CALIFORNIA

45 HOUR

CONTINUING EDUCATION COURSE

45 Hour California Continuing Education Course
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OF CONTINUING EDUCATION

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Agency

Knowledge of agency relationships is important to the practice of real estate in California. In light of recent changes to the Civil Code and constantly changing common law cases, an on-going continuing education program is essential to protect California consumers and avoid unnecessary and costly litigation.

We will examine the Civil Code, with references to pertinent sections relating to agency and agency disclosure. We will then look at two relevant court cases that relate to agency relationships and disclosures in California.

Civil Code

An agent is a person who represents another (called a principal) in dealings with third persons (CC 2295). In real estate transactions, the **agent** is a licensed real estate broker representing his principal in the transaction. The **principal** is usually the seller, buyer, lessor, or lessee in the transaction. **Third parties** are other parties in the transaction who have dealings with the agent.

> "An agency relationship is established between the principal and agent when a written employment agreement (called a listing agreement) is executed between them."

An agency relationship is established between the principal and agent when a written employment agreement (called a listing agreement) is executed between them. However, it should be noted that an agency relationship <u>can</u> also be established by actual or ostensible authority. An agency is **actual** when the agent is really employed by the principal.

An agency is **ostensible** when the principal intentionally, or by want of ordinary care, causes a third person to believe another to be his agent who is not really employed by him. An agency may be created by precedent authorization (listing agreement) or by subsequent ratification (ostensible). An agent can never have authority, either actual or ostensible to perpetrate fraud upon the principal.

Consideration (bargained for exchange) is not required for an agency relationship.

Even though not common in the real estate industry, an oral authorization is sufficient to establish an agency relationship; except, when an instrument is required to be in writing (Statute of Frauds), then the agency can only be conferred in writing. Since all real estate contracts are required to be in writing (except leases of a year or less) because of the Statute of Frauds, agency relationships are normally established in writing in California.

A ratification may be rescinded when made without such consent as is required in a contract, or with an imperfect knowledge of the material facts of the transaction ratified, but not otherwise. A principal can ratify an agency relationship by accepting the agent's actions, and thereby ratifying the agency. However, the principal can rescind the ratification if he is not in possession of the material facts relevant to the transaction. If the purported agent has not disclosed all material facts, then the principal may be able to rescind the ratified agency relationship.

One who assumes to act as an agent thereby warrants, to all who deal with him in that capacity, that he has the authority which he assumes. When an agent acts as an agent for a principal, he is warranting that he has the authority to act for the principal. He could be liable for damages if he does not indeed have this authority.

One who assumes to act as an agent is responsible to third persons as a principal for his acts in the course of his agency, in any of the following cases, and in no others (in other words the agent is responsible for his actions, not the principal):

When, with his consent, credit is given to him personally in a transaction. When he enters into a written contract in the name of his principal, without believing, in good faith, that he has authority to do so.

The Civil Code requires that all real estate transactions of one-to-four unit residential properties (and mobile homes), including options, ground leases, and real property sales contracts where an agent is involved in the transaction, an **agency relationship disclosure** must be given to both the buyer and the seller.

Agency is best defined as the relationship between the principal (seller or buyer) and another person who can act on their behalf (broker). In this capacity, the seller or buyer's agent is the broker who is acting on their behalf.

"Agency is best defined as the relationship between the principal (seller or buyer) and another person who can act on their behalf (broker)."

The standard of care owed by the broker is the degree of care that a "reasonably prudent real estate licensee would exercise." This is measured by the degree of knowledge through education, experience, and examination.

The broker may employ salespersons who are subagents of the broker. For example:

The salesperson obtaining the listing from the seller is really the seller's subagent. The broker is the seller's agent. However, the salesperson is considered an employee of the broker, and the broker thus has **vicarious liability** for the actions of the agent. This means that the broker is liable for all misrepresentations regarding the agency relationship or other material misrepresentations made by the salesperson. For this reason real estate brokers generally carry errors and omissions insurance to protect them against litigation resulting from misrepresentations of their salespeople, as well as their own actions.

It is the duty of a real estate broker or salesperson to a prospective purchaser to **disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal.** This requires the broker to have a written contract with the seller to find or obtain a buyer, or is a broker who acts in cooperation (MLS for example) with that broker to find and obtain a buyer.

The property inspection does <u>not</u> include areas that are reasonably and normally inaccessible. It also does <u>not</u> include an affirmative inspection of areas off the site of the subject property, public records, or permits concerning the title or use of the property. The property inspection does not include a planned development, condominium, or stock cooperative or more than the unit(s) offered for sale.

Next is a look at a new law regarding agency disclosure that came out January 1, 2015.


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AGENCY DISCLOSURE

Disclosure regarding Agency Relationships for Commercial Property
California Assembly Bill 1171 – Effective January 1, 2015

EXISTING LAW:

1. Requires specified disclosures by listing and selling agents to be provided to a buyer and seller of residential real property and defines the duties owed by the agents to the buyer and seller.
2. Requires those listing and selling agents to provide the seller and buyer with a copy of a specified disclosure form and to obtain a signed acknowledgment of receipt from that seller or buyer as follows:
   A. The listing agent, if any, shall provide the disclosure form to the seller prior entering into the listing agreement;
   B. The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form;
   C. Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be furnished to the seller by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his/her last known address, in which case no signed acknowledgment of receipt is required; and
   D. The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer.

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AGENCY DISCLOSURE (*continued*)

Disclosure regarding Agency Relationships for Commercial Property
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3. Provides that in any circumstance in which the seller or buyer refuses to sign an acknowledgment of receipt of the disclosure form, the agent, or an associate licensee acting for an agent, shall set forth, sign, and date a written declaration of the facts of the refusal.
4. Provides a specified form detailing the fiduciary duties of care owed by the listing or selling agent and the agent's conflict of interest disclosures that the agent is required to give to the seller or buyer.
5. Requires the listing or selling agent to disclose to the buyer and seller whether the selling agent is acting in the real property transaction exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and the seller. This relationship is required to be confirmed, as specified, in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the selling agent prior to or coincident with execution of that contract by the buyer and the seller, respectively.
6. Prohibits a selling agent in a real property transaction from acting as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction.
7. Provides that the payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship.
8. Prohibits a dual agent from disclosing to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. Prohibits the dual agent from disclosing to the seller that the buyer is willing to pay a price greater than the offering price, without the express written consent of the buyer.
9. Provides that a listing agent is not prohibited from also being a selling agent, and the combination of these functions in one agent does not, of itself, make that agent a dual agent.
10. Defines real estate listing and selling agent, buyer, seller, and specifies that

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AGENCY DISCLOSURE (*continued*)

Disclosure regarding Agency Relationships for Commercial Property
California Assembly Bill 1171 – Effective January 1, 2015

"real property" means any estate in property which constitutes or is improved with one to four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobile homes, when offered for sale or sold through an agent.

THIS BILL:

1. Adds "commercial real property" to that definition of "real property," thus applying all of the above disclosure requirements to commercial property sales.
2. Defines "commercial real property" to mean all real property in this state except single-family residential real property, residential rental units, mobile homes, or recreational vehicles.

BACKGROUND:

Prior to 1984, the law required a real estate broker to disclose to a buyer, material defects known to the broker but unknown to and unobservable by the buyer. In 1984, case law provided that the broker also owed a duty to disclose defects which the broker should have discovered through reasonable diligence. In Easton v. Strassburger (1984) 152 Cal.App.3d 90, the court held that real estate licensees owed certain duties of care to the property buyers, including while representing the sellers in a residential home transaction. That court refrained from extending these duties to commercial property transactions, stating in dictum: "unlike the residential home buyer who is often unrepresented by a broker, or is effectively unrepresented because of the problems of dual agency a purchaser of commercial real estate is likely to be more experienced and sophisticated in his dealings in real estate and is usually represented by an agent who represents only the buyer's interests."

After the Easton decision, there was extensive discussion in the real estate industry on how those duties were to be interpreted. SB 453 (Robbins, Chapter 223, Statutes of 1985) clarified the duties of real estate brokers and buyers in real property transactions. However, the law was still unclear as to whether real estate brokers had disclosure duties to buyers. In Smith v. Rickard (1988) 205 Cal.App.3d 1354, 1360, the court, after examining statutory construction and the Easton case dictum, held that real property brokers had a duty to inspect the property and to disclose to the plaintiff any

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AGENCY DISCLOSURE (*continued*)

Disclosure regarding Agency Relationships for Commercial Property
California Assembly Bill 1171 – Effective January 1, 2015

material defects affecting the value or desirability of the property.

In 1995, the Easton decision was further clarified and codified in SB 467 (Leonard, Chapter 428, Statutes of 1995) to require real estate listing and selling agents of residential property to provide specified disclosures to buyers and sellers. Those disclosures require the real estate listing and selling agents to disclose whether the agent represents the buyer, the seller, or both the buyer and seller (known as dual agency).

A breach of duty regarding an agency relationship shall not exceed two years from the date of possession, which means the date of recordation, date of close of escrow, or the date of occupancy, whichever occurs first.

Nothing shall relieve the buyer of the duty to exercise reasonable care to protect himself or herself, including those facts which are known to or within the diligent attention and observation of the buyer or prospective buyer.

Division 4 (commencing with Section 10000) of the Civil Code does not apply to transfers that require a public report by the Real Estate Commissioner. An example would be a subdivision of new homes.

If a consumer information booklet (**Environmental Hazards Booklet**) is delivered to a transferee (buyer) in connection with the transfer of real property (including manufactured housing) a seller or broker is not required to provide additional information concerning common environmental hazards (CC 2079.7(a)). This does not alter the seller or broker's duty to disclose the existence of known environmental hazards on or affecting the real property (CC 2079.7(b)).

If the **Homeowner's Guide to Earthquake Safety booklet** is delivered to a transferee (buyer) in connection with the transfer of real property, a seller or broker is not required to provide additional information concerning geologic and seismic hazards. This does not alter the seller or broker's duty to disclose the existence of known hazards on or affecting the real property.

The **Natural Hazards Disclosure** commonly in use in California is not mentioned in the Civil Code; however, it provides important disclosures regarding environmental, geologic, and seismic hazards…as well as several other required disclosures.

If the **Commercial Property Owner's Guide to Earthquake Safety booklet** is delivered to a transferee (buyer) in connection with the transfer of real property a seller or broker is not required to provide additional information concerning geologic and seismic hazards. This does not alter the seller or broker's duty to disclose the existence of known hazards on or affecting the real property.

If the informational booklet concerning the statewide home energy rating program is delivered to a transferee (buyer) in connection with the transfer of real property (including manufactured housing) a seller or broker is not required to provide additional information concerning home energy rating. This does not alter the seller or broker's duty to disclose the existence of known home energy rating program affecting the real property.

Every lease or rental agreement for residential real property and every contract for sale of residential real property comprising one-to-four units (entered into after July 1, 1999), shall contain, in not less than eight-point type, the following notice:

"The California Department of Justice, sheriff's departments, police departments serving jurisdictions of 200,000 or more and many other local law enforcement authorities maintain for public access a data base of the locations of persons required to register pursuant to paragraph (1) of subdivision (a) of Section 290.4 of the Penal Code. The data base is updated on a quarterly basis and a source of information about the presence of these individuals in any neighborhood. The Department of Justice also maintains a Sex Offender Identification Line through which inquiries about individuals may be made. This is a '900' telephone service. Callers must have specific information about individuals they are checking. Information regarding neighborhoods is not available through the '900' telephone service."

Upon delivery of the notice to the lessee or transferee of the real property, the lessor, seller, or broker is not required to provide information in addition to that contained in the notice regarding the proximity of registered sex offenders. The information in the notice shall be deemed to be adequate to inform the lessee or transferee about the existence of a statewide data base of the locations of registered sex offenders and information from the data base regarding those locations. The information in the notice shall not give rise to any cause of action against the disclosing party by a registered sex offender.

The State Legislature has attempted to codify the Easton v. Strassburger case that was the landmark case that defined agency relationships in California. Many brokers were having a difficult time obtaining errors and omissions insurance because of the lack of clarity in the common law regarding agency relationships and disclosures. The preceding Civil Code recitations are an attempt to resolve this issue.

Agency Terms Defined

"**Agent**" means a person acting under provisions of Title 9 (commencing with Section 2295) in a real property transaction, and includes a person who is licensed as a real estate broker under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code, and under whose license a listing is executed or an offer to purchase is obtained.

"**Associate licensee**" means a person who is licensed as a real estate broker or salesperson under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code and who is either licensed under a broker or has entered into a written contract with a broker to act as the broker's agent in connection with acts requiring a real estate license and to function under the broker's supervision in the capacity of an associate licensee.

"The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent."

The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent. When an associate licensee owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the associate licensee functions.

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

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

"**Listing agreement**" means a contract between an owner of real property and an agent, by which the agent has been authorized to sell the real property or to find or obtain a buyer.

"**Listing agent**" means a person who has obtained a listing of real property to act as an agent for compensation.

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

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

"**Offer to purchase**" means a written contract executed by a buyer acting through a selling agent which becomes the contract for the sale of the real property upon acceptance by the seller.

"**Real property**" means any estate specified by subdivision (1) or (2) of Section 761 in property which constitutes or is improved with one-to-four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobile homes, when offered for sale or sold through an agent pursuant to the authority contained in Section 10131.6 of the Business and Professions Code.

"**Real property transaction**" means a transaction for the sale of real property in which an agent is employed by one or more of the principals to act in that transaction, and includes a listing or an offer to purchase.

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

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

"**Selling agent**" means a listing agent who acts alone, or an agent who acts in cooperation with a listing agent, and who sells or finds and obtains a buyer for the real property, or an agent who locates property for a buyer or who finds a buyer for a property for which no listing exists and presents an offer to purchase to the seller.

"**Subagent**" means a person to whom an agent delegates agency powers as provided in Article 5 (commencing with Section 2349) of Chapter 1 of Title 9. However, "subagent" does not include an associate licensee who is acting under the supervision of an agent in a real property transaction.

Agency Agreement

An agency agreement is usually the listing agreement and must have:

1. Mutuality of agreement between the principal and his agent.
2. Legal Purpose. The agent cannot be used to fly drugs from Colombia into the U.S.
3. Both parties must have the capacity to enter into an agency contract. Minor and incompetents cannot contract and, therefore cannot enter into agency relationships. Minors can contract if they are emancipated by the courts, married, or in the U.S. armed forces.
4. There must be consideration (except gratuitous agents), which is a bargained for exchange. The principal agrees to pay the agent a commission if she finds a suitable property for her to purchase.
5. The agreement must be in writing, if required by law.

Termination of Agency Relationship

An agency agreement may be terminated by:

1. The expiration of the term.
2. The extinction of its subject matter (house burns down).
3. The death of the agent.
4. The agent's renunciation of the agency.
5. The incapacity of the agent to act as such.
6. Revocation by the principal.
7. The death of the principal.
8. The incapacity of the principal to contract.

Agency Disclosure Requirements

On December 31, 1987 California was one of the first states to require an agency disclosure to be completed for all one-to-four unit residential properties sold or exchanged in the state. Prior to this law there was much confusion regarding who each agent is really representing in the transaction.

This agency disclosure required agents to disclose the various types of agencies and agency relationships to their principal(s). The following disclosure form was adopted as a uniform vehicle for agents to comply with this requirement.

Next is a look at a landmark court case regarding dual agency.


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DISCLOSURE OF DUAL AGENCY

Harry Brown, Plaintiff and Appellant, v. FSR Brokerage, Inc., et al., Defendants and Respondents

This case addresses full disclosure of dual agency. The case initially came to trial in the Superior Court of Los Angeles County in 1998. FSR Brokerage, Inc. was successful in their request for summary judgment and the case was decided in their favor. There was not enough evidence or legal dispute to bring the complaint to trial.

Mr. Brown appealed the case to the Court of Appeal of California, Second Appellate District, Division Four and the decision was reversed. Here are the facts in the case and reasons why Justice Epstein (with Justices Vogel and Czuleger concurring) ruled in favor of Mr. Brown, the appellant.

Harry Brown, the seller, was the plaintiff in the trial court proceedings, and is the appellant here. The defendants are FSR Brokerage, Inc., a California Corporation and Sid K. FSR is a licensed real estate brokerage, and Sid K. is a licensed real estate salesperson working under FSR's broker's license.

Brown acquired the subject property, a large residence in Beverly Hills, on January 13, 1994. Some three months later, in April 1994, he listed it for sale with another broker. The asking price was $ 3,950,000. Over the course of the next 20 months, Brown successively reduced the listing price for the property, and relisted it. By June 1995 the asking price had been dropped to


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$2,895,000.

Brown gave an exclusive listing to FSR on December 19, 1995, with a listing price of $2,695,000. The selling price was eventually reduced to $2,495,000. The listing agents, each of whom was employed by FSR, were Barbara T. and Sid K. Brown had met Barbara and, through her, had agreed to list the property with FSR. It turned out that Barbara had a partnership arrangement with Sid, through which each was a listing agent on any property listed by the other.

The listing with FSR was extended, and was in force in May and June of 1996. Up to then, Brown had not received a single written offer to buy the property since its initial listing more than two years before. On May 31 or June 1, 1996, Sid brought over a prospect who, he told Brown, was interested in the property. That was Bernard Lafferty, about whom more will follow.

On leaving the residence, Sid told Brown that he expected that Lafferty would return with an offer. Sid and Lafferty returned later that day, or the next day. Lafferty was accompanied by an attorney, John D. Forbess. Barbara also was present.

Sid took Brown aside for a private conversation. Brown did not want to come below $2,495,000. Sid insisted that he lower the price to $ 2.4 million and said he would lose the buyer if he did not. "He was very convincing and he told me in the course of the discussion that he was working exclusively for me and only had my interests in mind. I felt reassured by this statement, and comfortable, although reluctant, in allowing myself to be persuaded by him that I should reduce the price to $ 2.4 million. I thereupon decided I would accept $2.4 million from the buyer. I never communicated this price until after Sid had persuaded me as set forth above." Sid told him that the buyer would not pay more than $2.4 million.

Besides trying to buy the property for a lower price, Lafferty insisted on a most unusual term of sale: Brown had to vacate the residence so that Lafferty could move in, in less than a week!


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DISCLOSURE OF DUAL AGENCY (*continued*)

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In the same conversation as the one in which Sid asked Brown to agree to the $ 2.4 million price, or in a different discussion—Brown was not sure which—Barbara urged Brown to hold to the $ 2,495,000 price "because there's nothing else like it (the house) on the market. These people need the house, they want it in three days, which is unheard of. There's nobody else in the whole city that could deliver a house in three days like you can. You should get your full price" she said, "first of all, because it's worth it." (At one point, Barbara suggested to Brown that he consult his own lawyer, pointing out that Forbess was Lafferty's attorney. Apparently, she undertook to furnish Brown with the name of an attorney, but by the time the person called, the deal had been completed.)

Brown decided to follow Sid's advice. During the negotiations, Sid said, "he was working exclusively for me," that "I'm trying to get you the best price I can." In his conversation with Brown, Sid repeatedly said that he was working exclusively for Brown. The day before (a Saturday), Sid told Brown, in the presence of Brown's girlfriend, "that he was working exclusively for us and the price and everything that he can get, it was just me, my girlfriend and him."

Brown thought the residence was worth $ 2,495,000. Asked at deposition why, in light of this, he agreed to accept $ 2.4 million he replied: "Because Sid, working exclusively for me, for the fifteenth time, told me that this is the best he's going to get and I'm going to blow the deal. He was the one promoting the two million four." (The reference to the "fifteenth time" is apparently a sarcastic comment that this or similar questions had been asked before at the deposition.) Again, asked why he did not simply say that $ 2.4 million was not good enough, Brown said that Sid "told me that he's working exclusively for me and he said he's been working on two million three fifty and it's the best he's going to get, he's not going to get any more. That's what he told me." Brown agreed to the price urged by Sid "because I assumed he was working for me exclusively and this was the best he was going to get. That's what he told me, and he's my xxxxxx broker, okay?"

Forbess thought the property was worth less than $ 2.4 million and that "there


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DISCLOSURE OF DUAL AGENCY (*continued*)

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was not a prayer in the world that [Lafferty would have paid] more than $ 2.4 million because he would—he would basically have to have beaten me up to get me to agree to it." Forbess also testified that while he realized it would be difficult for Brown to complete the sale, pack up and leave within a week ("almost an impossible undertaking"), Lafferty "was at a state of urgency in his own life, and if that sale was to take place it had to take place on those terms." Lafferty was, in fact, "almost at the point of a nervous breakdown, considering his position of not having a house and having his dogs—I think there were 11—and of which he was extremely fond, and all of which who were in a boarding facility or pound of some sort and not doing well physically. They were sick, some of them were sick and he was very concerned that they were going to start dying on him." And while Mr. Doyle, Lafferty's Chicago lawyer, was concerned about paying $ 2.4 million, Forbess understood that Lafferty "perceived that he was the client and had the ultimate say in the matter, and he told us that he didn't care what we said, what our advice was, that he was going to buy the place."

On Sunday, Brown agreed to the $ 2.4 million price. According to Forbess, Brown told him directly that he would not sell for the $ 2,350,000 then offered, and would not take less than $ 2.4 million. Brown denied saying this to Lafferty or to Forbess.

The next day, June 4, 1996, Barbara told Brown that it was time to go to escrow, and they did. Up to then, there was no written offer or signed agreement for purchase and sale of the residence. At the escrow office, Brown signed documents presented to him by Barbara for execution. Barbara identified the escrow instructions and asked Brown to sign them. Brown looked at the first page, saw that the agreed-upon purchase price was correctly stated, and read nothing more. He signed or initialed each of the succeeding pages and attachments as indicated. One of the attachments he initialed was a document entitled "Real Estate Agency Relationships." Paraphrasing the statute, it states the duties of the seller's agent and the buyer's agent, and then deals with the case where the same agent represents both. That is legal, it states, only with the knowledge and consent of both seller and buyer. The dual agent has "a fiduciary duty of utmost care, integrity, honesty and


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DISCLOSURE OF DUAL AGENCY (*continued*)

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loyalty in the dealings with either the Seller or the Buyer," and may not, without express permission, disclose to the buyer that the seller will take less than the listing price, or that the buyer will pay more than the amount offered. Barbara gave this document to Brown and directed him to sign it, but he did not know what it was. He thought it was merely a form to facilitate consummation of the transaction.

Paragraph 17 of the escrow instructions, located at page 16 of that document, recites that "FSR is the agent of both the Buyer and the Seller. Sid and Barbara are the listing agents and Sid is the selling agent." Another document, titled "Commission Instructions," instructed escrow to pay FSR $ 120,000 in commissions, and stated: "Listing agents (Sid/Barbara) shall receive $ 60,000.00. Selling agent (Sid) shall receive $ 60,000.00." Brown initialed these pages, but did not read them. There was no discussion about them.

Sid heard from Doyle, the Chicago attorney apparently in charge of Lafferty's legal representation, on the evening of Friday, May 31, 1996. Doyle said that his client, Lafferty, wanted a home and was unhappy with the brokers with whom he had been dealing for the last nine months. According to Sid, Doyle "wanted me to roll up my sleeves and try to find him a house to lease for him and his 11 dogs." Asked, "So it was your understanding that Mr. Lafferty wanted to stop using the services of his other brokers and start using your services," Sid answered, "That's correct." That was the understanding he gained from his discussion with Doyle, "and the following day, when Mr. Lafferty—he expressed the same thing to me."

Sid met with Forbess, learned what the Lafferty side wanted to pay and gained an understanding of what it would pay, and promised Forbess to try to work Brown down to $ 2.4 million. He specifically told Forbess that if Lafferty would offer $ 2.4 million he thought Brown would accept it.

Sid declared that when he showed the property to Lafferty, Sid "verbally told plaintiff Harry Brown that I was representing Mr. Lafferty." As we have seen, Brown denies this. According to Brown, he learned of the dual agency from his girlfriend, several days after the close of escrow, when she was leafing


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DISCLOSURE OF DUAL AGENCY (*continued*)

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through the transaction documents. He had never consented to a dual agency.

Brown filed suit against FSR and Sid in August 1996. The issue was joined and, after discovery, defendants moved for full summary judgment. The motion was opposed and was ultimately granted. In it, the court states that the evidence submitted establishes that FSR advised Brown that it was acting as a dual agent and not to accept less than the listing price for the property, but that Brown himself directly told the buyer what his bottom price was. As a result, the court concluded, FSR breached no duty to Brown and did not cause him any damage.

Judgment was duly entered, and a timely notice of appeal was filed.

Court of Appeal of California, Second Appellate District, Division Four Judge J. Epstein responded:

"Common sense and ancient wisdom join the law in teaching that an agent is not permitted to simultaneously serve two principals whose interests conflict about the matter served—at least, not without full disclosure and consent from both. In the context of brokered real estate transactions, this principle is codified in Civil Code sections 2079.14 and 2079.16."

Civil Code section 2079.14, a 1995 statute that was in force at the time of the representation and acts at issue here, provides: "Listing agents and selling agents shall provide the seller and buyer in a real property transaction with a copy of the disclosure form specified in Section 2079.16, and, except as provided in subdivision (c), shall obtain a signed acknowledgment of receipt from that seller or buyer, except as provided in this section or Section 2079.15, as follows: "(a) The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement.

"(b) The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form pursuant to subdivision (a).


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DISCLOSURE OF DUAL AGENCY (*continued*)

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"(c) Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be furnished to the seller (and acknowledgment of receipt obtained for the selling agent from the seller) by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his or her last known address, in which case no signed acknowledgment of receipt is required.

"(d) The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer."

The referenced provision, Civil Code section 2079.16, provides: "The disclosure form required by Section 2079.14 shall have Sections 2079.13 to 2079.24, inclusive, excluding this section, printed on the back, and on the front of the disclosure form the following shall appear: "Disclosure Regarding Real Estate Agency Relationship (As required by the Civil Code).

"When you enter into a discussion with a real estate agent regarding a real estate transaction, you should from the outset understand what type of agency relationship or representation you wish to have with the agent in the transaction."

The duty of a real estate agent to faithfully represent the interests of his or her principal, and to make full disclosure of adverse interests, long antedated this statute. Breach of these duties may result in loss of the right to compensation. (See [*18] *Baird v. Madsen* (1943) 57 Cal. App. 2d 465, 475 [134 P.2d 885]; *Sierra Pacific Industries v. Carter* (1980) 104 Cal. App. 3d 579, 582 [163 Cal. Rptr. 764].)

It should be noted that the statute requires disclosure to the seller "as soon as practicable *prior* to presenting the seller with an offer to purchase" unless disclosure already had been made. (Civ. Code, § 2079.14, subd. (b), italics


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DISCLOSURE OF DUAL AGENCY (*continued*)

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added.) The contemplated disclosure is to be in writing. The only written disclosures in this case were made when the escrow instructions were signed. Sid claims to have informed Brown, orally, that he was representing Lafferty when he first brought Lafferty over to see the property. But Brown denies that this occurred, leaving an unresolved triable issue of material fact.

The trial court emphasized evidence that Brown took charge of the negotiations himself, and personally informed Forbess of his bottom-line price. Again, Brown denies it, leaving the issue unresolved and unresolvable for purposes of summary judgment. But even if the claim were to be credited, it would not resolve the issue in respondents' favor. According to Brown, it was Sid who talked him into agreeing to the $ 2.4 million price, against Brown's better judgment. He did this, again according to Brown's evidence, while repeatedly reassuring Brown that he was acting for Brown alone, and without disclosing that he also was acting for Lafferty. He particularly did not disclose that he had promised Forbess to try to talk Brown down to $ 2.4 million and that he had informed Forbess that that was as low as Brown would go.

Even in a consented dual agency situation, the statute specifically forbids the agent from disclosing to the buyer, without express permission from the seller, that the seller will accept less than the listing price. (Civ. Code, § 2079.21.) Based on Forbess's testimony, that is substantially what Sid did.

Respondents argue that the documents signed or initialed by Brown include adequate disclosures, and that it was his decision not to read them. It is, of course, true that *"when a person with the capacity of reading and understanding an instrument signs it, he may not, in the absence of fraud, coercion or excusable neglect, avoid its terms on the ground he failed to read it before signing it." (Bolanos v. Khalatian* (1991) 231 Cal. App. 3d 1586, 1590 [283 [*20] Cal. Rptr. 209].)

There are at least two reasons this doctrine is not sufficient to secure victory to respondents. First, the statute and common sense require that the dual agent call attention to the fact of dual agency, and Brown has submitted

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DISCLOSURE OF DUAL AGENCY (*continued*)

Harry Brown, Plaintiff and Appellant, v. FSR Brokerage, Inc., et al., Defendants and Respondents

substantial evidence that they failed to do so. He was not on notice that any of the documents he signed or initialed was anything other than a routine instrument technically required for consummation of the sales transaction. Second, by the time the escrow papers were being signed, Brown already had "broken" HIS PRICE: he could hardly then demand a greater price, particularly since, so far as the record discloses, the buyer was guilty of no impropriety except through his dual agent.

Respondents argue, and convinced the trial court, that disclosure would not have made a difference because Lafferty would not have paid more than $ 2.4 million. They cite Forbess's testimony at deposition that Lafferty would have had to fight Forbess in order to go higher. There is, however, substantial evidence that a higher price would have been achieved.

First, the asking price of $ 2,495,000 is only 3.8 percent greater than the sales price.

Second, Lafferty had an urgent need for a suitable residence to house himself and his passel of dogs: He was demanding occupancy for himself and ouster of the resident-owner, all within a few days.

Third, Lafferty himself had made it clear to Forbess that it was his money and that he was going to buy the place.

Finally, respondents argue that appellant Brown has waived his claims because he did not seek to rescind the real estate transaction. They cite two cases. Neither supports them. The first, *Vice v. Thacker* (1947) 30 Cal. 2d 84 [180 P.2d 4], is a dual agency case in which the seller *did* rescind. The case does not deal with remedies other than those related to rescission. The other case, cited as a "see also," is *Gordon v. Beck* (1925) 196 Cal. 768 [239 P. 309]. It too deals with the right to rescind and nothing else. Brown has not sought to rescind the sale of his property to Lafferty. We see no reason why he was compelled to seek rescission. He has, instead, chosen to sue the dual agent, Sid, and the broker, FSR, for losses he claims to have suffered because he relied on their advice unaware that they were representing both sides of an

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DISCLOSURE OF DUAL AGENCY (*continued*)

Harry Brown, Plaintiff and Appellant, v. FSR Brokerage, Inc., et al., Defendants and Respondents

adversarial transaction.

We end our discussion as we began it: To the degree Brown can prove a monetary loss on account of actions and failures to act by respondents, he is entitled to appropriate monetary recovery. The amount is not an issue before us, and we do not address it. We hold, only, that respondents were not entitled to summary judgment and that appellant is entitled to have the ensuing judgment in their favor reversed.

Disclosure Regarding Real Estate Agency Relationship
(As required by the Civil Code)

When you enter into a discussion with a real estate agent regarding a real estate transaction, you should from the outset understand what type of agency relationship or representation you wish to have with the agent in the transaction.

Seller's Agent

A Seller's agent under a listing agreement with the Seller acts as the agent for the Seller only. A Seller's agent or a subagent of that agent has the following affirmative obligations:

To the Seller:
A fiduciary duty of utmost care, integrity, honesty, and loyalty in dealings with the Seller.

To the Buyer and the Seller:
(a) Diligent exercise of reasonable skill and care in performance of the agent's duties.
(b) A duty of honest and fair dealing and good faith.
(c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties.

An agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.

Buyer's Agent

A selling agent can, with a Buyer's consent, agree to act as agent for the Buyer only. In these situations, the agent is not the Seller's agent, even if by agreement the agent may receive compensation for services rendered, either in full or in part from the Seller. An agent acting only for a Buyer has the following affirmative obligations:

To the Buyer:
A fiduciary duty of utmost care, integrity, honesty, and loyalty in dealings with the Buyer.

To the Buyer and the Seller:

(a) Diligent exercise of reasonable skill and care in performance of the agent's duties.
(b) A duty of honest and fair dealing and good faith.
(c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties. An agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.

Agent Representing Both Seller and Buyer

A real estate agent, either acting directly or through one or more associate licensees, can legally be the agent of both the Seller and the Buyer in a transaction, but only with the knowledge and consent of both the Seller and the Buyer.

In a dual agency situation, the agent has the following affirmative obligations to both the Seller and the Buyer:

(a) A fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either the Seller or the Buyer.
(b) Other duties to the Seller and the Buyer as stated above in their respective sections.

In representing both Seller and Buyer, the agent may not, without the express permission of the respective party, disclose to the other party that the Seller will accept a price less than the listing price or that the Buyer will pay a price greater than the price offered.

The above duties of the agent in a real estate transaction do not relieve a Seller or Buyer from the responsibility to protect his or her own interests. You should carefully read all agreements to assure that they adequately express your understanding of the transaction.

A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.

Throughout your real property transaction you may receive more than one disclosure form, depending upon the number of agents assisting in the transaction. The law requires each agent with whom you have more than a casual relationship to present you with this disclosure form. You should read its contents each time it is presented to you, considering the relationship between you and the real estate agent in your specific transaction.

"A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional."

This disclosure form includes the provisions of Sections 2079.13to 2079.24, inclusive, of the Civil Code set forth on the reverse hereof. Read it carefully.

Agent (Signature)	Date	Buyer/Seller (Signature)	Date
Associate Licensee (Signature)	Date	Buyer/Seller (Signature)	Date

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

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

"As soon as practicable, the listing agent shall disclose to the seller whether the listing agent is acting in the real property transaction exclusively as the seller's agent, or as a dual agent representing both the buyer and seller."

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

________________________ is the agent of (check one):
(Name of Listing Agent)
( ) the seller exclusively; or
( ) both the buyer and seller.

________________________ is the agent of (check one):
(Name of Selling Agent if not the same as the Listing Agent)
( ) the buyer exclusively; or
( ) the seller exclusively; or
( ) both the buyer and seller.

No selling agent in a real property transaction may act as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction.

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

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

A dual agent shall not disclose to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. A dual agent shall not disclose to the seller that the buyer is willing to pay a price greater than the offering price, without the express written consent of the buyer.

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

Fiduciary duties include, among others, loyalty; confidentiality; the exercise of utmost care (and in certain fact situations, reasonable care); full and complete disclosure of all material facts; the obligation to account to the principal; the obligation to act fairly and honestly and without fraud or deceit; and the duty to "explain" and "counsel" about that which has been disclosed or should have been disclosed thereby permitting the principal to make an informed and considered decision to buy, sell, lease, exchange, borrow or lend.

Listing agents and selling agents shall provide the seller and buyer in a real property transaction with a copy of the Disclosure Regarding Real Estate Agency Relationships and obtain a signed acknowledgment of receipt from that seller or buyer as follows:

The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement (CC 2079.14.(a)).

The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form pursuant to subdivision (a) above (CC 2079.14.(b)).

Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be furnished to the seller (and acknowledgment of receipt obtained for the selling agent from the seller) by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his or her last known address, in which case no signed acknowledgment of receipt is required (CC 2079.14.(c)).

The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer (CC 2079.14.(d)).

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

Many real property disclosures are required for properties in California. Even though many states in the United States are just beginning to require property disclosures, California has been on the forefront of disclosure requirements.

The Real Estate Agency Relationships Disclosure is designed to inform the buyer and seller regarding WHO their agent is in the transaction and WHAT TYPE of agency relationship exists between them and the broker(s) involved in the transaction.

Disclosure Regarding Real Estate Agency Relationships (C.A.R. form AD) Must Be Delivered on Commercial Transactions

Presently, the Disclosure Regarding Real Estate Agency Relationships form (C.A.R.'s AD form) is required for real property transactions involving residential one to four dwelling units, leases of greater than one year and manufactured homes (if negotiated by an agent). Existing law also requires the listing or selling agent to disclose to the buyer and seller whether he or she is acting as the buyer's agent exclusively, the seller's agent exclusively, or as a dual agent representing both the buyer and the seller. This disclosure is typically made through the confirmation of agency relationships on the first page of CAR purchase agreements.

Under the law, the AD form and confirmation is required for any commercial, vacant land or industrial property; or any residential 1 - 4 property.

Senate Bill 1171 codified as Civil Code §2079.13. Effective January 1, 2015.

Next is a look at a significant court case that examines dual agency and resulting contract rescission.


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AGENCY DISCLOSURE AND CONTRACT RESCISSION

Huijers v. DeMarrais (1992)

LEENDERT P. HUIJERS, Plaintiff, Cross-defendant and Respondent,
v.
GORDON R. DeMARRAIS et al., Defendants, Cross-complainants and Appellants.

No. B060090
COURT OF APPEAL OF CALIFORNIA, SECOND APPELLATE DISTRICT, DIVISION SIX.
11 Cal. App. 4th 676; 14 Cal. Rptr. 2d 232; 1992 Cal. App. LEXIS 1419; 92 Cal. Daily Op. Service 9881; 92 Daily Journal DAR 16526
December 9, 1992, Decided

JUDGES

Opinion by Gilbert, J., with Stone S. J., P. J., concurring. Separate dissenting opinion by Yegan, J.

APPELLATE COURT OPINION

The real estate agency disclosure statute, Civil Code section 2374, says nothing about a failure to comply. A statute without a remedy might as well be written in invisible ink. We conclude the common law provides a remedy for failure to comply with section 2374.

A real estate agent representing both a buyer and seller in a transaction must provide a disclosure statement to both buyer and seller. (§ 2374.) Subdivision (a) of that section requires the real estate agent seeking to list residential property for sale to provide the seller with the agency relationship disclosure form prior to entering into a listing agreement.

We reverse. (The appellate court reversed the trial court's judgment and


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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

said:) “Here, an agent who represents a buyer interested in seller's property enters into a listing agreement with seller. The agent fails to provide the disclosure form to the seller prior to entering into the listing agreement. We hold that under these circumstances the listing agreement is voidable at seller's option.”

FACTS OF THE CASE

Leendert Huijers owned a nursery business in Huntington Park. He wished to relocate the business to Santa Barbara County. He sold his nursery in April 1987. The contract gave him until July 31, 1988, to find a replacement property to qualify for a tax-deferred real estate exchange. Until then he would continue to operate the Huntington Park nursery. The July closing date, however, would ultimately be extended to September.

After having looked at a number of properties, in July of 1988 Huijers retained Justine Larson, a real estate broker. Larson telephoned Gordon and George Ann DeMarrais, who owned a parcel of property in Lompoc. Part of the parcel contained a residence, and the remainder was used as a nursery. The DeMarraises told her they were willing to talk about selling their land, and they met with her on August 8.

At the August 8 meeting, Larson told the DeMarraises that she had a client who was interested in buying their property. The DeMarraises signed an exclusive right to sell listing agreement. The listing price was $ 325,000. The DeMarraises were willing to accept a note secured by a trust deed on the property as part of the purchase price. The price was determined solely by the DeMarraises.

Larson told them that under the agreement they would owe 6 percent commission if she found a buyer who would pay the listing price. Larson did not provide the DeMarraises with an agency disclosure statement prior to or at the time the listing agreement was signed. (§ 2373 et seq.)

On August 13 Larson called the DeMarraises and told them her Huntington Park client would be making an offer within a week. On August 20, prior

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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

having received any offer, the DeMarraises told Larson they wanted to increase the asking price to $ 375,000. Larson did not agree to do so, but replied that she would ask her father, who was also a real estate broker.

Huijers had been planning to offer $ 275,000. After he learned of the DeMarraises' desire to raise the asking price, he instructed Larson to prepare an offer that met the $ 325,000 listing price and terms.

Huijers, Larson and the DeMarraises met at the DeMarrais home on August 22. Huijers and Larson brought the proposed contract with them. Huijers told the DeMarraises that if they did not want to hear his offer at $ 325,000, he would leave. The DeMarraises decided to listen to the offer.

At one point early in the negotiations, one of the DeMarraises asked why they could not raise the price. Huijers responded it was his understanding of California law that once a broker has found a ready, willing and able buyer, she has done her job, and the DeMarraises would have to pay her commission.

The negotiations lasted for about seven to eight hours. At the end, the DeMarraises agreed to sign a contract. Upon signing, Gordon DeMarrais said, "... I have to pay the commission anyway."

It was only at the time of the signing of the purchase contract that the DeMarraises received the agency disclosure statement required to be given to them prior to signing the listing agreement. The purchase contract included a statement that Larson was acting as a dual agent for both buyer and seller.

The morning after the contract was signed, the DeMarraises' attorney called Huijers and Larson and told them the DeMarraises had rescinded. Huijers filed a complaint against the DeMarraises for specific performance and damages. The DeMarraises cross-complained against Huijers and Larson for fraud, negligent misrepresentation, breach of fiduciary duty, rescission and declaratory relief.

On August 13 Larson called the DeMarraises and told them her Huntington


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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

Park client would be making an offer within a week. On August 20, prior to After a nonjury trial, the court found Huijers' statement concerning Larson's right to a commission was a correct statement of law; at no time did Huijers or Larson make any misrepresentation in order to induce the DeMarraises to sign the purchase agreement; and the contract is valid and specific performance was the proper remedy. The trial court also awarded Huijers damages of $ 39,900 for tax liabilities incurred because of his inability to carry out a tax-deferred exchange, $ 36,400 for lost profits and $ 134,996.72 in attorney fees and costs.

DISCUSSION

The DeMarraises contend Larson's failure to provide them with an agency relationship disclosure statement prior to entering into the listing agreement made the listing agreement voidable. Thus, they argue, their signatures on the sales contract were obtained through the misrepresentation that they were liable for Larson's commission even if they did not sign the contract.

For residential real estate sales, a real estate agent is required by statute to make certain disclosures about the agent's duties to the parties and about which party or parties to the transaction the agent is representing. (§ 2373 et seq.)

Section 2374, subdivision (a), provides that "[t]he listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement." The disclosure is required to be made in the form set forth in section 2375. The form lists the duties of the seller's agent, the buyer's agent and advises that a real estate agent may represent both seller and buyer in a transaction. It also contains the warning that "[t]he above duties of the agent in a real estate transaction do not relieve a Seller or Buyer from the responsibility to protect their own interests."

