still wants to pay the lease payments on time, then the landlord must follow the legal eviction steps prior to taking the premises back.

Chapter Three Summary

- **Freehold Estates (a/k/a “estate of inheritance”):** This is an estate of indefinite duration that can be later freely sold, gifted, or granted to designated heirs by way of wills, family trusts, family limited partnerships, or other types of family inheritance structures.
- **Fee Simple Absolute** is the highest possible ownership interest in real property held in common law nations like the United States.
- **Fee Simple Qualified (Defeasible):** Properties owned with a few limitations or restrictions to usage of the property such as private deed restrictions.
- **Life Estates:** An interest in property that can be created by will or deed as long as one designated individual is still alive. The person who receives the full interests in the property when that life estate holder dies holds what is called an **estate in remainder**. Should the same property instead be returned by the heir back to the original owner, the estate owner will have an **estate in reversion**.

- A **life estate deed** is similar to a sale-leaseback type of transaction, but usually no rental payments are made. The **life tenant** must not intentionally damage the property.
- The grantor of the life estate deed to the subject property and the **“life tenant”** are most often the same person.
- Real and personal property interests are divided under community property law into two distinct types of property ownership for married couples: **separate** and **community** property. With separate property, the ownership interests belong to just one spouse. Under community property, the ownership interests are shared equally by both spouses.
- **Tenancy in common** or **estates in common**: This form of shared ownership interest between two or more parties or entities is the most common form of co-ownership for parties who are not married to one another.
- **Joint Tenancy** interest is another form of title held by owners of property, which shares many of the same characteristics as a tenancy in common. But the ownership interests are primarily different as it relates to how title is originally taken under the rule of **“TTIP”** (time, title, interest, and possession shared equally). And joint tenancy comes with the right of survivorship; tenancy in common does not.
- Besides title to property being taken individually, property can be held or owned by separate legal entities such as **corporations, partnerships, trusts, LLCs, and REITs**. There are many benefits and risks associated with acquiring and selling properties as these legal entities. Agents and their clients should seek competent and professional third-party advice before making a decision about how to best hold title to property.
- An **S Corporation** can also assist owners with the avoidance of double taxation that is seen with a C Corporation. **The profits earned within a C Corporation are taxed separately** from its owners under subchapter C of the Internal Revenue Code.

- With **condominium** units, the owner of the individual unit owns the airspace located within the walls of their specific unit while sharing interests in the common area in proportion with the other owners in the complex (e.g., 50 separate units = 1/50th common area interests).
- **Cooperative (“Co-op”) Units** are a more complex type of shared ownership interest in a building that is owned by a corporation. Individual co-op unit owners own shares in the corporation somewhat like one would hold equity shares in a public stock for a business like *Apple* or *IBM*.

Chapter Three Quiz

1. “Property” usually refers to _____.
 - A. Beneficial interest
 - B. Intangible personal property
 - C. Rights or interest in something owned
 - D. Residential properties only
 2. A possessory interest with limited duration or time is a:
 - A. Leasehold
 - B. Less-than-freehold estate
 - C. Fee simple absolute
 - D. Both A and B
 3. Which of the following gives the owner the most absolute rights and unlimited duration?
 - A. Fee simple absolute
 - B. Leasehold
 - C. Remainder
 - D. Fee simple defeasible
 4. Title to a property that is sold with a condition that the land will not be used for selling alcohol creates a(n):
 - A. Lien
 - B. Estate in remainder
 - C. Fee simple defeasible
 - D. CC&R clause
-

5. What term may also be defined as an estate of inheritance?
- A. Freehold estate
 - B. Leasehold
 - C. Trustee's interest
 - D. Fee simple with reversion
6. An agreement is signed between two parties for the use and possession of real property for 60 days which creates a(n):
- A. Freehold estate
 - B. Agency
 - C. Life estate
 - D. Term tenancy
7. Ownership in severalty is equivalent to _____.
- A. Sole ownership
 - B. Joint Tenancy
 - C. Tenancy in common
 - D. Community Property
8. What may arise after a periodic or term tenancy ends upon mutual acceptance?
- A. Eviction
 - B. Foreclosure
 - C. Tenancy at will
 - D. Vacancy
9. What is it called when two or more parties hold undivided interests?
- A. Community Property
 - B. Tenancy in common
 - C. Joint tenancy
 - D. Freehold interests
10. Who has unity of "time, title, interest, and possession?"
- A. Joint Tenants
 - B. Tenants in common
 - C. Lessees
 - D. Sole owner

11. What best defines “community property” as it relates to ownership?
- A. All property owned by a married couple
 - B. All property purchased by a spouse or domestic partner that is not separate property
 - C. Tenancy in common
 - D. The children’s interests
12. An agreement made by two spouses for the sale of community property is ____.
- A. Valid
 - B. Voidable
 - C. Unenforceable
 - D. None of the above

Answer Key:

1. C	7. A
2. D	8. C
3. A	9. B
4. C	10. A
5. A	11. B
6. D	12. A

CHAPTER 4

FAIR HOUSING AND CIVIL RIGHTS

Overview

In the “land of the free” here in the United States, every citizen is entitled to equal and fair treatment as it relates to their access to certain rights, like education and housing. It also relates to access to credit. Over the past few hundred years, various protected class groups of Americans have fought hard for their right to equal opportunities. Real estate licensees and property owners must understand the risks associated with any perceived violation of Fair Housing laws that could put them in jeopardy of losing their license, facing very expensive civil court actions, and even ending up in prison if they do not treat all parties with fairness and equality as we will learn in this chapter.

Early Civil Rights History

Some of the earliest origins of civil rights abuse and discrimination date back hundreds of years to the Colonial period in American history. Initially, many of the European settlers from England, Spain and other regions sailed by ship to the North American continent in search of wealth by way of grabbing prime pieces of land near coastal regions on both the East and West Coasts. Back then, millions of Native Americans were slaughtered, and their land and assets were seized by the European settlers.

The Jamestown Colony

The origins of housing discrimination and civil rights abuses on lands that later would become prominent territory in the United States might first begin with the Jamestown Colony in the Virginia region. Back on December 6, 1606, English sailors started their journey towards the promised land of America on three ships named the *Susan Constant*, the *Godspeed*, and the *Discovery*. One hundred four men and boys later

arrived on the shores near Virginia to start a new settlement or village for their people.

A joint venture was created between some of the English settlers that was named *The Virginia Company* prior to establishing the very first permanent English settlement anywhere within the North American continent. The Jamestown settlement and the adjacent river that would be named the James River were both named after their beloved King James I.

The main reason why the English settlers chose the name *Virginia Company* was that it was named in honor of Queen Elizabeth I, the “Virgin Queen” of Old England. At first, the Virginia territory was the English name for the entire eastern coast of North America that was located just north of Florida. One of the top priorities for associates of the *Virginia Company* was to search for gold and silver deposits up and down the East Coast.

Several factors went into the selection of Jamestown by the English settlers. First, the land was surrounded by water on three different sides and was also far inland from the main Atlantic Ocean beaches where their rival Spanish sailors liked to arrive on their ships. The inland location allowed the Brits to easily defend themselves against possible Spanish attacks, and there were also very few Native American settlements nearby. Additionally, the water levels were high enough on the James River for the British sailors to dock their own ships.

Over the next several years, the population of English settlers grew in Jamestown and created significant amounts of wealth by growing Tobacco and other types of crops. In spite of dealing with harsh winters, famine, and battles with the Spanish sailors and Native Americans, the British settlers were able to expand their housing options to new settlements, towns, or fully-enclosed fort regions such as James Forte, James Towne, and James Cittie.

Slavery & Loss of Civil Rights

Slaves were brought over from places such as the African continent and Ireland to assist the European settlers with the maintenance of their new forts, towns, cities, and other types of properties such as farms and

ranches. As time moved forward, neither the American Revolution nor the Declaration of Independence provided any real valid rights for the men, women, and children who originated from Africa. Shockingly, slaves were even legally defined as only three-fifths of a person. Thus, they were not granted the right to vote for elected officials.

Article 1, Section 2, Paragraph 3 of the United States Constitution:

*“Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, **three fifths of all other Persons.**”*

Originally, the “three-fifths” designation was meant more for voting rights and taxation as opposed to the promotion of discrimination and reduced civil rights for people of color. Yet people of color were sadly treated like people who were not entitled to 100% rights like the white Americans were.

Not True Independence for All

Some of the most important words that were included with the *Declaration of Independence* signed back in 1776 were as follows:

“We hold these truths to be self-evident, that all men are created equal. That they are endowed by their creator with certain unalienable rights, that are among these are life, liberty and the pursuit of happiness. That to secure these rights, governments are instituted among men, deriving their just powers from the consent of the governed...”

In spite of the “all men” phrase that was written in the *Declaration of Independence*, it is thought by many historians that the signers of this important document had meant to include all people, regardless of their race, nation of origin, age, or gender as a man, woman, or young child. The signers did believe that the “pursuit of happiness” should include the right to buy or build one’s own home.

Dred Scott v. Sandford

Dred Scott was born into slavery sometime around 1795 in Southampton County, Virginia. After the death of Mr. Scott's first owner, he subsequently spent time in two other states that were considered "free" states such as Missouri. After Mr. Scott married his wife, he attempted to buy freedom for himself and family by taking his case to court in Missouri. Surprisingly, he won his case and gained his freedom. But the case was appealed all the way up to the U.S. Supreme Court, partly because some of the slave owners were very concerned about this case setting a legal precedent for other slaves to follow on their way to their own freedom.

The 1856 U.S. Supreme Court case entitled *Dred Scott v. Sandford* (60 U.S. 393 (1856)) was later considered one of the worst court decisions in U.S. history as the high court was not as forgiving and empathetic to Mr. Scott's plight. The Court ruled that persons of African descent were not "citizens" even if they lived in a free state. As such, the court held that African descendants had no legal "rights" as U.S. citizens.

Specifically, as it related to the African man named Dred Scott who was a slave at the time, the U.S. Supreme Court ruled that even though Mr. Scott lived in a free state and a territory where slavery was prohibited, he was still not legally entitled to his freedom. The court went on to state that Africans were not and could never be true U.S. citizens. The court also found that the *Missouri Compromise*, which had declared areas west of Missouri and north of the 36th parallel (or the southern border of Missouri) "free," a main condition for the offer of statehood to Missouri, was **unconstitutional** before later pushing the nation much closer to civil war.

The U.S. Supreme Court found that the black man in general was legally bound to respect white residents. The Court also stated that its decision applied to all African persons living within the United States whether they were considered slaves or free.

"In the opinion of the court, the legislation and histories of the times, and the language used in the Declaration of Independence, show that neither the class of persons who had been imported as slaves, nor their descendants, whether they had become free or not, were then acknowledged as a part of the people, or intended to be included in the

general words used in that memorable instrument."

Source: <https://supreme.justia.com/cases/federal/us/60/393/case.html>

The Supreme Court decision was considered so controversial by both slaves and free people at the time that it is thought to be one of the main reasons for Abraham Lincoln's *Emancipation Proclamation* and the start of the Civil War between the North and South. Numerous legal scholars have described the *Dred Scott* decision as the worst decision ever made by the Supreme Court. A future Supreme Court Chief Justice named Charles Evans Hughes (1930 - 1941) also described this decision as the court's great "self-inflicted wound."

Civil Rights Act of 1866

Property rights and other types of rights were written into law through actions like the passage of the Civil Rights Act of 1866. This was perhaps the most important legal step towards the creation of significantly improved rights for most Americans; to be guaranteed the right to buy, sell,, lease, or inherit property, regardless of their race in most situations.

The Civil Rights Act of 1866 included this key section:

"All citizens of the United States shall have the same right, in every state and territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property."

Two years later, in 1868, the passage of the **Fourteenth Amendment** seemed to grant more property rights and civil rights to Americans in combination with the Civil Rights Act of 1866 and the following clause of the **Fifth Amendment**:

"No person shall be... deprived of life, liberty, or property without due process of law; nor shall private property be taken for public use, without just compensation."

The Fourteenth Amendment states:

“All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and the state wherein they reside. No state shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States, nor shall any state deprive any person of life, liberty or property, without the due process of law; nor deny to any person within its jurisdiction the equal protection of the law.”

In many ways, the passage of the Civil Rights Act of 1866 only guaranteed some rights for people of all races as it related more to government-owned properties as opposed to private properties. For almost the next 100 years, the state and federal courts made their civil rights decisions in discrimination cases relating more to zoning and usage than to enforcement of rights to protect members of protected classes from illegal evictions or from being denied the right to rent or buy due to the color of their skin.

Historical Civil Rights Cases and Laws

Modern-day laws in California and the rest of the nation can date back to legal decisions in state or federal court as recently as last week, or last year, or as long ago as last decade, or even last century. Some important legal decisions, both advancing discrimination and arguing against it, and legislation follow:

1896 - *Plessy v. Ferguson*

The legal doctrine known as “*separate but equal*” arose from this U.S. Supreme Court case in 1896. The court upheld the constitutionality of segregation after reviewing the case involving an African-American man named Homer Plessy and a dispute involving his train rides. The heart of the case involved the fact that Mr. Plessy refused to sit in a separate section of the train car that was for “colored people,” which was a violation of the existing Louisiana law at the time.

The Supreme Court fully rejected Mr. Plessy’s argument that his constitutional rights were violated when he was not entitled to sit

anywhere that he wanted to on the train. The Court determined that the Louisiana state law that “implied merely a legal distinction” between blacks and whites did **not** conflict with the 13th and 14th Amendments. Legal decisions related to restrictive legislation based upon matters of race and division would not be drastically changed in U.S. courts for the next 60+ years.

1917 - *Buchanan v. Warley*, 245 U.S. 60 (1917)

What is truly ironic about this case is that it was filed by a white man who ultimately argued on behalf of a black man’s right in a real estate transaction. Buchanan, a white man, sold a Louisville, Kentucky home to Warley, a black man. There was an existing ordinance in effect in Louisville that did not allow blacks to live on the same block where the majority of residents were white. Of the 10 homes on this block in question, eight of them were occupied by whites, so Warley was prohibited from buying the property due to the existing local laws.

It was the white seller, Buchanan, who initially took legal action to enforce the sale to Warley. In Warley’s defense, he primarily cited the existing city ordinance as the sole reason for the completion of the home sale.

The case went from the lower court on appeal up to the Kentucky Court of Appeals. It was there that Buchanan, the original Petitioner or claimant in the civil action, argued on behalf of Mr. Warley’s civil rights. He argued that the Kentucky ordinance violated the Due Process clause of the Fourteenth Amendment. The Kentucky Court of Appeals upheld the lower court’s previous decision that the existing city ordinance was valid and lawful.

The case was then appealed yet again up to the U.S. Supreme Court where they unanimously ruled that the ordinance was unconstitutional. Some of the primary reasons why the Supreme Court ruled in Buchanan’s favor, and in Warley’s favor as it related to his civil rights to own property in almost any neighborhood that he pleased, were the fact that the Civil Rights Act of 1866 and the Fourteenth Amendment “assured to the colored race the enjoyment of all the civil rights...enjoyed by white persons.” The Court also ruled that the ordinance would “deny rights created or protected by the Federal Constitution” in spite of the

city's police power rights that were designed for the "promotion of the public health, safety, and welfare."

1948 - *Shelley v. Kraemer*, 334 U.S. 1 (1948)

This was a landmark U.S. Supreme Court decision that ruled that courts could not enforce racial covenants on real estate properties. The Shelleys were a black couple who moved into a neighborhood in Missouri where the Kraemers, a white couple, lived. This same neighborhood had a restrictive covenant in place since 1911 that was somewhat akin to their local CC&Rs (Covenants, Conditions, & Restrictions) which prevented blacks from owning properties in the same neighborhood. The Kraemers took offense to the fact that a black couple wanted to live in their neighborhood, so they took them to court in order to enforce the restrictive covenant against the Shelleys.

The Supreme Court's decision noted that state courts could not constitutionally block the sale of homes from whites to blacks even if there is a racially restrictive covenant in place. Between private parties, this restriction might have some merit. However, once any federal agencies or courts got involved to work out the property dispute, the court's enforcement constitutes state action in violation of the Fourteenth Amendment. The Court found that there was "*government involvement that was sufficient to violate the equal protection clause of the Fourteenth Amendment.*"

It was not until 1972 when the Supreme Court made further rulings about how the recording of deeds with racial restrictions violated the Fifth Amendment to the Constitution and the Federal Fair Housing Law that was passed four years earlier in 1968.

1954 - *Brown v. Board of Education*, 347 U.S. 483 (1954)

This landmark court decision reversed the "separate but equal" decision found in the *Plessy v. Ferguson* case. The *Brown* case outlawed segregation and racial division in schools while also setting legal precedents for the outright banning of segregation in other places such as housing.

This case was a consolidation of four cases that arose in different states that were associated with how African-American children were denied access to certain public schools due to their race. The plaintiffs' attorneys argued that the segregation of these young children violated the Equal Protection Clause of the Fourteenth Amendment. Chief Justice Earl Warren, and the rest of the unanimous Court, held that "separate but equal" facilities are truly unequal and do violate the protections offered by the Equal Protection Clause. The Court also ruled that school segregation instilled a sense of inferiority in young African-American children that potentially might have a negative effect on their education and personal growth.

1962 - Executive Order 11063

President John F. Kennedy signed this presidential order that was entitled *Equal Opportunity in Housing*. This new legal act was designed with the intent to prohibit discrimination in the sale, leasing, or usage of all types of residential properties that were directly owned, managed, or financed by the federal government. While President Kennedy's intentions might have been good, there was very little impact on the overall housing market, partly because it lacked solid judicial enforcement behind it through the state and federal courts.

1964 - Civil Rights Act of 1964

This federal act was promoted to encourage more equal opportunity in housing. The act outlawed discrimination on the basis of race, color, nation of origin, and religion in any type of program or activity that was directly funded by the federal government. Yet federal programs for mortgage lending, such as FHA and VA were not covered by this act. Thus, only a very small percentage of properties received some benefits after this act passed.

1967 - *Reitman v. Mulkey*, 387 U.S. 369 (1967)

This important case in California affected a high percentage of tenants, buyers, landlords, and sellers in the state and the rest of the nation, directly or indirectly. In 1964, California voters passed an initiative and referendum in Proposition 14 (Article I, § 26) as an amendment to the California Constitution. This new amendment banned the state from making any laws that prohibited the rights of owners or landlords from discriminating against any prospective tenant for any reason, even if it was due to racial concerns. The Mulkeys (plaintiffs) were a married couple who later sued the Reitmans (defendants) for refusing to rent an apartment to them primarily due to the Reitmans' concerns about the Mulkeys' race. Specifically, the Mulkeys argued that Sections 51 and 52 of the California Constitution banned race-based discrimination in the rental of properties, and that the passage of Proposition 14 should be ruled "null and void" because it was unconstitutional. The Court agreed and ruled for plaintiffs.

1968 - *Jones v. Mayer*, 392 U.S. 409 (1968)

This Supreme Court case had a huge impact on modern-day civil rights and fair housing laws. The Court ruled that Congress could regulate the sale of real properties in an attempt to prevent racial discrimination. Jones, a black man, filed a lawsuit against the Alfred H. Mayer Company, a real estate brokerage firm based in St. Louis County in Missouri, for refusing to sell him a home in a particular neighborhood where he wanted to live because of his race.

The U.S. Supreme Court later found for Mr. Jones, and held that Section 1982 of the Congressional Act was intended to disallow all discrimination against blacks in the sale of real properties, which included both private and governmental discrimination. The Court also ruled that the Thirteenth Amendment's enforcement section gave Congress the power to completely eliminate all racial barriers that attempted to place obstacles in the way of any property buyer due to matters of race because these racial barriers were the equivalent of "badges of incidents of slavery."

42 U.S. Code § 1982 - Property rights of citizens

“All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property. (R.S. § 1978.)”

1968 - Fair Housing Act (Title VIII of the Civil Rights Act)

The Fair Housing Act, also known as the Civil Rights Act of 1968, was signed into law in April 1968. It prohibited discrimination practices concerning the sale, rental, and financing of residential real estate properties based upon any reasons related to race, nation of origin, religion, and gender. Any discrimination in advertising, real estate sales, mortgage lending, and other services that are directly associated with residential real estate were also made illegal by this act.

There were a few primary **exemptions** to the Fair Housing Act that were not impacted by the passage of this law. These exemptions include:

- Commercial real estate properties;
- Where the owner does not own more than three similar types of homes; and
- Where there is no real estate agent or broker involved in the transaction.

Rental properties (one to four units) are also excluded if:

- The owner occupies one of the units as his or her main residence.
- No real estate agents or brokers were involved in the lease transaction.
- No discriminatory advertising is used by the landlord.
- The landlord gives preference to religious or nonprofit groups that they may personally favor as long as these groups do not discriminate when selecting their own members.

- The principal may give preferential treatment to members of private club facilities that offer short or long-term housing options that are closed to the public.

Older age community exemption guidelines from the Fair Housing Act include:

- Properties designated under a government program to provide assistance to elderly citizens.
- Properties that were originally intended for sole occupancy by residents over the age of 62.
- Retirement communities such as golf course resorts built to attract residents over the age of 55, as long as at least 80% of the units are occupied by at least one person over the age of 55.

The Fair Housing Act was partly created as an updated amendment to the Civil Rights Act of 1964 that had more power of law behind it so that many more people would be inspired to follow these rules due to the new legal risks. The bill was passed shortly after the assassination of the charismatic and beloved civil rights leader, Martin Luther King, Jr.

Between 1950 and 1980, the total black population in urban centers in the U.S. increased from 6.1 million to 15.3 million, partly as a result of more access to third-party lending options to buy properties. Yet many white families began moving from the urban neighborhoods near downtown regions out towards suburbia due to concerns about the potential of increasing crime and racial conflicts between whites, blacks, and Hispanic neighbors. This movement of large numbers of white families out to the suburbs was referred to as “white flight” to suburbia.

1988 - Fair Housing Amendments Act

This amendment expanded the law to ban discrimination in housing while also including new protected class members that had challenges related to disabilities and family status (i.e., unmarried mothers with children or divorced people or unmarried couples). The updated amendments gave more power and control to the U.S. Department of

Housing and Urban Development (HUD) to enforce any violations committed by legally pursuing claims against both principals and real estate agents assisting them.

HUD Enforcement of Fair Housing Violations

Individuals who believe that a principal, real estate licensee, or some other third party has discriminated against them during the process of seeking a property to lease, sell, buy, or finance with a mortgage broker or bank have the legal right to file a personal civil lawsuit as well as file complaints with HUD and/or their affiliate state agencies. A HUD complaint can be filed up to one year from the date of the alleged act of discrimination.



After the agency completes its thorough investigation, it might either try to persuade the two opposing parties to settle their dispute between themselves by completing the lease or sale agreement, do nothing about it, or refer the matter to in-house legal counsel to argue during an administrative hearing. The U.S Attorney General's office may get involved and file a suit in federal court on behalf of the party alleging discrimination and against the party who engaged in the alleged discriminatory behaviors.

Depending upon the severity of the discrimination claims and past

history, penalties can vary between a few thousand dollars to \$110,000 for multiple offenses, in addition to thousands or millions of dollars in civil judgment amounts that may also be awarded in federal court.

Federal Fair Lending Laws

Below we review a few of the more relevant federal laws that offer American citizens fair and equal access to various types of credit and lending options.

The Consumer Credit Protection Act (CCPA)

This law was enacted in 1968 to help guarantee consumers equal rights to fair and honest credit or lending practices. This act helped to standardize lending approval guidelines across the nation so that a higher percentage of borrower applicants were treated equally. Over the years, other consumer protection laws were created under the CCPA umbrella, such as the Truth-in-Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Fair Debt Collection Practices Act, and the Electronic Fund Transfer Act.

Fair Credit Reporting Act

In 1970, the Fair Credit Reporting Act (FCRA) was the very first federal law to regulate how a person's personal information is used by a private business or marketing agency. Because there were so many mistakes on people's personal credit reports, this law was implemented in order to hopefully reduce the number of mistakes on credit reports that were unfairly causing consumers to be denied new credit access.

Each year, consumers are now allowed to request one free credit report so that they have an opportunity to see and fix any mistakes on it. Currently, there are at least three smaller acts under the FCRA: The Credit CARD (Card Accountability Responsibility and Disclosure) Act of 2009, the Dodd-Frank Act, and the Fair and Accurate Credit Transactions Act. The laws cover mortgage lending guidelines and consumers' legal rights should someone later steal their credit identity.

Equal Credit Opportunity Act (ECOA)

ECOA was first enacted back in 1974. The intent of this measure was to prohibit discrimination based upon any factors associated with race, color, religion, nation of origin, marital status, age, or source of income such as receiving public assistance. The Federal Trade Commission (FTC), the nation's top consumer protection agency, is in charge of enforcing the ECOA laws which were written to provide protections to consumers when applying for credit for financial entities such as small loan and finance companies, credit card companies, credit unions, department stores, licensed mortgage brokers, and banks.

Home Mortgage Disclosure Act (HMDA)

A federal law enacted in 1975 that requires various types of financial institutions to provide mortgage data to the public. One of the main purposes of HMDA is to assist governing authorities in the monitoring of any potential discriminatory and predatory lending practices. Some examples may include back when subprime mortgage lending was so prevalent in the early 2000s, and some lenders intentionally offered expensive loans to minority borrowers without first explaining to those borrowers what they were agreeing to.

Americans with Disabilities Act (ADA)

The ADA prohibits discrimination in employment (Title I), state and local government activities and public transportation (Title II), public accommodations (Title III), and telecommunications (Title IV). A person is legally defined as "disabled" if they have a physical or mental impairment that may substantially limit some sort of a "major life activity" such as talking, seeing, learning, and walking.

California's Discrimination Legislation

In addition to federal civil rights, credit protection, and Fair Housing rules and regulations, California has their own laws which must be closely followed by principals and real estate licensees. Some of the most important guidelines include the following.

Unruh Civil Rights Act

This act is one of four statutes enforced by the California Department of Fair Employment and Housing (DFEH). The overseeing DFEH agency protects state residents from employment, housing and public accommodation discrimination, as well as hate violence. Specifically, California residents shall be entitled to equal access and treatment in private and public business locations such as restaurants, banks, and hotels. This was to reverse the practice of denying access due to race, gender, religion, nation of origin, disability, or medical condition.

California employees, tenants, or others have up to one year from the perceived discrimination incident date to file a complaint with DFEH against their current or former employer, landlord, or a business owner. DFEH, in turn, has the option to do nothing, take the matter to the Fair Employment and Housing Commission, and/or file a civil complaint in court. Remedies that might be collected by the injured party or claimant include: 1) Out-of-pocket expenses; 2) Cease and desist orders; 3) Damages for emotional distress or other issues; and 4) Much higher punitive damages.

Rumford Act (Fair Employment and Housing Act)

The Rumford Act was passed in 1963 by the state of California in an attempt to ban unfair housing practices that had restricted minority applicants. Surprisingly, the California Real Estate Association has supported restricting housing activities in some limited situations. In 1980, the Fair Employment Practices Act and the Rumford Housing Act were combined and renamed the Fair Employment and Housing Act that was meant to ban housing and employment discrimination practices. This agency is governed by California's Department of Fair Employment and Housing (DFEH - <https://www.dfeh.ca.gov/>). Today, it is the largest civil rights agency in America.



Holden Act (The Housing Financial Discrimination Act)

This law was created to prohibit discriminatory lending practices. One of the main activities that it bans is the act of **“redlining”** (a strategy where lenders avoid providing mortgage loans in certain types of perceived “high risk” neighborhoods), which may or may not be filled with a high number of protected class members such as found in older, downtown urban centers. Lenders also cannot charge more fees to protected class members, including higher points, interest rates, and other closing costs.

Other potentially discriminatory lending and real estate agent practices that are frowned upon and legally enforced partly as a result of the Holden Act and/or other types of laws include:

Blockbusting or Panic Selling: This illegal activity can happen when a real estate agent tries to scare homeowners into quickly listing or selling their home with them under duress related to allegations that new

neighbors of different racial backgrounds may soon move into their neighborhood, which might lower home values.

Steering: This discriminatory activity by real estate licensees can also seem like the exact opposite of blockbusting or panic selling. It occurs when an agent shows prospective tenants or buyers only homes or apartment units in areas where similar types of people reside. An example may include showing an Asian couple only homes in a neighborhood that is primarily Asian. While it may seem like a valid business strategy for the real estate agent, it is considered a form of discrimination that can lead to the suspension or loss of his or her license as well as the imposition of fines and the filing of lawsuits.

Chapter Four Summary

- Property rights, and other types of rights, were written into law through actions like the passage of the **Civil Rights Act of 1866**. The Act improved property rights for many Americans in their pursuit of buying, selling, leasing, or inheriting property, regardless of their race in most situations.
- Important legal cases that helped improve equality slowly over time:
 - o **1896 - Plessy v. Ferguson:** The legal doctrine known as “*separate but equal*” arose from this U.S. Supreme Court case in 1896.
 - o **1948 - Shelley v. Kraemer:** This was a landmark U.S. Supreme Court decision that ruled that courts could not enforce racial covenants on real estate properties.
 - o **1954 - Brown v. Board of Education:** This landmark court decision reversed the “*separate but equal*” decision made in the *Plessy v. Ferguson* case. It would later help improve access for all to schools and housing.

- o **1968 - *Jones v. Mayer*:** A Supreme Court case that probably impacted modern-day civil rights and Fair Housing laws more than any other case decided in the last two centuries.
- **1968 - Fair Housing Act (Title VIII of the Civil Rights Act):** The Fair Housing Act (aka Civil Rights Act of 1968) prohibited discrimination practices when concerning the sale, rental, and financing of residential real estate properties based upon any reasons related to race, nation of origin, religion, and gender.
- **1988 - Fair Housing Amendments Act:** This amendment expanded the law to ban discrimination in housing disability and family or familial status (i.e., unmarried mothers with children or divorced couples).
- **Equal Credit Opportunity Act (ECOA):** ECOA was first enacted in 1974 to prohibit discrimination based upon issues related to race, color, religion, nation of origin, marital status, age, or source of income.
- **Unruh Civil Rights Act:** This act is enforced by the California Department of Fair Employment and Housing (DFEH). The Unruh Act protects state residents from employment, housing and public accommodation discrimination, as well as hate violence.
- **Rumford Act (Fair Employment and Housing Act):** The Rumford Act was passed in 1963 by the state in an attempt to ban unfair housing practices that had restricted minority applicants.
- **Holden Act (The Housing Financial Discrimination Act):** The Holden Act was created to prohibit discriminatory lending practices such as **redlining** (when lenders refuse to lend in certain rundown or older areas that are considered risky).
- **Steering:** It occurs when an agent shows prospective tenants or buyers homes or apartment units only in areas where similar types of people live.

Chapter Four Quiz

1. Which of the following is a discrimination law that originated in California?
 - A. The Civil Rights Act of 1866
 - B. Proposition 11
 - C. The Unruh Civil Rights Act
 - D. The Civil Rights Act of 1964

2. An agent who unlawfully tells homeowners to sell their homes now because new protected class members moving onto their block could drive prices downward is called _____.
 - A. Redlining
 - B. Blockbusting
 - C. Steering
 - D. Conversion

3. When an agent shows an Asian couple only homes in Asian neighborhoods, this is called _____.
 - A. Steering
 - B. Redlining
 - C. Blockbusting
 - D. Panic selling

4. In what year did the Fair Housing Act begin to prohibit discrimination based on disability or familial status?
 - A. 1958
 - B. 1968
 - C. 1988
 - D. 1998

5. Which California state law prohibits discrimination in the sale, rental, or financing for most types of housing?
 - A. California Fair Employment and Housing
 - B. Holden
 - C. Unruh
 - D. RESPA

6. What is another name for the Rumford Act?
 - A. Unruh Civil Rights
 - B. The California Fair Housing Act
 - C. Holden Act
 - D. Sutter's Act
 7. What is another name for the Holden Act?
 - A. Unruh Act
 - B. California's Housing Financial Discrimination Act
 - C. Hellman Act
 - D. The Usury Protection Act
 8. Which act was passed with the intent to help people with physical or mental disabilities gain equal access to public accommodations?
 - A. Holden Act
 - B. Fair Housing Act
 - C. Americans with Disabilities Act
 - D. Unruh Act
 9. Which unlawful action below violates The Home Mortgage Disclosure Act?
 - A. Steering
 - B. Redlining
 - C. Blockbusting
 - D. Commingling
 10. The Fair Housing Act:
 - A. Protects against improper disclosure
 - B. Protects parties with credit issues only
 - C. Prohibits discrimination based on race, color, religion, gender, national origin, disability, or familial status in U.S. residential properties
 - D. Guarantees people with physical and mental disabilities equal access to housing
 11. Which of the following acts is a federal law?
 - A. Fair Employment and Housing Act
 - B. The Civil Rights Act of 1964
 - C. Holden Act
 - D. Housing Financial Discrimination Act
-

12. Landlords who refuse applications from tenants because they have a young child likely are violating which act or clause?

- A. Credit
- B. Holden Act
- C. Civil Rights Act
- D. Familial status

Answer Key:

1. C	7. B
2. B	8. C
3. A	9. B
4. C	10. C
5. A	11. B
6. B	12. D

CHAPTER 5

ENCUMBRANCES AND LIENS

Overview

An **encumbrance** in any type of real property is property which is held by someone who is not currently the legal owner of that property. An encumbrance is having certain rights or interests in someone else's property that may be financial or non-financial. The financial encumbrance or lien may affect the owner's title, equity in the property, and his or her ability to sell or refinance at a future date. A non-financial encumbrance is likelier to impact the physical condition or usage of the property.

Let's review below some of the more common types of encumbrances or liens in California and elsewhere.

Liens

A **property lien** is a legal claim on one or more designated properties that may be the result of a loan granted to the owner by a third-party lender such as a local credit union, a national bank, or a private money lender. It is typically referred to as a mortgage.

With mortgage loans, the collateral for the debt is usually the property itself. Should the mortgage borrower be unable to repay the mortgage loan consistently and on time with monthly payments or by the end of the loan term, then the lender has the right to foreclose on the property and take back the collateral asset, per the terms of their original mortgage note.

A mortgage may also be secured by two or more properties by way of something called a **blanket mortgage** that will also likely have **partial release clauses** built into the loan so that an individual property may be released from the loan after a portion of the debt is paid (a common loan

situation for builders of multiple homes in a new subdivision).

Liens may be created to be **voluntary** or **involuntary** by either the property owner, a third party, or by mutual agreement between the owner and a third party, such as a lender or investment partner. **A mortgage loan is the most common type of voluntary lien** because it takes a ready, willing, and able property buyer to seek out a lender to assist with the purchase or refinance of his or her property. **An involuntary lien**, on the other hand, is one in which the owner does not typically first agree to the placement of the lien on his or her property due to financial or non-financial matters. Examples of involuntary liens are unpaid taxes, legal judgments, child support, or financial claims from contractors or subcontractors for work performed on the property.

An encumbrance may be structured as a **specific** lien. A lien that is placed upon just one designated type of property is a **specific lien**. Prime examples of specific liens include a trust deed secured by a mortgage loan, a mechanic's lien, a property tax lien, and a *lis pendens* (see below).

A **lis pendens** in California is defined as “a notice of the pendency of a legal or financial action in which the claim to real property is alleged by a third party.” The “notice of pendency of action” provides constructive notice to prospective purchasers or lenders for the subject property about the real near-term possibility of pending court action being taken, which could affect the possession, salability, and usage of the property. Because these types of lien notices are filed in public records, the entire general public is given a form of “constructive notice” about the possibility of future liens being placed against the property involuntarily. Contractors and/or their subcontractors are likely to use the *lis pendens* legal strategy on a new construction or remodel job so that they are paid in full by the property owner.

A **general lien** is a more broad-based type of lien that can affect all properties owned by a person or business entity, like a corporation. Examples of a general lien include a judgment lien from creditors for unpaid debts or court verdicts won in recent lawsuits or civil complaints, state tax liens from the California Franchise Tax Board, and IRS tax liens. Both general and specific liens may negatively impact the ownership interests in property by creating a “cloud” on the title. That cloud must be cleared up in most cases before the owner can sell or

refinance the property, due to the real potential that the owner's equitable interests in the property may be much less than it appeared earlier.



Lien Types

Mechanic's Lien: This type of lien is the equivalent of someone else filing a “hold” on an owner's property. It is usually filed by an unpaid contractor, subcontractor, laborer, or material supplier. It is generally filed in the same county recorder's office where the subject property in dispute is located. If the lien is not resolved in a timely manner by the property owner, the person or business that filed the mechanic's lien may be able to start foreclosure proceedings against the property and force its sale in order to get paid in full, plus any interest, legal, and filing fees.

The property owner still has potential legal and financial risks even if he or she pays the designated general contractor, who is in charge of the entire new construction or remodel project. The general contractor might

have 20 to 50 subcontractors, day laborers, and material suppliers working on the job site.

Even if the owner or developer pays the general contractor in full each week or month for their expenses, that also includes funds for payment to the subcontractors and other parties. If the contractor keeps the money, the subcontractors working under the general contractor's license may initiate their own mechanics liens against the owner. As such, owners and developers must be absolutely certain that the general contractor hired for the job site is both honest and financially stable.

After the filing of a lis pendens claim by a contractor or other parties who performed labor and/or provided supplies, warning the property owner about the potential of an impending court action against the property owner, the next questions to ask and steps to take in the mechanics lien process in California may include:

- * Is the construction worker legally considered a prime contractor or subcontractor? Even workers with a general contractor license issued by the state may not be legally designated as a "prime contractor" in the deal if they do not have a direct contract with the property owner.

- * For subcontractor parties, a Preliminary 20-day Notice to the owner will usually be filed and served, either personally, by certified or registered mail, or by way of a third party process server, within 20 days of the date on which they started to work in a form set out in California Civil Code §309. If the subcontractor did not properly serve the 20-Day Notice form in a timely manner from his or her first day of work, then the notice that is eventually served will cover the dates and expenses from the previous 20 days and for all days thereafter.

- * The subcontractor must try to find out if there was a formal **"completion"** of the construction project or a **"cessation of work"** on the project. A completion of a project occurs when the entire construction project assignment is done, which includes the owner's receipt of final inspection approvals by local planning agencies and the issuance of a Certificate of Occupancy form confirming that the property is officially complete under the law.

* A “cessation of work” can occur when all work on the project by contractors and subcontractors has stopped for a continuous and uninterrupted period of at least 60 days. This may be a sign that the owner or developer has run out of access to either their own personal cash or funds from their construction lender. If the financial trouble is really bad, then the subject property may later end up in foreclosure and the owner might wind up in bankruptcy court. If so, then many of the workers on the job site might end up with no more payments for their services performed or materials supplied. A foreclosure and bankruptcy example like this is another reason why workers on construction sites should file their mechanics lien claims as soon as possible so that they have higher priority for payoff ahead of other financial claimants.

* With a “completion” or “cessation of work” situation, a **subcontractor** must file their recorded mechanic’s lien within **60 days**. A **general contractor**, who has a direct signed contract with the owner, has up to **90 days** to file their mechanics lien notice after the completion or cessation of work.

* Owners can shorten the 60 and 90-day time requirements for general contractors and subcontractors to file their mechanic’s lien notices by filing and recording their “Notice of Completion” or “Notice of Cessation” forms with the County Recorder within 10 days of those events occurring.

* Mechanics liens can quickly expire unless the contractor or subcontractor takes action to enforce their lien within 90 days of when the mechanic’s lien was first recorded.

* The party requesting the mechanics lien may have the right to request a foreclosure action within 90 days after the recordation date of the mechanic’s lien. Otherwise, the mechanic’s lien will likely be void or worthless, and the filing party will probably lose his or her right to collect or foreclose.

* A **Notice of Non-Responsibility** filing by a property owner may occur in the following type of scenario. A tenant of a large industrial property hires subcontractors to remodel the interior of a 100,000 square foot site without properly notifying the owner about the job assignment. Since a large commercial building remodel can

run into the hundreds of thousands of dollars, the owner would be wise to quickly file a notice of non-responsibility action within 10 days of becoming aware of the unapproved construction work to protect and minimize the financial risks.

* The recording of a mechanic's lien does not automatically guarantee that the filing contractor or subcontractor will be paid in full without filing a civil suit in court. Even if the owner owes \$10,000 or more to the contractor for past services as mutually agreed to in the written contract between them, the mechanic's lien can expire after 90 days and the contractor may not have any more legal recourse to collect his or her fees. To make matters worse, the owner has the option to file in court what is known as a *Petition to Release the Property from the Lien*. If the owner is successful with his or her legal action, then the contractor might be required to pay the owner's attorney fees and court costs if the contractor does not quickly record a full release and reconveyance of the expired mechanic's lien.

* Often, these unpaid contractor disputes will be moved over to mediation or arbitration outside of the courtroom so that the parties work towards some sort of middle ground compromise or settlement between them.

* A mechanic's lien takes priority in a foreclosure action when the lien position is based upon the original first date of work on the project instead of the more common filing date. There have been several situations over the years where a mortgage lender thought that *it* was in first position. For example, a lender filed a new \$100,000 mortgage loan on a particular date, say March 10th. The lender did not realize that the contractor had a \$20,000 unpaid construction bill due from work that started on March 1st in spite of the mechanic's lien that was later filed on March 12th. The \$20,000 mechanic's lien could possibly wipe out the lender's entire \$100,000 first mortgage loan just several months later if the homeowner does not take care of this unpaid mechanic's lien.

Attachment Lien: An Attachment Lien is a court order used to “attach” or seize another person's real or personal assets. When a court issues an Attachment Lien, it is providing constructive notice to the general public that the plaintiff, claimant, or secured party has a **writ of attachment**

on the real and/or personal property of the named defendant or debtor. A writ of attachment is an involuntary, specific lien that attaches on one or more properties held by the owner, and is filed in the county where the property is located.

A **Prejudgment Writ of Attachment** can be requested before the claimant or plaintiff wins his or her case in small claims court (up to \$10,000 amounts for individuals or sole proprietors and up to \$5,000 for corporations and other entities). It may also be requested in state Superior Court or federal court (for unlimited amounts), in order to tie up the defendant's assets so that he or she cannot quickly sell them for cash and flee the area. The plaintiff must successfully prove to the court with enough evidence that the defendant engaged in fraud or other types of deceptive practices. as the plaintiff must also show the real risks that the defendant might sell his or her valuables before the issuance of a future judgment.

Judgment Lien: In court where there is a judge alone or a judge with a 12-person jury, the party who wins the case and is awarded financial damages is awarded a judgment lien. The lien is formally established upon the recording of a document called an **abstract of judgment**. The judgment lien is considered an involuntary and general lien that may be recorded in any of the 58 counties in California.



A **property lien**, as a result of the issuance of a judgment lien, can last for up to 10 years. During that same period of time, the lien will remain in place on the designated property unless it has been paid off. After 10 years and one day, the attachment lien will automatically be released. However, the judgment creditor has the option to renew the property lien before the expiration date. Any current or future properties owned or acquired during the 10-year time-period may also be attached by the judgment lien.

The property owner must pay off the judgment lien to release the property or properties from it. Otherwise, the judgment creditor has options like filing a foreclosure notice before the property is later sold by the court after the issuance of a **writ of execution**.

Property Tax Lien: Income, property, and special assessment taxes that are unpaid by a property owner faces the risk of having a tax lien filed against their property. These are types of involuntary and specific liens. After five years of not paying property taxes in California, the state has the power to foreclose on the property by way of tax-defaulted property auctions and the issuance of tax deeds. An exception to this would be if the property owner has agreed to his or her county's Five-Year Payment Plan program or some other type of mutually agreed upon repayment plan.

In most cases, property tax liens are higher in priority than all other liens on the property even if the first mortgage loan was recorded 20 years before the property tax lien. During a foreclosure process, all junior liens (i.e., first and second mortgage loans, mechanic's liens, and judgments) are usually wiped out by the higher lien that was filed ahead of them. As a result, investors who attend these property tax deed auctions in California will probably end up with a free and clear home that has no other debt attached to it, subject to a few exceptions. The winning bidder at a property tax sale auction in California will probably take possession within three to six weeks after the recordation of the Tax Deed.

California is one of many Tax Deed states that may or may not offer redemption rights to the previous homeowners to come up with the delinquent property tax amounts, late fees, and penalties. This is the case even after the Tax Deed sale for periods of time that might vary up to a few months or a few years. In California, there usually are no redemption rights for the property owner to cure his or her Tax Deed sale

after it has gone to auction, unlike some other states. In Arizona and Colorado, for example, Tax Deed or Tax Lien Certificate sales are offered, where investors can purchase the delinquent property tax liens from the county and file foreclosure on their own.

Listed below are the main Tax Deed states along with California that offer Tax Deed sales to investors after the property owner has missed his or her deadline to pay delinquent property taxes for a period of a few years or more (subject to change):

Alaska
Arkansas
California
Connecticut
Delaware
Florida
Georgia
Hawaii
Idaho
Kansas
Maine
Nevada
New Hampshire
New York
North Carolina
North Dakota
Ohio
Oklahoma
Oregon
Pennsylvania
Rhode Island
South Dakota
Tennessee
Texas
Utah
Virginia
Washington
Wisconsin

The states not listed may offer Tax Lien Certificate options where a third party individual investor or a corporate entity can make bids on

delinquent taxes through the county recorder's office in order to receive high rates of annual return (8% to 25%+). In those states, investors may also be able to later foreclose on a home for literally pennies on the dollar based upon current market value (e.g., the delinquent property tax lien debt may be only \$3,000 while the home's value is \$500,000).

Special assessment lien: These types of supplemental property tax levies may be assessed on properties in addition to the owner's base property tax rate of at least 1% of the property's purchase price or their most recent assessed value. The overall effective property tax rate is closer to **0.81%** in California because there are so many older properties that were purchased a few decades ago that have not been reassessed at today's higher prices. As a comparison, the national average for property taxes is over 1.1% of the property's value.

Proposition 13: The property tax rate in California was established after the passage of Proposition 13 in 1978. There were two main components included in Proposition 13 that were perhaps the core reasons why California property tax rates are lower than the national average. The first was the establishment of the 1% property tax base as compared with the property's value, excluding any additional supplemental tax fees. The second main feature was that properties cannot be assessed more than an additional 2% in value each year.

Supplemental tax rates that can be added to a homeowner's property tax bill might include:

- Mello-Roos taxes (special assessments used to build new roads, parks, and schools in brand new community regions);
- Additional tax rates to pay for local voter-approved debt;
- Emergency assessments or tax relief due to natural or environmental damage; and
- Parcel taxes (typically added by proposition to the ballot in local elections).

A property transfer may be **exempt from reassessment** by the County Assessor when the property is transferred between parents and children and even owners and their friends (i.e., some type of charity option) as long as the property was not transferred for any sort of profit (e.g., a deed transfer from a married couple to their new family trust with children

listed as beneficiaries). The difference between the property tax amount based on an older home purchased 40 years ago for \$30,000 and the property tax amount based on today's value of that home, for example, \$700,000, would be significant. As such, it is normally considered a positive situation when properties are not assessed at today's much higher property values.

Mortgage: A type of financial contract between a property owner/borrower (**mortgagor**) and the lender (**mortgagee**) that is a specific and voluntary lien. The borrower/owner will seek out a lender to finance the purchase of a residential or commercial property or to refinance property he or she already owns. The borrower/mortgagor offers their property as collateral for the repayment of the loan by agreeing to the attachment of a mortgage lien on the property.

A mortgage loan usually has priority when it is the first (or a first mortgage) to file liens against a property with the main exception being property tax liens. Some properties may have a second, third, fourth, and even a fifth mortgage on the property. Loans in junior position typically charge much higher interest rates and offer shorter loan terms due to the much greater risk of being wiped out in a future foreclosure situation where the first lender forecloses.

Deeds of Trust: There are three main parties involved with a deed of trust (a/k/a a "trust deed") as compared with just two in a mortgage. The parties are: 1) Trustor (borrower/owner); 2) Trustee (the neutral third party such as a title, escrow, or legal firm which maintains the mortgage and title security instruments); and 3) Beneficiary (mortgage lender). A **promissory note** (a legal "IOU" for the borrowed mortgage debt) is also provided along with the deed of trust. The promissory note is listed with the repayment terms, including the interest rate, principal amount, and due date. The deed of trust is the main document in most California transactions that permits the lender to file a foreclosure action in the event the borrower misses their monthly payments.

Homestead Protection: California, and many other states, offers homeowners a way to reduce their financial risks against the threat of future judgments and attachment liens filed against them and their property. Homeowners may file a voluntary **declaration of homestead**. This homestead protection will **not** protect homeowners against tax liens or the loss of their ownership equity (difference between the home's value

and the mortgage debt) in the event the lender forecloses, but it may protect them from many types of bankruptcy filings due to near financial insolvency situations.

Under California laws such as Code of Civ. Proc. §704.710 (for money judgments), property owners may declare somewhere between \$75,000 and \$175,000 worth of their primary residence's equity as a protected homestead during a bankruptcy proceeding or as a result of other types of creditor actions, depending upon several factors. A valid homestead filing must include these requirements:

- It must be an owner-occupied property;
- the main claimant must be designated as the head of household;
- the homestead claim must describe the property and its estimated value; and
- only one homestead per family is permitted at a time.

A homestead exemption amount may be as high as \$175,000 of protected equity from certain judgment creditors if either spouse is over the age of 65 and unable to work much, or if a person is over the age of 55 with a gross income of not more than \$25,000 if single or \$35,000 or less if married. A \$100,000 exemption may be available if a debtor or spouse resides in the home with at least one other family member with no interest in the homestead. And the exemption is up to \$75,000 for all others.

A homestead remains in place even if the property owner dies before the home is sold or gifted to another family member. The homestead continues onward for the benefit of other designated family members such as the surviving spouse, children, or any other family member listed as an heir.

In order to terminate a homestead because of the sale of the property and an intent to file a new homestead on the next home, the homeowner is required to file an **abandonment of homestead** before formally terminating the homestead.



Easements

An easement gives a person or an entity the legal right to use another property owner's land for a specific limited purpose. But the legal title to the land itself remains with the property owner. A homeowner might need to use a portion of his or her neighbor's land to gain access to their own property, so there might be an easement built into the title documents allowing this ongoing access and use of a portion of the neighbor's property. The right to enter another party's property by way of an easement is called an **ingress** while the right to exit is called an **egress**.

Two of the main types of easements include:

Appurtenant easement: An appurtenance is anything that can be used for the betterment of the land.

- The landowner who provides the benefit to something else or to another party is called a **servient tenement**.
- Conversely, a property owner who receives some sort of benefit from the easement is described as the **dominant tenement**. A prime example is a dirt road that might be used by a neighbor in a rural area to gain access to his home, farm, or ranch.

Easement in gross: An easement in gross is an easement that attaches a particular right to an individual or entity like a corporation instead of to the property itself. The easement, and the right to use another person's land, shall remain in place as long as the owner owns the land or until the holder of the easement dies. An easement in gross is often considered irrevocable for the life of the individual. But it can be rendered void in the event that the key property involved with the easement in gross is sold. It is more of a verbal agreement between two neighbors about the rights to go in and out of a neighboring property that only exists because of their personal relationship instead of local law requirements.

A **public service easement** is one in which a public utility like an electric or water company needs to gain access to a person's property in order to maintain their utility service connections.

The Creation of Easements

Express grant: The servient tenement grants the easement by deed or some type of written agreement. A fee simple owner has the right to grant an indefinite easement to another party, or for a period of the grantor's remaining life, or a shorter term. A tenant may have the right to grant an easement in their rented property if allowed by the landlord only during the length of the rental contract.

Express reservation: During the time that an owner sells off a portion of his land, if the owner reserves and maintains an easement in that same land by way of a deed or written supplemental agreement, he or she has an express reservation.

Implication: Here, the easement is implied, assumed, or verbally conveyed without it expressly being written in the deed or purchase agreement. The implication is that the easement is obvious partly since it has existed for many years. For example, a person driving their car on a portion of their neighbor's property to gain access to their home for many years is an implied easement.

Prescription: An easement by prescription is similar to gaining ownership to another's property by way of adverse possession. This is a strategy used by some people who may be called "**squatters**" as a result

of their “squatting” strategies. Squatting is when someone deliberately and intentionally enters a property without permission and lives there for a long period of time without paying any rent or other expenses.

For squatting to be valid in California and many other states:

- the use must be open and notorious;
- the owner must not give their permission to the squatter;
- the occupant must have some reasonable claim to the property such as the intent to grow vegetables and fruits; and
- if property taxes are assessed separately for the portion of land that is targeted for the easement, then the squatter is required to pay those taxes over a period of five years.

Recorded plat maps: Subdivided neighborhoods will likely include a reference to the easements allowed such as the alleys, roads, and driveways. Many subdivided neighborhoods will include easements in their CC&Rs (Covenants, Conditions, & Restrictions).

Dedication: A scenario where a private property owner gifts or grants an easement right to use his or her property for public use is a dedication. An example may be the granting of private land to a town so that they may build a community park.

Condemnation: A police power act where the government uses its power of **eminent domain** to acquire privately owned land for the public’s interests is referred to as condemnation. An example would be when a town needs to build a new freeway ramp, and will buy a private home nearby at market value prices so that the ramp can be built on that home’s site whether or not the property owner willingly agrees to it.

Easements may be terminated in the following ways: 1) Release; 2) Merger (combine two properties); 3) Failure of original purpose (the need no longer exists); 4) Abandonment (the neighbor or squatter leaves the property); and 5) Prescription (the servient tenement refuses to allow the dominant tenement access for at least five years).

Profits: The taking away of something of value from another person’s land is described as a profit. An example may include taking fruit and

vegetable crops or timber away from another's property. The profit opportunity may be created in a written contract or by prescription.

Licenses: The right to use another person's land for a relatively short period of time is through a license. Most types of licenses can be revoked. An example of a license is one where a hunter is allowed to shoot at birds on a person's ranch for a defined period of time.

Encroachments: An encroachment is when a person or entity intrudes upon the use or rights of someone else's property.

An example may be when a neighbor builds a new fence on his or her own property that also mistakenly or intentionally was partly placed onto the neighbor's property as well. At a later date, the neighbors may mutually agree that it is fine to keep the fence there as long as both property owners live there. Or, they may agree that when one of the neighbors sells their property, the portion of the fence that was built on both properties must be taken down. Other times, the neighbors may take their encroachment battles to court and let a judge decide the outcome.

An encroachment may potentially negatively affect property value for the burdened property, so it must be fully disclosed by sellers and all real estate agents involved in any transactions.



Chapter Five Summary

- An **encumbrance** (for example: a mortgage, judgment, mechanic's lien, etc.) related to any type of real property is one held by someone who is not currently the legal owner of that property.
- Liens can be created by the property owner or a third party, or by way of mutual agreement between the owner and a third party, such as a lender or investment partner. A mortgage is a **voluntary lien**. A court-ordered judgment is an **involuntary** lien.
- A **specific lien** includes a trust deed secured by a mortgage loan, mechanic's lien, property tax lien, and a ***lis pendens*** ("a notice of the pendency of a legal or financial action in which the claim to real property is alleged by a third party").
- A **mechanic's lien** is a type of lien that is equivalent to someone else filing a "hold" on an owner's property. Most often, it is filed by an unpaid contractor, subcontractor, laborer, or material supplier.
- A **subcontractor** must file their recorded mechanic's lien within **60 days** after the completion of their work. A **general contractor**, who has a direct signed contract with the owner, has up to **90 days** to file a mechanics lien notice. A **foreclosure** filing notice may be requested **90 days** after the mechanic's lien has been formally recorded.
- A financial contract between a property owner/borrower (**mortgagor**) and the lender (**mortgagee**) that is a specific and voluntary lien is called a **mortgage**.
- The three main parties in a deed of trust transaction are a: 1) **Trustor** (borrower or owner); 2) **Trustee** (the neutral third party such as an escrow or title company, or law firm that holds the mortgage instruments); and 3) **Beneficiary** (mortgage lender).
- An **easement** is the legal right to use another person's land for a specific limited purpose. The right to enter another party's property by way of an easement is called an **ingress** and the right to exit is

called an **egress**. **An easement can be created by express grant, express reservation, implication, prescription, recorded plat maps, dedication, and condemnation.**

Chapter Five Quiz

1. When an owner agrees to use his property as security to obtain a mortgage, he has created a(an) _____.
 - A. Voluntary lien
 - B. Involuntary lien
 - C. Judgment
 - D. Leasehold
2. Within how many days should a mechanic's lien be filed?
 - A. 10
 - B. 30
 - C. 90
 - D. 180
3. Within how many days of completion should an owner file a notice of completion for recording?
 - A. 10
 - B. 15
 - C. 21
 - D. 120
4. A court-ordered lien that is filed pending the outcome of a lawsuit is an example of _____.
 - A. Foreclosure
 - B. Eminent Domain
 - C. Attachment
 - D. Police Power

5. The right to use another's land for access to one's own land is a(an) _____.
A. Lien
B. License
C. Leasehold
D. Easement
6. A judgment lien is a type of _____.
A. Involuntary and general lien
B. Voluntary, blanket lien
C. Voluntary cloud on title
D. Involuntary and specific lien
7. The notice of a pending lawsuit or civil complaint that could potentially impact the clear title to a property is called _____.
A. Notice of Default
B. Notice of Trustee's Sale
C. Lis pendens
D. Easement
8. What is an oral, revocable, and non-assignable grant of permission to use another person's land without holding a possessory interest in the property?
A. Lease for less than a year
B. Tenancy by will
C. Possessory Rights
D. License
9. Which court order is used to sell property to satisfy a judgment debt that is payable to a creditor?
A. Writ of execution
B. Lis pendens
C. Summons
D. Default notice
10. Which answer below is not a financial encumbrance for a debt?
A. A judgment
B. A mechanic's lien
C. An easement
D. A secured credit line
-

11. What cannot terminate an easement?

- A. Release
- B. Merger
- C. Mutual agreement
- D. Condemnation

12. What is the name for a situation when a neighbor's fence is incorrectly built partly on another's property?

- A. Encroachment
- B. Easement
- C. Merger
- D. Encumbrance

Answer Key:

1. A	7. C
2. C	8. D
3. A	9. A
4. C	10. C
5. D	11. D
6. A	12. A

CHAPTER 6

WAYS TO TRANSFER REAL ESTATE

Overview

This chapter will focus on the numerous requirements to complete the transfer of real property and land as well as to confirm that the owner has clear title and valid ownership interests in the property. Pertinent parts of a deed, the most common instrument used to transfer California properties, will also be discussed in this chapter. Title insurance, one of the most important components associated with the sale of most types of real property, will be detailed as well, as will the rights of heirs and other third parties.

Title and Alienation

As you have learned, owning real property includes owning a bundle of rights that comes along with its ownership, such as the right to possession and to occupancy. An individual party who possesses all of the ownership interests in real property is said to hold **legal title** to that property.

Legal title differs from **equitable title**. Equitable title is more of an interest in obtaining or the right to obtain at a future date, full legal title in the property. Equitable title is set out in and in accordance with the terms of an existing purchase or seller-financed mortgage contract, such as a Contract for Deed (a/k/a Land Contract) or an AITD (All-Inclusive Deed of Trust). Up until the buyer in a purchase contract completes all of the required steps in the process, such as making payments for a year or two, he or she will hold only equitable title interests. Once all of the contract's conditions have been met, the purchaser will be hold full legal title in the property. A mortgage lender on the property is said to hold **beneficial interests** (a beneficiary typically benefits from some type of financial asset like a mortgage, will, or trust).

Voluntary Alienation

The unforced transfer of title from an owner who willingly conveys property to another is a **voluntary alienation**. A **private grant** occurs when the property conveyance is transferred by a private party. Conversely, a **public grant** happens when a government entity transfers public property to a private party. Sales, gifts, dedications, and transfers at death by way of a will, trust, or probate action are some of the most common types of voluntary alienation.



Valid Deed Requirements

For a deed to be valid in California, the document and parties involved must meet the following requirements:

- In accordance with the Statute of Frauds, the deed and other types of conveyance options that transfer ownership interests in property in a real estate transaction must be in **writing**.

- The full identities of the parties involved must be included. For individual parties, their names must be correctly spelled. If a person is married, then the other spouse must sign on the transaction or provide confirmation that they are not legally part of the deal should it not be a community property asset. One title vesting commonly used by married couples with the intent to own property separately is to hold it as “*John Doe, a married man, as his sole and separate property*” on the deed.
- For corporate, LLC, partnership, attorneys-in-fact, or other types of legal entities, proof must be shown that the designated party signing on behalf of another entity has the true full power to transfer or receive assets on behalf of the named entity involved in the transaction. Corporate deeds may be signed by an authorized person representing the corporation with or without a corporate organization seal stamped on the document.
- The grantor must have full **legal capacity** before assigning or transferring interests in real property. This includes meeting the minimum age requirement of 18 and being **mentally competent** (or free from any serious mental or emotional health challenges). At a later date after the sale, the transfer of property may be **voidable** (the deal might be canceled or revoked) or completely **void** (the deal is canceled or revoked) by the parties involved or by a court if these requirements are not met.
- The grantee should be clearly identified and meet basic legal capacity requirements to accept the new ownership of the property. The form of ownership must be specified on the deed, such as whether they are taking title as a “sole and separate property,” in “joint tenancy,” as “tenancy in common,” or some other type of ownership. **The grantee is usually required to be alive when identified on the grant deed, except under rare circumstances when there is a complex type of trust, estate, or family limited partnership involved.**
- There must be a valid **legal description** included on the deed that accurately and uniquely identifies the subject properties such as a lot, block, and tract number on a tax assessor’s plat map (land deals, especially) and/or a physical street address.

- A **granting clause** is required to be included that clearly expresses the conveyance option, intent, and type of ownership interests such as fee simple or life estate. In order to clearly and legally grant title, the grantor usually must have at least some type of minimal **vested interest** in the property at present or in the future.
- The deed should also include the type of **consideration** (money, a transfer of separate properties, a gift of love and affection, or something else of value) exchanged in the transaction. Some deeds may list token or nominal consideration amounts as low as \$10 on the deed to meet this requirement.
- All owners of the property must **sign** the deed, such as an individual, his or her spouse, an attorney-in-fact with a power of attorney, and an appointed corporate officer or LLC member with designated signing powers.
- The signatures need to have an **acknowledgment** for them to be valid. This type of formal declaration before a notary public, court official, or some other approved party that was designated by state law or some other jurisdiction, is a legal confirmation that the person signing the deed is really the same person and does have valid authority to sign the document conveying title to the property. Without the acknowledgment in place by a neutral third party like a notary public, the deed is very unlikely to be approved for recordation, even with the assistance of escrow and a title insurance company.
- The deed must be delivered by the grantor, directly or indirectly by way of an escrow officer, title representative, or attorney, and accepted by the grantee in order for it to be valid. Often, the date of delivery and acceptance is considered the official date of transfer that happens simultaneously upon the recording of the deed.

Types of Deeds

Deed of Trust (or Trust Deed): A **deed of trust** is the security instrument that is given to a third-party lender to secure or attach a loan or some other type of financial or legal obligation. Often, a real estate professional will use “deed of trust” and “grant deed” interchangeably because they are similar in many ways. But a grant deed is the transfer of interests in property from one private party to another. And a deed of trust is used for the transfer of a type of lien interest to a lender or lienholder if the property is not free and clear, in order to secure payment and the beneficial interests of the lender.



Grant Deed: The grant deed is the most commonly used real estate document to transfer property in the state of California. A grant deed for the sale of real property is similar to a bill of sale for personal property, goods, or services. The seller, and the person who first signs the grant deed, is the “grantor,” while the buyer, who receives the grant deed and property, is the “grantee” in the transaction.

A grant deed *should* include all of these elements: 1) grantor and grantee’s names; 2) the description of the property (legal description and/or street address); 3) purchase price; 4) grantor’s signature; and 5) recordation of the document, even though it is not required that a grant deed be recorded in order to become effective and valid. It does better protect the grantee and grantor’s legal and financial interests.

Gift Deed: The transfer of real property when the transferor/grantor does not receive full consideration, or anything of substantive value, when conveying the property to another. It is most often seen in

transactions involving family members such as a parent gifting a home to a child. Many gifted properties are taxable under Internal Revenue Code sections at the home's fair market value upon transfer, subject to several exemptions related to creative estate planning strategies. Yet, there are also some credits and other tax benefits that can reduce or eliminate portions or entire amounts of the potential tax bill.

Quitclaim Deed: This is an unusual type of deed that is used quite often in real estate transactions. Effectively, the owner/grantor/seller is releasing his or her interests in a property concurrently with the conveyance to another party. And this is done without fully confirming whether or not he or she holds any actual legal, equitable, or financial interests in the property. The quitclaim deed also prevents the grantor from later claiming that he or she had any past, current, or future interests in the property. Required for the quitclaim deed are the legal description of the property, the name of the person transferring his or her valid (100% ownership) or not-so-valid interests (0% ownership) in the property (grantor), the name of the person receiving interests (grantee), the conveyance date, and the notarized signatures of both parties.

Reconveyance Deed: It is often referred to as a **Satisfaction of Mortgage** document. A **Deed of Reconveyance (or Reconveyance Deed)** is a document that transfers title in real property from the Trustee to the borrower (Trustor) once the borrower has fully paid off the mortgage debt that was originally secured by the deed of trust.

Sheriff's Deed: A formal document that gives ownership rights in a property to a buyer after a Sheriff's Sale auction date. A Sheriff's Sale is held by the local county sheriff's department to pay off a court judgment against the owner of a property in some types of foreclosure settings that usually originated in court. Most types of foreclosures in California are non-judicial, i.e., outside of court, but there are many exceptions to this rule. Some, such as ones that begin with judgment creditors, are handled through the court system.

Warranty Deed: The legal instrument by which the seller guarantees that he or she is the true and rightful owner of the property and is selling or transferring it free of any liens is called a **warranty deed**. These assurances or guarantees about the conveyance of free and clear title

make up the **six covenants of title** that are discussed in detail below. Three of those six covenants are “present covenants,” while the other three are “future covenants” that are potentially enforceable against other parties in the chain of title history.



The **Six Covenants of Title**

Seisin: This is the most important **present covenant** in that the seller is guaranteeing that he or she is the rightful owner of the property. Seisin dates back to old English law just like much of U.S. Common Law, and applies to both the true and valid ownership interests in a specific property as well as the right to possess it.

No Encumbrances: Another **present covenant** makes the assurance that there are absolutely no encumbrances, both on the public record or hidden. It also gives assurances that the property is held free and clear at present while not being subject to any mortgages, taxes, easements, leases, judgment liens, or any other restrictions or limitations that may adversely impact the prospective buyer’s right to clear title, possession, or usage.

Right to Convey: And the right to convey is the last type of **present covenant** that confirms that the seller has required all legal rights necessary to sell, lease, gift, or transfer the property by will or trust. The right to convey covenant assures the buyer that the grantor does have full legal rights to sell the property to the buyer. Should a third party

come forward with ownership or beneficial interest claims in the property at a later date, then the grantor or guarantor may be found in breach of this very important covenant.

Quiet Enjoyment: This first of three **future covenants** is a guarantee that the buyer's right to possess the property will not be negatively impacted by a third party's legal claim to title of that property. If another party later makes a claim of ownership or beneficial interest in the property as some sort of hidden partial owner or lender, then the seller may be financially liable for any damages.

Warranty: A warranty is a **future covenant** that is quite similar to the quiet enjoyment covenant in that it is a promise that the buyer will defend against any current or future ownership or beneficial interest claims made by third parties. But it is also an assurance that the seller will pay for any damages suffered by the buyer as a result of having to fight back against third party claims in the property.

Further Assurances: This **future covenant** is a promise that the grantor/seller shall do whatever is required to assist the grantee/buyer with improving or perfecting the title should any future claims arise that may cloud or damage the title. One of the most common examples is the creation of an additional legal document to correct mistakes found in the closing documents *after* the sale has closed escrow and the property has been conveyed from the seller to the buyer.

Tax Deed: If a homeowner does not pay his or her property taxes, and has not agreed to any sort of repayment or redemption plan, the county where the property is located will hold a tax-defaulted property auction. The winning bidder, in most cases, will receive title to the property free and clear of any other liens by way of the recorded Tax Deed assignment.

Wills: It is highly recommended by most estate planning professionals that people who own valuable assets such as one or more properties should have at least some type of formal **will** and/or family trust agreement in place so that the ownership interests and valuable assets transfer to the intended family heirs. A person who creates a will is called a **testator**.

A **holographic will** is one that is handwritten and not formally witnessed by another party at the time of execution. As long as there are no

typewritten or printed parts of this type of will and the signature appears to be valid, a holographic will may be valid in most cases. A change or modification made to an existing will by the owner is referred to as a **codicil**.

A will is a legally-binding written statement that directs who will receive the personal and real property interests at the time of the testator's passing. A will may also appoint a legal representative (called an **executor**) to carry out the person's main wishes when transferring the ownership interests.



Trusts: A legal arrangement in which one person, or institution such as a bank or law firm, is appointed as a "trustee" to hold title to property and other assets for another person who is the named "beneficiary" in the trust document. A trust may be designated a "revocable" or "irrevocable" living trust that terminates when the person who created the trust (the "trustor" or "settlor") dies. Upon the passing of the trustor, the assets will automatically pass to the named beneficiaries such as the children or grandchildren without the need for probate

Probate: If a person with substantial assets dies without a will in place, he or she is described as having died **intestate** (or without a valid will). This person may have no family members or heirs available to make claims on the assets, or he or she might have a number of different

family members fighting amongst themselves to grab the bulk of the assets. The probate court will appoint an **administrator** to assist with the division and assignment of real and personal-property assets to named or unnamed heirs shortly after the owner dies.

The stated purpose of Probate Court is to work toward these main objectives:

- to allow creditors with perceived beneficial interests in the deceased person's estate to make claims with or without a will in place;
- to distribute the deceased person's personal and real property to the rightful heirs, according to the law and closeness of the family member; and
- to resolve any disputes or challenges to the will or any other formal types of written documents.

California Probate Attorney Fees

Lawyers in many states charge by the hour or collect a flat fee for their involvement in probate work. California, however, is one of only a few states where attorneys charge a "statutory fee" that is based upon a percentage of all of the assets that go through probate. Specifically, these percentage rates are defined in state statutes such as **Cal. Probate Code §§ 10810 and 10811**.

The most current probate attorney rates in California are as follows:

- 4% of the first \$100,000 of the gross value of the probate estate;
- 3% of the next \$100,000;
- 2% of the next \$800,000;
- 1% of the next \$9 million; and,
- 0.5% of the next \$15 million.

Property that can avoid probate might include:

- 1) Life insurance proceeds with a designated beneficiary already in place.
- 2) Most bank or brokerage accounts with pay-on-death designations.
- 3) Retirement accounts with listed beneficiaries.
- 4) Certain irrevocable trusts and family limited partnerships.
- 5) Property held under joint tenancy title with a “right of survivorship” that automatically transfers title to the surviving partner.
- 6) Some estates that are deemed to have minimal value insufficient enough to cover the high probate court costs.

Title Insurance: When purchasing, financing, or refinancing real property, title insurance is required, especially when there is a third-party mortgage lender involved. The difference between a clear and solid title-insurance policy and an imperfect title policy can be the difference between a profitable investment opportunity for a principal and their assisting real estate licensee, and a horrific nightmare scenario in which multiple parties end up in court and the licensee might later see his or her license suspended or revoked due to lack of professionalism.

Title insurance is a contract obligation where one party agrees to fully indemnify (or protect against future potential losses) or reimburse another designated party for financial losses or damages related to the terms and provisions included in the contract. Unlike life or casualty insurance that insures and protects against **future incidents or events** such as an accident or death, title insurance insures against the **past “chain of title”** history as of the issuance of the title policy. The policy guarantees that the owner has clear ownership of the property with no “clouds,” defects, or claims by known or unknown parties such as past owners, contractors, or lenders.

The title insurance premiums are based upon the amount and type of risks insured against, the property value, and any existing mortgage loan amounts. Items on a property’s “chain of title” history that can negatively impact the property’s value include:

- 1) Mistakes (incorrect legal descriptions or street addresses).
- 2) Forgery and fraud (phony signatures on past grant deeds).
- 3) Secret spouses (a person signed a grant deed as “single” without notifying their spouse first).
- 4) Unwanted easements and encroachments.
- 5) Zoning violations (a residential home built on a commercial lot).

The two types of primary title insurance policies are **standard coverage** and **extended coverage** policies. Standard coverage policies are generally less expensive and insure against fewer risks than extended coverage, and are likelier to just protect against issues that can be seen on public records such as tax, judgment, mechanic’s, and mortgage liens. Extended coverage policies will also insure against the same public record risks as well as certain other types of off-record risks, such as unrecorded judgments, leases, land contracts, and mechanic’s liens.

Many lenders prefer that their borrowers obtain extended coverage policies because it offers more protection for the mortgage loan secured by the property. For example, the extended coverage policy helps assure that the mortgage loan is really in first lien position instead of in third or fourth lien position behind some hidden or unknown mortgages or judgment liens that are not on public record.

Recording: Shortly after California was admitted to the Union by the United States on September 9, 1850, the California Legislature adopted a recording system so that evidence of title and interests in real properties could be collected and maintained in a more secure, safe, and central location. The recording system was designed to protect innocent buyers and lenders from being financially harmed by secret sales, fraudulent transfers, or from undisclosed liens and encumbrances on the property. Some of the main reasons for the establishment of a fair and efficient title recordation system were for properties to be more freely transferable by permitting the recording of the appropriate title instrument such as a grant deed while also penalizing any person who does not take full advantage of the title recording system or who tries to commit fraud.

California Documentary Transfer Tax: This tax is imposed by the County Recorder’s Office, where the subject property is located.

Concurrently with the recordation of the deeds and other instruments, the county will usually charge a documentary transfer tax fee with a minimum base rate near \$1.10 per \$1,000 of property value. For example, a home sold for \$1,000,000 will be hit with a \$1,100 transfer tax. This fee payment can be negotiated between the buyer and seller in the original purchase contract. But it is most often paid by the seller. Additionally, certain counties may add more fees on top of this base rate under a separate name and fee categories.

Patents: Patents are documents that transfer title of real and personal property to a private party. Most people probably think of a patent as an ownership claimed by an investor for a new business idea or product. Just like when the U.S. Patent Office transfers absolute ownership rights to the investor of a personal product, it can also transfer ownership rights in land to a private party. A patent is the ultimate source for all land under private ownership.

Involuntary Alienation

Property that is transferred without the owner's consent or agreement is considered **involuntary alienation**. There are not many people who want to be forced to transfer title to their property to another party without any financial gains. Involuntary alienation commonly occurs in tax sales, forced foreclosure sales from parties holding liens, adverse possession, condemnation or eminent domain, accession, and escheat.

Dedication: A private owner's donation of real property to the general public may or may not be voluntary. A **statutory dedication** is one that is in compliance with the existing statutes or laws, while a **common law dedication** might occur when an owner donates land for public use, such as a park or school playground, for an unknown period of time. A real estate developer who subdivides a large piece of land into smaller residential lots may build roads that connect the homes prior to assigning title to the new streets and to the local government for future maintenance. Creating one or more public streets is one example of a dedication.

Intestate succession: When an owner of real property in California dies without a will (also called dying intestate), the legal determination of ascertaining which family members, friends, charities, or other potential

heirs or beneficiaries shall be entitled to interests in the real property is known as intestate succession. Under California law, the surviving spouse is usually entitled to all of the community property. Individuals who obtain ownership in property by way of intestate succession are called *heirs*, and the process of receiving the property is known as *descent*. The probate court may be in charge of the supervision of the intestate succession through an appointed administrator or other third parties.

Escheat is the legal procedure by which property reverts back to the state government because the owner did not leave a will, and the court could not find any legal heirs with sufficient rights or claims to the property.

Condemnation: The police power rights given to state and federal governments to acquire private real property from individuals or business entities for the public's benefit is the act of condemnation. Owners are supposed to be paid *fair market value* (or the price that a willing buyer would probably pay to a seller for it at the time) or **just compensation** under the power of **eminent domain**.

Quiet Title: This is a legal action taken to “quiet” or “perfect” title interests in real or personal property from someone who may or may not be currently listed on the title or deed to the property. A claimant party can work towards trying to establish any legal, equitable, and/or beneficial rights, title, estate, lien, or other types of interests in a property or bring a “cloud” upon the existing title after proving their case in court. In situations where fraud is alleged, such as a forged deed transfer, the legal strategy is brought about partly to “quiet” any other challenges or claims to the property's title as well as to gain back the rightful interests in the property.

Partition: A **partition action** is one in which one of the co-owners in a shared property take the other owners to court in an attempt to either force the sale of a property or divide it up into proportional ownership shares. If the shared property is just one small home, the court's approval of this partition request by one party will likely lead to the forced sale of the home. Upon the recordation of the sale, the owners will then take the cash proceeds and divide up their amounts based on their ownership shares. With respect to large land sites over 100 acres, the courts may divide up the land into smaller shares so that each partner

may either spin off their land to a new buyer, build on it, or do nothing with the property.

Foreclosure: California is classified as a “non-judicial foreclosure” state in that lenders can avoid having to go to court to take back properties due to months or years of missed mortgage payments. Under the terms of the deed of trust in California, the lender has the right or “may make an election” to foreclose or repossess the property without having to get a court order in most situations if the loan becomes delinquent. A lienholder or mortgage lender under a deed of trust must closely follow the statutory procedures required when conducting a non-judicial foreclosure with the main legal steps that include the **Notice of Default** (formally starts the foreclosure process after two or three months of missed mortgage payments), the **Notice of Trustee’s Sale** (90 days later, this notifies the property owner of a possible upcoming Trustee foreclosure auction date), and the **Trustee’s Sale** (approximately 120 days after the Notice of Default date).

Bankruptcy: This is the legal process involving a person (Chapter 7 or 13 filing) or business entity (Chapter 11) that is unable to pay their bills or outstanding debts such as mortgage loans or mechanics’ liens. The bankruptcy process typically begins with a petition filed by the debtor. Sometimes, the bankruptcy might be requested by the creditors for larger types of complex business scenarios involving millions or billions of dollars. Prior to the discharge or close out of the bankruptcy and a few months after a creditor’s hearing has been held and attended by at least the debtor, the assets are measured, evaluated, and either used or not to apply towards the payoff of some percentage of the outstanding debts. Quite often, a property owner with a mortgage in foreclosure might file bankruptcy shortly before the scheduled Trustee’s Sale auction date as a strategy to buy more time to sell the property or raise new capital to save the property.

Adding and Subtracting Property Size

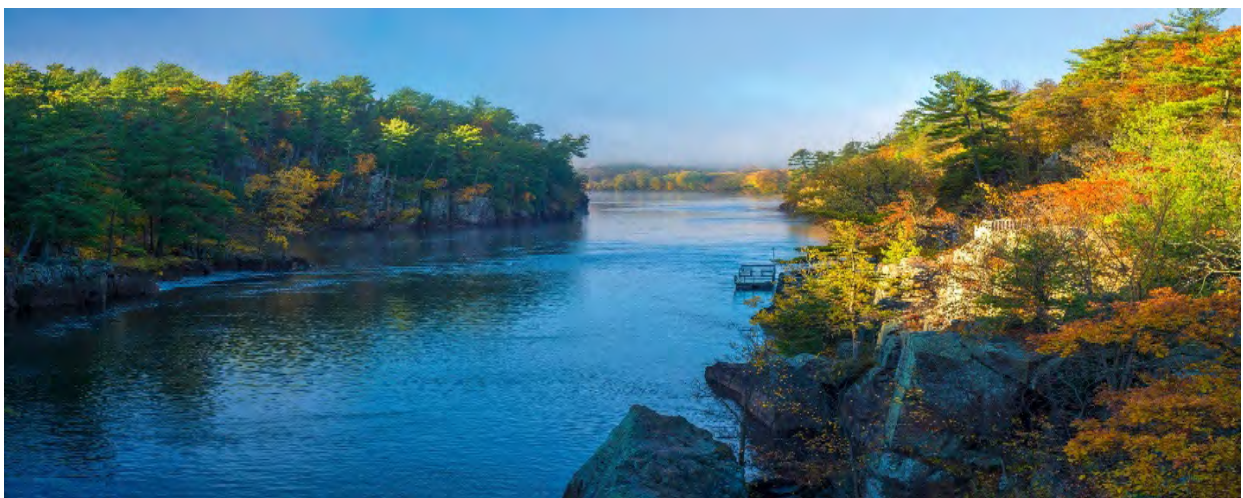
Accession: This is the process of adding or subtracting land from property through forces such as natural factors, labor, or the addition of new materials. **Involuntary accession** related to environmental issues includes the four geological components: erosion, accretion, avulsion, and reliction.

Erosion: Erosion is the **gradual decrease** of soil, sand, or other types of land due to rain, wind, and other environmental factors. The losses could be relatively minor or could eventually severely damage the overall usability, value, and title to the property if the losses are significant enough over time.

Accretion: Accretion is the **gradual increase** of land by natural forces near a body of water, which is the exact opposite of erosion. This type of situation might happen if soil from adjacent neighboring properties up the river flows from one land site to another. This new land that ended up on the new property site becomes part of the property unless claimed by the former owner of the land.

Avulsion: Avulsion is the removal or decrease in land due to flowing water or waves that is often associated with extreme weather or environmental events related to hurricanes, tornadoes, floods, earthquakes, volcanic eruptions, or a river quickly changing course or direction. The soil, sand, or other portions of the lost land that is swept out to an adjacent neighbor's property or much further away must be claimed by the original property owner prior to it being returned to the original land site even though this rarely happens. Otherwise, the new land becomes part of the neighbor's land site.

Reliction: This is the slower and much more gradual increase of land due to fluctuating water levels from nearby rivers or lakes. The new land location that was once underwater now is considered land added to the owner's property boundaries.



Chapter Six Summary

- Owning real property includes the ownership of a **bundle of rights** that is attached to the property. A person holding all of the ownership interests is one who holds **legal title** to the property.
- An **equitable title** to property is an interest or right to obtain the full legal title at a future date in accordance with the terms of an existing purchase or seller-financed mortgage contract like a Contract for Deed (a/k/a a Land Contract) or an AITD (All-Inclusive Deed of Trust).
- A **voluntary alienation** is the unforced transfer of title from an owner who willingly conveys property to another.
- A valid **deed of transfer** in California must include at least: 1) a written and signed deed; 2) the full identification of the parties involved in the transfer; 3) a grantor with full **legal capacity**; 4) a legal description of the subject property; 5) a granting clause; 6) consideration (money or something else of value); 7) signatures of the parties involved; and 8) formal delivery of the deed.
- **Deed types** include: a **Grant Deed** (the most common type), **Gift Deed**, **Quitclaim Deed** (grantor does not guarantee any actual interests in the property prior to agreeing to convey any real or invalid interests), **Reconveyance Deed** (property paid free and clear and issued by the lender), **Sheriff's Deed**, and a **Warranty Deed**.
- A **holographic will** is one that is handwritten and not formally witnessed by another party at the time of signing. Any change made to an existing will is called a **codicil**.
- A person who dies without a will in place is described as having died **intestate** (or without a valid will). A probate court may later appoint an **administrator** to assist the parties with the distribution of assets.

- **Title insurance** is a contract obligation where one party (title insurance company) agrees to fully indemnify or reimburse another designated party for financial losses or damages related to whether there is clear title to the property. The two types of title insurance policies include **standard coverage** and **extended coverage** policies.
- The minimum base rate for a **Documentary Transfer Tax** fee paid in California is usually assessed at a rate of \$1.10 per \$1,000 or the property's sale price.
- A private owner's donation of real property to the general public, which may or may not be voluntary, is called a **dedication**.
- Sand and soil can be added or subtracted to a land's site due to such factors as being adjacent to a flowing body of water like a river, excessive wind, and years of adverse impact from natural and extreme weather factors by way of conditions or occurrences known as **accession, erosion, accretion, avulsion, and reliction**.

Chapter Six Quiz

1. What is the most common way that real property is transferred from one party to another?
 - A. Gifting
 - B. Prescription
 - C. Alienation
 - D. Bequeath
2. Which type of deed is most likely to be used to transfer ownership interests from the grantor (seller) to the grantee (buyer)?
 - A. Grant
 - B. Quitclaim
 - C. Promissory
 - D. Warranty

3. Which type of deed transfers any known or unknown interests in a property with no absolute guarantees of ownership interests?
- A. Tax Sale
 - B. Quitclaim
 - C. Warranty
 - D. Foreclosure
4. What is the act called when a grantor swears before a notary public or another official witness that his signature is genuine, voluntary, and not under duress?
- A. Conveyance
 - B. Reconveyance
 - C. Transfer
 - D. Acknowledgment
5. The maker of a will is called a _____.
- A. Gifter
 - B. Recipient
 - C. Testator
 - D. Transferor
6. What is the name of the document that makes a change to an existing will?
- A. Modification
 - B. Amendment
 - C. Devise
 - D. Codicil
7. What is the definition of a dedication?
- A. The conveyance of private property between private parties
 - B. Squatter's right interests in real property
 - C. The voluntary donation of private property to the public
 - D. Eminent domain by way of condemnation
8. A signed handwritten will that is not witnessed is a(n) _____.
- A. Informal will
 - B. Void will
 - C. Holographic will
 - D. Formal will

9. The state's police power to take private property for public use is referred to as _____.
A. Eminent domain
B. Conveyance
C. Prescription
D. Encumbrance
10. Soil or sand from an adjacent river that is added to a person's property over many years is described as _____.
A. Reliction
B. Avulsion
C. Beneficial gain
D. Accretion
11. An adverse possessor (or squatter) must openly occupy a property for how much time before attempting to make a claim for adverse rights?
A. Two years
B. Four years
C. Five years
D. Twenty years
12. Which party is appointed by the probate court to assist with the transfer of real and personal property interests to named or unnamed heirs?
A. Administrator
B. Trustee
C. Executor
D. Facilitator

Answer Key:

1. C	7. C
2. A	8. C
3. B	9. A
4. D	10. D
5. C	11. C
6. D	12. A

CHAPTER 7

AGENCY LAW

Overview

The relationship between licensed real estate agents, principals, and third parties is really the most important part of real estate agency. Yes, most real estate transactions today revolve around the buying, selling, leasing, or financing of real properties. But real estate is more of a “people business” that begins with the establishment of trust between two or more parties. Once the trust is established between a principal (buyer, seller, lessor, or lessee) and agent, such as the belief that the other party is fair, honest, and knowledgeable, then the agency interactions can continue onward to the next level such as showing properties and other service options as will be addressed in this chapter.

The Core Definition of Agency

The earliest origins of agency law date back to common law in Old England just like the vast majority of laws in the United States. Past legal decisions that were made in court cases a couple of hundred years ago or just last week may have a direct effect on the rules and laws that California agents must currently follow.

Agency law is at the true core of any relationship between a principal (client or customer) and a licensed real estate agent. The relationship may at first be based upon a verbal agreement, unspoken actions, or a formal written agreement. These agreements are deemed either “explicit” (formal or written) or “implicit” (implied through actions or spoken words).

The law of Agency is based on Latin origins - “*Qui facit per alium, facit per se.*” Translation of that Latin phrase is “*He, who acts through another, is deemed in law to do it himself.*”

The Traditional Laws of Agency

To best remember the common law duties that agents must follow that date back to Old English laws set by judicial decisions, we used the acronym known as **COALD**. COALD stands for Care, Obedience, Accounting, Loyalty, and Disclosure.

Care: The licensee must show “reasonable care and skill” when assisting his or her clients or principals. An agent who is careless when working with clients is one who is at risk for later being found negligent by either his or her clients, a governing real estate board or agency, and/or a judge or jury. One of the main “rules of thumb” or standards used to determine whether or not an agent is acting recklessly with his or her clients is to ask this question: “How would other agents have acted in this exact same situation with their own clients?” If the answer is “Quite a bit differently,” then the agent might be at risk for being found reckless and careless.

Obedience: “The customer is always right” is an old saying about how business owners and licensed professionals should think and act around their clients. While few people can “always be right” about many things in life, it is important to remember that an agent should act “as if” the client is right about their needs and interests. If a client wants to buy a 4-bedroom home instead of a more affordable 3-bedroom home due to the size of their family and is formally qualified to buy it, then the agent should obey their instructions by continuing to show the client 4-bedroom homes in the neighborhoods and school districts of interest.

Accounting: Few things in the real estate profession will get an agent into more trouble than not properly accounting for or handling their clients’ funds. The act of accounting refers to the custodial care and detailed and accurate record keeping of all money collected from or on behalf of the principal. The agent must place their client’s funds into a separate trust account that is not mixed with the broker’s personal or business funds. Should the funds be merged with broker funds, this is called **commingling**. It can lead to license suspension or revocation as well as future litigation by the client.

Loyalty: The agent must put the client’s needs, interests, and goals far ahead of even their own personal interests and needs as long as the client’s needs and interests are legal. As part of the act of loyalty to

clients, agents are required to provide confidentiality to clients by not sharing their financial or family secrets with other parties to a real estate transaction or elsewhere. Often, the licensee acts like part real estate advisor, part therapist in order to help reduce their clients' stress levels and keep them focused, happy, and mentally strong prior to making perhaps their biggest financial decision ever. As such, agents must be trustworthy and loyal when working with their clients each day.

Disclosure: When all else fails, one of the most important steps for agents to follow is “disclose, disclose, disclose” when working with their clients. A complete written disclosure form is usually the best and safest option when working with clients as opposed to verbal disclosures. Even if the agent had unintentionally failed to share his or her knowledge about the slight potential of termite damage in one small corner of the garage, it could later be considered fraudulent and grounds for license suspension and litigation. It is also highly recommended that agents strongly encourage or at least recommend that principals hire competent and experienced third-party inspectors who can more thoroughly investigate any potential termite or insect damage, flood and mold issues, and seismic or earthquake risks associated with the subject property.

Agency Types

Seller Agency: This is where the agent represents only the seller.

Buyer Agency: A buyer agent represents only the buyer in one or more transactions. A buyer's agent is likely to be loyal, hardworking, and confidential with their buyer. The buyer, in turn, is also likely to stay loyal to his or her buyer's agent after the signing of the agency relationship form. The agent's primary fiduciary duties are to his or her buyer client instead of to both the buyer and seller equally, as is the case with a “dual agency” discussed below.

Dual Agency: Both the buyer and seller are equally represented by the same agent as long as the agent makes full disclosure in writing, and provides the same high level of fiduciary duties to both principals. Some types of agency relationships may also be described as **limited dual agency**, partly because it can be challenging for an agent to fully and equally represent both clients (buyer and seller) at the exact same time with the same amount of loyalty. **Inadvertent dual agency** occurs when

the agent accidentally or unintentionally creates a dual agency relationship by their actions, past relationships with both principal parties, and/or their spoken words. If inadvertent dual agency is alleged or claimed by anyone, then the agent must quickly move to formalize the relationships in writing.

Subagency: A subagency occurs when another real estate licensee joins an existing agency relationship in situations like listed homes for sale on the MLS. There is already a formal listing and agency relationship between the owner and listing agent. Once a new buyer's agent enters the scene with a buyer prospect, then he or she effectively becomes a **subagent** to the deal even before their client makes a formal offer to purchase. Other times, another agent might be appointed to assist the principal and original agent with finding and negotiating on the purchase or lease of a property.

Cooperating Agent: A licensee who finds a buyer for a property that is listed with another agent is a cooperating agent.



Cooperative Sale: A cooperative sale is a sales transaction in which the listing and selling agents work for different real estate brokerage firms.

In-House Sale: When both the listing and selling agents work for the same employing broker under the same roof or brokerage franchise, it is called an in-house sale.

The Creation of Agency Relationships

An **express agreement** is the safest and most effective type of agency relationship agreement. In this case, a principal formally appoints a specific agent to work on his or her behalf. The appointment may be verbal or in writing. But it is much better for agents to have their appointments and instructions be clearly defined in writing. Even without anything placed in writing and no potential to earn any income from the relationship, the agent still has rights, responsibilities, and liabilities with respect to the principal.

Ratification: The principal's acceptance of an act that has already been performed by the agent is called a ratification. An example is a situation when an agent brings in a buyer to purchase a seller's home after several months of conversations between the buyer's agent and the seller who listed the home for sale without a listing agent as a FSBO (For Sale By Owner). By accepting the offer to purchase the home, the seller created a form of agency by ratification with the agent after the fact.

Estoppel: An agency by estoppel is created when a principal leads another party to believe that some other person is the principal's agent even though no formal written agency contract exists between them at the time. An agency by estoppel requires the principal to accept the existence of the agency to protect third party's interests.

Implication: An agency by implication exists when someone behaves towards other parties in a way that implies that he or she is acting as the agent of the other person. With agency by implication, the agent must accept the existence of the agency relationship in order to protect the interests of the principal.

Types of Agents

In California, the two main types of agents are **general agents** and **special agents**.

General Agent: A general agent is a licensee who is given the authority to handle one or more jobs for the principal that are likely to last for a fairly long time. In the field of real estate, a general agent might, for example, handle all of the rental lease signings for an investor that owns a 50-unit apartment building. The agent is acting as a leasing agent and a property manager for the ongoing maintenance and supervision of the complex. The agent might be paid by commission only, a fixed salary with or without bonuses, or some combination of these income options.

Special Agent: The *most common* type of real estate agent is a special agent. They are appointed to handle the listing of one unique property for sale over a relatively short period of time such as a 90-day listing agreement. The agency relationship will terminate once the property sells or the listing term expires without a purchase offer in hand unless it is renewed by the principal.

Actual Authority: It is the principal who best determines the amount of authority assigned to a designated agent. When the appointment has been made in writing such as a listing agreement or buyer's agency form, then this is a type of **actual authority** that clearly details the agent's full scope of appointed authority to work on behalf of the principal.

Apparent Authority: But when an agent has no actual or written authority to act on behalf of a principal and when the principal either unintentionally or intentionally makes it appear that the agent has his full authority, then this is the definition of apparent authority. This is an example of an authority type that can be described as an **agency by estoppel**. The apparent agent in this situation is then called an **ostensible agent**.

Third parties should thoroughly investigate the potential agency relationship and scope-of-authority situation that may or may not exist between the other agent and his or her presumed principal. This is solid advice partly since the third party cannot later sue the principal for the actions of another agent who was clearly acting outside of his or her scope of authority and in a manner not authorized or condoned by the

principal.

Imputed Knowledge Rule: As per general agency law, the information about a property that is known by an agent is also presumed to be known by his or her principal, even if the agent did not share the details with the client. Both the principal and agent share “vicarious liability” partly due to the imputed knowledge rule in the event that any future litigation risks should arise. As such, it is critically important that both the principal and agent share details with one another, especially information that may be considered relevant material facts.

Agency Duties

An agent’s primary responsibility when working in the field of real estate is to their principals or clients. However, agents must show fairness, honesty, integrity, and professionalism to third parties as well. In many states, these third parties are described as “customers” in the real estate profession. An agent is required to work on behalf of their principal or client when working with third parties like other licensed agents, appraisers, mortgage brokers, listing sellers, and buyer prospects.

An agent effectively is an extension of his or her employing principal who is being represented in the transaction. Conversely, the actions of the principal in a real estate deal can also make the agent have tremendous financial, legal, and license liability should the client knowingly or unknowingly commit fraud in the deal. So, it is important to remember that an agent and his or her principal are truly a team working together as they strive towards success in any real estate endeavors. As such, agents, principals, and third parties are required to treat each other in a fair and honest manner, regardless of whether they are directly employed by one or more parties.

In the law of agency, a **customer** is a *potential* new real estate client or principal that an agent meets at an Open House showing or even at a party. A **client** is more likely one who has formally signed some type of agency relationship agreement (i.e., single or dual agency, buyer’s agent, listing agent, etc.), and has formally agreed in writing to work with a specific real estate agent for a defined period of time such as 60, 90, or 180 days. Even though the customer (prospect) has not signed any type of formal written agency relationship agreement with the licensee, the

customer should be treated “as if” they were about to become a client. It is not only a solid business strategy to act professionally and with courtesy around prospects, it is also a legal requirement under the law of Agency.

Agents are Fiduciaries

An agent is a type of “**fiduciary**” in real estate transactions. A fiduciary is generally defined as a person who acts under a position of trust and confidence in matters that typically involve money. Besides real estate, a fiduciary position may include a banker, a financial advisor, an attorney, a neutral trustee in a family trust or partnership, or some other business professional who is relied upon by the client for their most honest and straightforward financial and legal advice.

Fiduciary Core Definitions

The word “fiduciary” originates from the Latin word “fides” which translates to “trust” in English. Without the establishment of trust between a principal and his or her appointed real estate agent, the fiduciary or agency relationship would probably not exist in the first place.

A **Fiduciary**: One who is obligated to act in a position of authority on behalf of another in situations like the management and/or disposition of money, property, or other valuable assets. The fiduciary assumes a duty to act in good faith, honesty, truthfulness, and with extreme loyalty prior to and while fulfilling the assigned obligations.

Fiduciary Duty: The required duty to act as an agent, trustee, or some other fiduciary responsibility with loyalty, honesty, and in a manner that is consistent with the true best interests of the beneficiary of the fiduciary relationship such as the principal or client.

Fiduciary Relationship: The relationship between one who acts as an agent and the one that agent is representing. The fiduciary relationship is one of duty to the principal to act on the principal’s behalf above and beyond any other party.

Fiduciary Duties and OLDCAR

In many ways, the fiduciary duties for real estate agents are similar to the common law duties associated with the acronym COALD. However, a person who is designated a legal “fiduciary” is required to show much more than just care, obedience, accounting, loyalty, and disclosure, partly since they are supposed to act with even *more* loyalty, fairness, and professionalism than an unlicensed person who is not a true fiduciary like real estate agents today. Under COALD, the common law duties associated with confidentiality are listed under the “disclosure” category while they are separately designated under the **OLDCAR** acronym about the importance of fiduciary duties.

Obedience: The agent or fiduciary is under the control of the principal who hired them. The licensee must obey their principal’s written and verbal instructions as long as those instructions are legal. The primary exception to this rule is that agents must politely refuse to follow instructions that would knowingly violate disclosure, discrimination, and financial laws that could get both the principal and agent into legal trouble. Under the eyes of the law, an agent and a principal can be seen as one partly due to the following two legal definitions:

-Vicarious Liability: Under California law, vicarious liability is a legal doctrine under which one or more parties may be held indirectly liable for an injury even though they were not directly involved in the incident. A party who is found “**vicariously liable**” (**negligent or reckless**) may be required to pay for the plaintiff’s medical bills, lost wages, pain and suffering, and/or financial losses associated with a negative real estate outcome. For example, say a property owner loses \$300,000 in equity after the mortgage lender forecloses on him before the principal could financially complete the purchase deal that was already a month late to close.

Vicarious liability, or indirect liability, can arise out of a legal or professional relationship in which one party has the right to control at least some of the actions of another, and it is believed to be fair as a matter of public policy here in California to make that party assume the full legal risks associated with another person’s behavior. Vicarious liability claims in lawsuits in the state typically arise in the context of

business or investment relationships between an employer and employee as well as a principal and agent.

With civil litigation, the injured party will probably focus on which party on the other side of the courtroom has “deeper pockets” or greater wealth. Most of the time, the employing real estate brokerage company carries errors and omissions insurance or a business umbrella insurance policy to insure and protect against lawsuits filed by angry principals, agents, or other third parties that might be as high as \$1 million dollars or more per incident.

-Respondeat Superior: This is a legal doctrine that is most commonly used in tort. It provides that an employer or principal is legally responsible for the wrongful acts of an employee or agent if that employee’s or agent’s actions took place within the scope of their employment or agency relationship. The California Civil Code that is associated with Respondeat Superior claims includes CA Civ. Code § 2338 (through 2012Lexis). It is summarized as follows:

“Unless required by or under the authority of law to employ that particular agent, a principal is responsible to third persons for the negligence of his agent in the transaction of the business of the agency, including wrongful acts committed by such agent in and as a part of the transaction of such business, and for his willful omission to fulfill the obligations of the principal. (Enacted 1872.)”

Loyalty: The agent is required to show the most loyalty to their clients partly by putting the client’s needs and interests ahead of their own.

Disclosure: Agents must make full disclosure as soon as possible as it relates to any products or services that they are offering to their individual client or to the general public when advertising such things as the current physical condition of the listed property.

Confidentiality: An agent must not discuss or reveal facts or secrets that might harm the interests of the client without first obtaining permission from the client. In many ways, this confidentiality requirement is similar to the arrangement between attorneys and their clients as well as doctors and their patients. There is certain information that should be considered privileged, and may not be shared with other

parties both during the transaction and even for many years after the closing.

Accounting: Since agents are “fiduciaries” in real estate transactions, they are required to keep track of their clients’ funds, place them into the most appropriate trust account that is set aside for separate client funds, or hand them over to the designated or named third party listed in the contract in a timely manner. Agents who do not follow the client’s instructions related to the handling or collection of their funds such as rents and earnest money deposits may have high financial, legal, and license risks and very short careers as agents.

Reasonable Care and Diligence: Agents must act with care and diligence because their principals who appointed them expect nothing less from someone who was knowledgeable and qualified enough to pass their state real estate exam. Agents should understand the basic steps necessary to complete a real estate transaction, such as a purchase or lease deal. However, they should never give legal, tax, or accounting advice to their clients when asked questions. Instead, agents should suggest that the client seek advice from professionals who work in those fields and who are best qualified to assist them.

Breach of Duty

A **tort**, or a wrongful act which is as a result of a breach of duty under the law, is committed when an agent breaches or violates any required or necessary duty towards the principal or a third party. The injured party has the right to file a civil complaint or lawsuit against the agent for breach of duty.

In tort law, a **duty of care** is a legal obligation to adhere to and offer a consistent standard of reasonable care while performing any acts that could foreseeably and potentially harm another person. The financial risks associated with the principal and agent relationship are quite high in that an injured party or claimant might later seek hundreds of thousands or even millions of dollars in damages from both the principal and his or her appointed agent. The duty of care is typically the first element that must be established prior to moving forward with a legal action for negligence, fraud, and/or other types of claims.

The remedy or outcome in a **tort suit** filed against a real estate licensee and/or his or her principal is usually **compensatory damages** (money). Should the agent lose as the defendant in a civil complaint, the licensee, and his or her employing broker and/or their insurance company, will probably be ordered to compensate the injured party for their financial loss. The emotional pain and suffering damages can be significantly higher than the actual financial losses in some types of tort suits. Agents might be forced to return their entire real estate commission collected from the transaction in dispute; the injured party might be able to rescind or void their existing agreement, contract, or completed transaction even after close of escrow.

A seller or landlord may be sued right alongside their appointed agent by a buyer or tenant if the property was misrepresented by either of them. The principal (or seller) can be sued under the vicarious liability doctrine for fraudulent acts committed by the agent (and vice versa - the agent can be sued for fraudulent acts committed by the seller) because the principal is liable for any torts committed by the agent who acted within his scope of authority.



A breach of duty action or allegation claimed against an agent is a potential violation of real estate law. As a result, the California Department of Real Estate (DRE) may still take action against a licensee even if the injured party does not file a civil complaint. Should the DRE later determine that the agent did, in fact, breach their duty as an agent, then he or she may suffer consequences such as a DRE fine or a license suspension or revocation.

Disclosure Statements

Disclosure of material facts to the principal. If an agent comes across any new **material facts** that his or her principal was not aware of earlier in the transaction, the agent must fully inform the principal. A “material fact” is defined as something that might affect the decision of a principal in a particular transaction.

An example of a material fact could include a serious crack found in the foundation below the basement floor that a buyer’s agent first discovered. If the crack is severe it might lead to the buyer backing out of the deal before the contingency inspection period expired. In this scenario, the buyer’s agent would be committing fraud if he or she did not fully disclose the discovery of the cracked foundation to the client as quickly as possible.

Disclosures, and the sharing of verbal and written information received, can cover a seemingly wide range of situations in real estate transactions for agents such as the requirement to:

- Present all offers and counteroffers to the principal.
- Share information about the market value numbers for sales or rent comparables.
- Disclose any existing or potential agency relationship, especially a dual agency relationship.
- Disclose any physical defects discovered by the agent or by a third-party inspector, neighbor, or some other unrelated party that was shared with the agent.
- Disclose family relationships between a principal and his or her agent.

Agents are required to act with **reasonable care and skill** when dealing with their own principals as well as with third parties. This is especially true when providing disclosures (written or verbal) about the physical status or condition of the subject property. An intentional material misrepresentation committed by the agent can be a legal cause of a claim for **actual fraud**, while an unintentional misrepresentation can amount to **negligence** or **constructive fraud**.

Case examples

Actual fraud: A listing agent knows that there is toxic mold in the attic after seeing it firsthand and reading an old mold inspection report from a few years prior. The seller first checks the box on the listing disclosure form while noting that there is a potential serious mold issue, but the agent later erases the check mark made by the seller because the listing agent is in desperate need of a quick sale and commission check. Even though the seller properly disclosed the mold issue, the seller would still have the potential to be found vicariously liable due to the principal and agent relationship.

Negligence and Constructive Fraud: A buyer's agent wrote down the wrong contingency expiration date for his client to get formal loan approval. The buyer ran out of time as a result, and she lost her \$10,000 earnest money deposit because she did not show the seller a formal loan approval letter by the required date that was built into the contract. The buyer and the buyer's agent really wanted this transaction to close on time. But the buyer's agent made a huge mistake that cost him his client and a commission check even larger than the \$10,000 earnest money deposit. And later, the agent was sued by the client for the \$10,000 in lost earnest money alleging **negligence** and/or **constructive fraud**, in spite of it being an honest mistake that cost both the principal and agent dearly.

Puffing: A certain type of exaggerated statement that lies somewhere between factual truth and a non-factual statement. An example might be when the listing agent makes the claim that the local elementary school is the "best one in the county" when it doesn't even rank in the Top 10 lists compiled by professional educators and past student rankings. Yet the listing agent may believe it to be the "best school" partly due to the fact that the agent's own children went there and loved it as well as other

positive feedback received from fellow parents in the area.

Principals should not rely upon “puffing” statements that are based more upon the agent’s personal perceptions than the actual facts provided by unrelated parties or neutral reports. Since the law considers it to be “unreasonable” to rely upon a puffing statement that isn’t legally considered a material fact, these actions cannot be the subject or main core of a successful lawsuit. However, people can file suits over just about any activity these days, so agents are advised to minimize their legal and financial risks by not engaging in puffing.

Transfer Disclosure Statement

In California, agents who represent a seller in a listing transaction involving a home that is not brand new are required to inspect the property, detect any property defects, and inform the buyer and seller of any type of residential one-to-four-unit property of any defects found. There is no formal inspection required if the home is newly constructed and offered for sale for the very first time.

Homes that are sold “**as is**” in deals like “fix-and-flip” transactions are still required by state law to have the agent disclose any known defects. For properties that share small or large common areas such as a condominium or cooperative unit, the agent must inspect the interior space of each unit and make full disclosure. However, they are not required to inspect common area locations such as the community clubhouse or underground parking structures.

Principals and agents acting together to sell or lease a property must be certain that they are disclosing any known defects associated with the properties. Some of the most relevant key points that a seller should disclose in writing on any transfer disclosure or listing agreement forms must include:

- which items on the property will be included or excluded in the sale, such as unique and expensive lighting systems;
- any known defects in the property such as roof leaks, electrical fire risks, and/or plumbing problems; and

- nuisance or noise problems from adjacent neighbors who like to throw parties every weekend; or
- the neighbors have a dog that barks incessantly.

The **transfer disclosure statement** has separate sections that are to be completed and signed by the selling principal and the listing agent. Even if the seller refuses to acknowledge and confirm any known defects in the property in their section, the listing agent is legally required to make note of the defects in their section of the listing contract that were both told to the agent by the principal or discovered by the agent on his or her own.

The transfer disclosure statement should be given to the buyer or his or her buyer's agent as quickly as possible when requested or after an offer to purchase or lease has been made. The buyer can subsequently decide to rescind or revoke their purchase agreement offer within **three days** of receiving a hand delivered copy or **five days** if it is mailed.

Depending upon the town, city, or county in California, there may be additional disclosure forms that are unique to the region that principals and agents may wish to complete in addition to the usual transfer disclosure and listing agreement forms. The **local option transfer disclosure statement** might contain details about the local neighborhood or community that might serve to either inspire or discourage a buyer from moving forward with the transaction.

For many types of residential properties, there may be **supplemental disclosure forms** that cover a whole range of issues. The following are some of the disclosure matters covered in the supplemental forms.

-Natural Hazards Disclosures: This form is used to reveal whether or not a property is located in a potential high-risk region that is prone to environmental damage related to floods, earthquakes, and/or wildfires. Additionally, this form has sections regarding possible airplane noise from nearby airports, and noise, smell, or pollution risks linked to farms, ranches, factories, or other businesses.

-Earthquake Guide: For any property built before 1960 that was designed with a "light frame," the buyer prospects must still be handed a booklet entitled *A Homeowner's Guide to Earthquake Safety*, even if the home is not located in a high-risk seismic region. Most other property

types that are located in higher-risk earthquake regions built near major fault lines, like the San Andreas, also require that the seller give buyers the same booklet.

-Lead-Based Paint Disclosures: Lead-based paint is a true health risk for both children and adults. Federal law requires that the seller must disclose all known locations in the property that could possibly have any lead-based paint. Any past lead-based paint inspection reports must be provided to the buyer as well as a pamphlet about the risks associated with lead-based paint that is prepared by the U.S. Environmental Protection Agency. Further, the buyer must be offered an additional 10 days during which they have the option to get the home tested for unhealthy levels of lead by a third-party inspector.

-Taxes and Assessments: Should the listed property have any supplemental property taxes or special assessments related to things like recently-passed voter bonds or Mello-Roos fees, the seller must provide the buyer with the detailed tax-assessment fee list provided by the local taxing district. Some regions of California may have property tax bills that are closer to 0.88% of the property's value, while other newer communities might have property tax bills closer to 2.5% of the value due to special assessments that are in place to build new schools, roads, and parks.

-Transfer Fees: Some golf course resort home communities, or other types of subdivisions with a homeowner's association and CC&Rs, have extra transfer fees that sellers must pay each time a home is sold. In some cases, the transfer fees can be several thousand dollars each time the home changes owners. If so, this hidden or not-so-hidden transfer fee must be fully disclosed in writing by the seller or listing agent.

-Sex Offender List Disclosures: Under Megan's Law requirements, a notice must be included in a residential purchase contract about the fact that the California Department of Justice provides an updated list of registered sex offenders and their current locations to the general public.

-Drug Labs: Some properties sold in California were once used by previous owners or tenants as methamphetamine manufacturing and distribution centers (a/k/a "meth labs"). If the current seller is aware of this fact, then the seller and listing agent must fully disclose and provide any past health and safety orders that might limit or restrict the access

and use of these properties. Properties that previously had a meth lab have been shown to have tremendous fire risks due to past explosions from the chemicals used in the manufacturing process.

Negative Stigmas – To Disclose or Not To Disclose?

Some properties in the state are said to be “**stigmatized properties**” due to past health issues associated with the occupants or violent crimes committed on the premises.



There may be situations where the agent is not sure whether he or she must fully disclose and inform buyer or tenant prospects about the past history of the property or previous sellers. Here is a bit of guidance for a few situations.

California law requires that agents do *not* have to disclose if a current or past occupant of the home available for sale or lease had a formal diagnosis of AIDS or was HIV-positive, or if that individual died there as a result of his or her illness. Even if the buyer asks a direct question to the listing agent about whether past occupants had any AIDS or HIV-positive related diseases, the listing agent must *decline to answer* the questions or be in violation of fair housing laws that prohibit discrimination based upon disability or protected class members.

The death of anyone on the property currently listed for sale or lease

more than three years prior does *not* need to be formally disclosed to the buyer. This is true, regardless of the cause of death. However, an agent must truthfully answer any questions from the buyer should they discover that a big news story event occurred on the subject property such as a murder/suicide combination that was found in an online search. If the agent fails to answer truthfully, he or she may be engaging in **fraudulent misrepresentation**.

Agency Termination

Under the laws of Agency, relationships between a principal and agent may be formally terminated or ended in two primary ways: **1) termination by acts of the parties; and 2) termination by operation of law.**

The three most common ways that one or both parties can terminate an agency relationship include: **1) by mutual agreement; 2) by the principal's revocation; or 3) by the agent's renunciation.**

Mutual agreement: This is the easiest way to end an agency relationship when both the principal and agent agree to end it. The original written agency agreement should be terminated in writing by both sides. An example of a reason for the mutual decision to end the agency relationship is if the agent wants to retire or the principal has run into severe financial trouble and cannot afford to buy or lease at this time.

Revocation by principal: The principal has the option to revoke the agency by effectively firing the agent whenever he or she pleases either during or after the expiration of the term of the agency, listing, or buyer's agency contract. If the agency relationship is ended early by the principal unilaterally, then the agent might seek financial losses due to the breach of the contract.

An agency relationship may be **coupled with an interest** in that if the agent has some financial interests in the subject matter of the agency, (e.g., the agent spent a lot of money on advertising the property for sale). This type of agency cannot be revoked in many cases outside of valid fraud claims.

The losses for the principal could include the payment of the commission

to the previous listing agent even if another agent brought in the seller who made the offer before the original date of the listing agreement that was terminated early. If so, the principal might be paying two commissions for only one sale.

Renunciation by the agent: An agent has the right to renounce or end the agency relationship whenever he or she decides. However, if the agent cuts off services to the principal, that could potentially lead to the agent having financial liability for any losses the former client incurs due to the breach or early termination of the contract. The remedy though for damages cannot be in the form of **specific performance** which attempts to force the agent to work for free up until a future deal closes or not. This would be akin to forced labor, and would not likely be enforced by a real estate agency or court.

Termination by operation of law: There are at least four main ways that an agency agreement can be terminated by law:

1. The term written on the agency contract expired;
2. The primary purpose for creating the agency relationship in the first place has been satisfied, such as finding a home and closing escrow;
3. Death or mental incapacity of one of the key parties; and
4. When the subject matter, property, or service option is no longer relevant, is outdated, or destroyed (such as when a fire destroys a home listed for sale).

Independent Contractor and Employee Relationships

The vast majority of real estate licensees in California work as self-employed independent contractors. An independent contractor usually has much more flexibility when choosing his or her daily and weekly work hours than a full-time employee who is expected to be at the office 40 hours a week in exchange for a fixed monthly salary with or without bonus options. Employees are typically supervised and managed much more closely than independent contractors. Independent contractors may also be given the option of choosing their own marketing strategies rather than using the brokerage's strategies.

The downside risk of being a self-employed real estate agent is that if you do not work hard and smart, then you may not receive any income due to a lack of closed deals. The upside potential is that the sky may be the limit for income as long as the agent follows the managing broker's advice, consistently and creatively markets their services to a large network of prospects, and shows up to the office as much as possible. The self-employed agent will have to directly pay his or her own income tax obligations to the IRS and the California Franchise Tax Board instead of having the employing broker take taxes out of their paycheck as is done for the employed agents and the non-licensed office staff.

Under a provision in the Internal Revenue Code, a real estate salesperson will likely be classified as an independent contractor for income tax purposes under the following conditions: 1) he or she holds an active real estate license; 2) the bulk of his or her income originates from commissions from closed transactions instead of on an hourly basis; and 3) the salesperson has a written agreement with his or her employing broker stating that he or she will be treated as a self-employed individual instead of as an employee.

Broker and Salesperson Employment Contracts

Concurrently upon the mutual agreement that an employing broker will hire a new salesperson, the broker should create a formal employment contract between the two that clearly outlines some of the key points below:

- the expected duties of both parties;
- the licensee's commission split with the office (e.g., 70% to the salesperson and 30% to the broker in a 70/30 split);
- the type of supervision and management training that will be expected by and offered to sales people;
- reasons why a salesperson might be fired such as engaging in fraudulent actions; and
- whether the licensee will be treated as a self-employed independent contractor or as an employee for tax purposes.

Chapter Seven Summary

- To remember the steps required for agents to follow under common law, **COALD** stands for Care, Obedience, Accounting, Loyalty, and Disclosure.
- Agency types include Seller Agency, Buyer Agency, Dual Agency, Subagency, and Cooperating agency.
- An **express agreement** (or written and signed contract) is the safest and most effective type of agency relationship agreement.
- The principal's acceptance of an act that has already been performed by the agent is called a **ratification**. An **agency by implication** exists when someone behaves towards other parties in a way that implies that he or she is acting as the agent of that person.
- A **general agent** is a licensee who may work on multiple job assignments over a longer period of time for a client (e.g., a property manager for a 100-unit apartment building). A **special agent** usually works on one specific task for a relatively short period of time such as handling a 90-day listing agreement to sell one home.
- A real estate licensee is a **fiduciary** when acting with a principal. A fiduciary is one who is obligated to act in a position of authority on behalf of another in situations like the management and/or disposition of money, property, or other valuable assets. (Examples of those that have a fiduciary relationship with their clients include wealth advisors, accountants, attorneys, and real estate agents).
- Under California law, **vicarious liability** is a legal doctrine under which one or more parties may be held indirectly liable for an injury even though they were not directly involved in the incident (or a principal may be liable for their agent's actions and vice versa).

- A **tort**, or a wrongful act which occurs as a result of a breach of duty under the law, is committed when an agent violates any required duty towards the principal or a third party. This type of violation may lead to a civil complaint or lawsuit being filed.
- The **transfer disclosure statement** has separate sections that are to be completed and signed by the selling principal and the listing agent together and separately.
- A relationship between a principal and agent may be formally terminated by two primary ways: **1) by acts of the parties; and 2) by operation of law.** The completion of the contract (or sale of a home) is usually the most preferred way to end an agency relationship.

Chapter Seven Quiz

1. Which answer below is the least likely way to form an agency relationship?
 - A. Estoppel
 - B. Ratification
 - C. Rescission
 - D. Implied actions
2. A real estate agent primarily owes duties to which party?
 - A. Employing broker
 - B. Principal
 - C. To the agent himself
 - D. Sub-agent
3. A person who is appointed to handle a specific transaction is a:
 - A. Special agent
 - B. Principal
 - C. Sub-agent
 - D. General agent

4. When a principal later approves of an agent's actions on his or her behalf even though the agent was not formally appointed as an agent at the time, this is known as:
- A. Ratification
 - B. Prescription
 - C. Appointment
 - D. Authority
5. What does the "C" represent in the COALD acronym that is used to define the common law steps that an agent must follow?
- A. Conversion
 - B. Commitment
 - C. Confirmation
 - D. Care
6. Under general agency law, a principal can be financially and legally liable for his or her agent's action due to:
- A. Implication
 - B. Vicarious liability
 - C. Association
 - D. Ratification
7. With regard to agency laws, a broker's salesperson who keeps his or her license under the employing broker is defined as which party?
- A. Agent
 - B. General partner
 - C. Sub-agent
 - D. Principal
8. Which answer below will terminate an agency relationship?
- A. Contract term expires
 - B. The property sells, closes escrow, and all parties get paid
 - C. Death of the principal
 - D. All the above

9. What is it called when an agent greatly exaggerates how wonderful a property is to a client even if he or she believes it to be true?
- A. Salesmanship
 - B. Absolute fraud
 - C. Puffing
 - D. Intentional misrepresentation
10. Which duty is owed by the agent to the principal?
- A. Focus
 - B. Skill
 - C. Loyalty
 - D. Compassion
11. A principal can be legally and financially liable for:
- A. His own statements
 - B. Statements made by his broker
 - C. The broker's salesperson's actions
 - D. All the above
12. Dual agency relationships must absolutely be:
- A. Implied
 - B. Express or written
 - C. Void
 - D. Confirmed after the transaction has closed escrow

Answer Key:

1. C	7. A
2. B	8. D
3. A	9. C
4. A	10. C
5. D	11. D
6. B	12. B

CHAPTER 8

HOW PUBLIC REGULATIONS AFFECT REAL ESTATE

Overview

In this chapter, we will learn about how the government exercises its police power and constitutional rights to limit, restrict, ban, and stimulate housing growth by way of continually modifying zoning, usage, and building codes. Since new construction for residential and commercial properties may adversely impact or harm the local environment in regions such as protected wetlands and state and national parks, the topic of environmental controls will be included.

Lastly, the government's power of taxation will be covered as it relates to how city, county, state, and federal agencies use a number of taxation strategies to generate new revenue that is partly used for new roads, parks, schools, and highway systems that surround both new and older home communities.

Usage Restrictions for Land

The government's ability to quickly modify zoning restrictions or regulations for land can change a property's value from very minimal to quite valuable or the other way around. Private restrictions that limit the development or the remodel of existing properties may also help or harm those properties. However, it is much more challenging for property owners to battle with government agencies that have much "deeper pockets" and the power of the judicial system and law backing them up.

The owner of a parcel of property, whether it be raw land, a \$5 million custom home located on the pristine white sands of Newport Beach, or a \$100 million high-rise office building located in downtown San Francisco, is entitled to a **bundle of rights** as it relates to the owner's right to use, lease, sell, build, or remodel the property. Within the bundle of rights is the implied principle of **"as of right zoning"** (or "as of right

use”) that is simplified to mean that the **bundle of rights** is subject to local, state, and/or federal zoning code restrictions that can limit some of the owner’s rights in the property.

Zoning Law Case Study

Zoning regulations can negatively impact property value or it can boost it 10 times or more almost overnight once the more favorable zoning laws go into effect. For example, a one-acre land site (43,560 square feet) that is located a few miles inland from the beach in San Diego County has been zoned as “agricultural” for the past 70 years partly due to the fact that strawberry fields used to exist on the property, and the owner’s family members and other employees used to sell the picked strawberries to people driving or walking by the site.

Forty to seventy years ago, there were not many people or completed homes within a few-mile radius. However, the residential building boom over the past several decades in this part of San Diego County made the adjacent land incredibly valuable that was zoned as some type of “residential” classification such as R1 (single-family home zoning). An astute and tenacious real estate agent decided to contact the property owner so that she could hopefully set up a time to meet with the elderly man who was listed on the deed as the owner in public records. The agent’s intent was to educate the property owner about the best ways to change the zoning from agricultural to R1 residential so that the property value would increase as much as tenfold.

Almost a year later, the property owner’s request for a zoning variance (or modification) was approved at the local planning and zoning department. Once the new zoning was in place, the landowner sold the vacant land to a home builder who had received tentative approval from the local planning and zoning department to build six homes on the one-acre site with lot sizes that average close to 6,000 square feet each. Because new homes were selling for an average close to \$750,000 in the region, the developer was more than willing to pay the strawberry field farmer a price that was at least 10 times higher than the value of the land just one year prior.

Police Power

Some of the most common examples of **police power** as it relates to real estate are a city, county, state, or federal governmental agency's ability to control zoning, building codes, rent, and the assessment of taxes. The state would claim that the exercise of its police power is in the best interest of the public in spite of it restricting or limiting some of the fundamental freedoms and rights of private owners. These police powers or **restrictive powers** may include:

- Building codes
- Zoning ordinances
- Subdivision regulations and master plans
- Health and environmental guidelines
- Eminent domain or condemnation
- Taxation of properties

Eminent Domain (also referred to as “condemnation”):

Eminent Domain is “[t]he government’s police power... to take private property for a fair price or just compensation for the public’s benefit.” The Fifth Amendment to the U.S. Constitution forbids the government’s taking of private property for public use without “just compensation” being paid by the government to a private party. Some regions may need new roads, parks, schools, or highways, and the only property available to build on might include private land or homes adjacent to these new public development sites. If so, a government representative will contact the property owner while offering them a “fair market value” price for their property as more of a polite demand than a request to purchase by way of condemnation actions.

Taxation: Properties are assessed in relation to the current market value estimate or a recent sales price as a form of **ad valorem taxes**. The property tax year runs from **July 1st through June 30th** here in California. A property owner typically pays his or her annual tax bills by way of two separately paid equal installment payments. Cities also tax for building and remodeling properties.

The concept of an individual state's **police power** originates from the Tenth Amendment to the U.S. Constitution. The Tenth Amendment gives to states like California the rights and powers “not delegated to the United States” (or federal government). States are granted the power to create, regulate, and enforce laws that protect the welfare, safety, health, and morals of the community for the betterment of the public. Unlike the police power action of **eminent domain**, no additional “just compensation” is paid to property owners who are financially harmed when the local planning and zoning department downgrades their zoning from “highest and best use” to a new type of zoning that limits their ability to build or sell the property.

Comprehensive Planning

The process that determines a town, city, or county's goals in terms of community development that works for the vast majority of residents is called **comprehensive planning**. This community planning process for the present, as well as how it pertains to future planning strategies that may go out years or decades in advance, is designed to dictate public policy for community benefits such as land use, recreation, utilities, transportation, and especially for residential and commercial real estate buildings. Because so much revenue is created when homes are built, bought, leased, and sold by way of property tax payments, building and planning fees, and transfer taxes, a community is likely to focus on the most creative ways to spur housing activity with methods like efficient and prosperous zoning and usage designations.

A comprehensive plan may also be referred to as a **general plan** by a city or county. The zoning regulations in each community should be as effective and consistent as possible so as to avoid, for example, unhealthy levels of pollution too close to neighborhoods and schools, which might be coming from a chemical manufacturing plant right next door. Sections of a town that allow too much high-density (or “smart growth”) residential construction as seen in recent years with many coastal California regions can also cause serious traffic gridlock problems that double residents' commute time to and from work.

To minimize the problems associated with erratic and inconsistent zoning and development strategies, California requires that each city and county have their own **planning agencies** that are also called **planning**

commissions to monitor, maintain, and supervise the individual communities.

The planning commission's long-term plan for zoning, development, and usage for each local community is described as a **master plan** or **general plan**. Once the master plan is in place, then builders, owners, buyers, sellers, title companies, and real estate licensees must keep a close eye on these zoning requirements so that they are in compliance once the general plan is formally adopted. Local governments will use their **police power** to enforce these zoning regulations with options such as fines, condemnation, foreclosure, and modifying the zoning restrictions even further so that the owner is forced to sell their property to another party. The planning and usage goals for a community are achieved through at least three main phases in the planning and zoning process:

- The creation of a master plan for the community;
- the administration and supervision of the master plan by a municipal, county, or regional planning board or commission; and
- The implementation and enforcement of the plan through public powers and control methods linked to zoning, building codes, permits, fee payments, tax assessments, and other planning measures.