The form set forth in section 2375 gives buyers and sellers of real estate general information about a real estate agent's duties, and points out the fiduciary responsibility of the agent. Information about whether an agent represents both buyer and seller may not always be known prior to the seller


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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

signing the listing agreement. Section 2375.5 therefore requires the listing agent to disclose "[a]s soon as practicable" whether the agent is representing the seller only or both the seller and buyer.

There is no dispute that Larson failed to provide the DeMarraises with the disclosure form required by section 2375 prior to entering into the listing agreement. Huijers contends, however, that Larson was in substantial compliance with the law by providing the disclosure form at the time the purchase contract was signed.

The objective of a statute requiring a disclosure prior to signing the listing agreement is to allow the seller to make a more intelligent decision about whether to sign. For example, the property owner who is asked to sign a listing agreement because the broker has a buyer for the property may not fully comprehend that the broker intends to act as a dual agent. Because the seller pays the broker's commission, the seller may reasonably believe the broker has only the seller's best interest at heart and is working exclusively for the seller.

The disclosure form tells the property owner that a broker can act as a dual agent. Thus advised, the seller may wish to sell the property through his or her own agent or to seek independent advice on the price and terms of the listing.

The full measure of protection that the Legislature intended to provide to the seller cannot be achieved if the listing agent fails to provide the disclosure form prior to entering into the listing agreement. Because a reasonable objective of the statute is to give the seller information prior to signing the listing agreement, providing a disclosure form after the seller signs the agreement is not substantial compliance.

Huijers's reliance on subdivision (b) of section 2374 is misplaced. In contrast to subdivision (a), which requires a "listing agent" to provide the seller with a disclosure prior to entering into the listing agreement, subdivision (b) requires a "selling agent" to provide the seller with a disclosure form "as soon as

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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

practicable prior to presenting the seller with an offer to purchase, unless the Contrary to the position taken by the dissent, it is not enough to disclose only the fact of dual representation. The agent must also disclose all facts which would reasonably affect the judgment of each party in permitting the dual representation. (2 Witkin, Summary of Cal. Law (9th ed. 1987) Agency & Employment, § 56, p. 64.) We read section 2375 as a legislative determination that the information required to be disclosed alerts the parties to the potentially harmful consequences of dual representation, so they can make an informed judgment.

Nor do we believe our Legislature intended the remedy for violation of the statute to be confined to discipline by the Commissioner of Real Estate. Such a statute providing exclusively for discipline against a licensee would ordinarily be found in the Business and Professions Code and not the Civil Code. For example, Business and Professions Code section 10176, subdivision (d) provides that the commissioner may discipline a real estate licensee for "[a]cting for more than one party in a transaction without the knowledge and consent of all parties thereto."

The failure to disclose prior to entering into the listing agreement, relieved the DeMarraises from the obligation to pay their agent's commission. This failure to disclose, however, does not in itself relieve the DeMarraises from their obligation under the purchase contract. That is because the disclosure statement was ultimately given to them just before they signed the purchase contract. Nevertheless, they may be entitled to rescission of the purchase contract. Huijers's statement that the DeMarraises would have to pay Larson's commission was incorrect. Because the trial court erroneously found that Huijers's statement was correct, we must reverse for further findings on whether under the circumstances the misstatement constituted grounds for rescission.

We do not mean to say that the failure to provide a disclosure form will always result in a voidable listing agreement. A seller, for example, who has sufficient knowledge concerning the information contained in the disclosure form may be held to the listing agreement even though he or she did not

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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

receive the disclosure form.

There is no evidence here, however, that the DeMarraises had such knowledge. Larson's statement that she represented a client who was interested in buying the DeMarraises' property does not disclose all the information mandated by section 2375. Nor is the trial court's finding that the DeMarraises had "considerable knowledge and experience with respect to real estate and other transactions" equivalent to a finding that the DeMarraises had sufficient knowledge to make the disclosure form superfluous.

The judgment is reversed. Costs on appeal are awarded to appellants.

Stone S. J., P. J., concurred.

DISSENT BY: YEGAN, J.

I respectfully dissent. Justine Larson, a real estate broker, was retained by Leendert P. Huijers to find a nursery which would qualify for a tax deferred exchange for his existing nursery in Huntington Park. Larson located a property, owned by Gordon and George Anne DeMarrais, which had both a nursery and a residence. Larson expressly told the DeMarraises that she had a "client" who was interested in buying their property. The DeMarraises *alone* set the listing price at $ 325,000. Larson told them that if she brought them a buyer at that price, she would earn a 6 percent commission. The DeMarraises did not object and signed a written contract listing the property on these terms. Larson, however, did not provide a written dual agency disclosure statement.

Thereafter, Larson advised the DeMarraises that her "client" would be making an offer. Thus, she had already begun to perform her contract with the DeMarraises. Thereafter, the DeMarraises indicated that they wanted to raise the listing price to $ 375,000. Larson did not agree to modify the written contract that she had with them. (Civ. Code, § 2381.) When Larson told Huijers that the DeMarraises wanted to raise the price, Huijers, who had planned to offer $ 275,000, told Larson to prepare a full price offer of $ 325,000.

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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

When Huijers, Larson, and the Demarraises met, Huijers expressly told the DeMarraises that if they did not want to hear his $ 325,000 offer, he would leave. The Demarraises told Huijers to stay and the $ 325,000 full price offer was presented. An eight-hour bargaining session ensued. The DeMarraises asked why they couldn't raise the price. Huijers said that it was his understanding of California law that once a broker brought a willing and able buyer at the listing price, the seller was obligated to pay a commission whether the sale was consummated or not.

The DeMarraises abandoned the $ 375,000 price and accepted Huijers's offer. In doing so, Mr. Demarrais said, "... I have to pay the commission anyway." Larson then provided the DeMarraises with the written dual agency disclosure statement.

Long before the written agency disclosure statutes were enacted (Civ. Code, § 2373 et seq.), the California Supreme Court indicated: "[W]here an agent has assumed to act in a double capacity, a principal who has no knowledge of such dual representation ... may avoid the transaction. ... Such conduct is a fraud upon his [the agent's] principal ...." (*McConnell v. Cowan* (1955) 44 Cal.2d 805, 809 [285 P.2d 261].)

Relying on *McConnell v. Cowan, supra*, the majority hold that failure to provide the written disclosure statement relieves the seller from the obligation to pay the commission. The effect of this holding, in the majority of cases, works an unnecessary modification of the Statute of Frauds. (Civ. Code, § 1624, subds. (c) and (d).)

The salutory rule announced in *McConnell v. Cowan*, *supra*, does not compel reversal in this case. Here, Larson disclosed her dual agency relationship to the DeMarraises, albeit not in the written form required. On at least two occasions, she referred to her "client" who wanted to purchase the property.

The trial court expressly found that Larson committed no fraud and that she represented "... the interests of both plaintiff and defendants in a fair and neutral manner." The DeMarraises, experienced in real estate transactions,

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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

Huijers v. DeMarrais (1992)

knew that Larson was not their exclusive agent. The trial court expressly found that "... her role as a dual agent was fully disclosed to Defendants." Substantial evidence supports this determination.

There is a causation problem in the majority's analysis. The majority indicate that the failure to make the written disclosure relieved the DeMarraises of the duty to pay the commission and Huijers's opinion to the contrary may have been the cause of the DeMarraises entering into the contract. Not so. The trial court expressly found that the DeMarraises knew of the dual agency, alone set the initial price of $ 325,000, and after an eight-hour bargaining session, agreed to this price as well as other terms and conditions. Huijers initially indicated he would leave if the DeMarraises wanted him to do so. After the marathon bargaining session, Huijers suggested that they sleep on it and consult an attorney. In signing the real estate contract, Mr. DeMarrais said that he had planned to sell the property and "... that it was basically a fairly good deal."

The trial court impliedly, if not expressly, found that the failure to provide the written disclosure did not cause the DeMarraises to sell for the $ 325,000 price. This finding is supported by substantial evidence and the reasonable inferences which can and should be drawn therefrom. The DeMarraises have not demonstrated to the contrary as a matter of law. It is a question of fact whether failure to disclose is the proximate cause of damages. (*Montoya v. McLeod* (1985) 176 Cal.App.3d 57, 65 [221 Cal.Rptr. 353].)

If a broker fails to make a written disclosure of dual agency, the seller must still prove that he would not have entered into the transaction but for the failure to make the written disclosure. Where, as here, he does not do so, he must sell the property.

Inherent in this analysis is my disagreement with the majority that failure to provide the written disclosure of dual agency discharges the seller's duty to pay a real estate commission. No one coerced the DeMarraises into signing the listing agreement at the $ 325,000 price and it is speculative whether they would have conducted themselves differently had the written disclosure been


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AGENCY DISCLOSURE AND CONTRACT RESCISSION (*continued*)

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been made. The DeMarraises could not unilaterally change the listing agreement. (Civ. Code, § 2381.)

"[I]f a broker produces a buyer on terms set out in his listing agreement, and the seller refuses to perform, the broker may recover his commission on his contract with the seller." (*Seck v. Foulks* (1972) 25 Cal.App.3d 556, 569 [102 Cal.Rptr. 170].) In the absence of fraud, failure to provide written disclosure of dual agency should not change the rule announced in *Seck*, *supra*. Not every violation of a statute creates a private cause of action. (*Moradi-Shalal v. Fireman's Fund Ins. Companies* (1988) 46 Cal.3d 287, 204 [250 Cal.Rptr. 116, 758 P.2d 58].) A fortiori, violation of a statute does not inexorably create a defense to a civil action.

This case was bitterly contested from the outset and the attorney fees spent thereon are a testament to the fact that an early settlement would have been in everyone's best interest. The trial court issued a 29-page statement of decision which exhaustively and fairly decided the dispute. The judgment should be affirmed in its entirety.

Respondent's petition for review by the Supreme Court was denied March 11, 1993. Lucas, C. J., Mosk, J. and Panelli, J., were of the opinion that the petition should be granted.

Agency laws and disclosures are important knowledge areas for the real estate practitioner. An understanding of their requirements will keep the real estate agent out of unnecessary litigation and cashing more commission checks.

This concludes our three (3) hour continuing education course in Agency.

Ethics, Professional Conduct, and Legal Aspects of Real Estate

Real estate professionals in California are constantly faced with decisions that require **ethical and professional responses**; and this is not an easy task. Every real estate transaction is unique, and real estate professionals must be "fast on their feet" in order to consummate real estate transactions and institute real estate loans. In so doing, real estate professionals must create these "deals" within an ethical framework. This framework is delineated through **Business and Professions Code Sections 10176 and 10177**. It is also covered within relevant case law that will be presented at the end of this course.

Business and Professions Code Section 10176

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

> "The Real Estate Commissioner may temporarily suspend or permanently revoke a real estate license at any time."

(a) Making any substantial **misrepresentation**.

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

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

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

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

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

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

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

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

(j) Obtaining the signature of a prospective purchaser to an agreement which provides that such prospective purchaser shall either transact the purchasing, leasing, renting or exchanging of a business opportunity property through the broker obtaining such signature, or pay a compensation to such broker if such property is purchased, leased, rented or exchanged without the broker first having obtained the written authorization of the owner of the property concerned to offer such property for sale, lease, exchange or rent.

Section 10176.1. (a)
(1) Whenever the Commissioner takes any enforcement or disciplinary action against a licensee, and the enforcement or disciplinary action is related to escrow services provided pursuant to paragraph (4) of subdivision (a) of Section 17006 of the Financial Code, upon the action becoming final the Commissioner shall notify the Insurance Commissioner and the Commissioner of Corporations of the action or actions taken. The purpose of this notification is to alert the departments that enforcement or disciplinary action has been taken, if the licensee seeks or obtains employment with entities regulated by the departments.

(2) The California Bureau of Real Estate Commissioner shall provide the Insurance Commissioner and the Commissioner of Corporations, in addition to the notification of the action taken, with a copy of the written accusation, statement of issues, or order issued or filed in the matter and, at the request of the Insurance Commissioner or the Commissioner of Corporations, with any underlying factual material relevant to the enforcement or disciplinary action. Any confidential information provided by the Commissioner to the Insurance Commissioner or the Commissioner of Corporations shall not be made public pursuant to this section. Notwithstanding any other provision of law, the disclosure of any underlying factual material to the Insurance Commissioner or the Commissioner of Corporations shall not operate as a waiver of confidentiality or any privilege that the Commissioner may assert.

(b) The Commissioner shall establish and maintain, on the Web site maintained by the Bureau of Real Estate, a database of its licensees, including those who have been subject to any enforcement or disciplinary action that triggers the notification requirements of this section. The database shall also contain a direct link to the databases, described in Section 17423.1 of the Financial Code and Section 12414.31 of the Insurance Code and required to be maintained on the Web sites of the Department of Corporations and the Department of Insurance, respectively, of persons who have been subject to enforcement or disciplinary action for malfeasance or misconduct related to the escrow industry by the Insurance Commissioner and the Commissioner of Corporations.

(c) There shall be no liability on the part of, and no cause of action of any nature shall arise against, the State of California, the Bureau of Real Estate, the Real Estate Commissioner, any other state agency, or any officer, agent, employee, consultant, or contractor of the state, for the release of any false or unauthorized information pursuant to this section, unless the release of that information was done with knowledge and malice, or for the failure to release any information pursuant to this section.

10176.5. (a) The Commissioner may, upon his or her own motion, and shall upon receiving a verified complaint in writing from any person, investigate an alleged violation of Article 1.5 (commencing with Section 1102) of Chapter 2 of Title 4 of Part 4 of Division 2 of the Civil Code by any real estate licensee within this state. The Commissioner may suspend or revoke a licensee's license if the licensee acting under the license has willfully or repeatedly violated any of the provisions of Article 1.5 (commencing with Section 1102) of Chapter 2 of Title 4 of Part 4 of Division 2 of the Civil Code.

Business and Professions Code Section 10177

10177. The Commissioner may suspend or revoke the license of a real estate licensee, or may deny the issuance of a license to an applicant, who has done any of the following, or may suspend or revoke the license of a corporation, or deny the issuance of a license to a corporation, if an officer, director, or person owning or controlling 10 percent or more of the corporation's stock has done any of the following:

> "The Real Estate Commissioner may suspend or revoke the license of a real estate licensee, or may deny the issuance of a license to an applicant."

(a) Procured, or attempted to procure, a real estate license or license renewal, for himself or herself or any salesperson, by fraud, misrepresentation, or deceit, or by making any **material misstatement** of fact in an application for a real estate license, license renewal, or reinstatement.

(b) Entered a **plea of guilty** or **nolo contendere** to, or been found guilty of, or been convicted of, a felony or a crime involving **moral turpitude**, and the time for appeal has elapsed or the judgment of conviction has been affirmed on appeal, irrespective of an order granting probation following that conviction, suspending the imposition of sentence, or of a subsequent order under Section 1203.4 of the Penal Code allowing that licensee to withdraw his or her plea of guilty and to enter a plea of not guilty, or dismissing the accusation or information.

(c) Knowingly authorized, directed, connived at, or aided in the publication, advertisement, distribution, or circulation of any material false statement or representation concerning his or her business, or any business opportunity or any land or subdivision (as defined in Chapter 1 (commencing with Section 11000) of Part 2) offered for sale.

(d) Willfully disregarded or violated the Real Estate Law (Part 1 (commencing with Section 10000)) or Chapter 1 (commencing with Section 11000) of Part 2 or the rules and regulations of the Commissioner for the administration and enforcement of the Real Estate Law and Chapter 1 (commencing with Section 11000) of Part 2.

(e) Willfully used the term "**Realtor**" or any trade name or insignia of membership in any real estate organization of which the licensee is <u>not</u> a member.

(f) Acted or conducted himself or herself in a manner that would have warranted the denial of his or her application for a real estate license, or has either had a license denied or had a license issued by another agency of this state, another state, or the federal government revoked or suspended for acts that, if done by a real estate licensee, would be grounds for the suspension or revocation of a California real estate license, if the action of denial, revocation, or suspension by the other agency or entity was taken only after giving the licensee or applicant fair notice of the charges, an opportunity for a hearing, and other due process protections comparable to the Administrative Procedure Act (Chapter 3.5 (commencing with Section 11340), Chapter 4 (commencing with Section 11370), and Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code), and only upon an express finding of a violation of law by the agency or entity.

(g) Demonstrated **negligence** or **incompetence** in performing any act for which he or she is required to hold a license.

(h) As a broker licensee, failed to exercise **reasonable supervision** over the activities of his or her salespersons, or, as the officer designated by a corporate broker licensee, failed to exercise reasonable supervision and control of the activities of the corporation for which a real estate license is required.

(i) Has used his or her employment by a governmental agency in a capacity giving access to records, other than public records, in a manner that violates the confidential nature of the records.

(j) Engaged in any other conduct, whether of the same or a different character than specified in this section, which constitutes fraud or dishonest dealing.

(k) Violated any of the terms, conditions, restrictions, and limitations contained in any order granting a **restricted license**.

(l) Solicited or induced the sale, lease, or listing for sale or lease of residential property on the ground, wholly or in part, of loss of value, increase in crime, or decline of the quality of the schools due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry, or national origin.

(m) Violated the Franchise Investment Law (Division 5 (commencing with Section 31000) of Title 4 of the Corporations Code) or regulations of the Commissioner of Corporations pertaining thereto.

(n) Violated the Corporate Securities Law of 1968 (Division 1 (commencing with Section 25000) of Title 4 of the Corporations Code) or the regulations of the Commissioner of Corporations pertaining thereto.

(o) Failed to disclose to the buyer of real property, in a transaction in which the licensee is an agent for the buyer, the nature and extent of a licensee's direct or indirect ownership interest in that real property. The direct or indirect ownership interest in the property by a person related to the licensee by blood or marriage, by an entity in which the licensee has an ownership interest, or by any other person with whom the licensee has a **special relationship** shall be disclosed to the buyer.

(p) Violated Section 10229. If a real estate broker that is a corporation has not done any of the foregoing acts, either directly or through its employees, agents, officers, directors, or persons owning or controlling 10 percent or more of the corporation's stock, the Commissioner may not deny the issuance of a real estate license to, or suspend or revoke the real estate license of, the corporation, provided that any offending officer, director, or stockholder, who has done any of the foregoing acts individually and not on behalf of the corporation, has been completely disassociated from any affiliation or ownership in the corporation.

10177.1. The Commissioner may, without a hearing, suspend the license of any person who procured the issuance of the license to himself by fraud, misrepresentation, deceit, or by the making of any material misstatement of fact in his application for such license. The power of the Commissioner under this section to order a suspension of a license shall expire 90 days after the date of issuance of said license and the suspension itself shall remain in effect only until the effective date of a decision of the Commissioner after a hearing conducted pursuant to Section 10100 and the provisions of this section. A statement of issues as defined in Section 11504 of the Government Code shall be filed and served upon the respondent with the order of suspension. Service by certified or registered mail directed to the respondent's current address of record on file with the Commissioner shall be effective service. The respondent shall have 30 days after service of the order of suspension and statement of issues in which to file with the Commissioner a written request for hearing on the statement of issues filed against him. The Commissioner shall hold a hearing within 30 days after receipt of the request therefore unless the respondent shall request or agree to a continuance thereof. If a hearing is not commenced within 30 days after receipt of the request for hearing or on the date to which continued with the agreement of respondent, or if the decision of the Commissioner is not rendered within 30 days after completion of the hearing, the order of suspension shall be vacated and set aside. A hearing conducted under this section shall in all respects, except as otherwise expressly provided herein, conform to the substantive and procedural provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code applicable to a hearing on a statement of issues.

> "The Commissioner may, without a hearing, suspend the license of any person who procured the issuance of the license to himself by fraud, misrepresentation, deceit, or by the making of any material misstatement of fact in his application for such license."

10177.2. The Commissioner may, upon his or her own motion, and shall, upon the verified complaint in writing of any person, investigate the actions of any licensee, and he or she may suspend or revoke a real estate license at any time where the licensee in performing or attempting to perform any of the acts within the scope of Section 10131.6 has been guilty of any of the following acts:

(a) Has used a false or fictitious name, knowingly made any false statement, or knowingly concealed any material fact, in any application for the registration of a mobile home, or otherwise committed a fraud in that application.

(b) Failed to provide for the delivery of a properly endorsed **certificate of ownership** or **certificate of title** of a mobile home from the seller to the buyer thereof.

(c) Has knowingly participated in the purchase, sale, or other acquisition or disposal of a stolen mobile home.

(d) Has submitted a check, draft, or money order to the Department of Housing and Community Development for any obligation or fee due the state and it is thereafter dishonored or refused payment upon presentation.

10177.4. (a) Notwithstanding any other provision of law, the Commissioner may, after hearing in accordance with this part relating to hearings, suspend or revoke the license of a real estate licensee who claims, demands, or receives a commission, fee, or other consideration, as compensation or inducement, for referral of customers to any escrow agent, structural pest control firm, home protection company, title insurer, controlled escrow company, or underwritten title company.

A licensee may not be disciplined under any provision of this part for reporting to the Commissioner violations of this section by another licensee, unless the licensee making the report had guilty knowledge of, or committed or participated in, the violation of this section.

(b) The term "other consideration" as used in this section does not include any of the following:
(1) Bona fide payments for goods or facilities actually furnished by a licensee or for services actually performed by a licensee, provided these payments are reasonably related to the value of the goods, facilities, or services furnished.
(2) Furnishing of documents, services, information, advertising, educational materials, or items of a like nature that are customary in the real estate business and that relate to the product or services of the furnisher and that are available on a similar and essentially equal basis to all customers or the agents of the customers of the furnisher.
(3) Moderate expenses for food, meals, beverages, and similar items furnished to individual licensees or groups or associations of licensees within a context of customary business, educational, or promotional practices pertaining to the business of the furnisher.
(4) Items of a character and magnitude similar to those in paragraphs (2) and (3) that are promotional of the furnisher's business customary in the real estate business, and available on a similar and essentially equal basis to all customers, or the agents of the customers, of the furnisher. (c) Nothing in this section shall relieve any licensee of the obligation of disclosure otherwise required by this part.

10177.5. When a final judgment is obtained in a civil action against any real estate licensee upon grounds of fraud, misrepresentation, or deceit with reference to any transaction for which a license is required under this division, the Commissioner may, after hearing in accordance with the provisions of this part relating to hearings, suspend or revoke the license of such real estate licensee.

As you may have noticed, many of the regulations under B&P Code 10176 and 10177 can relate to the same actions by the broker or salesperson. The following three cases relate many of the ethical issues presented in the Business and Professions Code 10176 and 10177.

Is the Broker Providing the Real Estate Transfer Disclosure Statement?

CORRECT PROCEDURE:

The obligation to prepare and deliver the **Real Estate Transfer Disclosure Statement** (TDS) to the prospective buyer is imposed upon the seller and the seller's broker and any broker acting in cooperation with the seller's broker. If more than one broker is involved in the transaction, the broker obtaining the offer is required to deliver the TDS to the prospective buyer, unless instructed otherwise by the seller.

> The TDS must be given to the prospective buyer as soon as practicable before the transfer of title, or, in the case of a lease option, sales contract, or ground lease, before the execution of the contract. If the TDS or amended TDS is delivered after the execution of an offer to purchase, the buyer has three days after delivery in person, or five days after delivery by deposit in the mail, to terminate the offer by delivering a written notice of termination to the seller or to the seller's broker.

In addition, the listing broker and the selling broker each have the duty to conduct a reasonably competent and diligent visual inspection of the property and to disclose to a prospective buyer all material facts affecting the value or desirability of the property that an investigation would reveal.

Reference: Civil Code Sections 1102 et seq. and 20

CalBRE Able to Dispense Citations and Levy Fines

Found in Business and Professions Code Section 10080.9 and approved Commissioner’s Regulation 2907 (effective July 1, 2014), this tool gives CalBRE wide latitude to address all violations of the Real estate law committed by real estate licensees. It also allows action to be taken on the more serious issue of

unlicensed activity conducted by persons not licensed by CalBRE as a real estate broker, salesperson, mortgage loan originator, or prepaid rental listing service. The authority to issue citations and assess fines is expected to help in both obtaining a violator's attention and reinforcing compliance with the Real estate law.

How Citations and Fines Work

A **citation** or other formal action will be considered when a violation is found after an investigation, audit, or examination of a licensee's records by CalBRE in response to a complaint, through random selection of a licensee for an office visit, or from completion of a routine audit.

Depending upon the nature (such as the level of seriousness and potential for harm) and type of the violation, the appropriate action will be determined.

For relatively minor and technical violations, especially in those instances where there has been no injury or loss to a consumer or where there is little or no danger to the public, a citation is likely the appropriate action.

While CalBRE may issue a citation for any violation of the Real estate law, citations are particularly suited for minor violations that do <u>not</u> involve fraud, dishonesty, or loss or injury to a consumer.

Consumer protection remains paramount, but citations are especially intended for such minor violations as failure to notify CalBRE of one's change in address, failure to disclose a real estate license identification number in their first point of contact advertising material, failure to notify CalBRE of newly employed salespersons who were hired and added to office staff, or late or failure to submit required threshold or periodic business activity reports.

> "A citation issued by CalBRE may include an order of Correction as well as an administrative fine."

A citation issued by CalBRE may include an **order of Correction** as well as an **administrative fine**. An order of Correction is simply a demand to fix or correct the cited violation(s) within a specified period of time (usually 30 days). to satisfy an order of Correction, a licensee will need to correct identified violations or deficiencies and inform CalBRE with a **Statement of Correction/ Compliance** that all violations have been corrected and that the licensee is now in full compliance with the Real estate law.

In addition to the order of Correction, a citation may also—and will most likely—include an administrative fine assessed for each violation. The range of a fine—or the total of a fine assessed to a licensee—is set by statute at $0 to $2,500. The maximum fine amount for real estate licensees is $2,500 per citation, and fine amounts may vary, depending upon the nature of the violation and other criteria.

For example, answers to the following questions will help determine the appropriate fine: Is this the licensee's first violation of the sort, or is the violation a repeat of similar offenses? Was the violation inadvertent, deliberate, or a result of negligence? Did the violation involve or result in injuries to consumers?

Before a fine amount is assessed, each violation is evaluated according to specified criteria, which helps establish an appropriate fine amount. Persons **unlicensed** by CalBRE are also subject to citations and fines. Unlicensed activity is currently and has always been a significant challenge for CalBRE, so issuance of a citation—and accompanying administrative fine—may provide some relief in addressing the problem. Thus, the difference between those persons licensed and those unlicensed is one key factor in how fines will be assessed.

While the maximum fine amount for real estate licensees is $2,500 per investigation, those who are found to be conducting unlicensed activities may face substantially larger fine amounts or, rather, multiple fines tied to the same investigation.

CalBRE's Citation and Fine Program Now in Action

The California Bureau of Real Estate (CalBRE) recently finalized its authority to issue citations and assess administrative fines to violators of the California Real Estate Law.

Fines apply to each unlicensed act a person not properly licensed with CalBRE yet found to be conducting real estate activities that require a license may be issued a citation for the unlicensed activity and assessed the maximum fine amount per citation of $2,500. But while the maximum fine amount for a real estate licensee is $2,500 per case or investigation, the maximum fine amount for an unlicensed individual is a $2,500 fine for **each unlicensed act or transaction**.

Calculate the fines that may be assessed against an unlicensed person involved in 100 transactions, for example, and you can see how substantial the cost of operating without a license may become! CalBRE hopes this citation authority will help deter and discourage unlicensed activity.

What to Expect if you Receive a Citation

First, read the citation carefully, along with any notices and details that come with it. The citation will identify the violation(s) you committed, provide information on how to pay the fine, describe any corrective action needed (if necessary), and explain the process for contesting the citation, if you choose to.

If an order of Correction is included with the citation, then corrective action will need to be effected within a specific timeframe. Make note of any deadline for making the corrections and instructions for notifying CalBRE that you are now in compliance.

Finally, regarding the fine, if one is assessed, you will typically have 30 days from receipt of the citation to pay it. There is a review process if you want to contest the citation.

The first level of review is a **Citation Review Conference** (CRC), which is an informal review of the citation conducted by CalBRE. Depending upon information that you may submit in mitigation, the citation may be upheld, modified, or even dismissed. If the citation and fine are upheld, then the next level to contest the citation would be a **formal administrative hearing** before an administrative law judge.

CalBRE is looking to resolve every citation at the lowest possible level of review; however, in some cases an administrative hearing may be the last resort to remedy the matter. An administrative law judge will review the evidence collected by CalBRE and uphold the citation or determine that CalBRE was in error and dismiss the citation. Administrative hearings are expensive, for both CalBRE and the licensee, so CalBRE is going to strive to issue citations and assess fines only in cases where evidence is clear and unambiguous. Specific information regarding the review and appeal processes is available on CalBRE's website and from the Citation and Fine section.

"The first level of review is a **Citation Review Conference** (CRC), which is an informal review of the citation conducted by CalBRE."

CalBRE considers the issuance of citations an opportunity to help educate both licensees and nonlicensees alike and to encourage and reinforce compliance with Real Estate Law. Given this emphasis upon compliance education, **information regarding specific citations issued—and any fines paid—will not be posted on CalBRE's website, nor will such information be attached to one's individual public licensee website record.** The information is still public, however, and may be obtained through a request submitted to CalBRE pursuant to the Public Records Act. **Citations should not be ignored.**

Although they will not be recorded as discipline to your real estate license, the failure to pay a fine could lead to a nonrenewal of your real estate license and, in some cases, possible formal disciplinary action. As for fines received by CalBRE, all money will go into CalBRE's **Real estate Consumer Recovery Account**, which is used to assist victims of real estate fraud committed by licensed agents and brokers. Next is a look at an ethics case.


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REAL ESTATE RECOVERY ACCOUNT

Worthington v. Davi (2012)

Court of Appeal, Fourth District, Division 3, California.
Jennifer WORTHINGTON et al., Plaintiff and Appellant,
v.
Jeff DAVI, as Real Estate Commissioner, etc., Defendant and Appellant.
No. G045537. | Aug. 7, 2012.

BACKGROUND:
Judgment creditors of real estate broker applied for an order directing payment out of the Real Estate Recovery Account. The Superior Court, Orange County, No. 30-2010-00393682, Frederick Paul Horn, J., granted the application in part. Real Estate Commissioner and judgment creditors appealed.

HOLDINGS
The Court of Appeal, O'Leary, P.J., held that:

[1] arbitrator's factual findings supported determination that awards for two transactions were based on fraud. and


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REAL ESTATE RECOVERY ACCOUNT (*continued*)

Worthington v. Davi (2012)

[2] trial court was not required to find that the award for a third transaction was based on fraud.

Affirmed.

O'LEARY, P.J.
Jennifer and Guy Worthington (the Worthingtons) filed a complaint against their real estate broker and several other defendants alleging they were the victims in four fraudulent real estate transactions. The case was arbitrated, and the Worthingtons prevailed.

When the Worthingtons discovered the defendants' assets were insufficient to cover the judgment (approximately $280,000), they filed an application with the Bureau of Real Estate Recovery Account (Recovery Account) for payment of the unsatisfied judgment (pursuant to Business and Professions Code section 10471)1.

The Real Estate Commissioner (the Commissioner) granted part of their application, awarding $50,000 for one of the transactions. The Commissioner denied recovery on the other three transactions on the grounds judgment on those claims was based on breach of the broker's fiduciary duty rather than "fraud, misrepresentation, or deceit" as required by section 10471, subdivision (a).

The Worthingtons filed an application in the superior court for an order directing payment out of the Recovery Account on the remaining three transactions. The trial court, reviewing the issue de novo, determined two of the remaining three transactions involved a breach of fiduciary duty based on intentionally fraudulent misrepresentations and therefore must be paid from the Recovery Account.

Both the Real Estate Bureau (the CalBRE) and the Worthingtons appealed from this ruling, disputing whether all or none of the three transactions should qualify for payment from the Recovery Account. We find substantial evidence supports the trial court's judgment. The judgment is affirmed.

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REAL ESTATE RECOVERY ACCOUNT (*continued*)

Worthington v. Davi (2012)

In the winter of 2006, the Worthingtons filed an amended complaint in the superior court against several defendants including their real estate agent, Thomas Polander, for breach of contract, fraud, breach of fiduciary duty, and other causes of action.

They alleged that in January 2006, Polander solicited them to purchase real estate from his clients. Polander represented he knew of several income properties and he would secure qualified tenants or buyers for any property the Worthingtons purchased. Polander made offers on seven different properties on behalf of the Worthingtons, and “induced” them to refinance their own residence “to obtain lower mortgage payments by representing to [the Worthingtons] that doing so was necessary to qualify [them] to purchase the investment real properties.

Accordingly, [the Worthingtons] refinanced their 30–year fixed rate mortgage, at [an] interest rate of 6.25 [percent] to an adjustable rate mortgage with a large pre-payment penalty.”

Thereafter, Polander represented the Worthingtons in four real property transactions. In our record, the real estate transactions are referred to by their respective street addresses:
(1) the “Camomile” agreement was executed on January 2, 2006;
(2) the “Laurel Lane” agreement was executed on January 4, 2006; and
(3) the “Mambrino” agreement, and
(4) the “Drover” agreement, which were both executed on January 8, 2006.
As will be explained in more detail below, each of these transactions proved to be poor investments, resulting in great financial losses for the Worthingtons.

A. THE ARBITRATION AWARD

The case was sent to binding arbitration pursuant to the parties’ agreement. The arbitration award, prepared by retired Judge Tully H. Seymour, provided the following recitation of the facts, which we incorporate into our opinion as follows: The arbitration award recounted the Worthingtons were interested in investing in real estate and they met Polander, a licensed real estate sales


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REAL ESTATE RECOVERY ACCOUNT (*continued*)

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agent. Polander was employed by Income Realty, owned by Van Wilson. Polander's supervisor was Gallegos. Polander acted as the Worthingtons' agent in the following five real estate transactions.

The Mambrino Transaction

The arbitrator described the facts of this transaction as follows: Wilson told the Worthingtons that James and Nina Manry were buying the property from Wilson but the Worthingtons could first buy out Wilson's interest for $4,000. Polander told the Worthingtons they would make a lot of money on this transaction and that "he had screened the Manrys regarding their finances and determined they were o.k." Polander also represented the Manrys "had money and good jobs."

The arbitration award noted, "Polander testified that he met the Worthingtons through ... Wilson at Wilson's home. Polander ... told the Worthingtons that he and Wilson had made money investing in real estate. There was a discussion about the Mambrino property and the fact that Wilson had a contract to purchase the property. It was decided to change the contract so that the Worthingtons were substituted in as the buyers with a price increase from $630,000 to $670,000.

Wilson had the Manrys as tenants and potential buyers. They were not able to purchase the property because of poor credit. Polander said that he never saw any credit report for the Manrys.

Guy Worthington stated that Polander had told him that he received a letter from the Manrys describing their finances and that they were going to receive $60,000 from the sale of a coffee business. Polander did not make any investigation of the Manrys' finances. He took their word that they had the ability to pay the monthly payments.

Polander testified that he left it up to the Worthingtons to check out the credit of the Manrys. Polander acted as the Worthingtons' agent in negotiating the lease and lease option with the Manrys. The Manrys made only partial payments of the rent. The Worthingtons had to evict them."


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REAL ESTATE RECOVERY ACCOUNT (*continued*)

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ii. The Drover Transaction

The arbitrator described the facts of this transaction as follows: Polander showed this property to Ron Hewitt, but when he learned Hewitt would not qualify to buy the property due to bad credit, Polander (acting as a dual agent) introduced Hewitt to the Worthingtons "as a potential optionee on a shared appreciation agreement.

Polander told the Worthingtons that Hewitt would make a $35,000 down payment. Polander did not check Hewitt's credit nor did he verify his employment. He told the Worthingtons that Hewitt made a lot of money in the boat repair business."

The Worthingtons presented evidence that "Polander represented that he had made a thorough background check of Hewitt and that Hewitt made a lot of money from working on boats. Hewitt gave [the Worthingtons] a check for $11,000. Polander told Guy Worthington to give Hewitt the keys. He did and Hewitt moved in. The $11,000 check bounced. Hewitt paid a total of $2,900 in rent for a period that lasted from March to October 2006 when the Worthingtons were finally able to evict him."

iii. The Laurel Lane Transaction

The arbitrator described the facts of this transaction as follows: "The Worthingtons purchased this property from Carl Held for $5,000 and began assuming the monthly mortgage payments of $3,138.

As part of this transaction, Polander had the Worthingtons execute a promissory note in the principal amount of $48,000 payable to [the] Fresh Start Foundation.... Polander explained the note by saying that if the Worthingtons were not able to obtain financing, Polander would make up the difference. The Worthingtons subsequently lost the property through foreclosure." The Worthingtons also alleged Polander misrepresented his ability to secure a tenant to occupy the property.

iv. The Camomile Transaction

The arbitrator described the facts of this transaction as follows: "Polander


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REAL ESTATE RECOVERY ACCOUNT (*continued*)

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represented the Worthingtons who were the buyers, and the seller Carl Held in the sale transaction. The terms of the sale called for the Worthingtons to pay $20,000 to Held and assume the mortgages which were represented by Polander to total $540,000. The purchase price shown on the contract was $560,000. In reality, Held's mortgages totaled approximately $458,000. This resulted in an undisclosed equity of approximately $102,000 in the property. Polander delivered the $20,000 cashier's check to Held and then had him sign over the property to the Fresh Start Foundation which Polander controlled. Both Held and the Worthingtons testified they believed that the transaction was between them. They said they did not realize that title was going to the Fresh Start Foundation."

Polander asserted he disclosed the Fresh Start Foundation's involvement to both Held and the Worthingtons and they should have realized what was happening from the paperwork. The arbitrator stated, "Polander's explanation for this bizarre transaction was that he set it up that way so that he could get a commission since he did not have a listing from Held. Polander admitted he did not disclose the profit that he was going to make on the transaction."

The Worthingtons made mortgage payments on the Camomile property for nine months. Polander refused to convey title to them. The Worthingtons filed suit against Polander and his wife, as the record owners. In response, Polander's attorney, Scott Sayre, sent the Worthingtons a letter stating Polander had secured a buyer for the property. He proposed the following settlement of the lawsuit: Polander would split the net profits from the sale (totaling $59,000) if the Worthingtons would release the lis pendens.

In addition the selling costs would include payment of a three percent commission to Polander. The Worthingtons accepted the proposed settlement and released the lis pendens. After the property was sold, the Worthingtons learned Sayre's attorney fees and the repayment of an undisclosed third deed of trust ($24,000) recorded against the property reduced the net profits to $7,000.


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REAL ESTATE RECOVERY ACCOUNT (*continued*)

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v. The Marsh Court Transaction

This final transaction mentioned in the arbitrator's award is not at issue on appeal, but we nevertheless include it because it is evidence of one more failed transaction between these parties. Polander represented to the Worthingtons this property would be a good investment. The Worthington's lost their $1,000 deposit in escrow because the "transaction was not completed."

vi. The Arbitrator's Analysis

In the final section of the arbitration award, the arbitrator offered a two-page analysis that we will recite almost in its entirety because it should be considered context of the whole analysis.

The arbitrator concluded: "The evidence in this case shows that Polander committed serious and deliberate violations of his fiduciary duties owed to the Worthingtons as their real estate agent. It is clear that the Worthingtons relied on Polander's representations that they would make money through the shared equity investment scheme that he proposed.

They trusted his advice as an experienced real estate professional and they believed that he would guide them in finding properties that had good potential appreciation and that he would help them find tenant/optionees that would be financially reliable. The statutory and case law establish that a real estate agent has a fiduciary duty to disclose all material facts to his principal and to act with the utmost good faith in his dealings with the principal."

The arbitrator concluded, "Polander breached this duty by representing that the tenants he procured in the Mambrino, Drover Court, and Camomile properties were good risks and were financially capable of making the lease option/rental payments. Although Polander told the Worthingtons that the optionees had bad credit, he represented that they had good jobs, good cash flow, and could make the payments.

Polander did not make any investigation to confirm what the tenants epresented about their finances. He did not make any credit checks which would have revealed bankruptcies, evictions, judgments and other relevant

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information. He did not confirm their employment or their incomes. A credit check of Hewitt would have revealed his bankruptcy and 29 judgments against him.

This was not just one instance; there were a series of financially impaired tenants. The Worthingtons relied on Polander's assurances that the tenants were capable of making the payments. The Worthingtons had a right to rely upon the statements and recommendations made to them, and had no duty to make an independent investigation."

After this overview of the basis for the judgment, the arbitrator touched on each of the transactions as follows: "The Camomile transaction involved outright fraud and underhanded conduct on the part of Polander. His representations to Held and the Worthingtons about the value of the property were serious breaches of his duty to make full disclosures.

In buying the property in the name of [the Fresh Start Foundation] ... [Polander] concealed the fact that he was buying the property for himself. His explanation that the sale documents disclosed the fact that [the Fresh Start Foundation] was buying the property is accurate as far as it goes, but it does not square with the representations that he made to both Held and the Worthingtons that the Worthingtons were the buyers. Furthermore, a real estate agent is required to make an express disclosure and to obtain the client's consent. It is common knowledge that people sign legally binding documents without reading the details, particularly when a professional whom they trust tells them the nature and effect of the documents. The Worthingtons and ... Held relied on what Polander told them and they did not pay attention to what they were signing.

The Worthingtons were unsophisticated people who were taken for a ride by an unscrupulous, dishonest agent intent on earning commissions. The Worthingtons trusted Polander implicitly. Unfortunately for them, he abused their trust and they lost their life savings."

In the final part of the arbitrator's analysis, the arbitrator specifically


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discussed the Laurel Lane transaction, stating the Worthingtons entered into that transaction based on Polander's representation "they would have to buy Laurel Lane in order to buy Camomile. Polander represented that he would find a tenant or a buyer for the Laurel Lane property. He failed to perform and as a result [the] Worthingtons were unable to continue making the payments on the property. It was lost in foreclosure."

The arbitrator also addressed arguments raised by defense counsel in closing argument. He rejected the claim Polander failed to make any specific representations regarding the Manrys. He also was not persuaded by Polander's argument the representation Hewitt had been "fully screened" was ambiguous.

The arbitrator concluded under the circumstances it was plainly a representation Polander had "investigated Hewitt's finances and found them adequate." In addition, the arbitrator rejected Polander's defense he was shielded from personal liability because he was working for a corporation. The arbitrator explained the real estate license is held by an individual, not the corporation, and the licensee is accountable for his misconduct.

The arbitrator concluded Gallego was vicariously liable for Polander's torts. It ordered damages as follows:
(1) $30,308.74 for the Mambrino transaction (mortgage payments, association dues, property taxes, and special assessments);
(2) $52,272.29 for the Drover transaction (mortgage payments, association dues, property taxes, escrow deposit, and closing costs);
(3) $32,865.15 for the Camomile transaction (mortgage and association dues);
(4) $17,864.77 for the Laurel Lane transaction (mortgage and association dues); (5) $25,000 purchase money for the Laurel Lane and Camomile transaction; and
(6) $59,100 lost profit on the Camomile transaction.

The amount of these damages totaled $217,499 and was awarded against Polander, Income Realty, and Gallego jointly and severally. In addition, the arbitrator awarded $35,000 exemplary damages against Polander and Income


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Realty based on the **fraudulent misrepresentation** of the Camomile property. The arbitrator awarded $37,000 for attorney fees against Polander and Income Realty. The court entered a final judgment in May 2008.

B. APPLICATION TO THE BUREAU OF REAL ESTATE

When the Worthingtons were unable to collect from Polander and the other defendants, they filed an application with the **Recovery Account** for payment of the unsatisfied judgment. The Commissioner issued a written opinion, concluding the Worthingtons could recover on the Camomile transaction but not the other transactions.

In the opinion, the Commissioner essentially recounted many of the same factual findings delineated in the arbitrator's award (which we need not repeat). However, a few new facts came to light in the Commissioner's opinion.

With respect to the Camomile transaction, the Commissioner determined the Worthingtons paid $20,000 and assumed Held's monthly mortgage payment and homeowner's association dues. Polander made a commission of $5,000. Polander never conveyed the property to the Worthingtons, and he kept the proceeds of the subsequent sale.

The Commissioner stated Polander told the Worthingtons they were required to purchase the Laurel Lane property (also owned by Held) to complete the Camomile property transaction. Not wanting to lose the Camomile deal, the Worthingtons paid Held $5,000 and started assuming his monthly mortgage and association dues.

Polander never disclosed to the Worthingtons that they were assuming a mortgage with an **adjustable interest rate**. After the purchase, Held's mortgage payments adjusted, and the Worthingtons could no longer make the payments.

With respect to the Mambrino transaction, the Commissioner concluded the Worthingtons made a down payment of $7,050 and began making monthly


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mortgage and homeowner's association dues payments. Before the purchase, Polander represented the property was a good deal and he would negotiate an "**equity share' agreement**" with James Manry. Polander also represented he had reviewed James Manry's credit report and determined he made enough money to pay the monthly mortgage payments.

In reality, Polander had not made any investigation into the Manrys' finances. After evicting the Manrys, the Worthingtons lost the Mambrino property through foreclosure.

The Commissioner noted the arbitration award included findings of fact and conclusions of law. The Commissioner noted the arbitrator determined Polander **defrauded** the Worthingtons in the Camomile property transaction and awarded them actual damages as well as $35,000 **exemplary damages**.

he Commissioner determined the award reflected the legal conclusion Polander **breached his fiduciary duty** with respect to the Laurel, Drover, and Mambrino property transactions. As to these transactions, the Worthingtons were awarded **actual damages** and attorney fees.

The Commissioner determined that because the Worthingtons had a final judgment based on fraud as to the Camomile property transaction, and had satisfied all the other requirements of section 10471, they should collect $50,000 from the Recovery Account.

The Commissioner concluded the Worthingtons would not receive money for the other transactions because the judgment award indicated those transactions arose from Polander's breach of his fiduciary duty. Section 10471, subdivision (a), requires a judgment based upon the real estate agent's "fraud, misrepresentation, or deceit, made with intent to defraud, or conversion of trust funds."

The Commissioner noted this result was consistent with the allegations pled in the complaint. The fraud cause of action only made reference to the Camomile property. The breach of fiduciary duty claim made reference to the


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Laurel, Dover,and Mambrino transactions.

C. PROCEEDINGS IN THE TRIAL COURT

The Worthington's filed an "**Application for Order Directing Payment out of [the] Recovery Account**" for the Laurel, Dover, and Mambrino transactions. On April 29, 2011, after taking the briefing and argument under submission, the court issued the following minute order: "The California Bureau of Real Estate has a Recovery Account out of which unsatisfied judgments against a licensed real estate broker based on his fraud may be paid to the judgment creditor upon a specified application procedure...

On March 9, 2010, the ... Commissioner made the decision to pay [the Worthingtons] $50,000 from the Recovery Account. The remainder of the claim was denied on the basis that [section 10471, subdivision (a)] requires that the judgment be based on the [real estate agent's] fraud, misrepresentation, or deceit, made with intent to defraud, or conversion of trust funds to support payment from the Recovery Account...

On July 27, 2010, [the Worthingtons] filed an [a]pplication ... seeking recovery on the other three transactions.... The parties stipulated to a trial on the briefs ... and the court took the matter under submission.... The issue presented by this trial on stipulated facts is whether [the Worthingtons] are entitled to recover in connection with the other three transactions."

Applying this standard of review, the trial court concluded, "<u>The purpose of the Recovery Fund is to satisfy certain types of judgments against licensed real estate brokers and agents</u> as defined in the Real Estate Recovery Program when the aggrieved parties would otherwise go unpaid..."

There is no case directly on point, and whether a judgment on a cause of action for breach of fiduciary duty that is based on fraud by the Realtor falls within the coverage of the statute is not a clear-cut issue.

Courts have said that "[the Act] is to be given a liberal construction to promote its purpose and protect persons within its purview. As such, it has been held


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that relief will be granted under section 10471 unless to do so is clearly forbidden by statute. [Section 10471] will be construed when its meaning is doubtful so as to suppress the mischief at which it is directed, to advance or extend the remedy provided, and to bring within the scope of the law every case which comes clearly within its spirit and policy."

This expansive view is tempered by the 1987 amendments which were made to address claims that were brought by claimants who used judicial procedures designed solely to assure access to the Recovery Act. (See Yergan v. Bureau of Real Estate (2000) 77 Cal.App.4th 959, 966 [92 Cal.Rptr.2d 189]). The applicant has the burden of proving that the cause of action against the licensee was for fraud. (§ 10471.)

Doyle v. Bureau of Real Estate (1994) 30 Cal.App.4th 893, 36 Cal.Rptr.2d 193 (Doyle). The trial court found this case to be particularly instructive, stating it involved "a real estate broker who settled a fraud and deceit action against him arising out of a real estate transaction, and a stipulated judgment was filed. After the judgment creditors were unable to collect on the judgment, they applied for payment from the Recovery Account. The trial court and the appellate court rejected the broker's arguments that the judgment was not based on fraud. Although the stipulated judgment itself did not reveal its basis, the Commissioner properly considered that the only cause of action alleged in the complaint was for fraud and deceit, and also properly considered the facts set forth in the application to the Bureau of Real Estate.

The appellate court stated, "It has been consistently held that section 10471 is a remedial statute intended to protect the public from loss resulting from unsatisfied damage awards against licensed real estate personnel resulting from their **misrepresentation** and **breach of fiduciary duty**."

The trial court concluded, "Here, in contrast, while breach of fiduciary duty was the claim asserted and ruled on with respect to the three transactions at issue, considering the determinations made by the [a]rbitrator, it is evident that actual fraud was encompassed within the [a]rbitration [a]ward and the [j]udgment entered thereon. A cause of action for breach of fiduciary duty can


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be based on fraud."

The trial court reasoned, "The elements of fraud are
(a) misrepresentation,
(b) [d]efendant's knowledge of the statement's falsity,
(c) intent to defraud,
(d) justifiable reliance and
(e) resulting damage."

The findings in the [a]rbitration [a]ward show that each of the elements of fraud had been established with respect to the Mambrino and Drover properties. The [a]rbitrator's [a]ward established that his imposition of liability for breach of fiduciary duty for the Mambrino property was based on ... Polander's misrepresentations as to the suitability of the tenants.

The [a]rbitrator's [a]ward with respect to the Drover transaction demonstrates that it was based on Polander's **false representations** concerning Hewitt's suitability as a potential **optionee** on a **shared appreciation agreement**. Polander made statements that he had conducted credit checks when he had not done so. These were misrepresentations....

Polander made the statements with intent to induce [the Worthingtons] to rely on the statements. [The Worthingtons] justifiably relied on them and entered each of the real estate transactions, which caused them damage. The award went on to state that Polander's actions concerning the Camomile property constituted "**outright fraud** and **underhanded conduct** by the Defendants. The Worthingtons were unsophisticated people who were taken for a ride by an unscrupulous, dishonest agent intent on earning commissions."

The trial court further explained, "With respect to [the] Mambrino and Drover transactions, there was a breach of fiduciary duty by [Polander] resulting from fraudulent misrepresentations. With respect to the Mambrino property (which involved representations concerning the Manrys), and the Drover property (which involved Hewitt), the findings show that the breach of fiduciary duty was based on fraud by Polander. However, for the reasons discussed below,


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the findings concerning the Laurel property do not show that the judgment was based on fraud."

It the minute order, the trial court included large portions of the arbitration award verbatim, supporting its conclusion the award was based on a finding of fraud and fraudulent misrepresentations with respect to the Camomile, Mambrino, and Drover transactions. It explained the award did not show the Laurel Lane transaction was based on fraud and therefore denied the Worthingtons' application on that issue.

The trial court awarded judgment in favor of the Worthingtons, holding they were "entitled to the following sums from the Recovery Account Unit of the Bureau of Real Estate arising from the fraud perpetrated on them by ... Polander:

(1) Mambrino $30,308.74 + 7 [percent] interest from May 1, 2006 through date of judgment, but in no event no more than $50,000;
(2) Drover $50,000 (no interest payable);
(3) Camomile $50,000 (no interest payable).

The application is denied with respect to the Laurel property."

We (the appellate court) are presented in this appeal with the sole question of whether there is any substantial evidence contradicted or uncontradicted which will support the trial court's findings.

Recovery Account specifically covers only claims in which there were an "**intent to defraud**." In short, the Legislature narrowed the available remedy to victims of **deliberate fraud**, which would necessarily include **intentional** but not **negligent misrepresentations**.

D. THE TRANSACTIONS

With the Legislative history in mind, we now proceed with our review of the trial court's ruling. Neither party challenges the trial court's and Commissioner's conclusion the arbitrator's award concerning the Camomile

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transaction established the Worthingtons proved the judgment against Polander encompassed actual fraud and clearly came within the spirit and policy of the remedial statute. The record amply supports the trial court's ruling. We affirm this portion of judgment.

The Bureau disagrees with the trial court's conclusion the arbitration award concerning the Mambrino and Drover transactions was also based on Polander's "fraud, misrepresentation, or deceit, made with the intent to defraud." (§ 10471.) The Bureau focuses on the arbitrator's legal conclusion Polander breached his fiduciary duty with respect to these transactions. It asserts the judgment specifically mentioned a fraudulent intent with respect to the Camomile action but not with respect to the others. It concludes that a breach of fiduciary duty judgment is not covered by the Recovery Account.

The Worthington's contend the trial court correctly looked behind the arbitration award's legal terminology and properly relied on the clear factual findings that Polander deliberately devised a fraudulent "shared equity investment scheme" involving several properties.

They assert there was ample evidence of Polander's intent to defraud in all the transactions, including the Laurel Lane transaction. For this reason, the Worthingtons assert the trial court should have ruled all the transactions were part and parcel of Polander's overall deliberate ploy to take the unsophisticated Worthingtons "for a ride" and deplete their life savings.

The trial court correctly recognized that in this case Polander's breach of his fiduciary duty involved more than just negligent conduct (i.e., constructive fraud), and there were factual findings evidencing a clear intent to defraud the Worthingtons in the Mambrino and Drover transactions.

We conclude the trial court's decisions regarding the Mambrino, Drover and Laurel Lane transactions are fully supported by the record.

"It is immaterial for Recovery Account payment purposes whether the facts of an underlying case may or may not demonstrate fraudulent intent ... what


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is pertinent is the basis for the underlying judgment."

The Worthington's judgment was not based on partial settlement of their claims, but rather based on a judgment resolving their entire dispute.

Arbitration is defined as: "A process of dispute resolution in which a neutral third party (arbitrator) renders a decision after a hearing at which both parties have an opportunity to be heard. Where arbitration is voluntary, the disputing parties select the arbitrator who has the power to render a binding decision."

Stated another way, an arbitration award results when the parties voluntarily agreed to have their dispute finally resolved by a procedure other than a court action.

The Legislative scheme regarding the Recovery Account recognizes the similarities between court judgments and arbitration awards. The process applies equally to applicants who have "a final judgment in a court" and to those who have "an arbitration award that includes findings of fact and conclusions of law ... and where the arbitration award has been confirmed and reduced to judgment...."

[8] We therefore reject the Bureau's argument the trial court could look no further than the arbitrator's legal conclusion there was a breach of fiduciary duty and not consider the arbitrator's factual findings there was an intent to defraud.

"A misrepresentation that constitutes a breach of a fiduciary or confidential a relationship may, depending on whether an intent to deceive is present, constitute either actual or constructive fraud.

However, the issue is usually discussed in terms of whether the misrepresentation constitutes constructive fraud, because actual fraud can exist independently of a fiduciary or confidential relationship, while the existence of such a relationship is usually crucial to a finding of constructive fraud."

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We appreciate a real estate agent may breach his fiduciary duty by making a careless misstatement and such constructive fraud would not be covered by the Recovery Account.

However, in this case the trial court properly recognized the arbitration award repeatedly makes the factual finding Polander was guilty much more than careless or negligent remarks.

For example, Polander made intentional misrepresentations to falsely induce the Worthingtons over a one-week period to enter into several significant real estate transactions that wiped out their life savings. The arbitrator concluded, "The evidence in this case shows that Polander committed serious and deliberate violations of his fiduciary duties" in using the Worthingtons to carry out his "shared equity investment scheme."

Polander "abused" his clients' trust and intentionally misrepresented the financial stability of the "tenants he produced in the Mambrino, Drover Court, and Camomile properties."

We acknowledge the trial court pulled several other relevant factual findings from the arbitration award to support its conclusion Polander's breach of his fiduciary duty encompassed actual fraud.

Based on this record and the court's detailed minute order, we affirm the court's ruling as to the Mambrino and Drover transactions.

E. THE LAUREL LANE TRANSACTION

The arbitration award stated the Worthingtons purchased the Laurel Lane property owned by Held, and they executed a promissory note payable to Fresh Start Foundation.

The arbitrator noted Polander promised the Worthingtons he would help them find tenants and if they were not able to obtain financing, Polander would make up the difference.

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The Commissioner's award contained a few more details about the transaction, stating that the day after the Worthingtons agreed to purchase the Camomile property, Polander told them that they were required to also purchase the Laurel Lane property, also owned by Held.

The Worthington's paid Held $5,000 and assumed his monthly mortgage payments. When the monthly mortgage payments adjusted, the Worthingtons could not longer afford it.

Polander apparently also neglected to mention the Worthington's were agreeing to assume a mortgage having an adjustable rate and not a fixed rate. Thus, it appears Polander breached his fiduciary duty either by:
(1) not keeping his promise to help with tenants and financing;
(2) misrepresenting the necessity to purchase the property; or
(3) failing to disclose the adjustable rate mortgage.

Like the trial court we have examined carefully the factual findings and conclusions of the arbitrator. Although we appreciate this transaction occurred close in time to Polander's other intentionally fraudulent misrepresentations, the award simply does not indicate whether the arbitrator made any factual findings or conclusions regarding whether Polander deliberately made false promises or misrepresentations with respect to the Laurel Lane property.

For example, the arbitrator found Polander intentionally misrepresented the financial stability of the tenants (Hewitt and the Manrys) with respect to the Mambrino and Drover transactions, there is no evidence Polander misrepresented a potential tenant, or even located a tenant, for the Laurel Lane property.

Similarly, there is no evidence Polander intentionally refused to help the Worthingtons obtain financing. The arbitrator noted the Worthingtons lost the property due to high payments owed on the existing adjustable rate mortgage payment.


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There is no evidence Polander also promised to pay any shortfall for the existing mortgage. Finally, it cannot be assumed Polander intentionally misrepresented the Laurel Lane transaction was a necessary part of the Camomile transaction.

As noted in the Commissioner's award, both properties were owned by Held, who was financially insecure and indicated he needed to get "out from under" the Camomile property. It is possible he conditioned the Camomile sale on his ability to also unload his obligation to his Laurel Lane debt.

<u>The judgment is affirmed. The Worthingtons shall recover their costs on appeal.</u>

WE CONCUR: BEDSWORTH and IKOLA, JJ.
Parallel Citations
208 Cal.App.4th 263, 12 Cal. Daily Op. Serv. 9027, 2012 Daily Journal D.A.R. 10,981

All further statutory references are to the Business and Professions Code, unless otherwise indicated.

Other named defendants were Polander's employer, Peter Gallego, a real estate broker, and Gallego's company, Income Realty and Investments (Income Realty).

In addition, the Worthingtons also sued Fresh Start Foundation, a charitable foundation controlled by Polander.

The award was rendered on March 4, 2008, but later supplemented to add the Fresh Start Foundation as an additional party responsible to pay the award.

The supplemental award added the Fresh Start Foundation as a joint obligor to the $217,499 and $37,000 attorney fees and solely liable for an additional $25,000 in **punitive damages**.


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The court determined the Worthingtons were entitled to interest only on the award for the Mambrino transaction because, unlike the other transactions, the unpaid damages had not yet reached the statutory maximum of $50,000.

This concludes our CalBRE approved three (3) hour continuing education course in Ethics, Professional Conduct, and Legal Aspects of Real Estate.

Trust Fund Handling

Real estate brokers and salespersons receive **trust funds** in the normal course of doing business. They receive these funds on behalf of others, thereby creating a **fiduciary responsibility** to the funds' owners. Brokers and salespersons must handle, control and account for these trust funds according to established legal standards. While **compliance** with these standards may not necessarily have a direct bearing on the financial success of a real estate business, **non-compliance** can result in unfavorable business consequences.

Improper handling of trust funds is cause for revocation or suspension of a real estate license, not to mention the possibility of being held financially liable for damages incurred by clients. This Continuing Education (CE) offering discusses the legal requirements for receiving and handling trust funds in real estate transactions as set forth in the Real Estate Law and the Regulations of the Real Estate Commissioner.

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It describes the requisites for maintaining a trust fund bank account and the precautions a licensee should take to ensure the **integrity** of the account. It explains and illustrates the **trust fund record keeping requirements** under the **Business and Professions Code** and the **Commissioner's Regulations.**

The discussions and examples in this chapter involve real property sales and property management trust account transactions. Other types of real estate activities involving trust funds, although subject to the same laws and regulations, may also have to comply with additional legal and regulatory requirements. While these other types of transactions may require records significantly different from those illustrated, the record keeping fundamentals still apply.

General Information

Trust Funds and Non-Trust Funds

Since trust funds must be handled in a special manner, a licensee must be able to distinguish trust funds from non-trust funds. Trust funds are money or other things of value that are received by a broker or salesperson on behalf of a principal or any other person, and which are held for the benefit of others in the performance of any acts for which a real estate license is required.

Trust funds may be cash or non-cash items. Some examples are; cash; a check used as a purchase deposit (whether made payable to the broker or to an escrow or title company); a personal note made payable to the seller; or even an automobile's "pink slip" given as a deposit.

The discussions in this CE offering pertain to real estate trust funds received by licensees, and not to non-trust funds such as real estate commissions, general operating funds, and rents and deposits from broker-owned real estate. These other types of funds, as long as they are not commingled with trust funds, are not subject to the Real Estate Law and Commissioner's Regulations.

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It should be noted, however, that under certain circumstances the Bureau of Real Estate does have the jurisdiction to look into transactions involving non-trust funds.

Why a Trust Account?

A trust account is set up as a means to separate **trust funds** from **non-trust funds**. Although it can certainly be argued that keeping trust funds in a trust account will not prevent a dishonest broker from misusing the funds, separating client's funds from the broker's own funds provides a better physical and accounting control over the trust funds.

An important reason for designating a trust fund depository as a trust account is the protection afforded principals' funds in situations where legal action is taken against the broker or if the broker becomes incapacitated or dies.

1. Trust funds held in a true trust account cannot be ‘‘frozen” pending litigation against the broker or during probate.
2. Trust funds also have better insurance protection if deposited into a trust account.

The general counsel of the FDIC, in an opinion in 1965, held that funds of various owners which are placed in a custodial deposit (trust account) in an insured bank will be recognized for insurance purposes to the same extent as if the owners' names and interests in the account are individually disclosed on the records of the bank, provided the trust account is specifically designated as custodial and the name and interest of each owner of funds in the account are disclosed on the depositor's records.

Each client with funds deposited in a trust account maintained with a federally insured bank is insured by the FDIC up to $250,000, as opposed to just $250,000 for the entire account, as long as the regulatory requirements are met.

Trust Fund Handling Requirements

A typical trust fund transaction begins with the broker or salesperson receiving trust funds from a principal in connection with the purchase or lease of real property.

According to Business and Professions Code Section 10145, trust funds received must be placed into the hands of the owner(s) of the funds, into a neutral escrow depository, or into a trust account maintained pursuant to Commissioner's Regulation 2832 not later than three business days following receipt of the funds by the broker or by the broker's salesperson.

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An exception to this rule is when a check is received from an offeror (usually the buyer) in connection with an offer to purchase or lease real property. As provided under Commissioner's Regulation 2832, a deposit check may be held uncashed by the broker until acceptance of the offer if the following conditions are met:

1. The check by its terms is not negotiable by the broker, or the offeror has given written instructions that the check shall not be deposited or cashed until acceptance of the offer; and
2. The offeree is informed, before or at the time the offer is presented for acceptance, that the check is being held. If the offer is later accepted, the broker may continue to hold the check undeposited only if the broker receives written authorization from the offeree to do so.

Otherwise, the check must be placed, not later than three business days after acceptance, into a **neutral escrow depository** or into the **trust fund bank account** or into the hands of the offeree (usually the seller) if both the offeror and offeree expressly so provide in writing.

According to Business and Professions Code Section 10145, a real estate salesperson who accepts trust funds on behalf of the broker under whom he or she is licensed must:
1. Immediately deliver the funds to the broker, or
2. If directed to do so by the broker, place the funds into the hands of the broker's principal, or
3. Into a neutral escrow depository, or
4. Deposit the funds into the broker's trust fund bank account.

A neutral escrow depository, as used in Business and Professions Code Section 10145, means an escrow business conducted by a person licensed under Division 6 (commencing with Section 17000) of the Financial Code or by any person described in subdivisions (a)(1) and (a)(3) of Section 17006 of the Financial Code.

Identifying the Owner(s) of Trust Funds

A broker must be able to identify who owns the trust funds and who is entitled to receive them, since these funds can be disposed of only upon the authorization of that person. The person entitled to the funds may or may not be the person who originally gave the funds to the broker or the salesperson.

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In some instances the party entitled to the funds will change upon the occurrence of certain events in the transaction. For example, in a transaction involving an offer to buy or lease real property or a business opportunity, the party entitled to

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the funds received from the offeror (prospective buyer or lessor) will depend upon whether or not the offer has been accepted by the offeree (seller or landlord).

Prior to the acceptance of the offer, the funds received from the offeror belong to that person and must be handled according to his/her instructions.

If the funds are deposited in a trust fund bank account, they must be:

3. Maintained there for the benefit of the offeror until acceptance of the offer.

or

4. If the offeror wishes, his/her check may be held uncashed by the broker as long as he/she gives written instructions to the broker to do so and the offeree is informed before or at the time the offer is presented for acceptance that the check is being so held.

After acceptance of the offer, the funds shall be handled according to instructions from the offeror and the offeree as follows:

1. An offeror's check held uncashed by the broker before acceptance of the offer may continue to be held uncashed after acceptance of the offer, only upon written authorization from the offeree. [Commissioner's Regulation 2832(d)]
2. The offeror's check may be given to the offeree only if the offeror and offeree expressly so provide in writing. [Commissioner's Regulation 2832(d)]
3. All or part of an offeror's purchase money deposit in a real estate sales transaction shall not be refunded by an agent or subagent of the seller without the express written permission of the offeree to make the refund.

Trust Fund Bank Accounts

General Requirements Trust funds, such as a purchase money deposit check, received by a licensee that are not forwarded directly to the broker's principal or to a neutral escrow depository or for which the broker does not have authorization to hold uncashed must be deposited to the broker's trust fund bank account. (Business and Professions Code Section 10145)

Business and Professions Code Section 10145 and Commissioner's Regulation 2832 require that a trust account meet the following criteria:

1. Designated as a trust account in the name of the broker as trustee;

2. Maintained with a bank or recognized depository located in California; and
3. Not an interest-bearing account for which prior written notice can, by law or regulation, be required by the financial institution as a condition to withdrawal (except as noted in the discussion below of "Interest Bearing Accounts").

A broker may have an out-of-state trust account if the account is insured by the Federal Deposit Insurance Corporation (FDIC) and is used to service first loans for the types of note owners/investors specified in Section 10145(a)(2) of the Business and Professions Code.

Trust Account Withdrawals According to Commissioner's Regulation 2834, withdrawals from the trust account may be made only upon the signature of one or more of the following:

1. The broker in whose name the account is maintained;
2. The designated broker-officer if the account is in the name of a corporate broker;
3. If specifically authorized in writing by the broker, a salesperson licensed to the broker; or
4. If specifically authorized in writing by the broker who is a signatory of the trust account, an unlicensed employee of the broker covered by a fidelity bond at least equal to the maximum amount of trust funds to which the employee has access at any time.

No arrangement under which a person named in items 3 or 4 is authorized to make withdrawals from a broker's trust fund relieves an individual broker or the broker-officer of a corporate broker licensee from responsibility or liability as provided by law in handling trust funds in the broker's custody.

Interest-Bearing Accounts

A trust fund bank account normally may not be interest-bearing. A broker may, however, at the request of the owner of trust funds, or of the principals to a transaction or series of transactions from whom the broker has received trust funds, deposit the funds into an interest-bearing account in a bank or savings and loan association if all of the following requirements of Business and Professions Code Section 10145(d) are met:

1. The account is in the name of the broker as trustee for a specified beneficiary or specified principal of a transaction or series of transactions.

2. All of the funds in the account are covered by insurance provided by an agency of the federal government.
3. The funds in the account are kept separate, distinct, and apart from funds belonging to the broker or to any other person for whom the broker holds funds in trust.

> "Funds belonging to a licensee may not be commingled with trust funds."

4. The broker discloses the following information to the person from whom the trust funds are received and to any beneficiary whose identity is known to the broker at the time of establishing the account: the nature of the account; how the interest will be calculated and paid under various circumstances; whether service charges will be paid to the depository and by whom; and possible notice requirements or penalties for withdrawal of funds from the account.
5. No interest earned on funds in the account shall inure directly or indirectly to the benefit of the broker or to any person licensed to the broker, even if the funds' owners would permit such an arrangement.
6. In an executory sale, lease, or loan transaction in which the broker accepts funds in trust to be applied to the purchase, lease, or loan, the parties to the contract shall have specified in the contract or by collateral written agreement the person to whom interest earned on the funds is to be paid or credited. The only other situation where a real estate broker is allowed to deposit trust funds into an interest-bearing account occurs when the broker is acting as an agent for a financial institution which is the beneficiary of a loan.

In this case the broker may, pursuant to Commissioner's Regulation 2830.1, deposit and maintain funds received from or for the account of an obligor (borrower) into an interest-bearing trust account in a bank or savings and loan association in order to pay interest on an impound account to the obligor in accordance with Section 2954.8 of the Civil Code, as long as the following requirements are met:

1. The funds received from or for the account of the obligor are for the future payment of property taxes, assessments or insurance relating only to a property containing a one-to-four family residence.
2. The account is in the name of the broker as trustee.
3. All of the funds in the account are covered by insurance provided by an agency of the federal government.
4. All of the funds in the account are funds held in trust by the broker for others.
5. The broker discloses to the obligor how interest will be calculated and paid.
6. No interest earned on the trust funds shall inure directly or indirectly to the benefit of the broker or to any person licensed to the broker.

Commingling Prohibited

Funds belonging to a licensee may not be commingled with trust funds. Commingling is strictly prohibited by the Real Estate Law. It is grounds for the revocation or suspension of a real estate license pursuant to Business and Professions Code Section 10176(e). Commingling occurs when:

1. Personal or company funds are deposited into the trust fund bank account. Except for what is provided in Section 2835 of the Commissioner's Regulations as noted below, this is a violation of the law even if separate records are kept.
2. Trust funds are deposited into the licensee's general or personal bank account rather than into the trust fund account. In this case the violation is not only commingling, but also handling trust funds contrary to Business and Professions Code Section 10145. It is also grounds for suspension or revocation of a license under Business and Professions Code Section 10177(d).
3. Commissions, fees, or other income earned by the broker and collectible from the trust account are left in the trust account for more than 25 days from the date they were earned.

> A common example of commingling is depositing rents and security deposits on broker-owned properties into the trust account. As these funds relate to the broker's properties, they are not trust funds and, therefore, may not be deposited into the trust fund bank account.

Likewise, the broker may not make mortgage payments and other payments on broker-owned properties from the trust account even if the broker reimburses the account for such payments. Conducting personal business through the trust account is strictly prohibited and is a violation of the Real Estate Law.

Commissioner's Regulation 2835 provides that the following situations do <u>not</u> constitute "commingling" for purposes of Business and Professions Code Section 10176(e):

(a) The deposit into a trust account of reasonably sufficient funds, not to exceed $200, to pay service charges or fees levied or assessed against the account by the bank or financial institution where the account is maintained.

(b) The deposit into a trust account maintained in compliance with item (d) below of funds belonging in part to the broker's principal and in part to the broker when it is not reasonably practicable to separate such funds, provided the part of the funds belonging to the broker is disbursed not later than 25 days after the deposit and there is no dispute between the broker and the broker's principal as to the broker's portion of the funds. When the right of a broker to receive a portion of trust funds is disputed by the broker's principal, the disputed portion shall not be withdrawn until the dispute is settled.

(c) The deposit into a trust account of broker-owned funds in connection with mortgage loan activities as defined in subdivision

(d) or (e) of Section 10131 of the Business and Professions Code or when making, collecting payments on, or servicing a loan which is subject to the provisions of Section 10240 of the Business and Professions Code provided:

1) The broker meets the criteria of Section 10232 of the Business and Professions Code.
2) All funds in the account which are owned by the broker are identified at all times in a separate record which is distinct from any separate record maintained for a beneficiary.
3) All broker-owned funds deposited into the account are disbursed from the account not later than 25 days after their deposit.
4) The funds are deposited and maintained in compliance with item (d) below.
5) For this purpose, a broker shall be deemed to be subject to the provisions of Section 10240 of the Business and Professions Code if the broker delivers the statement to the borrower required by Section 10240. (d) The trust fund account into which the funds are deposited is maintained in accordance with the provisions of Section 10145 of the Business and Professions Code and the Commissioner's Regulations.

To summarize, a real estate broker's personal funds may be in the trust account in the following two specific instances:

1. Up to $200 to cover checking account service fees and other bank charges such as check printing charges and service fees on returned checks. Trust funds may not be used to pay for these expenses. (The preferred practice, however, is for the broker to have the bank debit his/her own personal account for any trust account fees and charges.)
2. Commissions, fees, and other income earned by a broker and collectible from trust funds may remain in the trust account for a period not to exceed 25 days. Regulation 2835 recognizes that it may not always be practical to disburse the earned income immediately upon receipt.

For instance, a property management company may find it too burdensome to collect its management fee every time a rent check is received and deposited to the trust account. Therefore, as long as the broker disburses the fee from the trust account within 25 days after deposit there is no commingling violation.

Note, however, that income earned shall not be taken from trust funds received before depositing such funds into the trust bank account. Also, under no circumstances may the broker pay personal obligations from the trust fund bank account even if such payments are a draw against commissions or other income.

The broker must issue a trust account check to himself/herself for the total amount of the income earned, adequately documenting such payment, and then pay personal obligations from the proceeds of that check.

Trust Fund Liability

Trust fund liability arises when funds are received from or for the benefit of a principal. The aggregate trust fund liability at any one time for a trust account with multiple beneficiaries is equal to the total positive balances due to all beneficiaries of the account at the time. Note that beneficiary accounts with negative balances are not deducted from other accounts when calculating the aggregate trust fund liability. Funds on deposit in the trust account must always equal the broker's aggregate trust fund liability.

If the trust account balance is less than the total liability a trust fund shortage results. Such a shortage is in violation of Commissioner's Regulation 2832.1, which states that the written consent of every principal who is an owner of the funds in the account shall be obtained by a real estate broker prior to each disbursement if such a disbursement will reduce the balance of the funds in the account to an amount less than the existing aggregate trust fund liability of the broker to all owners of the funds.

> "The aggregate trust fund liability at any one time for a trust account with multiple beneficiaries is equal to the total positive balances due to all beneficiaries of the account at the time."

Conversely, if the trust account balance is greater than the total liability, there is a trust fund overage and the broker may be in violation of Business and Professions Code Section 10176(e) for commingling. A trust fund discrepancy of any kind is a serious violation of the Real Estate Law. Many real estate licenses have been revoked after a CalBRE audit disclosed a trust account shortage.

To ensure that the balance of the trust account always equals the trust fund liabilities, a broker should implement the following procedures:

1. Deposit intact and in a timely manner to the trust account all funds that are not forwarded to escrow or to the funds' owner(s) or which are not held uncashed as authorized. This practice, required under Commissioner's Regulation 2832, lessens the risk of the funds being lost, misplaced, or otherwise not deposited to the trust account. A licensee is accountable for all trust funds received whether or not they are deposited. CalBRE auditors have seen numerous cases where trust funds received were properly recorded on the books but were never deposited to the trust account.
2. Maintain adequate supporting papers for any disbursement from the trust account. Record the disbursement accurately in both the Bank Account Record and the Separate Beneficiary Record. The broker must be able to account for all disbursements of trust funds. Any unidentified disbursement will cause a shortage.
3. Disburse funds from a beneficiary's account only when the disbursement will not result in a negative or deficit balance (negative accountability) in the account. Many trust fund shortages are caused by disbursements to a beneficiary in excess of funds received from or for account of that beneficiary. The excess disbursements are, in effect, paid out of funds belonging to other beneficiaries. A shortage occurs because the balance of the trust fund bank account, even if it is a positive balance, is less than the broker's liability to the other beneficiaries.
4. Ensure that a check deposited to the trust fund account has cleared before disbursing funds against that check. This applies, for example, when a broker who has deposited an earnest money check for a purchase transaction has to return the funds to the buyer because the offer is rejected by the seller. A trust fund shortage will result if the broker issues the buyer a trust account check and the buyer's deposit check bounces or for some reason fails to clear the bank.
5. Keep accurate, current and complete records of the trust account and the separate record for each beneficiary. These records are essential to ensure that disbursements are correct.
6. On a monthly basis, reconcile the cash record with the bank statement and with the separate record for each beneficiary or transaction.

Summary - Maintaining Trust Account Integrity

In summary, to maintain the integrity of the trust fund bank account, a broker must ensure that:
1. His/her personal or general operating funds are not commingled with trust funds;
2. The balance of the trust fund account is equal to the broker's trust fund liability to all owners of the funds; and
3. The trust fund records are in an acceptable form and are current, complete and accurate.

Accounting Records

General Requirements

An important aspect of the broker's fiduciary responsibility to the client is the maintenance of adequate records to account for trust funds received and disbursed. This is true whether the funds are deposited to the trust fund bank account, sent to escrow, held uncashed as authorized under Commissioner's Regulation 2832, or released to the owner(s) of the funds. These records:
1. Provide a basis upon which the broker can prepare an accurate accounting for clients.
2. State the amount of money the broker owes the account beneficiaries at any one time. (This is especially important when there are a large number of transactions.)
3. Prove whether or not there is an imbalance in the trust account. Some brokers audited by CalBRE have disagreed that their trust accounts had a shortage or an overage in the amount disclosed by the audit, but could not provide documentation to support their position.
4. Guarantee that beneficiary funds deposited in the trust account will be insured up to the maximum FDIC insurance coverage.

"An important aspect of the broker's fiduciary responsibility to the client is the maintenance of adequate records to account for trust funds received and disbursed."

There are two types of accounting records that may be used for trust funds:
1. Columnar records in the formats prescribed by Commissioner's Regulations 2831 and 2831.1;

and

2. Records other than columnar that are in accordance with generally accepted accounting practices which include details specified in subdivision (a) of the

Regulations and are in a format that will readily enable tracing and reconciliation in accordance with Section 2831.2.

Regardless of the type of records used, they must include the following information:

1. All trust fund receipts and disbursements, with pertinent details, presented in chronological sequence;
2. The balance of the trust fund account, based on recorded transactions;
3. All receipts and disbursements affecting each beneficiary's balance, presented in chronological sequence; and
4. The balance owing to each beneficiary or for each transaction.

Either

(A) Manually produced or computerized accounting records are acceptable. The type and form of records appropriate to a particular real estate operation as well as the means of processing transactions will depend on factors such as the nature of the business, the number of clients, the volume of transactions, and the types of reports needed. For example, manual recording on columnar records might be satisfactory for a broker handling a small number of transactions, while a computerized system might be more appropriate and practical for a large property management operation.

(B) Columnar Records

A broker may decide to use the columnar records prescribed by Commissioner's Regulations 2831 and 2831.1. The records required will depend on whether the trust funds received are deposited to the trust account or are forwarded to an escrow depository or to the owner of the funds. These records are:

1. Columnar Record of All Trust Funds Received and Paid Out - Trust Fund Bank Account (CalBRE form RE 4522);
2. Separate Record for Each Beneficiary or Transaction (CalBRE form RE 4523); and
3. Record of All Trust Funds Received - Not Placed in Broker's Trust Account (CalBRE form RE 4524).

The first two records are required when trust funds are received and deposited to the trust fund bank account. The third record is required when trust funds received are not deposited to the trust account, but are instead forwarded to the authorized person(s). If the trust fund account involves clients' funds from rental properties managed by the broker, the Separate Record for Each Property Managed

(CalBRE form RE 4525) may be used in lieu of the Separate Record for Each Beneficiary or Transaction. A broker who has an escrow division pursuant to Financial Code Section 17006(a)(4) must keep the above mentioned records for escrow funds. (Commissioner's Regulation 2951)

Record of All Trust Funds Received and Paid Out - Trust Fund Bank Account

This record is used to journalize all trust funds deposited to and disbursed from the trust fund bank account. At a minimum, it must show the following information in columnar form: date funds were received; name of payee or payor; amount received; date of deposit; amount paid out; check number and date; and the daily balance of the trust account.
All transactions affecting the trust account are entered in chronological order on this record regardless of payee, payor or beneficiary. If there is more than one trust fund bank account, a different columnar record must be maintained for each account, pursuant to Commissioner's Regulation 2831.

Separate Record for Each Beneficiary or Transaction

This record is maintained to account for funds received from or for the account of each beneficiary, or for each transaction, and deposited to the trust account. With this record, the broker can ascertain the funds owed to each beneficiary or for each transaction. The record must show the following in chronological order: date of deposit; amount of deposit; name of payee or payor; check number; date and amount; and balance of the individual account after posting transactions on any date.

> "If the broker has more than one trust account, each account must have its own set of beneficiary records."

A separate record must be maintained for each beneficiary or transaction from whom the broker received funds that were deposited to the trust fund bank account. If the broker has more than one trust account, each account must have its own set of beneficiary records so that they can be reconciled with the individual trust fund bank account record required by Commissioner's Regulation 2831.2.

Record of All Trust Funds Received - Not Placed in Broker's Trust Account

This record is used to keep track of funds received and not deposited to a trust fund bank account.

In this situation, the broker is handling the funds and must keep records of same. Examples are:
1. Earnest money deposits forwarded to escrow;
2. Rents forwarded to landlords; and
3. Borrowers' payments forwarded to lenders.

This record must show:
1. The date funds were received,
2. The form of payment (check, note, etc.),
3. Amount received,
4. Description of property,
5. Identity of the person to whom funds were forwarded, and
6. Date of disposition.

Trust fund receipts are recorded in chronological sequence, while their disposition is recorded in the same line where the corresponding receipt is recorded.

> Transaction folders usually maintained by a broker for each real estate sales transaction showing the receipt and disposition of un-deposited checks are not acceptable alternatives to the **Record of Trust Funds Received but Not Deposited to the Trust Fund Bank Account**.

An exception to this record keeping requirement is provided in Commissioner's Regulation 2831(e), which states that a broker is not required to keep records of checks made payable to service providers, including but not limited to escrow, credit and appraisal services, when the total amount of such checks for any transaction does not exceed $1,000.

However, a broker shall retain for three years copies of receipts issued or obtained in connection with the receipt and distribution of such checks and, upon request of the Bureau or the maker of the checks, a broker must account for the receipt and distribution of the checks.

Separate Record for Each Property Managed

This record is similar to, and serves the same purpose as, the **Separate Record for Each Beneficiary or Transaction**. It does not have to be maintained if a separate record is already used for a property owner's account. The **Separate Record for Each Property Managed** is useful when the broker wants to show some detailed information about a specific property being managed.