Zoning

Zoning is the main tool used by cities and counties to regulate, manage, and control land use. Zoning ordinances are implemented or put into practice to create the division of a region's land into zoning uses including residential, commercial, industrial, agricultural, mixed-use, and smart growth. (Smart growth may be for more high-density apartment or condominium units in a downtown metropolitan area or a prime coastal region in the state.)

Zoning designations for one lot must be somewhat uniform and conform to adjacent lots on all sides of the property. Some land sites that are not consistent or compatible with adjacent properties, such as an industrial warehouse building built near a single-family home neighborhood will

have **buffers** (or “buffer zones”) between them such as larger greenbelts or parks.



Residential Zoning

Each of the 58 counties in the state of California may have slight to significant modifications of the main residential building and zoning codes. A subdivision may be zoned as Residential, Commercial, Industrial, Mixed-Use, Recreational (campgrounds, timeshares, etc.), Agricultural, or some other zoning and usage designation. Note that standard building codes and zoning uses may be altered on a case-by-case basis, according to the needs and interests of the property owner

and the region at the time. Zoning ordinances are designed to regulate the use, shape, height, interior size, and property boundary setbacks for each structure between adjacent properties and public streets.

A zoning ordinance must be fair and equally applied to property owners as much as possible. These ordinances must not discriminate against any property owner, cannot be applied retroactively, and cannot create situations that benefit one neighbor much more than another due to personal relationships between the owner and local planning department personnel. Let's take a look below at the residential zoning regulations for the most populous county in the state, Los Angeles County.

Zone R1: Single Family Residence

- Permitted Uses: Single-family residences
- Minimum Required Area: 5,000 square feet per lot
- Maximum Height Limit: 35 feet from existing or excavated grade
- Minimum Required Parking: 2 covered parking spaces per residence
- Standard Yard Requirements: Front Yard: 20 feet; Rear Yard: 15 feet; Side Yard: 5 feet; Corner Lot: 5 feet with some exceptions
- Development Standards: Please see 22.20.105 regarding single-family development standards

Zone R2: Two Family Residence

- Permitted Uses: Two family residences (or duplex), single-family residences
- Minimum Required Area: 5,000 sq.ft./lot; 2,500 sq.ft./unit
- Maximum Height Limit: 35 feet from existing or excavated grade
- Minimum Required Parking: 1.5 covered spaces + 0.5 uncovered space per unit for each two-family residence
- Standard Yard Requirements: Front Yard: 20 feet; Rear Yard: 15 feet; Side Yard: 5 feet; Corner Lot: 5 feet

Other zoning designations for higher-density usage for three or more units, larger land tracts that allow detached homes with farming and livestock options in residential settings, and zonings that must conform to existing residential planned development zones as seen throughout much of the state. Three of the most common residential zoning designations in addition to R1 and R2 include:

Zone R3: Limited Multiple Residence

Zone R-A: Residential Agriculture

Zone RPD: Residential Planned Development

Zoning Exceptions and Amendments

As time moves forward and populations grow in size, many regions are in need of zoning amendments or modifications to keep up with the housing, business, and building demand. A zoning law created back in 1960 for a town with just 5,000 residents now may not make much sense for the same town that has closer to 200,000 residents today. As a result, builders, owners, and city or county government offices may decide to request a zoning exception or modification to meet the town's ever-changing needs and interests.

Nonconforming Uses: These are uses of a property that was once allowed under older zoning regulations established several years or decades ago that is now outdated and not permitted for newly built properties. However, the property owner is "grandfathered" in, meaning the state allows them to continue following their old zoning law restrictions that are not available to other property owners today. California state law does not usually regulate nonconforming uses, lots, or structures.

An example of a nonconforming use is a small mini-storage warehouse building that was once zoned as Industrial, but now the lot it is on and its neighboring lots were rezoned as R1 Residential. Because the mini-storage facility was there for the past 30 years, the city allows it to continue as is without forcing the owner to tear down the structure and build a new home on it.

An **illegal nonconforming use** is a property that conflicts with existing ordinances that were in place well before the use began by the current property owner. A common example would be the sale of a home in a residential neighborhood that is used as a commercial daycare business caring for up to 20 children per day as if it were a commercial-zoned retail or office center. If the new property owner continues operating the daycare business in the single-family home, then he or she is engaging in the illegal non-conforming usage of the property. (This is not to be confused, of course, with a family home daycare, which cares for six or up to 12 children.)

Variances: When a property owner goes down to the local planning and zoning department to ask for permission to change the existing zoning and usage requirements for his land that is currently prohibited by the city, his request is asking for a *variance*. The town or city may grant the variance request partly based on whether the owner can prove that without the variance, he will lose out on the same benefits that his neighbors currently enjoy with their similar properties. Alternatively, the owner can show that both he and the city will receive more financial gains than losses from a variance and that the variance may boost neighboring property values.

Often times, the request is for a relatively minor variance, such as to build a home with a minimum square footage design that is slightly smaller or larger than the current minimum or maximum square footage allowances. The variance of a land use that is not currently permitted at the time of request is called a **use variance**.

Conditional Uses: Certain types of unique properties that may or may not offer tremendous benefits to the local community such as a new hospital, school, or church may be granted a **conditional use permit** (or special exception permit). An example might be a ranch owner who requests that his home and ranch located on five acres be turned into a new church with a school and park for the community.

Rezones: When an owner believes that his property is not being used to its highest and best use potential, he may petition the local planning and zoning department for a **rezone or zoning amendment**. A rezone can also be called a **spot zoning** request. A rezoning applicant will likely request a type of **“special use permit”** and pay a fee for the zoning amendment request while assertively making the case that the zoning

change will help both the owner and the adjacent community.

Prior to the local planning authority agreeing to the zoning amendment request, they may notify adjacent neighboring property owners about the potential zoning modification. Neighbors will be allowed to attend the next planning hearing to either support or oppose the proposed zoning changes that may help or hurt the neighbors' property values. An example of a request to **downzone** a property may include attempting to change a multi-family designation (two, three, four, or five plus units) down to just a single-family designation for one unit.

Building Codes: Builders are required to meet at least a minimum construction quality and safety standard when building or remodeling properties. Included within these codes are certain standards for construction methods and the required high quality of materials used. Each of these building codes is usually divided into separate codes associated with **fire, electrical, and plumbing** requirements.

Subdivision Regulations

The division of land into **five or more parcels or lots** is called a *subdivision*. The regulation and maintenance of subdivisions and the control of land use is governed by local and state agencies. Subdivisions are usually classified as residential. Yet they can also be categorized as industrial or recreational.

Three of the main types of subdivisions in California include:

- Standard subdivisions
- Common interest subdivisions
- Undivided interest subdivisions

Standard subdivision: Land that is improved (foundations, underground utilities installed, streets, curbs, gutters, etc.) or unimproved (raw) and divided up into at least five or more parcels or lots that are for sale, lease, or available for financing is a **standard subdivision**. The separate parcels can be created by a tract or final subdivision map, a parcel map, and in certain California counties through a lot line or survey adjustment. A standard subdivision includes the offering of a residential

lot without any additional shared common area interests with adjacent neighbors.

Common Interest Subdivision: This is a residential subdivision community that is also referred to as a *common interest development* (CID) project. The owner owns his or her own lot while sharing interests in common areas in the community such as a clubhouse, pool, or park, with other homeowners in the subdivision. A condominium or townhome community with a few hundred units is a prime example of a common interest subdivision. A **planned development** with a homeowner's association in place to manage the shared common areas and the overall community is another CID example. Additionally, a **timeshare** investment holding related to the purchase of a few days or weeks or a month each year in one or more vacation resort settings such as a condominium unit in Pismo Beach is another type of CID.

The traditional suburban neighborhood home that originated and evolved in Orange County, California and elsewhere back in the 1950's, 1960's, and 1970's is the best-known type of subdivision example in the state. Many of those suburban homes were built within master-planned developments that featured hundreds or thousands of similarly designed California Ranch homes or Mediterranean-style homes. Other types of subdivisions may include condominiums and townhomes, cooperative units ("co-ops"), and other types of shared-interest housing communities with common areas and governing private homeowners' associations in place.

Undivided Interest Subdivision: Each owner has a tenant-in-common interest in the subdivision property that includes a non-exclusive right to occupy or use the land or buildings attached to it. A very common example would include a campground for RVs and trailers that has 200 lots, a clubhouse, a lake, a BBQ pit, a small grocery store, and tennis courts that are shared by all of the guests visiting the campground site. The buyer receives title to a specified lot or unit number and the right to shared common area interests. Usually, the lot owners would be assessed monthly homeowner's association dues or other types of special assessments.

A **subdivider** is a person or entity that intends to offer subdivided lands for lease or sale to the public.

The Subdivision Map Act

The regulation of land division in the state of California is guided through the **Subdivision Map Act** (Government Code 66410). The recorded subdivision map will legally convert a former larger single parcel of land or a group of contiguous parcels into separate numbered lots that will now appear on the new publicly recorded map.

The establishment of a statewide set of building and marketing procedures is created under the Subdivision Map Act once the subdivision plan is filed for a divided property. The physical aspects of the subdivision are included within the filed map such as the lot designs and sizes, the parking areas, streets, and sewer plans. The subdivision plan must meet the general plan requirements (i.e., the correct sizes for streets, parks, and lot setbacks) established by the local planning authority.

Tentative Map: The initial or first map filed with the legal description of the property and the proposed lot boundaries that may be subject to change after the builder and planning authority discuss the proposed options more in depth, is called the tentative map. The tentative map filing might confirm whether it is the city, developer, or land subdivider who is responsible for the installation of public utilities, streets, curbs, gutters, and lights, and whether or not the developer will donate any excess land to the city for green belts or parks that will later be maintained by the city.

Final Map: Once the local planning authority has approved the tentative map, the subdivider or developer is required to file a final map, which features the exact size and shape of each lot as well as their individual legal descriptions. Often, the subdivider has 24 months or less (with possible extension options) to complete the final map approval process from the original date of the tentative map that was filed.

Owners, builders, developers, and real estate agents cannot start marketing their subdivided property sites to the general public before receiving a **public report** from the California Department of Real Estate (DRE). These public reports usually contain important details for prospective buyers such as the CC&Rs (Covenants, Conditions, and Restrictions), which outline the property use restrictions or limitations, the costs and assessments for the ongoing maintenance of the

homeowner's association, the common area, and other material disclosure items.

Every single public report that is issued by the DRE includes an expiration date. Often, the Final "White" Public Report is valid for just five (5) years. In order to advertise and promote a property for sale to the public, the Public Report must be active. Certain changes to the subdivision use or ownership that are found to be "material changes" may invalidate an active Public Report. If so, the new owners might be required to file an amendment application with the DRE in order to reactivate the Public Report.

The Commissioner will issue the Public Report once approved, after confirming that the subdivider has met all of the legal requirements. It will include, among other things:

- The subdivision's name, location, size, and details about the subdivider
- Tax and assessment amounts
- private restrictions
- Environmental health risks nearby
- Financial transaction details about the sales

The Commissioner may at first issue a **preliminary (public) report** before issuing the final report for the subdivision. The preliminary report will likely expire after just one year, but it is renewable. Any prospective buyers who reserve the right to purchase one or more lots in a subdivision with a preliminary report usually have the legal right to back out and receive their deposits or advance funds back after the final report is issued.

Not all subdivisions fall under the jurisdiction of the DRE or other agencies. Per the Business & Professions Code §11010.4 below, there are certain types of subdivided properties that may be exempt from the requirements associated with the public reporting process. Excluded are subdivisions with four or fewer lots; public agency-created subdivisions such as affordable housing apartments; commercial or industrial-zoned

subdivisions; and some standard subdivision lots located within an incorporated city where the home builder intends to build homes on each individual lot prior to selling them off to the public. These may all be exempt from the filing of a public report for a subdivision.



§11010.4. The notice of intention specified in Section 11010 is not required for a proposed offering of subdivided land that satisfies all of the following criteria:

- (a) The owner, subdivider, or agent has complied with Sections 11013.1, 11013.2, and 11013.4, if applicable.*
- (b) The subdivided land is not a subdivision as defined in Section 11000.1 or 11004.5.*
- (c) Each lot, parcel or unit of the subdivision is located entirely within the boundaries of a city.*
- (d) Each lot, parcel, or unit of the subdivision will be sold or offered for sale improved with a completed residential structure and with all other improvements completed that are necessary to occupancy or with financial*

arrangements determined to be adequate by the city to ensure completion of the improvements. A lot, parcel, or unit shall satisfy the requirement that it be improved with a completed residential structure if it is improved with a completed residential structure at the time it is conveyed by the subdivider.

(Amended by Stats. 2013, Ch. 210, Sec. 1.5. Effective January 1, 2014.)

The Subdivided Lands Law: This law was originally enacted to prevent any misrepresentations, deceit, or fraudulent acts related to the sale or lease of subdivided property. The marketing and sales strategies used by owners or developers will be thoroughly analyzed after the public report applications have been filed. Any and all full and comprehensive disclosure of any vitally important details such as existing easements or flood risks that may negatively impact future property values must be fully disclosed. The handling of deposits and other types of purchase monies that buyers hand over to subdividers is also regulated by this law.

The Interstate Land Sales Full-Disclosure Act: The Interstate Land Sales Full Disclosure Act of 1968 is an act of Congress that was passed to protect consumers in activities related to the sale or lease of land in transactions covering more than one state. Some sellers who promote the sale of more than 100 lots in a subdivision that is marketed across state lines must first register with the U.S. Department of Housing and Urban Development (HUD) as well as provide additional updated reports to buyer prospects on the current state of the property.

One of the main intentions of the Act is to protect buyers from dishonest marketing practices in sales scenarios where the normal regulator (such as the state of California) does not have full jurisdiction. This would be true, for example, if the property is located in Nevada or Arizona. Developers with subdivided lots for sale outside of California must first be registered with the DRE prior to marketing these lots for sale anywhere in California. Out-of-state subdividers must also include a statement in their ads placed in California that discloses that the California DRE has *not* inspected or approved the project for sale.

Any violation of any provision of the Subdivided Land Laws may cause the Commissioner's office to issue a **desist and refrain** (or "cease and desist") order that will legally prevent the subdivider from continuing

onward with the marketing and sales activities related to their development project.

Environmental Laws

Almost 95% of the land in California has no residents living on it, partly due to topography (i.e., rural, desert or mountain regions), protected state and federal parks, and lack of interest by subdividers and buyers to buy and sell properties in remote regions. In addition, there are a good number of wetland areas along the coast and near lakes, rivers, and streams that the state wants to preserve from the damages caused by humans. As a result, there are many state and federal environmental protection laws that principals and agents must follow. Some of these are discussed below.

National Environmental Policy Act (NEPA): This Act was signed into law on January 1, 1970. It was designed to allow governing agencies to work closely together with private applicants to create and maintain conditions where people and nature can exist together in productive harmony without endangering certain types of plants, animals, landscape, or other parts of the natural environment. Federal agencies, like the EPA, are required, as a result of the passage of NEPA, to assess and closely analyze the potential positive and/or negative environmental effects of any proposed actions prior to making a formal decision on things like building permits, the adoption of federal land management actions, and the construction of highways and other types of publicly-owned facilities.



Each federal agency involved with issues related to development and business are required to incorporate environmental considerations before approving any building or business permits. Federal agencies engaged in the environmental assessment process will likely prepare detailed statements that outline the potential environmental impact associated with the building plan such as how it may affect nearby lakes and streams. Most often, these environmental assessment reports are called **Environmental Impact Statements (EIS)** and **Environmental Assessments (EA)**.

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA): This federal law is also commonly referred to as the “Superfund” project. The purpose and intent of the passage of this Act was to assist with the cleanup of uncontrolled or abandoned hazardous-waste sites due to past accidents or intentional or unintentional spills or releases of toxic chemicals or other types of hazards. It is governed and enforced by the EPA. If the property owner is still financially solvent after the cleanup operation, the EPA or other federal agencies may pursue the owner for the costs associated with the cleanup.

The **Pollution Control Law** was created by the federal government to set forth national standards for health related to air and water. Each individual state is expected to adhere to these standards. Any businesses

that release toxins or pollutants into the sky or nearby water are generally required to first obtain a permit from the state.

The California Environmental Quality Act (CEQA): This statute was passed by the state of California back in 1970, shortly after the U.S. federal government passed the National Environmental Protection Act (NEPA). One of the main purposes of the California act was to institute a statewide policy of environmental protection. The state will publish reports associated with potential environmental hazards or impacts by way of an Initial Study (IS), a Negative Declaration (ND), or an Environmental Impact Report (EIR).

The California Coast Act: This law was enacted in 1976 as a way to manage the development activity that is located along California's beautiful coastlines. The approval for new and remodeled development projects near the coast was supervised by groups like the California Coastal Commission. Over the past few decades, some of the matters brought to approval-process hearings that were open to the public were quite hotly contested. Owners and developers were attempting to build homes directly adjacent to the sand in pricey Malibu or La Jolla in Southern California while pro-environmental activist groups showed up to try to get the building plans canceled, citing risk factors associated with harming endangered animals living near the beach.

Below are some of the most relevant sections of this law, which note the reasoning behind its passage. It was a monumental act that still impacts residents and agents up and down the coastline today.

"30001. The Legislature hereby finds and declares:

(a) That the California coastal zone is a distinct and valuable natural resource of vital and enduring interest to all the people and exists as a delicately balanced ecosystem.

(b) That the permanent protection of the state's natural and scenic resources is a paramount concern to present and future residents of the state and nation.

(c) That to promote the public safety, health, and welfare, and to protect public and private property, wildlife, marine fisheries, and other ocean resources, and the natural environment, it is necessary to protect the ecological balance of the coastal zone and prevent its deterioration and destruction.

(d) That existing developed uses, and future developments that are carefully planned and developed consistent with the policies of this division, are essential to the economic and social well-being of the people of this state and especially to working persons employed within the coastal zone.

Alquist-Priolo Act: The Alquist-Priolo Earthquake Fault Zoning Act (AP Act) was signed into law in California on December 22, 1972. This act followed the destructive 6.6 earthquake that struck the San Fernando valley near Los Angeles on February 9, 1971. The purpose for the passage of the act was to attempt to mitigate the hazards associated with surface fault ruptures. The intent of the AP Act is to ensure public safety by prohibiting the design of most types of real property structures for human occupancy that are located too close to active fault lines.

There were several earthquake fault maps that were designed in correlation with the passage of the AP Act that covered high-risk seismic regions within Los Angeles and Napa Counties and other areas of the state.



Any properties located within high-risk seismic regions that may be a quarter of a mile in width on the fault maps are referred to as ***special studies zones***. Owners, sellers, and developers must fully disclose whether or not their properties are located within any of these special

studies zones or high-risk earthquake regions. Additionally, they may have to attach a recently completed geologic report that details how the nearby fault lines may impact the subject property.

Chapter Eight Summary

- An owner's right to use, lease, sell, build, or remodel the property is called a **bundle of rights**. These rights are called "**as of right zoning**" as it relates to existing local city, county, state, or federal zoning and use rules and laws.
- **Police powers** or **restrictive powers** that can affect an owner's usage rights include: 1) building codes; 2) zoning ordinances; 3) subdivision regulations and master plans; 4) health and environmental guidelines; 5) eminent domain or condemnation; and 6) taxation of properties.
- The **property tax year** runs from **July 1st through June 30th** in California. Properties are assessed tax rate fees that are called **ad valorem taxes** ("according to value").
- The process that determines a town, city, or county's goals in terms of community development that works for the vast majority of residents is called **comprehensive planning or general plan**.
- When a property owner requests the use of a property that once was allowed but no longer is, that request is called a **nonconforming use** request.
- A **variance** request is the process when an owner or contractor goes down to a local planning and zoning department to ask for permission to change the existing zoning and usage requirements for his or her land. It is similar to an exemption or change request for the usage or design of the property that goes against current building rules.

- The division of land into **five or more parcels or lots** is called a **subdivision**. The land can be zoned as residential, commercial, mixed-use, industrial, or some other type of usage designation.
- The regulation of land division in the state of California is guided through the **Subdivision Map Act** (Government Code 66410) with both a **Tentative Map** and a **Final Map**.
- California and the federal government have a series of laws, acts, and other requirements that must be disclosed to prospective buyers due to risk factors potentially linked to environmental hazards such as heavy metals and other toxins, earthquakes, fire, and climate issues. Additionally, there may be one or more “Superfund” accounts managed by agencies such as the EPA (Environmental Protection Agency) that may pay out to damaged property owners.

Chapter Eight Quiz

1. What is the name of a long-term community design plan created by a local planning commission department?
 - A. Forecast
 - B. Code enforcement
 - C. Master plan
 - D. None of the above
2. Which answer below is **not** a type of police power action?
 - A. Eminent domain
 - B. Zoning ordinance
 - C. Building codes
 - D. CC&Rs issued by a homeowner’s association

3. Which answer below is a potential outcome related to the modification of an existing zoning or use code?
- A. Building fee increases
 - B. Allowable size of the building on a lot increases
 - C. The disallowance of new construction on a specific site
 - D. All of the above
4. A builder who requests permission to build a structure that is not normally allowed to be constructed will ask the planning department for:
- A. An amendment
 - B. A variance
 - C. A conditional exemption
 - D. An upzone
5. An owner's right to use, lease, sell, build, or remodel property is most related to his or her _____.
- A. Bundle of rights
 - B. Zoning restrictions
 - C. Beneficial interests
 - D. Deed type
6. As what zone type can a subdivision in California be classified?
- A. Industrial
 - B. Mixed-Use (residential and commercial)
 - C. Residential
 - D. All of the above
7. What is another name for a timeshare interest property?
- A. Fractional reserve
 - B. Common interest development
 - C. Mutual shares
 - D. None of the above
8. What is the most logical first step for a property owner who wants to add another room to his home?
- A. Hire a subcontractor
 - B. Request a final map
 - C. Pay building fees
 - D. Request a building permit application

9. What is another name for a town's planning agency?
- A. HUD
 - B. Planning commission
 - C. Zoning division
 - D. Code enforcement
10. A property's ad valorem tax is generally assessed as _____.
A. Income tax
B. Zoning tax
C. Usage tax
D. The value of the property
11. A property's use that was once allowed under older zoning regulations established several years ago that are now outdated and no longer permitted as a use for new properties is called _____.
A. Nonconforming use
B. Conditional use
C. Exemption request
D. Variance
12. The property tax year in California is assessed from _____.
A. January 1 through December 31
B. July 1 through June 30
C. February 10 through February 9
D. June 1 through May 31

Answer Key:

1. C	7. B
2. D	8. D
3. D	9. B
4. B	10. D
5. A	11. A
6. D	12. B

CHAPTER 9

CONTRACT LAW

Overview

Contracts are the most important part of any real estate transaction. While buyers and sellers, or lessors and lessees as well as properties are usually needed for most real estate deals, it is the contract that defines the parties and the properties involved. Contracts, including numerous disclosure forms, also help real estate agents minimize their financial, license, and legal liability by confirming in writing everything from the buyer's potential risks with the purchase of a certain property, to the commission the licensee will collect upon the close of escrow.

Contracts

A contract is a promise that one party (individual or business entity) makes to another party to either do something or refrain from doing something. The individual or entity (corporation, LLC, etc.) is referred to as a **“party to the contract”** until it is complete. A contract promise can be made by just one side (unilateral) or both sides (bilateral) in the deal. The promise made by one or both parties is their **contractual obligation**, and the performance of that contractual obligation is called a **tender**.

The **tender** is the unconditional offer by one of the contracting parties to perform his or her part of the agreement. Often, a tender is necessary in a contract before any legal action may be filed to remedy or offset a breach of the contract.

If one party writes or states emphatically that he or she cannot or will not complete the original terms of the agreement and will instead back out of the deal, this is called an **anticipatory repudiation**. With confirmation that one party is definitely planning to not perform, there is no additional tender or clarification required in order to make a legal

claim to attempt to force the other party, directly, or by way of the court's enforcement, to perform their contractual obligations.

A contract has to meet certain minimum requirements in order to be legally binding and enforceable. It is the duty of each party to fulfill and complete the necessary steps on his or her side of the transaction. The party who does not complete their promise to perform and **defaults** may then be liable to the other contracting party in the transaction for **breach of contract**. If so, there may be significant monetary damages involved.

Contract Classifications

Every type of contract falls into a specific classification. These classifications include the following.

Express and implied contracts: An **express contract** is written while an **implied contract** is one that is based upon a combination of spoken words and/or actions of parties directly or indirectly involved in the transaction, such as an affiliate real estate licensee. With a written or express contract, the parties have clearly defined in handwritten or typed words what each is responsible to do in the deal.

An implied contract does not mean that there is a verbal agreement with definitive terms mutually agreed to by both sides. Rather, the implied contract might exist based upon the actions of the parties involved who appear to act "as if" there is a valid agreement in place between them. Sometimes, an agent or a selling principal may assume that another agent and principal are formally working together under a signed agency agreement, even though they do not have one in place.

Executory and executed contracts: A contract obligation that has yet to be 100% performed by one or both sides, or is in the process of being performed, is an **executory contract**. A contract obligation that has been fully completed or performed is an **executed contract**.

The word "**executed**" can mean "performed" or "signed" when used in the context of contracts, whether they are associated with real estate, wills, or any other type of legal document that binds each party to act or not act. For example, the signing of a grant deed by an executor who is handling the estate of a deceased person with multiple real properties is

described as “an executed deed transfer” in that the ownership interests in the property were both signed off, conveyed or transferred to another party, and completed.

Bilateral contracts: A **bilateral contract** is one in which two parties to an agreement must both promise to perform some action in order to fulfill the requirements of the contract. A very common real estate example for a bilateral contract is that the buyer agrees to pay \$300,000 within 45 days of the acceptance of the offer, and the seller agrees to simultaneously sign over the grant deed to the buyer once the deal has closed escrow.

Unilateral contracts: A **unilateral contract** is a type of legally enforceable promise between two or more legally competent parties to either perform or refrain from performing a specified legal act or acts. If one party does complete a certain duty or desired action, then the other party agrees to pay them cash or give them some other benefit. The party making the promise to pay is called the **promisor**, and the person receiving the cash or other item of value after completing the task is the **promisee**. The promisee gives his or her **assent** (agreement or approval) to accept the challenge to complete the task at hand by actually performing it.

An example of a unilateral contract may include a seller offering a real estate agent in another town a commission if he brings a buyer over to purchase his home. While the real estate agent is under no formal obligation to perform and actually find a buyer, partly because he doesn't have an agency or listing contract in place with the seller, he does have the unilateral (or one-sided) option to perform or not. Or, in a different scenario, a landlord may offer a \$500 bonus to any licensed agent who brings in a tenant with a signed lease agreement within the next week. It is performance for money.

The Elements of a Valid Contract

The acronym **COLIC** is one of the best ways to remember the five core elements required for a valid and enforceable contract in the state of California. A contract does not necessarily need to be in any particular format or style, but it must contain all of the essential elements to be valid. This is how COLIC is broken down and defined:

Competent parties

Offer and acceptance

Legal Purpose

In writing and signed

Consideration



Competent parties: A party must first have the legal capacity to enter into any type of formal written contract agreement prior to later being

legally held to those promises and terms originally agreed to. A party who is **incompetent** may not be held to those contract terms.

In order for a person to be considered competent, they are required to meet a few basic requirements beginning with the qualifying issues of (1) the **minimum age, 18**, (also known as the “age of majority” or the age when a person is legally considered an adult), and (2) whether they are of “sound mind” with no significant emotional or mental health issues.

A contract that is entered into by someone under the age of 18 is **voidable** by the minor person. The contract may be set aside by the minor as opposed to the other party in the contract, as long as the other party understood prior to executing the contract that he or she was entering into an agreement with someone who is under 18. Should the minor wish to proceed with the signed contract terms, then he or she remains legally bound *in most cases*.

Some people under the age of 18 in the state are legally “emancipated” by courts and formally declared “adults” even if they are as young as 13, 14, or 15 years of age. If so, then the younger emancipated party should much more easily be considered competent to enter into an otherwise valid contract. Some designated parties like a wealth advisor, court-appointed trustee or guardian, or an **attorney-in-fact** may serve as a fiduciary for a person (whether that person is an adult or either an emancipated or unemancipated minor) who appointed the fiduciary to sign contracts on their behalf under a trust agreement, court order, or power of attorney.

The properties and the wishes of parties who are now **deceased** may be handled by an executor named in a will, by an administrator appointed through probate court, or by a trustee on behalf of an existing family trust agreement, family limited partnership, or some other type of asset protection and conveyance document. The sale of the deceased person’s former primary home is one of the most common examples of a third party handling the sale of assets for a named deceased party. In situations like these, after the passing of a property owner, the court or family-appointed trustee, guardian, or executor will likely sign off on the grant deed prior to the completion of the sale.

Real estate agents may often be working with foreign-born property buyers and investors in California. We have a large population of

immigrants from Mexico and Central and South America, as well as from Asia. A foreign-born resident who lives in California, perhaps not yet a U.S. citizen, still has many of the same property and contract rights as a citizen.

Criminals who are currently serving prison sentences, and past felons also have certain rights to sell or purchase real property as well as to enter into many types of contracts.

Offer and acceptance: This is legally defined as a **mutual agreement** in contract negotiations. All parties involved in a contract such as a buyer and a seller, must either agree to all of the terms made in an original offer, or make a counter-offer in reply. The “**meeting of the minds**” in contract negotiations is also called **mutual assent**. Later in the transaction, both parties may decide together to voluntarily cancel or revoke the deal, which would be a **mutual rescission**.

Mutual agreement cannot truly exist if one or more parties entered into the contract due to the reliance upon deliberate deception, misrepresentation, coercion (by actual threats or under duress), or fraud. Contracts that were entered into based upon inaccurate or incomplete information, whether intentional or unintentional, may later be found to be **voidable** or completely **void** by one or more parties. For example, where one party tells an absolute lie that they know to be 100% false (also known as an “act of commission”), or fails to reveal or fully disclose a known material fact (“act of omission”), the contract may be voidable or void.

With respect to an **offer**, the person making the offer to purchase is the **offeror**, and the person receiving the offer is the **offeree**. On the standard, pre-printed real estate forms in California, it is relatively easy to determine which party is the *offeror* and which one is the accepting *offeree*.

Termination of Offers

There are several ways that an offer may be terminated by one or more parties involved in the contract. The quickest way to terminate an offer is if the offeree (i.e., the party who received the offer to purchase their home) immediately rejects it, or if the offeror changes her mind and revokes or cancels the offer before the offeree can respond.

The most common situations where an offer is terminated before being accepted include: 1) revocation of the offer by the offeror; 2) time lapse (where the seller/offeree missed the time deadline to respond); 3) the death or incompetence of the seller/offeree or buyer/offeror; 4) rejection by the seller/offeree; and 5) a counteroffer made by seller/offeree even if the new terms are just slightly different from the original offer.

Acceptance: The first step in the formal creation of a contract begins when the offeree/seller (or lessor) has communicated his or her formal acceptance back to the offeror/buyer (or lessee) within the required time limit stated in the contract. But if the acceptance of the offer is made under the pressure of **undue influence**, the contract is typically voidable by the offeree who was unduly influenced. An acceptance made with **undue influence**, where the offeree is not allowed to act under his or her own free will creates a voidable contract. Undue influence is where one person takes advantage of his or her position of power over another person to get the latter to sign the contract. The offeree may also sign the contract under **duress**, when he or she is being forced to do so, either by threats of physical harm, emotional blackmail, or outright fraud. Contracts are typically **voidable** by the party who acted while under duress.

There are varying degrees of fraud. The **intentional misrepresentation** of a fact as told by one person to another who takes that same misrepresentation as the valid truth prior to entering into a contract or a real estate transaction is considered *fraud* or a *fraudulent act*.

Actual fraud: This type of more definitive fraud occurs when a person knowingly and willingly makes a false statement of material fact with the intent to deceive another party in matters that usually involve financial gain like a real estate commission fee or profit from the sale of a home.

Constructive fraud: This is more of an unintentional type of fraud due to careless or reckless behavior or even an honest mistake.

Legal purpose: When a contract requires performance that is unlawful, it is *not* a valid contract. For example, a lease that does not allow an unmarried person with a young child to lease an apartment would probably violate the familial status portion of the Fair Housing Act since it discriminates against young families. Thus, such a contract would be void.

In writing and signed: California, and most other states, require that various types of contracts and agreements must be in writing for them to be valid, enforceable, or at least voidable by one party. It is very rare for courts to enforce an unwritten contract that was required to be in writing, so agents must be aware of the legal requirements. Under the **Statute of Frauds**, certain types of contracts, such as listing agreements, agency authorization forms, lease deals, and real estate loans are required to be in writing, especially the following:

- an agreement for more than a year, such as a lease contract;
- an agreement to finance real property with a new mortgage loan (i.e., a bank, private money, or seller-financed first, second, or wrap-around loan); or
- an agency agreement, which authorizes a real estate licensee to act on behalf of a principal as a listing or selling agent in a purchase deal or in a lease transaction that lasts more than 12 months.

Per the **California Civil Code - CIV § 1624:**

“(a) The following contracts are invalid, unless they, or some note or memorandum thereof, are in writing and subscribed by the party to be charged or by the party's agent:

(1) An agreement that by its terms is not to be performed within a year from the making thereof.

(2) A special promise to answer for the debt, default, or miscarriage of another, except in the cases provided for in Section 2794 .

(3) An agreement for the leasing for a longer period than one year, or for the sale of real property, or of an interest therein; such an agreement, if made by an agent of the party sought to be charged, is invalid, unless the authority of the agent is in writing, subscribed by the party sought to be charged.

(4) An agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate, or to lease real estate for a longer period than one year, or to procure, introduce, or find a purchaser or seller of real estate or a lessee or lessor of real estate where the lease is for a longer period than one year, for compensation or a commission.

(5) An agreement that by its terms is not to be performed during the lifetime of the promisor.

(6) An agreement by a purchaser of real property to pay an indebtedness secured by a mortgage or deed of trust upon the property purchased, unless assumption of the indebtedness by the purchaser is specifically provided for in the conveyance of the property.

(7) A contract, promise, undertaking, or commitment to loan money or to grant or extend credit, in an amount greater than one hundred thousand dollars (\$100,000), not primarily for personal, family, or household purposes, made by a person engaged in the business of lending or arranging for the lending of money or extending credit. For purposes of this section, a contract, promise, undertaking, or commitment to loan money secured solely by residential property consisting of one to four dwelling units shall be deemed to be for personal, family, or household purposes."

Per the Statute of Frauds, a valid contract could be in a wide variety of forms such as handwritten, typed, or included in a note, memorandum, or in a series of letters, emails, texts, or some other physical or virtual form of communication. The subject matter such as the identification of the property and price, the confirmation of mutual acceptance, and the signatures (real or digital) from the parties involved in the offer are at least some of the main requirements for the contract to be considered legal and binding. Any handwritten portion of a contract is actually considered more reliable than a pre-printed portion should any future disputes arise between the parties.

Legal Description: No two tracts of land or improved real properties are exactly the same. A contract involving real estate is not usually valid unless there is a definitive description of the subject property involved by way of a physical street address and/or some type of legal description such as a lot, block, and tract number. Without the valid legal description or address of the subject property in the real estate contract, then title, escrow, appraisal, and other third-party entities cannot complete their required steps as well in the real estate transaction process. (Some other states besides California do recognize the **legal description of real property** as a sixth element necessary because it is so important for a valid real estate contract.)

Because there are so many residents in California who speak more than one language, such as Spanish, Japanese, Chinese, Korean, and

Vietnamese, some business customers must receive a copy of the contract for real estate, mortgage, and other types of transactions in both English and their primary native language before they are allowed to sign the English version of the contract. This is especially true as it relates to the purchase, sale, leasing, and financing of real properties here in California. Borrowers in financial transactions must be given a translated copy of their loan application within three business days after receiving the original English version of the mortgage paperwork.

Consideration: The **exchange of promises** offered by each party to the other to do or not do something is perhaps the main core of consideration. Unlike the act of giving a gift to someone while expecting absolutely nothing in return, **consideration** is when something of value is offered by each party. In sales transactions, the seller agrees to sell the identified property in the contract to a buyer who is willing to pay the mutually agreed-upon price within the stated time period. In sales deals such as this, the **things of value** are the real property and the money. Other types of consideration may include the literal exchange of real properties without any cash involved, a service performed in exchange for another service or money. Consideration must be legally sufficient and bargained for.

Earnest money deposits are not required as a form of consideration when finalizing an offer and acceptance in real estate transactions. The earnest money deposit or **liquidated damages**, which may be equivalent to a negotiable percentage rate near 3% of the offering price, is seen as a form of “good faith” and serious intent to purchase the property in the event the buyer is unable to perform and later close the transaction. It is not required to be included as a form of consideration in a contract, but it is routinely done in real estate deals.

Contracts' Legal Status

There are **four (4) main legal statuses for a contract**. The status options include the following:

- **Void:** This type of contract has absolutely no legal effect; it is unenforceable because it is based upon fraud, it is lacking a competent party or parties, there is no mutual consent, and/or it is related to an unlawful object.

- **Voidable:** A voidable contract is one that is imperfect. It may appear to be valid, yet it has some minor or even serious flaws that could allow one or both parties to back out of the contractual agreement. As discussed earlier in this chapter, an example might include when one party enters a contract at the age of 17 with a landlord to rent an apartment unit. Before the prospective tenant moves into the unit, he may have the legal right to back out of the deal because he had not reached the primary “age of majority” of 18 years. The landlord may pursue legal actions in hopes of having a nearby court **ratify** or confirm the validity of the contract in situations where the underage party did not act quickly enough. Or, the 17-year old may ratify the contract by continuing onward with the deal in spite of the fact that the contract is voidable.

- **Unenforceable:** An unenforceable contract is one that cannot be enforced by a court because: 1) the content cannot be proven (e.g., it is an oral agreement to which there were no witnesses); 2) the contract may still be voidable by one party before it can be legally voided or terminated by the other party; and 3) the Statute of Limitations has expired (or the time limit allowed to make a legal claim).

Under the Statute of Limitations in California, an injured party allows claimants or plaintiffs to bring civil complaints or lawsuits up to **four (4) years** after the date of breach incident in regard to written contracts. For oral contracts in California, injured parties must file within **two years** of the breach date. (See discussion of Breach of Contract below.)

The **Doctrine of Laches** is a legal doctrine that courts closely follow that has many of the same elements included in the Statute of Limitations. Laches are “an equitable principle” that prevents someone from asserting a legal claim after an unreasonable time delay. An example would include a judge denying the filing of a lawsuit over a disputed written

listing contract in California because the injured party filed the civil complaint four years and one day after the date of injury.

- **Valid:** A valid contract has all of the required elements, but minimally it requires competent parties, a written offer for a legal purpose, an acceptance, and consideration. Again, if a contract is voidable, as discussed above, some reasons can be cured, and the contract will still be valid (such as the 17-year old who enters a lease and does not back out).

Formally Ending a Contract

A contract can end positively, negatively, or somewhere in-between or neutrally, depending upon the personal perspectives of the parties involved like the principals or agents. Most parties who enter into a contract probably hope that the terms and promises to perform are met by all sides, partly because it usually means each is getting some sort of financial benefit or asset gains related to home sale profits, real estate brokerage commissions, or a newly-purchased residential or commercial property.

A valid and enforceable contract may be discharged by way of: 1) full performance; or 2) an agreement between the parties.

Full performance: Full performance of the contract is when all parties bound to the contract have performed their promises, the contract was executed, and the deal was completed. A typical example is when the buyer brings in the required funds to purchase a home, the seller hands him the grant deed, and escrow and title fund, record, and close the transaction. Once the deal closes escrow and is finished, the previous purchase contract has been discharged by full performance.

Agreement by the parties: Parties to a contract may agree to terminate or discharge the agreement by way of Rescission, Assignment, Cancellation, or Novation.

Rescission: Rescission is when both parties mutually agree to rescind or take back the contract. The formal taking back of the contract or deal is done through the process of **rescission** (which is basically a contract to terminate a contract). Both parties will usually need to sign an

agreement to end the deal partly to get any earnest money deposit funds released back to the payor, buyer, or tenant. Sometimes, courts will enforce the formal rescission if both parties cannot mutually work it out between the two of them.

Assignment: An assignment is where one party to a contract is able to assign his or her interests in the contract to another unrelated party, unless it is clearly prohibited according to the original terms of the contract. The person assigning his interests in a contract is called an **assignor** while the person receiving the contract interests is an **assignee**. The assignor in a contract transaction may still have secondary liability down the road in the event that the assignee is unable to perform as required by the terms of the contract.

Sometimes an assignment may be made if a back-up buyer takes the place of the first buyer accepted in a purchase deal after the first buyer voluntarily decides to withdraw his offer. A personal service contract cannot be assigned to another party without the express written consent of the party obligated to perform the services.

Cancellation: If both parties agree to end the contract even though some of the required acts outlined in the contract were already performed, that is a cancellation. Cancelled deals may include financial losses for one or both parties due to expenses incurred during the early stages of the contract deal. Unhappy parties may later pursue legal actions against the other parties involved such as a principal, real estate agent, and/or the employing broker and his or her insurance carrier.

A prime example would be a home purchase deal where the buyer had to qualify for a third-party loan from a local mortgage broker. At the time of the offer and acceptance, the buyer wrote a check for a **Good Faith Deposit** that was equal to 3% of the full purchase price (or \$15,000 for a \$500,000 purchase deal). The check was placed into a trust account managed by an escrow company. The buyer also spent another \$600 on third-party inspection reports that were related to an appraisal and a pest control report. If the buyer missed the contingency time periods built into the purchase contract such as full loan approval within 21 days of the seller's acceptance date, then the buyer might end up with a cancelled contract and financial losses of \$15,600.

Novation: One type of **novation** option (“a substitution of parties or the contract itself”) includes the replacement of one party in an existing agreement who is also relieved of any and all liabilities associated with the contract. The second type of novation agreement is when both parties agree to replace the existing contract with an entirely new contract altogether. A novation for one party or the entire contract cannot be completed without the mutual consent of all parties involved.

Breach of Contract

A breach of contract, or a defaulted contract, occurs when one of the parties is unable to perform their promises made in the original contract without a valid legal excuse. The party injured by the default may be entitled to financial or legal relief if the breach is shown to be a **material breach** (i.e., an unfulfilled obligation which is a key part of the contract).

Time is possibly the most important commodity of them all as it relates to both life and real estate. The phrase **“time is of the essence”** is included in many real estate contracts. The simple definition is that all parties to a contract such as principals, agents, escrow officers, title companies, and third-party inspectors, must work as quickly and effectively as possible so that the deal closes on time. One of the most likely ways for a deal to fall apart and for one or more parties to lose money as a result is that the contingency (e.g., appraisal, mortgage loan approval, pest control inspections, etc.) or closing deadline dates were not met on time.



If the time period is not met, then one or more parties will be in **breach of contract**. The four legal reliefs that are most common for breach of contract are:

- Rescission
- Compensatory damages
- Liquidated damages
- Specific performance

Rescission: The act of rescission takes both parties back to the position before they formally entered into the contract. It is as if the deal never took place. The easiest and cheapest way for both parties to rescind or terminate a deal is by mutual agreement. Otherwise, a costlier and more timely approach is one that involves a court, and that may last for several months or years.

Compensatory damages: These types of financial damages can be a court-awarded judgment or a order from a Small Claims Court (up to \$10,000 if the plaintiff was an individual in California; \$5,000 if the claimant was a corporation or some other business entity) or from a Superior Court with no upper limits for the financial damage claims. These are the most common types of legal remedies for breach of contract situations.

Liquidated damages: The earnest money deposits, or Good Faith Deposits, may automatically become liquidated damages should the buying principal not be able to perform as promised, per the mutually agreed upon original contract terms. In most types of California real estate contracts, the seller is most likely entitled to the full amount of the collected Good Faith Deposit amount. Yet, if the seller takes the entire liquidated damage amount, he is usually prohibited from filing a civil complaint for even more money in a nearby court. If, on the other hand, the seller is not able to perform, the buyer may have the option to take back their earnest money deposit and sue the seller for additional compensatory damages in court.

Specific performance: An order of the court which requires that one party to the contract *must* perform a specific act that was included in the executed or signed contract. In many ways, it is an alternative to

compensatory damages or a new claim in civil court. It is considered an “equitable remedy” by way of injunctive relief that makes the injured party whole once again.

A very common example of a specific performance request is when a buyer is purchasing a new tract home for \$400,000, and, while the deal is tied up in escrow, the builder accepts an offer for \$475,000 for the same property from another ready, willing and able buyer. The builder, in turn, cancels the first offer for \$400,000 after realizing that he sold the home well below current market value, even though the first buyer has met all of the required terms and conditions on a timely basis.

The buyer’s legal remedy is to file a request for specific performance at the local court. Any subsequent injunction awarded by the court to the buyer after reviewing the contract’s main points will be a court order that compels or demands that the builder sell the at-issue property to the original buyer for the \$400,000 sales price. If the builder refuses to follow the court’s instructions, then the builder can face additional civil and criminal penalties which may even include imprisonment due to charges such as contempt of court (for not following the judge’s instructions).

Chapter Nine Summary

- A **contract** is a promise that one party (individual or business entity) makes to another party to either do something or refrain from doing something. The promise made by the parties is their **contractual obligation**.
- The party who does not complete their promise to perform is in **breach of contract**. If so, there might be significant financial damages involved that are payable to the injured party.
- An **express contract** is a written one, while an **implied contract** is one that is based upon one or more combinations of spoken words or actions of parties.

- A contract obligation that has yet to be performed by one or both sides is an **executory contract**. A contract obligation that has been fully completed, performed, or signed is an **executed contract**.
- A **bilateral contract** is one in which two parties to an agreement must both promise to perform in order to obligate one another to the signed contract. A **unilateral contract** is a one-sided agreement that obligates just one party (“promisor”) to make payments should the other party (“promisee”) agree to later perform the requested contract or job functions. An example may include an open listing agreement where the seller agrees to pay a 3% commission to any agent who brings him a qualified buyer.
- The five (5) main elements of a valid and enforceable California contract are COLIC:) **C**ompetent parties;) **O**ffer and acceptance; 3) **L**egal purpose; 4) **I**n writing and signed; and 5). **C**onsideration.
- The four main legal statuses for a contract include: **Valid, Void, Voidable, and Unenforceable**. A valid and enforceable contract may be discharged or terminated by way of: 1) Full performance (closing the deal); and 2) An agreement between the parties (mutual rescission).
- Earnest money deposits, or Good Faith Deposits, may automatically become **liquidated damages** should the buying principal not be able to perform as promised (or breaches the contract). This is usually the main way that parties are compensated for nonperformance of a signed contract in real estate deals.

Chapter Nine Quiz

1. Which answer below makes a contract the most valid?
 - A. One party was under duress
 - B. A contract that is put into writing
 - C. Consideration in the amount of less than \$10
 - D. One party who lacks legal capacity
2. When may a 17-year old person sign a valid contract?
 - A. When they don't live with their parents
 - B. As an orphan with no parents
 - C. When it is notarized
 - D. When they are emancipated after a court's approval
3. Which type of contract is currently in the act of being performed or completed?
 - A. Executed
 - B. Implied
 - C. Executory
 - D. Tentative
4. What is the illegal act of forcing someone to do something against their wishes such as signing a contract?
 - A. Implication
 - B. Misrepresentation
 - C. Express Fraud
 - D. Duress
5. Which answer below does *not* officially terminate a contract or agency relationship?
 - A. Contract term expires
 - B. Offeror revokes his offer
 - C. Offer, acceptance, and closing of the deal
 - D. Death of one party

6. What is the name of the process when both parties want to terminate the contract before it expires?
- A. Rescission
 - B. Revocation
 - C. Amendment
 - D. Assignment
7. What happens during the assignment of a contract?
- A. A new party takes over all contract liability
 - B. The assigning party transfers his contract interests to a new party, but remains secondarily liable
 - C. A contract is terminated
 - D. The assignee gives back all interests to the original assignor before the contract was scheduled to end.
8. Which type of contract may be ended by one or both parties due to a defect in the contract?
- A. Valid contract
 - B. Voidable contract
 - C. Illegal contract
 - D. Void contract
9. The Statute of Frauds requires that _____.
- A. Some contracts must be bilateral
 - B. Certain contracts must be written and signed
 - C. All contracts have a minimum consideration amount
 - D. All real estate lease contracts must be written
10. What is the financial loss called when a party to a contract suffers financially because the other party does not fulfill their contractual duties?
- A. Damages
 - B. Violation
 - C. Breach
 - D. Tort
11. An executed contract is one that is _____.
- A. Implied
 - B. Written
 - C. Signed
 - D. Both B and C

12. What is the law that sets a deadline date for claimants or plaintiffs to file a lawsuit from the date of perceived injury?

- A. The Statute of Limitations
- B. Judiciary Law
- C. The Statute of Fraud
- D. The Law of Contracts

Answer Key:

1. B	7. B
2. D	8. B
3. C	9. B
4. D	10. A
5. C	11. D
6. A	12. A

CHAPTER 10

REAL ESTATE CONTRACTS

Overview

This chapter will focus more specifically on the most popular types of contracts used in the real estate field today. These real estate contracts include listing and purchase agreements, leases with an option to purchase, seller-financed wrap-around mortgages and first mortgage carrybacks, commission-split designations, and more simple lease agreements. While solid marketing and selling skills are vital aspects of the real estate profession, the understanding and proper use of contracts is at least equally as important to agents and may be the main difference between a short and long prosperous career.

Listing Agreements

A contract through which a seller formally employs a broker to sell his or her real property (residential, commercial, land) to the general public is called a **listing agreement**. Essentially, the listing contract is a type of employment contract in which the seller is the employer and the listing agent is akin to an employee who is usually working with payment deferred until, hopefully, the property sells. At the point of sale and then close of escrow, the seller will then pay a **commission** (also referred to as a **brokerage fee**) to the listing agent's brokerage office.

The broker makes a sincere promise and effort to sell the client's property by way of the signed listing contract. The listing contract does *not* assign authority to the broker to accept offers or allow the broker to sign the grant deed and transfer title on the buyer's behalf. The listing agreement is more like a confirmation of an agency relationship between the licensee and the employing principal/seller.

Commissions

The main incentive that inspires an agent to accept a listing agreement is the **commission** fee that is mutually agreed to by both the seller and the agent in the listing agreement. Most often, the listing fee is based upon a percentage of the selling price as opposed to the original listing price.

For example, with respect to brokerage commission fees, the seller agrees to pay the listing broker 3% of the selling price and an additional 3% to the buyer's agent for a grand total of 6% in commission fees. A home that closes escrow at \$1 million dollars will generate a \$30,000 (3% of \$1,000,000) gross commission to the listing agent and another \$30,000 to the buyer's agent for a total commission payout of \$60,000. The listing agent must then usually split his or her share of the commission with the listing agent's employing broker. Those two also have a contract; it is a written employment contract with percentage amounts that might vary between 50% to the employing broker and 50% to the selling agent under him for newer agents and upwards of 80% to the selling agent and 20% for the employing broker for more experienced and successful agents who generate a high percentage of their office's entire closings each year.

Under California law and the Statute of Frauds, a listing broker cannot sue the seller for not paying him or her a real estate commission after the sale of a once-listed property unless there was a formal written agreement in place. The written agreement that most protects real estate licensees in listing transactions is the listing agreement.

An oral agreement between two or more brokers or agents to split a real estate commission may be enforceable by the courts (although probably not advisable). However, an agreement to pay a commission by a seller to a listing agent must be in writing for it to be enforced.

To collect a commission, a real estate professional must have an active license at the time of payment and must have sold the property, according to the terms of the listing contract before it has officially expired. (e.g., The property is sold on the 89th day of a 90-day listing contract; the licensee may not sell it on the 91st day without first having asked for and gotten an extension of the listing agreement beyond the 90 days).

An unfortunate part of the real estate profession that can cause grief, heartache, and financial pressures is when two or more agents argue over the payment of a commission fee after they both believe that they were the **procuring cause**, or the main reason, that the property sold and closed escrow.

One of the key determining factors for deciding which agent is entitled to the collection of the commission is if they brought a **ready, willing, and able buyer** (as is described in a clause in the listing contract) to the property prior to the sale and close of escrow.

Ready and willing: In accordance with California real estate law, a buyer who makes an offer that meets the seller's terms is a "ready and willing" buyer. This is especially true when the buyer agrees to match the seller's expected terms, such as offering the exact asking price, meeting the contingency dates and the closing date time period without asking for additional repairs from the seller prior to the close. Even if the seller rejects the buyer's offer which meets or exceeds the seller's needs and expectations, the listing broker may still be entitled to collect his or her full commission when the home sells. Conversely, brokers who bring in buyers' offers that do not match the seller's term requests are not entitled to the collection of a commission fee unless the seller fully agrees to the buyer's offering terms before later selling and closing the deal.

Able buyer: The definition of "able" in the context of a real estate buyer prospect is that he or she is financially able to purchase the property. An "able" buyer might have access to 100% cash or to some combination of personal cash, a gift, and perhaps third-party financing provided by a bank or mortgage broker. Ability to purchase must be confirmed by way of some type of pre-approval mortgage letter which includes the maximum qualifying mortgage loan amount, among other terms.

An agent who brings in a "ready, willing, and able buyer" to a seller who later is unwilling or unable to sell the listed property may be entitled to a full commission even without the sale going through if:

- The seller has a change of heart, and decides that he does not want to sell.

- The seller's title is not marketable because of judgment liens or other parties having ownership or beneficial interests that prevent the sale.
- The seller is not able to hand over possession of his rental property because the tenants refuse to vacate.

Some commission disputes can be over tens or hundreds of thousands of dollars for higher-priced residential and commercial real estate transactions in California. As a result, many conflicts over commission fees later end up in court where a judge or a jury may decide the outcome.

In California courtrooms, the determining factor for commission disputes typically revolves around two main issues: 1) which licensee really brought in the “ready, willing, and able” buyer; and 2) which licensee has a signed listing, buyer's brokerage, or some other type of real estate contract in hand from the seller?

The Types of Listing Agreements

The payment of a broker's commission is dependent upon the signed listing agreement that exists between the real estate agency and the seller. The three main types of listing agreements are:

Open listing: This type of listing agreement is much like a unilateral contract that is offered by a principal or seller to more than one real estate agent in the area. With an open listing, one party offers to pay a commission to any broker should they decide to accept the offer and bring in a new buyer.

While no broker is legally bound to perform when working with the seller since they have no formal signed contract in place, the seller agrees to pay them should they actually perform. It is a **non-exclusive** listing that is often seen with FSBO (For Sale By Owner) transactions that are offered to more than one agent. The first broker who brings in a “ready, willing, and able” buyer with terms that are acceptable to the seller will likely be the broker to get paid a commission. In situations like this one, the agent who performs is the **procuring cause** in the transaction and is entitled to

the collection of the commission.

There are potential disadvantages for licensees who decide to work on open-listing deals:

- Two or more brokers might later end up battling over the commission payment for bringing in the same buyer who later closed escrow. Often, a customer prospect might meet two or more brokers at Open Houses in the area prior to spending an equal amount of time with each agent. If so, each agent may believe that the customer is his or her client even though neither one of them has a signed buyer's agency contract with that customer, nor a listing agreement signed by the seller.
- Brokers who make a verbal offer to assist with the sale of an open listing property probably will not spend as much time working on marketing the property or too much money in advertising costs to sell the property because there is no guarantee that the broker will ever get paid a commission.
- When owners do not want to sign an exclusive listing agreement with one broker as most sellers will eventually do, the odds are much lower that the property will ever get listed in a local MLS system since the MLS
- usually will not accept open listings. With fewer marketing options and less exposure to agents and buyer prospects in the general area, the odds of success with the sale of the property may decline.
- On the other hand, brokers with signed listing agreements in place will probably work much harder to market the property because the likelihood of a future sale and commission payout is much higher, and it is spelled out in the listing agreement's commission split section.

Exclusive agency listing: The seller appoints just one broker to list his or her property for sale. The same listing broker will get paid a commission if he or she finds a "ready, willing, and able" buyer or if another licensed agent brings in a buyer. The only exception to this commission rule is that the seller can avoid paying the commission to

the listing agent if the seller finds the buyer him or herself. In accordance with California law, there must be a definitive termination date built into the listing contract or the agent may have to deal with serious disciplinary actions from the DRE.



Exclusive right to sell listing: This listing contract is, by far, the most preferred type of listing agreement that real estate agents ask for when making their presentation to a seller prospect. The listing agent will get paid a commission upon the closing of the sale, regardless of whether the listing agent, another broker, or the seller found the buyer. The commission will often be shared with a buyer's broker or subagent who actually brought in the buyer with commission splits that may be somewhere near 3% to the listing agent and 3% to the buyer's agent.

Typically, an exclusive right to sell listing has a **safety clause** (also referred to as a "protection period clause" or "protection clause") included within the listing contract that protects a listing agent's buyer prospect even well after the original listing contract expired. One of the best ways to protect clients is to provide a registered list of buyer prospect names to

the seller. Sometimes, a devious buyer and seller will agree to postpone their sales agreement until after the expiration of the listing contract in order to save upwards of 6% in commission fees. The safety clause will offer the listing agent even more layers of protection with regard to receiving his or her commission.

Both types of exclusive listing contracts are **bilateral contracts** through which the seller will agree to pay a commission if the same listing broker or another broker brings in a buyer. On the broker's side of the bilateral contract, he or she promises to perform by working as hard and effectively as possible even though the property may never sell. Should the seller successfully prove in court that an agent played no major role as a "procuring cause" in the sale of the property, the court may side with the seller and agree that the agent is not entitled to collect any commission.

Listing Agreement Components

As discussed earlier, the primary core elements that are required for most types of valid contracts include: 1) An offer and an acceptance; 2) competent parties (legal age and mental capacity); 3) consideration (money, service, or property exchanges); and 4) a lawful intent.

The most important part of a listing and commission agreement between a seller and a licensee is that it must be in writing. In California, a seller is highly unlikely to lose a lawsuit over unpaid brokerage commissions where there was an oral agreement instead of a more concrete written contract.

A written listing agreement should include:

Property description: The physical street address and/or the lot, block, and tract number (or some other legal description) must be included so that the property may be easily identified and is not later confused with another property sale.

Proposed terms of sale: The seller should note clearly exactly what terms and conditions are acceptable, especially the expected sales price and length of the listing term.

Broker's granted authority: The seller shall confirm in writing what powers that the listing agent has when acting on the seller's behalf. These powers might include the legal right to accept earnest money deposits from buyers and hold open houses on days when the seller is at work or out of town.

Defining the brokerage commission fee: Since most brokers do not work for free and do not typically receive salaries, their primary income comes from collecting fair amounts of commission fees for all of their hard work and for their investment in marketing expenses. Usually, the commission is a certain percentage amount of the selling price, such as 1%, 3%, 6%, or higher. But commission fees are not "set in stone," and can be negotiated in each transaction based upon the amount of work involved, the seller's profit margin, and other factors.

In some commercial and residential real estate transactions, a **net listing** fee is offered by a seller partially as incentive to find a buyer willing to pay more than a fixed dollar amount that the seller wants to net. Any net sales price over and above the seller's target price may be kept as a full commission by the listing agent as long as the commission amount collected is fully disclosed by the agent to the seller prior to the opening of escrow in any type of open or exclusive listing transaction, per California law.

A net listing example would be one where a seller wants to net \$500,000 on the sale of his land on an open listing agreement. A nearby broker brings in a qualified buyer willing to pay \$550,000 plus all closing costs for the buyer and seller. In this example, the seller nets \$500,000 and the broker keeps the extra \$50,000 as a commission that is equivalent to a 10% commission split.

Commission payments are usually paid directly by an escrow or title company in California by way of check, unless another method is mutually agreed to by the parties involved. On some lengthy and complex real estate transactions, the agent may be entitled to additional expense repayment fees (e.g., the agent spent \$1,000 to market the property to out-of-state buyer prospects) for a period of six months over and above the commission payment if mutually agreed to by all sides in writing.

Usually, the seller, an attorney, or another third party, like a court-appointed representative such as a guardian or trustee, or a privately

appointed attorney-in-fact will write the check or wire the commission funds directly to the employing brokerage firm rather than to the salesperson licensed under their main broker. Otherwise, it is a serious violation of both contract and real estate law.

Commission splits options for listing properties are easily found by licensees on the local **Multiple Listing Service (MLS)** in more urban and suburban regions of the state. The MLS is an organization made up of brokers wishing to share their listing details with as many qualified brokers as possible in order to increase the chances of a quick sale. For most properties listed in the MLS, the usual split is 50% to the buyer's agent and 50% to the selling agent unless otherwise noted.

Buyer Representation Agreements

A written agency representative agreement between a buyer prospect and an agent is known as a **buyer representative agreement**. The buyer prospect tells the agent what sort of property he or she is looking to purchase in the near term with details such as the price range, the minimum square footage, the number of bedrooms and bathrooms, the desired school system location if the buyer has children, the expected duties to be performed by the agent, and the broker's target commission fee.

The buyer's agreement may be structured as **exclusive** or **nonexclusive** contracts between the principal and agent. With an exclusive buyer's agreement contract, the agent may still be entitled to the full payment of the commission if the buyer finds a property to purchase during the term of the contract such as within a 60 or 90-day agency time period. This is true whether or not the same buyer's broker does not negotiate any of the terms or handle the paperwork.

A buyer's agent may be expected to find and show the properties to the client, assist the client with obtaining mortgage qualification, and negotiate the terms of the purchase deal with the seller and listing agent. Most buyers' agents also handle the setting of appointments with third-party inspectors such as appraisers, pest control inspectors, and environmental specialists, among others.

A buyer's agent is not usually prevented from showing the same listed

property to multiple buyer prospects. He or she may actually represent two or more buyers attempting to make an offer on the exact same property, but only if it is fully disclosed to all key parties involved.

In some cases, the buyer prospects will search out the properties by themselves before later settling on one specific home that interests them. They will then hire a buyer's agent to negotiate the price and terms for a smaller commission that must be laid out in a written contract between them. The property address and/or legal description must be included in these buyer representation agreements for them to be enforceable.

In most real estate transactions, it is the seller or landlord who is paying the commission to one, two, or more real estate agents involved in the deal. Under California law, the broker's duties remain unaffected by the fact that his own client is not actually cutting the commission check. Yet, the funds are usually originating at least indirectly from the agent's buyer or tenant client. After all, the buyer's or renter's money is typically where the seller's or landlord's proceeds come from at the closing of the transaction.

There are situations where the agents directly receive **buyer or tenant-paid fees**, regardless of whether or not the agent ever closes a deal with them. These situations are more likely in commercial real estate, land, and development deals than the standard home sale deal.