Other Accounting Systems and Records

A broker may use trust fund records not in the columnar form as prescribed by Commissioner's Regulations 2831 and 2831.1. Such records must be in accordance with generally accepted accounting principles (GAAP) and must include detail specified in subdivision (a) of these Regulations and be in a format that will readily enable tracing and reconciliation in accordance with Section 2831.2.

Whether prepared manually or by computer, they must include at least the following:

1. A journal to record in chronological sequence the details of all trust fund transactions.
2. A cash ledger to show the bank balance as affected by the transactions recorded in the journal. The ledger is posted in the form of debits and credits. (In some cases the cash ledger may be combined with the journal.)
3. A beneficiary ledger for each of the beneficiary accounts to show in chronological sequence the transactions affecting each beneficiary's account, as well as the balance of the account. To comply with generally accepted accounting principles, there must be one set of journal, cash ledger, and beneficiary ledger for each trust fund bank account.

Journal

A journal is a daily chronological record of trust fund receipts and disbursements. A single journal may be used to record both the receipts and the disbursements, or a separate journal may be used for each.

To meet minimum record keeping requirements, a journal must:

1. Record all trust fund transactions in chronological sequence.
2. Contain sufficient information to identify the transaction such as the date, amount received or disbursed, name of or reference to payee or payor, check number or reference to another source document of the transaction, and identification of the beneficiary account affected by the transaction.
3. Correlate with the ledgers. For example, it should show the same figures that are posted, individually or in total, in the cash ledger and in the beneficiary ledgers. The details in the journal must be the basis for posting transactions on the ledgers and arriving at the account balances.
4. Show the total receipts and total disbursements regularly, at least once a month.

> "A journal is a daily chronological record of trust fund receipts and disbursements."

Cash Ledger

The cash ledger shows, usually in summary form, the periodic increases and decreases (debits and credits) in the trust fund bank account and the resulting account balance. It can be incorporated into the journal or it can be a separate record, for example a general ledger account. If a separate record is used, the postings must be based on the transactions recorded in the journal. The amounts posted on the ledger must be those shown in the journal.

"The cash ledger shows, usually in summary form, the periodic increases and decreases (debits and credits) in the trust fund bank account and the resulting account balance."

Beneficiary Ledger

A separate beneficiary ledger must be maintained for each beneficiary or transaction or series of transactions. This ledger shows in **chronological sequence** the details of all receipts and disbursements related to the beneficiary's account, and the resulting account balance. It reflects the broker's liability to a particular beneficiary. Entries in all these ledgers must be based on entries recorded in the journal.

A separate beneficiary ledger must be maintained for each beneficiary or transaction or series of transactions.

Recording Process

Keeping complete and accurate trust fund records is easier when specific procedures are regularly followed. The following procedures may be useful in developing a record keeping routine:

1. Record transactions daily in the trust fund bank account and in the separate beneficiary records.
2. Use consistently the same specific source documents as a basis for recording trust fund receipts and disbursements. (For example, receipts pertaining to real estate resales will be recorded based on the Real Estate Contract and Receipt for Deposit form, and disbursements will always be recorded based on the checks issued from the trust account or debit notices from the bank.)
3. Calculate the account balances on all applicable records at the time entries are made.
4. Reconcile the records monthly to ascertain that transactions are properly recorded on both the bank account record and the applicable subsidiary records.

5. Reconcile the trust records to the trust account bank statement on a monthly basis to ascertain that amounts per the bank are in agreement with amounts per the trust fund records.
6. If more than one trust fund bank account is maintained, keep a different set of properly labeled columnar records (cash record and beneficiary record) for each account.

Reconciliation of Accounting Records

Purpose

The trust fund bank account record, the separate beneficiary or transaction record, and the bank statement are all interrelated. Any entry made on the bank account record must have a corresponding entry on a separate beneficiary record.

By the same token, any entry or transaction shown on the bank statement must be reflected on the bank account record. This applies to columnar as well as to other types of records. The accuracy of the records is verified by **reconciling them at least once a month.**

<u>Reconciliation is the process of comparing two or more sets of records to determine whether their balances agree</u>. It will disclose whether the records are completed accurately.

For trust fund record keeping purposes, <u>two</u> reconciliations must be made at the end of each month:

1. Reconciliation of the bank account record (RE 4522) with the bank statement;

and

2. Reconciliation of the bank account record (RE 4522) with the separate beneficiary or transaction records (RE 4523).

Reconciling the Bank Account Record with the Bank Statement

The reconciliation of the bank account record with the bank statement will disclose any recording errors by the broker or by the bank. If the balance on the bank account record agrees with the bank statement balance as adjusted for outstanding checks, deposits in transit, and other transactions not yet included in the bank statement, there is more assurance that the balance on the bank account record is correct.

Although this reconciliation is not required by the Real Estate Law or the Commissioner's Regulations, it is an essential part of any good accounting system.

Reconciling the Bank Account Record with the Separate Beneficiary or Transaction Records

"The balance on the bank account record should equal the total of all beneficiary record balances."

This reconciliation, which is required by Commissioner's Regulation 2831.2, will substantiate that all transactions entered on the bank account record were posted on the separate beneficiary or transaction records. The balance on the bank account record should equal the total of all beneficiary record balances. Any difference should be located and the records corrected to reflect the correct bank and liabilities balances.

Commissioner's Regulation 2831.2 requires that this reconciliation process be performed monthly except in those months when there is no activity in the trust fund bank account, and that a record of each reconciliation be maintained.
This record should identify the:

1. Bank account name and number,
2. Date of the reconciliation,
3. Account number or name of the principals or beneficiaries or transactions, and
4. Trust fund liabilities of the broker to each of the principals, beneficiaries or transactions.

Unexplained Trust Account Overages

When a broker performs a reconciliation pursuant to Commissioner's Regulation 2831.2, the broker may find an **unexplained overage**.

An unexplained overage is defined as funds in a real estate broker's trust account which exceed the aggregate trust fund liability of such account where the broker is unable to determine the ownership of such excess funds.

Unexplained trust account overages are trust funds and unless the broker can establish the ownership of such funds, the funds must be maintained in the broker's trust fund account or in a separate trust fund account established to hold such funds.

Unexplained trust account overages may not be used to offset or cover shortages that may exist otherwise in the broker's trust account.

A broker must keep a separate record of unexplained trust account overages including a separate subsidiary ledger to record the potential trust fund liability. Such records must include the date of recording and the date on which such funds became an unexplained trust account overage.

A broker holding unexplained trust account overages must perform a monthly reconciliation of such funds in accordance with Commissioner's Regulation 2831.2.

Suggestions for Reconciling Records

The following is a general discussion on how to perform the trust account reconciliations.

1. Before performing the reconciliations, record all transactions up to the **cut-off date** in both the bank account record and the separate beneficiary or transaction records.
2. Use balances as of the same cut-off date for the two records and the bank statement.
3. For the bank account reconciliation, calculate the adjusted bank balance from the bank statement and from the bank account record. (Brokers commonly err by calculating the adjusted bank balance based solely on the bank statement, ignoring the bank account record. While they may know the correct account balances, they may not realize their records are incomplete or erroneous.)
4. Keep a record of the two reconciliations performed at the end of each month, along with the supporting schedules.
5. Locate any difference between the three sets of accounting records. A difference can be caused by:
    a. Not recording a transaction
    b. Recording an incorrect figure
    c. Erroneous calculations of entries used to arrive at account balances
    d. Missing beneficiary records
    e. Bank errors

Documentation Requirements

In addition to accounting records, <u>the Bureau of Real Estate requires that the broker maintain all documents prepared or obtained in connection with any real estate transaction handled.</u> Here is a list of typical activities and the corresponding documentation:

Activity Documentation

1. Receiving trust funds in the form of:
   a. Purchase deposits from buyers
   b. Real estate purchase contract and receipt for deposit, signed by the buyer
   c. Real estate purchase contract and receipt for deposit, signed by the buyer
   d. Rents and security deposits from tenants
   e. Collection receipts
   f. Other receipts
   g. Collection receipts
2. Depositing trust funds
   a. Bank deposit slips
3. Forwarding buyers' checks to escrow
   a. Receipt from title/escrow company and copy of check
4. Returning buyers' checks
   a. Copy of buyer's check signed and dated by buyer, signifying buyer's receipt of check
5. Disbursing trust funds
   a. Checks issued
   b. Supporting papers for the checks, such as invoices, escrow statements, billings, receipts, etc.
6. Receiving offers and counteroffers from buyers and sellers
   a. Real estate purchase contract and receipt for deposit, signed by respective parties
   b. Agency disclosure statement
   c. Transfer disclosure statement.
7. Collecting management fees from the trust fund bank account
   a. Property management agreements between broker and property owners. (Note: If only one trust fund check is issued for management fees charged to various property owners, there should be a schedule or listing on file showing each property and amount charged, and the total amount, which should agree with the check amount.)
   b. Cancelled checks
8. Reconciling bank account record with separate beneficiary records

Record of Reconciliation

Additional Requirements: Documents

The following is an additional requirement of the Real Estate Law and the Commissioner's Regulations relating to the preparation and management of real estate transaction documents:

- Listing Agreements

- Real Estate Purchase Contract and Receipt for Deposit Forms
- Addenda to Contracts
- Property Management Agreements

Person Signing Contract to be Given Copy under Business and Professions Code Section 10142

Any time a licensee prepares or has prepared an agreement authorizing or employing that licensee to perform any acts for which a real estate license is required or when the licensee obtains the signature of any person to any contract pertaining to such services or transaction, the licensee must deliver a copy of the agreement to the person signing it at the time the signature is obtained.

The licensee must deliver a copy of the agreement to the person signing it at the time the signature is obtained.

Audits and Examinations

Because of the importance of trust fund handling, the Commissioner has an ongoing program of examining brokers' records. As necessary, audited licensees are made aware of deficiencies in trust fund handling and record keeping.

If an audit discloses actual trust fund imbalances or money handling procedures which may cause monetary loss, appropriate disciplinary proceedings are initiated.

Section 10148 of the Business and Professions Code provides that a real estate broker shall retain for three years copies of all listings, deposit receipts, canceled checks, trust records, and other documents executed by or obtained by the broker in connection with any transaction for which a real estate broker license is required.

The retention period shall run from the date of the closing of the transaction or from the date of the listing if the transaction is not consummated. After notice, such books, accounts and records shall be made available for examination, inspection and copying by the Commissioner or a designated representative during regular business hours, and shall, upon the appearance of sufficient cause, be subject to audit without further notice, except that such audit shall not be harassing in nature.

Questions and Answers Regarding Trust Fund Handling and Recordkeeping

Q. *Are security deposits on rental units the property of the owner or should they be held in trust by the broker for the tenant?*

A. They are trust funds. As such, control and disbursement of the security deposits are at the instruction of the property owner.

Q. *Am I permitted to wait until checks deposited to my trust account have cleared before I issue a trust check to fund a customer's check?*

A. Although the Real Estate Law is silent on this, good business practice dictates that you wait until a customer's check deposited to your trust account has cleared prior to the issuing of your trust check as a refund.

Q. *How should I handle an earnest money check which is to be deposited into escrow upon acceptance of the offer?*

A. Such a check may be held until the offer is accepted and then placed in escrow but only when directed to do so by the buyer, provided you disclose to the seller the fact the check is being held in uncashed form. In such cases, it is good practice to include such a provision in the deposit receipt. You must keep a columnar record of the receipt of the check, the name of the escrow company and the date the check was forwarded to the escrow.

Q. *As a broker-owner of rentals, do I have to put security deposits in a trust account?*

A. Money you receive on your own property is received as a principal, not as an agent. As such, these are not trust funds and should not be placed in the trust account.

Q. *Must I keep a deposit receipt signed only by the buyer and rejected by the seller?*

A. Yes. Such a record must be maintained for three years.

Q. *May I maintain one trust fund account for both collections from my property management business and deposits on real estate sales transactions?*

A. Since property management funds usually involve multiple receipt of funds and several monthly disbursements, it is suggested that separate trust fund accounts be maintained for property management funds and earnest money deposits. However, all trust funds can be placed in the same trust fund account as long a separate records for each trust fund deposit and disbursement are maintained properly and the account is not an interest-bearing account.

Q. *If the buyer and seller decide to go directly to escrow and the buyer makes out a check to the escrow company and hands it directly to the escrow clerk, do I have to maintain any records of this check?*
A. No. You must maintain records only of trust funds which pass through your hands for the benefit of a third party.

Q. *How long must I keep deposit receipts?*
A. Deposit receipts must be maintained for three years.

Summary

We might say this chapter presents the three R's of trust funds:
1. Responsibility,
2. Requirements, and
3. Records.

It is a real estate broker's responsibility to protect clients' funds at all times and keep clients fully informed of the nature and disposition of all trust funds.

To aid brokers in carrying out this responsibility, the Real Estate Commissioner's Regulations include requirements concerning trust funds. A real estate broker also needs to meet other requirements from a practical business point of view.

To protect clients' funds adequately and in the business-like fashion expected, the broker must keep accurate records. Additional detail and illustrations for trust fund handling can be found in the CalBRE's RE 13 Booklet entitled "Trust Funds."

Q1. *Is the bank account used for trust fund handling in the name of the broker as trustee?*
Correct Procedure:
A. If broker holds an individual broker's license, the account should be set up in his or her name or in the name of a fictitious business name if the broker is the holder of a license bearing such fictitious name and designated a "Trust Account."
For example: John Doe Trust Account, or; Jane Doe Trust Account, or; assuming broker has registered dba of 25th Century Realty, 25th Century Realty Trust Account
B. If broker is a corporate broker licensee, the account should be set up in the corporation's name or in the name of a fictitious business name if the

corporate broker is the holder of a license bearing such fictitious name and designated a "Trust Account."

For example: ABC, Inc. Trust Account, or; assuming corporate broker has registered dba of ABC Realty, ABC Realty Trust Account.

Reference: Real Estate Law Book, Regulation 2832

Q2. *Is the bank account used for trust fund handling an interest-bearing account?*

Correct Procedure:

Trust funds may, at the request of the owner of the funds, be placed into an interest-bearing account at a bank or savings and loan association if the following requirements are met:

A. The account is in the name of the broker as trustee for the designated beneficiary or principal of a transaction or series of transactions.
B. All of the funds in the account are covered by insurance provided by an agency of the United States.
C. The funds in the account are kept separate, distinct, and apart from funds belonging to the broker or to any other person for whom the broker holds funds in trust.
D. The broker discloses to the person from whom the trust funds are received, and to a beneficiary whose identity is known to the broker at the time of establishing the account, the nature of the account, how interest will be calculated and paid under various circumstances, whether service charges will be paid to the depository and by whom, and the possible notice requirements or penalties for withdrawal of funds from the account.
E. Interest earned on funds in the account may not inure directly or indirectly to the benefit of the broker or to any person licensed to the broker.
F. In an executory sale, lease, or loan transaction in which the broker accepts funds in trust to be applied to the purchase, lease, or loan, the parties to the contract shall have specified in the contract or by collateral written agreement the person to whom interest earned on the funds is to be paid or credited.

It should be noted that this would require the broker to maintain a separate bank account for each beneficiary who wishes to earn interest. See Reference: Real Estate Law Book, Section 10145(d) (1)-(6)

Q3. *Are control records complete and accurate?*

Correct Procedure:

Every broker shall keep a record of all trust funds received, including uncashed checks.

A. If a broker does not maintain a trust account or maintains a trust account but forwards all trust funds received to either the escrow or to the owner of the funds, then he/she must maintain a **Record of Trust Funds Received but Not Deposited** to a Trust Fund:
   1. Date funds received;
   2. Form of payment;
   3. Amount received and from whom received;
   4. Description of property or other identification;
   5. Identity as to whom funds were forwarded;
   6. Date of disposition.

However, a broker is not required to keep the above records of passing through checks made payable to service providers (e.g., escrow, credit and appraisal services) when the total of such checks from any one principal for any transaction does not exceed $1,000.

Upon request of the Bureau or the maker of such checks, a broker shall account for the receipt and distribution of such checks.
A broker shall retain for three years copies of receipts issued or obtained in connection with the receipt and distribution of such checks.

B. If a broker does maintain a trust account, he/she must maintain a Columnar Record of all **Trust Funds Received and Paid Out of the Trust Fund Bank Account** (for example, CalBRE Form RE 4522). This record should show the following in chronological sequence:
   1. Date funds received;
   2. From whom funds received;
   3. Amount received;
   4. Date of deposit;
   5. Check number and date of related disbursement;
   6. Daily balance of trust bank account.

Reference: Real Estate Law Book, Regulation 2831

Q4. *Are the separate transaction records complete and accurate?*
Correct Procedure:
Brokers must maintain a **Separate Record for Each Beneficiary or Transaction** (for example, CalBRE Form RE 4523). This record accounts for the funds received from, or for the account of, each beneficiary or each transaction and deposited to the trust fund bank account.

These records are necessary for the broker to ascertain the total owed to each of the beneficiaries. The record should show in chronological sequence the following:

1. Date of deposit;
2. Amount of deposit;
3. Date of each related disbursement;
4. Check number of each related disbursement;
5. Amount of each related disbursement;
6. If applicable, dates and amounts of interest earned and credited to the account;
7. Balance after posting transactions on any date.

Reference: Real Estate Law Book, Regulation 2831.1

Q5. *Is monthly reconciliation of the control records and separate records performed and documented?*

Correct Procedure:

The balance of all separate beneficiary or transaction records (for example, CalBRE Form RE 4523) must be reconciled with the record of all trust funds received and disbursed (for example, CalBRE Form RE 4522) at least once a month. A record of reconciliation must be maintained and it must identify the following:

1. Bank account name;
2. Account number;
3. Date of reconciliation;
4. Name of beneficiary;
5. Trust fund liabilities of the broker to each beneficiary.

For example:

ABC Realty, Inc. Trust Account 0339-000011 5/31/2014

Balances per Separate Beneficiary Records:

Jones	$500.00	
Smith	$250.00	
Thompson	$100.00	
Total of Separate Records		$850.00
Balance per Record of All Trust Funds Received:		$850.00
Difference (if any, should be fully explained)		$0.00

Reference: Real Estate Law Book, Regulation 2831.2

Q6. *Are trust funds deposited in a timely manner?*
Correct Procedure:
Unless otherwise specified in writing by the beneficiary of the funds, a broker is required to do one of the following three things with trust funds no later than three business days following receipt of the funds by the broker or the broker's salesperson:

A. Deposit the funds into a neutral escrow depository;
B. Place funds accepted on behalf of the owner into the hands of the owner of the funds;
C. Deposit the funds into a trust fund bank account maintained by the broker.

When broker is handling escrow funds: A real estate broker who is not licensed under the Escrow Law (Section 17000 et seq. of the Financial Code), when acting in the capacity of an escrow holder in a real estate transaction in which the broker is performing acts for which a real estate license is required, shall place all funds accepted on behalf of another into one of the three places listed above <u>not later than the next business day following receipt of the funds by the broker or the broker's salesperson.</u>
Reference: Real Estate Law Book, Regulation 2832

Q7. *Are authorized signatories either employed by the broker and licensed or unlicensed but bonded?*
Correct Procedure:
Withdrawals may be made from the trust account only upon the signature of the broker or one or more of the following persons with written authorization from the broker:

A. A salesperson licensed to the broker;
B. A person licensed as a broker who has entered into a written agreement with the employing broker;
C. An unlicensed employee of the broker with fidelity bond coverage at least equal to the maximum amount of trust funds to which the employee would have access.

Withdrawals may be made from the trust account of a corporate broker only upon the signature of an officer through whom the corporation is licensed or one of the persons detailed above. The corporate broker should always be a signatory on the trust account.

Concerning an unlicensed employee with fidelity bond coverage, it is recommended that the fidelity bond specifically identify the trust account which is being covered. The fidelity bond must <u>not</u> include a deductible clause.

Reference: Real Estate Law Book, Regulation 2834

Q8. *Are broker's funds commingled with trust funds?*
Correct Procedure:
Funds belonging to a broker should <u>not</u> be commingled with trust funds. Common examples of commingling are:

1. Personal or company funds deposited into the trust fund bank account;
2. Trust funds deposited into the general or personal bank account, and;
3. Funds collected on real property wholly owned by the broker handled through the trust account. A broker, however, is allowed to maintain up to $200 of personal funds in a trust account to cover checking account service fees and other bank charges.

> Commissions, fees, other income earned by a broker, and funds belonging in part to the broker's principal and in part to the broker when it is not reasonably practicable to separate such funds, must be withdrawn from the trust account within <u>25 days</u> from the date of deposit.

Reference: Real Estate Law Book, Section 10176(e); Regulation 2835

Why Do Real Estate Brokers Sometimes Have Difficulty Establishing Trust Accounts at Some Banks?

A trust account is a bank account managed by someone on behalf of someone else. The person who manages the trust is the **trustee**.

A trust account is set up to separate trust funds from non-trust funds. In a real estate transaction, the broker managing the trust account is a **fiduciary** to the beneficiaries of the account.

A fiduciary relationship can exist regardless of whether a formal trust agreement has been established. Explaining the absence of a “formal trust agreement” is often where real estate brokers have difficulties with some banks.
Individuals and families create trusts to distribute assets after a person’s death, and these trust agreements are usually prepared by an attorney. It is this formal trust agreement that a bank may ask for if a real estate broker simply requests to open a trust account.

What to Tell the Bank: When asking a bank official to open a trust account, the real estate broker should take the following steps:

1. Ask to open a business checking account.

2. Ask to have the account titled as a trust account in your name, registered fictitious name or corporate broker name, with the designation “as trustee” in the title or on the broker/designated officer signature line.
3. No separate trust agreement is required.

The bank will ask for additional documentation to verify your identity, business certificates, Articles of Incorporation, etc. The broker might need to tell the banker that the account to be opened is similar to an attorney trust account in that there is no trust agreement.

Sample Transactions

To demonstrate the record keeping requirements discussed in this chapter, we have simulated trust account records for typical real estate transactions occurring over a thirty-day period. To set the stage, let us assume that James Adams, a real estate broker, owns and operates a one-man real estate office specializing in residential sales and property management. Broker Adams has one trust fund bank account. We will look at the trust account activity for this office for the month of ***May 2015***.

As previously discussed, a broker may use other types of records as long as they meet generally accepted accounting standards.

2015 TRANSACTIONS

May 1 Opened a trust account with First County Bank, and deposited $100 of his own money to cover bank service charges.

May 1 Entered into agreements to manage the following rental properties:

Address	Owner’s Name	# of Units
a. 1538 South Avenue, Anycity, CA	T. Eddie	1
b. 3490 Tower Street, Anycity, CA	L. Stewart	4
c. 9152 High Way, Anycity, CA	W. Allen	4
d. 2351-2353 Kingston Way, Anycity, CA	S. Manly	2
e. 7365 Meadow Circle, Anycity, CA	J. Bird	1

May 3 Deposited the following rents received from tenants of managed properties:

Property	Tenant’s Name	Rent Received
a. 1538 South Ave.	B. Hamns	$600
b. 3490 Tower St., Unit 1	R. Robertson	350

c. 2351 Kingston Way	I. Warren	450
		$1,400

May 5 Received a $2,000 check payable to broker from Mr. and Mrs. Dennis White as deposit for their offer to buy a house at 615 Lake Drive, Anycity, owned by Mr. and Mrs. Richard J. Jensen. Buyers' offer instructed broker to hold the check uncashed until their offer was accepted by the Jensens.

May 5 Received and deposited $750 from T. Sundance representing rent of $500 for September 5 to 30, and $250 security deposits for 7365 Meadow Circle.

May 5 Was notified by the Jensens that they accepted the offer on their property.

May 6 Deposited the $2,000 check from Mr. and Mrs. White.

May 8 Obtained an exclusive listing to sell a six-plex at 915 Galaxy St., Anycity, owned by R. Jays.

May 9 Received $1,000 from W. Allen, owner of 9152 High Way, to cover anticipated expenses for the property. Amount was deposited the same day.

May 10 Issued the following checks to pay for various expenses connected with the managed properties:

Check No.	**Payee**	**Purpose**	**Amount**
1001	ABC Mortgage Co.	Mortgage payment for 1538 South Ave.	$450
1002	Anycity Treasury	Utilities for 1538 South Ave.	35
1003	Professional Cleaners	Cleaning for 3490 Tower St.	55

1004	Mr. Handyman	Minor repairs on 2351 Kingston	25
		TOTAL	**$565**

May 14 Received a $4,000 check from B. Sun, payable to Title Escrow Company, with an offer to buy the 915 Galaxy property.

May 15 Received R. Jays' acceptance of the buyer's offer on 915 Galaxy Street.

May 16 Delivered the $4,000 check from B. Sun to Title Escrow Company.

May 19 Issued check number 1005 for $2,000 to First Title Co. for account of Mr. and Mrs. White, buyers of the 615 Lake Drive property.

May 22 Received an offer and a $3,000 check as deposit from R. Olive to buy a single family house at 31009 Technology Street owned by T. Evans.

May 24 Returned R. Olive's check after seller rejected the offer.

May 31 Charged property management fees to the following accounts and issued check number 1006 for $330 payable to himself:

Property Owner	**Management Fee**
T. Eddie	$45
L. Stewart	100
W. Allen	80
S. Manly	60
J. Bird	45
Total	**$330**

May 31 Sent statement of account to each owner of the managed properties.

Background Information

James Adams keeps four types of columnar records:

1. Record of all Trust Funds Received and Paid Out - Trust Fund Bank Account (hereinafter referred to as "Bank Account Record"). This record is required under Commissioner's Regulation 2831 for each trust account a broker has.

2. Record of all Trust Funds Received - Not Placed in Broker's Trust Account (hereinafter referred to as "Record of Undeposited Receipts"). This is required under Commissioner's Regulation 2831.
3. Separate Record For Each Beneficiary or Transaction (hereinafter referred to as "Separate Beneficiary Record"). This is required under Commissioner's Regulation 2831.1.
4. Separate Record For Each Property Managed (hereinafter referred to as "Separate Property Record"). This serves the same purpose as the Separate Beneficiary Record.
   A. To illustrate the recording process, listed below are the entries made on the books by James Adams as well as the documents prepared or obtained as support for each transaction. The actual entries are shown on the forms/exhibits at the end of this chapter.

Note that:

- Each entry to any record shows all the pertinent information of the transaction, such as the date, name of payee, name of payor, amount, check number, etc.
- The daily *bank balance* is computed and posted on the Account Record after recording the transactions.
- The balance owing to the client is computed and posted on the Beneficiary Record or Separate Property Record, after posting transactions.
- Any entry made on the Bank Account Record has a corresponding entry on a Beneficiary Record or a Separate Property Record, and vice versa.
- All records except the Record of Undeposited Receipts show entries in chronological sequence regardless of transaction type. The Record of Undeposited Receipts shows the disposition of a trust fund in the same line as the receipt is entered, rather than in chronological sequence.

Step-By-Step Narrative of Trust Account Entries

Transaction Date	**Documentation**	**Entries**
May 1	Deposit slip prepared by broker.	Record the deposit on: 1. The Bank Account Record. Balance is $100. 2. A newly prepared Separate Beneficiary for James Adams. Balance is $100.

May 1	Management agreements signed by property owners and broker.	No entries needed since there was no receipt nor disbursement of trust funds.
May 3	Collection receipts Nos. 2, 3 and 4 issued to B. Hamns, R. Robertson, and I. Warren, respectively.	Record the $1,400 receipt on: 1. The Bank Account Record. New balance is $1,500. 2. Newly prepared Separate Beneficiary Records for: T. Eddie - balance is $600 L. Stewart – bal. is $350 S. Manly - balance is $450
May 5	Real Estate Purchase Contract and Receipt for Deposit signed by Mr. and Mrs. White. Collection receipt No. 1 issued to the Whites.	Enter transaction on the Record of Undeposited Receipts. No Separate Beneficiary Record is necessary since the check was not deposited.
May 5	Collection receipt No. 5 issued to T. Sundance. Receipt showed that $500 of the $750 was for rent and the other $250 was for security deposit.	Record the $750 deposit on: 1. The Bank Account Record. 2. Separate Beneficiary Records for: J. Bird - Sundance's Security Deposit, bal. is $250. J. Bird - balance is $500. (Since security deposits will be accounted to the tenant in the future, James Adams keeps a separate record for deposits. Total liability to the owner is the sum of the two records - one for security deposits, another for rents and other transactions.)
May 5	Real Estate Contract and Receipt for trust funds were received for Deposit signed by Mr. and Mrs. Jensen.	No entries were made since no trust funds were received or disbursed.

May 6	Deposit receipt prepared by broker.	Record $2,000 deposit on: 1. Bank Account record. New balance is $4,250. 2. A newly prepared Separate Beneficiary Record - Mr. and Mrs. White/Mr. and Mrs. Jensen. Account balance is $2,000. 3. Record of Undeposited Receipts. Shows disposition of check previously entered on the record.
May 8	Exclusive Listing Agreement signed by sellers and broker.	
May 9	Collection receipt No. 6 issued to W. Allen.	Record receipt on: 1. The Bank Account Record. New balance is $5,250. 2. A newly prepared Separate Beneficiary Record - W. Allen. Balance is $1,000.
May 10	Checks issued by broker. Supporting papers for each check.	Record disbursements on: 1. Bank Account Record. New Balance is $4,685. 2. Separate Beneficiary Records for: T. Eddie - New balance is $115. L. Stewart - New balance is $295. S. Manly - New balance is $425.
May 14	Real Estate Purchase Contract and Receipt for Deposit signed by B. Sun.	Record receipt on the Record of Undeposited Receipts.
May 15	Real Estate Purchase Contract and Receipt	No entry was needed since there was no receipt or disbursement of funds.

	for Deposit signed by R. Jays.	
May 16	Receipt issued by Title Escrow Company.	Note disposition of check on the Record of Undeposited Receipts.
May 19	Check issued by broker. Receipt issued by First Title Company.	Record disbursements on the: 1. Bank Account Record. New balance is $2,685. 2. Separate Beneficiary Record - Mr. and Mrs. White/Mr. and Mrs. Jensen. New balance is $0.
May 22	Real Estate Purchase Contract and receipt for Deposit signed by R. Olive.	
May 24	Real Estate Purchase Contract and Receipt for Deposit rejected by T. Evans.	Post the return of check on the Record of Undeposited Receipts.
May 31	List showing the breakdown of the check amount, showing the charge to each owner. (NOTE: A list is necessary as support for a check disbursement chargeable to a number of beneficiaries. Posting the entries on the separate records without such a list is not sufficient.)	Record disbursements on the: 1. Bank Account Record. New balance is $2,685. 2. Separate Beneficiary Records for: **New Owners** — **Balance** T. Eddie — $70 L. Stewart — $195 W. Allen — $920 S. Manly — $365 J. Bird — $455

After recording the daily transactions, the next step in the trust fund accounting process is the reconciling of records at the end of the month. James Adams prepared reconciliation schedules by comparing the bank balance on the Bank Account Record with the bank statement balance (the bank reconciliation) and also with the total of the Separate Beneficiary Records balances (the reconciliation report). The bank statement and reconciliations are shown below.

FIRST COUNTY BANK STATEMENT

MAIN BRANCH
5 Main Avenue
ANYCITY, CA 90002

PAGE 1 of 1

DATE OF THIS STATEMENT
05/31/15

JAMES ADAMS
TRUST ACCOUNT
8310 ORANGE AVENUE
ANYCITY, CA 90002

CHECKING ACCT. 123456 CUSTOMER SINCE 2005

SUMMARY: Previous Statement Balance on 04/30/15……….....	00.00
Total of 5 Deposits For……….……..…………………………	5,250.00
Total of 4 Checks For……….……………………………….…...	2,540.00
Total of 1 Other Debit For………………………………………..	7.00
Statement Balance on 05/31/15……………………………….….	2,703.00

Checks/Other Debits

Checks

Check Number	Date Posted	Amount
1001	5/14	450.00
1002	5/16	35.00
1003	5/16	55.00
1005	5/21	2,000.00

Other Debits

Date Posted		Amount
05/31	Service Charge	7.00

Deposits/ Other Credits

Deposits

Date Posted	Amount
5/1	100.00
5/5	1,400.00

	Date	Amount	Date	Amount
			5/5	750.00
			5/6	2,000.00
			5/9	1,000.00
Daily Balance	Date	Amount	Date	Amount
	5/1	100.00	5/14	4,800.00
	5/5	2,250.00	5/16	4,710.00
	5/6	4,250.00	5/21	2,710.00
	5/9	5,250.00	5/31	2,703.00

James Adams
Bank Reconciliation
First County Bank
May 31, 2015

Balance per Bank Statement, 5/31/15		$2,703.00
Add: Deposits in Transit		-0-
Less: Outstanding Checks		
Check #1004		$25.00
Check #1006	330.00	(355.00)
Adjusted Bank Balance, 5/31/15		$2,348.00
Balance per Books, 5/31/15		$2,355.00
Less: May Bank Service Charge		(7.00)
Adjusted Balance, 5/31/15		$2,348.00

James Adams
Reconciliation Report
First County Bank
Account No. 123456
May 31, 2015

Beneficiary	**Balance**
James Adams (Broker)	$93.00
W. Allen	920.00
J. Bird	250.00
J. Bird	455.00
T. Eddie	70.00
S. Manly	365.00
L. Stewart	195.00
Total per subsidiary records	$2,348.00
(Agrees with bank account record balance.)	

This concludes our three (3) hour continuing education course in Trust Fund Handling.

Fair Housing

Due to discrimination in housing, lending, and commercial business establishments, federal and state housing laws were enacted to prohibit these forms of **discrimination**.

Many of the blatant tricks that were used by real estate agents and lenders to deny purchases and/or loans to minorities in the past have been cast aside as a result of the many state and federal fair housing laws.

Unfortunately, as is many times the case, laws are only as good as the people who obey them. In recent times, many of the same discriminatory practices have been used, but on a much more subtle basis.

The following federal and state civil rights laws were legislated with the intent to prohibit many of the forms of discrimination that was tearing up our society.

I. FEDERAL FAIR HOUSING LAWS

Civil Rights Act of 1866

The **Civil Rights Act of 1866** was enacted just after the end of the Civil War (or what the South still calls the "War Between the States"). In any case, one of the key issues behind the above noted war was rights to all citizens in the United States.

The Civil Rights Act of 1866 gave ALL citizens in the United States the right to purchase, rent, sell, hold, and convey all (residential and commercial) real property and personal property without regard to race.

In addition all persons have the right to contract, sue, be sued, and enjoy the full benefits of the law.

"All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and extraction's of every king, and to no other."

Federal Fair Housing Act (Civil Rights Act of 1968)

The Federal Fair Housing Act prohibits discrimination in:

1. sale, rental, or advertisement of residential dwellings;
2. brokerage services;
3. appraisal of real estate; and
4. real estate loans and loan purchases.

Discrimination is based on a person's:

1. race;
2. religion;
3. national origin;
4. sex;

A broker may not discriminate on the sale or rental of a residential dwelling. Thus a broker may not:

1. refuse to sell or rent for discriminatory reasons;
2. evict a tenant for discriminatory reasons;
3. use different qualification criteria for selling or purchasing a residential dwelling;
4. impose different sale or rental charges for discriminatory reasons;
5. use different terms, conditions, and privileges in the sale or rental of residential dwellings;
6. perform differing maintenance activities for certain persons;
7. limit use of common areas or facilities to certain persons; and
8. refuse to provide service due to a person's refusal to provide sexual favors.

A broker may not steer a person into a residential neighborhood or community in an attempt to segregate housing patterns. This is called **steering** and is discriminatory and illegal.

"A broker may not steer a person into a residential neighborhood or community in an attempt to segregate housing patterns."

A broker also may not use advertising that discriminates in the sale or rental of real property. This relates to all advertising used in the course of business. A broker may not attempt to induce or actually induce a person to sell or rent their real property because of the entry of a certain class of people into the neighborhood. This is called **blockbusting** and is illegal.

Americans with Disabilities Act of 1990, Title III (ADA)

The ADA was enacted to prohibit discrimination against people with disabilities. It covers most commercial buildings and requires building owners to remove all "architectural and communicative barriers" that will "impede reasonable access to any facility."

The building may be exempted from this law if it can be shown that upgrading the building to ADA standards would be a "disproportionate cost to the overall alteration."

II. CALIFORNIA FAIR HOUSING LAWS

Unruh Civil Rights Act of 1959

The Unruh Act made it illegal for the proprietor of a business establishment to discriminate because of a person's race.

> It stated:
> "All persons within the jurisdiction of this State (California) are free and equal, and no matter what their sex, race, color, religion, ancestry, or national origin, they are entitled to the full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever."

A business establishment may not discriminate based upon age of the patron or occupant. However, business establishments used to preserve housing for senior citizens are allowed under an amendment to the federal Fair Housing Act. A senior citizen is defined as a person 62 years of age or older. However, if all persons are not over 62 years of age, the development may qualify under the 55 year old exemption. This means that at least 80% of the units must be occupied by someone 55 years of age or older.

Damages for violation of this Act are not less than $250 or three times the amount of the actual damages plus attorney fees.

California Fair Employment and Housing Act of 1963 (Rumford Act)

The Rumford Act was the first piece of legislation to use the term "affirmative action." The law related to: "Any activity for the purpose of eliminating discrimination in housing accommodations because of race, color, religion, sex, marital status, national origin, or ancestry." This was a much more stringent law since it pertained to any person who refused to sell, lease, or rent housing accommodations because of race, color, religion, sex, marital status, national origin, or ancestry. Unfavorable and discriminatory terms could not be used to discourage the above group.

> The Rumford Act prohibited discriminatory practices based on race, color, religion, sex, marital status, ancestry, national origin, or disability in the sale or lease of housing accommodations.

Discriminatory practices include:

1. a broker refusing to represent an individual because of one of the above reasons;
2. advertising that limits preferences based upon the above reasons;
3. making an oral or written inquiry into the above reasons for a person looking to rent or purchase a residential dwelling; and/or
4. limiting loans and financing based upon the above reasons.

The **Department of Fair Employment and Housing** and the **Fair Employment and Housing Commission** enforces the Rumford Act.

Housing Financial Discrimination Act of 1977 (Holden Act)

The Holden Act was enacted in response to discrimination in lending practices in California. Lenders, realizing a higher foreclosure rate in urban areas where a majority of minority owners resided, decided to curtail loans in these areas.

They placed a RED LINE circle around these areas, thus coined the term "**Redlining**."

> The Holden Act place restrictions on this practice by making it illegal to "consider the racial, ethnic, religious, or national origin composition of trends in neighborhoods surrounding a housing accommodation."

If the buyer was qualified to purchase a 1-4 unit residential property, the lender had to make a reasonable loan available to that buyer. In retrospect, most people believe this to be a good and well timed law which reduced discrimination in lending, increased loans in urban areas, and slowed down the decay in many urban residential neighborhoods.

Lenders cannot discriminate when making a loan on the basis of:

1. Race
2. Color
3. Religion
4. Ancestry
5. Sex
6. Disability
7. Marital Status
8. National Origin

Lenders cannot refuse a loan to a creditworthy borrower based upon the demographics of the neighborhood. They also cannot refuse a loan based upon a much lower appraisal of the property than in neighborhoods not composed predominantly of non-minority residents.

Lenders are required to post in a conspicuous public place a notice of a loan applicant's rights to file a lending discrimination claim with the Secretary of Business, Transportation, and Housing Agency. This includes state regulated banks and savings banks, and other institutions. It does not cover federally regulated banks.

"Lenders cannot refuse a loan to a creditworthy borrower based upon the demographics of the neighborhood."

Under the **Federal Home Mortgage Disclosure Act**, lenders are required to disclose home loan origination information to the public. This ensures that redlining will not exist in the United States.

In addition, California state regulated lenders must compile data on the number and amount of loans originated for each fiscal year. These are grouped by census tract and is available to the public for five years.

Real Estate Commissioner's Regulations

The Real Estate Commissioner has enacted regulations prohibiting real estate brokers and their salespeople from any practice that discriminates against anyone based on:

1. Race
2. Color
3. Religion
4. Ancestry
5. Sex
6. Disability
7. Marital Status
8. National Origin

The Commissioner also prohibits **blockbusting** and **panic selling**. Blockbusting has already been explained, however, panic selling occurs when a broker or salesperson goes into a neighborhood and induces homeowners and tenants to move out of the neighborhood because of an impending change in the ethnic makeup of the neighborhood.

The Commissioner also holds real estate brokers accountable to their agents to inform them of all fair housing laws and Commissioner's regulations regarding the matter.

Regulations of the Real Estate Commissioner, Regulation 2780 Discriminatory Conduct as the Basis for Disciplinary Action

Under Regulation 2780 discriminatory conduct is a basis for disciplinary action.

Prohibited discriminatory conduct by a real estate licensee based upon race, color, sex, religion, ancestry, physical handicap, marital status, or national origin includes:

Refusing to negotiate for the sale, rental, or financing of the purchase of real property or otherwise making unavailable or denying real property to any person because of such person's:

- Race
- Color
- Sex
- Religion
- Ancestry

- Physical handicap
- Marital status
- National origin

Refusing or failing to show, rent, or finance the purchase of real property to any person or refusing or failing to provide or volunteer information to any person about real property, or channeling or steering any person away from real property, because of that person's race, color, sex, religion, ancestry, physical handicap, marital status, or national origin or because of the racial, religious, or ethnic composition of any occupants of the area in which the real property is located.

It shall not constitute discrimination under this subdivision of the law for a real estate licensee to refuse or fail to show, rent, sell, or finance the purchase of real property to any person having a physical handicap because of the presence of hazardous conditions or architectural barriers to the physically handicapped which conform to applicable state and local building codes and regulations.

Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin against any person in the:

- Sale,
- Purchase,
- Negotiation,
- Solicitation of the sale or purchase,
- The collection of payments,
- The performance of services in connection with contracts of sale of real property,
- The performance of services in connection with loans secured directly or collaterally by liens on real property, or
- Business opportunities

will fall under Regulation 2780.

Prohibited discriminatory conduct by a real estate licensee under this subdivision does not include acts based on a person's marital status which are reasonably taken in recognition of the community property laws of California as to acquiring, financing, holding, or transferring real property.

Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin against any person in the terms, conditions, or privileges of sale, rental, or financing of the purchase of real property. This does not prohibit the sale price, rent, or terms of a housing accommodation containing facilities for the physically handicapped to differ reasonably form a housing accommodation not containing such facilities.

Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin against any person in providing services or facilities in connection with the sale, rental, or financing of the purchase of real property, including but not limited to:

1. Processing applications differently,
2. Referring prospects to other licensees because of the prospects' race, color, sex, religion, ancestry, physical handicap, marital status, or national origin,
3. Using with discriminatory intent or effect, codes or other means of identifying minority prospects,
4. Assigning real estate licensees on the basis of a prospective client's race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

Prohibited discriminatory conduct by a real estate licensee under this subdivision does not include acts based on a person's marital status which are reasonably taken in recognition of the community property laws of California as to acquiring, financing, holding, or transferring real property.

Representing to any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status, or national origin that real property is not available for inspection, sale, or rental when such real property is in fact available.

Processing an application more slowly or otherwise acting to delay, hinder, or avoid the sale, rental, or financing of the purchase of real property on account of the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of a potential owner or occupant.

Making any effort to encourage discrimination against persons because of their race, color, sex, religion, ancestry, physical handicap, marital status, or national origin in showing, sale, lease, or financing the purchase of real property.

Refusing or failing to cooperate with or refusing or failing to assist another real estate licensee in negotiating the sale, rental, or financing of the purchase of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of any prospective purchaser or tenant.

Making any effort to obstruct or discourage the purchase, lease, or financing of the purchase of real property by persons whose race, color, sex, religion, ancestry, physical handicap, marital status, or national origin differs from that of the majority of persons presently residing in a structural improvement to real property or in an area in which real property is located.

Performing any acts, making any notations, asking any questions or making or circulating any written or oral statement which when taken in context, expresses or implies a limitation, preference or discrimination based upon race, color, sex, religion, ancestry, physical handicap, marital status, or national origin; provided, however, that nothing herein shall limit the administering of forms of the making of a notation required by a federal, state, or local agency for data collection or civil rights enforcement purposes; or in the case of a physically handicapped person, making notation, asking questions or circulating any written or oral statement in order to serve the needs of such a person.

Making any effort to coerce, intimidate, threaten, or interfere with any person in the exercise or enjoyment of, or on account of such person's having exercised or enjoyed, or on account of such person's having aided or encouraged any other person in the exercise of any right granted or protected by a federal or state law, including but not limited to:

1. Assisting in any effort to coerce any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status, or national origin to move from or not to move from a particular area.
2. Punishing or penalizing real estate licensees for their refusal to discriminate in the sale or rental of housing because of the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of a prospective purchaser or lessee.
3. Evicting or taking other retaliatory action against any person for having filed a fair housing complaint or for having undertaken other lawful efforts to promote fair housing.
4. Soliciting of sales, rentals, or listing of real estate from any person, but not from another person within the same area because of differences in race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of such persons.
5. Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin in informing persons of the

existence of waiting lists or other procedures with respect to the future availability of real property for purchase of lease.

Making any effort to discourage or prevent the rental, sale, or financing of the purchase of real property because of the presence or absence of occupants of a particular race, color, sex, religion, ancestry, physical handicap, marital status, or national origin or on the basis or the future presence or absence of a particular race, color, sex, religion, ancestry, physical handicap, marital status, or national origin, whether actual, alleged, or implied.

Making any effort to discourage or prevent any person from renting, purchasing, or financing the purchase of real property through any representations of actual or alleged community opposition based upon race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

Providing information or advice to any person concerning the desirability or particular real property or a particular residential area which is different from information or advice given to any other person with respect to the same property or area because of difference in the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of such persons.

This does not limit the giving of information or advice to physically handicapped persons for the purpose of calling to the attention of such persons the existence or absence of housing accommodation services or housing accommodations for the physically handicapped.

Refusing to accept a rental or sales listing or application for financing of the purchase of real property because of the owner’s race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of any of the occupants in the area in which the real property is located.

Entering into an agreement, or carrying out any instructions of another, explicit or understood, not to show, lease, sell, or finance the purchase of real property because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

Making, printing or publishing, or causing to be made, printed, or published, any notice, statement or advertisement concerning the sale, rental, or financing of the purchase of real property that indicates any preference, limitation, or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin, or any intention to make such preference, limitation, or discrimination.

This does not prohibit advertising directed to physically handicapped persons for the purpose of calling to the attention of such persons the existence or absence of housing accommodation services or housing accommodations for the physically handicapped.

Using any words, phrases, sentences, descriptions, or visual aids in any notice, statement, or advertisement describing real property or the area in which real property is located which indicates any preference, limitation, or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

This does not prohibit advertising directed to physically handicapped persons for the purpose of calling to the attention of such persons the existence or absence of housing accommodation services or housing accommodations for the physically handicapped.

Selectively using, placing, or designing any notice, statement or advertisement having to do with the sale, rental, or financing of the purchase of real property in such a manner as to cause or increase discrimination be restricting or enhancing the exposure or appeal to person of a particular race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

This does not limit in any way the use of an affirmative marketing program designed to attract persons of a particular race, color, sex, religion, ancestry, physical handicap, marital status, or national origin who would not otherwise be attracted to the real property or to the area.

Quoting or charging a price, rent, or cleaning or security deposit for a particular real property to any person which is different from the price, rent, or security deposit quoted or charged to any other person because of difference in the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of such persons.

This does not prohibit the quoting or charging or a price, rent, or cleaning or security deposit for a housing accommodation containing facilities for the physically handicapped to differ reasonably from housing accommodations not containing such facilities.

Discriminating against persons because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin in performing any acts in connection with the making of any determination of financial ability or in the processing of any application for the financing or refinancing of real property.

Nothing herein shall limit the administering of forms of the making of a notation required by a federal, state, or local agency for data collection of civil rights enforcement purposes. In any evaluation or determination as to whether, and under what terms and conditions, a particular lender or lenders would be likely to grant a loan, licensees shall proceed as though the lender or lenders are in compliance with Section 35800 through 35833 of the **California Health and Safety Code** (The Housing Financial Discrimination Act of 1977.)

Prohibited discriminatory conduct by a real estate licensee under this subdivision does not include acts based on a person's marital status which are reasonably taken in recognition of the community property laws of this state as to acquiring, financing, holding, or transferring real property.

Advising a person of the price or value of real property on the basis of factors related to the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of residents of an area or of residents or potential residents of the area in which the property is located.

Discriminating in the treatment of, or services to, occupants of any real property in the course of providing management services for the real property because of the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of said occupants.

This does not prohibit differing treatment or services to a physically handicapped person because of the physical handicap in the course of providing management services for a housing accommodation.

Discriminating against the owners or occupants of real property because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of their guests, visitors, or invitees.

Making any effort to instruct or encourage, expressly or impliedly, by either words or acts, licensees or their employees or other agent to engage in any discriminatory act in violation of a federal or state fair housing law.

Establishing or implementing rules that have the effect of limiting the opportunity for any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status, or national origin to secure real property through a multiple listing or other real estate service.

Assisting or aiding in any way, any person in the sale, rental, or financing of the purchase of real property where there are reasonable grounds to believe that such person intends to discriminate because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

Section 2781 Panic Selling

Prohibited discriminatory conduct includes, but is not limited to, soliciting sales or rental listings, making written or oral statements creating fear or alarm, transmitting written or oral warnings or threats, or acting in any other manner so as to induce or attempt to induce the sale or lease of real property through an representation, express or implies, regarding the present or prospective entry of one or more persons of another race, color, sex, religion, ancestry, physical handicap, marital status, or national origin into an area or neighborhood.

Section 2725(f) Duty to Supervise

A broker licensee shall take reasonable steps to become aware of and to be familiar with and to familiarize his or her salespersons with the requirements of federal and state laws and regulations relating to the prohibition of discrimination in the sale, rental, or financing of the purchase of real property. Such laws and regulations include but are not limited to the current provisions and any amendments thereto of:

1. Unruh Civil Rights Act.
2. Title VII and IX of the United States Civil Rights Act of 1968.
3. The Housing Financial Discrimination Act (Holden Act).
4. Blind and other physically disabled persons.

III. FAIR HOUSING OVERVIEW

Civil Rights Act of 1866

The Civil Rights Act of 1866 gave all citizens in the United States the right to purchase real estate. The Civil Rights Act of 1866 also gave everyone in the United States the right to enjoy the full benefits of the law. However, this act was largely ignored in the courts during the more than one hundred years from 1866 to 1968.

Civil Rights Act of 1968

The Civil Rights Act of 1968 prohibited discrimination in the sale and rental of real estate. Exemptions from the act include a residential owner who does not own more than three single-family homes, does not live in the house, does not use a real estate agent in the sale of the home, and does not use discriminatory advertising.

The Civil Rights Act of 1968 prohibited discrimination in (the):

- Sale of Real Estate
- Leasing of Real Estate
- Advertising of Real Estate
- Offer of Real Estate Brokerage Services
- Real Estate Loans
- Real Estate Appraisal Services

Discriminatory actions based on a person's:

1. Race
2. Color
3. Religion
4. Sex
5. Ancestry
6. Marital Status
7. National Origin
8. Handicap

A handicap can be physical or mental and limits a person's activities. A broker may not discriminate by:

1. using different provisions for minority applicants than other applicants,
2. limit use of facilities, and
3. delay maintenance because of discriminatory reasons.

<u>A broker may not discriminate in advertising.</u> This is both oral and written. A broker may <u>not</u> induce people to move out of a neighborhood because minorities are coming into the area. This is called blockbusting and is illegal.

A person who has been a victim of discrimination may file a complaint with the Department of Housing and Urban Development.

A person who has been a victim of discrimination may file a complaint with the Department of Housing and Urban Development. The statute of limitations is one year from the discriminatory act.

Americans with Disabilities Act

A disability is a physical or mental condition that limits a person's normal life activities. Public and private buildings must be built or altered to comply with ADA. A person discriminates against a person with a disability may be liable for civil damages in the amount of $50,000.

Unruh Civil Rights Act

The Unruh Civil Rights Act prohibits discrimination based upon race, color, sex, religion, ancestry, national origin, or a disability in business establishments. This also applies to a person in the business of providing housing to the public.

> "The Unruh Civil Rights Act prohibits discrimination based upon race, color, sex, religion, ancestry, national origin, or a disability in business establishments."

California Fair Employment and Housing Act

The California Fair Employment and Housing Act prohibits discrimination in housing accommodations in California. Discriminatory practices include:

1. broker refuses to represent a minority person,
2. broker asks about a prospective client's race, color, sex, religion, disability, national origin, or ancestry,
3. Broker places an advertisement under discriminatory conditions

Equal Credit Opportunity Act

The Equal Credit Opportunity Act prohibits discrimination based upon race, color, sex, marital status, religion, and national origin. If is a federal law that attempts to stop:

1. asking about a loan applicant's race, color, sex, marital status, religion, and national origin.
2. requiring signatures from both spouses when one qualifies for the loan on his or her own.
3. making loan qualification for minority applicants more difficult than other non-minority applicants.

The lender has thirty days to notify the loan applicant that their application has been denied, and must deliver to the applicant a statement specifying the reasons the loan was denied.

Housing Financial Discrimination Act

The Housing Financial Discrimination Act, also known as the "Holden Act" was an attempt by California to prevent discrimination in lending.

The Holden Act stated that loan could not be denied to an applicant based upon:

1. Race
2. Color
3. Religion
4. Disability
5. Marital Status
6. Sex
7. Ancestry
8. National Origin

Home Mortgage Disclosure Act

The Home Mortgage Disclosure Act requires lenders to disclose home loan information to the public. This includes anyone making home loans, including state and federally regulated banks. However, there are many exceptions to this requirement.

Lenders must disclose:

1. type and purpose of the loan,
2. whether it is owner-occupied or investor loan,
3. income of the loan applicant,
4. amount of the loan,
5. sex and race of the loan applicant.

AIDS Disclosure

If the occupant died as a result of AIDS, the death does not need to be disclosed by the seller. If the buyer asks the broker a direct question, the broker must disclose that the occupant died from AIDS.

Advertising Guidelines

It is discriminatory to use words or phrases that request particular buyer or tenant. Words such as “white”, “black”, “single”, etc. are discriminatory. However, advertising that requests people age 55 years and old is not discriminatory. This is many times used in adult communities.

Use of the Department of Housing and Urban Development’s (HUD) Equal Housing Opportunity logo is a good way to advertise that the broker does not practice discriminatory practices in their business.

California Bureau of Real Estate (CalBRE)

The California Bureau of Real Estate (CalBRE) prohibits discrimination by real estate brokers. Discriminatory practices include:

1. Discouraging a client from purchasing or renting a property because of the client’s race, national origin, sex, etc.
2. Discriminating in management of properties.
3. Limiting use of Multiple Listing Services, and
4. Refusing to accept a listing, sale, or loan because of discriminatory reasons.

Blockbusting and panic selling are illegal. When a real estate attempts to induce a seller to sell their property because minorities are coming into the neighborhood and will devalue properties, this is called panic selling. The result is what is called blockbusting.

As you have seen from the many federal and state laws, as well as the Real Estate Commissioner’s Regulations, Fair Housing is a major issue in California and national real estate. For this reason, the California Department of Real Estate requires salesperson licensees to complete this three hour continuing education course prior to their first license renewal. The knowledge gained from this course will help the licensee avoid discriminating in the sale, lease, development, etc. of real property.

Next is a look at a court case that impacts fair housing in California.

VIOLATION OF THE CIVIL RIGHTS ACT OF 1968

UNITED STATES OF AMERICA DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT OFFICE OF ADMINISTRATIVE LAW JUDGES

January 28, 2011

FOR THE COMPLAINANTS:
Donnie Murray, Sylloris Lampkin, and Melissa Anderson, Attorneys, United States Department of Housing and Urban Development, Atlanta, GA

FOR THE RESPONDENTS:
Clint L. Maze, Attorney, Arab, AL

INITIAL DECISION AND ORDER
BEFORE: J. Jeremiah MAHONEY, Administrative Law Judge
Background. In March of 2009, sisters Melissa and Amanda Garrett and Amanda's fiancé, Christopher Doss (collectively the "Complainants"), sought to rent a residence for themselves and Amanda's infant child. Melissa Garrett was staying temporarily with a friend in Phillip Maze's neighborhood in Arab, Alabama. Melissa noticed nearby a vacant mobile home, rented years ago by her older sister from Opal Maze. Melissa contacted Opal's elder son, Respondent Phillip Maze, who agreed to repair and rent the mobile home. Opal Maze owns three single-family dwellings, including that mobile home, which is adjacent to her house, where she resides with her son, Phillip. Opal Maze owns a third dwelling, another mobile home, that has been rented by Louise Terrell for over 12 years. Now in her mid-80s, Opal Maze was diagnosed with dementia in 2004.

Opal Maze's younger son, Kenneth Maze, lives about ten miles from Arab, Alabama, and is named as Opal's attorney-in-fact in a durable power of attorney.

Respondent Phillip Maze and The Secretary, United States Department of Housing and Urban Development, on behalf of: MELISSA D. GARRETT, JAMAAL KING, AMANDA GARRETT, CHRISTOPHER DOSS (A/K/A TOMMY DOSS) AND THREE MINOR CHILDREN,
Charging Party,

Flickr / Chris Potter

VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

v.

PHILLIP MAZE AND OPALMINNIE MAZE,

Respondents.

His sister, Brenda Noble, are named as alternates to Kenneth Maze in the event that Kenneth is unavailable, unable, or unwilling to act as attorney-in-fact. However, none of those contingencies have occurred.

Phillip Maze, who resides with his mother as her caretaker, has been handling the maintenance for the dwelling occupied by Louise Terrell. Phillip also began collecting the rent from Louise Terrell as his mother's mental condition declined.

In negotiating the terms of the rental agreement for the vacant mobile home—which was in need of repair—the Complainants approached Phillip Maze, and dealt with him exclusively.

Phillip told the Complainants that rent would be $345 per month, including water. A verbal rental agreement was reached in February, 2009, and Phillip agreed to complete the necessary repairs before Amanda's family and Melissa moved in.

As the repairs took longer than expected, Kenneth Garrett, the father of Melissa and Amanda, assisted with the repairs to expedite the move-in.

In early March 2009, Amanda Garrett, Christopher Doss, and their infant daughter moved into the mobile home; Melissa Garrett moved in on March 6, 2009. On Sunday, March 8, 2009, Melissa Garrett drove to Trusssville, Alabama to pick up Jamaal King, an African-American medical student who was going to spend his spring break with her.

The following morning, March 9, 2009, Phillip Maze was in the Complainants' mobile home to complete some repairs when he encountered Jamaal King in the kitchen. Phillip nodded and stared at Jamaal, but did not speak, and left the mobile home without completing the repairs. That afternoon Phillip encountered Jamaal King in the yard, and stared at him, but


Flickr / Chris Potter

VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

did not speak, and left the mobile home without completing the repairs. That afternoon Phillip encountered Jamaal King in the yard, and stared at him, but again did not speak.

Later that day, Phillip Maze came over to the mobile home and asked to speak to “the man of the house.” (Tr. 181).1 Amanda Garrett brought Christopher Doss to speak to Phillip Maze. (Tr. 181).

Phillip told Christopher that there was a problem with Jamaal King staying at the property and “he needs to go.” (Tr. 24-25). Phillip Maze stated, “We can’t have that here because people will be talking” and he did not want to “keep looking over his shoulder.” (Tr. 25).

In addition, Phillip Maze stated that the people that live on the other side of him are black, “but there ain’t nothing I can do about that.” (Tr.79). After Phillip left, Christopher told Amanda about the conversation, and Amanda called her sister Melissa at work to inform her about what occurred. (Tr. 100-101, 182). That evening, Jamaal King received a call from Melissa Garrett, asking him to pick her up from work. (Tr. 280).

As he walked out of the mobile home to pick Melissa up at work, Jamaal King noticed Christopher Doss and Phillip Maze talking on the front porch. They stopped talking as he walked out. (Tr. 279-280).

The two men were blocking the steps, so as Jamaal King walked off the porch he said “excuse me,” and Christopher stepped to the side. (Tr. 280). Phillip Maze, however, just stood in place looking at Jamaal King. (Tr. 280).

Jamaal King said “excuse me,” but again, Phillip Maze did not move. (Tr. 280-81). Jamaal King had to squeeze by him to get down the steps. When he got to the car, he observed that Phillip Maze continued to stare at him. (Tr. 280-81).

Jamaal King drove to pick up Melissa from work. When he arrived at her workplace, she told him that Phillip Maze had a problem with him being there.


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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

After speaking with Christopher, Melissa went next-door to speak with Phillip Maze. They stood in front of Phillip Maze's house during the conversation, and Phillip told Melissa that he did not like interracial relationships, and that he wanted her to move out of the mobile home.

Melissa Garrett explained that Jamaal King was just visiting for spring break and was not moving into the mobile home. During their conversation, Phillip Maze continued to stare at Jamaal King, who was across the lot, on the mobile home's front porch.

Melissa explained to Phillip Maze that she was not in a position to move because she had just begun caring for her niece and nephew. She asked Phillip Maze whether she could stay, if she took Jamaal King home. Phillip agreed. She asked him if it would be okay if she took Jamaal King back on Wednesday because she was not off work until then. He told her to just make sure she did it.

At no point in his conversations with Christopher Doss, Melissa Garrett, or Amanda Garrett regarding the rental of the mobile home did Phillip Maze place any restrictions on visitors to the property.

Prior to Jamaal King's visit, Phillip Maze had never advised the Complainants of any limits on overnight visits by any of their family or guests. In addition, Phillip Maze expressed no issue with the visit of two white family members who had already stayed overnight at the subject property.

On Wednesday morning, March 11, 2009, Melissa Garrett was in the kitchen, washing dishes. At about 9:30 a.m., Phillip Maze cut off the water supply to the mobile home.

Christopher Doss went next-door to see if Phillip Maze's water was also off. On the way back to the mobile home, he saw a key sticking out of the water meter, which he had not previously noticed.

Melissa also went over to Phillip Maze's house to see if his water was on. When she asked, Phillip stated that he did not have any idea what was going on and denied that he turned off the water. Next, Melissa visited another


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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

neighbor to see if his water was on, and discovered it was.

She immediately went back to Phillip Maze's house, accompanied by Amanda, and asked Phillip again if his water was on. Phillip claimed not to know.

Melissa asked if he would check to see if his water was on. Then she asked if Phillip had cut off the water because Jamaal King was still at the mobile home.

Phillip Maze stated "yes," and Melissa Garrett asked him whether he would turn the water back on if she and Jamaal King left. P

Phillip stated "yes."

After making several calls – to the water company, the police, and the U.S. Department of Housing and Urban Development, Melissa left to drive Jamaal King back to his home near Birmingham.

When he saw the car leave, Phillip turned the water to the mobile home back on. The water had been off for at least two hours.

On her way back from dropping Jamaal King off in Trussville, Melissa Garrett experienced a panic attack and, pulled off the road, and called her father. She had trouble breathing and felt stressed. In addition, she began to worry about any visits by her own children, who are biracial, because of Phillip Maze's reaction to Jamaal King's presence at the property. She felt that her bi-racial children would not be welcomed as visitors.

After the incident with the water, Phillip stopped work on the repairs, and returned to the mobile home only once. However, Phillip stood in his yard and stared toward the mobile home and the Garrett/Doss residents.

Amanda Garrett and Christopher Doss felt uncomfortable remaining at the property, and they moved out of the mobile home on March 13 or 14, 2009.

Since they needed the time to find a new apartment in Arab and to save

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

enough money to pay for the first month's rent and to turn on the utilities, they moved in with Amanda Garrett's grandmother in Arab for approximately two weeks and then they moved to Nashville to stay with Christopher Doss's sister for approximately two and a half weeks.

Melissa Garrett also moved out because Phillip Maze told her to leave on Monday evening, and again on Wednesday morning.

On Monday evening, he told her that she could have part of her money back if she left.

On Wednesday, after he turned off the water, he told her it was time for her to go, and she could not have any money back. Melissa and her niece and nephew stayed in the mobile home for one or two more nights, but she was scared and could not sleep. She slept with a knife under the pillow because she felt intimidated by Phillip Maze and what he might do.

After she moved out, Melissa Garrett and her niece and nephew stayed with her father in Arab. During the last week of March, Melissa Garrett removed her belongings from the mobile home and into an apartment she rented in Arab, Alabama.

APPLICABLE LAW:
On April 11, 1968, President Lyndon B. Johnson signed the Civil Rights Act of 1968, which is now referred to as the Fair Housing Act. The Act expanded on the Civil Rights Act of 1964 to prohibit discrimination regarding the sale, rental, and financing of housing based on race, color, religion, and national origin.

PROCEDURAL HISTORY:
The Department of Housing and Urban Development (HUD) is a Federal Executive Department of the United States Government.

As part of its functions, HUD is responsible for enforcing the Fair Housing Act.

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

On December 17, 2009, the Secretary of the United States Department of Housing and Urban Development (the "Charging Party") issued a Determination of Reasonable Cause and Charge of Discrimination on behalf of Complainants and aggrieved persons Melissa Garrett, Jamaal King, Christopher Doss, Amanda Garrett, and three minor children, alleging that Respondents Phillip Maze and Opal Maze violated the Fair Housing Act (the "Act"), 42 U.S.C. §§ 3601-31.

Specifically, the Charging Party alleges that Respondents denied housing to Complainants, discriminated in the terms and conditions of their rental, made discriminatory statements, and interfered with Complainants' tenancy, because of race and/or color, in violation of 42 U.S.C. §§ 3604(a), (b), (c), and 3617.

The Complainants seek civil money penalties totaling $200,000.00.

None of the parties exercised the right to have this matter heard in federal district court, so the matter was ripe for hearing before an administrative law judge.

On May 25 and May 26, 2010, the undersigned conducted a hearing in this matter in the City Council chambers, in Arab, Alabama.
Over the course of two days, the Court heard the testimony of: 1) Christopher ("Tommy") Doss; 2) Melissa Garrett; 3) Amanda Garrett; 4) Kenneth Garrett; 5) Natasha Watson; 6) Jamaal King; 7) Ralph King; 8) Natasha Watson; 9) Louise Terrell; 10) Willie Pollock; 11) Kenneth Maze; 12) Dr. Robert Hargraves; and 13) Phillip Maze.

The parties filed Post-Hearing Briefs on July 16, 2010 and Reply Briefs on July 30, 2010. Accordingly, this case is ripe for decision.

FINDING OF FACT:
Based on a thorough and careful analysis of the entire record, including evidence in the form of testimony and documents adduced at the hearing, the Court finds the facts as described above, and further finds and takes cognizance of the following facts:

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

1. Complainants Melissa Garrett, Amanda Garrett, Christopher Doss, and all three children, who lived with them at 244 County Road 1840, Arab, Alabama 35016, are White.
2. Complainant Jamaal King is African-American.
3. Respondent Phillip Maze is White.
4. Respondent Opal Maze is White.
5. Phillip Maze resides with and cares for his mother, Opal Maze, in her house at 224 County Road 1840, Arab, Alabama 35016.
6. Aside from her residence, Opal Maze owns two rental dwellings located at 244 County Road 1840, and at 209 County Road 1840, both in Arab, Alabama 35016.
7. Kenneth Maze is Opal Maze's son and Phillip Maze's younger brother.
8. Kenneth Maze has been Opal Maze's attorney-in-fact since 2001, when she gave him a general power of attorney; under Alabama law, it is a "durable" power of attorney;
9. Opal Maze managed the two rental properties at 244 County Road 1840 and 209 County Road 209 until approximately 2004.
10. Since 2004, and at all times relevant to the issues in this matter, Opal Maze has not been competent to conduct any business transactions or enter any contractual agreements due to medically confirmed and worsening dementia (Tr.473-480); A Notice Regarding Issuance of Decision pursuant to 42 USC § 3612(g)(2), was filed with Secretary and the parties on November 9, 2011.
11. The water supply for the rental mobile home at 244 County Road 1840 is provided by an extension from the metered water supply for Opal Maze's nearby home at 224 County Road 1840.
12. By verbal agreement between Phillip Maze and Melissa Garrett and Christopher Doss, the Complainants rented the mobile home at 244 County Road 1840, and the water supply was included in the rent to be paid by the Respondents.
13. Melissa Garrett and Christopher Doss paid rent and part of the security deposit to Phillip Maze prior to moving to 244 County Road 1840.
14. Two adult white visitors stayed overnight at the mobile home early in the Complainants' tenancy.
15. Phillip Maze expressed no issue with the two white visitors' overnight stay.


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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

16. Phillip Maze did not turn the water supply off to the mobile home when the two white visitors stayed overnight during the Complainants' tenancy.
17. Phillip Maze agreed to allow two additional children to live at the mobile home with the Garrett/Doss family for a period of six weeks, bringing the total number of occupants to six.
18. During their tenancy, the Complainants did not receive any lease violation notices from Respondents.
19. Phillip Maze made repairs at the mobile home on or around March 10, 2009. During this time, he observed Jamaal King at the mobile home.
20. Phillip Maze took issue with Melissa and Jamaal King sleeping together while unmarried and their interracial relationship.
21. Phillip Maze does not approve of interracial relationships and told so to Melissa Garrett.
22. Phillip Maze did not approve of Melissa Garrett's relationship with Jamaal King.
23. Phillip Maze did not limit overnight visitation at the mobile home except when Jamaal King visited.
24. Phillip Maze turned off the water supply to the mobile home.
25. Phillip Maze did not return the security deposit to Melissa Garrett or Christopher Doss after they moved out of the mobile home.
26. Prior to Jamaal King's visit at the mobile home, Phillip Maze had not previously turned off the water supply to the mobile home.
27. Phillip Maze turned the water supply to the mobile home off for approximately two hours, until Jamaal King left the property.
28. Phillip Maze told HUD's investigators that no federal law will tell him to whom to rent.
29. None of Opal Maze's dwellings has been rented to African-Americans, but there is no evidence that any African-Americans ever sought to rent there, or were refused.

DISCUSSION:

This Court has considered all issues raised, and all documentary and testimonial evidence in the record and presented at the hearing. Those issues not discussed herein are not addressed because the Court finds they lack materiality or importance to the decision.


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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

THE LEASE:
A preliminary issue is whether the oral lease agreement between the Complainants and the Respondents is valid. The parties did not expressly raise this issue, but the validity of the lease is germane to determining whether the Act was violated.

The existence of a valid rental contractual relationship for the mobile home hinges on the law of Alabama, where the agreement was entered into and the rental mobile home was located.

Thus, the Court concludes that Phillip Maze—although he had no ownership interest in the mobile home— entered into an apparently valid agreement with the Complainants for month-to-month rental of the mobile home.

AGENCY:
The Complainants argue that Opal Maze is liable for Phillip Maze's discriminatory conduct under the principles of vicarious liability. The Complainants assert that Opal Maze authorized Phillip Maze to act as her agent, or alternatively, Kenneth Maze, as Opal's attorney-in-fact, authorized Phillip Maze to act as Opal's agent.

The Respondents, on the other hand, contend that—given Opal Maze's mental incapacity—she cannot be held to have authorized Phillip Maze's conduct, or be held liable for it.

The Court concludes that Opal Maze cannot be held liable for Phillip Maze's actions under agency principles because she had no capacity to authorize, and did not actually or apparently authorize Phillip to rent the mobile home to the Complainants, nor did she have the capacity to take the racially discriminatory actions complained of in this action.

FAIR HOUSING ACT:
Fair Housing Act (the "Act") under Title 42 U.S.C. § 3603(b)(1). This provision of the Act exempts from liability owners of:
1. No more than three single-family houses;
2. Who do not use in any manner the rental facilities or rental services of any

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

real estate broker, agent, or salesman, or of such facilities or services of any person in the business of renting dwellings, or of any employee or agent of such broker, agent, salesman, or person.

STANDING:
The Respondents contend that Jamaal King lacks standing to assert any claims under the Fair Housing Act because he did not buy or rent the mobile home.

However, the standing requirement under the Act only requires injury in fact.

Here, Mr. King alleges that as a result of Phillip Maze's actions in violation of the Act, he has suffered a "distinct and palpable injury." Havens Realty Co. v. Coleman, 455 U.S. 363, 372 (1982).
To initiate an administrative process under the Act, an "aggrieved person" can file a complaint within one year after an alleged discriminatory housing practice with the HUD Secretary. 42 U.S.C. § 3610(a)(1)(A)(1).

An "aggrieved person" under the Act is broadly defined to include any person who, inter alia, "claims to have been injured by a discriminatory housing practice." 42 U.S.C. § 3602(i).

In the case at hand, Jamaal King was neither a tenant nor occupant but a mere guest. Nonetheless, he has standing to pursue damages under the Act.

Jamaal King is an "aggrieved person" as defined under 42 U.S.C. § 3602(i).10 Thus, the Court concludes that Mr. King has standing for the purposes of the Fair Housing Act.

MOTIVATION:
The Respondents argue that Phillip Maze did not engage in discriminatory housing practices because his actions were motivated by the excessive

number of people staying in the mobile home rather than racial discrimination.

The Complainants, on the other hand, argue that the Respondents' claim is

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

belied by circumstances establishing that Phillip Maze knew that Jamaal King was merely a guest, and that Phillip's true motivation was based on Jamaal King's race.

The evidence is that Phillip Maze himself told Melissa Garrett that he did not like interracial relationships.

Phillip Maze claims to have discussed with Melissa the need for Jamaal King to leave "[b]ecause they had more people living in the trailer than we had agreed to" and "[b]ecause [Phillip] was the seventh person, the last person to show up there"

Notwithstanding that concern, Phillip clearly expressed to Melissa his disapproval of her interracial relationship with Jamaal King.
He also expressed to Christopher his concern about having an African-American on the property.

Based upon the facts established in this record, the Court concludes that Phillip Maze's motivation in turning off the water on Wednesday morning was because Jamaal King was African-American and he had not yet departed the property as Melissa had agreed.

The Court does not lightly dismiss the Respondent's claim that the number of occupants and guests in the mobile home was a violation of the lease agreement.

Phillip testified that at the time he made a rental agreement with the Complainants, he understood that Christopher, Amanda, their infant child and Melissa would reside in the two-bedroom, one-bath, mobile home.

But Phillip later agreed to Melissa's niece and nephew staying with them.

Later, Phillip again did not object to Jamie, Melissa's sister, and her husband spending a night at the mobile home.

Phillip states that he consented to the additional two people beyond that he

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

agreed to originally because "it was to be limited to six weeks and they were just children, they needed a place to live, and they . . . were just little darling kids."

Phillip also states that he allowed Jamie and her husband to stay because they "were the kids' parents" even though he did not feel the mobile home was big enough for all the people.

Since then, the matter asserted by Complainant King has been investigated by HUD, which has determined that the Charge should be brought on his behalf.

In sum, Phillip allowed four additional people to temporarily live in the mobile home, beyond the number agreed in the verbal lease.

Phillip allowed as many as four extra people in the mobile home at once, but expressed concern about having one more person in the mobile home, about whom he had made racially discriminatory comments.

Allowing for the legitimacy of Phillip Maze's concern that too many people were staying in the mobile home, the clear weight of the evidence establishes that Phillip's actions in requiring Jamaal King to leave—and in turning off the water to the mobile home when he did not leave as expected—were based on prohibited racial discrimination.

VIOLATIONS OF THE FAIR HOUSING ACT:
In view of the foregoing, the Court concludes that Respondent Phillip Maze has violated several provisions of the Fair Housing Act, as charged.

1. The Act makes it unlawful to refuse to rent after the making of a bona fide offer, or to refuse to negotiate for the rental of, or otherwise make unavailable or deny, a dwelling to any person because of race or color. 42 U.S.C. § 3604(a). By coercing Melissa to require her guest to leave because he was African-American, and turning off the water supply to the mobile home to enforce that unlawful coercion, Phillip Maze made the use and enjoyment of the Mobile home unavailable to Melissa in violation of Section 3604(a). (Tr.101, 106, 153).

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

2. Phillip Maze also violated Section 3604(b), which prohibits discrimination against any person in the terms, conditions, or privileges of rental of a dwelling, or in the provision of services or facilities in connection therewith, because of race or color. 42 U.S.C. § 3604(b). By imposing a more restrictive guest policy on the Complainants because of Melissa Garrett's association with an African-American, Jamaal King, Phillip Maze applied discriminatory rental terms and conditions in violation of the Act and intentionally interfered with the enjoyment of the mobile home by all of the tenants and authorized guests.
3. As discussed above, Phillip Maze made numerous racially discriminatory statements in violation of Section 3604(c), which makes it unlawful for any person to make any statement with respect to the rental of a dwelling that indicates any preference, limitation or discrimination based on race or color.
4. Finally, in each of the foregoing violations of the Act, Phillip Maze also violated Section 3617 of the Act by coercing, intimidating or interfering with any person in the exercise or enjoyment of any right granted or protected by Section 3604 of the Act.

REMEDY:
Damages for Emotional Distress:
The Complainants request $200,000 in emotional distress and inconvenience damages, broken down as follows: $55,500 for Melissa Garrett, $55,500 for Jamaal King, $40,000 for Christopher Doss, $40,000 for Amanda Garrett, and $3,000 for each minor child.

In particular, the Complainants claim that Amanda Garrett and Christopher Doss experienced inconvenience and stress in losing their housing.

As the Complainants argue, "the proper recourse for too many residents is a notice of lease violation, not depriving the residents of water."

Out-of-Pocket Expenses:
The Complainants argue that they suffered inconvenience and financial loss as a result of the Respondents' discriminatory acts.


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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

The Complainants request the Court to order the Respondents to pay $1,318.75 to Melissa Garrett, and $4,020.95 to Christopher Doss and Amanda Garrett for various out-of-pocket losses related to rent and security deposit for the rental of the mobile home, moving expenses, and rent and starting utilities at a new dwelling.

The Complainants, however, allege excessive out-of-pocket damages, including $1,852.50 in rent expense incurred by Christopher Doss and Amanda Garrett from May 2009 until the hearing in May 2010.

Upon considering all the exhibits and documentary evidence, this Court finds that an award of $737.50 to Melissa Garrett and $927.50 to Christopher Doss and Amanda Garrett in damages will adequately compensate the Complainants for the pecuniary losses they sustained as a result of the discriminatory housing practices.

Injunctive Relief:
The administrative law judge may order injunctive or other equitable relief to make the complainant whole and to protect the public interest in fair housing.

“Injunctive relief should be structured to achieve the twin goals of:
1. insuring that the Act is not violated in the future and
2. removing any lingering effects of past discrimination.”

The purposes of injunctive relief in housing discrimination cases include:
- eliminating the effects of past discrimination, preventing future discrimination, and positioning the aggrieved persons as close as possible to the situation they would have been in but for the discrimination. The relief is to be molded to the specific facts of the case.

The Complainants seek injunctive and other equitable relief in light of the violation.

The Court concludes that the requested injunctive relief will serve to rectify past harm and to deter prohibited discrimination by Phillip Maze and others.

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

Therefore the requested injunctive relief shall be ordered.

Civil Money Penalty:
As Charging Party, HUD seeks civil penalties in the amount of $16,000 to be assessed against Phillip Maze and $5,000 against Opal Maze.

To vindicate the public interest, the Fair Housing Act authorizes an administrative law judge to impose a civil penalty upon a respondent who has been found to have discriminated in violation of the Act.

Assessment of a civil penalty requires a consideration of five specific factors:
1. the nature and circumstances of the violation;
2. the degree of culpability;
3. any history of prior violations;
4. the financial circumstances of the Respondent; and
5. the goal of deterrence, and other factors as justice may require.

The Court finds that the nature and circumstances of Respondent Phillip Maze's violations merit the imposition of a civil money penalty.

In considering the nature and circumstances of his violations, the Court notes that they occurred in the period of just a few days during Jamaal King's curtailed stay at the mobile home.

Culpability for the violations rests solely with Phillip Maze.

Opal Maze—having no culpability in the matter—is not subject to a civil penalty.

Although Phillip Maze referred to the rental "business" as a fourth generation business.

In fact the Respondents have not had significant experience with rental transactions as they manage only two single-family rental dwellings without the use of any agent or real estate brokerage firm.


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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

The damages for Melissa covers the $250 rent and security deposit for the rental of the mobile home from Phillip Maze, the $172.50 rent for March 2009, and the $315 first-month's rent at her new apartment.

The damages for Christopher and Amanda cover the rent and security deposit for the rental of the mobile home from Phillip Maze, plus the ensuing $165 hotel stay and the $25 storage fee incurred during the first month after the move.

There is no history of prior violations of the Act, or allegations that Phillip Maze previously engaged in any discriminatory housing practices.

The Court has been provided no direct evidence bearing on the financial circumstances of Phillip Maze, but notes he has no regular outside employment, and that Kenneth Maze assumed that rental proceeds were the source of support for Phillip Maze in maintaining a household for himself and his mother.

Nonetheless, evidence regarding the Respondents' financial circumstances is peculiarly within his control; Respondents had the opportunity and the burden to introduce such evidence on the record to have it considered.

In the absence of evidence to the contrary, the Court may presume that Phillip Maze can pay the civil penalty, without suffering undue hardship.

Finally, an award of some civil penalty is appropriate to serve as deterrence to others.

Those similarly situated to Respondent Phillip Maze must be put on notice that violations of the Fair Housing Act will not be tolerated.

Based on consideration of the foregoing factors, the Court concludes that assessment of a civil penalty in the amount of $10,000 should be assessed against Phillip Maze.

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VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

CONCLUSION:
The preponderance of the evidence establishes that as a result of Respondent Phillip Maze's unlawful action, Complainants Melissa Garrett, Jamaal King, Amanda Garrett, Christopher Doss and three minor children suffered injuries which must be remedied by an award of compensatory damages.

In addition, to protect and vindicate the public interest, a civil penalty must be imposed upon Respondent Phillip Maze.
Accordingly, the following Order is entered.

ORDER:
Having concluded that Complainants Melissa Garrett, Jamaal King, Amanda Garrett, Christopher Doss and three minor children suffered injuries resulting from Respondent Phillip Maze's discriminatory housing practice in violation of the Fair Housing Act, the Court hereby ORDERS that:

1. Within thirty (30) days of the date on which this Order becomes final, Respondent Phillip Maze shall pay to Complainant Melissa Garrett $737.50 for tangible losses and inconvenience;
2. Within thirty (30) days of the date on which this Order becomes final, Respondent Phillip Maze shall pay to Complainants Christopher Doss and Amanda Garrett $927.50 for tangible losses and inconvenience;
3. Within thirty (30) days of the date on which this Order becomes final, Respondent Phillip Maze shall pay to the Complainants for emotional distress a total of $37,500, apportioned as follows:
    - Melissa Garrett, $12,000;
    - Jamaal King, $11,000;
    - Amanda Garrett, $6,000;
    - Christopher Doss, $4,000;
    - and the three minor children, $1,500 each.
4. Within thirty (30) days of the date on which this Order becomes final, Respondent Phillip Maze shall pay a civil penalty of $10,000 to the Secretary, United States Department of Housing and Urban Development;
5. Respondent Phillip Maze is hereby permanently enjoined from discriminating based on race, color, religion, national origin, sex, familial status, or disability, in violation of the Fair Housing Act;

VIOLATION OF THE CIVIL RIGHTS ACT OF 1968 (*continued*)

6. Respondent Phillip Maze shall not rent any dwelling unless he has first:
   (1) undergone training on the Fair Housing Act conducted by a qualified independent party; and
   (2) provided the HUD Regional Office notification of the name, address and telephone number of the trainer and or training organization and a copy of a certification confirming his training;
7. Respondent Phillip Maze, if he completes such training, and chooses to engage in the rental of any dwelling, shall provide to the Complainant HUD Regional Office, for purposes of monitoring such rental activity:
   (a) copies of any advertisements or notices of rental vacancies;
   (b) copies of any written lease applications;
   (c) a statement as to each applicant's status protected by the Act, if any;
   (d) if any applicant is rejected, a statement as to the date and reason for such rejection; and
   (e) a copy of any executed lease agreement(s), which shall be in writing.