The buyer or tenant prospect may agree to one of the following payment options with the agent: 1) payment of a commission based on a percentage of the final purchase price or of the rent (sometimes, the agent will receive a commission percentage from both the buyer and seller); 2) a fixed hourly rate for services performed that is similar to a consulting fee; or 3) a fixed specific amount of money like \$5,000 or \$10,000 that will be paid if the buyer closes escrow on a transaction within a definitive amount of time, regardless of the final purchase price or lease amount.

Some brokers will request or demand an upfront **retainer** fee of, for example, \$1,000 or \$2,000, from his or her buyer or tenant client before diligently working hard to find them their desired property. The retainer is generally a nonrefundable deposit which is paid directly to the employing broker before an agent begins to work on finding residential, commercial, or land property that suits the buyer's needs. If and when

the client later closes escrow on the purchase of real property with the same buyer's agent, the retainer fee may or may not be credited or deducted from the broker's earned commission, depending upon what was originally negotiated.

Purchase Agreements

If and when the buyer and agent find a property together that suits the buyer's needs, they will complete a written contract with all of the written terms and conditions. This is called a **purchase agreement**. The standard purchase agreement form includes sections for the buyer's initials and signatures and a proposed earnest money deposit that is offered. An offer of 3% of the purchase price, for example, may be a Good Faith Deposit for **liquidated damages**. This is offered by the buyer to the seller to ensure that he or she will perform on a timely basis. If he or she does not do so, the seller will probably be able to keep the entire deposit.

Should the buyer's terms and conditions be acceptable to the seller, then he or she will sign it and make it a binding contract between all parties involved (principals and agents). Additionally, the buyer will likely be provided with a receipt for the paid deposit from the seller. Sometimes a purchase agreement is referred to as a **deposit receipt**.

At this stage, the buyer has **equitable title**, which are legal interests, as opposed to true valid ownership interests in the property up until the purchase deal closes. These equitable title interests may later need to be protected by a court in a legal action if the buyer has met his or her requirements per the purchase terms, but the seller is trying to back out of the deal due to a change of heart and subsequent breach of contract. A court may rule that the seller *must* sell the property to the buyer. Such a remedy is called **specific performance**.

The purchase contract is the legal document that details the required steps or tasks in the transaction process which must be met by all sides in the deal in order for the deal to close on time. Some of the most important elements associated with a valid, written purchase contract include:

- the identification of both parties;
- the legal description of the property;

- the price and the way the funds will be paid (cash and/or bank loans); and
- a specific closing date when the title is scheduled to change hands and the buyer can take possession.

Some of the most important parts of a signed and countersigned purchase contract include:

Contingency clauses: There might be several key deadlines that the buyer, seller, and/or agents must meet in a timely manner before the deal can close escrow. The most common contingency dates include the time required for the buyer to obtain his or her own appraisal report to confirm that their purchase price is at current market value. This is incredibly important if the buyer is primarily using bank funds to close the deal. A contingency date for the completion of an appraisal and formal mortgage loan approval might be 21 or 30 days after the acceptance date.

If more time is needed to complete the appraisal or loan approval process, the buyer and his or her agent may ask for an extension in writing. Should the appraisal come in at a value well below the offer price during the contingency time period, then the buyer is likely to cancel the deal and get back his or her entire earnest money deposit. The same can be true if a pest control or environmental inspector finds an unreasonable amount of termites or toxic mold during the contingency time period.

Disclosures: The seller and listing agent must fully disclose any and all known property and environmental defects nearby, especially **material facts** that may scare off the buyer of the property such as a leaky roof. This is true even if the property is sold “as is” as a fixer-upper or “fix-and-flip” deal to a sophisticated investor or contractor.

Property condition: The seller and listing agent are required to note the current positive or negative conditions of certain relevant aspects of the property, such as the condition of the floors, roof, plumbing, electrical, bathroom fixtures, and kitchen appliances. The contract will probably include a provision which gives the buyer the right to inspect the property once again with his or her agent and an inspector, if interested in hiring one, before closing the transaction.

Clear title: The seller agrees to deliver clear title to a property that is free from any negative encumbrances like judgment or tax liens. Both parties will be fully insured and protected by the selected title insurance policy that is identified in the contract. Without the assurance of clear title that is completed after a **chain of title** search that details the history of current and former owners and lenders on the subject property, the property may not be able to be transferred on a timely basis (remember that **“time is of the essence”**).

A **wild deed** is a recorded deed that was not included in a recent chain of title history because a past mortgage or deed instrument that was connected to the chain of title was never formally recorded. It is an attempt by a title company or law firm to cure or perfect the title history by recording the new deed today instead of when it should have been recorded in the past. An example might include a seller’s unrecorded grant deed transfer over 10 years ago that is now recorded today to clear up the title chain history.

Escrow and closing: The buyer should provide within the original purchase contract or in subsequent escrow amendments his or her full vesting preference when taking title to the property, i.e., how the buyer wishes the title to be recorded (e.g., *John and Jane Doe, a married couple as joint tenants*, or 123 Main Street, a California LLC). The name and address for the selected escrow or title company that was mutually agreed to by both parties will be included as well.

These days, some closings may be at actual closing tables in a conference room at an escrow or title company, at an attorney’s office, or done online 100% while using a computer desktop, smartphone, or digital tablet device (like an iPad) with all electronic or digital signatures. There are even cases where the properties are found online, purchased, and escrow is closed online by buyers who’ve yet to even visit the property in person. Foreign investors, especially, are likely to purchase and close properties online that they have yet to walk through, sometimes paying 100% cash.



Occupancy and possession: The desired occupancy or possession date should be clearly defined in the purchase deal. Sometimes, the buyer needs to take possession **before** the deal closes on time. If so, then a document called an **Interim Occupancy Agreement** is used along with possibly another supplemental short-term lease agreement to protect the interests of both parties. Other times, a seller may sell the home, close escrow, and agree to a leaseback contract (a “**sale leaseback deal**”) where the seller pays monthly rent to the new buyer/landlord for a specific period of time.

Under the **Uniform Vendor and Purchaser Risk Act**, sold properties that are damaged or completely destroyed by fires, floods, or other devastating events, are usually primarily the seller’s risk until the deal officially closes and the grant deed transfers to the new buyer. This is normally true unless the buyer and seller have some sort of a

supplemental agreement or amendment in place that transfers some of the risk to the buyer (or buyer/tenant), who moved in earlier than the scheduled close date. This would have to include the buyer's insurer, as well. A definable **risk clause** that covers some of the potential negative outcomes may reduce financial and legal risks for both parties.

Broker's identification number: The full name of the employing broker and his or her broker's license number as well as the name and license numbers for any other agents involved are required to be included in a purchase contract and in updated escrow amendments. The broker's commission payment will later be paid out to the clearly identified brokers in dollar amounts based upon a percentage of the selling price or a fixed dollar amount described in the purchase contract as we discussed above.

Amendments: Shortly after the signing of the purchase contract, the terms of the contract can only be modified in writing by way of an **amendment** (or "**rider**") that is usually created by a third-party escrow or title company. An **addendum** is a modification of a purchase contract before it has been mutually accepted as a finalized contract deal, while an **amendment** reflects changes made after the deal has been approved and during the escrow process.

Seller-Financed Deals

Approximately 33% of all residential properties nationwide are owned "free and clear" with no mortgage debt, and the other 66% are leveraged with one or more loans or liens. Homes with no debt can more easily be sold using a brand new, seller-financed first mortgage that will be created by the local escrow and title companies with the interest rate and loan term clearly identified in the mortgage note.

In sluggish economic cycles, when interest rates are too high and mortgage underwriting guidelines are too strict, the approach to selling property using creative seller-financed strategies becomes more popular. This is especially true when there is both a motivated buyer and seller wishing to complete the deals.

When there is already mortgage debt on the property such as an existing first loan, or a first and second mortgage from two different banks, and

some significant amounts of real equity (or the difference between the property value and mortgage debt) left in the property, then the owner might consider one of the following: a recorded or unrecorded land contract as discussed below; an AITD (all-inclusive deed of trust), discussed earlier in this course, that typically had a deed transfer prior to the buyer moving in; or a lease with an option to purchase.

Let's review some of the more common strategies more in depth below:

Land Contracts: Other names include a contract for deed, a real estate property sales contract, a **wraparound mortgage** (the new seller financed mortgage does literally wrap around an underlying mortgage), and an installment sales contract. Typically, a third party, such as an escrow officer, title company, or attorney, holds the seller's signed grant deed during the term of the land contract. Often, the land contract buyer's installment terms are for relatively short periods of time, such as three, five, or seven years.

In cases where there is an underlying 30-year mortgage (at \$70,000) still in the seller's name that has another 22 years to go, the seller wants to be paid off well before his or her own mortgage loan balance becomes due and payable. The seller also wants to collect the extra equity at payoff (if priced at \$100,000, then the net profit is \$30,000 less any closing costs).

The buyer is given possession of the property, a fixed monthly mortgage payment amount, a defined purchase price that must be paid by a certain date in the future, and an "equitable interest" in the property. Until the seller is fully paid off on or before the end of the contract for deed term, the seller retains full legal ownership interests. The buyer in a land contract is the **vendee** and the seller is the **vendor**. (e.g., the term might be fully amortized over 30 years and all due and payable within seven years, a 30/7 amortization schedule).

The risk for land contract buyers is that the seller might decide to later place another mortgage on the property without being required to inform the buyer/vendee during the term of the land contract. Another risk is that the seller/vendor might collect the monthly installment payments, but not pay the first mortgage still in the seller's name. As a result, the first mortgage lender may file foreclosure and take back the property from both the seller *and* buyer. Other risks include that the seller might

be hit with unpaid tax and judgment liens that “cloud” the title to the property and possibly wipe out all remaining equity in it.

Typically, the land contract payment amount will be much higher than the seller’s first mortgage payment. For example, the collection of a \$1,000/month land contract and a payment of just \$700 to the seller’s first mortgage company where the seller nets \$300 per month in profit up until the land contract is paid off in full. Usually, the buyer pays it off by taking a new purchase loan.

$$\begin{array}{r} \$1,000 \text{ (Wraparound Mortgage in a Land Contract)} \\ - \$700 \text{ (1st Mortgage in Seller's Name)} \\ \hline \$300 \text{ (Seller's Net Monthly Profit)} \end{array}$$

Note that sellers are more likely to charge much higher interest rates (e.g., 6%) than banks (e.g., 3.5%) due to higher risk factors, such as being in second lien position behind a bank’s first mortgage that could one day be foreclosed on, completely wiping out the buyer’s beneficial interests.

Remedies for default: The vendee/buyer has the right to sue for **specific performance** (or request that the court compel or force the sale) after completing all of the necessary requirements described in the contract for the deed, like making all monthly payments on time and qualifying for a new bank loan to pay off the remaining balance in full to the seller.

The **vendor/seller** has the right to legally terminate the contract for reasons such as missed monthly payments or severe damage to the property. Often, a **vendee/buyer** is paying the equivalent of above-market rent prices for the right to later complete the purchase of the property and receive a deed of trust in his or her name. Depending upon the terms of the original land contract, the defaulted vendee/buyer may or may not be entitled to any partial refund for past payments made. If damage was caused by the vendee occupant, then the vendor may be able to deduct the costs to repair out of the vendee’s original deposit payment or out of any collected extra monthly payment amounts.

If the seller-financed land contract had an unrecorded grant deed transfer option in which the formal title would not be transferred and recorded by a title insurance company, then the eviction process might

be simpler and more like a standard tenant and landlord eviction process.

For other types of land contract and AITD deals that were recorded before the buyer occupant moved in, the vendee/buyer is likely to have a **right of redemption** to cure the defaulted amount prior to being evicted. The vendor may later have the right to foreclose on the vendee or obtain a signed quitclaim deed from the vendee/buyer in which the vendee agrees that he or she holds no valid legal interests in the property. The signing of a quitclaim deed from a vendee/buyer might come at a cost for the vendor/seller (i.e., a fixed payment amount to move out that can be referred to as a “relocation fee” or a partial credit for past payments made). Yet, it still may be cheaper and much quicker than going through a judicial or nonjudicial foreclosure process.

Lease with option to purchase: This is a more complex type of lease contract that assigns rights from the landlord to the tenant to purchase the same rental property for a specific dollar amount at a definitive date sometime in the future. The owner of the property is called the **optionor** while the tenant with the right to convert the lease to a future purchase deal is the **optionee**. This is a type of **unilateral contract** where only one side is obligated to perform - the seller/optionor.

If and when the tenant decides to buy the property within the designated time period, then the lease converts to a formal purchase contract. Any real estate agent working with the tenant/optionee in a lease with an option to purchase, might collect both a leasing fee and a commission once the purchase deal closes escrow.

A lease with an option to purchase must include all of the same elements required for a valid contract such as: 1) monetary consideration payable to the optionor/owner; 2) the fixed monthly rental payment amounts; 3) the term of the agreement; and 4) the mutually agreed-upon purchase price.

A lease option may or may not be recorded, depending upon the wishes of the parties involved. For a two-year lease option deal, the seller/optionor cannot sell the property to any other buyer partly because the buyer/optionee was formally given a **“first right of refusal”** to purchase the property. The option contract is also binding on any of the heirs or future assignees associated with the optionor/seller.

The optionee has no legal responsibility to actually complete the purchase of the property at the end of the term in a year or two. Often, a tenant/optionee realizes that he or she does not like the property so much while living there, so he or she just vacates the premises at the end of the lease term. If that happens, the seller/optionor can attempt to lease or sell it again to someone new.

Leases

A **lease** (or **rental contract**) is defined as a contract between a tenant and a landlord, which gives the tenant a legal tenancy (or use and possession rights) in the property. The transfer of at least some partial rights in a property from a landlord to a tenant is called a **demise**.

The mutual interest in a specific property held by the tenant and landlord is called **“in privity.”** The landlord’s interest is described as a **leased fee estate**, while the lessee’s interest is a **less-than-freehold estate** in real property.

The rental agreement will likely include the rights, responsibilities, and interests held by the tenant as well as the landlord. A lease term will either be a **term tenancy** (lease expires one year later), or a **periodic tenancy** (month-to-month until one side terminates it with sufficient notice) in the contract.

The five main **lease types** used more in commercial property transactions than residential properties (with the exception of the fixed lease payment) include:

A **fixed lease**: As the name implies, the tenant agrees to make the exact same lease payment each month. This fixed payment amount is used for both residential and commercial properties. The landlord will then be required to pay the property taxes, maintenance, insurance, and any underlying mortgage payment out of the rental income proceeds.

A **graduated lease**: This type of lease is equivalent to a fixed lease payment, but it has a graduated **“inflation index”** or **“escalation clause”** that might be tied to the Consumer Price Index or some other type of price inflation index. For example, the rent increases 3% per year. This lease might also be called a **step-up lease** agreement.

A **percentage lease:** A tenant, especially one that is a restaurant or retail shopping mall occupant, makes a fixed monthly lease payment plus a percentage of the business's gross monthly income.

A **net lease:** A commercial tenant pays a fixed monthly rent plus one or more of the landlord's prorated building expense fees that are associated with that space. In a Single Net lease agreement, the tenant might pay one of the landlord's expenses such as the property tax payments in a fractional share that is related to the building space size (e.g., if the tenant leases 20% of the building's space, then he or she or the business pays 20% of the property taxes). With a Double Net lease agreement, the tenant might pay 20% of both the property tax payments and the insurance premium. For Triple Net (more common in prime Class A office buildings), it may be taxes, insurance, and common area maintenance.

A **ground lease:** Owners of land might hold 49 or 99-year land leases that must be paid each month, quarter, or year by the occupants of homes or commercial buildings on the site. In California, land owned by Native Americans in the Palm Springs or Rancho Mirage regions quite often have underlying land lease payments that must be made by the owner. Most mortgage lenders will not lend on properties where the land lease is set to expire before the expiration of the 15, 20, 25, or 30-year mortgage loans. In fact, many lenders want there to be at least a 5-year cushion in that the existing land lease must be at least five years longer than the mortgage lender's loan term.

Estoppel: The **estoppel certificate** is a type of document used in many commercial real estate mortgage negotiations to establish facts and financial obligations such as the tenant's name, current monthly rent, security deposit amount, and other terms. The estoppel certificate is signed by the tenant to confirm that they are in fact paying a specified amount of monthly rent as well as for the remaining length of time in their existing lease contract. The verified rental payment amounts will help the mortgage lender complete the underwriting process prior to determining if the landlord/borrower/applicant has a sufficient level of income to offset expenses.

Elements in a Valid Lease

Just like with most other types of contracts, the elements necessary for a valid lease include:

- named and legally competent parties who mutually agree to the terms;
- payment of some type of consideration (money or something else of value);
- the rent amount and expected due dates such as on the first of each month;
- leases less than one year may be verbal and automatically convert into a periodic or month-to-month tenancy. leases greater than 12 months must be in writing;
- the landlord/lessor must sign the lease; the tenant/lessee is not required to sign it; the tenant's main acceptance of the lease terms is usually his or her act of moving into the property; and
- a proper and valid legal description of the subject property.

Duties and Rights for Tenants and Landlords

Tenants have legal rights to use the property, and landlords are required to take care of any serious maintenance problems such as plumbing leaks. Rent is normally paid upfront at the beginning of the lease period (June 1st rent payment is for the entire month of June) as opposed to mortgage payments that are paid in arrears (June mortgage payment is for the previous month of May). Most often, tenants will pay by check (personal or cashier's) unless both parties make other arrangements.

With a **month-to-month** or periodic tenancy, the landlord should give at least **30 days of advance notice** to the tenant before any rent increase is demanded. For residential properties up to four units in California, any rent that increases by more than 10% in a 12-month time period requires that the landlord provide up to 60-days of advance notice.

Security deposit: A security deposit paid by a tenant may be almost any type of payment, deposit, fee, or advance rent payment that is used to

secure the lease payment and subject property. **Fully furnished residential lease deals usually have security deposits that are equal to three times the fixed monthly lease payment.** Unfurnished units are closer to two times the monthly payment. For lease terms that are longer than six months, owners are legally allowed to ask for rental deposits up to six times the amount of monthly rent even though one or two times the monthly rent is the norm in most regions of California.



It is illegal in California to label a security deposit “non-refundable” in lease deals. Landlords are required to return the security deposit (full or partial amount less any damage, cleaning fees, or other deductions that are not considered “normal wear and tear”) within **21 calendar days** of the tenant vacating the unit. The landlord may be penalized up to twice the amount of the security deposit if he or she does not return the deposit within that same 21-day time period.

The tenant is required to return the rental unit to the owner in almost the exact same condition as when the tenant first moved in at the start of the lease. The landlord is required to maintain any common areas in

larger apartment buildings, such as the elevators, garage structures, or green belts as well to make any interior unit repairs when needed.

Inspections: A landlord has the right to enter and inspect his or her leased premises under most types of lease agreements by giving at least 24-hours' notice to the occupying tenant to make repairs, improvements, or to show other prospective tenants during business hours or some other mutually agreeable time. In some emergency situations such as serious electrical or fire hazard risks, the landlord is usually allowed to enter the unit to make quick repairs.

Contract Renewal: A term tenancy lease contract with a definite end date like one year after the start of the contract may include a provision for the tenant to give enough notice (30 days or more) to the landlord about whether he or she intends to vacate or renew the lease contract. If both the tenant and landlord mutually agree to the lease contract renewal in writing, then this is an **express renewal**. If, however, the tenant just keeps paying the monthly lease payment after the end of the lease term, then the landlord's acceptance of the rent checks is an **implied renewal**.

Both new original and renewal lease agreements must include:

- 1) The property owner's name or the appointed property manager; and
- 2) The name of the person or entity that will receive the rental payments, their address, the rent amount, and the preferred method to receive the payments. (Note that for verbal lease agreements, the landlord has up to 15 days to provide the same details as above to the tenant either directly in person, by mail, or posted on at least two conspicuous places in the building.)

Lease Transfers

If permitted by the lease contract, the tenant may transfer his leasehold interest in the property by way of assignment, sublease, or novation.

Assignment: An assignment is when the leaseholder (**assignor**) transfers his or her remaining interest in the leasehold agreement to another party

prior to the expiration of the lease term. The recipient of the lease assignment is called the **assignee**. The assignee then becomes responsible for the ongoing payment of rent to the landlord while the liability of the original tenant (assignor) becomes secondary. Should the assignee later default and run out of cash, then the landlord will likely pursue the assignor for any losses.

Sublease: A sublease is where the possession of a leased property transfers from the original tenant/lessee to a new party (the sublessee). But the primary legal responsibility of paying the rent still remains with the original tenant (the sublessor). Sometimes, the sublessee will be paying a much higher monthly rental fee to the sublessor than the sublessor is paying to the landlord. The difference between the two rental amounts becomes pure profit for the sublessor or original tenant. The sublessee is only financially liable to the sublessor as opposed to the landlord. It is the sublessor who continues to have liability risks with the landlord until the lease term expires. (Sometimes a sublease is called a “sandwich lease.”)

Novation: A novation is when a new lease contract is created which replaces the original contract and/or the parties involved. Upon the execution of the novation agreement, the old contract is terminated. The same or different parties involved with the lease contract are now obligated to follow the new contract terms.

Termination of a Lease

There are a number of ways in which a lease contract may terminate such as:

- end of the lease term;
- a formal termination notice (30 to 60 days in advance) due to missed payments or damage or tenant’s intent to vacate;
- tenant willingly surrenders and vacates the unit with the landlord’s approval;
- breach of implied or expressed promise by the landlord;

- illegal use of the property such as operating a business in a residential unit;
- condemnation by way of eminent domain;
- foreclosure.

Implied covenant of quiet enjoyment: A landlord may *breach the implied covenant (promise)* of “quiet enjoyment” if he knowingly engages in unlawful interference related to the tenant’s exclusive right to occupy the property, such as evicting the tenant without sufficient cause or notice.

Actual eviction is defined as forcing the tenant to vacate the premises before the end of the lease term, while **constructive eviction** can be a more passive-aggressive method of eviction. For example, the landlord “forgetting” to pay the bill for electric and water. If the covenant of quiet enjoyment is violated and the tenant is wrongfully and illegally evicted, , the tenant may be legally relieved of any additional financial obligations to the landlord.

Under the **implied warranty of habitability**, the landlord must comply with building and housing code regulations. Should the tenant later notify the landlord of any serious building defects or code violations, the landlord is required to quickly fix them. If the repairs are not completed as soon as possible, then the tenant may be able to terminate the lease.

The notice that is issued by the landlord to the tenant for eviction from the premises due to nonpayment of rent is called an **unlawful detainer**. The landlord will request from the court a **writ of possession** if the court also agrees that the tenant is in default after reviewing the contract. Once the writ of possession is received, the tenant must quickly vacate peacefully or be removed by the sheriff’s office.

Chapter Ten Summary

- A contract through which a seller formally employs a broker to sell his or her real property to the public is called a **listing agreement**.
- Under California law and the Statute of Frauds, a listing broker cannot sue the seller for the full payment of a real estate commission *unless* there was a formal written agreement in place (a/k/a “listing agreement”).
- One of the key determining factors for deciding which agent is entitled to the collection of commission fees is whether that agent brought a **ready, willing, and able buyer** (“procuring cause”) to the property, and whether that buyer purchased the property and closed escrow at a later date. The main types of listing agreements include: **Open** (lease protection for agents), **Exclusive Right to Sell** (protects the listing agent the most), **Exclusive Agency** (seller can find his own buyer and not be forced to pay a commission to the listing agent), and a **Net listing** (where the agent keeps a certain amount of the sales price over and above a mutually agreed-upon selling price).
- Some buyers’ agents will agree to a **fixed hourly rate** for consultation services, a flat dollar amount rate, or a **percentage** amount of the sales price as the commission or fee payment.
- A **land contract** (or **contract for deed**) is a type of real estate property sales contract. A **wraparound mortgage is where** the new seller- financed mortgage does literally wrap around an underlying mortgage. An **installment sales contract** is where the **buyer (vendee)** agrees to make timely monthly payments for usually a period of several years to the **seller (vendor)**. The vendee holds an equitable interest in the home up until the buyer pays off the land contract in full and receives the formal legal interest by way of a signed grant deed.
- A **lease** is a contract between a tenant and landlord that gives the tenant a legal tenancy (or use and possession rights) in the property.

- A lease can last for a specific period of time (e.g., a lease that expires in one year is a **term tenancy**), or be month-to-month until one side later decides to end it with sufficient notice (**periodic tenancy**).
- Interests in a lease may be transferred by the original tenant by way of **Assignment, Sublease, or Novation**.
- Some of the most common ways to end a lease, purchase, or land contract agreement are the expiration of the lease, option or purchase terms, by mutual agreement, a declaration of bankruptcy, or foreclosure.

Chapter Ten Quiz

1. Which type of listing agreement protects the listing agent the most, regardless of who later sells the property?
 - A. Exclusive Right to Sell
 - B. Exclusive Agent
 - C. Net
 - D. Open
2. Which type of listing is most like a unilateral contract in that it is a promise to pay a commission to any agent who brings in the qualified buyer to close?
 - A. Exclusive Agency
 - B. Exclusive Right to Sell
 - C. Non-Exclusive Agency
 - D. Open listing
3. The safety clause in a listing agreement assists the agent with the:
 - A. Automatic renewal of an expired listing contract
 - B. Collection of a commission payment even if another buyer's agent was the procuring cause of the sale
 - C. Collection of a commission payment from the sale of the property to one of the listing broker's past clients who purchased directly from the seller after the listing agreement expired
 - D. The avoidance of full disclosure to buyers if the seller doesn't disclose as well

4. How is a buyer's good faith deposit established in most cases?
 - A. DRE
 - B. Commissioner
 - C. Mutual agreement between the buyer and the seller
 - D. Agreement between the brokers
5. What does not always have to be included within a buyer's agency agreement to be enforceable?
 - A. Purchase price
 - B. Buyer's signature
 - C. Offer's termination date
 - D. Property's legal description
6. How may a buyer-paid fee agreement *not* be decided?
 - A. By the buyer alone
 - B. Based on an hourly consultant rate that is mutually decided
 - C. By a percentage amount of the selling price
 - D. By a specified flat dollar amount fee if the offer is successful
7. What is a condition set forth in a purchase contract that must be met within a fixed number of days?
 - A. Safety clause
 - B. Performance clause
 - C. Contingency clause
 - D. Due diligence clause
8. What is an agreement to keep an offer open for a specific property?
 - A. Option
 - B. Assignment
 - C. Leasehold
 - D. Freehold
9. What is a modified attachment of an existing contract that is added *before* the parties have originally signed it?
 - A. Amendment
 - B. Option
 - C. Novation
 - D. Addendum

10. Under a land contract or contract for deed, the vendee is entitled to _____.
A. Beneficial interests
B. Possession
C. Equitable Title
D. Both B and C
11. For a lease to be valid, it must be signed by the _____.
A. Landlord
B. Tenant
C. Agent
D. No signature required
12. When a leased property is sold, what happens to the existing lease agreement(s) in place?
A. The lease terminates
B. The lease is automatically conveyed back to the new owner
C. The lease is still in effect with the new owner
D. The tenant can move out and demand full repayment of all deposits

Answer Key:

1. A	7. C
2. D	8. A
3. C	9. D
4. C	10. D
5. D	11. A
6. A	12. C

CHAPTER 11

REAL ESTATE CLOSINGS

Overview

A real estate transaction is not fully complete until it **closes**. At the closing, the seller will receive his or her funds that will concurrently pay off the existing mortgage lender (if applicable), the title, escrow, and other closing costs, and the excess funds shall end up as net profit or cash to the seller. The real estate agents involved in the deal will usually have their commission fee checks issued by escrow directly to their respective employing brokers. We will also address some of the tax consequences associated with buying and selling property.

Escrow

The closing is the end goal of most parties involved in a real estate transaction. It is the final stage in the purchase transaction process after all parties involved have initialed, signed, and mutually accepted the offers, counteroffers, inspection reports, and the approval and receipt of loan documents from the bank (if any) involved in the purchase. In some states like New York, the “closing table” might be a conference table in an attorney’s main office where so many New York closings are held. But in California, the closings are more likely to take place at a neutral, independent escrow company in Southern California, or at a title insurance company office in various parts of Northern California. Sometimes, the title company owns the escrow company, so it can get a bit confusing and cloudy with respect to the options for closings.

In some complex closing transactions related to development and large commercial real estate properties, the closings may take place at a real estate attorney’s office with the assistance of escrow and title insurance representatives who meet alongside the principals and agents. In some simpler transactions, an escrow company may send out a notary public to witness the signatures in person and handle the rest of any documents

by way of email or electronic document delivery systems. For principals who live far away from the subject property being purchased or sold (perhaps in other states or countries), the option of having a nearby local notary receive the escrow, title, and loan document instructions prior to delivering the documents to the principal's work or home address for notarized signatures can be the easiest and quickest option possible.

Escrow is the place where money and documents are held by a neutral third party up until the transaction is about to close (or "close escrow"). The main party in charge of the closing at escrow is usually either an **escrow agent** or an **escrow officer**. The escrow agent owes fair and equal fiduciary duties to both principals as well as to their appointed real estate agents in the transaction, while acting as a **dual agent** in the deal.



Both parties involved in the escrow must mutually agree and confirm that they are willing to work with the escrow company selected. Many times, the listing agent will select the escrow company with which he or she has a fairly long relationship. However, the selection of the escrow company is completely negotiable in most types of real estate transactions.

The first set of **escrow instructions** are usually based on the signed and countersigned purchase contract. The details usually include the purchase price, target closing date, commission fees, earnest money deposit receipts, and any existing lender(s) to be paid off. Additionally, the details include various contingency dates when appraisals, mortgage qualifications, and pest control reports must be complete, usually seven, 14, or 21 days from the acceptance date.

The escrow instructions are a type of **bilateral contract** between the buyer and seller in that both sides are promising to perform one or more functions. The escrow agent will distribute funds to the parties involved and make sure that the buyer receives clear title and a signed grant deed that legally conveys or transfers the ownership interests. In the alternative, those documents may be given to the buyer's designated entity, like a corporation or LLC, per the terms of the signed escrow instructions or updated amendments. The updated and signed escrow instructions usually take priority over any previously signed purchase contracts should any future disagreements or legal disputes arise. When all else fails, the escrow officer will follow the latest signed copies of escrow instructions when making disbursements or canceling the deal.

Steps in the Escrow Process

Escrow officers and their assistants typically work on the following steps in the vast majority of real estate closings. They:

- order one or more title reports from the selected title insurance company;
- order and/or request copies of any third-party inspection reports;
- pay off any existing loans or liens attached to the subject property;
- prepare the deed and other documents with the correct property-holding status, like “joint tenancy” or “sole and separate property”;
- collect earnest money deposits, and other buyer and seller funds, and make receipts;
- create a tentative and final list of closing costs for all parties to review and approve;

- record the grant deed, or any other real estate or legal documents, concurrently at the closing; and
- disburse funds to the parties as instructed, pay commissions, and deliver the final closing documents.

Escrow can **terminate** when the transaction closes, when all of the terms and conditions have been met by one or more parties per the escrow documents, by court action, or, if both parties mutually agree, by dissolution of the escrow transaction. If a conflict arises over funds or other things of value in an escrow, the escrow agent has the option to file an **interpleader** action which moves the conflict from her office over to a nearby legal jurisdiction such as Superior Court. The court will then settle the monetary dispute between the two parties because the escrow officer must remain truly neutral and has no authority to adjudicate the dispute.

Per California escrow law, all independent escrow companies must be licensed by the **Department of Business Oversight**. What is really unique about California escrow companies is that they must be established as **corporations** instead of under individual owner names. Banks, insurance companies, title companies, law firms, and real estate brokers are *not* required to obtain that escrow license, partly because they are not regulated by other agencies.

The escrow licensing exemption for California real estate brokers is limited to business activities that require a real estate broker's license. This exemption for brokers may occur when one party is represented by the broker, or the broker is actually a principal in the transaction. Surprisingly, brokers can provide escrow services to their own clients and charge fees even though it seems to go against the requirements of escrow agents acting as "neutral" parties. However, real estate brokers cannot act as escrow agents in transactions in which they do not have any legal interests other than offering escrow services.

Settlement Statements

There can be thirty or more individual **closing costs** listed on the escrow company's **settlement statement (or closing statement)** for even relatively small and simple single-family home sales transactions as well

as for complicated multi-million dollar commercial real estate purchases or new construction deals. If a dispute arises in an escrow transaction, the odds are fairly good that the conflict might revolve around which side should pay the fee.

Often, the original purchase contract will clearly identify which party will pay for fees related to third party inspections or credits towards work performed either before or after the closing. Other times, escrow will be forced to create amendments a week or a month into the transaction that are required to be signed by both sides after the parties learn about an unexpected expense before the completion of one or more inspections. A prime example of an unexpected fee that is later negotiated in escrow is when a pest control inspection discovers termite and mold damage much more severe than anyone had expected.

The estimated and final **settlement statements** will break down the expenses in ways that show how much money the closing costs will be for the buyer and seller, and how much money the agents will earn as commission by listing those fees as **credits** or **debits** on the closing statements. The items paid *to* a party are listed as **credits**, while the items paid *by* a party are listed as **debits** (or expenses). For example, a \$250,000 mortgage loan for the buyer/borrower is listed as a “credit,” and a \$1,000 termite work expense fee is listed as a “debit” on the settlement statement.

Buyers, sellers, and their appointed real estate agents should all closely review the proposed net proceeds, payoff amounts, debits, credits, commissions, and other closing costs so that there are no serious mistakes that can cause the escrow transaction to fall apart at the last minute.

The **double-entry accounting method** is used in California settlement statements so both parties will likely have a credit and debit column. A properly balanced settlement statement should show the buyer’s credits equaling their debits on the sheet just like a check register balances out on a bank statement. You can visualize a debit as a check written against a bank account. And a credit is like a cash or check deposit (that hopefully balances out to zero instead of negative at the closing of the bank account). A zero balance is the desired outcome at the closing of the escrow transaction.

One item that is payable by one party to another will appear on the closing statement as a debit for the party who is paying it; the same fee will appear as a credit for the party receiving the funds. For example, the purchase price will be listed as a debit for the buyer (paying money) and a credit for the seller (receiving money).

Third-party fees that are listed on a settlement statement will be listed in the debit column for the paying party (buyer or seller) while it is not listed as a credit for the other main party in the transaction because they do not receive the funds. The payment of a home inspection fee balance due that is owed by the buyer will be listed as a “debit” for the buyer and the name of the inspection company being paid (example: Park Place Home Inspection) will be listed as receiving the “credit” or check.

Sellers can receive items listed as a “credit” on the settlement statement that are not also listed as a “debit” on the buyer’s side of the closing statement. An example might be paying off an existing FHA mortgage loan with impounded or additional collected property tax or insurance payment reserves that are then refunded back to the seller/borrower upon the closing and payoff of the seller’s mortgage.

Let’s review below some of the most common charges listed on a settlement statement:

Purchase price: Since the price paid for the property comes from the buyer to the seller, it is listed as a debit for the buyer and as a credit for the seller.

Good faith deposit: At first, the earnest money deposit (“good faith deposit”) is listed as a credit for the buyer when the check is first handed to the escrow officer at the start of the transaction. The deposit might equate to about 3% of the purchase price (or \$3,000 in a \$100,000 deal). This same amount will be reflected in the entire purchase price amount that is listed as a debit for the buyer and a credit for the seller. So, there is no need to list the same \$3,000 deposit amount as an additional credit on the seller’s side of the closing statement because that would be counting the \$3,000 amount twice (\$6,000) instead of once.

New mortgage loan: Most buyers need some form of a third-party mortgage loan to complete the purchase of the property. The loan amount is listed as a credit for the buyer. Just like with the earnest

money deposit (3% or some other mutually agreed upon number), the mortgage loan (80% loan-to-value amount or some other amount) is already factored into the total purchase price as a debit and credit. Thus, there is no additional entry made for the loan amount on the seller's side of the closing statement.

Seller financing details: Sellers who carry some of their equity or profits in the property as a new second mortgage behind the buyer's first mortgage from a bank, if allowed, are listed as a type of credit on the buyer's side of the settlement statement. Sometimes, properties are sold free and clear with no existing mortgage debt, so the seller will carry most of the sales price as a recorded new first mortgage. Other times, the seller may create a recorded or unrecorded wraparound mortgage as a land contract or all-inclusive deed of trust (AIDT) in second or third position behind the existing institutional bank loan(s) already in place. The seller's net cash profits are reduced (debit for seller) when they provide a portion of the sales price as a loan to the buyer (credit for buyer).

Seller's mortgage payoff: Escrow officers will send out a **beneficiary's statement** to the existing mortgage lender(s), and any other lien holder, secured by the subject property. The main intent of these updated payoff statements is that they are required by escrow before paying off the secured loan or debt on the property as calculated on a daily basis for the most accurate payoff amounts. The loan payoff is listed as a debit for the seller while no entry is made for the buyer's side of the closing statement.

Seller's mortgage impound account: In FHA, VA, and various other types of residential mortgage loans, the lender will maintain their own escrow account (also referred to as an **impound account**) for prepaid items such as property taxes and insurance that might be paid upfront several months or even a full year in advance. These prepaid items are referred to as **recurring costs**. When this mortgage is paid off by escrow, the lender will refund through escrow the extra prorated escrow, insurance, and other assessment fees already collected, which may amount to several thousand dollars. This refund of the impound account money shall be listed as a credit on the seller's side of the settlement statement, and will not be listed at all on the buyer's side.

Seller's mortgage prepayment penalty: Some residential and

commercial mortgage loans may have early payoff (or prepayment) penalty fees in the event the borrower pays off the lender too soon. Many times, the lender will offer their borrowers a very attractive interest rate that is well below the average priced loan offered by other lenders at the time. To make up the difference for offering clients an exceptional rate and/or a fairly risky private money residential loan, or a complex commercial loan, lenders will add a prepayment penalty. These penalty amounts that may be as high as 1% to 5% of the remaining unpaid mortgage principal balance are applied if the mortgage is paid off too soon amounts. If so, this prepayment penalty will be listed as a debit for the seller.

Appraisal fee: Usually, a mortgage borrower applicant will have to pay using a check out of their own personal account directly to the appraiser hired by the mortgage lender before the appraisal or property valuation work begins. But sellers might agree to pay the appraisal fee directly or give the buyer a credit for the entire appraisal fee as long as the property appraisal is completed, the buyer's loan is approved, and they close the purchase deal. The appraisal fee will be listed as a debit for either the buyer or seller, depending on who is paying this expense.

Home inspection fee: Per the terms of the original purchase contract or an updated escrow amendment, one or both parties may share in the expenses related to the home inspection and any potential subsequent repairs. In some cases, the buyer will pay for the home inspection (a debit on the buyer's side of the closing statement), while the seller will agree to pay for any requested repairs (a debit on the seller's side of the closing statement).

Pest control inspections and repairs: Similar to the home inspection, the expenses for the pest control inspection and repairs may be split by both parties, per the terms of their agreement, and be listed as a debit for each.

Mortgage broker origination fee: The bulk of a mortgage broker's or bank's profit may be linked to their origination fee (1% or 2%+) charged to the borrower. On the settlement statement, the mortgage origination fee is listed as a debit because it is subtracted from the mortgage loan balance proceeds.

Mortgage arrears: Mortgage payments are paid in arrears. This means

that a March 1 payment is actually the mortgage interest due from the previous month of February. At the closing, the escrow officer will collect the days remaining in the month as a debit on the buyer's side of the closing statement. As an example of **prepaid interest** or **interim interest**, a January 24th closing will cause the escrow to collect another 7 days of mortgage interest because there are 31 days in the month. The borrower's first official mortgage payment statement that he will receive in the mail will begin on March 1st for the collection of all of February's mortgage interest charges.

Mortgage discount points: Mortgage borrowers often have the option, to "buy down" the interest rate (or reduce the rate below the best market prices) by agreeing to pay buydown mortgage fees at 0.25%, 0.50%, 0.75%, or one full point (1%) or more to get the best interest rates. Sometimes, the seller will agree to offer "closing cost credits" that assist the borrower/buyer with a portion of the closing costs. The party who eventually pays the discount point or any other mortgage loan fee will have the expense listed as a debit on his or her side of the closing statement.

Mortgage insurance premiums: FHA, VA, and other types of government- insured or guaranteed loans require that certain items be paid upfront such as a few months of property taxes and insurance. These prepaid items are listed as a debit on the buyer's side.

The **proration of fees or expenses** by escrow, a lender, or some other party, is the division and allocation of certain recurring expenses proportionately based on time, interest, or benefit to a party in the escrow transaction. Sellers who still owe a few more days of mortgage payments at the time of closing will have the payments listed as a debit. And any excess mortgage refunds from impound accounts will be listed as a credit.

The expenses are usually calculated over 365 days in a year on a daily or **per diem** basis (or over **360 days** using a "**Banker's Calendar**" method). The escrow officer will then calculate how many days in the month the buyer and seller will be responsible for their share of the expenses.

For example, a very common prorated item is property tax; the property tax year in California runs from July 1 to June 30. Depending upon which month and day of the year the property ownership changes hands

at closing, the new buyer will be responsible for the remaining days on the property taxes assessed as a debit, and the seller will receive back an equal credit for the extra property taxes already paid in advance.

Title Insurance premium and fees: The buyer and seller may split the title insurance premiums 50/50 or one side agrees to pay the entire expense. In Northern California, it is more likely that the buyer will pay for the *owner's title insurance policy* as well as the *lender's (or extended) title insurance policy* if required by the lender. This is true in most of the state. In Southern California, it is more likely that the seller will pay for it. However, the title fee payment (the service fees associated with issuing the title insurance policy), is fully negotiable no matter where the property is located. The title fee will be listed as a debit for the paying party.

Whether the insurance option selected by the homeowner covers past history like title insurance or is against the potential of future negative events (like homeowners, automobile, umbrella, health, and life insurance), the insurance may be a real lifesaver that could save the insureds from financial ruin.

Home insurance policy: A homeowner's or hazard insurance policy is usually paid for at least one year in advance. The fee payment will then be listed as a debit for the buyer.

Documentary transfer tax: Every piece of real property sold in California is assessed a documentary transfer tax (approximately \$1.10 per \$1,000 of the final sales price). This fee is also referred to an **excise tax**. Most often, the fee is paid by the seller and listed as a debit.

Recording fees: The party who receives the benefit from the recording of the various documents associated with the subject property in the escrow transaction is usually the one who pays the fee that will be listed as a debit. For example, the recording of the buyer's mortgage loan is generally paid by the buyer because he benefits from it.

Escrow fees: This fee might be described as a **closing fee** or **settlement fee**. It is for the compensation of the escrow officer and his or her assistants for all of their work that was needed to close the transaction. The fee is usually split 50/50 between the buyer and seller, unless otherwise negotiated in the agreement.

Rent: Rental properties sold, such as a fourplex or a 500-unit apartment building, will have rental income that must be credited and debited to the buyer's and seller's sides of the closing statement, respectively. Rent, unlike mortgage payments, is paid upfront by the tenants. If the seller collected \$10,000 in rent for the month of June and the transaction closed the 15th of the month (the exact middle of that 30-day month), then the buyer will receive a credit of \$5,000 for the remaining 15 days of rent already collected by the seller.

Cash to close: Most purchase deals require at least some amount of physical cash or wired digital funds from the buyer's side. If the credits and debits do not balance out completely on both sides, the amount of cash provided by the buyer (20% cash plus an 80% LTV (loan-to-value) first mortgage equals 100% of the purchase price) should help to balance out the numbers completely. Sometimes, properties sold are "upside down" where the mortgage debt exceeds the sales price. If so, the seller might have to bring in additional cash proceeds in order to balance out and close the escrow.

Income Tax & Closings

There can be significant tax obligations for many of the parties involved in a sales and escrow transaction. The seller may be required to pay capital gains taxes at the most current rates unless they are exempt under the owner-occupied home sale exemption rule for a main residence, which is typically held at least two years (\$250,000 for a single person and \$500,000 for a married couple as tax-free income).

Form 1099-S: The real estate agents who receive their commission checks, either directly or indirectly, from escrow, a mortgage company, or the agent's employing broker, will receive a Form 1099-S along with their full name and social security number as a declaration of self-employed commission income for any amount over \$600 within the period of a year.

FIRPTA: There are a tremendous number of foreign born buyers and sellers in California from places such as Canada, Mexico, China, Japan, and other countries. Under FIRPTA (Foreign Investment in Real Property Tax Act of 1980), a portion of the sale of real property in the U.S. by a

foreign person (the transferor) is subject to some tax withholding by the buyer (transferee), escrow, or other appointed party.

According to the main website for FIRPTA, here are the latest guidelines for tax withholdings for foreign individuals and corporate entities:

Rates of Withholding

The transferee must deduct and withhold a tax on the total amount realized by the foreign buyer on the disposition. The rate of withholding used to be 10%, but rose to 15% in February 2016 and has remained at that rate at least through 2020.

The amount realized is the sum of:

- The cash paid, or to be paid (principal only);
 - The fair market value of other property transferred, or to be transferred; and
 - the amount of any liability assumed by the transferee or to which the property is subject immediately before and after the transfer.
-
- If the property transferred was owned jointly by U.S. and foreign persons, the amount realized is allocated between the transferors based on the capital contribution of each transferor.
 - A foreign corporation that distributes a U.S. real property interest must withhold a tax equal to 35% of the gain it recognizes on the distribution to its shareholders.
-
- A domestic corporation must withhold tax on the fair market value of the property distributed to a foreign shareholder if:
 - the shareholder's interest in the corporation is a U.S. real property interest; and
 - the property distributed is either in redemption of stock or in liquidation of the corporation.

- The corporation generally must now withhold 15% of the amount realized by a foreign person.

Source: <https://www.irs.gov/individuals/international-taxpayers/firpta-withholding>

Cal FIRPTA: In addition to the federal withholding guidelines for foreign sellers, the state of California also has its own 3.33% withholding requirement after the passage of California Revenue and Taxation Code Section 18662, which was enacted on January 1, 2003. The tax funds withheld by the buyer or the escrow agent after the confirmation that the seller is a foreign resident or business entity should be sent directly to the California Franchise Tax Board.

RESPA, Dodd-Frank, and TRID

RESPA: The Real Estate Settlement Procedures Act (RESPA) was a federal law passed back in 1974. The intent of this act was to protect consumers in residential financial transactions by way of two main strategies: 1) by requiring lenders to provide more accurate financial disclosures to mortgage borrower applicants so they better understand the costs and fees; and 2) by forbidding the process of kickback or referral fees to unrelated parties, especially if they did not have an active real estate license.

RESPA applied more to loans designated “federal” loans for residential property (one to four unit) loans, individual condominium or cooperative apartment units, and lots with an attached mobile or manufacture loan. Any lender that has financial assistance from any governmental body such as FHA or VA, and Fannie Mae, Freddie Mac, and Ginnie Mae in the secondary markets shall be automatically deemed a federal financial institution.

Lenders were considered exempt from RESPA guidelines if:

- the loan was used to buy 25 acres or more;
- it was a business, agricultural, or commercial (5+ units, industrial, office, retail, etc.) loan;
- it was for one of many types of raw land deals, except for some owner-occupied home construction loans; or

- it was for a short-term interim construction loan.

Within three (3) days of receiving a borrower's loan application, a lender was required under RESPA to provide:

- a booklet about **settlement procedures** and closing costs that was prepared by HUD;
- a **mortgage servicing disclosure statement** which helps confirm whether the funding lender will service the loan itself after funding, or sell it off in the secondary market to a group like Fannie Mae; and
- a **good faith estimate of closing costs** that provides a detailed disclosure of all closing cost estimates.

The escrow officer would later provide a complete **uniform settlement statement** (or a HUD-1 closing statement) as soon as possible to the principals after the close of escrow. The buyer's and seller's closing costs used to be listed on the second page of the HUD-1 statement. The buyer's costs began on line 103, and the seller's costs began on line 502.

The guidelines and required financial disclosure paperwork that first began with RESPA evolved into new regulations with significant changes. In recent years, Congress passed the Dodd-Frank Act, the Consumer Financial Protection Bureau (CFPB) was born, as well as TRID, which will be detailed below. While it is important to learn about the origins of RESPA, it is more important to learn the latest disclosure requirements that have made significant changes to the mortgage lending and real estate brokerage professions over the past several years.

The Dodd-Frank Act: The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Barack Obama on July 21, 2010 as a reaction to so much financial fraud and insolvency that happened to individuals at the hands of multi-billion dollar financial institutions after the near implosion of the U.S. financial system in September 2008 and the following Credit Crisis. Under the Dodd-Frank umbrella, the Consumer Financial Protection Bureau (CFPB) was created to act as an independent agency that governs and regulates credit unions, banks, securities firms, debt collectors, payday lenders,

and foreclosure relief firms.

TRID: This is the Consumer Financial Protection Bureau’s “*Know Before You Owe*” disclosure form that became available in late 2015. The stated purpose of TRID was to improve mortgage disclosure forms so that borrowers knew what they were really borrowing and how much it would cost them within a fairly short period of time before really obligating themselves to the purchase or refinance deal.

Know Before You Owe link:

<https://www.consumerfinance.gov/know-before-you-owe/>

The name TRID is somewhat of a hybrid acronym or name that was based upon the merger of previous mortgage loan disclosure forms called TILA. Only in the mortgage world would we make an acronym out of acronyms, so let’s break this down a little further.

TILA is the Truth-in-Lending Act and RESPA is the Real Estate Settlement Procedures Act. The CFPB modified both rules in its TRID final ruling. TRID applies to most types of closed-end mortgages secured by residential properties. However, it does not apply to reverse mortgages, lines of credit, or mobile or manufactured homes not attached to the land.

Prior to TRID, there were four main forms sent out by lenders to their mortgage applicants that included:

- a Good Faith Estimate;
- an initial Truth-in-Lending Statement;
- HUD-1; and
- a final Truth-in-Lending Statement.

TRID merged the old Good Faith Estimate and Initial Truth-in-Lending Statement that were sent out close to the start of the transaction by the lender into a new **Loan Estimate** form. TRID also merged the back-end of the deal paperwork that used to be the HUD-1 closing statement estimate and the Final Truth-in-Lending Statement into a new **Closing Disclosure** form.

TRID was so complicated for many people partly because the guidelines

written by the CFPB were 1,888 pages long and were supposed to be reviewed by real estate licensees, escrow officers, title representatives, and other third parties involved in the field of real estate.

Link here: http://files.consumerfinance.gov/f/201311_cfpb_final-rule_integrated-mortgage-disclosures.pdf

Chapter Eleven Summary

- **Escrow** is the place where money and documents are held by a neutral third party (a/k/a **escrow officer or escrow agent**) up until the transaction is about to close (“close escrow”).
- The first set of **escrow instructions** are usually based on the signed and countersigned purchase contract. These details usually include the purchase price, closing date, commission fees, earnest money deposit receipts, any existing lender(s) to be paid off, and various contingency dates.
- Escrow **terminates** when the transaction closes, when all of the terms and conditions have been met by one or more parties per the escrow documents, by court action (a/k/a **interpleader**), or by mutual agreement.
- All independent California escrow companies must be licensed by the **Department of Business Oversight**.
- The **double entry accounting method** used in escrow settlement statements will show a credit and debit column for each of the parties.
- The prorated expenses (mortgage interest, property taxes, and insurance) are usually calculated over 365 days in a year on a daily or **per diem** basis.
- Every real property sold in California is assessed with a **documentary transfer tax** (approximately \$1.10 per \$1,000 of the final sales price).

- The real estate agents who receive their commission checks from escrow, a mortgage company, or the agent's employing broker will receive a **1099-S** tax form.
- **TRID** is the Consumer Financial Protection Bureau's "*Know Before You Owe*" disclosure form that became available in late 2015. TRID merged old RESPA and TILA (Truth-in-Lending Act) disclosures into two new separate forms: **Loan Estimate** and **Closing Disclosure** forms.

Chapter Eleven Quiz

1. Which below is the least likely to be prorated at the closing?
 - A. Buyer's mortgage interest
 - B. Seller's insurance payments
 - C. Security deposit
 - D. Prepaid property taxes
2. What must be included to create an escrow agreement?
 - A. Credits from the seller
 - B. A binding and valid contract
 - C. Dual agency
 - D. All of the above
3. Which agency is in charge of independent escrows in California?
 - A. DRE
 - B. Department of Corporations
 - C. California Treasury
 - D. Department of Business Oversight
4. Which item below would most likely appear as a credit on the seller's side of a closing statement?
 - A. Commission that is payable to the listing agent
 - B. Commission that is payable to the buyer's agent
 - C. Delinquent property taxes
 - D. Prepaid taxes

5. What is the accounting name for California escrow settlement statements that show both parties with a credit and debit column?
- A. Double entry accounting method
 - B. Ledger
 - C. Journal
 - D. Spreadsheet
6. How is an earnest money deposit normally listed on a settlement statement at first on the buyer's side?
- A. Debit
 - B. Credit
 - C. Expense
 - D. Benefit
7. How would a home purchase loan appear on the closing statement?
- A. Debit to the buyer
 - B. Credit to the buyer
 - C. Debit to seller
 - D. Credit to seller
8. Which answer below will likely be listed as a recurring cost in a closing statement for escrow?
- A. Title insurance fees
 - B. Property tax payments
 - C. Escrow fees
 - D. Broker's commission
9. What is the name of the document that an escrow officer will send out to a lender about to be paid off?
- A. Reconveyance statement
 - B. Beneficiary's statement
 - C. Novation
 - D. Promissory Note
10. For disputes over funds held by escrow between a buyer and seller, the legal action that is taken by an escrow company is called _____.
- A. Interpleader
 - B. Tort
 - C. Summary judgment
 - D. Injunction

11. A buyer's side of the settlement statement will probably contain:
- A. All liens about to be paid off
 - B. Mortgage loan origination fees
 - C. The borrower's FICO credit score
 - D. Seller's commissions to be paid
12. The base rate fee for most types of Documentary Transfer tax fees is approximately ____.
- A. 1% of sales price
 - B. 1.5% of sales price
 - C. \$1.10 per every \$1,000 of sales price
 - D. \$1.10 per every 10,000 of sales price

Answer Key:

1. C	7. B
2. B	8. B
3. D	9. B
4. D	10. A
5. A	11. B
6. B	12. C

CHAPTER 12

MORTGAGE LOAN APPLICATIONS

Overview

In this chapter, we explore the history and evolution of residential mortgage financing. Most buyers who are involved in residential purchase transactions are also mortgage loan applicants in need of some type of third-party lending option to complete the acquisition of the desired property. Real estate agents and their principals should understand the basic steps involved in the selection of lenders as well as how to find the best terms and rates.



Sources for Residential Loans

Some of the most popular types of residential mortgage loans available today may originate from a visit to a bank branch down the street with a loan officer, to a private money source such as a small “hard money guy,” or online from a multi-billion-dollar crowdfunding platform for real estate firm that specializes in offering quick approvals for “fix-and-flip” deals.

Historically, the easier the mortgage underwriting process, the more expensive the money offered is likely to be for the mortgage applicant. Back in the 1980’s and early 1990’s, some “hard money loans” were called “Perfect Vision Loans” in that the rates were 20% and the fees were 20 points (20/20 = Perfect Vision). Back then, the interest rate differences might be as much as 12% to 13% between private money and funds from a conventional lender. In recent years, the cost of funds has rapidly declined for both conventional and non-conventional lenders partly because interest rates have reached all-time lows.

The competition for qualified clients from the different funding sources has created a price war of sorts that was meant to find high-quality deals and clients. Agents and principals who best understand that they have more than one or two funding options will likely find much more competitive rates than if they visited one local bank down the street.

Primary Mortgage Lenders

Let’s take a look at the similarities and differences between the two main types of primary mortgage lenders that have been offering funding solutions for mortgage applicants for the past several decades: institutional lenders and non-institutional lenders.

Institutional Lenders

An institutional lender is a financial institution that provides loans to consumers while being closely watched or supervised by legal regulations with fairly strict lending practices. The source of the loans tends to originate from their banking customers’ deposits.

Institutional lenders such as community banks act as **financial intermediaries** because they pool their depositors' funds prior to investing them in real estate and other types of loans.

Institutional lenders usually have these qualities:

- They usually include commercial banks, savings and loans, and life insurance companies.
- They are highly regulated by state and federal agencies.
- These lenders are not as likely to be subject to usury laws (or they can charge higher rates and fees than most other lenders).
- Many institutional lenders may offer FHA, VA, and other saleable loans to secondary market investors, like Fannie Mae and Freddie Mac.
- They have the option to offer a “lock-in” period on their interest rates for a short period of time as it relates to underlying indexes like the 10-year Treasury yields.

Commercial Banks: Commercial banks are financial institutions that act as depositories for customers' funds as well as short-term lenders for commercial loans (i.e., business, automobile, and some construction loans). Most of the banking customers' funds are placed in **demand deposit** type accounts (business and personal checking).

Because a high percentage of these funds may be withdrawn rather quickly by depositors, the commercial bank rarely uses these funds for longer term mortgage loans for more than five years. However, commercial banks do provide capital for construction loans (up to 12 months with extension options), home improvement loans, and certain types of swing loans for up to a year or so.

Thriffs and Savings and Loans: A thrift may also be referred to as a savings and loan (or “savings bank”). These financial institutions were designed to accept depositor funds before they began offering longer term mortgages to assist their customers with their homeownership needs. Depositors were willing to accept lower rates for their deposited funds primarily since the financial institution was federally insured by the Federal Deposit Insurance Corporation (FDIC). Savings banks can be state or federally chartered and supervised under the direction of

agencies such as the Federal Housing Finance Board and the Office of Thrift Supervision.



Non-Institutional Lenders

Lenders who are not regulated nearly as much as institutional lenders are called **non-institutional** lenders. These may include private money firms, pension and endowment funds from schools, REITs (Real Estate Investment Trusts), credit unions, and crowdfunding platforms for real estate.

Credit Unions: A credit union is a depository and may be considered as both a non-institutional and an institutional lender depending upon the products, services, and regulation requirements under which they act. They are financial institutions that are a type of **financial co-operative**. Historically, they were best known as being created, owned, and operated by large employment unions such as those representing: public school

teachers, former and current military personnel (Navy Federal Credit Union (NFCU) is the larger credit union by asset size), and rather large aerospace engineering unions associated with firms like *Boeing*. Credit unions may offer shorter term loans while also assisting with the management of retirement funds in various types of stocks, bonds, and real estate investment options.

Mortgage Companies: Unlike depository institutions like credit unions, banks, and thrifts, a mortgage company does not usually collect depositor funds. However, there are some cases where the company acts somewhat like a private money lender while offering private investors higher rates of return for investments secured by trust deed investments or other types of pooled capital that is used to purchase and develop various types of real property. Usually, mortgage companies act as **loan correspondents** in that they find one of their many lenders in their usually long list of banks or equity funds to provide capital for their clients.

Some mortgage companies will **service** the mortgage loan by collecting the monthly mortgage payments for a fee. Others will just let the bank, insurance company, or savings bank collect the loan fees (if they have not already spun or sold the loan off to one of their secondary market investors such as Fannie Mae). Sometimes, a mortgage company will offer a **warehousing** option where it funds the loan in its name, holds it a month or two or longer while collecting interest and fees, and then sells off the loan to other investors.

Mortgage Loan Originators (MLO): Under the S.A.F.E. Act (Secure and Fair Enforcement for Mortgage Licensing Act) of 2008, a mortgage broker or banker who offers owner-occupied residential loans to customers will probably need an MLO license before offering the loan product to a prospective client. The MLO licensee must be licensed and/or registered through the Nationwide Mortgage Licensing System and Registry, as required by the S.A.F.E. Act. Some loan officers who are directly employed by a federally-insured depository institution are **exempt** from MLO licensing requirements and do not need a separate license to assist borrowers with owner-occupied mortgage loans.

Loan Costs

Residential mortgage loans may include several different and fairly-expensive charges. Some of the most common types of loan fees include:

Origination fees: A mortgage broker or loan officer will probably collect most of their personal fees for funding a loan from the origination fees. The fees or points charged can vary between 0.5% to 2% (or two points) or more, depending upon the negotiated and mutually agreed upon terms. For a \$200,000 mortgage loan, for example a 1% (one point) loan fee is a \$2,000 paid commission to the mortgage broker.

Discount points: These point charges are offered by lenders to borrowers interested in reducing their fixed mortgage rates. The additional fee paid by borrowers provides lenders with higher-rate yields and profits while offering borrowers rates at or below the best prevailing fixed rates at the time of funding.

For example, a loan might be offered at **par pricing** with no upfront discount point fees at 3% for a 30-year fixed term. If the client wanted a 2.75% fixed loan instead, then he might be given the option to pay an additional 0.375% discount fee to buy down the rate.

Annual Percentage Rate (APR): The APR is the relative cost of credit related to a mortgage loan that is expressed as an annual rate. It is the difference between the actual fixed mortgage note rate (example: 3%) and the note rate plus all mortgage loan fee charges as if they were charged as an interest rate in the first year (APR example: 4.14%). The APR is also called the “effective rate of interest” and allows borrowers to more easily compare mortgage loan pricing options either in person or online.

Financial Disclosure Requirements in California

California has its own financial disclosure laws and requirements in effect that are in addition to federal laws such as the Truth-in-Lending Act, TRID, and the Consumer Financial Protection Bureau (CFPB) laws and guidelines. Unfortunately, many consumers do not fully understand basic financing charges and how to read the mortgage disclosure forms. As a result, many borrowers agree to loans that they thought were fixed for 30 years, but were actually short-term adjustable loans that could

double the amount of the required payment just a few years later. California has made efforts to fix this.

Some of the best solutions meant to improve the mortgage disclosure process both nationally and in California included enhanced disclosure laws and clearer and more understandable disclosure forms. California, specifically, has a few legal statutes that were enacted to better protect mortgage applicants against **Predatory Lending** actions undertaken by greedy **subprime credit** or EZ Doc-type lenders that charge rates and fees well above fair market prices. These include the Mortgage Loan Broker Law and the Seller Financing Disclosure Law.

Mortgage Loan Broker Law

Licensed agents acting as mortgage brokers or bankers in California are required to closely follow and comply with the Mortgage Loan Broker Law (also referred to as the **Real Property Loan Law**, or **Article VII of the Real Estate Law**). Under the Mortgage Loan Broker Law, a licensed real estate agent acting as a loan broker must give his or her customer/borrower a disclosure statement in a timely manner before he or she officially moves forward with the loan application. This is especially true for residential (one to four units - home, duplex, triplex, or fourplex) properties that are owner-occupied by the mortgage applicant. There are lawful restrictions in regard to the amount of loan commissions and other types of fees that the lender can legally charge their clients.

Some of the most important legal provisions under these laws include:

Disclosure statement: This form must be approved by the Real Estate Commissioner and issued by the DRE for:

- 1) most types of conventional mortgage loan products; and
- 2) non-conventional mortgage products that allow the borrower to defer repayment of principal or interest as used to be the case with negative amortization loans that were popular several years ago.

Commissions, costs, and terms: Loan fees that a mortgage broker may charge are determined by such issues as the loan type and amount being

requested. A loan that is designated as an **Article VII loan** (secured by a residential property with one to four units) is classified as follows:

- a first mortgage for less than \$30,000; or
- a junior mortgage (a second loan or lower) for less than \$20,000.