J. Jeremiah Mahoney Administrative Law Judge

This concludes our three (3) hour continuing education course in Fair Housing.

Risk Management

Understanding the Basic Concept of Risk Management

The management of risk by real estate licensees is extremely important in today's litigious society. A real estate company's success may be hindered or enhanced depending upon how they manage the risks associated with real estate brokerage, lending, and/or property management in California.

> "A real estate company's success may be hindered or enhanced depending upon how they manage the risks."

There are several key terms and definitions that are important to understanding real estate risk management in California.

Terms and Definitions

Standard of Care: Some duties have a higher standard of care than others. For example, a fiduciary duty is a much higher standard of care than the duty of honest and fair dealing. A fiduciary duty requires utmost honesty, loyalty, integrity, competence, confidentiality, and truth. Whereas the duty of honest and fair dealing owes the duty to disclose all material facts regarding a property.

Contract Preparation: The contracts most often encountered by real estate professionals include the listing agreement, purchase agreement and receipt for deposit, counter offers, and addendums. All of these contracts contain inherent risk and must be completed with skill and diligence by the licensee.

Property Condition: A property's condition must be observed by the real estate professional through a visual inspection of accessible areas. Items of concern for most one-to-four unit residential properties are generally noted in the Real Estate Transfer Disclosure Statement.

Property Ownership: Real property ownership includes land, items affixed to it, and anything appurtenant or incidental to the land. Affixed to the land includes fixtures and emblements (trees and bushes). Items appurtenant or incidental to the land includes appurtenant easements, prescriptive easements, easements in gross, CC&R's (Covenants, Conditions, and Restrictions), stock in a mutual water company, and riparian water rights.

Trust Fund Handling: Trust fund handling includes the broker's trust account that is held in trust for his clients. Earnest money checks, property management rents, and security/cleaning deposits are deposited into a broker's trust account. A broker and any bonded employees can access the account. Too much control over the account by one employee can cause embezzlement problems and is a trust fund violation according to the CalBRE.

Material Fact: A material fact is a fact that will affect the value of a property. Agents under both fiduciary duties and duties of honest and fair dealing are required to disclose all material facts regarding a property. Material facts are generally disclosed (on one-to-four unit residential properties) using the Real Estate Transfer Disclosure Statement.

RESPA: RESPA denotes the Real Estate Settlement Procedures Act.
There are several key areas that must be examined:

- Lenders cannot pay referral fees on one-to-four unit owner-occupied property (dwelling) loans.
- Lenders must provide a good faith estimate and Settlement Costs and You booklet within three business days of the borrower applying for the loan.
- Lender must provide the HUD-1 (Uniform Settlement Statement) by close of escrow.
- Lenders cannot charge a fee to provide the HUD-1.

Plus several other requirements that lenders must be aware of in today's lending environment.

Conflict of Interest: Agents cannot compete with their principles in the purchase of a property. They also do not want to get into a conflict of interest in lending and brokering a home to prospective purchaser—without disclosing this to both the buyer and seller.

Negligent Advice: When an agent gives a client advice that is incorrect and the agent should have known that it was incorrect, this is called negligent advice. If, in light of a normal agent's education, training, and experience, the agent should have known certain facts regarding a property or gave bad advice to the principal regarding that property, then the agent is liable for his actions. The broker may also be liable through vicarious liability.

Agency Duties: There are several duties that come into existence when an agent represents his principal in a transaction. Both agents owe fiduciary duties to their principals. Each agent owes a duty of honest and fair dealing to the other principal on the other side of the transaction (e.g., listing agent to buyer or selling agent to seller).

Dual Agency: When an agent represents both the buyer and seller in the same transaction, this is called dual agency. Dual agency must be disclosed to BOTH the buyer and seller in the transaction.

Secret Profit: An agent may not make a secret profit. Clients are relying on real estate licensees to price their properties. For this reason, agents may not make a secret profit on a piece of real property. An unlicensed person <u>can</u> make a secret profit on a parcel of real estate.

Ostensible Agency: If there is no written or verbal agency relationship existing between a principal and real estate licensee, and the licensee starts acting as if he is the principal's agent—and the principal starts acting as if the licensee is his agent—then the licensee <u>is</u> considered his agent through ratification. This is called ostensible agency.

Gratuitous Agent: When an agent accepts all the liabilities of being an agent—without being paid, he is called a gratuitous agent.

Agency Disclosure: In 1988 agency disclosure became a new law in California for one-to-four residential properties where an agent is involved. Agents must complete the agency disclosure form and deliver it to the seller and buyer as soon as possible. The agency disclosure form goes with the listing agreement and also goes along with the purchase agreement when it is presented.

"Agents must complete the agency disclosure form and deliver it to the seller and buyer as soon as possible."

Patently Frivolous Offer: The agent is relieved of the obligation of presenting a patently frivolous offer. An offer to purchase a one million dollar residence for one dollar would be considered a patently frivolous offer.

Contracts: A contract is an agreement to do or not to do something.

Express: An express contract is an agreement to do something that is either written or oral.

Implied: An implied contract is a contract that is implied by the actions of the parties. If a party has relied on someone else and that person caused them harm, the party who was harmed can pursue a cause of action under the Doctrine of Promissory or Equitable Estoppel. In other words, if there is no written or oral contract between the parties, the courts will make a contract (under detrimental reliance by one of the parties) and file suit under the Doctrine of Promissory or Equitable Estoppel as a cause of action.

Unilateral: A unilateral contract is a contract that contains a promise for an act. An open listing agreement is considered a unilateral contract. The act of bringing in the buyer results in the promise by the seller to pay a commission.

Bilateral: A bilateral contract is a contract that contains a promise for a promise. An example is an exclusive authorization and right to sell listing agreement. The agent promises to use diligence in finding a buyer if the seller promises to pay him a commission.

Valid: Elements of a valid contract include: Competent parties (cannot be declared incompetent in a court of law), Capacity to contract (not under 18 years of age—unless married, divorced, emancipated by the courts, or in the military), Mutuality (meeting of the minds), Consideration (bargained for exchange between the parties), and Writing. All real estate contracts (except leases of one year or less) must be in writing. In addition to all real estate contracts, all contracts (real estate or not) that are not to be performed within one year of their making must also be in writing according to the Statute of Frauds.

Voidable: A voidable contract can be voided by one of the parties to the contract. A contract signed under duress is an example of a voidable contract.

Void: A void contract is a contract that has no legal basis. There is no contract at all.

Aliens: Non-resident aliens have the capacity to own real property in California.

Minors: Someone under 18 years of age is called a minor and is restricted from contracting in California.

Statute of Frauds: The Statute of Frauds came from England and states that all real estate contracts must be in writing (except leases of one year or less).

Power of Attorney: When one person gives another person the ability to act for them (i.e., sign documents), this is called a power of attorney. The person acting for another is called an attorney-in-fact.

Specific Performance: Each parcel of real property is unique and cannot be replaced. If a buyer has a contract to purchase a property and the seller refuses to perform (convey title), the buyer can institute an action called specific performance and try to compel the seller to sell the property according to the terms of the contract.

Liquidated Damages: On one-to-four unit residential dwellings, if a buyer and seller initial the liquidated damages clause in the purchase agreement, then the damages will be set ahead of time if the buyer "flakes out" and does not close the sale of the property. Of course, collecting this can be difficult since the earnest money funds are generally in escrow and cannot be released without the buyer's signature.

Options: An option is a contract to keep an offer open for a specified period of time.

Fair Housing: There are numerous federal and state fair housing laws, including the Civil Rights Act of 1968, Redlining, Unruh Civil Rights Act, Rumford Act, Holden Act, Steering and Panic Peddling, and Americans with Disabilities Act (ADA).

Intentional Misrepresentation: When an agent intentionally misrepresents information regarding a property, this is called fraud.

Negligent Misrepresentation: When an agent accidentally or innocently makes a mistake regarding a property, this is called negligent misrepresentation.

Concealment of Material Facts: If an agent conceals material facts that will affect the value of a property, this is a major infraction by the licensee.

Unlicensed Assistant: Unlicensed assistants are restricted from providing property information of any kind. An unlicensed assistant can call for an appraisal; however, the assistant cannot provide property information to the appraiser. An unlicensed assistant cannot write an advertisement, the assistant can only provide to the newspaper (or other advertising medium) what her broker or agent told him or her to write.

"Unlicensed assistants are restricted from providing property information of any kind."

Risk Management Policy: Each broker should have an office policy and procedures manual outlining office policy regarding all of the items in this course.

Broker-Salesperson Agreement: This is a written agreement between the broker and salesperson. The agreement between the broker and salesperson must be in writing, however, the form of the agreement is not regulated by law.

Office Policies and Procedures Manual: This is a manual that each office should have available to the agents. The manual outlines policies and procedures for handling day-to-day issues that face a real estate office. All of the risk management items in the manual are covered throughout this course.

Custodian of the Public Interest: Agents are the custodians of the public interest and must work for the benefit of the public in general.

Statutory Duties of Licensee: Statutory duties of licensees are duties that are prescribed by legislative law. Laws enacted by the California State Legislature are called "Statutes" and must be understood and followed by real estate licensees.

Mediation, Arbitration, and Litigation: Mediation is non-binding and non-judicial (not through the courts) dispute resolution. Arbitration is binding dispute resolution, also not through the courts. Litigation is binding dispute resolution through the courts, with an appeal process.

Bureau of Real Estate (CalBRE): Regulates licensees in California.

Real Estate Commissioner: Appointed by the governor, head of the CalBRE.

District Attorney and the Criminal Courts: The district attorney prosecutes people who act as if they have a real estate license—but does not have one. If a person brokers real estate without a real estate license, the district attorney in the county where the activity occurred will prosecute that person in the criminal courts.

With the previous terms and definitions in mind, let's take a look at risk management for real estate licensees in California.

The Probability of Risk

It is imperative that real estate agents understand the risks involved in real estate transactions, real estate lending, property management, leasing, business opportunities, as well as several other areas covered by a real estate license. As litigious as California has become over the last many years, an understanding of risk management—as well as a plan to manage risks is essential to a successful career in real estate.

Standard of Care Issues

The standard of care owed by a broker under article 2079.2 of the Civil Code is the degree of care a reasonably prudent real estate licensee would exercise and is measured by the degree of knowledge through education, experience, and examination required to obtain a real estate license.

After a basic understanding of the concepts of risk management, a look at common areas of risk to real estate licensees is important to avoid potential litigation in the future.

Common Areas of Risk

Some common areas of risk include contract preparation, investigation of the property condition, property ownership, trust fund handling, broker supervision of employees, failure to research, investigate, and disclose material facts, RESPA violations, conflicts of interest, and negligent advice.

Contract Preparation

An agent should consider the risks inherent with contract preparation and understand the basic elements of contract law.

Particular areas of concern are competent parties, capacity to contract, mutual consent, lawful objective, sufficient consideration, and in writing.

A capacity issue is a real estate contract to a minor. Unless the minor has been emancipated by the courts, in military service, or married/divorced, they are restricted from contracting in California. Minors do have the ability to contract for necessity items, however, real estate is not considered a necessity item.

Contracts with someone who has been formally committed to a mental institution are void—at least while they are formally committed to the institution. Once they are released they may, however, be able to once again obtain the power to contract.

Contracts with someone who has been declared incompetent by a court of law are also void. There have been instances when a person was NOT declared incompetent by a court of law; however, their medical doctor declared that the person did not fully understand what was going on around her. In this instance, it is a good idea to contact her medical doctor and a competent attorney prior to proceeding with any contracts with that person.

All of these contracts are void and have no force or effect.

Property Condition
The agent is required to make a visual inspection of all accessible areas and note his findings on the Real Estate Transfer Disclosure form. The listing agent should inspect the property condition and note any obvious conditions that are material facts that must be disclosed to the buyer.

Property Ownership
Areas of concern regarding property ownership include the land, any affixed to the land, and anything appurtenant or incidental to the land.

Land
Land includes the soil, rocks, and other substances that compose the earth. It also includes the space below the surface all the way to the center of the earth, as well as the airspace up to the heavens (at least as much as a property owner can reasonably use). Courts have recognized a public right to use the airspace above real property as a highway as long as it does not unreasonably interfere with the landowner's enjoyment of the property.

In addition, the courts recognize the fluid nature of subsurface gas and oil and a property owner has the right to drill vertically to capture these substances. However, an adjoining landowner does not have the right to drill slantwise to capture a neighbor's subsurface gas or oil.

An agent should consider not only the surface area, but the area underneath and airspace above the parcel.

Anything Affixed to the Land

This includes buildings, trees, and anything permanently affixed to the land. Real property does not usually move. Examples include houses and things permanently attached to a house, which may include (for example) a built-in microwave oven or kitchen cabinets. Since these types of items are immovable, they are considered real property.

> "Fixtures are personal property that is incorporated into the land and thus becomes real property."

If a microwave oven is sitting on the top of a kitchen counter (instead of being built into the cabinets) it will probably be considered personal property because it is movable and mobile.

Fixtures are personal property that is incorporated into the land and thus becomes real property. Kitchen cabinets and a built- in microwave oven would generally be considered fixtures and, therefore, real property.

Tests for a fixture include:

- *Method of attachment*

  This is the method by which property is incorporated into the land. The degree of permanence of the annexation is also important. If the fixture is attached by cement or concrete it is probably classified as a fixture, and therefore considered real property.
- *Adaptability or Annexation*

  Personal property that is attached to the land and being used as an ordinary use in connection with the land is usually considered a fixture. A house key is a good example.
- *Relationship*

  The relationship between the person who placed the item (possible fixture) on the property and the person who disputes its classification is another important test in determining whether an item is a fixture. Since the buyer/seller relationship is adversarial in nature, the agent must specify in the purchase agreement particular items that may be disputed by the parties.

- *Intent*

  Intent is the most important test for a fixture. Window coverings are an example of conflicts of intent. The seller's intent is that the item is personal property and will go with him when he sells the property. The buyer's intent is that the item is real property and will stay with the property. Since the buyer's and seller's intents are in conflict, the only answer is what the agent specifies in the purchase agreement.

- *Agreement*

  When there is a clear agreement between the buyer and seller, whether an item is a fixture should not be in dispute. It should be plainly determined through the agreement.

Emblements

Emblements include planted trees, vegetation, and trees in nature. When emblements are severed they become personal property. A growing corn crop is considered and emblement and real property since it is attached to the land. However, once it is severed (harvested) it becomes personal property. Therefore, the un-harvested corn crop is real property unless specified in the purchase contract. If the seller of the real property would like to harvest the corn crop after the sale, and he doesn't state this in the contract, the corn transfers with the property and is now owned by the buyer. If, however, the growing crop was sold (even if it is still on the stalks) it is considered personal property.

Anything Appurtenant to the Land/Incidental to the Land

An appurtenance is anything that is used with the land for its benefit. Hence the name, "runs with the land." Examples of appurtenances include: easements, water company stock, covenants, and riparian water rights.

Easement

An easement is the right to use someone else's land. For example, an easement over "B's land benefits A. The easement is appurtenant to A's parcel and must stay with that parcel. If owner Smith who owns Parcel A decides to sell it, the easement across Parcel B (which is in the deed) must STAY with the property. Smith cannot take the easement with him when he leaves the property. Any future owners of Parcel A will enjoy the rights to drive across Parcel B.

There are generally three major types of easements: appurtenant easement, prescriptive easement, and easement in gross.

Appurtenant Easement
Property owned by Anderson has an easement from Baker over Baker's property, this is called an appurtenant easement. Appurtenant easements are always held by the dominant tenement.

An appurtenant easement must benefit one tenement and burden another, parcels of land must be owned by two different persons, and the easement is transferred with the dominant tenement. Remember, however, the dominant and servient tenements do not have to abut or adjoin each other (touch each other). However, an appurtenant easement does benefit adjoining landowners.

Prescriptive Easement
A prescriptive easement is a way of gaining the right to use another person's property without their permission. The use must be open and notorious, uninterrupted for five (5) years or more, claim of right, and hostile to the owner's intent.

Adverse possession is very similar to a prescriptive easement. An adverse possessor must be open and notorious, used continuously for five (5) or more years, have a claim of right, and be hostile to the owner's intent. In addition, an adverse possessor must pay the property taxes on the portion of neighbor's property being used. If he does all of these things (including paying the property taxes), he acquires title and owns the property. A quiet title action will perfect his title. Conversely, a prescriptive easement holder only has the right to *use* the property—he does not own it (as in adverse possession).

Easement in Gross
Farmer gave Bryan an irrevocable right to cross his farm and fish for "lunker trout" in his crystal clear trout stream. Bryan has an *easement in gross*. Utility company easements area considered easements in gross. An easement in gross is irrevocable and a license is revocable.

Stock in a Mutual Water Company
Water users may organize a mutual water company in order to secure an ample water supply at a reasonable cost. In most cases, the stock is made appurtenant to the land; that is, each share of stock is attached to a particular parcel of land

and cannot be sold separately. This enables the water company to plan its distribution more easily and prevents speculation in shares. No cash dividends are given to the mutual water company stockholder; however, credits are given if there is a water surplus. If operating revenues are not covered, then a special assessment may be levied to make up the loss.

Covenants, Conditions, and Restrictions (CC&R's)

A covenant is usually defined within the framework of "CC&R's." This stands for Covenants, Conditions, and Restrictions. CC&R's usually run with the land and are thus appurtenant to the land and automatically go to the new owner.

CC&R's can be created by deed, agreement, or recorded declaration of restrictions. A breach of a covenant (promise) is a minor breach and is remedied by monetary damages. A breach of a condition is a major breach and is remedied by loss of title to the property. Because of loss of title, a condition must be contained in the deed. A restriction is a private deed restriction and restricts the use of the property. An injunction is used to enforce private deed restrictions.

> "CC&R's can be created by deed, agreement, or recorded declaration of restrictions."

Riparian Water Rights

Riparian water rights allow a parcel that is adjacent to a river, stream, or watercourse to use as much water as they can reasonably use. This right runs with the land and can be a great advantage to agricultural properties.

Trust Fund Handling

Trust funds are funds held in trust by a broker for his principal. Trust funds fall into two categories, (1) earnest money deposits collected in the course of sales transactions and (2) property management rents (and security/cleaning deposits) collected from tenants.

When a broker mixes his own money with the money or property of others it is called *commingling*. The broker must deposit or place trust funds received into the hands of the principal, into escrow, or into a trust fund account within three (3) business days after receipt. The broker may not keep buyer's cash deposit in the broker's safe, it must be in the trust account.

A broker must keep trust fund checks for a minimum of three years. He can keep up to $200 of his own money in the account to cover the costs of the account.

If a broker negotiates a deal between a buyer and seller and then opens escrow, and the buyer deposits an earnest money check directly into escrow, the broker must log the deposit in his trust account ledger as un-deposited funds. It is illegal for a broker to place rents collected on his own apartment building into his client's trust account. Employees who have access to the account must have divided duties to guard against potential embezzlement of the trust funds. Giving one employee too much control over the account is a trust fund violation according to the CalBRE.

The broker or an unlicensed employee of a broker who is authorized in writing can make withdrawals from the broker's trust account provided the employee is covered by a fidelity bond for at least the amount of the funds to which the employee has access at any given time.

A broker must reconcile his trust fund account on a monthly basis. A broker must deposit his trust account all monies paid to him specifically for advertising, etc.

Broker Supervision
It is the broker’s duty to properly supervise each salesperson under his broker’s license. If the broker does not properly supervise these subagents, he can be liable for their actions through vicarious liability.

Failure to Research, Investigate, and Disclose Material Facts
According to Civil Code sections 1102-1102.7, agents must make a visual inspection of all accessible areas and disclose any material facts that result from the inspection. A material fact is a fact that will affect the value of a property. Material facts must be disclosed to both buyers and sellers.

For most resale one-to-four unit residential properties, a Real Estate Transfer Disclosure Statement (TDS) is required in the sale of the property. The TDS may not be waived in an “as is” sale. With an “as is” sale, the seller is not going to fix anything—however, he must disclose all material facts regarding the property to the buyer.

RESPA Violations
Section 8(a) of RESPA prohibits giving and receiving any fee, kickback, or thing of value for the referral of settlement services. Things of value are broadly defined under RESPA’s rules and may include monies, trips, an opportunity to win a prize, free advertising, and stock in a company.

Some examples of prohibited practices include:
1. Title companies, mortgage broker, and lenders offering real estate agents a free chance to win a contest or prize, such as trips, money, coupons, and discount certificates.
2. Mortgage brokers, lenders, and title companies offering to pay or defray any costs that real estate brokers or agents would otherwise have to incur, such as providing continuing education or paying disproportionate costs for joint advertising.
3. Mortgage brokers, lenders, and title companies providing "thank you" gifts to real estate agents for referring business.
4. Mortgage brokers or lenders paying "finders fees" to friends and past customers for referring new business (soliciting business, not a mere introduction).

The provisions under Section 8 of RESPA do NOT prohibit compensation for providing actual goods, facilities, or services. However, compensation must be reasonably related to the market value of such goods, services, or facilities. HUD may consider any excess payment as compensation for referring business.

Here are some situations to avoid involving compensation for goods, facilities, and services:
1. Mortgage brokers paying commissions to lenders or other mortgage brokers for their turndowns or so-called "leads." It is okay to purchase lead lists as they are considered "goods." However, compensation based on the outcome of the lead is not permissible.
2. Title companies paying real estate agents for performing duplicate or unnecessary work.
3. Mortgage broker or lenders attempting to employ real estate agents as loan officers to pay them a percentage of the loan amount for performing minimal, duplicative, or unnecessary services, such as completing or helping with loan applications.
4. Real estate agents receiving additional payment without performing additional work, remember that providing referral services is not a compensable service.
5. Real estate brokers receiving above-market rates for renting desk or office space to loan officers, mortgage brokers, lenders, or title companies. Or, collecting rent for desk or office space that is rarely used by the loan officer, mortgage brokers, lenders, or the title companies.
6. Real estate brokers and agents who enter into marketing agreements with lenders to provide marketing services, but only provide referral services.

In 1983, Congress amended RESPA to permit referrals between settlement service providers in an Affiliated Business Arrangement (AfBA), under certain conditions. An AfBA exists when a person in a position to refer business, or their "associate," owns more than one (1) percent of a provider of settlement services, and either person directly or indirectly refers business to that provider. An associate of a person in a position to refer business includes a partner, employer, officer, spouse, parent, or child; or where an entity is a corporation related to another corporation as parent to subsidiary by an identity of stock ownership.

Under the 1983 rule, referrals made between affiliates do not violate RESPA so long as the following three conditions are met:

1. The consumer receives a written disclosure of the nature of the relationship and an estimate of the affiliate's charges. (This disclosure must be provided at the time the referral is made, by the person making the referral. HUD provides the format for this disclosure at Appendix D of the regulations, 24 CFR 3500.)
2. The consumer is not required to use the affiliate.
3. The only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest.

An example of a RESPA-compliant AfBA might include a real estate broker who owns a mortgage brokerage company and the real estate agents refer loan business to the broker. Under this scenario, the broker and agents would satisfy the law provided the agents give the customer the AfBA disclosure at the time they make the referral, the broker does not require agents to refer loan business, and the broker does not compensate agents for making referrals.

Participation in "sham" affiliated business arrangements violate RESPA's anti-kickback and unearned fee provisions. HUD recently increased its investigation and enforcement activity of sham affiliated business arrangements as more settlement service providers try to circumvent RESPA's prohibitions by establishing shell settlement service businesses to function as a conduit for paying referral fees.

Often, title companies or lenders create sham arrangements with persons in positions to refer business. Additional guidance of AfBAs is contained in HUD's 1996-2002 Statement of Policy, "Sham Controlled Business Arrangements."

The following are a couple of examples of sham arrangements:

1. A title company and a real estate firm establish an affiliated title agency. The affiliated title agency has the same business address as the partner title company, the real estate firm is the affiliated title agency's sole source of business, and employees of the partner title company perform the core title functions.
2. Several real estate agents create an LLC to purchase an interest in a title company. The title company and the LLC share profits based upon their ownership interest. However, the LLC disburses profits to its member real estate agents based on the volume of title business referrals.

All licensees should operate in compliance with RESPA, particularly the provisions of Section 8, as the violation of this part may carry a fine of up to $10,000 or imprisonment of up to one year, or both. For more information on RESPA, visit HUD's website at www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm or call HUD at (202) 708-0502.

Referrals to Vendors and Third Parties

Agents need to be particularly careful referring vendors and third parties. RESPA does not allow referral fees to be paid between loan officers and agents if the property is an owner-occupied (dwelling) and one-to-four units.

As mentioned earlier, some companies have affiliated business arrangements that allow them some flexibility in this area.

Conflicts of Interest

An agent has a duty not to compete with his principal. If a property is offered for sale, the agent must not move forward and make an offer to purchase the property when his principal is attempting to purchase the property also.

"An agent has a duty not to compete with his principal."

Negligent Advice

An agent must not be negligent in giving advice to his client. In light of the normal education and training that goes into being a real estate agent, an agent must not give negligent advice to his clients. If knowledge of the circumstances should have been within the agent's diligent observation, then he will be guilty of negligence.

Next is a look at licensee activities that are likely to contribute to risk.

Licensee Activities Likely to Contribute to Risk

Licensee activities that are likely to contribute to risk include agency duties, authorization to accept a deposit, secret profit, ostensible agency, gratuitous agency, agent acting in excess of his authority, patently frivolous offers, preparation, formation, interpretation, performance, and termination of contracts, express contracts, implied contracts, unilateral contracts, bilateral contracts, executory contracts, executed contracts, elements of a valid contract, minors, aliens, handwritten items vs. preprinted clauses in the contract, sufficient consideration, statute of frauds, voidable contracts, void contracts, attorney-in-fact, novations, statute of limitations, specific performance, liquidated damages, and options.

Agency Duties

An agency relationship is created when one person (the principal) gives another person (the agent) the right to act on his behalf. These acts are generally limited to a special agency of a broker listing a property for sale. In this instance, the agent is employed to find a ready, willing, and able buyer to purchase the property; and can neither sell the property for the principal nor bind him to any contract for the sale of the property.

> An agency gives rise to a fiduciary duty of utmost care, honesty, integrity, and loyalty of the agent to the principal. This is a higher standard of care that the agent must exercise when acting for his principal. The agency relationship is terminated at close of escrow.

The best way to avoid litigation between a principal and a broker is to have a written contract or agreement.

An agency relationship/fiduciary duty can be terminated by revocation by the parties, agreement of the parties, or death of one of the parties.

An agency gives rise to a fiduciary duty of truth, confidentiality, and competence. A real estate agent generally acts as a fiduciary. The relationship between principal and agent is called a fiduciary obligation.

Broker Owes Buyer

The listing agent owes the buyer the duty of honest and fair dealing. This is disclosure of all material facts related to the property. The same duty is owed by the selling agent to the seller (however, he usually doesn't know anything about the property).

Dual Agency

Dual agency occurs when a broker represents both the buyer and the seller in a real estate transaction. Thus, the broker has fiduciary duties to both the seller and the buyer and must act with extreme care. Loyalty and confidentiality can be easily compromised for each party.

If an agent does NOT disclose dual agency to both parties, he may be disciplined by the Real Estate Commissioner, he may not receive his commission, and it may be grounds for either party to rescind the contract.

Mr. Brown hired a broker to find a warehouse for lease and agreed to pay a commission for the service. Several days later, Mr. Green tells the broker he has a warehouse lease and agrees to pay a commission if he finds a tenant. The broker writes the lease that is signed by both parties. Mr. Brown knows that the broker was representing Mr. Green, but Green did not know that the broker was representing Mr. Brown. In this case NEITHER is liable to pay a commission. Acting for more than one party in a transaction without the knowledge or consent of all parties is called a divided agency (not dual agency). Dual agency occurs when the agent informs and obtains consent from each principal. Then he may collect a commission from each.

"Dual agency occurs when a broker represents both the buyer and the seller in a real estate transaction."

Therefore, a dual agency is legal if the buyer and seller consent to it.

Accidental Dual Agency

When a real estate agent acts as an agent for both the buyer and seller in a transaction, but does not specifically reveal this fact because he is unaware that both consider him their agent, he is involved in accidental dual agency.

Authorized to Accept Deposit

Able, the owner of Blackacre, lists a property for sale with Broker Baker. Able fails to authorize the agent to accept the deposit on his behalf. Buyer Charlie makes an offer on Blackacre and gives Broker Baker a check for $5,000 as a deposit. Under these circumstances, Broker Baker can accept the deposit check on behalf of Buyer Charlie and place the monies in his broker's trust account.

The agent is required to do as his principal instructs him to do. However, he must inform the seller of the any check held by the broker because this is a material fact.

Secret Profit

A broker cannot receive secret profits. It is a violation of the Real Estate Law, laws of agency, he is subject to disciplinary action by the Real Estate Commissioner, and subject to a civil suit by the seller or buyer.

A licensee may not receive a secret profit from the sale of one of his listings or other purchase he is involved in as a licensee.

A person who is NOT a licensee may make as many secret profits as possible on the transaction.

Licensee must disclose to his principal the full amount of commission or profit if he purchases the property.

A licensee must reveal to the other party (buyer or seller) that he has a license when involved in real estate transactions as a principal. He cannot buy through a "dummy" buyer.

If the buyer is a close relative (brother), the broker must reveal this fact to the seller.

Ostensible Authority

An agency relationship can result from the conduct and actions of the parties, even though there is no express agency agreement between the broker and principal(s) in the transaction.

Ostensible authority occurs when Seller Able lets Buyer Baker assume that Broker Charlie is his agent.

Gratuitous Agent

Compensation is not essential to establish an agency relationship. An agent who acts without compensation is still held under certain

"A gratuitous agent assumes all the liabilities of an agent who is being paid a commission in the transaction, yet doesn't receive a commission."

standards of care to his principal. A gratuitous agent assumes all the liabilities of an agent who is being paid a commission in the transaction, yet doesn't receive a commission.

Agent Acting in Excess of His Authority
The seller is not liable for the broker's actions if the broker acts in excess of his authority.

Agency Disclosure
As soon as practical or practicable an agent must disclose who is representing whom in a real estate transaction. This includes who is representing the seller, buyer, and if a dual agency exists. This disclosure must be in writing.

Patently Frivolous Offer
A broker is relieved of the obligation to present an offer to purchase real property to the principal when the offer is patently frivolous, he is acting under express written instructions of his principal, or the property is sold and escrow has closed.

Preparation, Formation, Interpretation, Performance, and Termination of Contracts
A contract is an agreement to do or not to do something. It is a legally enforceable agreement between competent parties who have agreed to perform certain acts for consideration or refrain from performing certain acts.

Express Contract
An express contract is a contract where the parties put their intentions and the terms of the agreement in words, either written or oral.

Implied Contract
An implied contract is a contract where the agreement between the parties is shown by acts or conduct rather than words.

Enforceable Contract
A purchaser may make a contract contingent upon obtaining satisfactory leases (inspection of an existing lease and approving it). This would be considered an enforceable contract. However, if a purchaser attempts to make an offer subject to obtaining a satisfactory lease, this is called an illusory contract and is not a contract.

Bilateral Contract

A bilateral contract is a promise for a promise. The promise of one party is given in exchange for the promise of the other party. For example, when a seller promises to pay the agent a commission when the home is sold and the agent promises to use diligence in marketing the property, this is called a bilateral contract. A listing agreement is usually considered a bilateral contract. Able gave Broker Charlie a listing and promised to pay him a 6% commission if he finds a suitable buyer. This is a bilateral executory contract.

Unilateral Contract

A unilateral contract is a promise for an act. A promise is given by one party to induce an act by the other party. For example, A promises to pay B $10 if she will walk across Brooklyn Bridge. B walks across Brooklyn Bridge, therefore, A owes B $10. B performs her requirements under the contract with an act rather than a promise. An example of a unilateral contract is an open listing.

Executory Contract

An executory contract is a contract that is in the process of being performed and has not yet been completed.

Executed Contract

An executed contract is a contract that has already been completed.

Valid Contract

1. **Competent Parties/Capacity To Contract** – The parties to the contract must not have been declared incompetent in a court of law. In addition, the parties to the contract must have the capacity to contract—specifically, minors may not contract for real property. The exceptions to this rule are minors who are married, divorced, in the military, or emancipated by a court of law.
2. **Mutual Consent** – This is mutuality of agreement. In other words, what what the buyer thinks he has agreed to in the contract the seller thinks he has agreed to also. There is a meeting of the minds. Genuine offer and genuine acceptance is used to facilitate a meeting of the minds.
3. **Lawful Objective** – The purpose of the contract must be of a legal purpose. A contract to smuggle illegal drugs into the U.S. would not be a valid contract because it has an unlawful objective.
4. **Sufficient Consideration** – Consideration is the bargained for exchange that occurs when two people contract to do or not to do something. For

Valid Contract *(continued)*

example, if Able gives Baker $100,000 for Baker's real property and Baker signs the deed conveying the real property to Able, there is sufficient consideration and a valid contract. Able's $100,000 is consideration on his part, and Baker's conveying the property to Able is Baker's consideration.

5. Real estate contracts have a fifth element: **in writing**. Not all contracts are required to be in writing, however, real estate contracts are require to be in writing (except leases of a year or less are not required to be in writing).

Minors

A minor can receive title to real property by gift or inheritance without court approval. However, the minor cannot convey the real property without court approval.

A single young man enters into a contract to sell real property he owns. After escrow had closed and the deed was recorded, the title company determines that the young man is under 18 years of age. In this circumstance, the transaction was void.

A minor can receive a parcel of real property by gift or inheritance without court approval. He cannot sell it without court approval.

A married or divorced person under 18 years of age has the capacity to contract and is not considered a minor.

Aliens

Non-resident aliens have the capacity to contract. Minors, convicts, children, and incompetents are all restricted from contracting. Non-resident aliens who are not citizens of the United States of America, however, do have the capacity to contract.

Handwritten vs. Preprinted Clauses

Many real estate contracts contain preprinted clauses and spaces for information to be handwritten. In a legal dispute, when there is a conflict between the preprinted clauses and the handwritten information, the handwritten information takes precedence over the preprinted clauses.

Sufficient Consideration

Consideration is required for a valid contract. Anything of value can be used as consideration (bargained for exchange).

Consideration is defined as services rendered, a promise to perform an act, an act of forbearance, or an exchange of money.

Statute of Frauds

The Statute of Frauds is an old concept that came from England (where it was abandoned a few years ago). However, it is still used in California. The Statute of Frauds states that all real estate contracts must be in writing including any and all agreements that are not to be performed within one year of their making (real estate or not). Since a lease of a year or less WILL be performed within one year of its making, it does not fall under the statute. Thus, a lease of one year or less is not required to be in writing. All other real estate contracts must be in writing.

Unenforceable Contract

An unenforceable contract is a contract that is valid, however, for some reason cannot be proved or sued upon. An example is when a contract cannot be enforced because of the passage of time within the statute of limitations. Another example of an unenforceable contract is an oral contract to purchase real estate. However, an oral agreement may be enforced if the purchaser has gone into possession, paid part of the purchase price, and made improvements to the property.

"An unenforceable contract is a contract that is valid, however, for some reason cannot be proved or sued upon."

Voidable Contract

A voidable contract is a contract that appears valid and enforceable but is subject to rescission by one of the parties who acted under a disability. In other words, one of the parties is able to void the contract or go through with it at their discretion. An example of a voidable contract is one that is signed under duress. The person who was held under duress while signing a contract can void the contract (rescind it) or enforce it at their sole discretion.

Void Contract

A void contract has no legally binding effect. It is unenforceable from the very beginning and is not a contract at all.

Examples of void contracts include:

- contracts to commit a crime.

- real estate contracts with minors.
- contracts with someone who has been formally committed to a mental institution.
- contracts with someone who has been declared incompetent by a court of law.

Power of Attorney

A power of attorney is a written instrument giving authority to an agent. For example, Brother #1 is in Sydney, Australia and would like Brother #2 to sign for him in the conveyance of a home purchased by the two of them some years ago. Brother #1 signs a power of attorney form at the American Consulate in Sydney, has it notarized, and sends it to his brother in the U.S. Brother #2 then acts as attorney-in-fact for Brother #1 and signs escrow instructions on his behalf.

Attorney-In-Fact

An attorney-in-fact is a person who is authorized to act on behalf of another person. Brother #2 in our previous example would be considered an attorney-in-fact for Brother #1.

Assignment

An assignment is the transfer of rights, interests, or title to property of a person (assignor) to another person (assignee). A typical assignment is when trust deeds are sold from one lender to another.

Novation

A novation is the substitution of a new contract for an old one. For example, when the lender releases a seller from the obligation to pay the loan in a loan assumption, and substitutes the buyer as the one responsible to repay the debt, this is called a novation.

“A novation is the substitution of a new contract for an old one.”

Statute of Limitations

The statute of limitations is the amount of time in which a person can bring an action in court. A purchaser of real property generally has two (2) years to bring a claim in court if it is related to disclosure on a Transfer Disclosure Statement. Breach of fiduciary duty is generally four (4) years from the close of escrow or when the defect is discovered by the plaintiff in the lawsuit. If these time periods are exceeded, then the statute of limitations takes effect and the person is prevented from bringing an action in court.

Specific Performance
Specific performance is a court action brought to force a party to carry out the terms of a contract. Specific performance is usually used to force a party to convey real property as stated in a purchase agreement. Each piece of real estate is considered unique and legal damages are many times not adequate to compensate a buyer for a seller's breach of contract. Therefore, the courts force the seller to convey the property to the buyer under the terms of the contract. Consideration for the contract, however, must be reasonable or sufficient relative to value for the courts to require specific performance.

Liquidated Damages

Liquidated damages are the predetermined amount of damages the parties of the contract agree to as the total amount of compensation an injured party will receive if the other party breaches the contract.

For example, a buyer and seller initial the liquidated damages clause to a real estate purchase agreement. The buyer removes all contingencies to the contract and then defaults on the purchase of the property (changes his mind and does not go through with the contract). The maximum amount of damages the seller can receive from the defaulting buyer has already been predetermined by the liquidated damages clause in the contract. The amount is usually 3% of the sales price or the earnest money deposit, whichever is lower for all one-to-four unit dwellings in California.

The liquidated damages clause in a real estate purchase contract must be initialed by both buyer and seller. If the buyer subsequently receives news of a job transfer and decides not to buy the property. Under these circumstances, the deposit is generally split 50% seller/50% listing broker.

Option

An option is an agreement to keep an offer to sell or lease real property open for a specified period of time. Options are commonly used in the purchase of raw land, allowing the buyer to resolve zoning, entitlement, and feasibility questions prior to committing the funds necessary to purchase the property. An option must be accompanied by consideration. Options are assignable.

If the optionee decides to exercise his or her option during the period specified, then the optionor must perform and sell the property as per the contract.

Next is a look at the broker's risks associated with advertising.

Advertising

Risks associated with advertising include blind ads, misleading advertising, and a broker breaking his promise to advertise.

Blind Ad

A blind ad does not have the name of the agent or broker who has the property listed for sale. Blind ads are illegal because "agt.", "bro.", "bkr.", or the name of the broker must accompany each advertisement for the sale of the property.

A licensee must disclose when advertising, that he is an agent. A blind ad makes the agent appear to be the owner. It does not identify the broker.

Misleading Advertising

Advertising cannot mislead a prospective buyer regarding the condition or other facts about a subject property. A "fixer" property should be called a "fixer," and not a "move right in" dream home.

Broker Breaks Promise to Advertise

A broker breaking his promise to advertise is illegal. If a broker promises to advertise a property and then does not do as promised, she may be liable for damages under actual fraud.

Next is a look at fair housing risks.

Fair Housing

Fair housing risks include Federal Fair Housing Laws, State Fair Housing Laws, race restrictions on a deed, marital status discrimination, and the Americans with Disabilities Act (ADA).

Federal Fair Housing Laws

The main federal fair housing law was the Civil Rights Act of 1968. This Act has been instrumental in prohibiting discrimination in the sale and lease of housing throughout the U.S. In 1968 the U.S. Supreme Court prohibited all racial discrimination when real property is sold or rented.

The Civil Rights Act of 1968 allows all prospective buyers to be given the same opportunity to purchase residential properties without racial restrictions.

If a seller asks a broker to disclose a buyer's race, the broker should not disclose the purchaser's race because it is not a material fact.

Redlining
Redlining occurs when a lender obtains a map and places a red line around an area where he does not want to make loans. This is called "redlining" and is illegal.

State Fair Housing Laws
There are four important fair housing laws that have been enacted in the State of California:

California Fair Housing Act – The owner of a single-family residence may take in a boarder and be exempt from the California Fair Housing Act.

Unruh Civil Rights Act – prohibited discrimination in business establishments in California.

Rumford Act – prohibited discrimination in the sale and rent of residential properties in California.

Holden Act – prohibited discrimination in lending in California.

Housing Financial Discrimination Act of 1977 (Holden Act)
For example, XYZ Savings and Loan Association negotiates a $200,000 loan with Maria Gomez. Maria speaks no English. In order to complete the transaction XYZ provides loan forms written in Spanish. In the escrow closing statement Maria is charged a 1/8% higher interest rate than other borrowers who speak English. Under these circumstances the lender could <u>not</u> impose the extra charge. This is a violation of the Housing Financial Discrimination Act of 1977.

If a loan broker asks a person applying through the broker's office for a new loan to fill out a questionnaire in which the borrower's race and marital status are requested, the applicant can refuse disclose his race or marital status.

Steering
Steering occurs when an agent steers a client out of communities that are not of his ethnic race. Steering is illegal.

A real estate licensee has a practice that when he is approached by members of minority groups who want to be shown property, he avoids showing them property in integrated areas. This would be an example of steering.

Panic Peddling and Blockbusting

Panic peddling and blockbusting are very similar terms. For example, when an agent goes into a neighborhood and informs the homeowners that they should sell their homes now because minorities are coming into the neighborhood and their homes will suffer a loss in value, this is called panic peddling or blockbusting. Both of these activities are illegal.

A real estate broker who undertakes to canvas a neighborhood area that is very near to a section into which minorities have recently moved telling the people to whom he talks that they should sell now as their property might suffer a loss in value in the future, this is called panic peddling and blockbusting. Again, both are illegal.

A licensee who contacts owners of homes in an area indicating that they should list their homes for sale with him because minorities may be moving into the area, this practice would be considered blockbusting, panic peddling, and illegal.

Race Restrictions on a Deed

Regarding the conveyance of a deed including race restrictions, the deed is valid but the race restrictions are unenforceable. Race restrictions on a deed are unenforceable because they violate the U.S. Constitution.

"Regarding the conveyance of a deed including race restrictions, the deed is valid but the race restrictions are unenforceable."

When a deed includes race restrictions, the race restrictions can be changed with a court order.

Marital Status Discrimination

It is illegal for a landlord to require a tenant to have a co-signor because he or she is not married. This is marital status discrimination and illegal.

Americans with Disabilities Act (ADA)

The Americans with Disabilities Act (ADA) requires equal access to public buildings for all handicapped persons.

Real Estate Commissioner Creates Color Blind Industry

The Real Estate Commissioner's policy is to create a "color blind" industry. This means that agent's should maintain an attitude that is color blind and free of bias, race, creed, and color are not material facts in a real estate transaction, and agents should treat all people like they themselves would like to be treated.

Next are some practical examples of high risk areas for licensees.

Practical Examples of High Risk Areas

Practical examples of high risk areas for licensees are fraud, misrepresentation, non-disclosure, concealment of material facts, and unlicensed assistants.

Fraud/Misrepresentation/Non-Disclosure

Fraud is a nice word for lying. Misrepresentation occurs when the agent misrepresents the condition of the property or some other material fact(s) about a property. Non-disclosure occurs when a licensee or his clients (seller or buyer) do not disclose material facts that are pertinent to the purchase of real property.
When an agent makes a promise that influences a person to enter into a transaction, this is called a False Promise.

Misrepresentation

Misrepresentation has two categories:

- intentional misrepresentation (another name for fraud or lying)
- negligent misrepresentation (unintentional mistake).

Obvious knowledge by the broker is considered misrepresentation.

Concealment of Material Facts

A material fact is a fact that affects the value of a property and if a buyer knew about the fact she probably would not purchase the property. Examples of material facts are leaky roofs and extensive plumbing repairs.

Unlicensed Assistant

If a broker has his unlicensed receptionist schedule an appraisal for a property, she cannot give the appraiser information concerning the property. She can only schedule the appraisal. If she were a licensed assistant, then she would be able to provide information regarding the property.

An unlicensed receptionist cannot advertise (design and make advertisements) for the broker. She can only place what the broker told her to write in the newspaper or other advertising medium.

If a real estate broker has his unlicensed assistant hand out door hanger fliers in his farm area and make telephone cold calls soliciting prospective buyers, sellers, and borrowers, this is unlawful for both the broker and the unlicensed assistant.

Next is a look at some risk reduction techniques to help licensees reduce their exposure to risk.

Risk Reduction

Risk reduction techniques include a company adopting an official risk management policy; risk can be minimized by planning, training, supervision, and enforcement; broker delegating document review to salesperson; it is the responsibility of brokers, office managers, and supervisors to manage risk by educating, training, and supervising employees and associates; broker-salesperson agreements; goals of risk management clearly stated and communicated to agents and employees; consequences of illegal and unethical behavior; need for licensees to stay current; and risk is ongoing and reduced through proper training, supervision, and enforcement of office policies.

Companies Should Adopt an Official Risk Management Policy

It is advisable for real estate companies to adopt an official risk management policy. This policy should cover areas of risk to the company and its licensees, as well as the company's policies dealing with each area. This should be contained in the company's office policy and procedures manual.

Risk Can Be Minimized by Planning, Training, Supervision, and Enforcement

Risk to the real estate company can be minimized by planning, training, supervision, and enforcement. The company should plan to train, supervise, and enforce the policies set forth in their office policies and procedures manual.

> "Risk to the real estate company can be minimized by planning, training, supervision, and enforcement."

Planning: A formal plan regarding minimizing risk as set forth in the office policies and procedures manual.

Training: Coverage of risk reduction issues within the company's formal training program for new agents and on-going training for experienced agents.

Supervision: All broker-officers and sales managers should be aware of risk reduction issues when supervising licensees. Corrections should be made to on-going licensee training as needed to reduce risk to the company.

Enforcement: Licensees who do not follow the company's risk reduction policies should be reprimanded and then, if the policies are not followed, subsequently terminated by the company.

Broker Delegates Document Reviews to Salesperson

It is quite common for large real estate brokerage operations to delegate to a salesperson (usually called a sales manager) within an office the ability to review and initial documents completed by other salespersons within the office. The broker can delegate these reviews to a salesperson who has at least two (2) years full-time experience as a real estate salesperson within the past five (5) years.

The Responsibility of Brokers, Office Managers, and Supervisors to Manage Risk by Educating, Training, and Supervising Employees and Associates

It is the responsibility of brokers, office managers, and supervisors to manage risk by educating, training, and supervising employees and associates. These responsibilities should be covered within the office policies and procedures manual. Educating, training, and supervising should be covered within the post-license training program for new licensees—as well as on-going training during office meetings. The broker-officer and sales managers should adequately supervise the licensees under their responsibility.

Broker-Salesperson Agreement

A written broker-salesperson agreement is required between all real estate brokers and salespersons in California. A written agreement between the broker and salesperson is required by the Real Estate Commissioner's regulations. A salesperson is legally an employee of the broker; however, he is an independent contractor for tax purposes. The broker must keep a copy of broker-salesperson agreements for three (3) years after termination of employment. The agreement between a broker and salesperson is not required to be approved by the Bureau of Real Estate. However, it must be in writing.

Goals of Risk Management Clearly Stated and Communicated to Agents and Employees
Brokers during initial and on-going training, office meetings, and in their Policies and Procedures Manual should clearly state risk management goals. Proper completion of all contracts and disclosures is critical to file management and resulting risk reduction.

Consequences of Illegal and Unethical Behavior
The consequences of illegal and unethical behavior is either a correction of the agent's actions or termination and notification to the CalBRE.

Need for Licensees to Stay Current
All real estate licensees should stay current in their area(s) of expertise by reading industry publications and completing continuing education requirements as prescribed by the CalBRE.

Risk is Ongoing and Reduced through Proper Training, Supervision, and Enforcement of Office Policies
As mentioned earlier, risk reduction is a constant and ongoing process and can be reduced by training, supervision of agents, and enforcement of office policies.

Next is a look at risk management and the consumer.

Risk Management and the Consumer

Risk Management and the Consumer investigates the impact of the consumer's increased access to information and the consumer's demand for greater value from a licensee's services. Licensees are custodians of the public interest when conducting licensed activities and have fiduciary duties to the consumer.

Impact of the Consumer's Increased Access to Information and the Consumer's Demand for Greater Value from a Licensee's Services
With the advent of the internet, information is much more accessible than ever before. For this reason consumers are demanding more value from their agents.

Agents bring several things to a real estate transaction:
1. Knowledge of the contracts.
2. Knowledge of the disclosures.
3. Knowledge of the real estate market.
4. Knowledge of financing.

5. Knowledge of inspections and repairs.
6. Buffer zone between the seller and buyer.
7. Negotiator and advocate for their client in the transaction.

Licensees are Custodians of Public Interest When Conducting Licensed Activities

Real estate licensees are custodians of the public's interest when conducting licensed activities. For this reason, the CalBRE takes its regulatory duties very seriously.

An agent who harms members of the general public and then skips town and does not pay any judgments against them, is definitely the exception and not the rule in California.

The CalBRE has a Recovery Fund or Recovery Account that can be used by members of the general public who have un-collectable judgments against a licensee. Part of all license fees go into the Recovery Fund. If there is an un-collectable judgment against a real estate licensee, the consumer who was harmed may collect up to $20,000 from the fund. However, the CalBRE will pay a maximum of $100,000 for each licensee. So if there are more than five consumers harmed by the licensee, the sixth will receive nothing (5 x $20,000 = $100,000).

Fiduciary Responsibility

"An agency relationship gives rise to a fiduciary duty of utmost care, honest, integrity, and loyalty of the agent to the principal."

An agency relationship gives rise to a fiduciary duty of utmost care, honest, integrity, and loyalty of the agent to the principal. This is a higher standard of care that the agent must exercise when acting for his principal. Fiduciary obligations include truth, confidentiality, and competence. A real estate agent has a position of trust and generally acts as a fiduciary.

The following are two major breaches of an agent's fiduciary duty to his principal:

1. A listing agent informed the buyer that the seller will take less money for the property. This is a breach of fiduciary duty to the seller.

2. A selling agent cannot reveal anything negative about his buyer to the seller. This is a breach of fiduciary duty to the buyer.

Next is a look at the legal responsibility placed on real estate licensees.

Legal Responsibilities

Legal responsibilities include vicarious liability for individuals, supervisors, and the company; statutory duties and responsibilities for licensees; legal claims based on mediation, arbitration, and litigation; license discipline; the Real Estate Commissioner; claims stemming from self-regulation, such as grievances/arbitration; and the district attorney and criminal courts.

Vicarious Liability for Individual, Supervisor, and Company

If a salesperson does something unethical or illegal, the salesperson and the broker are <u>both</u> liable. If the broker does something unethical or illegal the salesperson is <u>not</u> liable for the broker's action.

Statutory Duties and Responsibilities of the Licensee

There are many statutory duties for licensees that have been imposed by the State Legislature. Some duties to consider are disclosure of material facts, agency disclosure, and natural hazards disclosure.

Legal Claims Resolved by Mediation, Arbitration, or Lawsuit

Legal claims between licensees and principals can be resolved by mediation, arbitration, or litigation (lawsuit). Mediation is voluntary.

A mediator hears the case and makes a determination. The mediator's ruling is non-binding.

An arbitrator hears the case and makes a determination. His determination is binding between both parties. Both the buyer and seller must agree to the type of dispute resolution used by initialing the arbitration clause in the purchase agreement and/or listing agreement. A binding arbitrator (usually a former judge or real estate attorney with at least five years experience) hears the case and makes a determination. There is generally no appeal—and arbitration can cost more than litigation.

In litigation, a judge or jury hears the case. They make a determination and there may be an appeal process. Generally the trial courts hear the case, and the one of the appellate courts in California reviews the case on appeal. The three appellate court justices check the rules of law that relate to the trial court's decision.

In lieu of litigation, both plaintiff and defendant may agree to alternative dispute resolution which entails mediation of the dispute. This is generally a cheaper and easier way to decide the matter.

License Discipline by the Bureau of Real Estate
The Real Estate Commissioner suspends and revokes real estate licenses. When an agent has done something wrong, the Real Estate Commissioner first issues an accusation. The licensee can then plead his case and the Commissioner may suspend his license for a certain period of time or revoke it entirely. The CalBRE Bulletin is now published on their website and lists all of the agents who are in trouble.

Real Estate Commissioner
The Real Estate Commissioner is appointed by the Governor of the State of California. The Real Estate Commissioner has primary regulatory authority over all real estate subdividers and licensees in California.

The Real Estate Commissioner revokes real estate licenses. In addition, the Commissioner issues cease and desist orders to subdividers who do not follow the real estate laws.

The Real Estate Commissioner will start an action against a licensee with an injunction and has three years to take action on a violation.

The maximum fine the Real Estate Commissioner can levy against a broker who pays an unlicensed person for soliciting borrowers or negotiating loans is $10,000.

Claims Stemming from Self-Regulation of the Real Estate Industry, Such as Grievance/Arbitration
The National Association of Realtors (NAR) is a national industry group associated with the California Association of Realtors (CAR) and local associations. A licensee MUST be a member of NAR to call themselves a "Realtor."

If a licensed real estate broker is not a member of the California Association of Realtors or the National Association of Realtors and in his advertising he indicates that he is a Realtor, he is subject to disciplinary action by the Real Estate Commissioner.

Should a dispute regarding a commission arise between two sales licensees who are members of the National Association of Realtors, by provisions of that organization's Code of Ethics they will settle the matter by arbitration.
Misuse of the name "Realtor" is a violation of the California Real Estate Law.

District Attorney and the Criminal Courts

The district attorney would prosecute a non-licensee who performs acts required by a real estate license. In the event a non-licensee performs an act for which a license is required, the party that would prosecute the non-licensee is the district attorney in the county where the activity occurred.

For example Jones, who does not have a real estate license, is the owner and president of an investment firm. He advertises and sells properties for his clients. Since these transactions involve real estate, the district attorney will prosecute him for violating the real estate law.

"The district attorney would prosecute a non-licensee who performs acts required by a real estate license."

Risk management is a critical area for real estate licensees to consider in all of their real estate endeavors. The Risk Management course has been designed to address some of the most pressing areas that confront licensees on a day-to-day basis and it is hoped that real estate licensees will be able to reduce their risk in today's litigious environment.

This concludes our three (3) hour continuing education course in Risk Management.

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OF CONTINUING EDUCATION

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WHO CAUSED THIS MESS?

"If stupidity got us into this mess, then why can't it get us out?" -Will Rogers

During the mid to late 1990s, the U.S. real estate market finally bottomed-out and moved into an **upward-trending sellers' market**. Real estate investors were having a difficult time getting excited, however, because the real estate market did not look like it was going to **appreciate in value** very quickly.

Accordingly, lenders were not thrilled about the prospects of future declining interest rates. **Baby boomers** were retiring and demand for real estate loans was decreasing, causing a decrease in loan interest rates. It looked like single-family home prices would slowly appreciate until the **median income** of homebuyers matched interest rates and **lender underwriting guidelines.**

The **Graham-Leach Bliley Act of 1999** ("Act") unintentionally extended this upward-trending sellers' market much further than it should have gone—especially in light of existing economic and financial conditions. This was caused by removing the barrier among traditional banks, investment banks, and insurance companies to become involved in each other's businesses. This gave rise to "**Shadow Bankers**" who acted like bankers, but were **investment bankers**, **hedge funds**, insurance companies, and other entities mostly operating on Wall Street. Many of these institutions were involved in all three areas: traditional banking, investment banking, and insurance.

Some of these Shadow Bankers were Wall Street hedge funds. Hedge funds by definition pursue above-average returns and the MBAs who run the funds thought they saw a way to increase returns through real estate loans. They came out with **adjustable rate loans (ARMs)**, so when the cost of money increased—so did the borrower's loan interest rate and monthly payments. This transferred the **interest rate risk** from the lender to the borrower.

The interest rate for a **fixed rate loan** does not change, so when interest rates increase the borrower's interest rate and monthly loan payment does not change. Generally, during times of low interest rates, it is in a borrower's best interest to obtain a fixed rate loan. Getting an ARM is not really a very intelligent move during this type of real estate market.

> "Generally, during times of low interest rates, it is in a borrower's best interest to obtain a fixed rate loan."

ARMs tend to work fairly well during an appreciating market that is heading upward. This is because the borrower can generally cover any loan payment increases; however, they are disastrous during a **downward-trending buyers' market** where the loan payments are going upward and the property value is heading downward. When this occurs, the homeowner will become "**underwater**" as the loan is more than the value of the home.

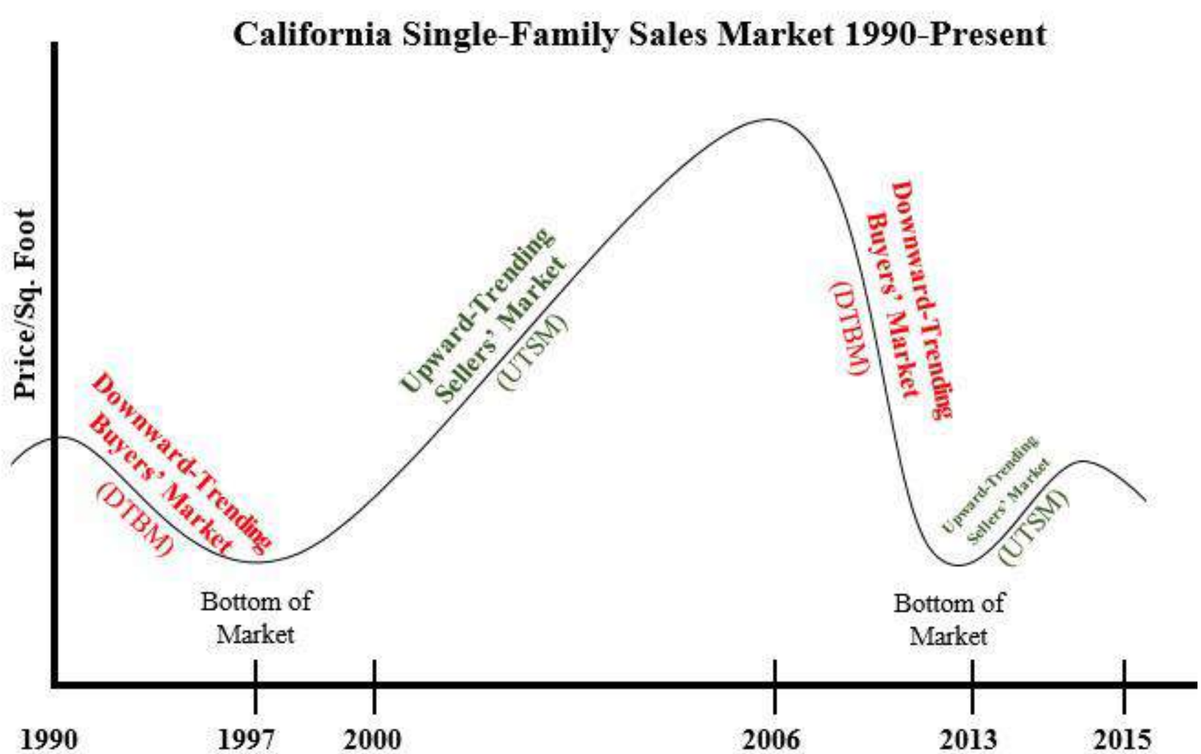


Figure 1.1 California Real Estate Market Cycles

The Shadow Bankers also wanted the **deferred interest** from **negative amortization loan**s. With a negative amortization loan, the borrower does not pay any **principal reduction**, nor initially any interest that is due on the loan. So this "deferred interest" that was not paid, was added to the balance of the loan and the loan amount went *up* and not down during the life of the loan. How much were the borrowers drinking when they signed that one?

The Shadow Bankers were able to count the deferred interest as an **asset** on their books, even though they had not yet received it. It was considered a **note receivable**. Negative amortization loans changed **simple interest loans** into **compound interest loans**. Now borrowers were paying interest on the loan balance and interest on the deferred interest. Paying interest on interest gave the lenders a greater return than normal simple interest rate loans.

The Shadow Bankers enticed borrowers to accept ARMs with negative amortization and resulting deferred interest by offering initial "**teaser rates**" that had a very low starter rate, and increased a short time later. The Shadow Bankers were able to borrow money at a 40 to 1 ratio against the deferred interest they had not yet received. Talk about a house of cards! In addition, in 2004 the Securities Exchange Commission (SEC) released major investment banks from the new capitalization rules that had required them to maintain certain reserves. These reserves tended to limit an investment banker's **leverage** and **overall risk.**

As the Shadow Bankers started taking over the lending market with these aggressive loans, the regular bankers were forced to get into the act as well. It was either move forward with these risky loan types or lose their home loan market share. In fact, during this time period **Fannie Mae** and **Freddie Mac's** market share declined from 70% to 40% of all the home loans made in the U.S. They had been issuing **mortgage-backed securities** for many years; however, now competitors had entered the market and were taking away their market share at a very alarming rate.

The **Federal Housing Administration (FHA)** and **Veteran's Administration (VA)** were only making a few loans at the time. This was because they could not compete with the risky loans being made by the Shadow Bankers and regular banks. Lenders in both the **conventional**, **jumbo**, and **government insured and guaranteed lending markets** were losing market share to the Shadow Bankers.

When the regular bankers finally got into the market and started making competing loans, many of these were called "**Pick-a-Payment Option ARM**" loans because they were adjustable-rate loans that had negative amortization schedules. This allowed borrowers to "pick their payment." There were generally four payment options: 15 year amortized, 30 year amortized, interest-only, and negative amortization. Since the negative amortization payment was the lowest of the four options, most borrowers paid that option—not knowing that the loan balance was actually <u>increasing</u> during the life of the loan.

> Lenders made **100% loan-to-value loans** (i.e., no down payment) to borrowers with stated income. This meant that borrowers were allowed to fabricate whatever income they wanted on the loan application—and it was not verified by the lender. Someone called them "**NINJA**" loans: <u>N</u>o <u>I</u>ncome, <u>N</u>o <u>J</u>ob, No <u>A</u>ssets, NO PROBLEM.

Lender wholesale representatives were known to come to **mortgage brokers'** offices during the heyday, from 2001 through 2006, and train loan officers how to correctly "state" the borrower's income to get the loan through their own underwriting guidelines. Lender wholesale reps were paid a commission for each loan that was funded, so they had a personal interest in the loans being approved and funded. When looking at a **borrower's net income after taxes,** almost all of their net pay may have been needed to cover the loan payment!

Wholesale lenders paid mortgage brokers three or more **yield spread points** on the back-end of the loan to make these dangerous loans. For example, if a borrower obtained a $400,000 loan, the mortgage broker who originated the loan was paid $12,000 or more by the wholesale lender to make the loan. This was in addition to the **loan origination fees** paid by the borrower to the mortgage broker. With this type of enticement, it is no wonder the only loan mortgage brokers were willing to sell during the heyday between 2001 and 2006 was Option ARMs. They were virtually the only loan product that lenders' wholesale representatives were training mortgage brokers and their employees to sell during this time period.

All the loans made during the heyday were called "**subprime loans**" because they were supposed to be made to borrowers with less than exemplary loan qualification criteria—hence the name "**subprime crisis**." In reality, many of these "subprime loans" were made to financially solid **"A" paper** quality borrowers who did <u>not</u> need to pay the higher interest rates inherent with subprime loans. Whether highly-qualified borrowers were given subprime loans by mistake or by design is a question that will never be satisfactorily answered.

Lenders started issuing high-risk mortgage-backed securities called **derivatives**. They were securities collateralized by real estate loans and given some catchy names such as: "**Collateralized Debt Obligations**" (CDOs) and "**Structured Investment Vehicles**" (SIVs.). The lenders made loans, packaged them into similar risk groups—called **tranches**, and sold them to investors all over the world.

Loans that were sold as mortgage-backed securities to investors were AAA rated by the bond rating agencies of Standard and Poors, Moody's, or Fitches—yet they were really **junk bonds** of dubious value. The bankers hired, and more importantly *paid*, the bond rating agencies for their endorsements. So, if rating agencies did not give AAA ratings to these de facto junk bonds, they would not be hired again in the future to rate more CDOs and SIVs. They were placed in a compromising position of going along with the lenders or losing revenue and market share in the bond rating industry. Thus, the three bond rating agencies gave their AAA stamp of approval to junk bonds purchased by financial institutions, pension funds, and endowment funds located all over the world. In addition, President Clinton signed the **Commodities Futures Modernization Act of 2000** that deregulated the derivatives markets. Thus, both the legislative and executive branches of the federal government were involved in this mess, as well as both major political parties.

For several years, no one could figure out what the bankers were thinking when they violated many of their own cardinal rules of lending, especially loan-to-value ratio and income verification. What they were really doing was so sophisticated that very few people knew what was really going on at the time.

The derivatives market was not traded on the **stock exchanges** or **commodities exchanges** and therefore, lacked **transparency**. No one, except the perpetrators, really knew what had happened and what had really caused this mess. And they were not talking. It finally came out some time later that they were betting against the loans they had made with credit default swaps from AIG and other insurance providers. *They bought insurance against their <u>own</u> loans defaulting.* If a loan went underwater and into foreclosure, the credit-default swap insurance company, usually AIG or others, would be required to pay the difference to the investor

"The derivatives market was not traded on the stock or commodities exchanges and therefore, lacked transparency."

who purchased the CDO or SIV and to the original lender—if needed. Of course, when things really went south with a severe stock market adjustment in 2008, AIG could not pay all the sustained losses and the **real estate bubble** called the "Subprime Crisis" became a reality. It is absolutely amazing that these top-level finance executives actually believed that AIG was going to be able to cover lenders' risky loan underwriting decisions.

The System

Lenders had become a little "aggressive" and started making loans to people who really could not afford them. The problem was greed at all levels: investment bankers, retail bankers, rating agencies, credit default swap companies, and mortgage lenders. Who was left holding the bag? The borrowers who lost their homes and the investors who bought the ill-fated mortgage-backed securities—while not understanding inherent default risks.

At the peak of the frenzied real estate market, lenders were making home loans to people who could not qualify for a cell phone! In addition, they made loans using 100% loan-to-value financing—so borrowers had no down payment and nothing at stake. This was generally accomplished using an 80% LTV 1st loan coupled with a 20% LTV 2nd loan.

When the real estate market turned from an upward-trending sellers' market to a downward-trending buyers' market, AIG's credit default swap division could not afford to cover all the defaulting loans (no kidding). AIG needed a bail-out loan from the US government to keep their credit default division solvent. This actually turned out to be preferred stock that was held by the U.S. government through 2012. Since AIG had several healthy divisions that were not tied into the derivatives market, the bailout loan may have been a decent idea at the time—and was instrumental in keeping liquidity in the financial markets.

> Questionable underwriting standards involved with so called "liars loans" caused an artificial inflation of real estate prices throughout the U.S. Prices in the U.S., and in particular California, were many times higher than what the real estate market could justify under normal loan underwriting conditions, where a borrower's creditworthiness and income are generally major determining factors in whether a loan is made.

Shadow bankers may have been slick with their adjustable rate loans, compound interest, catchy derivative names, and credit default swaps; however, they did not understand (nor apparently care) that loan-to-value ratio is generally a lender's first line of defense against loan default. Loan-to-value (LTV) ratio divides the loan amount into the sale price or appraised value, whichever is lower. Lenders traditionally have been reluctant to make loans above an 80% LTV ratio.

Under normal underwriting guidelines, when lenders make loans above an 80% LTV ratio, they generally require **private mortgage insurance** (called PMI) or **lender-paid mortgage insurance**. Lenders will have a good chance of recovering most, if not all, of the loan amount if they must foreclose on the property in the future. The borrower and PMI company will take the loss. This concept has worked well for many years. Most lenders adhered to this policy during the 1990's real estate market downturn and weathered the losses fairly well.

"Under normal underwriting guidelines, when lenders do make loans above the 80% LTV, they usually require private mortgage insurance (called PMI) or lender-paid mortgage insurance."

Since the 1930s, lenders have sold some of their loans to Fannie Mae and Freddie Mac who bundled them up, packaged them, and sold them to investors as mortgage-backed securities. From 2001-2006 the investment bankers tried to emulate Fannie Mae and Freddie Mac; however, they missed one key area: default risk underwriting guidelines that adequately measure a borrower's risk of default.

To cause more problems, if a buyer bought a home with a no down payment Option ARM loan and made the minimum (negative amortization) payment, within two or three years of buying the home the loan payment would most likely **recast**. This is an adjustment from the negative amortization minimum payment to an **interest-only** minimum payment. Monthly payments could increase by hundreds of dollars per month. Many borrowers could not afford this increase in payments and ended up defaulting on their loans.

In addition to a loan recast, the loan may adjust due to a movement in the underlying interest rate **index** tied to the adjustable rate loan. If the index increases, the borrower may experience a "double whammy" increase in payments. This is caused by the recast of the loan and an increase in payments resulting from an upward adjustment in the ARM's interest rate index. The result was an increase in loan payments, along with an increase in the payments caused by the loan recast. <u>Some borrower's payments increased by as much as $800 per month!</u>

Suddenly, many homeowners were not able to afford the loan payments on their own homes. This is because the lender may have used "stated income" to make up whatever income was needed to qualify for the loan. Many homeowners could not afford to make their loan payments and went into default. When the lenders and investors went to AIG for payment on their credit default swaps, AIG was not able to cover the losses and this led to the so called "subprime crisis" and subsequent stock market devaluation in 2008.

The result was hundreds of banks failures across the country, lenders tightened credit underwriting criteria, and the recession hit:

- Collapse of Lehman Brothers 9/08
- Collapse of AIG 9/08 (only their CDO division)
- Merrill Lynch was sold to Bank of America 9/08
- Washington Mutual failed, sold to Citigroup 9/08
- Security Pacific Bank failed 11/08
- Downey Savings and Loan failed 11/08
- Bear Stearns failed 3/09

In 2009, President Bush approved a $168 billion **economic stimulus bill** through **tax rebates** to low and moderate-income taxpayers. This was designed to encourage consumer spending, give businesses tax incentives to encourage investment, and raise Fannie Mae and Freddie Mac loan limits so they could continue purchasing loans on the secondary mortgage market. Unfortunately, these efforts became futile as an **economic recession** loomed on the horizon.

Today, lenders have been reluctant to make loans except to the most qualified borrowers. This has pushed the downward-trending buyers' market much further downward than anyone expected. The shock to the real estate market was so great that the single-family real estate market in California continued to decrease until the next real estate bubble: single-family home **rental derivatives** became a reality.

Single-Family Home Rental Derivatives

Rather than issuing mortgage-backed securities and insuring them against default (derivatives), a few Wall Street hedge funds came up with the idea of issuing

rent-backed securities (derivatives) that were based on single-family home rental revenue streams and insured against loss through credit default swaps. Potential losses could come from tenant defaults, evictions, and foreclosures—and not loan defaults. Wall Street hedge funds bought over 45,000 single-family homes located in select markets throughout the U.S.

The homes were purchased with all cash. The hedge fund bundled the investments up into similar investment grades, and sold them to investors as securities backed by the **rental streams** originating from these single-family rental properties. This allowed Wall Street to enter the single-family rental market that had been the domain of **mom and pop investors** in the past.

As the hedge funds continued buying so many single-family homes, they drove the prices up due to the increased demand and limited supply of properties on the market. Since the homes were purchased with all cash they did not require **appraisals**, so the hedge funds could pay whatever they wanted for the properties. The increase in property values actually favored the hedge funds because the value of the rent-backed securities was increasing and thus providing more **collateral** for the investors who purchased them.

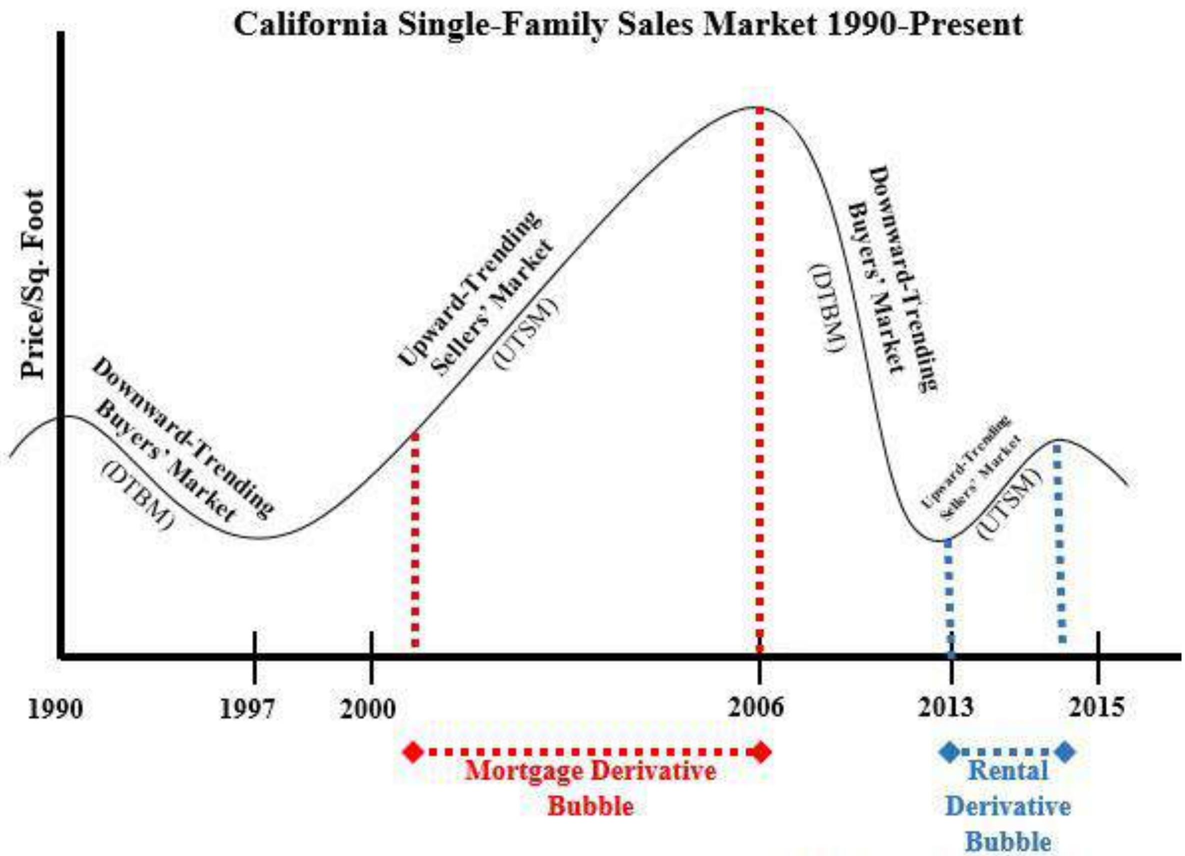


Figure 1.2 Mortgage Derivative and Rental Derivative Bubbles

Single-family home prices increased from 2013 through 2014 as hedge funds purchased homes, hired property managers, rented the properties, and set up effective collection procedures for the numerous rental income streams.

Each home that is purchased will affect the values of up to 90 homes that surround it. Therefore, 45,000 homes purchased by the hedge funds x 90 homes per **sales comparable** = over 4 million single-family home prices were affected by the hedge funds. This caused a real estate bubble that artificially propped up real estate prices from 2013 through 2014, until the hedge funds completed their buying spree and single-family home prices slid back toward more normal market levels.

The U.S. real estate markets moved from a **mortgage derivative bubble** to a **rental derivative bubble**, with each bubble allowing lenders and real estate hedge funds to realize future profits today rather than in the future. Next is a look at real estate market timing and how it affects single-family investments.

2

REAL ESTATE MARKET TIMING

"Good Judgment comes from experience, and experience comes from a lot of bad judgment." -Will Rogers

Real Estate Market timing is the single most critical factor that will affect the success or failure of a client's single-family property investment. During an upward-trending sellers' market, property prices are usually rising and being a real estate owner can be a very profitable situation. At or near the top of the real estate market, smart single-family investors may have the opportunity to sell their single-family rental homes to *owner-occupied buyers* who will gladly pay top-of-the-market prices to own them.

Cyclical Markets

Real estate markets are generally cyclical—they go up and they go down over time. When nearing the bottom of a downward-trending buyers' market, your clients may be able to negotiate a much better deal than is possible during an upward-trending sellers' market.

> "When your clients are near the bottom of a downward-trending buyers' market, they may be able to get a better deal than during an upward-trending sellers' market."

Single-family rents may increase during an upward-trending sellers' market because more rental properties are being converted into owner-occupied single-family homes and there may be a reduced supply of rental properties. As the single-family sales market changes from an upward-trending sellers' market to a downward-trending buyers' market, home prices will start to decline. At this point, foreclosures usually start to increase as people walk away from their homes and allow them to go into foreclosure. The equity in the home has reduced so far that the loan amount is now greater than the market value. Many homeowners see no alternative but to walk away from their homes and reenter the rental market as tenants.

Many single-family homes may be on the way to foreclosure, so the single-family segment of the real estate market may initially not have a large number of available rentals. Over time, however, single-family rentals will take over the rental market because of their greater desirability over higher density properties such as halfplexes, townhouses, condominiums, and apartment buildings.

High-Density Properties

During the last upward-trending sellers' market, many homebuyers purchased high-density halfplexes (half of a duplex), townhouses, and condominiums for owner-occupied use. In contrast to single-family homes, these property types tend to experience a greater loss of value during the early stages of the next downward-trending buyers' market. As property values of high density homes start to decrease, the number of foreclosures tends to increase as property owners walk away from their homes. This, in turn, causes an increase in demand for residential rental properties as former homeowners are forced to enter the residential rental market.

"During the last upward-trending sellers' market, many homebuyers purchased high-density halfplexes (half of a duplex), townhouses, and condominiums for owner-occupied use."

> The only market that is quick and available for new tenants to occupy is the apartment rental market. As more and more homeowners lose their homes, the apartment rental market will usually heat up and rents may increase as a result.

Later, after the downward-trending buyers' market has run its course, there will usually be a large number of single-family homes being foreclosed by lenders and sold through a trustee's sale on the court steps or as a lender-owned Real Estate Owned (REO) property.

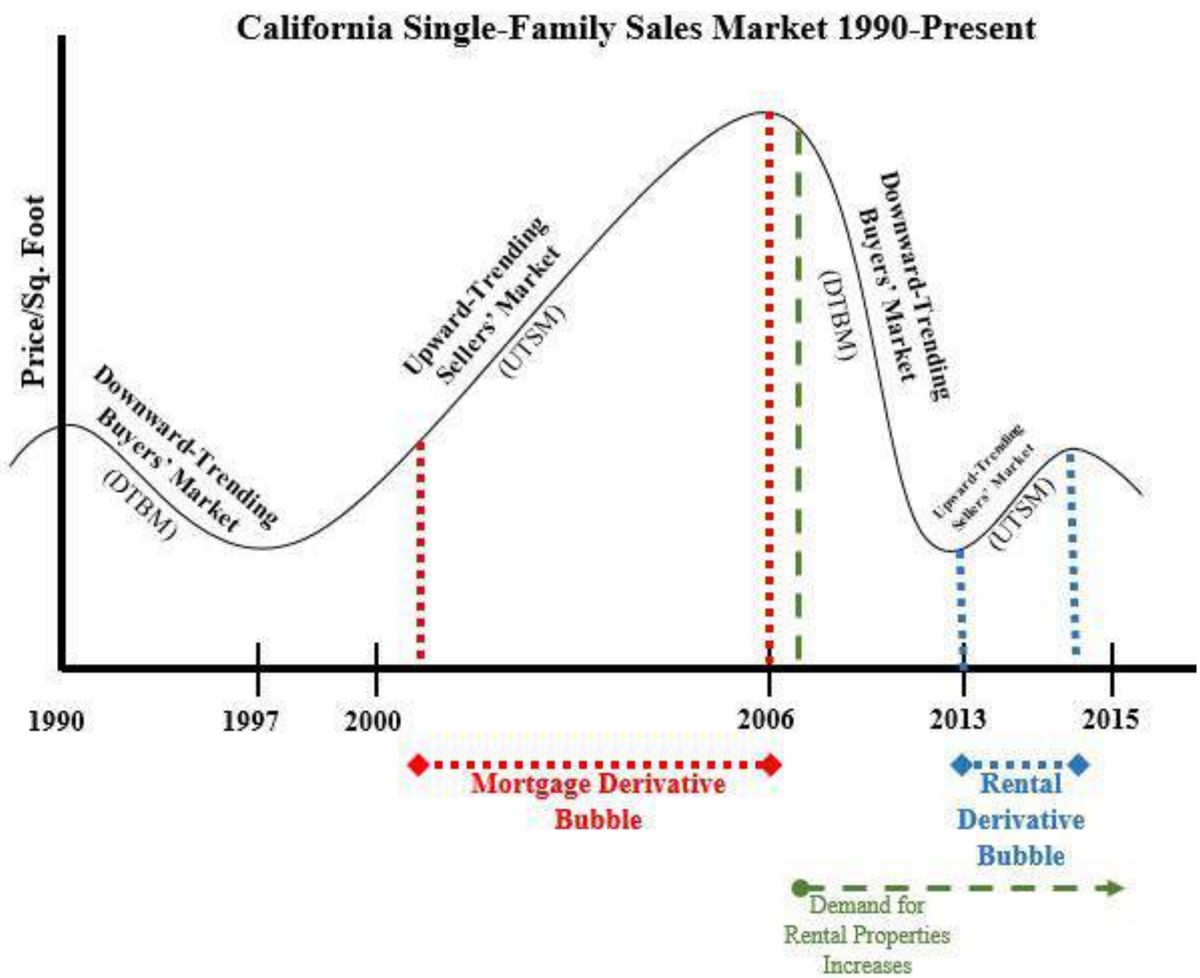


Figure 2.1 Demand for Rental Properties in California

A large number of former homeowners, who had their credit ratings damaged by delinquent mortgage payments and resulting foreclosures, will usually not be able to qualify for another owner-occupied home loan for at least three to five years after the time of foreclosure. Thus, a key real estate market of owner-occupied buyers is effectively precluded from purchasing single-family homes for at least three to five years. The only buyers who are able to purchase these distressed homes are real estate investors who pay all-cash and then turn them into single-family rental properties.

Clients Want to Sell at the Top of an Upward-Trending Sellers' Market

Your clients may have sold all of their single-family rental properties at or near the top of the last upward-trending sellers' market, paid the **capital gains taxes** owed to both federal and state governments, placed their money in the bank, waited until the next downward-trending buyer's market bottoms out, bought more rental properties, rented them out, held them until the next upward-trending sellers' market nears the top, sold the homes, and the cycle continues…

Some investors sold their real estate assets and played the stock market rather than placing their profits in the bank. This seemed like a good idea, until an unexpected stock market "adjustment" wiped out their profits in the blink of an eye—or the click of a mouse.

Inexpensive Older Homes Located in Lower Socio-Economic Neighborhoods

Near the bottom of a downward-trending buyers' market, some real estate investors were able to take their money out of the bank and buy inexpensive older homes located in lower socio-economic neighborhoods. Some of these investors were able to obtain a 12% or higher **return on investment (ROI)**; however, this was not a bed of roses. Real estate investors were faced with increased management intensity and higher maintenance costs than they experienced with newer properties located in higher socio-economic neighborhoods.