For the first mortgage loan amount of \$30,000 or less, the highest commission fee that the broker is allowed to charge is 5% (or \$1,500) of the original principal amount if the loan term is less than three (3) years, and up to 10% of the principal amount as a commission (or \$3,000) if the loan is more than three (3) years.

For the junior mortgage in second position or lower as a deed of trust, the commission amount that a loan broker can charge is 5% of the loan amount if the term is less than two (2) years, 10% of the principal amount if the loan term is somewhere between two (2) and three (3) years, and 15% as a commission charge if the loan term is more than three (3) years.

Balloon payments: A balloon payment is one that requires at least one payment that is more than double the smallest loan payment offered in the mortgage loan. A loan categorized as an Article VII loan that has a loan term of less than three (3) years does not allow balloon payoffs in which the entire loan balance is fully due and payable under the Mortgage Loan Broker Law.

For owner-occupied properties with loan terms less than six (6) years, balloon payments are usually prohibited as well. After the passage of TRID and the creation of the Consumer Financial Protection Bureau, there are now very few conventional and non-conventional residential mortgage loans that allow any balloon payments, even if California allows it.

Violation Penalties: Any mortgage broker who is found to have violated the Mortgage Loan Broker Law may be required to fully refund any commissions and other fees collected within 20 days of a written demand letter that is mailed or personally delivered by a third-party process server. If the agent does not refund his or her fees collected within 20 days, the borrower has the legal right to sue the loan broker for the

actual damages and for at least twice the fees collected as a form of **compensatory** or **punitive damages**.

Seller Financing Disclosure Law: This law is also referred to as the **Residential Money Loan Disclosure Law**. Some sellers will carry some or all of their equity in the property as a new type of first or second mortgage, or a more complex type of wraparound mortgage by way of a Land Contract or AITD (all-inclusive deed of trust). The seller, and any other party considered to be an “arranger of credit” such as a mortgage broker, must follow the legal requirements under these disclosure laws. An “arranger of credit” is anyone who is part of the real estate transaction besides the buyer and seller who: assists with negotiating the credit arrangement; helps with the preparation of the documents; and receives some type of financial compensation for their involvement with the financial portion of the transaction. Most attorneys and escrow officers are not considered “arrangers of credit” in seller-financed property sales **unless** they are directly involved as a buyer or seller.

Coverage of the seller-financed law: The disclosure laws will apply when the seller gives the buyer any sort of financial credit for all or part of the purchase price if and when at least these three requirements are met:

- The property is residential with one to four units.
- There was some sort of finance charge and more than four (4) payment options in addition to the down payment.
- An “arranger of credit” assisted with the transaction.

The **disclosure requirements** under the **Seller Financing Disclosure Law** need to be made before the mortgage note or security instrument (deed of trust) is signed by the buyer. The seller must make the minimal required financial disclosures to the buyer, and the buyer must also make disclosures to the seller.

This is true especially as it relates to whether they are financially creditworthy in order to assure the seller that the buyer is able to make the payments to the seller on a consistent and timely basis.

It is the responsibility of the arranger of credit to help verify if the disclosed details that were submitted by both the seller and buyer are accurate.

Some of the most important items to disclose are:

- the terms of the note (rate, loan term, fees) for any first or second mortgage;
- the type of security instrument involved (deed of trust or mortgage);
- a warning to the buyer about any potential balloon payment included; and
- the verification of income, employment, and credit history from the buyer, or a statement from the arranger of credit that he or she did not request any detailed verifications from the buyer.

Loan Application Process

The **Uniform Residential Loan Application (Fannie Mae form number 1003)** is the most commonly used residential loan application form used in the U.S. today and over the past few decades. An experienced loan officer or mortgage broker will usually assist their clients in person or over the phone with the completion of this main application form. The ten (10) main sections included within the 1003 application form are as follows:

Section I: Type of Mortgage and Terms of Loan - Is it a proposed first or second mortgage and how much is the potential loan amount?

Section II: Property Information and Purpose of Loan - The property address (if known at the time of application) is listed here along with a description of the loan as a purchase, refinance, or construction loan.

Section III: Borrower Information - Name, address, social security number, and other personal details about the applicant(s).

Section IV: Employment Information - Is the borrower employed, self-employed, retired, or an investor?

Section V: Monthly Income and Combined Housing Expense - The applicant details all sources of income to better verify whether he or she is able to make the monthly mortgage payments as well as come up with the required down payment for any sort of purchase loan.

Section VI: Assets and Liabilities - The applicant lists his or her assets (cash, stocks, bonds, equity in real estate) and liabilities (credit card, automobile, student, and mortgage loans) to show the lender his or her current net worth.

Section VII: Details of the Transaction - The important items associated with the new mortgage loan will be noted here, such as the estimated closing costs and total expenses.

Section VIII: Declarations - The applicant will declare and confirm whether or not they have had past foreclosures, bankruptcies, or current lawsuits filed against him or her.

Section IX: Acknowledgment and Agreement - The applicant's signature in this section is the most important part of the 1003 application process.

Section X: Information for Government Monitoring Purposes - The 10th and final section full of questions and blank boxes to check is used to determine the racial and ethnic background of each mortgage applicant so that the federal government can learn if the national lending system is treating all applicants equally and fairly.

Debt-to-Income Ratios: After reviewing a borrower's credit history report (300 to 850 FICO credit score system - the higher scores are more creditworthy) before deciding which loan program the mortgage applicant might qualify for at the time, the mortgage underwriter will calculate two main types of debt-to-income ratios that include:

- A **housing-to-income ratio** that is determined after dividing the mortgage applicant's monthly gross income by the proposed new mortgage payment (principal, interest, taxes, and insurance). For

example, a client with \$10,000 per month in gross income and a proposed new \$2,000 per month mortgage payment will have a 20% housing-to-income ratio ($2,000/10,000 = 20\%$).

- A **debt-to-income ratio** is arrived at after factoring all consistent monthly debt expenses (mortgage and credit card, automobile, student, and business loans) prior to dividing them by the current gross monthly income. For example, using the same \$10,000 per month in gross income, an applicant with \$4,000 per month in total monthly debt expenses will have a 40% debt-to-income ratio (also referred to as a “**back-end debt ratio**”).

Some types of government-backed or insured loans offered by agencies like FHA require front (mortgage only) and back-end (all monthly debts) ratios at 31% or below (front end) and 43% or below (back end). Other conventional lenders may consider exceptions above their desired 43% back-end ratios up to as high as 50% due to other positive factors such as a lengthy solid credit history and a fairly large amount of liquid assets.

Once the mortgage underwriter, loan broker, and/or the bank’s manager have signed off and approved the mortgage applicant’s request for a loan, a **loan commitment** (also referred to as a “pre-qualification letter” or a “pre-approval letter”) will likely be issued with a proposed maximum loan amount that the borrower has qualified for with the financial institution. Any new offers to purchase properties will usually have this formal loan commitment letter attached to the purchase agreement so that the seller is more likely to accept the offer.

Mortgage Financing Programs

There are not as many adjustable-rate programs or fixed hybrid rate (or “**Hybrid ARM**”) programs that offer some combination of both fixed and adjustable rate options since 2009 or 2010. This is due to the high number of national foreclosures that were associated with adjustable or negative amortization loans.

But some lenders may still offer a 3/1 or 5/1 program in which the loan is fixed at a certain lower introductory rate for a period of 3 or 5 years

before automatically converting to an adjustable-rate product for the next 25 to 27 years.

With an adjustable loan, the loan is pegged to an underlying **index** rate that is tied to a floating one-year Treasury bill, MTA (Monthly Treasury Average), or an 11th District Cost of Funds Index (COFI) here in California. The lender will then add what is known as a **margin** that is fixed and consistent that shall be added on top of the floating index.



For example, the margin might be set at 3% and the latest 11th District COFI index is 0.729% which leads to an effective note rate of 3.729% for the borrower. The lender is required to add a maximum payment or rate cap which might be 6% higher than the starting payment or rate estimate. If so, the maximum cap interest rate that can be charged over the life of the loan would be 9.729%.

Additionally, the borrower's note may limit the annual rate increases to a maximum of just 2% per year as a way to minimize the **payment shock**

for borrowers if the rates and payments increase too fast in a relatively short period of time.

Conforming Loans

Loans that have the best 30-year pricing options and that are able to be sold off by the primary lender such as a savings bank to the secondary market (Fannie Mae or Freddie Mac) are generally called **conforming loans**. Sometimes a conforming loan is also referred to as a **qualified mortgage** if the borrower has a solid credit history, low debt-to-income ratio, and a sufficient level of income.

In addition, a conforming loan in most counties in California has a maximum loan limit of **\$510,400** (as of 2020). In many pricier coastal and metropolitan regions in the state such as near San Francisco, a high-cost conforming loan limit may be as high as **\$765,600** (as of 2020). A loan amount higher than either of these standard or high-cost conforming limits is generally referred to as a **jumbo loan**.

Most often, lenders prefer that the maximum **LTVs (loan-to-value ratios)** for a first mortgage loan that is conforming is at 80% LTV or below. Some conforming lenders will allow the seller to carry some of their equity as a concurrent second mortgage that records behind the conforming first loan, or, they may allow a second mortgage from another lender behind the conforming first. If so, the CLTV (combined loan-to-value) between the first and second might be as high as 90% or 95% (the buyer comes in with just a 5% to 10% cash down payment instead of 20%).

Private Mortgage Insurance (PMI): Some lenders ask borrowers to pay an additional monthly private mortgage insurance fee if their LTV levels exceed 80% for the first mortgage or their down payment invested is less than 20% at the time of purchase. If the loan borrower later defaults, the mortgage insurance company may cover 20% to 25% of the loan amount instead of the entire unpaid loan balance that may later go all the way to foreclosure. The insurance fund helps to minimize the risks for lenders that make riskier types of loans.

Under the federal **Homeowners' Protection Act**, a lender is supposed to remove the monthly mortgage insurance premium fee if the LTV for the first mortgage falls below 80% after the home hopefully appreciates in

value. Borrowers usually have the option to send in the latest price comparables for similar homes in the area to their lenders in an attempt to eliminate the monthly mortgage insurance premium fee that might run \$100 or more per month, depending upon the mortgage balance.

FHA: An FHA loan is usually fixed at the same rate for 30 years with full amortization (principal is eventually paid down to zero); it is a type of highly-leveraged, owner-occupied loan that is offered for residential properties (one-to-four units) and for certain types of commercial properties. FHA loans began during the depths of the Great Depression in the 1930's as a way to improve access to affordably-priced mortgage loans as well as a way to inspire more confidence in the national banking system.

The borrower pays a monthly mortgage insurance premium rate (anywhere between 0.45% to 0.85% of the mortgage principal amount) in addition to the monthly principal and interest payment to FHA for taking the risk to fund a loan up to 96.5% of the purchase price. The borrower may come in with just 3.5% or less of their own cash funds to close, less-than-perfect credit and higher back-end debt ratios to qualify. The borrower may also receive additional credits from the seller or gifted funds from other family members to purchase the property. Since 2010, the vast majority of funded residential loans nationwide have been FHA-insured mortgages.

VA: A 30-year mortgage loan that is offered through private lenders with partial loan guarantees through the Department of Veterans Affairs do *not* require any mortgage insurance. VA loans are offered to current active and retired military veterans who can show their lender a **certificate of eligibility** form to qualify.

VA loans are best known for having exceptional fixed mortgage rates with down payment options as low as zero percent (or no money down). In certain pricier regions of California, the 100% financing options for owner-occupied VA borrowers can surpass \$1 million dollar loan amounts. In the event of a foreclosure, VA will guarantee a certain percentage of the funding lender's losses by paying back the lender on behalf of the VA borrower.

Chapter Twelve Summary

- An institutional lender is a financial institution that provides loans to consumers while being closely watched or supervised by legal regulations with fairly strict lending practices.
- Most of the banking customers' funds at **commercial banks** are placed in **demand deposit** type accounts (business and personal checking).
- A **thrift** or savings and loan (or "savings bank") may be a state or federally-chartered institution that offers longer term mortgage loans.
- Lenders that are not regulated nearly as much as institutional lenders are **non-institutional** lenders (REITs, crowdfunding platforms for real estate, and some credit unions).
- A **mortgage company** does not usually collect depositor funds. Instead, it will act as a type of **loan correspondent** between its clients and upwards of 50 or more approved lending sources.
- Some mortgage companies will **service** the mortgage loan by collecting the monthly payments for a fee. Other mortgage lenders will sell off the loan to another investor, or let the funding bank collect the monthly payments.
- Under the **S.A.F.E. Act (Secure and Fair Enforcement for Mortgage Licensing Act) of 2008**, a mortgage broker who works on most types of owner-occupied residential loans (one-to-four units) is required to obtain a **Mortgage Loan Originators (MLO)** license that is renewed each year.
- A **mortgage broker** will probably collect most of his or her fees for funding a loan from the **loan origination** fees that may be 1% or more of the funded loan amount (subject to negotiation). A **discount point** fee is a price that a willing borrower can pay the lender to buy down or reduce the amount of the best available fixed rate (for example: the borrower may pay an additional .50% fee to reduce the mortgage rate from 3% down to 2.8% over a 30-year term).

- There are **10 main sections** in a 1003 residential mortgage application. The borrower applicant's signature near the end of the 1003 form is the most important section in the application.
- Fixed institutional mortgage loans with the best rates and fees for borrowers are usually called **conforming loans** (\$510,400 as of 2020 or below in most California regions or up to as high as \$765,600 as of 2020 in some **high-cost conforming** regions). They may also be called **qualified mortgage** loans. This is true because they are generally offered to borrowers with fairly solid credit and relatively low debt-to-income ratios. These loans are saleable in the secondary market, which makes them less risky for the funding primary lenders.
- FHA insures mortgage loans (3.5% down payments) while VA (0% down payment options) guarantees a portion of the funded loan amount should the borrower later lose the property to foreclosure.

Chapter Twelve Quiz

1. What is a type of demand deposit account?
 - A. Mortgage
 - B. Business checking
 - C. Personal checking
 - D. Both B and C
2. Which loan is likeliest to have a balloon payment?
 - A. Fully-amortized loans
 - B. Partially-amortized loans
 - C. FHA loan
 - D. VA loan
3. A fee that a borrower may pay for a slightly lower fixed rate is called a:
 - A. Discount point
 - B. Loan processing fee
 - C. Mortgage broker fee
 - D. Underwriting fee

4. Seller-financed mortgage disclosure laws go into effect when there are more than how many buyer payments to the seller after the down payment that is originally made at the time of closing?
- A. 1
 - B. 4
 - C. 12
 - D. 24
5. What is the very first section in a 1003 mortgage loan application form?
- A. Borrower's name
 - B. Property address
 - C. Type of terms of mortgage requested
 - D. Income and expenses
6. What is the best FICO credit risk score for a borrower applicant?
- A. 375
 - B. 482
 - C. 690
 - D. 775
7. Which debt-to-income ratio will a lender prefer the most for a mortgage borrower applicant?
- A. 25% front-end debt ratio
 - B. 37% front-end debt ratio
 - C. 49% back-end debt ratio
 - D. 56% back-end debt ratio
8. What is another name for a lender's loan commitment?
- A. Formal approval
 - B. Pre-approval letter
 - C. Secondary market investor approval
 - D. Funded loan
9. How does a hybrid ARM loan differ from other mortgage loans?
- A. Adjustable for 30 years
 - B. Fixed for 30 years
 - C. Highly leveraged loans
 - D. A combination of fixed and adjustable rates during the loan term

10. Which statement about mortgages insured by FHA is most true?
- A. Borrowers must have near perfect credit
 - B. Mortgage insurance is only required for loans higher than 90% LTV
 - C. The borrower usually must be an owner-occupant
 - D. 100% LTV loans with no money down are available
11. Which funded mortgage loan is the least likely to be sold to Fannie Mae or Freddie Mac in the secondary markets?
- A. Conforming mortgage
 - B. Qualified Mortgage
 - C. First mortgage funded by a bank at 50% LTV ratios
 - D. Private mortgage

Answer Key:

1. D	7. A
2. B	8. B
3. A	9. D
4. B	10. C
5. C	11. D
6. D	

CHAPTER 13

THE TAXATION OF REAL ESTATE

Overview

Investors, agents, and other taxpayers are required to pay a wide variety of taxes each year on their income earned from work as well as from investments related to things like real estate, stocks, and bonds. These tax assessments may originate from the city, county, state, or federal government. We will explore how real estate is especially impacted with taxes, and shall detail how real estate also provides incredible tax shelters and deferral options for property owners.

Tax Assessment Categories

A tax may be defined as “**proportional**,” “**regressive**,” or “**progressive**” for taxpayers. A **proportional tax** is one in which the same exact tax rate is applied to all income levels or brackets. A **regressive tax** is one that is assessed at a lower proportional tax rate for higher levels of income. The federal income tax is described as a **progressive tax** because the more money a taxpayer earns in any given year will likely cause the person to pay a proportionally higher tax rate. Yet higher income earners may often pay lower overall tax rates if they have enough creative tax shelters in place involving things like real estate investments.

Tax brackets vary based upon such factors as whether the taxpayer is single, married and filing jointly, or married and filing separately. In addition, they are based on the amount of taxable income earned each year after all valid deductions are applied towards the taxpayer’s annual gross income. Let’s review the income bracket categories for the tax year 2020 to learn more details. Please note that the income amounts are the maximum taxable amounts that will be hit with the tax rate percentage listed in the same section.

Tax Rate	Single	Married/Joint	Married/Separate
10%	\$9,875	\$19,750	\$9,875
12%	\$40,125	\$80,250	\$40,125
22%	\$85,525	\$171,050	\$85,525
24%	\$163,300	\$326,600	\$163,300
32%	\$207,350	\$414,700	\$207,350
35%	\$518,400	\$622,050	\$311,025
37%	\$518,401+	\$622,051+	\$311,025+

As you will note from the tax bracket chart above, the tax rates get progressively higher along with the taxable income earned each year. The tax rate that applies to the last or most recent dollar earned each tax year is known as a **marginal tax rate**. Due to higher tax percentage rates and tax dollars paid each year, wealthier Americans are likely to seek out tax shelters like rental properties that they hope will move them into lower tax brackets with much lower tax payments required.

Hidden and Obvious Taxation Fees

The most common type of income source that is taxed each year originates from a person's employment or self-employed income. Yet, there can be upwards of another 100 or so additional taxes that consumers pay directly or indirectly each year, especially here in the state of California. Those taxes may include:

1. Gasoline taxes
2. Business registration fees
3. Cigarette taxes
4. Corporation taxes (federal and state)
5. LLC fees
6. Driver's license fees
7. Employer health mandate taxes

8. Social security taxes paid by the employer
9. Estate taxes
10. Medicare taxes paid by the employer
11. Federal unemployment taxes
12. Franchise business taxes
13. Garbage taxes
14. Gift taxes
14. Highway access fees
15. Property taxes
16. Mello-Roos and other special property assessments
17. Inheritance taxes
18. IRA (or other types of pensions) early withdrawal tax penalty
19. Local school taxes
20. Local income taxes
21. Marriage license taxes
22. Parking meters
23. Professional licenses and fees (real estate, especially)
24. Telephone taxes
25. Zoning permit fees

Income and Deductions

With income earned each year, it is not how much a person actually earns that is so important; rather, it is how much the taxpayer *keeps* that is more relevant to his or her ability to pay his or her monthly living expenses. And hopefully he or she has enough to keep some extra funds available to save and make investments. As such, taxpayers are usually quite interested in maximizing their **deductions (or taxable write-offs)** so they can pay less in taxes and keep more of their hard-earned money. Each deduction is subtracted directly from the taxpayer's gross income

which will, in turn, possibly move the taxpayer's taxable rates to a lower bracket at a reduced percentage rate.

A taxpayer may also significantly reduce one's tax amount owed to the IRS and Franchise Tax Board (FTB) for California taxes by subtracting a portion of the tax amount that would have been due to the IRS or FTB had he or she not had the tax credit in place. For example, a tax credit benefit of \$1,000 would reduce the taxpayer's \$5,500 tax obligation to the IRS down to \$4,500.

Gains and Losses

Taxpayers may be faced with minimal or tremendous financial gains or losses each year from sources such as work income or investments. These gains or losses may later reduce the taxpayer's tax obligations or they might be assessed with higher tax penalties and fees than first expected. A **gain** is most often a **taxable** source of income, and a **loss** might be **deductible** or **deferred** as either a loss or a tax benefit that reduces other income sources for a taxpayer.

Real property investments are some of the most popular tax shelter options that investors seek out when working with real estate agents. The goal for most investors is to maximize their financial gains with real estate holdings while minimizing their tax assessments. However, sometimes property owners can be hit with the worst gain and loss combination such as a horrific financial loss coupled with a tax penalty as well.

A savvy and experienced real estate investor may choose to buy and sell properties under some type of business entity such as a California corporation or an LLC (limited liability company). There can be more deduction options for properties held under a business entity than ones owned under individual names if the losses were directly related to their main trade or business activity.

Individual property owners they can deduct a loss only if it was incurred due to 1) the taxpayer's business or investment activity; 2) a transaction or investment that was originally intended to be "for profit"; or 3) a loss, casualty, or theft of the property that was owned by the taxpayer.

The deductible losses for individual taxpayers are related more to investment or rental properties as opposed to an owner-occupied home residence. Deductions are not usually allowed for property losses from the taxpayer's main residence (e.g., home, condominium, or townhome unit) even if he or she lost \$100,000 or more when comparing the final sales price to the original purchase price several years earlier.



Capital gains and losses: A **capital gain** or **capital loss** is defined in tax codes as a gain or loss related to the sale of an asset held for personal use or as a short or long-term investment. If the gain is greater than the deductible loss when added together, then there may be a capital gain tax penalty. Conversely, when the losses far exceed the gains, then there will likely be no tax, a tax credit, or some type of deferred tax benefit that the owner can use in the near term or over several years.

The tax rates for **capital gains** (15% to 20% federal tax rate ranges) are generally lower than income tax brackets. This is partly because the lower capital gains rate offers incentives for property owners willing to

take financial risks to acquire both owner-occupied and investment properties.

There is an annual limit of capital losses that a taxpayer is allowed to deduct each single tax year; the net capital losses deducted cannot exceed **\$3,000** each tax year. Any losses that exceed \$3,000 may be carried forward into subsequent tax years. These loss deductions are more for real property investments as opposed to most types of personal property losses that typically cannot be deducted unless they were considered to be a vital part of a taxpayer's business operations in some rare circumstances.

For many types of **business and rental properties**, the gains and losses on the sale of real property used in a business such as a small retail strip center or a rental home are treated differently depending upon the length of time that the properties are held. Often, the minimal length of time for a property to be held that will determine whether or not the gain is considered to be taxable as ordinary income or capital gains income is **12 months**.

The \$3,000 annual limit on the deduction of a capital loss does **not** apply if the property was owned and held for less than just **one year**. The full amount of the investment loss may likely be fully deducted against the ordinary income in the same tax year for which it was incurred if held less than one year.

The determination of a property owner's potential gain or loss usually first begins with something known as their **basis** in the property. The basis is effectively the original purchase price plus any significant property improvements made shortly after the time of acquisition. Improvements made to rental properties which add value or prolong economic life are referred to as **capital expenditures**.

For example, a home purchase as a remodel for a long-term hold had an original purchase price of \$800,000 and an additional \$200,000 in construction upgrades. The updated **adjusted basis** for the property then is equal to \$1 million dollars (\$800,000 + \$200,000). An adjusted basis includes additional capital expenditures or construction upgrades made by the owner to improve the property and increase value with such improvements as a major kitchen or bathroom remodel, new flooring throughout the home, or redesigning much of the interior of the home

with the latest appliances, lighting systems, and plumbing upgrades. Maintenance expenses related to certain types of landscaping and roof cleaning are not usually considered capital expenditures that can be fully deducted.

At a later date, when the property is sold, the gain or loss will be offset by the \$1 million dollar basis number. If the property sells for \$1,400,000 several years later, then the gain is \$400,000 that may or may not be reduced due to other factors such as depreciation and other deductions or credits.

In this same example above, the **initial basis** (also known as the **cost basis** or **unadjusted basis**), would first begin with the \$800,000 plus any additional closing costs. If the loan, escrow, title, and third party inspection fees reached another \$10,000, then the cost basis for the investor would begin at \$810,000.

Realization

Gains or losses may not be fully taxable or credited at or closely near the time of the property sale. The ownership of a real property asset that appreciated in value will likely involve a gain as opposed to a loss for tax purposes in most situations. The gain is separated from the asset for tax purposes after the sale or exchange of the asset.

The number that is arrived at after calculating the difference between the net sale price, or the **amount realized** in the tax code, and the latest adjusted basis (purchase price + closing costs paid + capital improvements) will equal either the gain or loss **realized** on a transaction. The **realized** gain or loss for tax purposes may be far different than the actual financial gains or losses experienced by the property seller at the time of sale.

Net sales price (amount realized) - adjusted basis = gain or loss

On the seller's side of the transaction when determining the amount realized, the sales price may consist of the money or other property received in an exchange, minus any existing mortgage debt and selling expenses (commissions, escrow, title, and other closing costs).

Money collected + market value of other property received (if applicable) + mortgage debt balance at time of payoff - selling expenses = net sales price (or amount realized).

The gains from property sales, and various other types of income sources, are **recognized** in the year it is taxed in many cases. However, there can be multiple exceptions to this rule that allow taxpayers to defer or partially or completely eliminate these gains. An example may include the fact that the tax code allows an individual selling his or her rental property on an **installment basis** (more details later in the chapter) to defer taxation for a portion of the gains to later tax years instead of in the same year of tax sale. The tax code provisions that may allow delay or deferral are known as **non-recognition provisions**.

Types of Real Property Classifications

Just as there are several different types of real properties ranging from raw, unimproved land to 100-story office buildings, there are also many types of real property classifications as defined under the federal tax code. These property designations for tax purposes include the following:

1. Main owner-occupied residence
2. Personal use property
3. Unimproved investment property
4. Investment properties held for income production
5. Trade or business property
6. Dealer property

Main owner-occupied residence: This is the primary residence where the taxpayer resides. It may be a single-family home, a condominium unit, or an owner-occupied duplex, triplex, or fourplex. If a person spends time at two or more residences throughout the year, he or she must declare one of the properties as his or her main residence based upon where he or she spends the majority of his or her time each year.

Personal use property: A second home or vacation home is a prime example of this type of residence in which the owner may spend only a few weeks or months there each year.

Unimproved investment property: Raw land is perhaps the best example of an unimproved investment property. The site might be located near a beach, desert, or mountain location. Investors are usually motivated by the expectation of future value appreciation, especially if the land is located near the a developing area.

Investment properties held for income production: Residential, commercial, industrial, retail shopping centers, and mixed-use properties are types of investment properties held to generate rental income for the owner.

Trade or business property: This is the real property, including the land and the building(s) on it that are used by the owner for his or her business or trade, such as a cement manufacturing plant.

Dealer property: This is property held for the short-term rather than long-term for sales to customers. A builder or developer who improves subdivided lots or entire tracts of new homes is engaged in the act of selling dealer properties to consumers as defined under the tax code.

Non-Recognition Transactions

Property sellers usually want to minimize their tax penalties that were related to the sale of their owner or non-owner occupied properties. If the deductions cannot completely eliminate their taxable gains, then owners have ways to defer their gains from the year of sale to several future years or or ways to roll the profits into one or more investment properties. These deferrals are not completely “tax-free” sales. Rather, they are just deferred or delayed to future years.

Three of the most common ways to defer the recognition of the capital gain includes: 1) installment sales; 2) involuntary conversions; and 3) 1031 Tax-deferred exchanges.

Installment Sales: An installment sale is defined under the tax code as one in which less than 100% of the sales price is received in the year of

sale. A seller-financed property sale where the seller carries some or all of the equity as a mortgage note or some other type of financial instrument (e.g., a land contract, a new first or second mortgage, or a recorded wraparound mortgage or AITD) over the next several years is one of the most common examples. Taxes are assessed on the actual amount of profit received in the year collected.

The calculation of the **gain recognized** in any given tax year in an installment sale is based upon the ratio of the gross profit to the contract price. The **gross profit** is determined by subtracting the sales price by the adjusted cost basis (and any closing costs such as real estate commissions, title, and escrow fees).

The calculation of the **gross profit ratio** (a/k/a “gross profit percentage”) is determined after comparing the gross profit with the contract price. The total amount of all principal payments (e.g., 60 months of \$1,000 principal payments paid in a 5-year seller financed second mortgage) in which the buyer agrees to pay to the seller, is equivalent to the **contract price** for purposes of taxation estimates. The contract price will usually be the same as the sales price unless the buyer is assuming a portion of the seller’s existing first mortgage balance from a bank.

Gross profit/Contract price = Gross profit ratio

An important fact to remember is that the gross profit ratio is not applied to the interest that the seller collects from the buyer. Rather, all interest payments received are counted as taxable income in the year collected.

Involuntary Conversions: The process of converting an asset to cash without the owner’s deliberate intent or desire is considered an involuntary conversion. A prime example is the government’s use of police power to condemn or take a property from an owner through **eminent domain** actions after paying “fair market value” for the property. You will recall that eminent domain actions are made on behalf of the “public’s good or interests” such as needing the land to expand a road or highway. Another example is the payment of cash from an insurance company after a tornado levels the home to the ground.

Often, the payment of cash proceeds to an unwilling property owner represents either the replacement cost or market value of the subject property, and is defined under the tax code as the realization of a gain

from the involuntary conversion. However, these gains may be deferred if the property owner uses the funds received to replace the property during the course of the replacement time period established by the IRS. Most often, the IRS's definable replacement period is two (2) years from the date the property was destroyed, lost, or forced to be sold under actions like eminent domain. Any gains not used to purchase or replace the property may still be taxable as income.

1031 Exchanges: Section 1031 of the Tax Code includes the rules associated with tax-deferred investment property sales and exchanges. Any realized gain from the property sale of most types of real property that is not the owner's primary residence, second home, or dealer property, may be exchanged for other "like-kind properties," even though this definition is somewhat misleading. "Like-kind" is more of a reference to exchanging income-producing properties as opposed to similar types of property buildings such as a home for a home. A person may exchange a \$1 million home for a small apartment building with 8 units in it.

There is an old "napkin test" that was supposedly once developed on a cocktail napkin in a bar by an attorney that simplified the meaning of a 1031 exchange. Using the upwards arrow sign three times on a bar napkin, the attorney wrote the following details:

^ Debt
^ Equity
^ Value

An investor can defer their gains from an investment property or properties if he or she exchanges one or more properties for one or more other properties, as long as the investor increases his or her new mortgage debt amounts, equity, and/or property value by at least \$1. For example, a rental home with a \$100,000 mortgage, \$100,000 in equity, and \$200,000 sales price value may be exchanged for a property that is at least \$200,001 in order to defer the gains.

California rental properties may be exchanged for new properties in other states. The properties must only be located somewhere within the U.S. Taxpayers may be paid with cash, stock, or debt relief (the difference between old and new mortgage balances) that are referred to as "**boot**" (or something of value that is exchanged) in these 1031 exchanges. The boot is taxable only up to the amount of real gain for the owner. As such,

only the gain will be taxed as opposed to the entire amount of the boot if the boot received exceeds the taxpayer's realized gain on the sale.

The main rules for qualifying to exchange rental properties under the 1031 guidelines includes these key points:

1. The taxpayer is the seller and buyer of the properties.
2. One or more properties is identified within 45 calendar days post-closing of the first property sold.
3. The subsequent purchase of the new property/properties is completed within 180 days (6 months).

The investor is trading up with higher new property value.

Tax Deductions for Owner Occupants

Prior to 1997, taxpayers used to be allowed to "roll over" the deferral of taxation into new owner-occupied properties. The sales gains were deferred if the homeowner's sales proceeds were used within two years from the date of the original home closing to buy another home. The main exception was for sellers over the age of 55 who were allowed to take a one-time exclusion of the gain, and they were not required to reinvest the sales gains into another property. In 1997, these two main owner-occupied tax rules were merged into one simpler tax rule that was offered to homeowners of most age ranges instead of just older than 55 years of age.

After 1997, the sale of owner-occupied residences now offers perhaps the absolute best type of tax-free gain option with real estate. While 1031 exchanges provide investors with tax deferred gains, owner occupants are entitled to completely exempt **\$250,000 for single or unmarried residents** and **\$500,000 for married couples** if the property has been held long enough (see below). Any profit amounts over the \$250,000 (single) and \$500,000 (married filing jointly) gains will be taxed at the taxpayer's capital gains rate.

The main time requirements necessary for homeowners to qualify for the large capital gains exemptions are that the owners must have lived in the

property for either the past two (2) consecutive years, or for at least two years during a five-year period of ownership that ends on the date of sale. A homeowner may use this capital gains exemption every two years if he or she buys and sells multiple properties to live in that are spaced two years apart. But homeowners can only claim one primary residence at a time during these qualifying time periods.

Property Owners' Deductions

A **deduction** is subtracted from a taxpayer's income before the tax rate is applied. The higher the number of deductions, the less taxes that the taxpayer might be required to pay. Some of the most commonly used deductions for owners include:

- Depreciation
- Mortgage interest
- Uninsured losses
- Property taxes
- Repairs

Depreciation: Depreciation also refers to the **cost recovery deduction** for property owners. This deduction allows taxpayers to recover the cost of an investment asset (a/k/a **"recovery property"**) over a relatively long number of years. Properties that are excluded, or not allowed, for the cost recovery deduction include a main residence, a second home, unimproved land, and dealer properties.

Time takes a toll on properties (and people). Property, specifically, might be in need of new paint, a roof, exterior siding, windows, and floors over a period of many years. These types of assets (also called **depreciable assets**) found in a home or building will probably need to be repaired or fully replaced at some point in the future. But land doesn't wear out, so the dirt value is not normally part of the deduction calculation.

The **depreciation schedule** established for investors by the IRS is **27.5 years for residential properties** (one to four unit properties) and **39**

years for commercial buildings, such as office, retail, and warehouse.

If a rental home is valued at \$1 million dollars (\$200,000 for land and \$800,000 for the home structure), the \$800,000 improved portion of the rental property asset will be divided by 27.5 years ($800,000/27.5$) to arrive at an annual deduction of \$29,090 per year. If the same property were classified as a commercial property (e.g., a 5-unit apartment building), the \$800,000 improved building value would be divided over 39 years ($\$800,000/39$) to end up with an annual depreciation deduction of \$20,512 per year that can be used to reduce the taxpayer's income.

The annual depreciation deductions, regardless of whether they are taken or not on a taxpayer's tax returns each year, will reduce the original adjusted basis for the subject property. The taxpayer's future gain or loss (realized or not) will be affected by the deductions since the adjusted basis has been reduced over the years after claiming or not claiming the annual depreciation deductions.

Mortgage interest: The mortgage interest deductions are usually allowed for both owner-occupied and investment properties. Yet owner occupants may be limited to up to \$1 million for married property owners who file their returns jointly, or up to \$500,000 for married couples filing separately or single owners.

The deductible mortgage interest debt may be used to purchase, build or develop brand new structures, or remodel existing properties with a first or second mortgage or line of credit. Some of the mortgage fees associated with closing these loans such as origination and discount points may be fully deductible in the same tax year as when these loans were funded.

Uninsured losses: Any losses incurred from uninsured casualty (fire, floods, etc.) or theft will probably be deductible for the taxpayer against his or her income in the same year that the damage occurred, if the loss was caused by an event that is not covered by homeowners' insurance.

Property taxes: Property tax rates in California can vary from an effective rate near 0.88% to 2.5% or more of the purchase price or assessed property value due to special assessments and bond fees for the construction of new roads, schools, and parks. Most types of property taxes are deductible. However, some special assessments for common

areas such as sidewalks are not deductible for the property owner.



Repairs: Any repairs made to the property as a type of one-time incident such as a broken water pipe are typically deductible in the same year paid. For example, a \$500 expense that was paid to a handyman may be fully deducted from the rental income earned in the same tax year.

The **deduction of operational losses** from rental property investments is capped at **\$25,000** for the owner and active manager of rental properties against his or her ordinary income. To qualify as an active manager, the owner must truly be “hands on” and not a silent partner in an LLC or partnership that hires a third-party property manager to manage the property. Many real estate professionals with active licenses are more likely to be classified as “active investors” because they are acting in the same profession when managing and owning rental properties.

Often, a **passive income** is designated by the IRS for “passive investors” who are not directly involved in the day-to-day management. Any losses from passive income may be offset by other passive income gains instead

of against ordinary income from sources such as work. If the annual expenses and losses related to things like unexpectedly high vacancy rates or \$25,000 in repair expenses, the property owner can deduct up to \$25,000 in rental real estate losses.

Rental payment deductions: Tenants who rent residential or commercial properties for their business operations may be able to deduct a portion of the rental payments as a business expense. However, they may not deduct any rental payments for properties that are not used in a business or trade such as their primary home or apartment unit that they lease.

California Income Tax

California's state income tax law provisions are similar to the Internal Revenue Code in that the state bases its tax assessments on gross income, adjusted gross income, itemized deductions (with some exceptions), and taxable income amounts. Just as with federal taxes, the tax rates are progressive in that higher rates are imposed on higher taxable income amounts by the California Franchise Tax Board.

Let's take a closer look at sample tax brackets for California residents that are single or married filing separately:

- 1% on the first \$8,809 of taxable income.
- 2% on taxable income between \$8,810 and \$20,883.
- 4% on taxable income between \$20,884 and \$32,960.
- 6% on taxable income between \$32,961 and \$45,753.
- 8% on taxable income between \$45,754 and \$57,824.
- 9.3% on taxable income between \$57,825 and \$295,373.
- 10.3% on taxable income between \$295,374 and 354,445.
- 11.3% on taxable income between \$354,446 and \$590,742.
- 12.3% on taxable income of \$590,743 and above.

An additional 1% surcharge (“the mental health services tax”) is also collected on taxable incomes over \$1 million or more. As a result, California’s highest tax bracket is really 13.3% (12.3% + 1% “mental health tax”), which makes it one of the highest state tax brackets in the nation.

Chapter Thirteen Summary

- A tax can be defined as **“proportional”** (same tax rate applied to all people), **“regressive”** (lower tax rates for less income), or **“progressive”** (higher tax rates for more income) for taxpayers.
- The tax rate that applies to the most recent dollar earned each tax year is the **marginal tax rate**.
- A **deduction** (or tax write-off) is subtracted directly from the taxpayer’s gross income which might move the taxpayer’s taxable rates to a lower bracket at a reduced percentage rate. A **tax credit** is equivalent to an amount of money that can be used to completely offset a tax liability (i.e., a \$500 tax credit may reduce the taxpayer’s total annual tax bill by the same \$500 amount).
- A **capital gain** or **capital loss** is a gain or loss related to the sale of an asset held for personal use or as a short or long-term investment. Capital gain tax rates (15% - 20% federal tax rate range) are usually lower than ordinary income tax rate brackets.
- The determination of a property owner’s potential gain or loss usually first begins with something known as the **basis** in the property (purchase price). The **adjusted cost basis** is equal to the purchase price plus any significant capital improvements (or **capital expenditures**).
- The gains from property sales, and various other types of income sources, are **recognized** in the year it is taxed. This can be true, regardless of whether the gains were realized or collected in other

calendar years.

- Section **1031** of the Tax Code includes the rules associated with tax-deferred investment property sales and exchanges. The basic “rule of thumb” is that an investor must increase their debt, equity, and total overall value when rolling the equity or profit gains from one or more rental properties into one or more new rental properties in order to keep deferring the tax gains.
- Owner occupants are able to avoid paying any taxes (or completely tax-free income) on **\$250,000 for single or unmarried residents** and **\$500,000 for married couples** as long as they lived in the primary residence for at least the past two years (or at least two of the past five years that ends on the date of the home sale). Unlike a 1031 exchange, the owner(s) do not have to reinvest any of these tax-free gains in any other real estate.
- Depreciation is also referred to as the **cost recovery deduction** for property owners (building value minus land = dollar amount to be depreciated). The **depreciation schedule** established for investors by the IRS is **27.5 years for residential** (one to four-unit properties) and **39 years for commercial buildings**.
- **Property tax rates** in California can vary from an effective rate near 0.88% to 2.5% or more of the purchase price or assessed property value. The property tax calendar in California goes from **July 1st - June 30th** with two installment payments due.
- California’s state income tax brackets start at a low of 1% (\$8,809 of taxable income) up to one of the nation’s highest state income tax bracket rates of 13.3% (\$590,743 and over of taxable income).

Chapter Thirteen Quiz

1. Income losses from passive investments related to such investments as a REIT (Real Estate Investment Trusts) or some partnerships can be deducted against which type of income on tax returns?
 - A. Passive Income
 - B. Ordinary Income
 - C. Active Income
 - D. Any type of income
2. Which answer below would most affect an owner's cost basis in his principal home after adjustments are made on his tax return?
 - A. The property taxes paid
 - B. The cost of adding a new kitchen
 - C. Closing costs paid at the time of purchase
 - D. Maintenance expenses related to weekly gardening fees
3. Which of the following is the most likely tax deduction option for the owner of raw, unimproved land?
 - A. Depreciation losses over a 27.5 year time period
 - B. Depreciation losses over a 39 year time period
 - C. A loss on any future sale of the land site
 - D. \$250,000 capital gain exemption
4. What is the main determining factor for the amount of taxes that someone has to pay each year?
 - A. Source of income
 - B. Type of profession
 - C. Number of dependents
 - D. Tax bracket percentage rate
5. Property held by a builder/developer for the short term that is sold off to the public in new home subdivisions are generally classified under tax codes as _____.
 - A. Income property
 - B. Dealer property
 - C. Chattel
 - D. Boot

6. Income earned by an investor without significant or material participation is known as _____.
A. Passive
B. Active
C. Ordinary
D. Tax-free
7. Which answer below is the least likely to be considered a form of boot in a 1031 tax-deferred exchange?
A. A car
B. A duplex rental
C. \$100 cash
D. A retail strip center
8. Per the federal income tax code, income is typically taxed in the year that it is _____.
A. Earned
B. Physically collected
C. Realized
D. Recognized
9. Which answer below probably will not qualify for a 1031 tax-deferred exchange?
A. Owner-occupied home
B. An office building
C. A 10-unit apartment building
D. A 26-room motel
10. What is the name for something that an investor adds to a rental property by way of property upgrades or improvements that increases overall value and prolongs the building's economic life?
A. Boot
B. Capital expenditures
C. Basis
D. Adjusted basis

11. What is the maximum amount of tax savings that a single person can receive as a benefit after selling his or her owner-occupied home after living there for three years?

- A. All gains from the sale are taxable at his or her ordinary income tax bracket rate
- B. \$100,000 is tax-deferred
- C. \$250,000 is tax-free
- D. \$250,000 is tax-deferred

12. What is the maximum tax benefit that a married couple can receive after selling their owner-occupied home after living there for 10 years?

- A. \$250,000 tax-deferred
- B. \$250,000 tax-free
- C. \$500,000 tax-deferred
- D. \$500,000 tax-free

Answer Key:

1. A	7. A
2. B	8. D
3. C	9. A
4. D	10. B
5. B	11. C
6. A	12. D

CHAPTER 14

REAL ESTATE APPRAISALS

Overview

The valuation of real property is incredibly important for buyers, sellers, agents, and lenders because the real property is the main asset in the transaction and the main piece of collateral that is used to secure any loan. With most types of assets, value is defined by the market price that a willing buyer and seller agree to even if there are no other solid comparables at the time of the transaction. The appointment of a third-party appraiser will likely offer a neutral and fair assessment of what the true market value of the property is even if the buyer is more than willing to pay well above the market value at the time of purchase. In this chapter, we will address the various steps undertaken by qualified appraisers as well as learn details with respect to how they arrive at one or more of the different definitions of value.

Appraisal Functions

The absolute number one reason why an appraisal is ordered in a real estate transaction is to define the true average property value by analyzing both general and specific data at the time of purchase. Most often, the appraiser is attempting to define market value. Yet there are several other valuation methods that can be used, depending upon the property types and the owner or buyer's intent with respect to how to best use the property.

Appraisers can be hired for the following reasons:

- to determine fair market value
- to help a lender finalize their potential loan-to-value amounts
- to identify the highest and best use for the subject property

- to provide the latest data for rental rates
- to estimate the remodeling or new construction costs
- To establish how much insurance might be required in case of damage
- To offer the latest value estimates for property exchanges or condemnation
- To estimate property values for gift, estate, merger, or bankruptcy actions

If a third-party lender is involved with the purchase, construction, or refinance transaction, it will probably be the lender who directly hires and appoints the appraiser to estimate value using one or more valuation methods. Other times, the appraiser may be hired by a government agency for reasons such as condemnation and eminent domain, government-backed or insurance mortgage loans, or by private corporations, courts for reasons such as probate (wills and trusts), judgments, and real estate brokerage firms.

A third-party appraiser might be self-employed or employed under a larger appraisal company umbrella firm. Self-employed appraisers who are hired to appraise properties for a fee may be referred to as a **fee appraiser**. The appraiser's fee is fixed in advance (i.e., a fee of \$300 to \$600 or more is charged for many residential appraisals). The fee is determined ahead of time by the appraiser's estimated time to complete, and cannot be calculated as a percentage of the final estimate of value or by the client's satisfaction with the report.

The person who appoints the appraiser is the **client** or **principal**, and the appraiser is his or her **agent**. As such, a **principal-agent** relationship is formed under the **Laws of Agency**, and it forms a fiduciary relationship as well. The appraiser is bound by a **duty of confidentiality** in which he or she may share the details only with the client who hired the appraiser, unless granted permission to share the appraisal report with other designated parties. The appraiser must not have any ownership, beneficial, or any other types of interests in the subject property being appraised.

A licensed **mortgage loan originator (MLO)** is not allowed by Fannie Mae, Freddie Mac, or the Consumer Financial Protection Bureau to directly hire or have any significant communication with an appraiser in a mortgage loan transaction; that especially includes owner-occupied one-to-four-unit residential properties. Owners of properties being appraised cannot attempt to influence or bribe appraisers to change their value estimates. It is a violation of California law for any owner or licensee to try to adversely influence the appointed appraiser.

Licensing and Certification Requirements

Appraisers are certified and licensed by the state of California. Under federal law, a state-licensed and certified appraiser, as defined under the **Uniform Standards of Professional Appraisal Practice (USPAP)** guidelines, can work on federally-related, backed, or insured mortgage loans or government-owned properties that were originally built and owned or foreclosed upon by government agencies or entities. The USPAP regulations are a set of principles that were adopted by a non-profit foundation called the **Appraisal Foundation**.

Any appraiser working on a property secured by a federally-backed or insured loan transaction who knowingly violates the USPAP standards and defrauds a lender will likely be charged with a felony for any transactions that are greater than **\$250,000**.

Appraisers are licensed in California by the **Office of Real Estate Appraisers**. An appraisal license is valid for just two (2) years. To renew the license (subject to change), appraisers are required to pay their renewal fees and complete a 7-hour national USPAP update course.

There are four levels of appraiser license options in the state. Each requires at least a 15-hour national USPAP course to be completed as part of the educational requirements.

1. **Certified General Real Estate Appraisers:** This license designation is usually the highest level that an appraiser can reach. To qualify, an applicant must finish 300 hours of appraisal-related education and show proof of 3,000 completed hours of appraisal experience (1,500 hours of which must involve non-residential properties) over a period of at least 30 months. License candidates

may need either an undergraduate bachelor's degree from an accredited college, or at least 30 credit hours of related appraisal coursework. Additionally, the license applicant must pass the **Uniform State Certified General Real Property Appraiser Examination**.

2. **Certified Residential Real Estate Appraisers:** Appraisers with this license may appraise one-to-four-unit residential properties, and any non-residential or commercial property with a value under \$250,000. Applicants for this license must first pass the **Uniform State Certified Residential Real Property Appraiser Examination**. To qualify to take this exam, you must have a minimum of 200 hours of appraisal education, 2,500 hours of appraisal experience over at least 30 months, and an associate college degree or 21 semester units in related studies.

3. **Residential License:** Appraisers with this license designation are qualified to value residential properties up to \$1 million dollars as well as non-residential or commercial properties up to \$250,000. To qualify to take the required **Uniform State Licensed Residential Real Property Appraiser Examination**, an applicant must complete 150 hours of appraisal education and show a minimum of 2,000 hours of appraisal experience or at least 1,000 hours of experience as a licensed real estate broker in California.

4. **Trainee License:** The brand-new applicant in the appraisal field must first work under an experienced licensed appraiser during the training process. The trainee may assist the supervising appraiser on any type of appraisal transactions. To qualify for this new license, the applicant must have completed 150 hours of appraisal course instruction within the period of the past five (5) years as well as passed the **Trainee Level Appraiser Examination**.

Defining Value

Value is usually measured in terms of money. But it may also be defined as "the present worth of future benefits." And it may be what two or more parties are willing and able to pay for an asset, consumer good, or service.

There are four **elements** of value and four **principles** of value. (Note that in this context an **element** is a part or aspect of something that is abstract, especially one that is essential or characteristic, while a **principle** is a fundamental truth or proposition that serves as the foundation for a system of belief or behavior. We will discuss the elements of value first, followed by the principles of value.

The Four Elements of Value:

- **Utility** (provides a service or meets a need),
- **Scarcity** (lack of a readily available product),
- **Demand** (when demand exceeds supply at any given time), and
- **Transferability** (the ease of salability).

Two of the main classifications of value for appraisals are **value in use** and **value in exchange**. The value in use is more subjective and biased since it is the value estimate assigned to a property by the owner. The value in exchange (also referred to as “**market value**”), is the amount willing to be paid by a buyer. These two price estimates may vary widely between the owner/seller and buyer. It will be the appraiser who will offer his or her own fair and unbiased value opinion that will most likely settle the value dispute between two or more parties such as principals and agents.

The Uniform Standards of Professional Appraisal Practice defines **market value** as: *“The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and the seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.”*

Market value is the price that the sale of the property should have been based upon under “normal market conditions” while **market price** is the actual price paid by a willing and uncoerced buyer.

The Four Principles of Value

Value is influenced by at least four principles that include:

- Social beliefs

- Ever-changing economic cycles
- Government regulations
- Physical size and shape along with external environmental factors

These factors may include a family having more children prior to seeking out a larger home, an improving or weakening local job market, zoning and land usage ordinances passed by government entities, and environmental damage caused by floods, earthquakes, or fires. Some personal and external reasons can damage values while others can improve property values, such as the rezoning of a land site that allows a larger and more expensive property to be built. The increase in property value from an external force is called an **unearned increment**.

Appraisers will factor in both personal and external factors or principles that can increase or decrease property values prior to determining their final estimate of value.

These value principles include:

Principle of Highest and Best Use: This is the use of property that will usually bring in the highest value estimates over the long term. An example would be a raw land site that would be most valuable if a home (“the highest and best use”) was allowed to be built on it instead of a small farm. The **net return** description used by appraisers for this principle can come from financial profits, income, personal satisfaction, and an owner’s pleasure while using the property.

Principle of Supply and Demand: An increase in the demand or supply of real property or other assets will either increase or decrease value. A **buyer’s market** exists when there are more unsold properties available for purchase in a specific market region. A **seller’s market**, on the other hand, is a period of time when the number of motivated and qualified buyers far exceeds the available supply of homes for sale. Supply, demand, and current market price are like a seesaw because they can be inverse to one another. When the supply of homes for sale is much higher than the buyer demand, then prices may fall. If the available home supply is low and the buyer demand is high, then the home prices will generally increase.

Principle of Anticipation: Value is created by the expectation of future benefits. An appraiser will assign a value based upon **anticipated returns** or the **expectation of future benefits**.

Principle of Change: The fluctuation of real property values is related to the ongoing changes directly related to social, governmental, economic, and environmental factors affecting value.

Principle of Substitution: If two properties are equally desirable, the less expensive one is likeliest to sell first.

Principle of Conformity: Properties will usually be valued higher if the surrounding properties are similar, such as homes you may find in master-planned, single-family home communities.

Principle of Competition: Solid profits from the sale of a home or other assets, goods, or services at a certain time may bring about more competition from others who also want a share of those high profits. . But if too many sellers enter the market at the same time, then the prices for these items may fall because there are more sellers than buyers. When given the choice to buy two or more identical homes, a buyer is, of course, likelier to purchase the more affordable home. Conversely, fewer sellers and more buyers will probably push home prices higher.

Principle of Balance: The maximum value for a unique real estate property is reached when the agents in production (land, labor, coordination, and capital) are properly balanced with each other as determined by appraisers and others. An example of this principle can be the relationship between cost, added cost, and the value that it returns for every dollar invested to upgrade a property. For example, a \$10,000 investment to remodel a kitchen should increase the overall home value by more than \$10,000 (or more than a \$1 gain for every \$1 invested).

Appraisal Steps

There are several steps in the appraisal process before determining final value. These steps include the following strategies:

1. **Define the problem:** The appraiser must be given a specific subject

property to value for current or future value estimates for transactions involving things like construction loans. The **improved value** is the value of land combined with any improvements made to the site, such as a completed home.

2. Identify the usable data: The two main data categories used by appraisers are **general data** (i.e., population and employment trends, zoning, interest rate and economic forecasts, proximity to schools, transportation, and stores) and **specific data** (the size, shape, zoning, and legal usage of the property itself and surrounding properties). Land will usually be valued separately from the building itself in two different types of valuation categories, regardless of whether the property is zoned residential or commercial.

When determining **general data**, the appraisal will take into account factors such as: 1) the percentage of owner and non-owner occupants; 2) the number of nearby vacant properties and lots; 3) the issue of **conformity** such as whether or not the nearby properties are uniform or similar in size, shape, color, quality, land use, and age; 4) the similarity of land topography (flat, hills, mountain slopes, etc.); 5) the quality of adjacent streets, parks, and schools; 6) the access to shared utilities; and 7) the types of public services, government influences (zoning, usage, etc.), and external public nuisances like high levels of noise, pollution, or traffic.

For the value assessment of **specific data** and a **site analysis** of one individual property, the appraiser will likely use these factors: 1) the width of the lot; 2) the frontage of the lot as it relates to a street, lake, ocean, river, or some other location; 3) the measurement of the land site in area such as by square feet and/or acreage; 4) the depth of the lot from the front to the back; 5) the shape of the lot; and 6) the site location near surrounding influences of value. A corner location for a business site, for example, may improve the value due to the higher visibility and traffic from customers. (This is called the **corner influence**.)

The depth and value of a property site may be described by a value principle known as the **4-3-2-1 Rule**. In accordance with this principle, the front quarter of the lot makes up 40% of the land's overall value, the second quarter equals 30%, the third quarter holds 20% of value, and the rear fourth quarter is equivalent to just 10% of the overall value partly due to the fact that it is the last accessible portion of the land site.

Some appraisers or tax assessor offices will use a **depth table** when determining how the depth of a lot or land parcel potentially impacts its overall value. Mathematical factors are used to multiply the front portion of a lot or land parcel when estimating the value of the land with a certain specified depth. A tax assessor's office may be more likely to use it than an appraiser. Value may be greatly added to a land parcel when two or more adjacent lots are combined to make up a much larger plot of land. This may make the land use more efficient by increasing the overall land value through **plottage**.

3. Collect and verify the general and specific data.

4. Select and apply the valuation method targets: The appraiser usually has three different options when valuing properties. These options include the **sales-comparison approach, the cost approach, and the income approach**. It will be up to the appraiser to determine which value analysis method will be the most effective and appropriate for the subject property, or the appraiser may use two or all three of the valuation methods for the same property.

5. Reconcile the data prior to estimating final value: The value figures or outcomes that are produced by the three different types of approaches are called **value indicators**. Each of the three value methods can show an indication of potential value, but they are not the final estimates of worth individually.

6. The issuance of the final appraisal report will then follow these steps.

Building Analysis

In most valuation situations, the improved building structure on the land site will usually represent the majority of the property's overall value. An exception to this rule might be if the home is built on prime beachfront property, or on a few hundred acres near a beautiful mountain ski resort such as near Lake Tahoe or Mammoth Mountain.

Appraisers will analyze the functional utility of a home based upon factors such as:

- 1) The overall quality of construction
- 2) The age and condition of the subject property
- 3) The size of the property, by noting the total overall square footage of the interior portion of the home as well as garage, porch, and basement space
- 4) The design of the interior and exterior of the property; an appraiser will probably note the **functional utility** (or usefulness) of a property by looking closely at its design, which may be outdated (fewer buyers may demand that type of property design) or in style.
- 5) The orientation, or positioning of the property, as it pertains to proximity and views associated with sunlight, wind, noise, and privacy issues
- 6) The number of bedrooms, bathrooms, and other types of rooms
- 7) The type of parking areas for cars such as an enclosed, spacious garage, a small partially covered carport, or only on-street parking
- 8) The quality of heating, air conditioning, and overall energy efficiency

Appraisal Methods

After collecting and closely analyzing the general and specific data, the appraiser will begin to apply one, two, or three valuation methods for the appraisal that include:

Sales Comparison Approach: This is also referred to as the **market data approach**. For residential one-to-four-unit properties, it is generally considered the most popular and reliable value comparison approach. The subject property is compared to nearby similar-sized properties that have recently sold. They are referred to as **comparable sales** or **comparables (a/k/a “comps”)**. The important criteria that is compared is usually associated with a fairly close date of sale within the past three to six months, the close proximity between properties (in the same general neighborhood), the physical characteristics, and terms and conditions for the sales.

Since no two properties are exactly alike, the appraiser will make price adjustments upward or downward for the differences in size, amenities, and location prior to arriving at an **adjusted selling price**. If there are not enough similar sales in the area, the appraiser might be forced to compare home listings outside the area while trying to determine what the true market value is.

Cost Approach: The second appraisal method is based upon the belief that the value of a property is limited by the cost of replacing it, partly following the **principle of substitution**. The estimated cost to build an entirely new building structure on the land site is then added to the land site's estimated value through the cost approach method called the **summation method**.

The three main steps used in the cost approach method are:

- Estimating the cost to replace a portion or all of the building improvements;
- Calculating and deducting any accrued building depreciation due to years of wear and tear; and
- Adding the updated building value to the current land value estimate.

The estimate for rebuilding a property structure can be explained either by its **reproduction cost** or its **replacement cost**. The reproduction cost is an estimate to rebuild the existing building as an exact replica using today's prices. A replacement cost is used more for estimating the cost to rebuild a much older home, using today's updated construction standards and prices.

The **replacement cost** may be estimated using the following analysis methods:

- 1. Square foot method:** This is the simplest option, and is also referred to as the **comparative cost** method, as the value estimates are based upon a price per square foot to rebuild (i.e., a 2,000-square foot home with a \$100 cost estimate per square foot to build would equal \$200,000).

2. Unit-in-place method: The unit-in-place method is an estimate of the cost to replace certain components in a property such as the roof, floor, plumbing, or electrical systems. For example, the new replacement hardwood floor prices might be calculated at \$12 per square foot throughout the house.

3. Quantity survey method: This appraisal method focuses more on the costs associated with construction materials and labor. The combined costs are then added directly to cost estimates for building permits, surveys, and use fee assessments. This is the most complicated of the appraisal methods and more likely to be used by experienced appraisers for small or large construction projects.

Estimated Depreciation

There are a few ways that residential and commercial properties can lose value. Appraisers will note in their reports that any home that is not a brand new custom or tract home in a subdivision will probably have experienced some loss of value over time. It is only the building that will depreciate in value as opposed to the land, partly since dirt will continue to be dirt in the near term and long term. Land can be appraised using the **development method (or anticipated use method)** when evaluating the potential highest and best use for the land site that includes the projected development costs in addition to the land value.

Let's review below some of the main types of depreciation that an appraiser is likely to include in his or her report:

Physical Deterioration: Wear and tear on a property due to the occupant's usage and environmental issues may cause physical deterioration. Some examples include torn carpeting in the family room, a roof with leaks and patches from excessive rainfall, and mold damage in the basement from years of floods. The damage to the property may be classified as **curable** (fixable) or **incurable** (when the cost to repair or correct it is not financially within reason). Curable physical deterioration is also referred to as **deferred maintenance**.

Functional Obsolescence: This is a construction style of an older property that is considered outdated and no longer in demand at this time or in a certain location. An example might be a three-story home

built in the 1970s for young families that is now surrounded by older residents who prefer single-story homes.

Economic Obsolescence: It is also referred to as external obsolescence because the external area can positively or negatively impact the subject property's value. An example might be one last remaining single-family home surrounded by new and older commercially zoned properties such as retail strip malls and industrial plants in a downtown metropolitan region.

Calculating Depreciation

Two of the main ways that appraisers will calculate depreciation for properties are **direct methods (straight-line and engineering)** and **indirect methods (capitalization and market-data)**.

Let's start with the **indirect methods**:

Capitalization Method: The "cap rate" is the return on a real estate investment property that is based on the income that the property is expected to generate in the near future. The cap rate is used by appraisers, investors, and real estate agents when estimating a property's value. This is especially true for properties such as multi-unit apartment buildings. The capitalization *value* should be lower than the replacement value partly because it factors in the estimated cost of depreciation damage to the subject property. The amount of accrued depreciation is the difference between the replacement cost and the capitalized value.

Market-Data Method: An appraiser will use the market-data or sales approach when estimating property value. He or she will subtract the value estimate from the replacement cost in order to calculate the depreciation amount.

With respect to the **direct methods**, there is the:

Straight-Line Method: This is a mathematical calculation used by appraisers when estimating the economic or useful remaining life of a subject property. It is also referred to as the "age life method." The appraiser will divide the estimated useful life of the building by the

building's replacement cost prior to calculating how much depreciation will occur each year.

Appraisers will determine a building's **effective age** based upon ongoing wear and tear instead of on its actual chronological age. If a property such as a 100-unit apartment building is thought to have 40 remaining "useful years" before it is likely to be torn down, the useful life is divided by the property's replacement cost (100% of its value) to arrive at the estimate of the percentage of its original value that it will lose each subsequent year (or 100% divided by 40 = 2.5% depreciation each year).

And the **Engineering Method**: This appraisal valuation method is also called the **observed-condition method**. The appraiser physically inspects the property and makes observations based upon the actual depreciation or wear and tear. This is usually considered the most reliable method.

The **adding of land value** is the very last step for the replacement cost process. The land is added back to the depreciating value of the building. The land is also valued to similarly-sized land parcels or lots by way of the sales comparable method.

Income Approach: The third method of appraisal is the **capitalization** method as noted earlier. To best determine the income and expenses for this method, the appraiser will analyze these key numbers:

Gross Income: The true collected or potential annual income for the subject property. The actual past rents collected is the **historical rent (or contract rent)** while the potential market rent that could be collected on the open market is the **economic rent**.

The economic rent (also called **potential gross income** or **gross scheduled income**) is the estimate for the building as if it were occupied with tenants at 100% occupancy rates who paid full market rent prices. It so rarely happens when a building has 100% occupancy, so appraisers will calculate estimates of certain vacancy rate projections (or **vacancy factor**) that are normal for the region, as well as potential **bad debt** or unexpected financial losses before arriving at the **effective gross income**.

Operating Expenses: The appraiser will deduct standard operating expenses from the property's effective gross income.

The three main categories of expenses typically include:

1. **Fixed expenses**, such as property taxes and insurance that are fairly consistent.
2. **Maintenance expenses** related to tenant services such as cleaning, repairs, supplies, and utilities.
3. **Reserves for replacement** that are regular allowances kept in reserve to replace equipment like air conditioners, kitchen appliances, and building structures in tenants' units.

The last remaining income after subtracting the potential gross income by the operating expenses equals the **net income** (or **net operating income**).

The capitalization rate is used to convert the net operating income (NOI) into a meaningful present market value. After the investor, owner, real estate agent, and/or lender have decided what rate of return selected is fair for the immediate region, it is inserted into the mathematical formula below. Investors who purchase newer, multi-unit apartment buildings in prime downtown metropolitan regions are likelier to accept lower rates of annual return (or cap rate) due to the perception of less risk. Conversely, investors who purchase older properties in rundown urban or rural regions may demand much higher annual cap rate returns.

Net Operating Income/Capitalization Rate = Value

The building's value will be much higher if a lower cap rate is used for the subject property. As a result, property values and cap rates are inverse to one another. Declining cap rates in an improving neighborhood that has more buyers than quality properties will lead to increasing property values.

The investor's **desired rate of return** on his or her investment is also referred to as the **recapture** of funds invested. A capitalization rate that includes both interest and recapture is called an **overall rate** by the appraiser.

The **summation method** is the third method used for selecting a cap rate. There are four elements used for the capitalization rate. They are:

1. **Safe Rate:** The rate paid for secure investments at the time, such as bank accounts or long-term government bonds.
2. **Risk Rate:** The rate portion of the investment that is made to repay the investor for the risks involved with making the investment in the first place.
3. **Non-Liquidity Rate:** The extra rate of return that an investor expects to receive for the non-liquid or equity portion of gains from investments like real estate.
4. **Management Rate:** The rate paid to the investor for managing and investing any funds collected from the investment.

Gross Income Multipliers: The appraiser will analyze and compare collected gross annual rents with current projected market values or the sales price for the subject property (also referred to as the **gross rent multiplier method**). If similar apartment buildings are selling for seven times (7x) their annual gross income price, then a subject property with \$50,000 in annual gross income would be valued at \$350,000 (50,000 x 7).

Site Valuation & Value Reconciliation

An appraiser will then compile, analyze, and record in writing all of the details collected that may affect value as a **reconciliation** for their final appraisal report. The final estimates of value may be presented by the appraiser to the client as a **narrative report** or as a **form report**. A narrative report is a more detailed and lengthy report, while a form report is much shorter and presented on a standardized form used by many lenders and government agencies, like FHA and VA.

The form report is the most common appraisal report used today that includes basic facts and details that were relied upon by the appraiser prior to determining the final estimate of value. This final report is called the **Uniform Residential Appraisal Report** form.

Chapter Fourteen Summary

- An appraisal is usually ordered to determine the true average property value by analyzing both **general data** (economic and neighborhood trends) **and specific data** (lot size, shape of home, zoning for the subject property) at the time of purchase.
- A self-employed appraiser who is hired to appraise properties for a fee may be referred to as a **fee appraiser** because he or she is usually paid a flat fee for the services he or she performs.
- Appraisers are certified and licensed by the state of California. Under federal law, a state-licensed and certified appraiser, as set out in the **Uniform Standards of Professional Appraisal Practice (USPAP)** guidelines, may work on federally-related, federally-backed, or federally-insured mortgage loans or government owned properties.
- The **four (4) elements of value** are: Utility, Scarcity, Demand, and Transferability. Two of the main classifications of value for appraisals include **value in use** and **value in exchange**.
- **Principle of Highest and Best Use:** The use of property that will usually bring in the highest value estimates over the long term. The appraisal analysis of a vacant lot is one example of this “highest and best use” assumption.
- **Principle of Substitution:** Given the choice between two almost identical homes to purchase, a buyer is likely to buy the more affordable one.
- The depth and value of a property site may be described by way of a value principle known as the **4-3-2-1 Rule**. The site’s value is broken down as follows: 40% (front quarter of the land site that is adjacent to the street), 30% (second quarter), 20% (third quarter), and 10% (back portion of the lot).
- The rebuilding of a property structure estimate is its **reproduction cost** and **replacement cost**.

- Damage to a property (or “**physical deterioration**”) is classified as **curable** (fixable) or **incurable** (when the cost to repair or correct is not financially within reason). Curable physical deterioration is also known as **deferred maintenance**.
- The **capitalization rate** (or “cap rate”) is used to convert the net operating income (NOI) into a meaningful present market value. $NOI / Cap\ Rate = Value$.
- An appraiser will compile, analyze, and record in writing all of the details he or she collected that may affect value as a **reconciliation** for his or her final appraisal report (provided either in **narrative** or **form** style).

Chapter Fourteen Quiz

1. What is generally the main purpose for ordering an appraisal?
 - A. To determine market value
 - B. To establish the original listing price
 - C. To find the future value
 - D. For property tax assessment purposes
2. What four main elements determine real estate value?
 - A. Demand, depreciation, scarcity, and utility
 - B. Price, demand, governmental regulations, and economics
 - C. Demand, scarcity, transferability, and utility
 - D. Cost, population trends, demand, and zoning
3. What would probably be the main reason why an investor would order an appraisal report for his raw, unfinished lot that is surrounded by homes in a subdivision?
 - A. Income potential
 - B. Highest and best use
 - C. Sales comparables
 - D. Replacement cost

4. What is an appraiser's comment about the potential *functional utility* of a property really about?
- A. Salability
 - B. Design
 - C. Usefulness
 - D. Both B and C
5. The party who hires the appraiser to estimate the current market value of a subject property is the _____.
- A. Buyer
 - B. Lender
 - C. Seller
 - D. Client
6. When there are more unsold properties available for purchase in a specific neighborhood than buyers, an appraiser and a real estate agent would describe this as a _____.
- A. Balanced market
 - B. Seller's market
 - C. Buyer's market
 - D. Economic time when prices will probably rise
7. The economic principle that states, "if two properties are equally desirable, the less expensive one is likeliest to sell first" is the:
- A. Principle of Supply and Demand
 - B. Principle of Anticipation
 - C. Principle of Change
 - D. Principle of Substitution
8. An appraiser who is estimating the cost to replace certain components in a home such as kitchen flooring for a new remodel project are probably using which analysis method?
- A. Square foot method
 - B. Quantity survey method
 - C. Appraisal survey method
 - D. Depreciation method

9. What type of general data can be gathered and reviewed by an appraiser?
- A. Population trends
 - B. Home price trends
 - C. Nearby schools
 - D. All of the above
10. The size, shape, and zoning designations for a subject property researched by an appraiser is the _____.
- A. General data
 - B. Specific data
 - C. Private data
 - D. None of the above
11. The depth and value of a property site can be described by way of a value principle known as the _____.
- A. Principle of Competition
 - B. 4-3-2-1 Rule
 - C. Principle of Highest and Best Use
 - D. Land survey
12. The rebuilding of a property structure estimate can be described as a _____.
- A. Highest and best use
 - B. Replacement cost
 - C. Reproduction cost
 - D. Both B and C

Answer Key:

1. A	7. D
2. C	8. B
3. B	9. D
4. D	10. B
5. D	11. B
6. C	12. D

CHAPTER 15

CONSTRUCTION AND ARCHITECTURAL DESIGN

Overview

In the field of real estate, agents will likely be working with numerous clients who purchase one or more investment properties as well as who wish to buy land and develop individual custom homes or small to large residential housing tracts with upwards of hundreds or thousands of units. Some of these transactions might be just as relatively simple as an owner-occupied purchase deal for real estate agents while other transactions may be much more complicated and much more profitable for the investors and agents. In this chapter, we will cover the relevant points related to some of the best ways to buy, hold, and manage investment properties, the various steps in the construction process, and the comparisons between renting and buying income-producing properties.

Construction

An agent should learn as many different sides of the real estate profession as possible to better assist his or her clients. But agents should not claim to be experts in any one of the other fields associated with real estate. Tax consequences related to investments, the steps required in the construction process, how to act as a successful property manager for multi-unit apartment buildings, and how to inspect land and improve building structures for potentially significant mold, termite, or seismic fault issues are best left up to the experts in those areas. A responsible agent should refer his or her clients to third-party specialists in related fields who can assist both the principal and agent with the completion of the purchase, sale, lease, or construction transaction.

There are many steps involved in the construction process here in California. This is true, regardless of whether one home is being built or

300 homes are being constructed over a period of several years. But agents should learn as much as possible about some of the components involved such as:

- Local building codes and regulations
- The types of architectural styles
- The job functions of architects
- What types of plans and specifications are allowed for the region
- Construction methods and terminology used by contractors and other building professionals

Suburbia's Evolution in California and the U.S.

The introduction of suburban communities began on the East Coast in Levittown on Long Island in New York. However, suburban communities truly evolved after the 1950's in California partly after more Americans were attracted to a state with a warmer climate and more job opportunities related to sectors such as entertainment, the defense industry, and agriculture. The increased availability of both FHA and VA mortgage loans have helped tens of millions of Americans buy suburban homes with down payments between 0% and 5% since the 1930's and 1940's.

The "cookie-cutter" designed, mass-produced suburban homes that were reminiscent of the homes featured in beloved old television shows such as *Ozzie and Harriet* and *Leave It to Beaver* were in high demand from buyers up and down the California coast who aspired to live the same "American Dream" that they first saw on television. Work on the building of master-planned housing communities that began to pop up throughout many parts of Southern California near the mid-20th century was modeled on the Ford Motor Company's automobile assembly line workers. Just like with cars being built in an automobile plant by workers with specific job functions that they repeated over and over, there were numerous subcontractors helping the general contractor build homes by performing the same construction tasks over and over again on each home.

The 1950's and 60's, were two of the best decades for housing investments in California. This was partly because the size of American families was reaching its peak during the "Baby Boom" years (1946 - 1964). Fertility rates reached their highest in 1957 with an average married couple having 3.77 children. (The fertility rate in 2020 is 1.71 children per family and has been on a downward trend for the last several years.) With larger families back in the '50's and '60's, more and more home buyers were demanding four and five-bedroom homes near school districts, parks, shopping malls, and freeways.

A high percentage of California investors created the bulk of their family's overall generational net worth after purchasing properties in California sixty to seventy years ago for prices as low as \$15,000 to \$30,000 per home. Often, these same homes could be purchased at those low prices even near prime coastal areas such as La Jolla, Huntington Beach, Santa Monica, Santa Barbara, and San Francisco. Now, those properties might be valued at well over a million dollars.

Because lot prices have moved skyward over the past several decades in many of the most desirable neighborhoods in the state, it is not surprising that some owners and investors may decide to demolish their existing decades-old homes to rebuild a much more valuable, newer home on the same lot. In some coastal communities, the lot value alone might be worth somewhere between \$500,000 and \$2 million dollars plus. If so, the highest and best use for the subject property that is now probably free and clear after making 30 years of mortgage payments is to try to build a larger home with today's modern upgrades.

Architectural Designs

With almost 40 million residents in California today that are made up of people from many parts of the world, there is a wide variety of architectural styles to choose from in the state. Some residents who were born on the East Coast might prefer homes with brick facades and basements while other residents from Europe, Asia, or Mexico are likely to prefer home designs that remind them of *their* early childhoods back home.

Let's take a look below at some of the more popular architectural designs and styles found up and down the state:

- California Ranch
- American Craftsman
- Mission Revival
- Spanish Colonial
- Mediterranean Revival
- Modern
- Contemporary or Art Deco
- Manor House
- Mansion
- Adobe
- Split-Level
- Neoclassical
- Cape Cod
- English Tudor
- French Provisional
- Georgian Colonial
- Dutch Colonial
- Farmhouse
- Bungalow
- Cottage
- Victorian

Some neighborhoods might have many different architectural styles on the same street. Other master-planned communities, on the other hand, may have just three or four floor plan variations of almost the exact same

Mediterranean style that is so often found in communities with homeowners' associations, like those in Orange County.

Some of the more popular home designs in California from the 1950's, 1960's, or 1970's include Spanish, California Ranch, Split-Level, and Modern.

A **Split-Level Home** (sometimes called a "tri-level home") is a home design in which the floor levels are staggered. There may be two or three sets of interior stairs that run upward towards most of the bedrooms and downward to a playroom or basement off the main entrance or living area near the kitchen. The entrance to the home is usually located between the divided floors. These homes may be surrounded by lush landscaping and hilly terrains and a very deep and spacious backyard.

The **Spanish Colonial Revival** design first became popular with homeowners in many parts of the nation as far back as the early 20th century. This architectural style really goes back a few hundred years to when both Spanish and Mexicans occupied many regions before California was officially invited to join the Union. In California, the home designs that featured white or pastel stucco one and two-story houses with red tile roofs were somewhat modeled after the Catholic missions built in the San Diego and Los Angeles areas. This type of home design was quite effective in keeping its occupants cooler during the warmer spring and summer months.

A **Modern** designed home is usually a much larger home with white exteriors, large windows that welcome in more natural light, glass entrance doors, and spacious and open interior rooms. Many of these homes are built adjacent to hills, mountains, or beaches. The modern style was first created during the 1920's to the 1950's. Other housing designs that appear similar, such as **Contemporary**, are more fluid and ever-changing than the earlier Modern styles.

The housing style that might exemplify classic California architecture is the **California Ranch**. A ranch home is usually a one-story home that may be wider than it is deep. This style with wide open spaces was based more upon the ideal notions of the American West that were glorified in old Western films and television shows. Many of these homes have flat or low-pitched roofs that may have red or natural colors. The exteriors are typically wooden, stucco, or masonry (or some combination of two or

three of these exteriors) and are painted white or sand colored. The floor plans are relatively simple with a large living room and one or two separate bedroom “wings” off to the left and/or right side of the generally large entryway.

Design Costs

Of these popular housing design styles in the state, the simplest and most affordable to build over the past several decades was probably the one-story ranch home. Most often though, the ranch home requires more land, so they are built in locations much further away from busy and congested metropolitan regions. The outlying areas around Los Angeles (Pasadena, San Marino, and Pacific Palisades), San Diego (Presidio Park and Balboa Park areas), Santa Barbara, and Palm Springs have been some of the most active parts of California in the construction of ranch-style homes, partly because they offer investors more access to larger lots and land parcels.

The other design styles, such as the split-level home, can be much more expensive to build due to such issues as the excavation of adjacent hilly land prior to the development of the home right next to it.

Land was much more affordable 50 or 60 years ago in Southern California, especially, than it is today. The economics of buying a piece of land for a few hundred or a few thousand dollars prior to constructing a ranch or other type of home made much more sense back then as compared to now. When land prices are much higher, the construction of a one-story home might not make financial sense when compared with a more efficiently designed two or three-story home that may double or triple the living space for the property owner and generally requires a smaller lot. This is partly why there are so many narrow and tall new homes being built near expensive coastal regions such as in Marina Del Rey, Malibu, Laguna Beach, and Newport Beach.

In some of these coastal areas, the homes are selling at prices well above \$1,000 per square foot. At that price, a newly built single-story 2,000-square-foot home might be valued at \$2 million dollars while a 4,000 square foot home stacked skyward up to three floors may sell for \$4 million dollars. A two or three-story home is generally more cost effective to build on a per-square-foot basis because two or three times the living

space can be built under the same roof and over the exact same foundation below the property.

Building Codes, Plans, and Specifications

Owners and their appointed architects and general contractors must make sure that they are closely following the latest building codes and design requirements that the local planning and zoning department require for all town or city residents.

A **building code** is a set of **regulations** that governs the design of the new construction, or the modification (or remodel) of existing residential or commercial building structures. The code also may set the guidelines for the ongoing maintenance of these properties. The personnel who work at the local nearby planning and zoning departments, architects, and general contractors or experienced subcontractors are all great sources of information about the basic requirements of building design and construction quality for property owners or soon-to-be investors who are interested in building a new home or remodeling an existing property.

Building codes may help establish a uniformity in construction by creating the minimum building standards related to features like building materials (e.g., electrical outlets, plumbing fixtures, appliances, roof components, and setbacks from the front, side, and back neighbors and streets). Safety issues are a main reason for the issuance of construction codes so that property owners are better able to reduce their risks of damage caused by such disasters as fires, floods, and earthquakes.

The Architect's Role

Both principals and agents are likely to work closely with architects for brand new construction projects or major remodels with potentially costly and extensive renovations. It is the primary role of an architect to design a residential or commercial building that meets or exceeds the owner's needs and interests.



The goal of the architect is to create a building structure that works best for the property owners instead of for the architect who may personally prefer other design styles. Yet the architect may offer his or her own perspective to the owner and the owner's real estate agent assisting with the project.

Once the owner approves the architect's proposed renderings or designs, then the architect will usually work as quickly and effectively as possible to finalize the blueprints or designs. The local planning and zoning department and/or other government agencies will then hopefully approve and sign off on them. The architect may also help the owner find a qualified contractor who is experienced with building similarly designed projects. The architect may help the property owner analyze competing price bids from local building contractors or subcontractors.

The architect may also act as the owner's representative through the entire building process in various ways such as approving the periodic payments to workers onsite and walking the site regularly in order to make sure that the structure is being built exactly as the architect designed it. Whether the architect does these activities and others, depends upon what is included in the contract he or she entered into with the owner.



Wood Frame Construction

Even though there are dozens of exterior design styles for residential homes, there are still relatively few *interior* construction designs that offer the key support for the entire building structure. While some homes may be built with steel beams, concrete, and/or manufactured or prefab material, the wood frame building is the most common type of home construction.

Let's review below some of the most popular materials used for home construction from the ground up:

Timber Frame: A type of wood frame construction that relies upon large wooden beams or planks. Typically, there are much smaller, thinner, and more narrow wooden beams located in between for support.

Wood Panels: These are prefabricated panels that sandwich rigid foam insulation between smaller wood pieces. Just like with timber frames, wood panel homes are susceptible to warping, mold, and rot from water,

wind, and other environmental factors as well as damage from termites or other types of pests. One of the main positives associated with wood panels is that they often will use a renewable resource (timber trees) and can be much more affordable to build with than a traditional timber frame home.

Manufacturing or Prefab: These types of homes use components that have been constructed elsewhere in large quantities, such as at offsite manufacturing plants. Some wood panel homes are partially prefabricated with just wood materials while other prefabs include materials like fiberboard, fiberglass, and plastics with or without additional wood components. A prime example of a property with 100% prefab materials would be a mobile or manufactured home. You may have even seen from time to time one half of a prefab house being transported on a large truck while driving on California's freeways.

Concrete: Insulated Concrete Form (ICF) is one of the fastest growing types of housing materials used in both residential and commercial real estate properties. The process uses concrete forms that provide a solid, superior, and rigid base for many different types of building structures. Instead of tearing down trees for timber or oil-based petroleum products that may not be environmentally friendly, ICF is made from concrete and is less damaging to the local environment. But note that the cost to construct buildings out of a concrete base is usually much higher than using wood or plastic prefab materials. Nevertheless, one of the main benefits associated with concrete base homes are that they tend to be very energy efficient as it relates to both lower heating and cooling bills. And another benefit is that they are highly resistant to fires, pests, and destructive weather events like hurricanes, tornadoes, and serious floods.

Steel Stud: Steel studs or beams are more commonly associated with low and high-rise commercial properties than residential homes. With a steel stud construction process, many of the same building techniques that involve the use of wood frame construction are replaced instead with steel. Instead of nails being used with wood beams, screws hold the steel components together and form the base structure. Steel is obviously much more fire resistant than wood, and termites cannot devour it like their preferred diet of wood. This is partly why more homeowners and general contractors are beginning to build steel frame homes. And once the steel frame home is complete, it may be indistinguishable from

traditional homes that are made with a timber base.

Foundation: Regardless of the framing materials selected for a new home, most forms of building *foundations* are made with reinforced concrete. Concrete is reinforced by steel bars or mesh, and usually is quite resistant to bending or cracking.

The widest part of the foundation or base is a home's or building's **footing**. It is the footing that primarily supports the main weight of the building structure. On top of the concrete foundation is a board that is called a **sill plate**. It is the framing of the house that rests on the sill plate just above the underlying concrete foundation.



Chapter Fifteen Summary

- The introduction of suburban communities began on the East Coast in areas like Levittown, New York on Long Island. The “cookie-cutter” construction process was based on the automobile assembly line techniques first developed by Ford Motor Company.
- A **Split-Level Home** (sometimes called a “tri-level home”) is a home design in which the floor levels are staggered.
- The **Spanish Colonial Revival** design is based on old Catholic missions that were built in the San Diego and Los Angeles regions a few hundred years ago.
- A **Contemporary** home is more fluid and ever-changing than the earlier **Modern** styles that haven’t changed much over the past 100 years.
- A **California Ranch** home is typically a one-story home that may be wider than deep and built upon a fairly large lot or land parcel site.
- A **building code** is a set of **regulations** that govern the design of new construction or remodels of existing residential or commercial building structures. as the code may also set the guidelines for the ongoing maintenance of those properties.
- A **timber frame is a** type of wood frame construction that uses large wooden beams or planks. It is the most common type of frame construction option in the state. **Steel frame** is more popular for commercial properties and some newer types of larger homes.
- A **manufacturing or prefab home** (a/k/a “manufactured home” or older “mobile homes”) is a type of home that uses components that have been constructed in large quantities elsewhere in offsite manufacturing plants.
- Most building foundations are made with **reinforced concrete** that is reinforced with steel bars or mesh.

Chapter Fifteen Quiz

1. What is one of the main ways that building construction in a certain community maintains uniform standards of construction quality?
 - A. Planning commission
 - B. Zoning ordinances
 - C. Building codes
 - D. Contractor's licensing requirements
2. On what part of a home does the framing sit?
 - A. Footing
 - B. Sill Plate
 - C. Beam
 - D. Wood panels
3. A set of regulations that govern the design for new construction or modification (or remodel) of existing residential or commercial building structures is called _____.
 - A. Building codes
 - B. Zoning designation
 - C. CC&Rs
 - D. Planning commission's rules and regulations
4. What is the most popular type of frame construction component used by builders here in California?
 - A. Wood panels
 - B. Timber frame
 - C. Prefab
 - D. Steel
5. What is considered an advantage when comparing a steel frame property with a wood framed one?
 - A. More fire resistant
 - B. Less termite and other pest problems
 - C. Holds up better to strong winds
 - D. All of the above

6. A home design in which the floor levels are staggered is called a:
- A. California Ranch
 - B. Split-Level
 - C. Modern
 - D. Spanish Colonial
7. A larger home design with white exteriors and larger windows that welcome in more natural light is called _____.
- A. Ranch
 - B. Tudor
 - C. Contemporary
 - D. Modern
8. A one story home that may be wider than deep in a desert region in California on a big one-acre lot is likely to be which architectural design?
- A. Spanish Colonial
 - B. Victorian
 - C. California Ranch
 - D. Contemporary
9. Most building foundations are made of _____.
- A. Steel beams
 - B. Wood timber
 - C. Reinforced concrete
 - D. Prefab components
10. The widest part of the foundation or base is a home's:
- A. Footing
 - B. Sill plate
 - C. Heading
 - D. Depth ratio
11. Which home design style has changed the least over the past 100 years?
- A. Modern
 - B. Contemporary
 - C. Split-Level
 - D. Art Deco

Answer Key:

1. C	7. D
2. B	8. C
3. A	9. C
4. B	10. A
5. D	11. A
6. B	

CHAPTER 16

CALIFORNIA LICENSE LAW

Overview

Real estate license applicants usually work extremely hard to qualify to take their agent or broker exams. It is an even more wonderful accomplishment to actually pass the state exam prior to paying the fees to receive a new license. The main purpose of this chapter is for new and experienced real estate professionals to better understand the laws and rules that they must follow or risk license suspension or complete license revocation. “Ignorance of the law is not a valid defense” in most legal cases. That holds true when it comes to real estate agents, as well. An agent must understand what they are obligated to do and to not do after earning their licenses.

The Administration of California Real Estate Law

Real Estate License Law in the state of California is covered in depth with legislative “guidelines” issued through **Sections 10000 to 10580 of the California Business and Professions Code**. These sections are the “license law” for real estate professionals in the state. The purpose of these laws is to protect the public from incompetent, unethical, and fraudulent licensed real estate professionals and those who claim to be licensed but are really unlicensed.

It is the **Department of Real Estate (DRE)**, a division of the California Department of Consumer Affairs, that administers the Real Estate Law. The Real Estate Commissioner, the chief officer at the DRE, is in charge of the enforcement of various real estate laws. It is the Commissioner who can adopt, modify, or terminate existing regulations as they relate to the administration of real estate law as partly defined in Sections 2705 to 3109 of Title 10 in the California Code of Regulations.

Some of the Commissioner's powers include:

- The right to investigate people acting in real estate who may or may not hold an active license
- The screening of license applicants who hope to qualify for the exam
- The option to investigate complaints that were filed against licensees
- The review of agents' advertisements and trust account records

If the Commissioner finds that an agent did not properly follow the established real estate laws, then the Commissioner may suspend, deny, or revoke a person's license or application to take the exam. The Commissioner may also approve payments of funds from the Real Estate Recovery Fund to claimants holding judgments for fraudulent or inappropriate actions committed by a licensee.

The Commissioner is first appointed by the Governor. To qualify for the job, the Commissioner must have been an active real estate broker in the state for at least five (5) years, and have had significant and active real estate experience in California for five (5) of the past 10 years. Neither the Commissioner nor DRE employees are permitted to engage in real estate activities or hold any personal interests in brokerage firms during the time that they are employed by the DRE.

It is the state Attorney General who helps to advise the Commissioner on various legal issues. Anyone who violates sections of the Real Estate Law can be prosecuted for criminal conduct by the local county District Attorney.

Requirements for a Real Estate License

In accordance with the Real Estate Law, any person who advises, advertises, or acts as if he or she were a licensed professional is required to hold an active salesperson or broker's license.

A **real estate broker** is defined as one who:

- Sells, buys, and exchanges properties or business opportunities on behalf of another private party, business entity, or governmental agency
- Assists with the leasing, or collection of rents, from rental properties or businesses
- Promotes his or her services and products that are associated with real estate on listings or various forms of advertisements (print media or online)
- Charges or collects money upfront as a type of **advance fee** when promoting the sale or lease of a property or business opportunity
- Acts as a mortgage loan broker by finding and funding loans for clients from one or more lending sources
- Buys, sells, or exchanges securities or loans that are related to seller- financed mortgages such as land contracts, first and second Trust Deeds, and income streams associated with business opportunities. In some cases, the real estate licensee may also be required to hold a separate Securities Brokerage license as well.

MLO Endorsement

Most types of owner-occupied residential (one-to-four-unit) loans now require an additional MLO (Mortgage Loan Originator) endorsement for the licensee, along with having an active real estate license. This law went into effect at the end of 2010. To receive an MLO endorsement designation, the licensee has to be approved and licensed through the **Nationwide Mortgage Licensing System**.

Without the MLO endorsement, it is unlawful for an agent or broker to receive a commission payment from most types of owner-occupied residential loans. A mortgage loan origination endorsement license expires on December 31st of each year and must be renewed. The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) requires that each state-licensed MLO complete eight hours of NMLS (Nationwide Mortgage Licensing System) every year (including three hours on federal laws, two hours on ethics issues -- fair housing,

consumer protection, fraud -- and two hours on updated lending standards for non-conventional or subprime credit-type loans).

Often, there can be a fine line between being an active licensee and an unlicensed principal who is acting as a buyer or seller of properties, loans, or securities investments. Brokerage laws usually apply to agents who are acting on behalf of other parties. However, many brokers will act on deals themselves as principals too.

To better distinguish between an “active” and an “inactive” real estate broker under state law, a person is considered an “active broker” (and “in the business”) if he or she is engaged in the following activities within the same calendar year:

- Buys, sells, or exchanges eight or more land contracts, promissory notes, trust deeds, or other types of real estate securities investments.
- Offers and funds eight or more loans from his or her own personal funds that are secured by residential (one-to-four-unit) properties.

A **salesperson** is hired by a broker to perform one or more of the acts listed in the broker definition above. A salesperson is allowed to perform real estate activities if he is managed and supervised by the broker. A salesperson may not act directly for a principal in a real estate deal because it is the employing broker who is the true agent in the transaction. Only the broker can pay the commission directly to the salesperson as opposed to the client or escrow cutting the check directly.

An **Associate Broker** (also referred to as a **Broker-Salesperson**) is a person with an active real estate broker’s license who decides to work under another broker’s license. All licensees who work under one individual or corporate broker’s license are called **affiliated licensees**.

For a corporation to qualify to hold a real estate license that lists the entity as the main broker, there must be at least one corporate officer who needs to be designated as the primary person performing the brokerage duties. This appointed corporate officer must also hold an active individual brokerage license in his or her personal name.

Unlicensed activities: Any person who performs acts that require a

salesperson or broker's license without having an active license in place at the same time may be fined up to \$20,000 and sentenced up to six months in prison for an individual. A corporation can be fined up to \$60,000 for operating without an active broker's or salesperson's license.

Exemptions

The individuals or business entities listed below are generally exempt from real estate licensing requirements:

- Those individuals or entities acting as principals in their own real estate transactions.
- A corporate officer with permission granted from the employing corporation or a general partner acting on behalf of the partnership regarding properties leased, purchased, or sold by that corporation or partnership.
- An attorney-in-fact, or a person acting with powers granted through a power of attorney, from the owner of the property.
- An attorney who offers legal services to one or more clients.
- A party with court-appointed powers such as a bankruptcy receiver, guardian, or trustee.
- A trustee acting under an existing deed of trust.
- An employee of a financial institution such as a large bank, insurance company, pension group, or a licensed residential mortgage officer (e.g., a clerical worker or secretary who does not provide prices, terms, or other details to clients about properties).
- Activities related to mortgage loans, income streams tied to certain real estate investments, or business opportunities that require certain other types of securities broker-dealer licenses instead of real estate licenses.
- An onsite manager at a hotel, motel, mobile or manufactured home park, or at a large apartment building who is directly employed by the site owner.
- An employee at a property management company who is employed by a licensed real estate professional.

- Assistants to salespersons and brokers as long as they do not discuss key price, term, and condition points about properties or mortgage loans with the clients.

Salesperson Qualifications: To qualify to take this exam, a licensee applicant must meet the following requirements:

- Be at least 18 years old
- Be truthful and honest
- Pass the real estate exam
- Apply for the license on the required form within one year
- Pay the licensing fees within one year of passing the exam
- Provide fingerprints and pass background checks
- Provide a social security number
- Submit proof of legal residency here in the United States
- Complete 135 hours of education that includes **Real Estate Practice (45 credit hours)**, **Real Estate Principles (45 credit hours)**, and one more **45-hour** elective from the following list of courses: Real Estate Appraisal, Real Estate Finance, Real Estate Economics, Legal Aspects of Real Estate, Business Law, Escrow, Property Management, General Accounting, Real Estate Office Administration, Mortgage Loan Brokering and Lending, Common Interest Developments, or Computer Applications in Real Estate.

Salespersons renewing for the first time: Salespersons who plan to renew their license for the first time must complete another 45 clock hours of CalDRE-approved continuing education that includes:

- five (5) separate three-hour courses (15 hours total) in the subjects of: Agency, Fair Housing, Risk Management, Ethics, and Trust Fund handling;
- 18 or more clock hours related to consumer protection courses; and

- the remaining twelve (12) clock hours may be about the subject of consumer service or consumer protection.

Broker's qualifications: A broker's license applicant must:

- Be at least 18 years of age
- Have two (2) or more years of experience working full-time as a real estate licensee within the past five (5) years, or have a bachelor's degree from a four-year college with a major or minor in real estate. An attorney who is a member of the bar of any state in the U.S. will usually qualify on the basis of their past education and experience, so they are statutorily exempt from the college-level course requirements.
- Be truthful and honest
- Pass the real estate exam
- Pay the required license fees after passing the test
- Be fingerprinted and submit to background checks
- Provide the applicant's social security number to the DRE
- Show proof of legal residence here in the United States
- All broker license applicants must have completed the following five (5) college level-type courses: 1) Real Estate Practice; 2) Legal Aspects of Real Estate; 3) Real Estate Finance; 4) Real Estate Appraisal; and 5) Real Estate Economics or General Accounting.

In addition, broker applicants must pass three (3) additional course electives from this group listed below:

- Business Law
- Real Estate Principles
- Escrows
- Property Management
- Mortgage Loan Brokering and Lending
- Real Estate Office Administration

- Advanced Real Estate Finance
- Advanced Real Estate Appraisal
- Advanced Legal Aspects of Real Estate
- Computer Applications in Real Estate

Brokers renewing for the first time: Since January 1st, 2016, brokers in California who renew their broker's license for the first time must complete an additional 45-clock hours of CalDRE-approved continuing education subjects that consist of:

- six (6) separate three-hour courses (18 total clock hours) in these subjects: Agency, Ethics, Fair Housing, Trust Fund Handling, Management and Supervision, and Risk Management;
- an additional 18 clock hours of consumer protection courses; and
- The remaining nine (9) clock hours may be completed with courses related to either consumer protection or consumer services.

License Terms

License applicants have up to one year from the date of passing their exam to pay for and obtain their license. Real estate licensees from other states must also have an active California real estate license before conducting any real estate business within the state.

A salesperson or broker's license term is good for up to four (4) years. A person cannot send in his or her renewal application along with the proof of having met the continuing education requirements until 90 days or sooner before the expiration date of his or her current license. The mailed application must be stamped before midnight of the expiration date to prevent the assessment of late fee penalties.

For any licenses that expire, a person can renew on a late basis for up to two (2) years following the expiration date. However, people holding expired licenses may **not** engage in real estate activities until their license has been formally renewed.

All continuing education courses must be completed within four (4) years

of the date that the late renewal application was filed. **The late renewal fees are 150% of the on-time filing fees.**

70/30 continuing education exemption: A California licensee who is 70 years of age and who has over 30 years of active real estate license experience is **exempt** from the continuing education requirements each time they renew their license. However, they must submit proof of this exemption information to the DRE.

Brokerage Offices

A licensee is required to have a place of business somewhere in California. The licensee may also have one or more branch offices. Each branch office is required to have a separate license. To add or cancel the branch office, a form must be filed with the DRE.

Each managing broker at a main or branch office should hold all of his or her affiliated licensees' real estate licenses in a safe and secure location at the time of hiring them.

Termination of brokerage affiliation: A salesperson or broker who either resigns or is fired by the employing broker must receive the license certificate from the managing broker within three (3) business days. The broker, in turn, must also submit a notification of the employment termination to the Commissioner within 10 days.

If a salesperson is fired or terminated for issues related to **disciplinary cause**, bad conduct, or fraud, the broker is required by the DRE to file a certified **written statement of facts** with the Commissioner. Should the broker fail to do so, the broker's license could be suspended or revoked even though he or she was not the one who committed the fraud.

All affiliated licensees under a managing broker who has a revoked or suspended license may be automatically cancelled as well. But the salespersons are allowed to transfer their licenses to a new managing broker's office. Employing a broker with a license that expires will cause his or her affiliated licensees to have their own licenses placed on a **non-working status**. The salespersons' licenses will become active once again if and when the managing broker renews his or her license, or the salesperson transfers to another broker's office.

When a salesperson transfers to an unrelated broker at another office, the new managing broker must notify the Commissioner's office within five (5) days after hiring the licensee. The salesperson must cross out the name and address of his or her former broker, add in the new broker's name and address details, date and initial the changes, and hand it over to the new employing broker once officially hired.

Address Changes: A broker is required to list his or her full name and most current mailing address for the main business office and any affiliated branch offices. A salesperson is also required to provide the updated mailing address where he or she is working. Any address changes must be sent to the DRE within one business day of the change.

A **fictitious name** is allowed to be used by a broker on his or her license as long as it is not:

- Involving the name of a salesperson licensed under the broker
- Implying a corporation, partnership, or LLC that is non-existent
- Misleading to the public while signifying false advertising
- A previously used brokerage name used by the licensee that was revoked

A fictitious business name statement must be filed with the clerk of the county where the business is located. The statement should be published in a local county newspaper once per week for four consecutive weeks to legally inform the public. An **affidavit** (or a written statement sworn before a notary public) that confirms that the advertising requirements for the new business name statement were met must also be sent to the county clerk. The business statement shall expire after the period of five (5) years.

Child support delinquency: Any licensee who ends up on a California Department of Child Support Services (DCSS) list of people who are past due on a certain amount of unpaid and delinquent child support amounts can have their license suspended along with their Driver's License after a 150-day warning notice from the DRE, or not be issued a new or renewed license until the past due amounts are brought current.

This license or application suspension rule applies even if the payor of the child support did, in fact, make all his monthly child support payments, and it was mistakenly listed as “unpaid” for a certain period of time. A release form must be received from the DCSS prior to the licensee sending in this proof of payment to the DRE so that the license will be reactivated.

Business Opportunities

A business opportunity is the lease or sale of a business that may or may not include its fixtures, inventory, goodwill (a positive business name as viewed by the local community), and/or lease assignments. Most often, a real estate license is required to engage in business opportunity activities, regardless of whether any real property is sold, leased, or exchanged. If a portion of the sale includes stock shares in a corporation, then the agent may also need a securities license.

A **franchise agreement** is a type of business transaction where the buyer (franchisee) agrees to purchase the right to sell goods or services under a specific brand name and marketing system offered by the franchisor (seller of the franchise agreement) for a fixed or percentage franchise fee. Those with a real estate license, a securities license, and possibly others registered under the Department of Business Oversight may be permitted to sell a franchise opportunity.

Any sale of personal property such as furniture or business inventory will likely be transferred to the buyer by way of a bill of sale. The bill of sale must include the names of the transferor/seller and the transferee/buyer, the property address, and a short description of the personal property items.

If the business sale involves both personal and real property, there may be two separate purchase agreements used by the buyer and seller. The seller will sign over a deed for the real property and a bill of sale for the personal property.

A **sales tax** would apply to the transfer of any personal property. The buyer pays the assessed sales tax to the seller who, in turn, pays the tax directly to the Board of Equalization. For any unpaid past wholesale or

retail sales tax amounts, the buyer might have **successor's liability** for the seller's unpaid taxes. In addition, the buyer must pay for a new seller's permit from the Board of Equalization.

The **Uniform Commercial Code** establishes certain types of requirements for unusually large sales of business inventory (a/k/a a **"bulk sale"**) to just one buyer, especially when the inventory amount exceeds 50% at the time of sale. It is up to the buyer -- not the seller -- to give notice to any potential creditors of the seller by recording a notice of the bulk sale transaction with the local county recorder's office by certified or registered mail as well as by publishing a bulk sale notice in the local newspaper. The buyer's failure to do so may lead to his or her later being financially liable to the seller's creditors.

Some business transfers include a **liquor license transfer**, such as in the sale of a bar or restaurant. The existing liquor license may be transferred from person to person or from the old to new business premises if approved first by the Department of Alcoholic Beverage Control (ABC). To receive approval, the seller and buyer should apply to ABC. They should also publish a notice regarding the submission of their application to ABC on the business premises. It will then be up to ABC to investigate and approve the buyer and proposed business location.

Investigations and Discipline

The Real Estate Commissioner is required to investigate a licensee's action after one or more parties have submitted a formal written complaint. Even without a written complaint, the Commissioner still has the right to investigate a licensee if perceived violations might have occurred. The investigation may include the collection of statements from witnesses and the licensee, the checking of public records, bank records, or title company records, and the scheduling of an informal meeting with all key parties involved.

If the office of the Commissioner finds some wrongdoing on the part of the licensee in question, a written statement of the charges levied upon the agent may be filed in an **accusation**. This statement must be filed within three (3) years of the alleged unlawful act committed by the agent. For acts related to intentional misrepresentation, false promises, or outright fraud, charges must be brought against the licensee within one

year of the date of discovery, or within three years of the occurrence, whichever is later. But in no case shall an accusation be filed later than 10 years after an occurrence.

After the accusation is formally served on the licensee, a date is then set for an **administrative hearing**. It will be up to an administrative law judge to decide the outcome of the case. The accused agent has the legal right to bring an attorney to the hearing or to appear alone.

If the charges against the licensee are agreed to by the judge, then the agent may have his or her license suspended or revoked. A suspension can last for a certain number of days or much longer; a revocation can last for a certain amount of time as well, or be permanent if the unlawful acts are deemed significant. The licensee may apply for reinstatement after a year, if allowable.

In addition to or instead of a license suspension or revocation, the Commissioner may levy a fine of up to \$250 per day as calculated by the number of days that the license would have been suspended (i.e., 10 days = \$2,500 and 40 days = \$10,000). The \$10,000 amount is the absolute maximum penalty that can be assessed by the Commissioner.

The Commissioner can prohibit any licensee who was found liable in a civil or criminal matter, or who caused “material damage to the public” by their actions, from performing any future real-estate-related jobs as a manager or employee for up to 36 months.

The Commissioner also has the option to:

- Issue a restricted license instead of suspending or revoking a license
- Issue desist and refrain orders to agents to demand that they stop violating licensing laws
- Suspend a license without a hearing for actions that were potentially related to misrepresentation, material misstatements of fact, and fraud; a follow-up hearing will then later be held to finalize the licensing outcome.

Grounds for Discipline

The main list of actions committed by licensees that can be grounds for suspension or revocation of a license can be found in Sections 10176 and 10177 of the California Business and Professions code.

Some of the most common actions (or inactions) that may jeopardize an agent's license include:

- Making an intentionally false statement
- Making a false promise that harms a principal or other agent
- Not disclosing that the agent is working for both sides as a dual agent
- Commingling client trust funds with a broker's personal or business funds.
- The act of conversion (or theft) where the agent spends the client's funds
- Not listing a definitive termination date on a listing agreement
- Not disclosing a hidden profit or ownership interest in a real estate transaction
- Getting paid a commission without properly signed disclosure forms
- Not disbursing funds as instructed in sales, lease, or mortgage deals
- Submitting a false license application form to the DRE
- Being convicted of a crime (or pleading guilty) in a court of law in felony matters or matters that are related to real estate and financial activities
- False advertising to the general public
- Any violation of Fair Housing laws
- Not disclosing any known property defects in a listing transaction

The Real Estate Recovery Fund

It is the state treasury that is in charge of the collection of license fees which are then credited to the Real Estate Fund and to some other accounts. Approximately 8% of the money credited to the **Education and Research Account** is used to enhance future education and research projects. Another 12% of the funds collected from the Real Estate Fund goes to the **Recovery Account**. This is the same Account that pays out funds to injured parties due to agents' incompetence or fraudulent actions.

After the claimant in a civil action is awarded a judgment that confirms that the court agrees that the agent engaged in conduct that violated laws and that the claimant can prove that the agent does not have sufficient funds to pay the entire judgment amount, the Recovery Fund can pay out up to \$50,000 for losses related to a single transaction. A grand total of up to \$250,000 can be paid out by the Recovery Fund to multiple parties due to actions from a single licensee during his or her entire career.

If just one dollar or more is paid out by the Recovery Fund, the licensee associated with the funds paid out to claimants will have their license automatically suspended as of the payment date. To reinstate the license, the agent must pay back the Recovery Fund the entire amount paid out plus interest. Even if the licensee is forced to file Chapter 7 or Chapter 13 bankruptcy, he or she will still be obligated to pay back the Recovery Fund in order to reactivate the license.

Trust Funds

The misuse of client trust funds is one of the main ways for a licensee to have his or her license suspended or revoked, regardless of whether the actions were intentional or unintentional. A trust fund may be linked to the payment of cash, check, promissory note, or something else of value. The licensee is holding the cash or valuable item on behalf of the client for some type of real estate transaction such as a purchase, sale, or rental deal.

In purchase transactions, the buyer will often write a personal check as a **good faith deposit** that may be 3% of the offering price (subject to negotiation). It will be up to the broker to hold these client funds in a separate earmarked client account that is deposited “in trust” for the principals.

When handling trust funds that are collected from clients, the money should be deposited into:

- a neutral escrow account that was mutually agreed to by all parties;
- the hands of the principal who was named as the recipient; or
- a trust account set up at a federally insured financial institution that is maintained by the broker.

Sometimes, the client’s check will not be given to any of these escrow accounts or to the other principal in the transaction if the broker had written instructions from the buyer to not give the check to the seller until after the acceptance of the buyer’s offer. The deposit cannot usually be refunded if the deal falls apart unless express written permission has been provided by one or more required principal parties.

If there is a financial dispute over the funds placed with a neutral independent escrow company, or one owned by a title company, then the escrow agent will file an **interpleader** action which will transfer the control of funds to a court to let it decide the final outcome.

Each month, the broker should check their monthly check registers or accounting records with the actual bank statements received to ensure that the funds balance out every 30 days. This balancing act by the broker, or appointed office staff, is called **reconciliation**. Sometimes, the funds are short (**trust fund shortage**) and other times there is too much money in the accounts (**trust fund overage**) due to reasons such as the broker incorrectly depositing their own funds into the client trust fund account. Whether there is too little or too much money in a client trust fund account, it is still a violation of real estate licensing laws.

There are a few exceptions to the “no commingling” rule for brokers as it pertains to trust funds. These exceptions may include:

- 1) Because the service charges on a trust account that are payable to banks must be paid by the broker out of his own main account, he can deposit \$200 from his own funds into the trust account.
- 2) With written permission from the client (i.e., for the payment of advance funds to a broker for work about to be performed or still not completed), the broker may be entitled to collect commission income directly from the trust account. If the commission cannot be paid right away, it can remain in the trust account for only a maximum time of up to 25 days.

Trust accounts should be opened up in the name of the main broker at a prominent California bank that has a sufficient amount of FDIC insurance. The account name listed on the bank account should include a reference to the fact that it is a trust account (e.g., Smith Realty Trust Account) and that the broker is the primary trustee for the account. Often, the funds are deposited into non-interest bearing accounts unless the client gives written instruction that the funds may be deposited into accounts that pay monthly interest returns. However, the broker may not financially benefit from any interest earned in the account that must later go back to the client, or some other third-party designated by the client.

Prior to the **withdrawal** of funds from the trust account, the signature of the broker or trustee named on the account is required, or the signature of one of the broker's appointed representatives. A broker-appointed representative is typically a , a broker-employed associate broker, or an unlicensed employee with a sufficient level of fiduciary bond insurance (this can protect against employee theft of assets) that is equal to or greater than the total amount held in trust. Regardless, it is the broker who ultimately has the most liability should the trust funds later go missing.

Trust Fund Records

The broker is required to choose from two types of trust fund accounting record systems - a simple columnar system or a more complex type of general accounting practice option. With either accounting system selected, the records should include:

- 1) A list of all trust fund receipts in chronological order according to the dates collected
- 2) The balance of each trust account
- 3) A list of all expenses paid out in chronological order
- 4) The name of all parties or beneficiaries who were paid funds

The **Columnar System** must keep three different types of records that include:

1. A record of all collected and paid-out trust funds with these details:
 - the date of received funds;
 - the name of the party who wrote the check;
 - the total amount received;
 - the date the funds were deposited;
 - for disbursements, the name of the party who received the funds;
 - the amount paid out;
 - the check number and date; and
 - the daily balance of the bank account;
2. A record for every client or transaction that must include:
 - the date that the funds were deposited;
 - the total amount deposited;
 - the name of the payor or payee; and
 - for any funds paid out, the check number, amount, and date of issuance; and
3. For funds received and not yet deposited into the trust account, this information should be included:
 - the date that the funds were received;
 - the form of payment (check, cash, promissory note, etc.);
 - the total amount received;
 - the name and location of the place where the funds were deposited; and
 - the date of the deposit.



The **General Accounting Practices** accounting system can include the following methods:

- 1) **Journal:** A chronological record of trust fund receipts and disbursements that are listed by the date of collection, the identification of the parties in the transaction, and the list of total receipts and disbursements made on at least a monthly basis.
- 2) **Cash ledger:** The increases or decreases in a trust account and the latest updated account balance listed in summary form.
- 3) **Beneficiary ledger:** Each client is to be listed under a beneficiary ledger that notes the series of transactions collected or paid out on his or her behalf. Each subsequent account balance will be listed in chronological order.

The Commissioner has the right to inspect any and all trust fund accounts managed by a broker. The broker is required to keep copies of all trust fund records and cancelled checks for every transaction for up to at least three (3) years from the date of the transaction closing, cancellation, or listing if the broker was handling a property sale.

Broker's Maintenance of Documents

Brokers must keep copies of all documents that are associated with a real estate transaction at least three years as well. These documents include:

- Buyer agency agreements
- Listing agreements
- Purchase agreements
- Rent collection receipts
- Bank deposit slips
- Canceled checks
- Escrow statements
- Transfer disclosure statements
- Property management agreements

Document Copies and Broker Reviews

It is a mandatory requirement for brokers to provide copies of signed documents to the same party or parties who signed them, such as buyer's agency, listing agreements, and various disclosure statements. It is up to the broker to make sure that all contracts are signed properly and shared with principals in any and all real estate transactions that go through the broker's office. If not, the broker may have the most financial, legal, and license liability.

Any **broker-salesperson agreement** that is executed or completed between a new salesperson and his or her employing broker must be filed and kept at the broker's office for up to three years after the termination of the broker-salesperson relationship.

Advertising

Any advertisements that are published in print media or online by a real estate licensee or on any real estate signs must clearly identify the licensee designation. If the agent is not properly identified as a licensed real estate professional (for example: "broker," "agent," and "realtor"), it is a violation of real estate laws and is generally referred to as a **blind ad**.

One exception to this agent identification rule is for classified ads for rental properties if the phone number and address for the rental property are clearly listed. If so, then the licensee designation is not required to appear in the ad.



Under the **first contact** rule as it relates to brokers advertising their services to the public, the licensee is required to list his or her license identification number in addition to his or her name.

This is true for business cards, advertising flyers, and other materials designed to find new clients who do not have a past relationship with the advertising broker or agent. However, “For Sale” signs do not need to include the agent’s license number.

With internet advertising via brokers’ personal websites, blogs, videos, or other online marketing methods, there is something called the “One Click Rule” that agents must adhere to when marketing their services or products online. The rule requires that visitors to an agent’s website or blog must be able to find the agent’s contact information and license details within just one click after visiting the site or blog. A prime example of the “One Click Rule” is an “About Us” button that is listed on a website or blog.

For agents who are advertising mortgages or real estate investments such as discounted deeds of trust, the agent must clearly outline the true interest rate, APR (Annual Percentage Rate), and/or the actual interest amount paid or collected at face or par value or at a discount.

Gifts or Prizes

A real estate professional may offer a gift, prize, or some other type of incentive in certain cases to the general public if they attend his or her sales presentation about purchasing properties. Yet, these types of **inducements** are usually not allowable if associated with any type of financial or mortgage transaction. The agent must fully disclose in the advertisement if a prospect or client's attendance is mandatory to receive the gift or prize in addition to any other conditions, if necessary, to collect the offered prizes. An inducement is considered a **material fact** that must be fully disclosed to all prospects or parties involved in a potential real estate or mortgage deal.

Do-Not-Call Registry List: It is illegal, per the Federal Trade Commission's (FTC) rules, for agents to make unsolicited "cold calls" to telephone prospects whose names appear on the Do-Not-Call list.

There is also a "do not spam" list for email addresses that real estate professionals should research before they attempt to begin an email or newsletter campaign. The fines per call or email may be as high as \$40,000 each, so this is a very serious financial risk for agents if they do not follow these marketing guidelines.

Chapter Sixteen Summary

- Real Estate License Law in California originates from legislative “guidelines” issued through **Sections 10000 to 10580 of the California Business and Professions Code**.
- The **Department of Real Estate (DRE)**, is a division of the California Department of Consumer Affairs, that administers the Real Estate Law. The Commissioner is appointed by the Governor.
- Any person who advises, advertises, or acts as if he or she is a licensed professional, is required to hold an active salesperson or broker’s license.
- To receive an **MLO (Mortgage Loan Originator)** endorsement license, the licensee has to be approved and licensed through the **Nationwide Mortgage Licensing System**. The MLO license expires every December 31st as it is only valid for one year at a time.
- An **Associate Broker** (a/k/a a **Broker-Salesperson**) is a person with an active real estate broker’s license who decides to work under another broker’s license. All licensees under an employing broker are known as **affiliated licensees**.
- All licensees who apply to take any real estate exam must be at least 18 years of age, truthful and honest, and must meet various forms of basic or advanced types of new or continuing education requirements.
- License applicants have up to **one year** from the date of passing their exam to pay for and obtain their license.
- A salesperson and broker’s license are valid for **four-year terms** once activated after the fees are paid and all educational requirements are met. Late renewal fees are **150%** of on-time filing fee prices.
- A **business opportunity** is the lease or sale of a business that might include fixtures, inventory, goodwill (a positive business name as viewed by the local community), and/or lease assignments. It can be a transaction involving both real and personal property.

- The **Recovery Fund** may pay out up to **\$50,000** for losses related to a single transaction for judgments awarded to claimants against licensees for fraudulent actions. Up to **\$250,000** may be paid out by the Recovery Fund for multiple actions against one license.
- The broker may choose from two types of trust fund accounting record systems - a **simple columnar system** or a **general accounting practice** option such as a journal, cash ledger, or beneficiary ledger method.
- A **blind ad** is when an agent does not properly identify him or herself when advertising a property or his or her services.

Chapter Sixteen Quiz

1. California's Real Estate License Law originates primarily from _____.
 - A. The DRE
 - B. The Commissioner's office
 - C. Section 10000 to 10580 of the California Business and Professions Code
 - D. The Attorney General
2. What is the full term of a real estate license?
 - A. Four years
 - B. Three years
 - C. Two years
 - D. One year
3. Who or what agency administers the Real Estate Law in California?
 - A. The Commissioner
 - B. The Governor's office
 - C. CalDRE (also known as the Department of Real Estate)
 - D. The Attorney General

4. Where should the main employing broker keep the licenses of all of his affiliated licensees?
- A. With the DRE
 - B. At the Commissioner's office
 - C. In the broker's office
 - D. Licenses should remain in the possession of each agent
5. Who is allowed to withdraw trust funds out of a broker's trust account?
- A. The Broker
 - B. A broker from another office
 - C. An unlicensed employee who is covered by a fiduciary bond that is at least equal to the total amount held in the trust account
 - D. Both A & C
6. An MLO endorsement license is valid for how long?
- A. One year
 - B. Two years
 - C. Three years
 - D. Four years
7. What is the name of the act of mixing client's trust funds with a broker's business fund account?
- A. Commission
 - B. Conversion
 - C. Commingling
 - D. Balancing records
8. What is the maximum amount the Real Estate Recovery Fund account will pay out on behalf of one agent involved in a single transaction?
- A. \$250,000
 - B. \$150,000
 - C. \$100,000
 - D. \$50,000
9. What is the total amount that the Recovery Account will pay out for the actions of one licensee during the course of their entire career?
- A. \$1,000,000
 - B. \$500,000
 - C. \$250,000
 - D. \$100,000

10. What are the late fee percentage rates as compared with the on-time rates for license renewal in California?

- A. 110%
- B. 150%
- C. 200%
- D. 250%

11. How old does a licensee in California with over 30 years' experience need to be in order to be exempt from continuing education requirements?

- A. 80
- B. 70
- C. 65
- D. 60

12. The lease or sale of a business that may or may not include fixtures, inventory, and goodwill is a type of _____.

- A. Chattel arrangement
- B. Business opportunity
- C. UCC exchange
- D. Franchise swap

Answer Key:

1. C	7. C
2. A	8. D
3. C	9. C
4. C	10. B
5. D	11. B
6. A	12. B

CHAPTER 17

REAL ESTATE FINANCE AND MATH

Overview

“Money makes the world go around,” as the old saying goes about the crucial impact that money has in both the world and the world of finance. Money is the key component in the vast majority of real estate transactions. This is partly due to the fact that most buyers use it in the form of cash, or cash plus third-party financing options from banks. In addition, sellers usually need money to get out of a deal when they sell properties. As such, money allows principals to get into and out of real estate, while also generating much-needed commission income for the real estate agents assisting with the deals. Whether the access to money is conventional (through local bank access), or more creative via private money (such as crowdfunding platforms for real estate, seller-financed wraparound mortgages, or investments by corporations, LLC’s, or partnerships with anonymity and tax-shelter options), money remains a main factor in any type of real estate deal.

Economics and Real Estate

The ease of access to capital is typically the main driving force behind a “booming” (positive) or “busting” (negative) real estate cycle. When mortgage rates are at historical lows like they have been for the past several years, or mortgage underwriting guidelines make it easier to qualify for a loan (such as the old “EZ Doc” adjustable-rate mortgage loans with very low teaser starting rates like prior to 2008, a/k/a an **“easy money market”**), then buyers’ demand for properties is usually stronger than when rates are higher or loans are more difficult to obtain, a/k/a a **“tight money market”**. In many ways, the state and national employment rates play less of a role in the supply and demand of real estate and whether or not real property prices are increasing, than the access to cheap and easy third-party money. Cheap and easy money tends to get buyers quickly into and out of properties.

Real Estate Cycles

Historically, the economic boom and bust cycles for residential housing have not *always* followed the same time patterns. But in recent decades, we have seen these cycles closely follow a 7-year pattern. Let's take a look at some of the more famous boom and bust years that affected the national economy as well as California's, especially dating back to the early 1970's.

1973 - Oil Shock Crash: The "gold standard" was first established at Bretton Woods in 1944 between 44 allied nations near the end of World War II. Also established then was the International Monetary Fund (IMF) to regulate the world financial system. The latter was replaced by President Richard Nixon's new Petrodollar ("oil backed by dollars") currency system as far back as 1971. The U.S., Saudi Arabia, and several other prominent Middle Eastern nations began trading oil around many parts of the world using only dollars which then pushed inflation rates much higher, especially in the U.S.. This was because more dollars were in circulation and the value or "purchasing power" of the dollar began to fall at a faster pace. In an attempt to slow down the higher inflation rates, the Federal Reserve began increasing interest rates that slowed the demand for new capital to acquire investments such as real estate for many years.

1980 - Sky High Interest Rates: The higher rates of inflation throughout much of the 1970's and the early 1980's reached a peak when the Prime Rate hit a mind-boggling 21.5% in December 1980. Thirty-year mortgage loans also reached double-digit figures of about 10%. As a result, more home buyers asked sellers to carry much of their equity as a new seller-financed mortgage by way of a new first or second loan, a land contract, or an all-inclusive deed of trust (an AITD) at rates that were lower than conventional bank rates being offered at that time.

1987 - Black Monday Stock Crash: On October 19, 1987 ("Black Monday"), the Dow Jones index fell 508 points in one day. This was equivalent to an overall market value loss for the Dow Jones Industrial Average (DJIA) of more than 20% because the entire Dow Jones index at the time was only about 2,600 shortly before the market fell on Black Monday. As a comparison, the Dow Jones index values in 2020 are closer to 30,000. A drop of 500 points would now be only about 1.6%.

1994 - Bond Market Crash: The Federal Reserve raised interest rates several times in 1994 in spite of lower inflation rates at the same time. The financial markets did not positively react to mortgage rates going from a low near 6% to rates closer to 8% within a relatively short period of time. As a result, bond values (30-year fixed mortgage rates are tied to the direction of underlying 10-year Treasury yields) lost an estimated \$600 billion because there were more interested sellers than buyers. Around the world, global bond prices might have fallen approximately \$1.5 trillion.

2001 - Post-9/11 Stock Crash: On the first trading day (September 17th) after the tragic 9/11 event took place in New York City, Washington D.C., and Pennsylvania, the Dow fell 684 points (a 7.1% market decline). For the entire first week back in operation after 9/11, the Dow fell a total of 1,370 points (or 14% of the overall market value) and the Standard & Poor's index (S&P 500) fell 11.6%. Shortly thereafter, the Federal Reserve began a massive series of interest-rate cuts that helped the stock, bond, and real estate markets boom yet again over the next several years as access to money improved and mortgage loan underwriting requirements got easier.

2008 - Near Financial Market Implosion: On September 29, 2008, the Dow Jones fell a record 777 points. Once prominent financial institutions like Lehman Brothers, Bear Stearns, AIG, Washington Mutual, Merrill Lynch, and Countrywide Mortgage either collapsed or almost collapsed and had to be bailed out due to the imploding global derivatives market that was "freezing" around the world. Homeowners were being foreclosed upon in record numbers when their low introductory teaser-rate adjustable mortgages reset, and owners could not make their monthly payments.

2015 - Global Currency Wars: A currency war is a condition in international affairs where countries are attempting to gain a trade advantage over other countries by causing the exchange rate of their currency to fall in relation to other countries' currencies. In 2015, the currencies of a consortium of nations (i.e., BRICS - Brazil, Russia, India, China, and South Africa), and cryptocurrencies, like Bitcoin and many other anonymous or semi-anonymous financial systems, started to quickly push values down in relation to the dollar at an extremely fast pace. Stock market prices and currency values became more volatile. As

a result, there were several stock market and currency price “glitches” around the world that investors became incredibly nervous about.

The Control of Money Supplies

The Federal Reserve, the U.S. Treasury, and demand from individual and institutional investors across the U.S. and many other parts of the world impacts access to money for principals in need of mortgages to buy and sell properties.



Fiscal Policy

Fiscal policy is the collective term for the taxing and spending actions of governments. At the hub of fiscal policy is the use of **government revenue collection** (or **taxation**) and **expenditure (spending)** that is used to influence the economy to stimulate or slow down economic growth. Under Keynesian economic theory, the **aggregate demand** from consumers and overall economic activity would stabilize the economy over the course of the next desired business cycle. In sluggish economies, the government might quickly cut income and capital gains taxes to encourage more people to buy assets like stocks and real estate. Other

strategies to boost the economy might be when state and federal government agencies hire more people to work on public works-type projects such as the building of new freeways, schools, and parks, such as. President Roosevelt's New Deal programs to get us out of the Great Depression in the 1930s.

Often, the federal government will borrow money to fund the expansion of its spending and hiring programs if the collected tax revenues are not high enough to cover the annual budget deficit. To cover the budget shortfall, the U.S. Treasury and affiliate agencies will likely offer government-backed, interest-bearing securities to private investors and even to foreign corporations and nations by way of options such as the ones discussed below.

Treasury Bills: Securities issued for a term of one year or less.

Treasury Notes: Securities issued for terms between two and 10 years. A 30-year mortgage rate is tied to the direction of the latest 10-year Treasury yields. The prices paid for a Treasury securities investment falls when demand decreases and rises when investor demand increases. But bond prices and yields are inverse to one another. As a result, decreased investor demand for these types of securities generally leads to falling prices and higher Treasury yields and mortgage rates.

Treasury Inflation Protected Securities (TIPS): TIPS are investment options that are indexed to inflation as measured by the **Consumer Price Index** in order to protect investors from the negative effects of inflation on their investments held in cash. TIPS are considered extremely low-risk investments because the par value rises with inflation, the interest rate is fixed, and the investment is guaranteed by the federal government.

Treasury Bonds: Treasury bonds are securities that are issued for periods of up to 30 years. The longer the investment term for a securities option, the higher the government is generally willing to pay for the money. On the other hand, shorter-term securities like T-Bills usually pay the lowest rates of interest partly due to less risk for investors.

Monetary Policy

The simplest way to explain **monetary policy** is that the movement of interest rates for consumers and banks is directly impacted by the decisions made by the Federal Reserve (a/k/a “The Fed”). In spite of the “federal” name in Federal Reserve, it is actually more like a private, non-governmental financial entity that is owned and controlled by domestic and foreign banks and governments.

The Fed was established in 1913 after the passage of the Federal Reserve Act in December 1912. It is considered the central banking system of the entire United States. The Fed is governed by the Federal Reserve Board’s members and ruling chairman or chairwoman who are in charge of twelve (12) Federal Reserve districts across the nation. Each of the thousands of commercial banks in the U.S. is a member of the Fed.

The **12 Federal Reserve Districts** are divided up into these main regions:

- 1st District: Federal Reserve Bank of Boston
- 2nd District: Federal Reserve Bank of New York
- 3rd District: Federal Reserve Bank of Philadelphia
- 4th District: Federal Reserve Bank of Cleveland
- 5th District: Federal Reserve Bank of Richmond (Virginia)
- 6th District: Federal Reserve Bank of Atlanta
- 7th District: Federal Reserve Bank of Chicago
- 8th District: Federal Reserve Bank of St. Louis
- 9th District: Federal Reserve Bank of Minneapolis
- 10th District: Federal Reserve Bank of Kansas City
- 11th District: Federal Reserve Bank of Dallas
- 12th District: Federal Reserve Bank of San Francisco

The Fed’s main stated objectives are to boost the economy by assisting with the maintenance of high employment as well as price, interest rate, and financial market stability.

Monetary policy and other actions taken by the Fed directly impact the real estate industry partly because the price of borrowed money can fluctuate as a result. Some of the primary tools used by the Fed include:

- The movement of key interest rates
- The modification of reserve requirements
- Changes made to open market operations

Key interest rates: The Fed directly controls and moves the **Federal Funds Rate** (rates for loans from banks to other banks overnight on an uncollateralized basis). And it controls the **Discount Rate** (rates for banks to borrow funds from the Fed). The Federal Open Market Committee (FOMC) members meet eight times per year to determine the establishment of the key rates.

When banks have to pay higher rates to borrow funds from other member banks or directly from the Fed, then the bank, in turn, will pass on those higher rates to banking customers. One of the main economic concerns for the Fed is annual inflation rates. To slow down inflation, the Fed typically increases interest rates, which slows down borrowing and spending trends that will later (hopefully) bring annual inflation rates lower too.

Reserve Requirements: Commercial banks are required to keep a small percentage of their funds on hand in their branch as well as on deposit with the Federal Reserve Bank. Banks need to set aside a certain amount of cash on hand in their vaults, or by way of electronic fund access, in case of financial panic situations like “bank runs” when too many depositors withdraw cash on the same day, as we saw during some of the worst economic days of the Great Depression. (A run on the bank was glorified in the film *It’s a Wonderful Life*.)

The Fed can change the requirements for cash that banks must set aside and not lend to their banking customers. When those reserve requirements are higher (e.g., 10% of all deposited funds cannot be loaned out to banking customers), then the cost to borrow funds and the access to capital may be worse for banking clients. Conversely, lower reserve requirements, for example, 2% to 5%, allow the bank to lend out a much higher percentage of its funds. With those low reserve requirements, 95% to 98% of all customer deposits may be loaned out for automobile purchases, business loans, and home mortgages.

Open Market Operations: The Fed will buy and sell securities investments such as Treasury bonds, notes, and bills, in an attempt to control the money supply while also affecting interest rates and borrowing trends. To increase the supply of money to member banks, the Fed will purchase more securities. To decrease the access to capital funds, the Fed will sell its securities investments.

How Other Federal Agencies Impact Real Estate Finance

The privately held Federal Reserve has more power than any federal agency to impact the mortgage and real estate industries positively or negatively. Listed below are some other relevant governmental entities.

-Federal Home Loan Bank System: There are 11 regional and privately-owned wholesale banks that make up the Federal Home Loan Bank System (FHLB). The FHLB's origins date back to the enactment of the **Federal Home Loan Bank Act** that was passed on July 22, 1932 with the assistance of President Herbert Hoover to lower the cost of mortgages and fees for consumers.

-The establishment of the **Federal Home Loan Bank Board** assisted with the charter and supervision of federal savings and loan institutions that govern many of the 7,300 member banks that offer mortgage loans.

-Federal Deposit Insurance Corporation: 1933 was perhaps the worst year during the Great Depression (1929 - 1939) when "bank runs" were at or near their peak as banking customers literally ran to their banks to pull out most or all of their cash before their bank went out of business. 1933 was also the very same year that the Federal Deposit Insurance Corporation (FDIC) was established to insure bank deposits against financial insolvency.

Over the past 80+ years, the FDIC has offered insurance protection amounts of \$100,000 to \$250,000 per qualified bank account in the event that the customer's bank was forced out of business and ran out of its own cash. The creation of the FDIC insurance system gave more banking customers faith in the stability of the U.S. banking system which, in turn, led to more funds being deposited and loaned out for home mortgages and business loans.



-The Department of Housing and Urban Development (HUD): This is the main federal agency in charge of programs associated with housing needs, fair housing opportunities in accordance with the **Fair Housing Act**, and developing and improving affordable communities across the nation for both owners (better priced mortgage loans with reduced fees) and tenants (public housing, urban renewal projects, etc.). Mortgage loan programs that are insured by the **Federal Housing Administration (FHA)** and other types of mortgages sold in the secondary market to agencies such as Ginnie Mae have all been under the influence and leadership of HUD in varying degrees over the years.

-Rural Housing Service: This agency that was formerly known as the **Farmers Home Administration (FmHA)** is under the governance of the Department of Agriculture. The agency focuses on offering and guaranteeing construction and purchase loans that are used to finance affordably priced properties in more rural regions of the country.

-Farm Credit System (FCS): Congress first established the FCS in 1916 as a way to provide a more reliable source of credit for ranchers and farmers. Currently, it is a nationwide network of borrower-owned lending institutions and specialized service organizations that have offered

several hundred billion dollars to rural homeowners and business owners.

Sources of Bank Capital

Banking customer and mortgage client funds typically originate from two main sources - the primary and secondary markets. As the names suggest, the funds that originate from banks, credit unions, or other financial institutions first are in the **primary market** before many of these same loans are sold off to the **secondary market** as the second step in the funding process. Banks need to sell off most of their funded mortgage loans as quickly as possible before they run out of cash.

Primary Market: In the old days back in the mid to late-20th century, many borrowers walked or drove to their nearby community bank, thrift and loan, savings and loan, or credit union to meet with their banking representative face-to-face prior to filling out a loan application together. As such, the typical primary market lender was their nearby local bank that took in depositor funds from their local customers prior to later lending those same funds to help start-up businesses and provide mortgage loans for home buyers. In the 21st century, the primary lender source might be an online bank with a physical headquarters thousands of miles away from the borrower and the subject property the borrower is trying to finance.

Secondary Market: The secondary market has evolved and swung back and forth from government-backed and insured investment agencies to “quasi-government” (a hybrid of government and private investment agencies) to a completely private investment group, such as an investment bank on Wall Street. Some of those investment banks became fully governmental when financial bailouts were needed after the worsening of the Credit Crisis in 2008. Depending upon the quality of the mortgage loans made in the primary bank at any of the thousands of member U.S. banks after meeting the more stringent mortgage



underwriting guidelines, the loans will likely be packaged in pools of hundreds or thousands of loans at a time and sold off to a well-known secondary market agency investor like Fannie Mae, Freddie Mac, or Ginnie Mae. The secondary markets have been described as the place where Wall Street (or the secondary market investors) meet and intersect with Main Street (or the home loans being purchased).

The secondary market investors (private or public) then have the option to spin off some of the monthly or annual income streams in the form of **mortgage-backed securities** to private or institutional investors. Because so many of these income streams are “guaranteed” by the federal government, the rates paid are generally fairly decent and the investors feel relatively safe about the investment.

Fannie Mae: The **Federal National Mortgage Association (FNMA - pronounced “Fannie Mae”)** was founded in 1938 as a **government-sponsored enterprise (GSE)** near the end of the Great Depression as a way to improve consumers’ faith in the U.S. banking system. It was also a way to increase access to funds for consumers and home buyers. Shortly after the banks or primary lenders funded their mortgage loans to qualified buyers, these banks would sell them off to Fannie Mae for additional cash funds that could be used to make additional mortgage loans.

In 1968, Fannie Mae became more of a publicly-traded “quasi-public” and “quasi-private” entity in that it was privately held but it had some government-insured or backed benefits in case of default. In September 2008 when the financial markets were in disarray and serious financial disorder, both Fannie Mae and Freddie Mac (discussed below) were placed into financial conservatorship or management under the direction of the newly formed **Federal Housing Finance Agency (FHFA)**. At the time, Fannie Mae and Freddie Mac held upwards of \$12 trillion dollars’ worth of mortgages.

Had Fannie Mae or Freddie Mac run out of cash in 2008, then the entire U.S. mortgage market might have completely collapsed.

Freddie Mac: Just like with Fannie Mae, Freddie Mac (**Federal Home Loan Mortgage Corporation**) was set up as a stockholder-owned GSE to purchase funded mortgage loans in the secondary marketplace. Freddie Mac was chartered by Congress in 1970, and created with the intent to

purchase, guarantee, and “securitize” (or break down into smaller pieces to sell off) mortgages to form mortgage-backed securities. Often, their securities that were sold off to individual or institutional investors had very high credit ratings close to that of U.S. Treasuries due to the perceived safety of the investment class.

Ginnie Mae: This is a type of secondary market that has always been under the direct ownership and management of the federal government. It purchases and helps guarantee mortgage loans that were first made, directly or indirectly, through FHA (Federal Housing Administration) and VA (Veterans Administration).

Financial Documents

Financial and mortgage contracts usually include some of the following documents or clauses that bind a borrower to a lender under the law while securing the subject property as the primary collateral in the event of a potential default and foreclosure at a later date. These legal documents typically include:

A **Promissory Note:** This is basically a glorified “IOU” for the mortgage debt that is akin to a “promise to pay it back” in the future. The note usually makes a reference to the mortgage principal loan amount borrowed, the borrowers’ names, and vesting type (e.g., joint tenancy, sole and separate property, etc.), and the interest rate (some maximum “usury laws” may or may not apply which limits the maximum interest rate and fee charges), loan type (fixed, adjustable, interest-only, fully amortizing), and loan term (number of months or years). The borrower is the “maker” of the note while the lender is the “payee” who shall later be repaid in full for their loan.

A promissory note is more concerned with the loan or debt and is *not* recorded in public records for the public to see the loan details. The **deed of trust** or grant deed is **recorded** upon the completion of the purchase or loan refinance, and includes the legal description, street address, and other property details. The deed and note are attached to one another as a type of security instrument.

Some lenders in years past might have required that the borrower deposit a certain minimum amount of money with his or her financial

institution as a condition of the mortgage being offered. If so, the amount of money deposited with the bank to minimize the financial risk is called a **compensating balance**.

Some promissory notes are described as **straight notes** (or “**interest-only**”). With these typically shorter-term loans, the borrower is paying only the monthly interest payments on the mortgage debt. At the end of the loan term, the same principal amount will be due and payable as back when the loan began. A **simple interest** loan is charged on the unpaid principal amount (e.g., a 10% rate charged on a \$120,000 mortgage equals \$12,000 per year or \$1,000 per month in simple interest). A **compound interest** loan is one in which interest is charged on the unpaid principal, and interest can compound, magnify, or “snowball” in larger payment amounts over time.

Other loans are categorized as **installment notes** (or “**fully amortized**”) in that the monthly mortgage payments will apply towards both principal and interest over the entire length of the mortgage until the loan balance ends up at zero or fully paid off. A 30-year fixed mortgage is the most common example of a fully amortized loan.

A promissory note is usually described as a **negotiable instrument**. The payee/lender that is due to be paid off at some point in the future may have the right to sign (endorse) the note over to another party in exchange for cash, property, or something else of value, by including a clause such as “payable to the order of” or “to bearer” to validate the note.

When a party receives a note endorsement, it is called a **special endorsement**, and any other nonspecific party receives an endorsement “in blank” from the payee. The party that currently holds ownership or beneficial interests in the note is called a **holder in due course**.

There is only one promissory note that is created for each real estate loan. This is partly so that multiple notes cannot be fraudulently sold off to different investors. Once the debt is paid off in full by the original borrower, the note is marked as “paid” and returned to the maker or original borrower.

The payee who endorses or sells off his or her interests in the note may prefer to offer the note **without recourse**, meaning that the original

lender cannot guarantee the continued timely note payments from the maker/borrower, and that the payee has no legal risks in the event that the maker/borrower defaults on the note payments. If so, the borrower and the new noteholder will have to battle between themselves for future payments and/or foreclosure or bankruptcy matters. An endorsement of a note without recourse is also called a **qualified endorsement**.

Security Instruments

The primary security instrument used alongside a promissory note is the deed to the property. Should the borrower default after not making timely payments that were set out in the note, the lender has the legal right, by way of a trustee, to file foreclosure and take back the property, which was declared as collateral for the loan.

Under **title theory** and **lien theory**, the lender is protected against a borrower's default by having the legal right to take over title to and ownership of the property through judicial actions or non-judicial (Trustees' Sale) auctions. The title to the property is given to the lender as a guarantee for future loan payments, but the borrower keeps possession under the legal doctrine of **hypothecation** (which you will learn more about in your Finance course). In **title theory states**, title is held in the lender's name until the final payment is made, when title is passed or re-conveyed to the borrower. In **lien theory states**, title to the property is held in the name of the borrower with a security interest or lien to the property being granted to the lender.

Legal title (also referred to as bare title or naked title) is the transfer of title to property only as collateral without possessory rights. **Equitable title** is defined as the property rights maintained by the borrower without the legal title in hand.

California is a lien theory state as it relates to mortgages, and a title theory state in regard to trust deeds. Under both theories and either way, a borrower will lose his property to the lender if mortgage payments are not paid when due.

Sometimes, personal property is offered with or without additional real property as collateral in exchange for a loan by way of a **pledge** to the

lender. In cases like those, the borrower signs a formal **security agreement** which is somewhat similar to a mortgage or deed of trust.

Mortgages and Trust Deeds: Mortgages and Trust Deeds are real property security instruments that guarantee the lender that payments will be made on time or the property will end up back with the lender upon completion of foreclosure. There are two parties to a mortgage - **mortgagor (borrower)** and a **mortgagee (lender)**.

With respect to a deed of trust, seen more in California, there are three parties involved - **trustor (borrower)**, **beneficiary (lender)**, and **trustee (neutral third party who handles the foreclosure process and payoffs)**.

For security instruments like a mortgage or deed of trust to be valid, there must be certain items, features, or steps completed:

- It must be signed by the borrower.
- It must be recorded by the lender.
- There must be assignment or endorsement features in the document that allow the lender to sell off their interests.
- An **offset statement or beneficiary's statement** must be signed by the borrower to confirm the balance due for a new lender or investor.

Most provisions in financial documents include certain **key clauses** such as:

-Mortgaging or granting clause: A clause that states that the borrower “grants and conveys” title to the property to the trustee as collateral for the loan in the event of future default.

-Property description: The note shall be attached to a deed or mortgage with a full legal description of the subject property.

-Taxes and insurance: This section of the security instrument notes the requirement of the borrower to pay his or her property taxes, insurance, and any other special assessments on time or face the risk of a lender or tax lien foreclosure.

-Acceleration clause: The lender has the right to accelerate the entire remaining unpaid balance as “all due and payable” should the borrower miss his or her mortgage payments. This action is also referred to as “accelerating the loan,” “calling the loan,” or a “call provision” in the loan documents.

-Alienation clause: Similar to an acceleration clause, an alienation clause is a **due-on-sale clause** that also gives power to the lender to “accelerate” the loan as “all due and payable.” But an alienation clause is used after the borrower transfers title to a new buyer without first obtaining permission from the lender. Unlike a regular sale, the borrower wants a new buyer to take over (assume) his or her existing mortgage payments without the existing lender first qualifying or approving the buyer. Some loans, on the other hand, allow a formal **assumption** of the mortgage debt by a qualified borrower/buyer after being approved by the lender.

-Late payment penalty: Per the terms of the lender and state law requirements, a monthly mortgage loan can have late fees as a fixed dollar amount or a percentage rate of the monthly payment if the borrower is more than 10, 20, or 30 days late.

-Lock-in clause: Some loans (commercial and non-owner occupied private money, especially) may have a lock-in clause under which a borrower is assessed an additional **prepayment penalty** for paying off a loan too soon in periods that can vary between one and five years. The penalties can be equivalent to six months of mortgage interest or a percentage amount of the loan balance. Most often, a borrower is allowed to pay off up to 20% of the original principal loan balance within a one-year time period without being assessed a prepayment penalty.

-Subordination clause: A clause that states that the new lender will have secondary lien position behind an existing mortgage loan already secured, or about to be secured in situations involving construction loans. Most construction lenders want to be in first position, so they will ask that the existing loan(s) on the land site agree to sign off on the subordination clause that moves them into second or third lien position behind the new construction loan.

-Defeasance clause: Once the lender is paid off in full, the borrower

regains full title, and the existing security instrument is cancelled and the property is now “free and clear” under the terms of this clause.

If a trust deed was used as the main security instrument, then a **deed of reconveyance** is signed off by the lender that also confirms and wipes out the debt of record while transferring full title rights back to the borrower/owner. The lender must present the deed of reconveyance within 30 days after the loan is paid off, and the trustee must complete it within 21 days of receiving the request.

For properties secured by a mortgage-secured loan that were paid off in full by the borrower, the mortgage loan is fully released and the property is deemed “free and clear” upon the completion of a document called a **certificate of discharge** or **satisfaction of mortgage** document (also referred to as a “lien release” document). The lender/mortgagee must record this document within 30 days, or face penalties of at least \$500.

Foreclosures

Usually, the foreclosure filing process from start to finish goes in the following sequence with or without possible lender extensions that can last from days, weeks, months, or even years before the lender actually takes the subject property back at the final trustee’s auction sale or it is purchased by another investor there.

Step 1: If a mortgage borrower is late two or more months on his or her payments, the lender will then start sending them threatening “warning letters” about the real possibility of a near-term foreclosure filing.

Step 2: The lender files a **Notice of Default (NOD)** to begin the foreclosure process if the borrower is still behind on his or her mortgage payments.

Step 3: The lender files a **Notice of Trustee’s Sale (NTS)** approximately ninety (90) days after the NOD has been filed if the borrowers still have not caught up with the delinquent mortgage payments. In a local legal newspaper, the lender will advertise its upcoming scheduled Trustee’s Sale (or the final auction) once a week for the next three weeks (21 days). It is here where the lender may extend the scheduled final auction date by days, weeks, months, or even years for reasons such as mutually-

agreed-upon payment plans, potential Short Sale options, or threats of a bankruptcy filing by the borrower that could automatically postpone the scheduled sale.

Step 4: The lender holds the final Trustee's Sale (or auction) at places like a county courthouse's front steps or at a title insurance company. The earliest date that this sale can be held is 120 days or more past the original Notice of Default filing that started the foreclosure process. The opening bid will likely include the entire amount of the unpaid mortgage, back payments, interest, legal fees, and trustee's fees. If nobody shows up with a cashier's check (or equivalent solid proof of funds), then the property automatically goes back to the lender.

Mortgage Loan Types

There are a number of different mortgage loan types offered by lenders to borrowers . Let's review some of the most popular types of mortgages below.

First mortgage: A first mortgage is a loan in first lien position that has the highest priority upon payoff and is usually the type of loan used by banks for conventional types of purchases or refinancing.

Second mortgage and other junior liens: These are loans or judgment creditor liens in second, third, fourth, or more lien position behind the first mortgage. They are riskier than first loans, and can be wiped out at a foreclosure sale behind a foreclosed first mortgage.

Purchase money mortgage: A purchase money mortgage is a first mortgage, or a concurrent first and second mortgage, used to buy a property (also referred to as a "soft money mortgage" because the borrower receives credit as opposed to actual physical cash from the lender). A "**hard money mortgage**" refers to a private money loan that is usually more expensive than a bank loan with higher rates and fees. Most often, the borrower receives a credit instead of physical "hard money" from the lender. Yet, there are some lenders who will still lend physical cash or "hard money" to motivated borrowers.

Swing loan: A swing loan is a type of loan used in both residential and commercial loans (a/k/a "gap loan" or a "bridge loan"). A borrower takes

out a loan on property that he or she currently owns (an equity loan), and then takes the cash from that equity loan as a new down payment to purchase another property.

Package mortgage: The combination of personal and real property “packaged” together as collateral for a loan.

Construction loan: A type of short-term **interim loan** that finances the construction or development of a property site. A lender may offer a **standby loan commitment** letter with the proposed loan terms to a borrower hoping for a future construction loan. Once the property is completely built, a **take-out loan** (or permanent financing) will likely pay off the construction loan if the owners wishes to keep the property.

Blanket mortgage: A blanket mortgage is a loan secured by multiple properties with a **partial release clause** included that allows the borrower to pay off some of the mortgage debt while releasing one or more properties used as collateral for the loan.

Participation mortgage: This is usually a type of commercial loan that gives the lender some ownership and income interests in the subject property. Many times, it is an insurance company acting as the lender who is likely to participate in the property’s ownership interests in large commercial projects, like Class A office buildings.

Shared-equity or shared appreciation mortgage: This is a type of loan where the lender has the right to share in any future property appreciation gains. These types of loans have been used for both residential and commercial properties.

Graduated payment mortgage: Graduated payment mortgage is a type of adjustable loan where the payments may be fixed for the first year prior to slowly escalating over the next few years. For example, the rate might be 5% in year one, 6% in year two, and 7% in any year past three.

Subprime mortgage: After the worst of the Credit Crisis in 2007 to 2009, very few mortgage lenders now offer these types of mortgage loans to borrowers who have less than perfect credit. These loans require less formal income documentation, known as “EZ Doc” loans. Today, private money lenders are likeliest to offer these types of “subprime” loans.

Home equity loan: Borrowers can pull out some of the equity after writing themselves an actual check from their home equity account. The loan might be in first or second position. The funds, many times, can be used to make improvements to the property or pay off consumer debts (a/k/a “HELOC - home equity line of credit).

Reverse mortgage: This is a hybrid loan and insurance contract that gives older Americans the right to pull cash out of the built-up equity in their property over a relatively long period of time. It is the opposite of a traditional mortgage in that the lender sends the borrower a monthly check instead of the other way around. The loan shall be paid off upon the death of the main person named as the owner of the property.

Refinancing: Borrowers might seek out new mortgage loans with lower interest rate options as well as the chance to pull some additional cash out of their property after years of appreciation gains by qualifying for a new refinance loan. The additional cash obtained in the **cash-out refinancing** might be used to remodel a kitchen or bathroom, pay off high credit-card balances, or purchase a rental property.



Using Math Skills for Real Estate

The calculation of numbers, property sizes and values, and commission rates play a large role in the real estate field. Income and expense ratios, capitalization rates, loan-to-value ratios, and other percentage formulas are used by lenders, investors, appraisers, and agents every single day. Agents must learn the basics to be able to quickly calculate how the square footage of a residential or commercial property translates into values or selling prices on a price-per-square-foot basis as will be discussed in this chapter.

How to Solve Math Problems

There are four (4) steps that can be used for many types of math or financial problems or opportunities that are discussed below:

1. Read the statement or question: The reading and thorough understanding of the math or financial problem being presented is the most important first step.

2. Write down the selected math formula: Once the math problem is understood, the most effective math formula should be selected. For example, the formula for area such as for a land site is as follows: *Area = Length x Width* ($A = L \times W$).

3. Replace or substitute numbers: The most important numbers will then be selected from the math problem and placed into the formula equation. Some whole numbers will be converted into fractions or percentages before solving the math problem (e.g., $\frac{1}{4}$ acre may be converted to 0.25 or 25%).

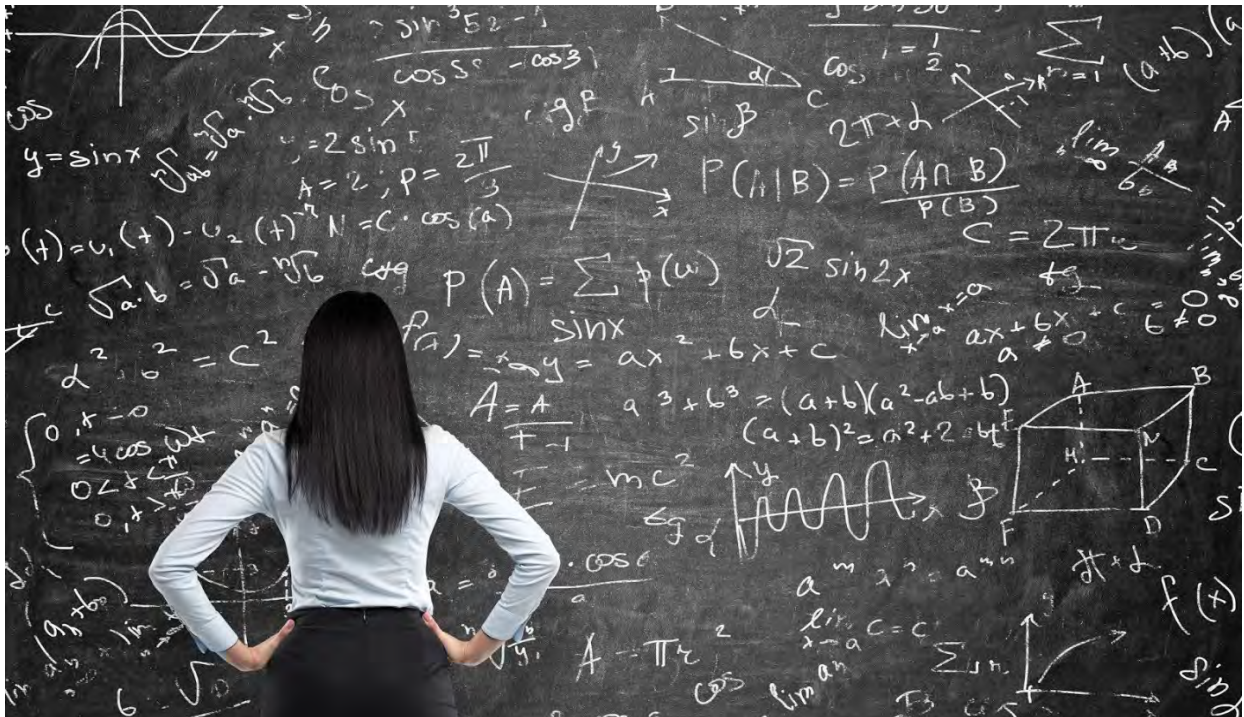
4. Calculate the numbers: Once the newly converted numbers are added into the appropriate math formula, the calculation can then be made to find the missing or unknown component that is needed to solve the equation. Often, there will just be one missing portion of the math formula that needs to be solved. For example, the “A” (Area) is the missing piece of the math puzzle in the $A = L \times W$ equation.

Let's now use the four (4) steps in the context of a math problem involving the size of a small apartment unit that is being offered for lease. The downtown metropolitan studio unit has the following dimensions:

20 feet in width and 30 feet in length.

Area = 20 (W) x 30 (L)

Area = 600 square feet



Decimals and Fractions

When converting a fraction or whole number into a decimal, we must first divide the top number of the fraction (the numerator) by the bottom number of the fraction (the denominator).

Here is an example of this fractional conversion process:

To convert $1/10$ into a decimal, divide the number 1 (top number or numerator) by 10 (the bottom number or denominator) to find 10% (10 percent) which may also be written as .10.

To convert percentages into a decimal, we just move the decimal point two places over to the left side of the equation. A zero digit may also be added to the far left side of the fraction.

Examples:

85% becomes .85 or 0.85

7% becomes .07 or 0.07

Conversely, to convert a decimal into a percentage, we just do the exact opposite of the examples above in that we move the decimal point two places to the right side before adding a percentage sign.

Examples:

.30 becomes 30%

.04 becomes 4%

.09 becomes 9% (whereas .90 becomes 90%)

Using a calculator, the conversion of a percentage to a decimal may be completed by using the percent key. With most calculators, you can just key in the digits on the machine, press the percent key, and the calculator will show the percent in decimal form.

Decimal Calculations

Calculators will process decimal numbers just as quickly as whole numbers. This will be true as long as you enter the numbers with the decimal point in the correct location. If not, the answers will be significantly different.

For example, if you enter 1.100 (1.1) instead of 1100.0 (1,100) on your calculator when adding up the numbers, you will get the incorrect result.

Example:

If a room has 120.5 square feet and a second room has 79.5 square feet and you want to add them together, you add:

$$\begin{array}{r} 120.5 \text{ sq. ft.} \\ +79.5 \text{ sq. ft.} \\ \hline 200.00 \text{ sq. ft.} \end{array}$$

If you place the decimals in the right way, and line them up correctly, you get the correct answer.

For the **multiplication of decimals**, just multiply first as you normally would without worrying about the decimal point. Once the new calculated number has been determined, then add back in the decimal point in the new correct location.

Example:

$$.3 \times .2 = ?$$

$$3 \times 2 = 6$$

$$\text{So } .3 \times .2 = .06$$

While it should be obvious to most people that $3 \times 2 = 6$, the trickiest part of this math problem is the correct new placement of the decimal point. It must be moved over an additional space to the left in order to arrive at .06 (or two spaces to the left in total) instead of one space, or .6.

The key is to count how many spaces to the left each decimal point is located in each number to be added. (One space to the left for .3, and one more space to the left for .2. Total number of spaces to the left is 2.)

When you arrive at your answer (6, without the decimals), just count two spaces to the left, add the 0 as a place holder, and put your decimal point before the 0.

When **dividing a decimal**, the decimal point must be moved to the right.
Example:

$$.6/.3 = ?$$

$$6/3 = 2$$

$$\text{So } .6/.3 = 2 \text{ (or } 2.0\text{)}$$

But:

$$.6/3 = 0.2 \text{ and}$$

$$6/.3 = 20 \text{ (or } 20.0\text{)}$$

Size, Shape, and Area Calculations

Real estate math problems for properties usually involved some type of cost or price per square foot or square yard. One of the more common types of cost per square yard equations involves the cost to replace carpet in one or more rooms. Many times, buyers will ask the seller for some type of financial credit to replace the worn out carpet in a home that they plan to move into. If so, they may deduct from their offering price to purchase the home the cost estimate to replace the older carpet in one or more rooms. Or, they may ask the sellers to give them a dollar for dollar credit that can be used towards closing costs.

Most people will be more familiar with calculating prices using a square foot formula instead of a square yard formula that is used more often with carpet, or other types of flooring prices. The first step in the math equation is to correctly convert square footage numbers into square yards before finding the final price for the new flooring option.

Let's take a look below at a small room that is in need of new carpeting.
Statement or question: The room measures 15 feet in length and 12 feet in width.

Formula: $A = L \times W$

Substitute: $A = 15 \times 12$

Calculate: $15' \times 12' = 180$ square feet.

The next step in this problem is to convert square feet into square yards to best determine the cost of carpet being sold on a square-yard basis. For this example, the carpet that was selected by the new buyer is priced at \$15 per square yard.

Statement or question: The room is 180 square feet in size. There are three feet in one yard, and 9 sq. feet in one sq. yard.

Formula: $A = L \times W$

Substitute: $A = 3\text{ft.} \times 3\text{ft.}$

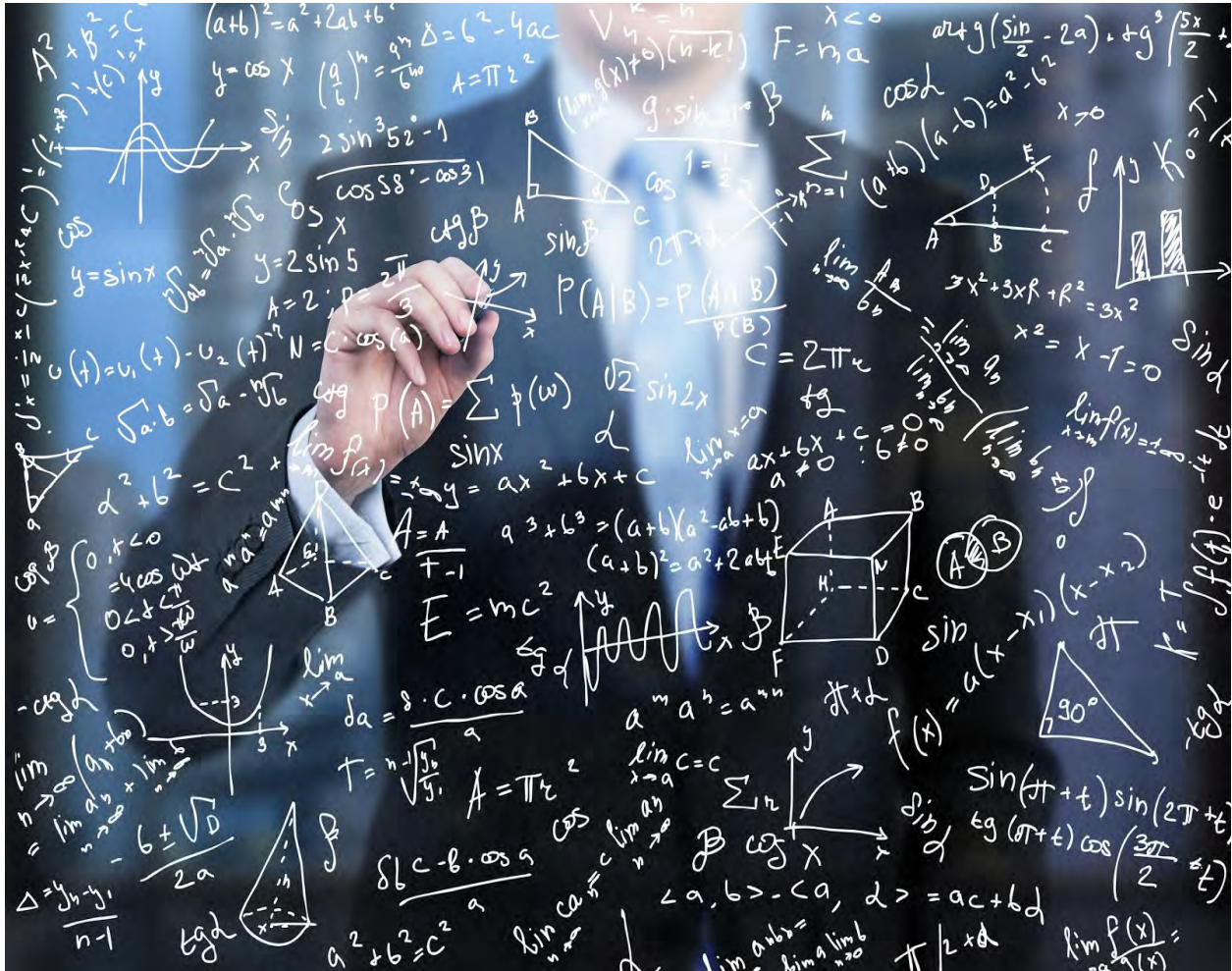
Calculate: $3\text{ft.} \times 3\text{ft.} = 9$ square feet

Now we know that there are nine (9) square feet in a square yard. The next step in this math equation is to divide the 180 square-foot room size from above by nine (9) square feet (**180 sq. ft./9 sq. ft. = 20 square yds**).

The 20-square yard size for carpet space will then be multiplied by the cost per square yard which is priced at \$15. The math formula to find the total cost of the carpet needed for the room is as follows:

$20 \text{ square yards} \times \$15 \text{ price per square yard} = \$300$

So, it will cost the buyer or seller \$300 to replace the carpeting in the one room.



Triangles

Some odd-shaped lots or buildings may have shapes somewhat similar to triangles.

Let's take a look below at the basic formula used when determining the size of a triangular-shaped property:

$$\frac{\text{Height} \times \frac{1}{2} \text{Base}}{\text{Area}}$$

Or: $\text{Area} = \frac{1}{2} \text{Base} \times \text{Height}$

Example:

The cost to purchase raw land in one neighborhood is estimated to be \$10 per square foot. How much will the total price be for a triangle-shaped lot that is 70 feet in height (length) and has a 100-foot base (width) before meeting the street?

Statement or question: You must find the total square footage of the lot before finding the total cost to make improvements.

Formula: $A = \frac{1}{2} \text{ Base } \times \text{ Height}$

Substitute: Area = $\frac{1}{2}$ of 100ft. $\times$ 70ft.

Calculate: 50ft. $\times$ 70ft. = 3,500 sq. ft.

To solve for the potential purchase price, we will multiply the size (3,500 sq. ft.) by the price per square foot (\$10).

3,500 sq. ft. $\times$ \$10 price per sq. ft. = \$35,000

Volume Problems

The calculation of volume is a little more complicated because we are working with a three-dimensional space. Volume is either in cubic feet or cubic yards. It can be used to define the area of a swimming pool behind a home or the interior space in a warehouse facility.

The formula for the calculation of volume for a three-dimensional space is as follows:

$$\text{Volume} = \text{Length} \times \text{Width} \times \text{Height or } V = L \times W \times H$$

Example:

A mini-storage unit space measures 11.5ft. by 16ft., and the ceiling is 13ft high. Let's work towards finding the volume of the unit in cubic yards:

Statement: Determine the volume of the mini-storage unit.

Formula: $V = L \times W \times H$

Substitute: Area = 16ft. x 11.5ft. x 13ft.

Calculate:

Step 1: 16ft. x 11.5ft. = 184 sq. ft.;

Step 2: 184 sq. ft. x 13ft. = 2,392 cubic ft.

Now, we must convert the cubic feet into cubic yards. Once again, a square yard measures 3 feet x 3 feet (or 9 sq. ft.). A cubic yard, in turn, measures 3 feet x 3 feet x 3 feet (or 27 cubic feet).

So, we now divide 2,392 cubic feet by 27 to arrive at 88.592 cubic yards.

$$2,392 / 27 = 88.592 \text{ cubic yards}$$

Percentages

Agents will come across percentage problems in real estate on almost a daily basis at the office. These percentages may be associated with the proposed loan-to-value for a mortgage, a debt-to-income mortgage underwriting ratio that is needed for their clients to qualify for a new purchase, and the commission split being offered by the seller, landlord, and employing broker that helps the agent pay his or her monthly bills.

To solve a percentage problem, you will need to convert the percentage into a decimal number, calculate, and then convert back the answer into a percentage. A percentage is converted into a decimal by removing the percentage symbol and then moving the decimal point two spaces to the left. For example, 5% will become .05 as a decimal.

When something is expressed as a percentage of another whole number, we must multiply the other number by the percentage selected.

For example, if the seller is willing to pay 50% of the \$5,520 in closing costs as a credit towards the buyer, then this will be quickly calculated below as follows:

Step 1: 50% becomes .50

Step 2: \$5,520 in closing costs is multiplied by .50 ($\$5,520 \times .50 = \$2,760$)

With percentage problems, we are finding a part of the whole.

The formula for using smaller percentage numbers and much larger whole numbers can be stated as follows:

A percentage of the whole equals the part.

Part = Whole $\times$ Percentage

Let's review a situation below where a brand new salesperson has a 50/50 (or 50% to the salesperson and 50% to the broker) commission-split agreement in place with her employing broker. The salesperson has worked hard for the past month trying to get her first purchase deal funded and closed so that she could earn some much needed income. The gross amount paid by the selling brokerage office is \$30,000 (3% commission from a \$1 million home sale).

Statement or question: How much will the salesperson net after the broker keeps his share of the \$30,000 earned commission check?

Formula: $P = W \times \%$

Substitute: Change the salesperson's 50% commission split from her brokerage employment agreement to .50.

Calculate: 30,000 gross commission $\times$.50 split = \$15,000 net to the salesperson.

Sometimes, you may know a different part of the equation instead of the whole number being used in the mathematical formula. If so, then the

formula's calculation will be reversed somewhat to find the whole (or larger) number.

$$\text{Whole} = \text{Part} / \text{Percentage}$$

When the percentage is not known, we will divide the part by the whole to find the answer.

$$\text{Percentage} = \text{Part} / \text{Whole}$$

Loans

Nationwide, approximately 66% of all residential properties have mortgage loans on them while the remaining 33% are “free and clear” with no mortgage debt. As such, it is statistically more likely that a real estate transaction will have a mortgage loan than not. The principal amount of mortgage debt (e.g., a \$100,000 first mortgage) that is used to buy a home is applied to a certain interest rate before calculating the borrower's new mortgage payment for the debt.

To determine payments for a new mortgage loan, it is generally solved using this formula:

$$\text{Part} = \text{Whole} \times \text{Percentage}$$

With loans, the part is equal to the interest rate (the smallest number in the equation) while the whole is the mortgage principal amount (the largest number).

Example:

Statement or question: Mr. Smith qualifies for a \$100,000 private money land loan that has a much higher 12% annual interest rate due to the perceived risk of the loan. The payments are made as “interest only,” and the principal amount will not drop at all during the short 5-year term offered by the private money lender. What are the annual and monthly payments for this loan?

Formula: Part = Whole x Percentage, or $P = W \times \%$

Substitute: $P = \$100,000 \times .12$

Calculate: \$12,000 per year in interest and \$1,000 per month in payments (\$12,000/12 months = \$1,000 per month).

To reverse this formula and find the annual interest rate being paid for this mortgage, the formula will change as follows:

$$\% = W/P$$

Or: 12% = \$100,000 divided by \$12,000 in annual payments (12% = \$100,000 / \$12,000)

Profit and Loss

Businesses need profits and positive net cash flow to keep their doors open. When the financial losses far exceed the net profits, then business or property owners may be faced with bankruptcy and/or foreclosure. As such, the calculation of profits and losses are important to learn for business and property owners as well as for self-employed real estate professionals.

One of the main math formulas used to calculate a profit or loss is as follows:

$$Now = Then \times Percentage$$

The *Then* being used in this formula was the original purchase price. The *Now* used is the current market value of the subject property. The *Percentage* number is 100% at its base, and then will either be a positive or negative number after factoring in the differences between the original purchase price and today's market price.

If a property was purchased five years ago for \$300,000 and today's market value is still the same \$300,000, then today's *Now* value is still 100% of last year's *Then* value. In booming economic times, that same \$300,000 property might have doubled in value to \$600,000 five years

later. If so, the *Now* value is 200% of the *Then* value because it doubled in value ($100\% \times 2 = 200\%$).

To summarize the property example from above, let's break it down using the four main steps in the formula evaluation process:

Statement or question: The property has a current market value of \$600,000 as compared with the original \$300,000 purchase price over the period of five years. What's the *Now* value and the annual rate of appreciation gain over the past five years?

Formula: $Now = Then \times \%$

Substitute: The property is now worth double the original purchase price, so the percentage price for *Now* will be 200% of the *Then* price (\$300,000).

Calculate: *Then* price: $\$300,000 \times 200\% = \$600,000$ *Now*

Cap Rates

The **capitalization rate ("cap rate")** is the rate of return on a real estate investment that a property is expected to generate. The cap rate is used to find the investor's potential rate of return on his or her investment. Most often, the cap rate is used for the assessment of commercial property values such as multi-family apartments or high-rise office buildings.

The capitalization formula is another variation of the percentage formula. Instead of the $Part = Whole \times Percentage$ formula, the cap rate formula is expressed as $Income = Value \times Capitalization Rate$

The *Value (V)* used in this formula is either the investment property's current market value or the purchase price that the investor is willing to pay for the property.

The expected rate of return for the buyer willing to take the risk to buy the property is the *Capitalization Rate (CR)*. The *Income (I)* described in the capitalization formula is the annual net income produced by the

investment property.

Example:

Statement or question: The annual income for an investment property is \$22,000 per year. An investor is hoping to receive back a 12% rate of return on his funds invested in the property. How much should the investor pay for the property?

Formula: $I = V \times CR$ (*Income = Value x Capitalization Rate*)

Substitute: $\$22,000 = V \times .12$

Calculate: To find the value, we must rearrange the formula above to find it

$$\$22,000 / .12 = V$$

$$V = \$183,333.33$$

Let's take a look at another cap rate example for a 30-unit apartment building that generates a Net Operating Income (NOI) of \$200,000 that is currently for sale. Most investors in the area are expecting a 10% rate of return for the risk associated with making the investment. With cap rates, the higher the cap rate, the higher the perceived risk associated with making the investment.

Some buildings found in older rural regions are considered riskier investments that may have 10% to 12%+ cap rates. Other newer properties located near a prestigious beach community may be priced with much lower 4% to 6% cap rates. Or, investors are willing to accept lower cap rates due to the perception that the property investment is much safer. When a property value is divided by a lower cap rate, the value will become much higher. Conversely, buildings with a higher cap rate will generally have lower property values.

Statement or question: What is the approximate value of an apartment building that generates \$200,000 in Net Operating Income and is expected to provide a 10% cap rate?

Formula: $V = I / CR$

Substitute: $I = \$200,000$ divided by $.10$

Calculate: $\$200,000 / .10 = \$2,000,000$ value

Let's take a look at the same property above using a much lower cap rate. In this example above, let's say that this property is located inland somewhere in Riverside County and that the building is 40 years old. Now, let's imagine that the same 30-unit apartment building was constructed just last year approximately one block from the sand in Long Beach. In this region, most apartment buildings might be selling for 5% cap rates.

Statement or question: What is the approximate value of an apartment building near the beach that generates \$200,000 in Net Operating Income and is expected to provide a 5% cap rate?

Formula: $V = I / CR$

Substitute: $I = \$200,000$ divided by $.05$

Calculate: $\$200,000 / .05 = \$4,000,000$ value

Tax Assessments

The vast majority of tax assessment problems for property tax calculations can be solved using this formula:

Tax = Assessed Value x Tax Rate

The property's assessed value must be found prior to determining the rest of the formula numbers. The assessed value in the example below is 80% of the original purchase price.

The property tax rate applied would then be 2% (base tax rate + special assessments and bond fees) of the assessed value. It is to be paid each year by the property owner.

Example:

Statement or question: What is the annual property tax payment for a home that was purchased for \$500,000 earlier this year?

Formula: Purchase price (\$500,000) is multiplied by 80% (assessed value) to find a \$400,000 assessed property value.

Substitute: Tax payment = \$400,000 x .02

Calculate: \$400,000 x .02 = \$8,000 annual property tax payment

Seller's Profit Numbers

Sellers want to maximize their net profits by way of a combination of reaching the highest sales price with the lowest closing costs. Buyers, on the other hand, want to pay the lowest home prices along with the least amount of closing costs possible.

Let's take a look below at a mathematical formula for determining the profit numbers for a seller in his or her sales transaction.

Statement or question: The seller wants to net an even \$100,000 from the sale of his home. The current mortgage balance is \$75,000. The cost of repairs that the seller has agreed to credit the buyer is \$1,500. And there is another \$4,500 in closing costs related to escrow, title, and transfer fees. The seller has also agreed to pay his listing broker and the buyer's broker a combined total of a 6% commission rate. What is the minimum selling price that the seller must obtain for the property in order to reach his goal of the net profit of \$100,000?

Calculate (1st step): Let's add the desired target net profit for the seller (\$100,000) to the costs of the sale without adding the commission yet.

\$100,000	seller's net
\$75,000	mortgage balance
\$1,500	repairs
\$4,500	closing costs
<u>\$181,000</u>	Total

Calculate (2nd step): Subtract the commission rate (6%) from 100%.
 $100\% - 6\% = 94\%$

Calculate (3rd step): Divide the total amount in step one (\$181,000) by 94% to find the sales price needed to net \$100,000. $\$181,000 / .94 = \$192,553.19$ (or the amount would be rounded up to the next highest number of \$193,000 for the seller to net at least \$100,000).

Property Tax and Insurance Prorations

A proration is the allocation of expenses between two or more parties that are divided according to their time of ownership. A common example is the proration of property tax and insurance payments that are balanced out to the month of closing. The **three main steps in the proration process** include:

1. Find and calculate the per diem (daily) rate of expense to be credited or debited to the buyer and seller.
2. Determine the exact number of days for which one person will be responsible for the expense, according to factors like the proposed or actual closing date.
3. Multiply the per diem rate by the number of days before calculating the expense that one or both sides will pay for in the deal. The formula is: *Share = Rate x Days*.

Often, the days used by an escrow officer to determine the per diem expense is the actual calendar year of 365 days (366 days in a leap year). However, sometimes a "banker's year" number is used that is equal to a 360-day year. The 360-day year (30-day month) can be easier to

calculate for real estate agents, investors, and escrow officers.

Let's review three of the most common types of prorations used in the real estate field below:

Property Tax Prorations

Statement or question: March 5th is the date of closing for a home sale. The annual property taxes are \$3,200. The seller has already made the full payment for the tax year (July 1 - June 30). The seller is expecting a credit back from escrow for the period of time between the March 5th closing date and the end of the property tax year on June 30th. This amount will become a debit on the closing statement for the buyer. **How much of the property tax proration will the buyer be required to pay while using a 360-day year for the calculation?**

Calculate (step 1): To find the per diem rate for the taxes while using a 360-day year, the formula is as follows: $\$3,200 / 360 = \$8.89$ per diem (or day)

Calculate (step 2): Count the number of days for which the buyer must cover the property tax payments between March 5th and June 30th.

25 days, March 5 - 30
30 days, April
30 days, May
+ 30 days, June
115 days

Calculate (step 3): Now, we substitute the rate and number of days into the *Share = Rate x Days* ($S = R \times D$) formula.

115 days
x \$8.89 per diem
\$1,022.35 credit to the seller (and a debit to the buyer)

Insurance Prorations

Let's now review how property or hazard insurance credits and debits are calculated at the time of closing:

Statement or question: A property has sold and has a scheduled closing date of June 15. The owner has already paid a \$1,000 annual hazard insurance premium for his home insurance policy. The coverage is paid up until the end of September. **How much of the insurance premiums will be credited back to the seller if determined using a 360-day year?**

Calculate (step 1): Find the per diem rate for the insurance.
 $\$1,000 / 360 \text{ days} = \$2.77 \text{ per day}$

Calculate (step 2): Add up the number of days for which the seller is entitled to a refund using 30-day months.

	15 days, June
	30 days, July
	30 days, August
+	<u>30 days, September</u>
	105 days

Calculate (step 3): The daily per diem rate and the number of days will be substituted into the *Share = Rate x Days* formula and calculate.

	105 days
x	<u>\$2.77 per diem</u>
	\$290.85 credit to the seller (and debit to the buyer)

Rent Prorations

Investment property sales with multiple rental units such as a small 6-unit apartment building will usually have rental income that must be credited back to the buyer based upon the exact date of closing. While mortgage payments are made in arrears (July payments are for the previous month's worth of interest in June), rent payments are made upfront (July 1 payment is for the days up to July 31). The escrow officer, or other closing agent, needs to properly balance the rents and other prorations so that the buyer and seller receive their fair amounts.

Statement or question: A 6-unit apartment building is sold with a scheduled closing date of June 15. The rent for each of the six (6) units is \$1,500 per unit. All six of the tenants paid their entire share required on June 1st. **How much will the seller owe out of the collected rents if the property closes on time on June 15?**

Calculate (step 1): Let's multiply the total amount of rent collected for June.

$$\$1,500 \times 6 \text{ units} = \$9,000$$

Calculate (step 2): Divide the total collected monthly rent (\$9,000) for the month of June using 30 days.

$$\$9,000 / 30 = \$300 \text{ per diem}$$

Calculate (step 3): Let's multiply the per diem amount by the number of days of rent for which the buyer is entitled. Using the closing date of June 15th, there will be an additional 15 days until the end of the month on June 30th.

$$\begin{array}{r} \$300 \text{ per diem} \\ \times \underline{15 \text{ days}} \\ \$4,500 \text{ prorated rent} \end{array}$$

The \$4,500 amount will be credited by the seller to the buyer. It will be listed as a **credit on the buyer's side** of the closing statement and as a **debit for the seller**.

Chapter Seventeen Summary

- The Federal Reserve, the U.S. Treasury, and demand from individual and institutional investors across the U.S. and many other parts of the world impact the availability of access to money.
- The Fed uses **monetary policies** such as easing and tightening the access to capital through strategies such as the increasing or decreasing of short-term interest rates. The Treasury, in turn, uses **fiscal policy** methods such as taxation and increasing or decreasing national governmental spending patterns.
- **Treasury Bill:** Securities issued for the term of one year or less.
- **Treasury Note:** Securities issued for two, three, five, seven, and 10-year terms.
- **Treasury Bond:** These securities are issued for periods of 30 years.
- There are **12 Federal Reserve Districts** nationwide. The only one located in California is the Federal Reserve Bank of San Francisco (12th District).
- The Fed directly controls and moves the **Federal Funds Rate** (rates for loans from banks to other banks overnight on an uncollateralized basis) and the **Discount Rate** (rates for banks to borrow funds from the Fed).
- **Open Market Operations:** The Fed will buy and sell securities (Treasury bonds, notes, and bills) in an attempt to control the money supply while affecting interest rates, borrowing, and consumer spending trends.
- The **Primary Market** consists of banks and other financial institutions that lend directly to their customers. The **Secondary Market** involves government (Fannie Mae, Freddie Mac, Ginnie Mae) and private investors who purchased funded loans from primary banks for longer-term holds.

- There are three parties in a mortgage transaction in California: 1) trustor (borrower); 2) trustee (neutral third-party); and 3) beneficiary (lender).
- A foreclosure process from start to finish usually takes about 120 days if no extensions are offered by the lender.
- *Area* is found in various math formulas by multiplying *Width x Length*.
- *Volume* is determined by multiplying *Length x Width x Height*.

Chapter Seventeen Quiz

1. An interest-bearing securities instrument that is issued by the U.S. Treasury for between two and ten years is called a _____.
 - A. Treasury bond
 - B. Treasury note
 - C. Treasury Inflation-Protected Securities (TIPS)
 - D. Treasury bill
2. Which policy below is *not* a tool used by the Federal Reserve to influence monetary policies and the overall economy?
 - A. Increasing taxation rates
 - B. Increasing short-term interest rates
 - C. Decreasing bank's reserve requirements
 - D. Changing the discount lending rate
3. The collective term for the taxing and spending actions related to governments as described in economics is:
 - A. Fiscal policy
 - B. A reserve requirement
 - C. Monetary policy
 - D. Capital supply

4. What is considered the “IOU” for the bank’s loan in a refinance transaction?
- A. Trust Deed
 - B. Promissory Note
 - C. Grant Deed
 - D. Mortgage clause
5. Which kind of securities instrument offered by the Treasury has the longest term?
- A. Bill
 - B. Note
 - C. Grant
 - D. Bond
6. Who or which group directly impacts monetary policy the most?
- A. Treasury
 - B. President
 - C. Federal Reserve
 - D. Congress
7. How many Federal Reserve Districts are there across the nation?
- A. 5
 - B. 7
 - C. 12
 - D. 33
8. What is the name of the rate that is charged to banks to borrow short-term funds from the Federal Reserve?
- A. Origination
 - B. Discount
 - C. Overnight yield
 - D. Weekly rate
9. Fannie Mae, Freddie Mac, and Ginnie Mae are types of:
- A. Loan guarantors
 - B. Secondary market investors
 - C. Primary market lenders
 - D. Privately-owned partnerships

10. A due-on-sale clause that also gives power to the lender to “accelerate” the loan as “all due and payable” after the borrower transfers title to a new buyer without first obtaining permission from the lender is called _____.

- A. Defeasance
- B. Alienation clause
- C. Acceleration clause
- D. Subordination clause

11. What is the math formula typically used to find *Area*?

- A. Square feet x Height
- B. Depth x Frontage
- C. Length x Width
- D. Volume x Unit

12. Which answer below is the largest?

- A. .02
- B. 35%
- C. .00567
- D. 42%

Answer Key:

1. B	7. C
2. A	8. B
3. A	9. B
4. B	10. B
5. D	11. C
6. C	12. D

GLOSSARY

Abandonment: Giving up possession or ownership of property by not using it, generally indicated through some affirmative act, like removing one's belongings from an apartment.

Abstract of judgment: Document that summarizes the result of a legal action, which can be filed in any county where the judgment debtor owns a property.

Abstract of title: Summation of all recorded transfers, conveyances, legal proceedings, and any other facts relied on as evidence of title to show ownership continuity and signify any possible loss to title.

Acceleration clause: Provision in a real estate financing instrument allowing the lender to declare the full debt due immediately if the borrower breaches any of the provisions of the loan agreement. Also referred to as a call provision.

Acceptance: (a) Agree to the terms of an offer to enter into a binding contract. (b) Receive delivery of a deed from the grantor.

Accession: The process of manufactured or natural improvement or addition to property.

Accretion: A steady addition to dry land through the forces of nature, as when waterborne sediments get deposited on waterfront property.

Acknowledgment: Formal declaration made before an authorized person (generally a notary public) by an individual who has executed a written instrument that it has been done voluntarily.

Acquisition cost: Amount of money required to acquire title to a property; it includes the purchase price as well as the closing costs, legal fees, escrow, service charges, title insurance, recording fees, and other such expenses.

Acre: Area of land measuring 160 square rods, 4,840 square yards, or

43,560 square feet; a tract of about 208.71 feet square.

Actual age: Number of years since a building was completed; also called *historical* or *chronological* age.

Actual authority: Authority actually given to an agent by the principal (expressly or by implication).

Actual eviction: Forcing someone physically off real property or preventing someone from re-entering property or using legal action to make someone leave the premises.

ADA: Americans with Disabilities Act.

Addendum: A page containing additional provisions attached to a purchase agreement or any other contract.

Adjacent: Next to, nearby, bordering, or neighboring (not necessarily in real contact).

Adjustable-rate mortgage (ARM): Loan in which the interest rate increases or decreases to reflect changes in cost of money.

Adjusted basis: Purchase price of property plus cost of specified improvements, minus any depreciation deductions taken.

Adjustment period: Time period between when the interest rate or monthly payment for an adjustable-rate mortgage is changed.

Administrative agency: Government body administering a complicated area of law and policy, implementing and enforcing detailed regulations that have the force of law. For example, the Department of Real Estate is the administrative agency charged with regulating the real estate business.

Administrator: Individual appointed by the probate court to manage and distribute the estate of a deceased person if no executor is named in the will or there is no will.

Ad valorem: Latin phrase meaning “according to value,” referring to

taxes assessed on the value of property.

Adverse possession: A way of acquiring title to real property belonging to someone else by occupying it without permission, and fulfilling other statutory requirements.

Affidavit: Acknowledged sworn statement in writing made before a notary public (or any other official authorized to administer an oath).

Affiliated licensee: A real estate salesperson or associate broker employed by a broker.

Affirm: (a) To confirm or approve. (b) To make a sincere declaration that is not under oath.

After-acquired title: If a title is acquired by a grantor, only after a conveyance to a grantee, the deed to the grantee becomes effective at the time the grantor actually receives title.

Age of majority: Age of a person when he or she becomes legally competent (usually 18 years old).

Agency: The association between a principal and the agent of the principal that is formed by way of a contract—may be oral or written, express or implied—through which the agent is employed by the principal to do certain acts dealing with a third party.

Agency, Apparent: When the impression given to a third party is that someone who hasn't been approved to represent another is that person's agent, or the impression that an agent has been approved to perform acts which are actually beyond the capacity of his authority; also called *ostensible agency*.

Agency, Dual: An agency relationship where the agent represents two principals in their dealings with each other.

Agency, Exclusive: Listing agreement that employs a broker as sole agent for a seller of real property for which the broker is entitled to compensation if the property is sold via any other broker, but not if a sale is negotiated by the owner without the services of an agent.

Agency, Ostensible: See Apparent agency

Agency confirmation statement: Written statement indicating the representation of a real estate agent of a party. It should be signed by both the buyer and the seller before they enter into a residential purchase agreement.

Agency disclosure form: Form explaining the duties of a seller's agent, a buyer's agent, and a dual agent—required to be signed by both the buyer and the seller before they enter into a residential purchase agreement.

Agency law: Body of legal rules governing the relationship between agent and principal by imposing fiduciary duties on the agent as well as liability for the actions of the agent on the principal.

Agent: Individual authorized to represent another (known as the principal) in dealings with third parties.

Agents in production: Elements necessary to generate income and establish a value in real estate: labor, coordination, capital, and land.

Agreement: Contract between two or more persons to do or not do a certain thing, for consideration.

Air rights: The right to unobstructed use and possession of the airspace over a parcel of land. This right may be transferred separately from the land.

Alienation: The transfer of ownership or an interest in property from one person to another, in any way.

Alienation, Involuntary: Transfer of an interest in property against the will of the owner, or without any action by the owner (ensuing through operation of law, natural processes, or adverse possession).

Alienation, Voluntary: When an interest in property is voluntarily transferred by the owner to someone else (generally by deed or will).

Alienation clause: A security instrument provision giving the lender

the right to declare the full loan balance due immediately if the borrower sells or transfers the security property; also termed as due-on-sale clause.

Alluvion: Increase of soil along the banks of a body of water by natural forces.

Alquist-Priolo Act: A law in California that requires applications for development of property in an earthquake-fault zone to include a geologic report.

ALTA: American Land Title Association is a nationwide organization of title insurance companies. An extended coverage title policy is also referred to as an ALTA policy.

Amendment: A supplementary agreement that changes one or more terms of a contract is a contract amendment or contract modification. It must be signed by all the parties to the original contract.

Amenities: The features of a property that adds to the pleasure/convenience of owning it, such as a swimming pool, a beautiful view, a gym, and so on.

Americans with Disabilities Act: Federal law mandating that public facilities must be accessible to disabled people.

Amortization, Negative: The adding of interest-not-paid to the principal balance of a loan.

Amortize: To pay off a debt gradually with installments that include both principal and interest.

Annexation: When personal property is attached to real property, so that the personal property becomes part of the real property by law.

Annexation, Actual: Physically attaching personal property to real property, so that it can be made a part of the real property.

Annexation, Constructive: Associating personal property with real property so it is treated as a fixture by law, although not attached physically. Example: jewelry is constructively annexed to a house.

Annual percentage rate (APR): All the charges paid by the borrower for the loan (including the interest, origination fee, discount points, and mortgage insurance costs), expressed as an annual percentage of the amount borrowed.

Annuity: Sum of money received in a series of payments at regular intervals (usually annually).

Anticipation, Principle of: In appraisal, when value is created by the expectation of benefits to be obtained in the future.

Anticipatory repudiation: Action taken by one party to a contract to inform the other party, before the time set for performance, that he does not intend to fulfill the contract.

Anti-deficiency rules: Laws prohibiting a secured lender from suing the borrower for a deficiency judgment in certain circumstances.

Apportionment: A division of property or liability into proportionate parts (may not be equal parts).

Appraisal: An estimate or opinion of the value of a piece of property as of a specific date.

Appraiser: Person who evaluates the value of the property, especially a trained and experienced person who has expertise in this field.

Appraiser, Fee: A self-employed appraiser hired to appraise real estate for a fee, as opposed to an appraiser who works for a lender, a government agency, or some other entity as a salaried employee.

Appreciation: An increase in value; the opposite of depreciation.

Appropriation: Keeping property or reducing it to a personal possession, excluding others from it.

Appropriative rights: A person's rights to a water appropriation permit.

Appropriative rights system: A water-rights allocation system, in which a person wanting to make use of water from a certain body of

water (like a river or lake) is supposed to have a permit. A permit that is issued earlier has precedence over a newer permit. This is also called the prior appropriation system.

Appurtenances: Rights that go along with ownership of a particular piece of property, such as air rights or mineral rights. These are generally transferred with the property, but in some cases they may be sold separately.

Appurtenances, Intangible: Rights concerning ownership of a piece of property that does not comprise physical objects or substances. An access easement is a good example of this.

APR: *See* Annual percentage rate (APR)

Area: (a) Locale or region. (b) The size of a surface, normally in square units of measure, as in square feet or square miles.

ARM: *See* Adjustable-rate mortgage

Arm's length transaction: Transaction where there is no family relationship, friendship, or pre-existing business relationship between two parties.

Arranger of credit: Real estate licensee or attorney who arranges a transaction for credit to be extended by seller of residential property.

Artificial person: A legal unit, such as a corporation, treated as an individual having legal rights and responsibilities by the law; as distinguished from a human being. An artificial person is also called a legal person.

Assemblage: Merging two or more adjoining properties into one expanse.

Assessment: Property valuation for taxation purposes.

Assessor: Officer responsible for determining the value of the property for taxation.

Asset: A thing of value owned by a person.

Assets, Capital: Assets that a taxpayer holds, other than (a) property held for sale to customers, and (b) depreciable property or real property used in the taxpayer's trade or business. Real property is a capital asset if it is used for personal use or for profit.

Assets, Liquid: Any assets or cash that can be turned into cash (liquidated), such as stock in a company.

Assets, Section 1231: Properties used in a trade or business or held for the production of income (it is referred to as Section 1231 in the federal income-tax code).

Assign: Transfer of rights (particularly contract rights) or interests to another.

Assignee: One to whom rights or interests are assigned.

Assignment: (a) Transferring contract rights from one person to another. (b) In case of a lease, the transfer of the entire leasehold estate by the original tenant to another.

Assignment of contract and deed: The instrument through which a new vendor is substituted for the original vendor in a land contract.

Assignor: Someone who assigns his rights or interest to another.

Assumption: Action by a buyer to take on personal liability for paying off the seller's existing mortgage or deed of trust.

Assumption fee: A fee paid to the lender, generally by the buyer, when a mortgage or deed of trust is assumed.

Attachment: Court-ordered seizure of property belonging to a defendant in a lawsuit, so it will be available to satisfy a judgment if the plaintiff wins. An attachment creates a lien in case it is real property.

Attestation: The act of witnessing the execution of an instrument, such

as a deed or a will.

Attorney General: The principal legal advisor for state government, including legal advisor to the Department of Real Estate on matters regarding the Real Estate Law.

Attorney in Fact: Someone who is authorized to represent another by a power of attorney, not necessarily a lawyer.

Attractive nuisance: A dangerous feature appealing to children, thus posing a potential source of liability for the property owner.

Auditing: Verifying and examining records, particularly the financial accounts of a business or other organization.

Avulsion: (a) A sudden (not slow) tearing away of land by the action of water. (b) A sudden shift in a water course.

Bad debt/vacancy factor: A percentage deducted from a property's potential gross income to find the effective gross income, estimating the income that will probably be lost due to vacancies and non-payment of rents by the tenants.

Balance, Principle of: An appraisal principle which holds that the maximum value of real estate is achieved when the agents in production (labor, capital, land, and coordination) are in proper balance.

Balloon payment: A payment on a loan (usually the final payment) that is substantially larger than the regular installment payments.

Bankruptcy: (a) A condition resulting when the liabilities of an individual, corporation, or firm exceeds assets. (b) A court declaration that an individual, corporation, or firm is insolvent, resulting in the assets and debts being administered under bankruptcy laws.

Barter: To exchange or trade one commodity or piece of property for another without the use of money.

Base line: Main east-west line in the government survey system from which township lines are established. Each principal meridian has one

base line associated with it.

Basis: Figure used in calculating the gain on the sale of real estate for federal income-tax purposes; also called the cost basis.

Basis, Adjusted: The initial basis of the owner in the property, plus capital expenditures for improvements and minus any allowable depreciation deductions.

Basis, Initial: The amount of the owner's original investment in the property—the cost of acquiring the property including closing costs and other expenses along with the purchase price.

Bearer: A person in possession of a negotiable instrument.

Bench mark: A surveyor's mark at a known point of elevation on a stationery object, used as a reference point in calculating other elevations in a surveyed area, most often a metal disk set into cement or rock.

Beneficiary: (a) One for whom a trust is created and on whose behalf the trustee administers the trust. (b) The lender in a deed of trust transaction. (c) Someone who is entitled to receive real or personal property under a will (a legatee or devisee).

Beneficiary's statement: Document in which a lender confirms the status of a loan (the interest rate, principal balance, etc.) and describes any claims that could affect an interested party.

Bequeath: To transfer personal property to someone by will.

Bequest: Personal property (including money) that is transferred by will.

Betterment: An improvement to real property that is more extensive than ordinary repair or replacement which increases the value of the property.

Bilateral contract: Contract under which each party promises performance.

Bill of sale: A document used to transfer title to personal property from a seller to a buyer.

Blanket mortgage: Mortgage that includes more than one property parcel as security.

Blind ad: An advertisement placed by a real estate licensee that does not indicate the ad is from a licensee.

Block: A group of lots surrounded by streets or unimproved land in a subdivision.

Blockbusting: Attempting to lure owners to list or sell their homes by predicting that the members of another race or ethnic group, or people suffering from some disability, will be moving into the neighborhood—also called “panic selling.” It is a violation of antidiscrimination laws.

Blue sky laws: Laws regulating the promotion and sale of securities in order to protect the public from fraud.

Board of directors: The body responsible for governing a corporation on behalf of shareholders.

Bona fide: In good faith; genuine, not fraudulent.

Bond: (a) A written obligation, normally interest bearing, to pay a certain sum at a specified time. (b) Money put up as a surety, protecting against failure to perform, negligent performance, or fraud.

Bonus: An additional payment over and above the due payment.

Boot: Something given or received in a tax-free exchange, which is not like-kind property. For instance, in an exchange of real property where one party gives another party cash in addition to real property, the cash is the boot.

Boundary: The perimeter or border of a parcel of land; the dividing line between two pieces of property.

Branch manager: An associate broker appointed by a firm’s primary

broker to manage the operations of a branch office.

Breach: Violation of an obligation, duty, or law.

Breach of contract: Failure to perform a contractual obligation.

Broker, Associate: Someone who is qualified as a broker and is affiliated with another broker.

Broker, Cooperating: A broker belonging to a multiple listing service who helps sell a property listed with another member of the listing services.

Broker, Designated: A corporate officer or a general partner who is authorized to act as the broker for a licensed corporation or for a partnership.

Broker, Fee: A real estate broker who—in violation of the license law—allows the use of his license to another person to carry on a brokerage.

Broker, Listing: A broker having a listing agreement with a property seller.

Broker, Real estate: Someone who is licensed to represent members of the public in real estate transactions in exchange for compensation.

Brokerage: Business of a real estate broker.

Brokerage fee: Service charges of a real estate broker that is paid as a commission or as other compensation.

Buffer: Undeveloped area that separates two areas zoned for incompatible uses.

Building codes: Regulations that set minimum standards for construction methods and materials.

Building restrictions: These are rules that apply to building size, type, or placement. They may be public restrictions, such as zoning ordinances or private restrictions (e.g., CC&Rs).

Bulk transfer: The sale of all or a substantial part of the merchandise, equipment, or any other inventory of a business that is not in the ordinary course of business.

Bulk transfer law: A law that requires a seller who negotiates a bulk transfer (generally connected with the sale of the business itself) to furnish the buyer with a list of creditors and a schedule of the property being sold, and to notify creditors of the impending transfer.

Bump clause: A provision in a purchase agreement allowing a seller to keep the property on the market while waiting for a contingency clause to be fulfilled. In the meantime, if the seller receives another good offer, he can ask the buyer either to waive the contingency clause or terminate the contract.

Bundle of rights: The rights inherent in ownership of property, including the right to use, lease, enjoy, encumber, will, sell, or do nothing with the property.

Department of Real Estate: The DRE administers the Real Estate Law of California, as well as the licensing of real estate brokers and salesperson.

Business opportunity: A business that is for sale.

Buy down: Discount points paid to a lender to reduce (buy down) the interest rates charged to a borrower, especially when a seller pays discount points to help the buyer (borrower) qualify for financing.

Buyer representation agreement: A contract in which a prospective buyer hires a real estate broker to act as his agent for locating desirable property and negotiating its purchase, or in negotiating the purchase of a property that the buyer has already found. This is also called the buyer agency agreement.

California Coastal Act: Law that is designed to protect and control development along the California coastline.

California Fair Housing Law: Law that guarantees equal treatment for

everyone in all business establishments; often referred to as the Rumford Act.

California Veterans Farm and Home Purchase Program: State-sponsored residential finance program utilized to provide cheap home and farm loans to veterans; often called the “Cal-Vet program.”

Call: A specification that describes a segment of the boundary in a metes and bounds description; for example, “South 20°, west 100 feet” is a call.

Cancellation clause: Terminating a contract without undoing acts that have already been performed under the contract.

Cap: A limit on how much a lender may raise an adjustable-rate-mortgage interest rate or monthly payment—per year, or over the life of the loan.

Capacity: The legal ability or competency to perform any act, such as enter a binding contract (contractual capacity) or execute a valid will (testamentary capacity).

Capital: Money or other forms of wealth available for use in producing more money.

Capital assets: Assets held by a taxpayer other than property held for sale to customers in the normal course of the taxpayer’s business; it also comprises depreciable property or real property used in the taxpayer’s trade or business. Therefore, real property is a capital asset if owned for personal use or for profit.

Capital expenditures: Money spent on improvements and alterations that add to the value of the property and/or prolong its life.

Capital gain: Profit achieved from the sale of a capital asset. It is a long-term capital gain if the asset was held for more than one year, and it is a short-term capital gain if the asset was held for one year or less.

Capital improvement: Any improvement designed so that it becomes a permanent part of the real property or that will have the effect of

prolonging the property's life significantly.

Capitalization: A method of appraising real property by converting the anticipated net income from the property into the present value; also called the income approach to value.

Capitalization rate: A percentage used in capitalization ($\text{Net Income} = \text{Capitalization Rate} \times \text{Value}$). It is the rate believed to represent the proper relationship between the value of the property and the income it produces; the rate that would be a reasonable return on an investment of the type in question; or the yield necessary to attract investment of capital in property like the subject property. It is also called the cap rate.

Capital loss: A loss that is a result of a sale of a capital asset. It may either be long-term (held for more than one year) or short-term (held for one year or less).

Capture, Rule of: Legal rule that grants a land owner the right to all oil and gas produced from wells on his land, even if it migrated underneath from land that belongs to someone else.

CAR: California Association of Realtors®.

Carryback loan: See Purchase money mortgage

Cash flow: Residual income after deducting all operating expenses and debt service from gross income.

Cash on cash: The ratio between cash received in the first year and cash initially invested.

CC&R: A declaration of covenants, conditions, and restrictions that is generally recorded by a developer to place restrictions on all lots within a new subdivision.

CEQA: California Environmental Quality Act.

CERCLA: Comprehensive Environmental Response, Compensation, and Liability Act.

Certificate of discharge: Document given by the mortgagor to the mortgagee when the mortgage debt has been paid in full, acknowledging that the debt has been paid and the mortgage is no longer a lien against the property; also called a satisfaction of mortgage or mortgage release.

Certificate of eligibility: Document issued by the Department of Veterans Affairs regarding the veteran's eligibility for a VA- guaranteed loan.

Certificate of occupancy: Document issued by a local government agency (such as the building department) verifying that a newly-constructed building is in compliance with all codes and may be occupied.

Certificate of reasonable value (CRV): Based on an appraiser's estimate of the value of a property, it is mandatory in order for a VA- guaranteed home loan to be authorized; the amount of the loan cannot be more than the CRV.

Certificate of sale: Document given to the purchaser at a mortgage foreclosure sale instead of a deed; it is replaced with a sheriff's deed only after the redemption period expires.

Chain of title: Record of encumbrances and conveyances pertaining to a property.

Change, Principle of: An appraisal principle which holds that the future, not the past, is of primary importance in estimating a property's value.

Charter: A written instrument granting a power or a right of franchise.

Chattel: An article of personal property.

Chattel mortgage: Using personal property as security for a debt.

Chattel real: Personal property closely associated with real property. A lease is a good example.

Civil Rights Act of 1866: Federal law guaranteeing all citizens the

right to purchase, lease, sell, convey, and inherit property— regardless of race and color.

Civil Rights Act of 1964: Federal law that disallows discrimination on the basis of race, color, national origin, or religion in programs for which the government provides financial assistance.

Client: Someone who employs a broker, lawyer, appraiser, or any other professional. A real estate broker may have clients who are sellers, buyers, landlords, or tenants.

Closing: The last stage of a real estate transaction when the seller receives the purchase money and the buyer receives the deed with the title transferred to him. It may also be called a settlement.

Closing costs: Expenses incurred while transferring real estate in addition to the purchase price.

Closing date: Date on which all the terms of a purchase agreement have to be met, or else the contract is terminated.

Closing statement: Accounting of funds from a real estate purchase, furnished to both seller and buyer.

Cloud on title: A claim, encumbrance, or apparent defect that makes the title to a property unmarketable.

Code of ethics: Set of rules of accepted standards of conduct, reflecting principles of fairness and morality.

Codicil: An addition to or a revision of a will.

Collateral: Anything of value used as security for a debt or obligation.

Collusion: Agreement between two or more persons to defraud another.

Color of title: Appears to be of good title, but in fact, is not.

Commercial bank: Type of financial institution that has traditionally emphasized commercial lending (loans to businesses), and also makes residential mortgage loans.

Commercial paper: Negotiable instruments, such as promissory notes, sold to meet the short-term capital requirements of a business.

Commercial property: Property that is zoned and used for business purposes, such as restaurants and office buildings. Set apart from residential, industrial, and agricultural property.

Commingled funds: Funds received from different sources that are deposited in one account and thus, lose their separate character.

Commingling: Illegally mixing trust funds held on behalf of a client with personal funds.

Commission: (a) Compensation received by a broker for services provided in connection with a real estate transaction (normally a percentage of the sales price). (b) Group of people gathered for a purpose or a function (generally a governmental body, as in a planning commission).

Commitment: A lender's promise to make a loan in real estate finance; loan may be firm or conditional. (A conditional loan is based on fulfillment of certain conditions, such as a satisfactory credit report on the borrower.)

Common elements: Land and improvements in a condominium, planned unit development or other housing development that are owned and used collectively by all the residents, such as parking lots, hallways, and recreational facilities provided for common use.

Common elements, limited: Features outside of dwelling units in condominiums and other developments—reserved for the use of owners of particular units—are also called limited common areas. For example, assigned parking lots.

Common law: Long-established rules of law based on early English law; it usually prevails unless overruled by statutory law.

Community property: In California as well as other community-property states, property jointly owned by a married couple, as

distinguished from each spouse's separate property; usually, any property acquired through the labor or skill of either spouse during marriage.

Co-mortgagor: Family member (generally) who accepts responsibilities for the repayment of a mortgage loan—along with the primary borrower—to help the borrower qualify for the loan.

Comparable: In appraisal, a property that is similar to the subject property and which has been sold recently. The sales prices of comparables provide data for estimating the value of the subject property using the sales comparison approach.

Comparative market analysis: Estimate of property value for an appraisal based on indicators from the sale of comparable properties.

Competent: (a) Having a sound mind for the purpose of entering into a contract or executing a legal instrument (mentally competent). (b) Having a sound mind and also having reached the age of majority (legally competent).

Competition, Principle of: Appraisal principle which holds that profits tend to encourage competition, and excess profits tend to result in disastrous competition.

Compliance inspection: For the benefit of a lender, a building inspection done to determine if the building codes, specifications, or conditions established after a prior inspection have been met—before funding a loan.

Comprehensive Environmental Response, Compensation, and Liability Act: A federal law governing liability for environmental cleanup costs.

Condemnation: (a) Taking private property for public use via the government's power of eminent domain. (b) A declaration that a structure is not fit for occupancy and must be closed or demolished.

Condemnation appraisal: An estimate of the value of condemned

property to find out the just compensation to be paid to the owner.

Condition: (a) A provision in a contract that makes the parties' rights and obligations depend on the occurrence (or nonoccurrence) of a particular event; also called a contingency clause. (b) A provision in a deed that makes title-conveying subject to compliance with a particular restriction.

Conditional use permit: Authorization for a land use that would otherwise not be allowed by zoning ordinances.

Condominium: A subdivision that provides an exclusive ownership (fee) interest in the airspace of a particular portion of real property, and an interest in common in a section of that property.

Confirmation of sale: Court approval of a sale of property by an executor, administrator, or guardian.

Conflict of interest: Situation in which an action that would promote the interests of the agent is in conflict with an action that would promote the interests of the principal. In such a situation the agent must inform the principal and offer to retreat.

Conforming loan: Home mortgage loan in which the borrower and real estate conform to Fannie Mae and Freddie Mac guidelines, with a lower interest rate than a non-conforming loan.

Conformity, Principle of: This principle holds that property values are boosted when buildings are similar in design, construction, and age.

Conservation: (a) Preservation of structures or neighborhoods in a healthy condition. (b) Preservation or limited use of natural resources for long-term benefits.

Consideration: Something of value provided to induce entering into a contract: money, personal services, love. Without consideration, a contract is not legally binding.

Construction lien: See Mechanics lien

Consumer Price Index: An index that tracks changes in the cost of goods and services for a typical consumer.

Contiguous: Adjacent, abutting, or in close proximity.

Contingency clause: See Condition

Contract: A written or oral agreement to do or not do specified things, in return for consideration.

Contract, Bilateral: A contract by which each party is bound to a promise to perform.

Contract, Executed: A contract whose contractual obligations have been completely performed by all parties.

Contract, Executory: A contract in which one or both the parties have not yet completed their contractual obligations.

Contract, Express: A contract that has been worded, either spoken or written.

Contract, Implied: A contract that has been worded, but is implied by the actions of the parties.

Contract, Land: A contract for the sale of real property in which the buyer (the vendee) pays in installments. The buyer obtains possession of the property immediately while the seller (the vendor) retains legal title until the full price of the property has been paid. It is also called the conditional sales contract, installment sales contract, real estate contract, or contract for deed.

Contract, Oral: A spoken agreement that has not been written down, also called a parol contract.

Contract, Unenforceable: An agreement that a court of law refuses to enforce.

Contract, Unilateral: A contract that is accepted by performance. The offerer promises to perform his side of the bargain if the other party

performs, but the other party has not made the same promise.

Contract, Valid: A binding, legally enforceable contract.

Contract, Void: An agreement that is not an enforceable contract, as there is an absence of a required element (like consideration) or there is a defect of any kind.

Contract, Voidable: A contract that any of the parties involved may negate without liability, due to lack of capacity or a negative factor such as fraud or duress.

Contract for deed: *See* Land contract

Contract of adhesion: A one-sided contract that is unfair to one of the parties.

Contractual capacity: The legal capacity to enter into a binding contract. A mentally competent person who has attained the age of majority is a person with contractual capacity.

Contribution, Principle of: An appraisal principle which holds that the value of real property is at its best when the improvements produce the highest return proportionate with their cost—the investment.

Conventional loan: Mortgage loan not guaranteed by governmental agency, such as the Veterans Administration.

Conversion: (a) Misappropriating property or funds belonging to another (e.g., converting trust funds to one's own use). (b) The process where an apartment complex is changed to a condominium or cooperative.

Conveyance: Transfer of title of real property from one person to another through a written document (usually a deed).

Cooperating agent: A member of a multiple listing service who finds a buyer for property listed for sale by another broker.

Cooperative: Building owned by a corporation in which the residents

are the shareholders. Each shareholder receives a proprietary lease for an individual unit along with the right to use the common areas.

Cooperative sale: A transaction in which the listing agent and the selling agent work together but for different brokers.

Corporation: Legal entity that acts via its board of directors and officers, usually without liability on the part of the person or persons owning it.

Correction lines: Guide meridians running every 24 miles east and west of a meridian, and standard parallels running every 24 miles north and south of a base line, used to correct inaccuracies in the rectangular survey system of land description caused by the earth's curvature.

Cost approach to value: One of the three key methods of appraisal. An estimate of the subject property's value is determined by estimating the cost of replacing the improvements, and deducting the estimated accrued depreciation from it while adding the estimated market value of the land.

Cost basis: *See* Basis

Cost recovery deductions: *See* Depreciation

Counteroffer: Reacting to a contract offer by changing some of the terms of the original offer as a substitute offer.

Covenant: An agreement or a promise to perform or not perform certain acts (generally imposed by deeds). *See* CC&Rs

Covenant, Restrictive: A promise to do or not do acts concerning real property, particularly a promise that concerns land. Most often it is an owner's promise to not use the property in a certain manner.

Covenant against encumbrances: A promise (in a deed) that the property is not weighed down by any encumbrances other than those disclosed in the deed.

Covenant of quiet enjoyment: A promise to not disturb a buyer's or

tenant's possession by the previous owner, landlord, or anyone else that makes a lawful claim against the property.

Covenant of right to convey: A promise (in a deed) that the grantor has the legal ability to make a valid conveyance.

Covenant of seisin: A promise (in a deed) by the grantor that he actually owns the interest being conveyed to the grantee.

Covenant of warranty: A promise (in a deed) that the grantor will defend the title of the grantee against claims superior to the grantor's that exist when the conveyance is made.

CPM: A Certified Property Manager has satisfied the requirements set forth by the Institute of Real Estate Management of the National Association of Realtors®.

Credit arranger: A mediator between prospective borrowers and lenders negotiating loans, such as a mortgage broker.

Credit bidding: When the lender obtains a property by bidding the amount the borrower owes in a foreclosure sale.

Credit union: Financial institution that may serve only members of a certain group (as in a labor union or a professional association), and traditionally emphasizes consumer loans.

Cul-de-sac: A dead-end street with a semi-circular turnaround at its end.

Damages: (a) Losses suffered by a person due to a breach of contract or a tort. (b) An amount of money the defendant is ordered to pay to the claimant in a lawsuit.

Damages, Actual: See Compensatory damages

Damages, Compensatory: Damages that are awarded to a claimant as compensation for injuries (personal injuries, property damages, financial losses) caused by the acts of the defendant; also called actual damages.

Damages, Liquidated: Sum agreed upon by the parties in advance, while the contract is being made, to serve as full compensation in case a breach of contract occurs.

Damages, Punitive: An award added to actual damages (in a civil lawsuit) as a punishment to the defendant for contemptible or malicious conduct, and to discourage others from doing such acts.

Dealer: Someone whose business is to buy and sell real estate.

Dealer property: Property that is held for selling rather than for long-term investment. An example of this would be a developer's inventory of subdivision lots.

Debit: A charge or debt owed to another.

Debtor: Someone who owes money to another.

Decedent: A deceased person.

Declaration of abandonment: An owner-recorded document that voluntarily releases a property from homestead protection.

Declaration of homestead: A recorded document that creates homestead protection for a property that would otherwise not receive it.

Declaration of restrictions: See CC&Rs

Decrement: Means a decrease in value, the opposite of increment.

Dedication: Land that is given by its owner for public use and accepted (for that particular use) by the appropriate representative of the government.

Deduction: Amount on which income tax is not required to be paid.

Deed: Correctly executed and delivered written instrument that conveys title to real property (from the grantor to the grantee).

Deed, Administrator's: Deed that an administrator of an estate uses to convey a deceased person's property to his heirs.

Deed, General warranty: Deed by which the title is warranted by the grantor against defects that may have surfaced before or after his tenure of ownership; also called a warranty deed.

Deed, Gift: Deed in which there is no support of valuable consideration, most frequently listing “love and affection” as the consideration.

Deed, Grant: The most commonly-used type of deed in California, it uses “grant” in its words of conveyance and holds certain implied warranties that the property is not encumbered and has not been deeded to someone else.

Deed, Quitclaim: Deed conveying any interest in the property that a grantor may have at the time of executing the deed, without warranties.

Deed, Tax: A deed that a buyer of a property obtains at a tax foreclosure sale.

Deed, Trustee’s: A deed that a buyer of a property receives at a trustee’s sale.

Deed in lieu of foreclosure: A deed given to the lender by the borrower (who has defaulted) to avoid foreclosure proceedings by the lender.

Deed of reconveyance: Once the debt has been repaid, the security property is released from the lien that is created by a deed of trust. The instrument used is called the deed of reconveyance.

Deed of trust: To secure the repayment of a debt, this instrument is used to create a voluntary lien on real property. This lien includes a power of sale clause that allows non-judicial foreclosure. The parties to this deed are the grantor (borrower), the beneficiary (lender), and the trustee (neutral third party).

Deed restrictions: Provisions in a deed that set restrictions on the use of property. It may either be covenants or conditions.

Default: When one of the parties to a contract fails to fulfill one or more of the obligations or duties as enforced by the contract.

Defeasance clause: There is a clause in a mortgage, deed of trust, or lease which provides for the cancellation of a certain right if a particular event occurs.

Deferred maintenance: Curable depreciations that ensue due to maintenance or repairs that were postponed and thus caused physical deterioration.

Deficiency judgment: Determination by the court that the borrower owes more money when the security for a loan does not completely satisfy a debt default.

Delivery: When a deed is legally transferred from the grantor to the grantee, thus transferring title.

Demand: One of the four elements of value (the other three being scarcity, utility, and transferability). It is a desire to own along with the ability to afford.

Demise: (a) Conveying an interest in real property via the terms of a lease. (b) Transferring an estate or interest in property to someone for a long time period, for life, or at will.

Department of Housing and Urban Development: (HUD) Federal agency responsible for public housing programs, FHA-insured home mortgage loans, and enforcing the Federal Fair Housing Act. The FHA and Ginnie Mae both are a part of HUD.

Depreciable property: In regard to the federal income-tax codes, it is a property that is qualified for depreciation deductions as it might wear out and may have to be replaced.

Depreciation: (a) A loss in value as a result of physical deterioration, functional obsolescence, or external obsolescence. (b) Allocating the cost of an asset over a period of time for the purpose of income-tax deductions.

Descent: When a property is transferred through intestate succession rather than by will. Receiving property by intestate succession is said to

be received by descent (not by devise or bequest).

Developer: Someone who subdivides land or improves land to obtain a beneficial use.

Devise: Transferring title to property by will. See Bequest

Devisee: Person who receives title to real property by way of a will.

Devisor: Testator by whom real property is devised by way of his will.

Disaffirm: To request a court to terminate a contract that is voidable.

Disbursements: Money spent out or paid out.

Disclaimer: Denying legal responsibility.

Discount points: Percentage of the principal amount of a loan that is collected by the lender or withheld from the loan amount when the loan is originated. This is done to increase the lender's revenue on the loan.

Discount rate: Interest rate that is charged when a member bank borrows money from the Federal Reserve Bank.

Discrimination: Unequal treatment given to people on the basis of their race, religion, sex, national origin, age, or some other trait.

Disintegration: Period of decline in a property's life cycle when the property's current economic usefulness is ending and constant maintenance becomes inevitable.

Dispossess: Forcing someone out of possession of real property by using legal procedures, as is done in an eviction.

Down payment: Portion of the purchase price of a property that is paid in cash by the buyer, generally the difference between the purchase price and the financed amount.

Downzoning: Rezoning land for limiting its use.

Drainage: Natural or artificial method of removing surface or sub-surface water from an area.

Duress: When someone enters into an agreement as a result of threats of physical violence or mental harassment.

Dwelling: A place of residence; a house or a home.

Earnest money: Deposit made by a real estate buyer demonstrating her good faith.

Easement: Right given to another person or entity to trespass upon property that is not owned by that person or entity.

Easement, Access: An easement that allows the holder of the easement to reach (and leave) his property (which is the dominant tenement) by passing through the servient tenement; also called an easement for ingress and egress.

Easement, Appurtenant: An appurtenant easement is a right to use an adjoining property. The one benefitting from the easement is the dominant tenement.

Easement by express grant: Easement that is voluntarily created in a deed, will, or other written instrument.

Easement by express reservation: When an easement is created in a deed by which the property is divided by the landowner—the servient tenement is transferred while the dominant tenement is retained.

Easement by implication: Easement that is created by law so as to provide access to a landlocked parcel of land.

Easement by necessity: Such an easement is most commonly implied in favor of grantees that do not have any access to their land except over the land owned by the grantor.

Easement in gross: Easement benefitting a person rather than a piece of land. There is a dominant tenant, without a dominant tenement.

Economic life: Time period when an improved property yields a return

on investment apart from the rent due for the land itself; also called the useful life.

Economic obsolescence: Loss of value due to factors from beyond the property.

Effective age: Age of a structure as its condition indicates and the remainder of its usefulness (as opposed to its actual age). Effective age of a building may be increased if maintained well.

Ejectment: Legal action through which possession of real property is recovered from someone who has illegally taken possession of it; also called an eviction.

Emblements, Doctrine of: Law allowing an agricultural tenant to enter the land for harvesting the crops even after the lease period ends.

Eminent domain: Right of the government to take title to real property for public use by condemnation. The property owner receives just compensation for property.

Encroachment: Unlawful intrusion onto neighborhood property, often due to a mistake regarding boundary location.

Encumber: Placing a lien or encumbrance against the title to a property.

Encumbrance: Non-possessory interest in real property, such as a mortgage (loan), a lien (voluntary or involuntary), an easement, or a restrictive covenant that limits the title.

Entitlement: In terms of a VA loan, it is the amount of the borrower's guaranty.

EPA: Environmental Protection Agency.

Equal Credit Opportunity Act: Federal law prohibiting lenders from discriminating against loan applicants on the basis of race, color, religion, national origin, sex, marital status, or age—or that the applicant's income is generated from public assistance.

Equitable remedy: Judgment granted by a civil lawsuit to a complainant that is not an award of money/damages which could be an injunction, rescission, or a specific performance.

Equitable right of redemption: Real estate owner's right to take back property after default—but before foreclosure—by paying all debt, costs, and interest.

Equity: Difference between the current market value of the property and the liens against the property.

Erosion: Process where the surface of the land wears away by the actions of water or wind.

Escalation clause: Provision in a lease agreement that allows an increase in payments on the basis of an increase in an index, such as the consumer price index.

Escheat: Reverting of a property to the state in case there are no capable heirs found.

Escrow: Agreement that a neutral third party will hold something of value (money or a deed) until the provisions of a transaction or a contract may be carried out.

Escrow agent: Neutral third party entrusted by a seller and purchaser to hold something of value pending the fulfillment of conditions needed to close a transaction.

Escrow instructions: Directions that a party to a transaction gives to an escrow agent specifying the terms under which the escrow is to be conducted.

Estate: Interest held by the property owners; it may be a freehold or a leasehold property.

Estate at sufferance: Unlawful occupation of a property by a tenant after their lease has terminated.

Estate at will: Occupancy of real estate by a tenant for an indefinite

period, which either party can terminated at will

Estate of inheritance: Estate that may be passed on to the heirs of the holder, as in a fee simple.

Estate for years: Interest in real property that permits possession for a set time period.

Estoppel: Legal principle that restricts a party from negating or asserting a certain fact owing to that party's previous actions or statements.

Estoppel certificate: Document that prevents a person who signs it from later asserting facts different from those mentioned in the document; also called an estoppel letter.

Et ux: Abbreviation for the Latin phrase *et uxor* which means "and wife."

Eviction: Dispossession through the process of law.

Eviction, Actual: Forcing someone physically from a property or preventing them from re-entering the real property, or using lawful procedure to make someone leave the premises.

Eviction, Constructive: Act of the landlord that interferes with the tenant's quiet enjoyment of the property to such an extent that the tenant is forced to move out.

Excess land: Part of a parcel of land that does not add to the value of the property.

Exclusive agency listing: Employment contract providing one broker the right to sell a property for a definite period, while also enabling the owner to sell it without having to pay commission.

Exculpatory clause: Provision in a mortgage relieving the borrower of personal liability on the loan (for certain defaults or problems) if the borrower voluntarily surrenders the property to the lender.

Execute: (a) Signing an instrument and taking other steps that may be necessary for validation. (b) To perform or complete.

Executor: Person named in a will to carry out the provisions of the will; also called a personal representative.

Executed contract: Contract for which all terms and conditions have been completed, making it legally enforceable.

Exemption: Provision by which a law or a rule is not applicable to a certain group or person.

Expenses, Fixed: Recurring property expenses such as real estate taxes or hazard insurance.

Expenses, Maintenance: Cost of cleaning, supplies, utilities, tenant services, and other administrative costs for properties that produce income.

Express: Spoken or written words.

Fair Employment and Housing Act: Civil rights law in California prohibiting all housing discrimination on the basis of race, color, religion, sex, marital status, national origin, sexual orientation, familial status, source of income, or disability; also called the Rumford Act.

Fair Housing Act: Also called Title VIII of the Civil Rights Act of 1968; federal law that makes discrimination illegal on the basis of race, color, religion, sex, marital status, national origin, sexual orientation, familial status, source of income, or disability for the purpose of sale or rental of residential property (or just land that may be used for constructing a residential building).

Federal Deposit Insurance Corporation (FDIC): Federal agency that insures accounts in savings and loans and commercial banks, bolstering confidence in the banking system.

Federal Home Loan Bank System (FHLB): Twelve regional wholesale banks that loan funds to FHLB members to bolster local community lenders.

Federal Home Loan Mortgage Corporation (FHLMC) (Freddie Mac): Federally-sponsored agency that buys mortgages on the secondary market, then bundles and sells them to investors.

Federal Housing Administration (FHA): Federal agency that insures lenders for the repayment of real estate loans.

Federal National Mortgage Association (FNMA) (Fannie Mae): Federally-sponsored agency that buys and sells residential mortgages, thereby enhancing liquidity in the mortgage market.

Federal Reserve (the Fed): Government body that regulates commercial banks and implements monetary policy in order to stabilize the national economy.

Federal Reserve System: Twelve Federal Reserve Banks which make loans to member banks.

Federal Trade Commission (FTC): Federal agency with the responsibility for investigating and terminating unfair and misleading business practices; enforces the Truth in Lending Act.

Fee: See Fee Simple

Fee simple: Recognized as the highest form of estate ownership in real estate. Duration of this ownership is unlimited and can be conveyed in a will to the owner's heirs.

Fee simple absolute: A form of freehold ownership, not subject to termination.

Fee simple defeasible: A form of fee simple estate subject to termination if a condition is not being fulfilled or if there is an occurrence of a specified event; also called a qualified fee.

Fee simple subject to a condition subsequent: Form of estate ownership that can only be terminated by legal action in case a condition is not fulfilled; also called a conditional fee.

Fidelity bond: Bond that covers any losses that occur due to an

employee's dishonesty.

Fiduciary relationship: Relationship of trust and loyalty in which one party owes a high level of good faith and loyalty to someone else. For example, an agent is in a fiduciary relationship with his principal.

Financial statement: Summation of facts that show the financial condition of an individual (or a business), including a detailed list of assets and liabilities.

Finder's fee: A referral fee paid to someone who directs a buyer or a seller to a real estate agent.

First lien position: Mortgage or a deed of trust that has a higher lien priority than any other mortgage or deed of trust against the property.

Fiscal year: Twelve-month period that is used as a business year — in contrast to a calendar year—for accounting, tax, and other financial activities.

Fixed disbursement plan: Financing arrangement in a construction project where loan proceeds are to be disbursed in a series of preset installments at different phases of the construction.

Fixture: Personal property that is permanently attached to land or improvements so that it becomes a part of the real property.

Floor area ratio: Zoning requirement controlling the ratio between a building's floor space and the percentage of the lot occupied.

Foreclosure: Sale of real property by mortgagee, trustee, or other lien-holder when a borrower defaults.

Foreclosure, Judicial: (a) Sale of property as ordered by the court.

(b) Lawsuit that is filed by a mortgagee or deed of trust beneficiary to foreclose on the security property of a defaulting borrower.

Foreclosure, Nonjudicial: Trustee's foreclosure under the power of sale

clause in a deed of trust.

Foreign Investment in Real Property Tax Act (FIRPTA): Federal law which requires a real estate seller to withhold funds from a buyer who is neither a U.S. citizen nor a resident alien.

Forfeiture: Failure to perform a duty or condition leading to a loss of rights or something else of value.

Franchise: Government-granted right or privilege for conducting a particular business, or a private business-granted right for the use of its trade name for conducting a particular business.

Fraud: Premeditated or careless misrepresentation or cover-up of a material fact—on which someone is relying, causing him to suffer loss or harm.

Fraud, Actual: Premeditated deceit or misrepresentation to cheat or defraud someone.

Fraud, Constructive: Misrepresentation made without any fraudulent intent.

Freehold: Estate in land where ownership is for an indefinite length of time, such as a fee simple or a life estate.

Front foot: Property that is measured by the front linear foot on its street line, each front foot extending the depth of the lot.

Front money: Money needed to initiate a project, including expenses such as attorney's fee, loan charges, feasibility studies, and a down payment.

Frontage: Distance between the two side boundaries at the front of the lot.

Fructus industriales: Plants such as crops that are cultivated by people.

Fructus naturales: Plant growth that flourishes naturally, such as

trees, plants, and shrubbery.

Fugitive substance: Substance that is not stationary in nature such as natural gas, oil, and water.

Functional obsolescence: Loss of value from causes within the property, excluding any due to physical deterioration.

Garnishment: Legal procedure through which a creditor acquires access to the funds or personal property of a debtor previously under the control of a third party.

General plan: Long-term, comprehensive plan for development of a community implemented through zoning and other laws; also called a comprehensive plan or master plan.

Gift funds: Money given by a relative (or a third party) of a buyer who himself does not have enough cash to close a transaction.

Good faith deposit: Deposit provided by a prospective buyer to the seller as evidence of his good intention of closing the transaction; also called an earnest money deposit.

Goodwill: Intangible asset of a business it acquires from having a good reputation with the public. Goodwill is generally an indication of the future return business.

Government National Mortgage Association (GNMA) (Ginnie Mae): One of the three main secondary market agencies, this federal agency is part of the Department of Housing and Urban Development.

Government-sponsored enterprise: GSEs are private corporations chartered and managed by the federal government. Secondary market agencies Fannie Mae and Freddie Mac are the most important GSEs in the real estate industry.

Government survey system: System of grids made up of range and township lines dividing land into townships, which are further subdivided into sections. Identification of a particular property is done

through its location within a particular section, township, and range; also called the “rectangular survey system.”

Grant: To transfer or convey an interest in real property through a written instrument.

Grantee: Person receiving a grant of real property.

Granting clause: Words in a deed that point out the grantor’s granting clause.

Grantor: Person conveying an interest in real property.

Gross income multiplier: Figure multiplied by the gross income of a rental property to calculate an estimate of the property’s value; also called the gross rent multiplier.

Gross income multiplier method: Way of appraising residential property by reference to its rental value; also called gross rent multiplier method.

Guardian: Person appointed by a court to manage the affairs of a minor or an incompetent person.

Guide meridians: Lines running north-south (parallel to the principal meridian) at 24-mile intervals, in the Government Survey System.

Habendum clause: Clause included after the granting clause in many deeds; it begins, “to have and to hold” and describes the type of estate the grantee will hold.

Habitability, Implied warranty of: Warranty implied by law in every residential lease that states that the property is fit for habitation.

Heir: One who is entitled to inherit the property of another under the laws of intestate succession.

Heirs and assigns: Phrase used in legal documents to take into account all successors to a person’s interest in property. Assigns are

successors who acquire title in some manner other than inheritance (e.g., in deed).

Hereditament: Real or personal property that can be inherited.

Hereditament, Corporeal: Real or personal tangible property that can be inherited; a property with physical substance such as a car or a house.

Hereditament, Incorporeal: Real or personal property that is intangible and can be inherited; for example, an easement appurtenant or accounts receivable.

Highest and best use: Legal and physically possible use of a property that, at the time it is appraised, is most likely to generate the greatest return over a particular time period.

Holder in due course: One who has taken a note, check, or similar asset prior to it being overdue—in good faith and for value—and with no knowledge that it had previously been dishonored.

Holdover tenant: Tenant who keeps possession of leased property after the lease term has expired.

Home equity line of credit (HELOC): Credit account secured by equity in the borrower's home, enabling him to borrow up to a specified credit limit.

Home equity loan: Loan secured by a second mortgage on a principal residence, usually used for a non-housing purpose.

Homeowners association: Non-profit organization comprising homeowners from a particular subdivision, responsible for enforcing their CC&Rs and managing other community affairs.

Homestead: Dwelling occupied by the owner along with any appurtenant outbuildings and land.

Homestead law: State law providing limited protection to homestead properties against judgment creditor's claims.

HUD: See Department of Housing and Urban Development

Hypothecate: Using real property as collateral for a debt without having to give up possession of it.

Implied agency: Understood from actions or circumstances without expressing in words that an agency relationship exists.

Impounds: Borrower's funds collected and kept in a reserve account by the lender.

Improvements: Additions to land property that are man-made.

Imputed knowledge: Legal doctrine stating that a principal is considered to have notice of information that the agent has, even if the agent never told the principal.

Inadvertent dual agency: Occurs when a real estate agent—while representing one party to a transaction—unintentionally becomes the agent of the other party (i.e., a dual agent) by leading the other party to believe he is acting as his agent.

Inchoate: Unfinished or incomplete; a task begun but not completed.

Inchoate instruments: Documents not fully executed, or documents that should be, but have not been, recorded.

Income, Disposable: Income that remains after the payment of taxes.

Income, Effective gross: Measure of a rental property's capacity to generate income calculated by subtracting a bad debt/vacancy factor from the economic, rent-potential gross income.

Income, Gross: total income of a property before making any deductions such as bad debts, vacancies, operating expenses, etc.

Income, Net: Income that is capitalized to estimate the value of a property. It is calculated by subtracting the operating expenses (e.g., fixed expenses, maintenance expenses, and reserves for replacement) of the property from the effective gross income.

Income, Potential gross: Economic rent of the property; the income the property would earn if it were available for lease in the current market.

Income approach to value: One of the three main methods of appraisal in which an estimate of the property value is based on the net income it produces; also called the capitalization method or the investor's method of appraisal.

Income property: Property which generates rent or other income for the owner, referred to as property held for the production of income in the income-tax code.

Income ratio: Criteria used for qualifying a buyer for a loan, to find if their income is sufficient. The buyer's debt and proposed housing expenses should not be over a specified percentage of his income.

Incompetent: Person who cannot manage their own affairs due to reason of insanity or lack of mental capacity; business matters relating to an incompetent should be overseen by a guardian.

Incorporeal rights: Rights in real property where physical possession is not involved, as in an easement.

Index: Changes in the cost of money indicated in a published statistical report, which can be used to make adjustments in such areas as wages, rental figures, and loan interest rates.

Inflation: Decrease in money's purchasing power, measured by the Consumer Price Index; real estate is considered a hedge against inflation because it generally holds its value.

Injunction: Court order or writ designed to stop a party with a lawsuit from committing an act that is seen as unjust or inequitable in regard to the rights of another party.

Installment sales contract: Real estate purchase structured to be paid in installments with title retained by seller until all payments are made; also called contract of sale and land contract.

Installments: Portion of a debt paid in successive periods, usually to reduce a mortgage.

Instrument: Written document formulated to set the rights and liabilities of the parties; examples are a will, lease, or promissory note.

Inter vivos trust: Trust created during a person's lifetime.

Interest: (a) Money charged by bank or other lending institution for the use of money. (b) A partial degree of ownership.

Interest rate: Percentage of an amount of money that is the cost of using it, usually expressed as a monthly or yearly percentage.

Interpleader: Proceeding started by a third party to find the rights of other claimants to a property or in a transaction.

Intestate: One who dies leaving no will, or a will that is incomplete or not transacted correctly; property then is conveyed to heirs at law or next of kin.

Investment property: Property acquired for its capacity to produce income or anticipated resale value, such as office buildings or undeveloped land.

Involuntary lien: Lien applied against a property without the owner's agreement, such as unpaid taxes.

Irrevocable: Incapable of being reversed or revoked; unalterable.

Joint tenancy: Ownership of a property interest by two or more parties, each of whom has an undivided interest with the right of survivorship (sharing equally in the interest of a deceased joint tenant with the surviving tenants).

Joint venture: Agreement to invest in a single property or business by two or more parties.

Judgment: A court ruling directing that one party is indebted to another, and setting the amount of indebtedness.

Judgment creditor: Party who has received a judgment from the court for money owed to her.

Judgment debtor: Party whom a judgment has been directed against for money owed.

Judgment lien: Claim upon the property of a debtor as the result of a judgment, enabling the judgment creditor to have the property sold for payment to satisfy the judgment.

Junior mortgage: Mortgagee whose claims on a property will be addressed only after previous mortgages have been settled.

Laches: Negligence or delay in putting forward one's rights.

Land: Earth's surface area that is solid and not composed of water.

Land contract: Installment agreement for the purchase of real estate in which the buyer may use and occupy the land, without the passage of deed or title until all or a portion of the selling price is conveyed.

Landlord: Person, the lessor, who rents property to another person, the lessee.

Landmark: A stationary object that serves as a boundary or reference point for a land parcel.

Late charge: Amount assessed by a lender against a borrower who misses making an installment payment when due.

Lateral support: Support which the ground of an adjoining property provides to a neighbor's land.

Lease: Contract agreement in which an owner of real property, in exchange for the consideration of rent, passes the rights of possession to the property to another party for a specified time period.

Leasehold estate: Tenant's ownership interest in the property that is leased to her.

Leasehold improvements: Fixtures attached to real estate that are

installed by the tenant and which can be moved by him after the lease's expiration if their removal does not damage the property.

Legal description: Legally proper identification of realty by one of three agreed-upon methods: the government rectangular survey, metes and bounds, lot and block number.

Lessee: Person to whom property is rented under a lease; a tenant.

Lessor: Person who rents property to another person; a landlord.

Leverage: Using borrowed funds to raise purchasing power and enhance profitability of an investment.

License: Having the right granted by the state of California to work as a real estate broker or salesperson.

Licensee: Person who hold a real estate license, which conveys the privilege to accept compensation for helping with a real estate transaction.

Lien: Encumbrance against property rendering it security for the payment of a debt, mortgage, or other money judgment.

Life estate: Freehold land interest that terminates upon the death of the owner or another designated person.

Life tenant: Individual who is permitted to possess property for her lifetime or during the lifetime of another specified person.

Limited partnership: Business organization in which at least one partner is passive, with liability limited to the sum invested, and one partner whose liability extends beyond his amount invested.

Liquidated damages: Amount designated in a contract that one party will owe the other party in case of a breach of contract.

Lis pendens: Recorded notice that the rights to the possession of real property is the subject of litigation, thus affecting disposition of its title.

Listing: (a) Employment contract in writing between an agent and

principal, authorizing the agent to conduct services for the principal regarding the principal's property. (b) A record of the property for sale by the broker authorized by the owner to sell it.

Loan-to-value ratio (LTV): Ratio calculated by dividing the mortgage principal by the property value.

Lock-in: Agreement to maintain a certain rate or price for a specified time period.

Lot and block number: Method of land description that relies on the placement of recorded plats.

MAI: Professional membership in the Appraisal Institute.

Margin: Figure added to an index in order to adjust an interest rate on an adjustable-rate mortgage.

Marginal property: Realty that generates barely enough income to cover the cost of using it

Marketable title: *See* insurable title. Title that a court will assess as being free enough from defect so it will enforce its acceptance by buyer.

Market data approach: One of the three methods of appraisal, it compares recently-sold properties to the property being appraised. *See* Sales comparison approach

Market price: Actual price paid for a property in a transaction.

Market value: Highest price a willing buyer will pay for a property and the lowest a willing seller will accept—assuming no undue, outside pressures.

Material fact: Fact that is significant in regard to a particular transaction, without which it can be assumed a contract would not be agreed upon.

Mechanics lien: Lien created by law against real property as security for payment for the labor and materials used for the

improvement of the property.

Mello-Roos Community Facilities Act: Enacted in 1982, it authorizes creating community facilities, issuing bonds, and levying taxes to finance specified public services.

Meridian: North-south line used in government rectangular survey.

Metes and bounds: Land description method that relies on land boundary lines, utilizing those lines with their terminal points and angles.

Mineral rights: Authorization to amass income from the sale of gas, oil, and other resources underground.

Misrepresentation: Untrue or misleading statement, whether unintentional or on purpose. Where there's a misrepresentation of a material fact, the injured individual may sue for damages or revoke any agreement affected by the false assertion.

Monument: Fixed object and point specified by surveyors to establish land locations, such as boulders or unusual trees.

Mortgage: Written instrument that establishes a lien on real estate as security for payment of a designated debt.

Mortgage banker: Person who originates, finances, sells, closes, and services mortgage loans, which are generally insured or guaranteed by a private mortgage insurer or government agency.

Mortgage broker: Places loans with investors for a fee, but does not service them.

Mortgage commitment: Agreement between a borrower and a lender to set up a loan at a later date, dependent on the conditions specified in the agreement.

Mortgage loan disclosure statement: Statement on a form approved by the Real Estate Commissioner that discloses to a potential borrower the terms and conditions of a mortgage loan - required by law to be

proffered by mortgage brokers before the borrower is bound by the loan terms.

Mortgagee: Someone who receives a mortgage from a mortgagor to secure a loan or performance of a duty; also called a lender or creditor.

Mortgagor: Person who provides a mortgage on property to a mortgagee to secure a loan or the mortgagee's performance of a duty.

Multiple listing: Arrangement between real estate brokers to cooperate by providing information to each other regarding listings and to split commissions between the listing and selling brokers.

National Association of Realtors (NAR): Organization which promotes professionalism in real estate business.

Negative amortization: Increase in a loan's outstanding balance due to periodic debt-service payments not covering the total amount of interest attached to the loan.

Net income: Actual earnings remaining after deducting all expenses from gross income.

Net lease: In addition to rent, tenant pays charges against the property, such as taxes, insurance, and maintenance.

Net listing: In a sale, broker's commission payment is anything over and above an agreed-upon net price to the seller.

Net operating income: The income from realty or a business after deducting operating expenses but before deducting tax payments on and interest and principal payments.

Non-conforming loan: Mortgage loan that does not meet the criteria for being funded by Fannie Mae or Freddie Mac.

Note: Written instrument acknowledging a debt and promises to pay.

Notice, Actual: Implied or express factual knowledge.

Notice, Constructive: Fact which should have been discovered due to

one's actual notice and/or inquiries that a reasonably prudent person would be expected to make.

Notice, Legal: Notice required by law to be given.

Notice to quit: Notice provided to a tenant to vacate property.

Novation: Substitution of a revised agreement for a previous one, and agreed to by all parties.

Null and void: Without any legal validity.

Obsolescence: Decline in value due to a reduction in desirability and usefulness of a structure—because its design and construction become obsolete or decline due to the structure becoming outmoded (i.e., not in keeping with current needs).

Offer to purchase: Proposal to a property owner by a potential purchaser to acquire the property under previously-stated terms.

Open listing: Listing provided to a number of brokers without a duty to compensate any besides the particular broker who first secures a buyer—ready, willing, and able to accept the listing's terms—or obtains the seller's acceptance of a different offer.

Open mortgage: Mortgage that has matured or whose payments are late, so that it is open to being foreclosed upon.

Open-end mortgage: Mortgage including a clause under which the mortgagor may obtain additional funds from the mortgagee after a certain number of loan payments have been made.

Operating expenses: Funds used to maintain property, such as insurance and repairs, but excluding depreciation or finance costs.

Operating lease: Lease that a lessee subleases to another party who is the actual user of the property.

Option: Right, without the obligation, to lease or purchase a property upon specified terms during a specified period.

Optionee: One who receives or acquires an option.

Optionor: One who gives or sells an option.

Oral contract: An agreement not in writing, usually unenforceable.

Ostensible authority: Authority that a reasonable third person believes an agent was given, due to the principal's acts or omissions.

Overall capitalization rate: Rate calculated by dividing net operating income by the property's purchase cost.

Package mortgage: Mortgage created in which the principal loan amount is raised to include improvements and movable items such as appliances, along with real estate.

Paramount title: Title which takes priority over any others.

Partition: Dividing real property between its owners in undivided shares.

Partnership: Agreement between two or more parties to enter into a business venture with each partner sharing in the partnership's profits, as well as being liable for its debts.

Party wall: Constructed on the dividing line between two properties with different ownership, a wall that either party has a right to use.

Patent: Title conveyed to government land.

Percentage lease: Property lease with the rental amount based on a percentage of sales made on the premises, with a set minimum amount; usually used by retailers.

Periodic estate: Lease based on a specified calendar amount of days, like month to month or year to year; also called a periodic tenancy.

Personal property: All property that is not realty; also known as personality.

Physical depreciation: Decline in value stemming from age, wear and tear, and the elements.

Planned unit development (PUD): Zoning or land-use plan for large tracts that includes intensive development of common and private areas, designed as one integrated unit.

Plottage: Increasing the value of a plot of land that has been assembled from smaller plots under a single ownership.

Points: Fees provided to lenders to attract a mortgage loan. One point equals one percent of the principal loan amount, which lowers the funding amount advanced by the lender, effectively raising the interest rate.

Police power: Government right to pass laws and enforce them to achieve health, order, public safety, and general welfare for the public.

Power of attorney: Instrument through which a principal confers authority to a person to act as her agent.

Premises: Land and buildings; an estate.

Prepayment clause: Mortgage clause conveying the privilege to a borrower to pay her entire debt prior to its maturity; in some cases, a penalty is assessed against the borrower for exercising this right.

Principal: (a) Employer of a broker or agent. (b) Amount of money from the mortgage or other loan, apart from the interest due on it. (c) One of the main parties in a real estate deal.

Private mortgage insurance (PMI): Mortgage guarantee insurance that protects conventional lenders in case of default, with premiums paid by the borrower.

Probate: To prove the validity of a will of a deceased person.

Procuring cause: Legal term for the cause resulting in the objective of a real estate broker or agent procuring a ready, willing, and able realty purchaser—used to determine who is entitled to a commission.

Promissory note: Borrower's signed promise to repay the loan to a specific person under specific terms.

Property: Rights that a party has to use and possess land or chattel to the exclusion of anyone else.

Proprietorship: Business ownership, including the management of real estate, by a person, as opposed to a corporation or partnership.

Proration: Allocation between seller and purchaser of proportional shares of a debt that has been paid—or due to be paid—regarding a realty sale, such as property taxes and insurance.

Purchase capital: Funds used to purchase realty, from whatever source.

Purchase money mortgage: Mortgage provided by a buyer (grantee) to a seller (grantor) in partial payment of a real estate purchase price.

Quiet enjoyment: Right of an owner or tenant to the use of a property without any interference to their possession.

Quiet title: Court action to remove a defect or cloud on an owner's legal right to a piece of realty.

Quitclaim deed: Conveyance establishing only the grantor's interest in real estate, with no ownership warranties.

Range lines: Used in the government rectangular survey method of land description; they are lines parallel to the principal meridian, demarcating the land into 6-mile strips called ranges.

Ratification: Approval of an action done on someone's behalf without prior authorization.

Real estate: Land and all permanent attachments to it.

Real Estate Advisory Commission: Ten-member board that makes recommendations to the Real Estate Commissioner on pertinent issues.

Real Estate Commissioner: Governor-appointed head of the

Department of Real Estate (DRE), who appoints the Real Estate Advisory Commission and administers the Real Estate Law.

Real estate investment trust (REIT): Mutual fund authorized by law to be immune from corporate taxes if most of its profits are distributed to individual investors who are taxed.

Real property: All the rights in ownership to use real estate.

Realtor: Real estate professional following the code of ethics based on their membership in the National Association of Realtors.

Recapture clause: Contract clause allowing party granting an interest or right in real estate to re-take it under specific conditions.

Recording: Act of entering documents regarding title to real estate in the public record.

Recourse: Authority of a lender to assert a claim to funds from a borrower in default, besides the property pledged as collateral.

Redlining: Unlawful policy by a lender of not making loans in certain areas with high minority populations due to alleged overall lending risks, without considering creditworthiness of each applicant.

Release clause: Mortgage clause that provides property owner with the right to pay off part of their indebtedness, releasing a specified portion of the property from the mortgage.

Reliction: Gradual lowering of water level, uncovering dry land.

Remainder: Estate that goes into effect after a prior estate, usually a life estate, is terminated.

Rent: Compensation paid for the use of realty.

Replacement cost: In appraisals, the cost of construction to replace or serve the same function as a similar, previous building.

Reproduction cost: In appraisals, the cost of construction of a replica

of a property as of a certain date.

Rescission: Terminating a contract and restoring the parties to the identical positions they occupied before entering into the contract—permitted when the contract was induced by fraud, duress, misrepresentation, or mistake.

Restriction: Limitation placed on property use, as included in the deed or other instrument in the chain of title.

Reversion: Lessor's right to take possession of leased property upon the end of a lease.

Reversionary interest: Future interest held by a person in property upon the termination of the preceding estate.

Revocation: Recalling power of authority previously conveyed, such as by an agency.

Right of survivorship: Right of a surviving joint tenant to take the interest of a deceased joint owner.

Right of way: Easement, right-to-use access or passage to a specific path, as well as the subdivision areas allocated to government use (e.g., streets and other types of public access).

Riparian rights: Rights regarding water use on, under, or adjacent to a person's land—providing reasonable use of such water.

Rumford Act: See Fair Employment and Housing Act

Sale-and-leaseback: Seller retains occupancy to land by leasing it back simultaneously with its sale, generally for a long term lease.

Sales comparison approach: In appraisals, estimating value through analysis of comparable properties' recent sales prices.

Salesperson: One licensed to perform any act authorized by the state's Real Estate Law, if employed by a broker who is also licensed.

Sandwich lease: Leasehold which has been sublet by a lessee to

another party, so the former becomes a lessor.

Section of land: Square mile in the government rectangular survey description of land.

Security instrument: Realty interest permitting the property to be sold if the obligation for which the security interest was created is defaulted upon.

Separate property: As distinguished from community property, property owned by a spouse prior to marriage—acquired by gift or bequest, or by proceeds from other separate property.

Setback: Area from the curb or other set line of demarcation within which no structures can exist.

Special assessment: Property is assessed a certain amount to pay for public improvements which will benefit the property.

Special warranty deed: Deed under which the grantor warrants the title provided to the grantee only against defects that arose during grantor's ownership, not from any that might stem from conditions existing before that time.

Specific performance: Court action directing a party to fulfill contract terms which he has refused to perform.

Statute of Frauds: State law holding that certain contracts be in writing and signed to be enforceable, unless the terms of a contract can be performed within one year.

Straight-line depreciation: Method of depreciation which uses equal yearly reductions to estimate property's book value.

Subagent: One who receives the powers of an agent not from a principal, but from another agent whom the principal has authorized to do so.

Subdivided Lands Law: Regulating the sale of subdivided land in California, this law mandates a subdivision meet state standards and

that the Real Estate Commissioner publish a Subdivisions Public Report provided to potential purchasers.

Subdivision: Land tract divided into plots, appropriate for the construction of homes, under the state's Subdivided Lands Law.

Subject to mortgage: Method to take title to mortgaged realty without being personally liable for payment of amount due on the promissory note. If the new buyer fails to make payments going forward, the most he will lose is his equity in the property.

Sublease: Lease from a lessee to a different lessee, who becomes the sublessee or subtenant.

Subordination clause: Instrument allowing a mortgage recorded at a subsequent date to take precedence over an earlier mortgage.

Surety: One who guarantees another's performance; a guarantor.

Surrender: Lease's cancellation before its termination by consent of both the lessor and lessee.

Survey: Procedure under which a parcel of land is measured and its area calculated.

Tax-free exchange: Trade of one property for another that is excluded from tax liability on any profit when the trade occurs.

Tax sale: Property being sold after a period of unpaid taxes.

Tenancy at sufferance: Tenancy created when a lawful tenant retains possession of a property after the lease terminates.

Tenancy at will: License to possess realty and tenements for an indefinite period, at the owner's will.

Tenancy by the entirety: Estate that exists just between spouses, with each having equal right of possession and with right of survivorship.

Tenancy in common: Ownership of real property by two or more

persons, with each having an undivided interest but without the right of survivorship.

Tenant: Person given possession of real property belonging to someone else for a fixed term or at will.

Testament: A will.

Testamentary trust: Trust established by will, which only comes into effect after testator dies.

Testate: The making of a valid will.

Time is of the essence: A contract condition requiring that all references to specified dates regarding performance be followed exactly.

Title: Establishes that a land owner has lawful possession of a property, having all the elements of ownership.

Title insurance: Insurance policy providing protection from losses caused by possible defects in the title.

Title search: Public records inquiry to ascertain any issues of ownership and encumbrance regarding realty.

Topography: Surface of the land; may be hilly, flat, rocky.

Tort: Wrongful act, not criminal in nature, but giving rise to a civil action with the one committing the tort (tort-feasor) potentially liable for civil damages.

Township: Six-mile square tract located between two range lines and two township lines, created by government rectangular survey.

Trade fixtures: Articles annexed to rental structures by a commercial tenant in the course of operating their business, removable by the tenant.

Trust deed: Conveyance of realty to a neutral third party (trustee) which that person holds for another party's benefit.

Trustor: Party who gives property to a trustee to be held on a beneficiary's behalf, so that the trustor becomes the owner of real estate and the lender is the beneficiary.

Unearned increment: A rise in real estate value due to no effort by the owner, usually due to population growth.

Unit in place method: Projecting the cost of building a structure based on estimating the price of its individual components, such as the foundation, floors, walls, and cost of labor.

Unity: Four unities are needed to establish a joint tenancy: interest, possession, time, and title. Thus, joint tenants are required to have equal interests created by a conveyance, the identical undivided possession, and the same use during the same time.

Unruh Act: State law requiring borrowers be provided with explicit notices of default on mortgages, to safeguard homeowners from losing their residence due to default on an installment purchase.

Usury: Interest rate impermissibly set higher than allowed by law.

Utility: One of the elements of value—the capability to provide gratification—inciting the wish to possess a property.

Valid: Having legally sufficient force, enforceable by a court.

Value: What something is worth to a particular party.

Variable expenses: Operating costs for a property that rise upon occupancy.

Vendee: Buyer; a purchaser.

Vendee's lien: Lien applied to property according to a contract of sale, to secure buyer's deposit.

Vendor: Seller.

Void: With no force of law or effect

Voidable: Something that can be voided, but action must be directed to void it.

Voluntary alienation: Term designating a sale or gift made with free will.

Warranty: Promise or guaranty included in a contract.

Warranty deed: Instrument that includes a covenant declaring the grantor will protect the grantee from claims on title.

Will: Directions for the disposition of one's property after death.

Without recourse: Phrase employed in endorsement of a note or bill indicating that the holder cannot expect payment from the debtor personally if non-payment occurs.

Zoning: Governmental authority designating an area for a particular use.

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