One solution was to hire a professional **property manager** to manage the properties on a day-to-day basis. Property managers who manage single-family and higher density homes usually charge between 8% and 10% of the **gross collected rents** per month to manage each property. The amount varies by individual market and the number of properties each client has under management. The greater the number of properties or units a client has under management, usually the lower the management fee that may be negotiated.

Real estate investors could have chosen to perform a **1031 tax-deferred exchange** at the top of the last upward-trending sellers' market and moved their **equity** into another real property located within the U.S. However, the last big upward-trending sellers' market saw almost all properties in every **geographical market** and **property type** increase in price to a point where moving equity into another property type and geographic location was <u>not</u> going to escape the next downward-trending buyers' market. Therefore, to liberate equity in their properties, real estate investors were forced to sell and pay the capital gains taxes.

If real estate investors did not sell their income properties at the top of the upward-trending sellers' market, they were probably forced to ride the downward-trending buyers' market all the way back down, collecting rents along the way, and waiting for the top of the next upward-trending sellers' market to dispose of the asset.

Trophy Properties

Some single-family home investors may own well-located **trophy properties** that are very difficult to replace. An ocean view single-family home located in a high socio-economic area is a good example of a trophy property that investors tend to keep over the long-term. In fact, some investors who are looking at long-term holds may ride out several real estate markets, both up and down, with no intention of selling these irreplaceable properties.

Upward-Trending Sellers' Market

If your investor client is facing an upward-trending sellers' market, home prices will generally rise due to the intense competition for homes, especially if they are located in higher socio-economic neighborhoods. There may be a "frenzy" of owner-occupied buyers making emotional, and often bad, purchase decisions because of pressure coming from other owner-occupied buyers. When **demand** for single-family homes is exceeding **supply**, fast and up-to-date property listing information is critical to find good, high quality single-family investment properties. Your real estate investor clients should plan on being a seller and not a buyer during this type of market.

> "If your investor clients are facing an upward-trending sellers' market, home prices will generally rise due to the intense competition for homes, especially if they are located in higher socio-economic neighborhoods."

During an upward-trending sellers' market, the best single-family homes are usually sold long before they reach the local **Multiple Listing Service (MLS)** and good deals may be few and far between. It is difficult to find good deals when there are multiple offers coming in on each property—driving prices upward and creating a sense of urgency that causes homebuyers to pay above market prices. Real estate investor clients cannot overpay for a property and expect to make a profit when they sell it in the future. Real estate investors must get into the market at the start of an upward-trending sellers' market, long before owner-occupied buyers enter the market.

> Real estate investor clients need to have made their purchases near the bottom of a downward-trending buyers' market, so they can ride the next upward-trending sellers' market to the top and then sell, pay the capital gains taxes, and put their money in the bank; or do a 1031 exchange and move their equity into another property type or geographical location within the U.S.

Time Usually Heals

Time usually heals, and over the years this has generally been true. Your clients only lose if they sell at the bottom of a downward trending buyers' market. Some real estate investors like to buy when everyone else is selling and sell when everyone else is buying. This is exactly opposite of the crowds. So when the news media is in the doldrums and crying in their beer, that's when the savvy real estate investors break out their checkbooks and go shopping. They either find the deals or they make the deals—and there are usually a large number of single-family homes on-the-market.

> "Fast, up-to-date property listing information is not as critical during a downward-trending buyers' market."

Once a seller makes one price reduction, it is easy to ask for another. Homes that are over 60 days-on-the-market (DOM) may be where the best deals are to be found.

Fast Property Listing Information is not as Critical During a Downward-Trending Buyers' Market

Fast, up-to-date property listing information is not as critical during a downward-trending buyers' market because quality properties tend to stay on-the-market long enough for agents to find them, and their investor clients to buy them.

Tracking the Real Estate Market

Tracking real estate markets for single-family homes has become much easier with the advent of the internet. If real estate investors are not familiar with a particular geographic area, they tend to look at the highest priced older homes with standard-size lots that do not have huge acreage. This is generally a lot size of approximately .12 to .15 acres for homes located in urban and suburban areas and .25-.50 acres for those located in rural areas. Any lot sizes above these size ranges are removed from the analysis, because they tend to skew the research toward a higher cost per square foot than is indicative of "normal" size (e.g., smaller subdivision) lots located in the targeted area.

Real estate investors take note of the zip codes where the higher-end homes are located. This is a good place to start the home search. They can then work their way downward, considering desirability and corresponding price levels of homes built in each successive lower socio-economic neighborhood. Real estate investors have found that it is usually easier to work their way downward, rather than upward. They are always looking for a better quality property for the same price, so they will already know what they can get for their money in the higher-priced neighborhoods. It also allows them to consider what **property renovations** will yield over time.

Some real estate investors track a real estate market back in time to see where it is trending. Based upon this information, they usually try to buy single-family rental properties somewhere near the start of the next upward-trending sellers' market. This is not always easy to predict. They must look at prevailing wages in the local market area, median home prices, and existing loan interest rates in an attempt to determine how far down the downward-trending buyers' market will actually go.

The real challenge is determining the **real bottom** of the real estate market as opposed to a **false bottom**. It will become apparent that a real estate market has bottomed out about six months after it actually happens. With this in mind, some real estate investors use a continuous buying program that is similar to long-term investors in the stock market. When real estate investors think the real estate market is nearing the bottom, they start buying rental homes on a continuous basis throughout the bottom of the trough.

> "The real challenge is determining the real bottom of the real estate market as opposed to a false bottom."

Real estate investors using this strategy are trying to buy at a price as low as possible, and then wait the least amount of time necessary to reach the top of the next upward-trending sellers' market. In other words, real estate investors want to buy the asset as cheaply as possible and keep it for the least amount of time needed to sell it for a profit at the top of the next upward-trending sellers' market.

If real estate investors buy a single-family rental home too soon during a downward-trending buyers' market that has not bottomed out, they may pay too much for it and have to wait a long period of time before the top of the next upward-trending sellers' market. Their return on investment will be reduced, especially if the **time value of money** is taken into account. Money sitting in a person's hand today is worth more than it will be if it is received in the future. Having money in hand will allow an investor to invest it and receive a **compound rate of return** (interest on the money invested and *interest on the interest* received) over their holding period. Conversely, if they receive the same amount of money five years from now, that amount will <u>not</u> include the compound interest return they received during the five year **holding period**. In other words, they did not have the money in their hands and could not invest it. This is the basis of the time value of money.

> "Money sitting in a person's hand today is worth more than it will be if it is received in the future."

If real estate investors wait too long to acquire a single-family rental property, they may pay too much for it as prices during an upward-trending sellers' market move upward. However, the investors may not have to wait too long until the top of the next upward-trending sellers' market. If the real estate investors miss both of these opportunities, they will pay too much for the single-family rental home and this will reduce their return over the property holding period. However, during an upward-trending sellers' market, investors may be able to increase their return by performing a renovation as they near the top of the next upward-trending sellers' market.

> Real estate investors may swoop in near what they think is the bottom of a downward-trending buyers' market, purchase single-family foreclosures at perceived "rock bottom" prices, convert them into rental properties, hold them as long-term rentals, ride the real estate market upward over time, and then sell at the top of the next upward-trending sellers' market.

The other option for real estate investors is to perform a major renovation of each foreclosed property and then **flip** (sell) them immediately to an owner-occupied buyer at top-of-the-market prices. This tends to work fairly well during an upward-trending sellers' market, but can be disastrous during a downward-trending buyers' market. The single-family sales market may be heading downward as the real estate investor completes a property renovation. When this occurs, the real estate investor will be fortunate to recoup the property investment without a loss. This is similar to swimming upstream. Instead, a savvy investor will want to swim downstream, so their renovation work will increase the value of the property while the real estate sales market is increasing at the same time. This produces some very happy real estate investor clients.

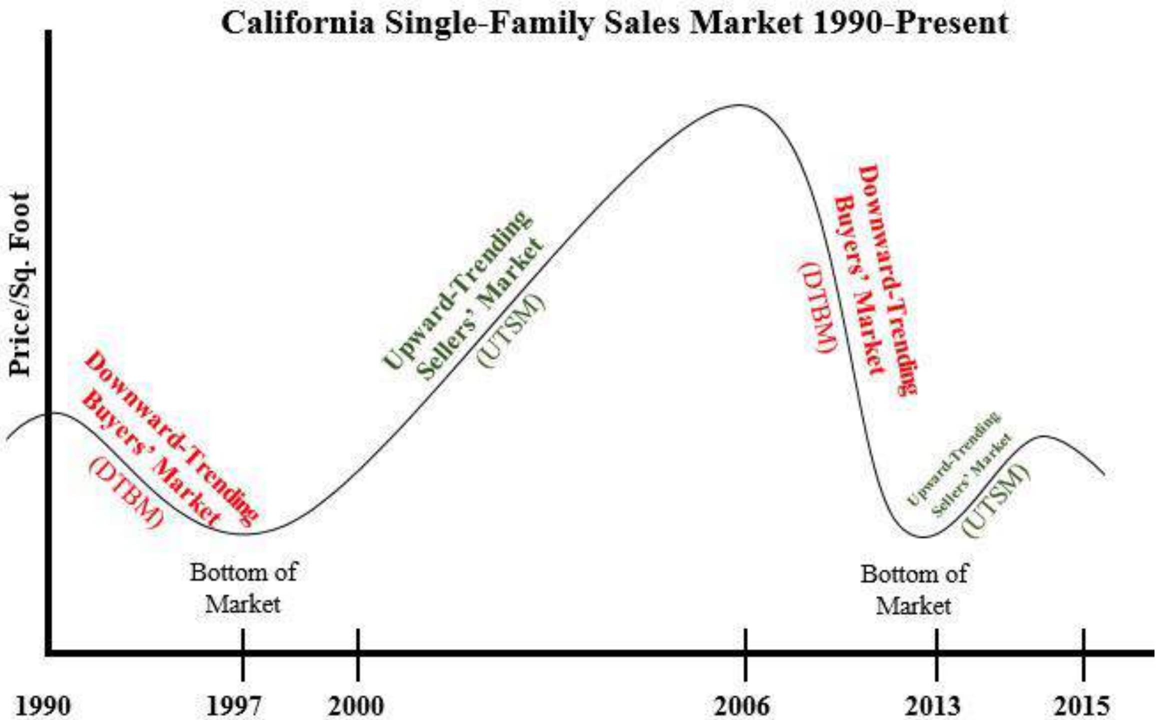


Figure 2.2 Real Market Bottom

As already mentioned earlier, prices of homes will generally adjust downward during a downward-trending buyers' market. Many more buyers may now qualify for government loans for homes they could not have afforded a few short years earlier. High loan-to-value (LTV) government loans provide first-time home buyers with the ability to purchase a home with a small down payment and easier loan qualifying criteria than conventional loans. The result is usually an increase in property prices due to the easier financing. There are more buyers who can qualify for high LTV government loans, thus increasing the demand for single-family homes. According to supply and demand, when demand increases and supply stays the same, the price of the home will increase. Again, this is good news for real estate investor clients.

The real estate investor may be in competition with owner-occupied government loan buyers. So, the best deals may come from foreclosures that are in such disrepair that they will <u>not</u> qualify for government financing. One of the usual stipulations for high LTV government financing is a home that is in livable condition, with no broken windows, missing window screens, exposed wiring, or missing appliances. A single-family home that is in disrepair will not fulfill government financing requirements, and will thus require a lower LTV conventional owner-occupied loan (20% down payment) or an all cash purchaser to buy the property. When real estate investors find a property that does not qualify for government financing and it has been on the market over sixty days, they may be able to negotiate a really good deal for the property. The number of owner-occupied competitors is significantly diminished when a property is in physically poor condition and only investors with cash or some type of nonowner-occupied conventional financing (with usually 25% or more down payment) will be able to purchase the single-family home.

> Tenants living in apartment buildings may decide to move out of their existing apartments and into more desirable single-family homes. This may be as a tenant renting a single-family home or as a buyer purchasing a home with government financing.

Single-family homes tend to be the most desirable property type, with halfplexes, townhouses, and condominiums following on the desirability continuum. If real estate investors purchase single-family rental properties at the right time, they are in a good position for future price appreciation.

Tenants will generally pay higher rents to live in single-family homes than in other property types previously mentioned. Therefore, in a downward-trending buyers' market apartment owners initially benefit by an increase in market rents, however, single-family homes may later "steal" their tenants away from them.

Owner-Occupied Homeowners Have Different Alternatives than Real Estate Investors

Owner-Occupied Homeowners

A homeowner may consider selling a home at the top of an upward-trending sellers' market and becoming a renter during the entire downward-trending buyers' market. The homeowner could then buy at the bottom of the next upward-trending sellers' market and **leverage** the purchase (with a loan) to increase the return through price appreciation—while riding the real estate market back up again. Many homeowners have a difficult time becoming a tenant after having been a homeowner for a long period of time.

> "During a downward-trending buyers' market, homes located in higher socio-economic areas tend to have slower depreciation rates than those located in lower socio-economic areas."

If the real estate market is a downward-trending buyers' market and possibly heading into the abyss, homeowners may be able to protect themselves by buying the smallest size home located in the highest **socio-economic neighborhood** within their price range. The smallest home will generally have the least relative **price depreciation** (loss of value) as opposed to larger homes located in the same geographic area. During a downward-trending buyers' market, homes located in higher socio-economic neighborhoods tend to have slower **price depreciation rates** than those located in lower socio-economic neighborhoods.

A homeowner is usually elated when their home increases in value, and quite depressed when it loses value. The equity in the property, which includes the down payment and any price appreciation, is <u>not</u> earning interest while it sits in a person's home. This is called **opportunity cost** because the homeowner is losing the opportunity to receive income on this money. Although, homeowners will experience the **emotional security** of owning their own home, they may continue to be vulnerable to market and property risks.

Real Estate Investors

Real estate investors generally have different alternatives than owner-occupied homeowners. They can buy and sell, not based upon their own home and where they live, but strictly by market timing. When the real estate market nears the top of an upward-trending sellers' market, many investors perform a 1031 tax-deferred exchange and move their equity into another real estate market that has not yet peaked.

One of the decisions real estate investors must make is where to move their money? If all the real estate markets are at or near their peak, where do they place their money to experience the least amount of loss in value? The answer may be to cash out completely, pay the capital gains taxes, put the money in the bank, and wait for the bottom of the next downward-trending buyers' market.

If it is advantageous, some real estate investors play the stock market during the period between real estate market cycles. Otherwise, they may keep their money in **liquid bank deposits** waiting for the proper time to invest back into the real estate market. They may also look at buying businesses that derive good cash flows. It really depends upon the investor's experience, tolerance for risk, and comfort levels.

One word of caution to your clients: Advise them not to tell anyone what they are doing. As soon as their relatives hear that the real estate investor has cashed out and is sitting on a pile of money, every distant cousin will show up with some very creative hard luck stories. A good thing to remember is that *money chases good deals and bad deals chase the money*. The relatives may have any multitude of investment schemes trying to separate your clients from their hard-earned money. Silence and patience are two virtues of the successful real estate investor.

New Real Estate Investors

Some newer real estate investors may not have enough money to pay all cash for a property. One possibility is to purchase a single-family home with a government loan and live in the property. The real estate investor may be able to live in it, renovate it—but not too much if it's going to become a rental in the future—and then buy another larger owner-occupied home. The new real estate investor can then consider renting out the smaller home rather than selling it.

This is especially true if the new real estate investor does not need the equity from their existing home to use as a down payment for the new single-family home that will be used as a principle residence.

Real estate investors look at the rental property for:
(1) Positive cash flow—depending upon market timing and interest rates,
(2) Price appreciation during an upward-trending sellers' market
(3) Depreciation, which is a paperwork loss the IRS may allow the real estate investor to deduct on their income tax return.

Difficulty Determining the Top of an Upward-Trending Sellers' Market

Because it is difficult to determine the top of an upward-trending sellers' market, real estate investors may want to consider selling their properties <u>just before</u> they hit the top of the market. If the investor believes they are fairly close to the top of an upward-trending sellers' market, it will be easier to sell the property when everyone else thinks the market is still on a roller coaster to the moon. If the investor can capture at least 80% of the property's total price appreciation, this will maximize returns—while reducing risks at the same time.

This strategy is similar to stock market investors who adhere to a **constant buying program** for securities. They make sure they are in the market somewhere near the bottom and out somewhere near the top, thereby striving to capture 80% of the total price appreciation.

Real estate investors can use a similar tactic by buying real estate investment properties through the bottom of a downward-trending buyers' market. They may get into the real estate market a little late and out a little early, but they will know the market has bottomed out and it is generally easier to sell a single-family investment property when nearing the top of an upward-trending sellers' market. Everyone (and their dog) will be out buying over-priced properties.

By buying a little before the bottom of a downward-trending buyers' market, the real estate investor can find some really good deals. There generally isn't as much competition for single-family properties during this type of real estate market. After the market bottoms out and everyone knows it has hit bottom, there will usually be a frenzy of buying activity and good deals may be more difficult to find.

Market timing is critical to real estate investment success. Single-family homes typically increase and decrease in value through real estate cycles that can be anticipated during normal economic and financial markets. However, when a sector of the market expands too fast, the results can be disastrous. Future market price appreciation is taken now and not in the future, thus leaving future markets to wither on the vine trying to make up for the excesses that were caused by the previous market bubble. With that in mind, let's take a look at real estate itself and why investors buy it for use as an investment vehicle.

3

WHY INVEST IN REAL ESTATE?

"Experience is a hard teacher because she gives the test first, the lesson afterwards." -Vernon Sanders Law

I. Five Variables that Affect the Value of Real Estate

Real estate investors usually consider five variables that will affect their real estate investment:

A. Price
B. Terms
C. Condition
D. Location
E. Market Timing

A-C. Price, Terms, and Condition

Price, terms, and condition of a property can usually be changed. This is where a real estate investor can use his or her experience and expertise to increase the value of a real estate investment property. "**Value-added**" real estate investment properties allow the real estate investor to negotiate price and terms with the seller to obtain the lowest out-of-pocket costs to acquire the investment. They allow a real estate investor to change the physical characteristics of an investment property to increase its value and/or derive greater rental income over the holding period.

D. Location

Location, on the other hand, cannot be changed. There is an old saying, "Location, location, and location," meaning that location is the most important variable to consider when acquiring a real estate investment property. This is why many real estate investors consider location to be the most important long-term factor affecting price appreciation of an investment property and are very careful *where* they purchase real estate investment properties.

E. Real Estate Market Timing

Alongside location in importance is real estate market timing. *When* a real estate investor enters and exits a real estate market is critical to overall investment returns. A real estate investor cannot change market timing, but he or she can spend a considerable amount of time and resources measuring it to maximize profits over the long-term or within each real estate bubble.

Many years ago real estate markets were somewhat slow and steady, giving real estate investors plenty of time to gauge real estate markets and make prudent investment decisions based on long-term market trends. Today, real estate market have been upended by short-term real estate bubbles caused by mortgage-backed and rent-backed securities originating from Wall Street. For this reason, it is critical for a real estate investor to move quickly, read each artificially-fabricated short-term bubble, and invest accordingly.

"The real estate rules tend to work fairly well during long, slow upward-trending sellers' markets when economic growth is the backbone of real estate price appreciation."

Buying a poorly-maintained distressed house in a lower socio-economic neighborhood directly violates the rule of location. However, that is exactly what a large number of real estate investors did in response to the Federal Reserve Bank's (FED) quantitative easing programs. Real estate investors feared inflationary pressures caused by the increase in the FED's balance sheet from $800 billion in the early 2000's to $4 trillion in 2015.

The real estate rules tend to work fairly well during long, slow upward-trending sellers' markets when economic growth is the backbone of real estate price appreciation. However, when central banks (i.e., the FED) introduce new and untested stimulus techniques into the market trying to jump start a sluggish economy, the rules tend to go out the window.

Rental houses located in a lower socio-economic neighborhoods may have the potential for huge cash flows—if purchased near the bottom of a downward-trending buyers' market. If appreciation in value seems to be many years down the road, cash flow may be the main reason to invest in real estate—along with wealth preservation strategies. Some investors may decide to keep their money in the bank, especially if inflationary pressures are low and they are not obtaining enough cash flow and/or price appreciation in light of the perceived risk of the investment.

II. Location and Condition Work Together to Affect Value

Two variables that may have a significant impact on the value of a single-family investment property are neighborhood socio-economics and age of the property.

The following diagram indicates the four possible quadrants a real estate investor may select when purchasing a single-family investment property.

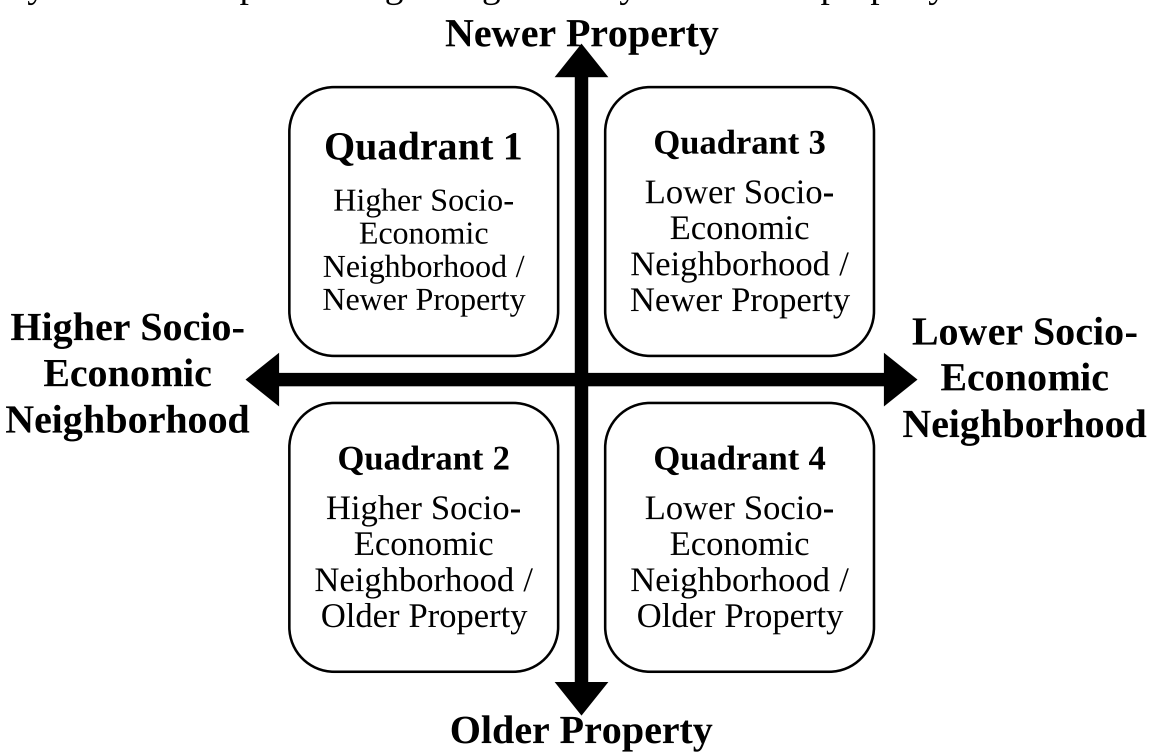


Figure 3.1 Four Quadrants of Single-Family Investment Success

1. Higher Socio-Economic Neighborhood/Newer Property

In Quadrant #1, your real estate investor client is purchasing a newer home located in an upscale and usually very expensive neighborhood. This type of home is typically the most expensive of the four quadrants, yet it has the highest potential increase in value. The home is usually fairly new in age, probably five years old or less, and will most likely require less maintenance than older homes.

During an upward-trending sellers' market, this type of home usually sells for whatever the market will bear, and it will usually bear a lot. The seller may receive multiple offers, all of them considerably over list price.

During a downward-trending buyers' market, these homes tend to experience a lesser loss in value than other quadrants. In other words, they tend to hold their value better than properties located in the other three quadrants. Unfortunately, many home owners tend to keep these quality homes during a downward-trending buyers' market, waiting for an upward-trending sellers' market to sell at a much higher price. Occasionally, a seller will sell one of these quality homes during a downward-trending buyers' market and this is when a real plum will come on the market for your investors.

Due to the nature of a downward-trending buyers' market, you may actually have enough time to locate quality homes for your clients. Savvy real estate investors make some of their best deals during a downward-trending buyers' market. A home that would normally be sold long before it hit the market during an upward-trending sellers' market, will not only end up on the MLS, but remain there long enough for you to go see the property, write up an offer for your client, and get it into contract before anyone else figures out that a quality property has just come on the market.

Quadrant #1 properties generally have very minimal styling problems called functional obsolescence. They usually have a large master bedroom, large walk-in closet, large master bathroom with separate tub and shower, three car or larger garage, large kitchen with island, nook, and large pantry, nine foot or higher ceilings, separate formal living room, formal dining room, and family room.

There are usually newer schools located in Quadrant #1 neighborhoods. The schools are usually wired for computer networks and the internet. They also may have newer facilities and more and better school materials and supplies because of the socio-economics of the surrounding neighborhood. Parent involvement in the local schools, especially at the elementary level, usually results in a high-quality learning environment.

New Homes Generally Do Not Have an Entrenched Social Structure
If there are a large number of new homes coming into a higher socio-economic area, there is generally no entrenched social structure because everyone is new to the area. For this reason, new homes have an increased intrinsic value by placing everyone on an equal social footing. The children will all be new to the area and will not have to deal with an existing social structure in the local neighborhood or at school.

Quadrant #1 single-family homes typically rent to high quality tenants, however, they usually do not cash flow very well for investors. The reason is that real estate investors must compete with owner-occupied buyers who will usually pay a lot of money to live in these neighborhoods. They are generally utilizing owner-occupied financing that usually has lower interest rates than investors can get in the market. This allows owner-occupants to pay more for a property because they are looking more at their payments and less at the price of the home. Their purchase decision is usually based on emotion.

Conversely, real estate investor decisions must be based purely on the numbers. If the real estate investor tries to compete with owner-occupied buyers, the investor may overpay for a property and have a difficult time finding a tenant who is willing to pay a high enough rent to cover the debt service on the loan.

Rents usually equate to supply and demand. If a large number of financially solid tenants are now buying Quadrant #1 homes, then the number of available tenants for this market will be diminished. This lack of demand for high-end rentals will result in decreased rents for these types of properties. In other words, there are many tenants who can afford $1,000 per month, but not too many who can afford $4,000 per month—and the people who can afford $4,000 per month may be out buying homes rather than renting them.

> "Real estate investor decisions must be based purely on the numbers."

As a result, if interest rates are fairly low and the real estate market is at the start of an upward-trending sellers' market, it may be better to buy rather than rent. Financially solid people tend to be astute and understand market timing. So, you will probably get your best returns for your clients through price appreciation over the holding period. The financially solid people who are buying in Quadrant #1 may drive up the prices of these highly-desirable properties and make your clients a lot of money in the process. Quadrant #1 homes tend to rent very quickly and to high-quality tenants; however, as mentioned earlier; they generally do not cash flow very well, so the greatest return will be through long-term price appreciation.

2. Higher Socio-Economic Neighborhood/Older Property

In Quadrant #2, your clients are purchasing an older home located in a higher socio-economic neighborhood. Older homes located in this type of neighborhood generally tend to hold their values well. However, they usually require more maintenance than newer homes located in higher socio-economic neighborhoods.

Neighborhood Changing Over Time

Many older homes, due to their established nature and low probability of the neighborhood changing over time, may actually be worth more than newer homes located in higher socio-economic areas. Even though older homes may have some styling issues, are typically smaller in size than newer homes, and generally experience on-going maintenance issues, they may actually sell for a considerably higher per square foot price than homes located in Quadrant #1. This is because the stable nature of an older neighborhood may provide less perceived risk to both homeowners and investors.

Entrenched Social Structure

Older neighborhoods are generally well established and probably will not change very much in the future. For this reason, they may have an entrenched social structure of neighbors who have known each other for a long period of time. Being the "new kid on the block" may provide difficulties breaking into the existing neighborhood social structure.

Unfortunately, this type of situation is quite common within small towns located throughout California. Joining groups and organizations is one way to break into an entrenched social structure and get to know the long-time residents.

Typical Locations for Older Neighborhoods

Older neighborhoods that have maintained their property values are typically located within the inner circle of growth just outside the Central Business District. This location usually provides convenient access to job sources within the city. Many of the homeowners are older and stay in their homes for many years. They probably started as homeowners with children and moved to empty nesters.

Homes located in these areas are usually good renovation candidates due to the higher socio-economics of the surrounding neighborhoods and resulting contribution to value that results from a well-planned renovation project. Newer families move into the area and the cycle repeats itself.

Upward-Trending Sellers' Market

During an upward-trending sellers' market, there are usually many buyers who want to buy homes located in Quadrant #2. Buyers see long-term value when buying a home that is appreciating in price and may not physically change too much in the future.

In addition, buyers may be able to do a cosmetic renovation and increase the value of the home <u>even more</u> than can be achieved through price appreciation in the local real estate market. Sellers understand this situation too and may price an "old dilapidated piece-of-junk" home at nearly the same price as one that is in good physical condition. Intense market competition from buyers facing multiple offers may cause a market frenzy that is good for sellers and bad for buyers. Accordingly, your investor clients will want to be sellers during this type of market—and not buyers.

"During an upward-trending sellers' market, there are usually many buyers who want to buy homes located in Quadrant #2."

Downward-Trending Buyers' Market

Real estate investors need to buy Quadrant #2 properties near the bottom of a downward-trending buyers' market, when everyone is crying the blues. Some real estate investors may do just enough renovation work to find a good quality tenant and then ride the upward-trending sellers' market back up.

Whether the real estate investor is going to sell the property and cash out, or do a 1031 tax-deferred exchange and move the equity into another real estate market, in either case the investor may try to sell the property for the highest price possible—while <u>not</u> doing the major renovation at all. When there are multiple above list price offers coming in on every property that hits the market, sellers may be able to obtain nearly as high a price for an out-of-style "dated" home as they can selling it in a renovated condition.

One problem with this plan is the real estate investor must buy the property near the start of an upward-trending sellers' market, when properties are starting to appreciate in value. Otherwise, the investor will be stuck with a property that is losing value while trying to renovate it during a downward-trending buyers' market. This is similar to swimming upstream and is not a good situation for an investor.

California Remodel

Sometimes a real estate investor may be better off tearing the home down, rather than renovating it. A "California Remodel" occurs when a real estate investor tears down all of the walls to the home, except one that is left standing, and then rebuilds the rest of the house. The reason homeowners tend to like California Remodels is because they generally do not require building permits for the work being completed. It is generally considered a renovation of an existing property and no walls or additional square footage property additions have been added that would require a building permit. Be sure to have your clients check the local laws before starting a California Remodel.

Established Neighborhood

One thing that is nice about an established neighborhood is that it *is* established. It takes the guess-work out of where a neighborhood will evolve during the next ten, twenty, or thirty years. As mentioned earlier, a mature neighborhood located in a higher socio-economic area is probably going to stay in the same condition for many years to come.

Figure 3.2 San Francisco Neighborhood

Negative Aspects of Older Neighborhoods

Older neighborhoods may have some negative aspects that need to be considered. Many have outdated plumbing lines and fixtures, both within the property itself and in the off-site improvements located throughout the neighborhood. If the homes were built prior to 1978, they may have asbestos in certain building materials and special care must be taken when replacing old asbestos sewer lines. Of course, "popcorn" ceilings may need to be professionally removed from the home as well.

Power Lines vs. Underground Utilities

Another negative aspect of an older neighborhood is overhead power lines. Older homes may have overhead power lines carrying electricity and telephone lines. In contrast, newer homes generally have underground utilities, which may include electrical and telephone lines—as well as the normal water, sewer, and gas lines. Newer homes may also have fiber optic cables that allow high-speed internet connections. Older homes may not have any of these amenities, which may detrimentally affect the amount of rents your investor client will receive during the holding period—as well as the property's value in the future.

Property Line Disputes

Within some older neighborhoods, property lines may not be as well-defined as they are in newer neighborhoods. The use of Global Positioning Satellite (GPS) units for surveying today's properties is much more accurate than the old "oujia board methods" used in the past. Most lot line disputes usually come from older properties that were surveyed prior to the use of GPS coordinates.

Private Streets vs. Public Streets

If the home sits on a lot that is adjacent to a private street, your real estate investor client may want to consider the future costs of repaving the street when it starts developing pot holes and other maintenance issues. Public streets are generally repaired by the city or county where the property is located and are usually paid by the taxpayers.

Bonds and Special Assessments

Many of the older neighborhoods located in California were developed before the establishment of modern-day Mello-Roos bonds or special assessments. These bonds and assessment usually pay for off-site improvements such as streets, sidewalks, and schools. Older neighborhoods may have some minor assessments or fees that were later imposed by the existing homeowners, however, they are usually small in comparison to the costs of modern-day bonds and assessments. This may provide older higher socio-economic neighborhoods with greater perceived value than newer neighborhoods because they do not have the increased costs associated with bonds or special assessments.

"Each seller in California is required to disclose the existence of a Mello-Roos bond to the buyer."

In California, a common private bond assessment may be issued under the Mello-Roos Community Facilities Act. It is called a Mello-Roos Bond and is used to support the sale of tax-exempt bonds for capital improvements within a local geographical area. This levy can be quite expensive and may continue for 25 years or more after the bond is issued.

Each seller in California is required to disclose the existence of a Mello-Roos bond to the buyer. Your clients should consider these costs very carefully before buying a property. Future buyers will definitely be considering them when it is time for your investor to sell.

Mature Landscaping

Wikimedia Commons / David Studarus
Figure 3.3 Mature Landscaping

In existing older neighborhoods, the landscaping may have remained in the same condition for a long period of time. Bushes and hedges can be used to define property lines and full-grown trees can provide good protection from sun and wind. Both paint and landscaping can have a profound effect on the value of a single-family home.

Newer homes generally have smaller trees and shrubs. It usually takes a significant amount of time for good landscaping to fill-in around a home. In areas where there are large existing trees (e.g., majestic oaks, Ponderosa Pines, etc.) home builders may decide (or be forced by the building department) to build around the trees. This gives the neighborhood immediate character.

Fruit Trees in the Backyard Story
One prospective seller couldn't understand why his house was not worth more than his neighbor's house. Even though both homes had the same square footage, he thought his home was worth more because of the fruit trees growing in the backyard. He started rattling off the Latin names for the trees. The agent informed him that his trees were nice, however homes sell and appraise by square footage, not by the number of fruit trees growing in the backyard.

Many Retirees and Empty Nesters

In older more established neighborhoods, many of the homeowners have gone through the progression from newlyweds, parents, and then empty nesters. They may continue living in their home until retirement and sometimes into old age.

Due to sentimental reasons many retirees like to keep the home where their children grew up. They also like to have their children and their families come "home" to visit. This is especially true during the holidays.

3. Lower Socio-Economic Neighborhood/Newer Property

Homes located in Quadrant #3 are generally less expensive than newer properties located in higher socio-economic areas. Since these homes are fairly new in age, they tend to require less maintenance than older homes.

Slow Price Appreciation Rate

During an upward-trending sellers' market these homes usually increase in value at a slower rate than homes located in higher socio-economic areas. Accordingly, they tend to experience a decrease in value at a faster rate during a downward-trending buyers' market. In other words, their value goes up slower and down faster than homes located in higher socio-economic areas.

Quadrant #3 properties may change from owner-occupied to non owner-occupied use over time. Since Quadrant #3 properties are usually less expensive than those located in higher socio-economic areas, real estate investors may be able to cover their loan payments and possibly derive some positive cash flow from the home when it is rented to a tenant. However, since the home will probably not appreciate as fast as homes located in higher socio-economic areas, most of the return will probably come from cash flows rather than price appreciation.

As the neighborhood changes from predominately owner-occupants to renters, there is usually a corresponding decline in the upkeep of the homes. The main reason is because owner-occupants usually will take care of their properties better than tenants. Tenants generally do not have the pride of ownership that owner-occupants have and may be destructive to the property. A good indication that an area has changed from owner-occupants to renters is a large number of cars parked around the property, especially during the evening hours, and oil spots on the driveways. A large number of cars parked outside a property indicates several tenants occupying the home, with each possibly renting a room. The oil spots indicate cars in disrepair and typically come from rental properties existing in the area.

The front yard landscaping may not be as well maintained as those located in higher socio-economic areas. This is usually due to a tenant's haphazard gardening practices that may be in stark contrast to an owner's pride of ownership grounds maintenance techniques.

However, some tree roots tend to spread outward from the trunk and may be cut off during the excavation process. Old majestic Oak trees may gradually die within a couple of years after their roots have been cut. Pine trees, on the other hand, usually have a long tap root running straight downward and are not as susceptible to excavation risks. If your client suspects that tree roots have been cut, it is a good idea to hire an arborist to help decide what course of action will help save the tree.

Your clients should be concerned with cash flow and price appreciation over the holding period. A poorly maintained property will reduce the amount of rents that can be charged during your client's holding period and reduce the property's sale price when it is sold near the top of the next upward-trending sellers' market.

Income vs. Social Class

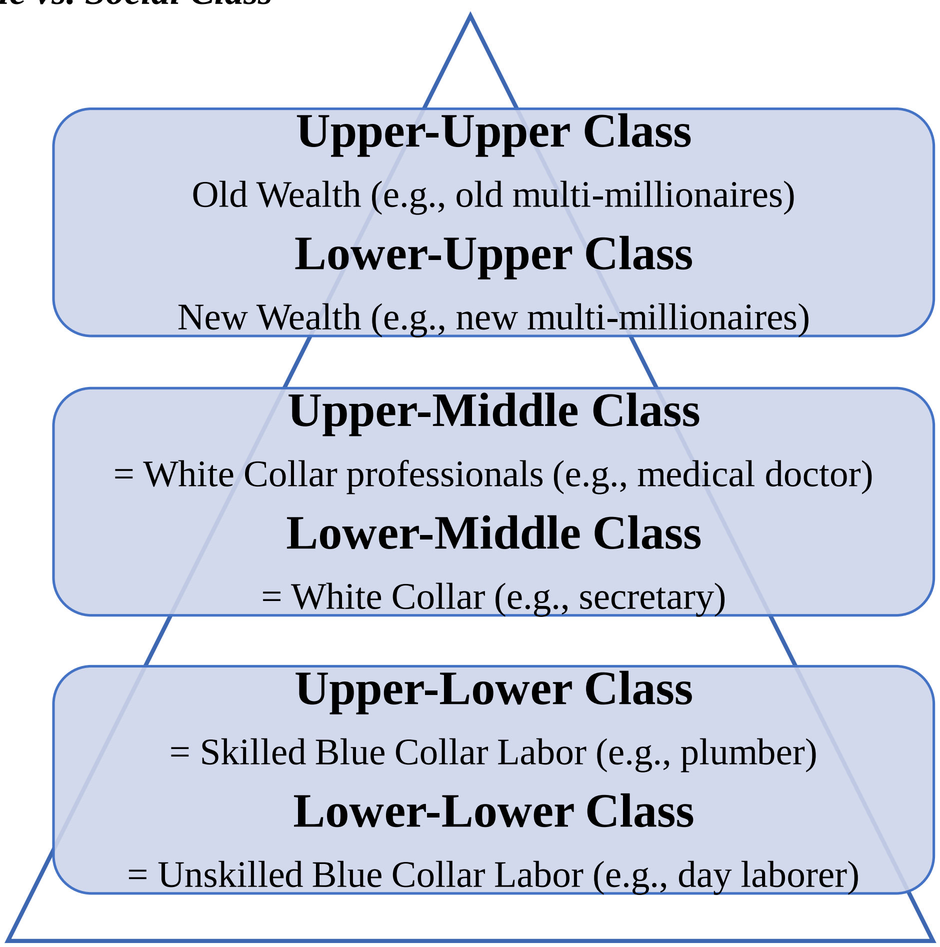


Figure 3.4 Social Class Chart

Some studies have shown that income and social class have very little to do with each other. How a person spends their money is a better indication of social class. For example, the upper-lower class is generally comprised of skilled blue-collar professionals. A plumber is a good example. The lower-middle class is generally comprised of white-collar workers. A secretary would be an example of this social class. The plumber may have an income that is three times the secretary's, however, they *each spend their money differently*. The plumber may buy a 4x4 pickup truck to drive to work. The secretary might purchase a mid-size family car such as a Honda Accord to do the same thing.

The neighborhood where someone lives is much more indicative of their social class than looking solely at their income. A secretary will make every attempt to live in a white collar neighborhood, while a plumber will be content living in a blue collar area where he does not have to worry about offending the neighbors when he changes his truck's oil in the driveway. The plumber might have an income that is significantly more than the secretary's, yet each person has their own lifestyle. More importantly, each social class tends to flock together with the schools being indicative of this situation as well.

4. Lower Socio-Economic Neighborhood/Older Property

An older Quadrant #4 property located in a lower socio-economic neighborhood will generally experience the slowest price appreciation rate during an upward-trending sellers' market and the fastest price depreciation rate during a downward trending buyers' market. In other words, Quadrant #4 property prices will usually go up at the slowest rate and down at the fastest rate—the worst of both worlds. Quadrant #4 properties usually need a lot of maintenance and will generally not increase in value as fast as properties located in the other quadrants. The question is "Why should a real estate investor buy properties located in Quadrant #4?" The answer is cash flow.

Cash Flow vs. Appreciation

One way your clients can achieve high cash flows may be to buy older homes located in lower socio-economic neighborhoods. In other words, buy older, less expensive single-family homes that may require more maintenance than newer properties. Tenants also tend to be more destructive, causing management intensity to be much greater than experienced with homes located in higher socio-economic neighborhoods.

When the economy turns toward a **recession**, lower socio-economic neighborhoods generally contain a large number of blue collar workers who many times are tied into the local construction trades. A downturn in the economy usually results in a corresponding slow-down in the construction industries and a resulting high unemployment rate for these types of tenants.

Your clients may be able to protect themselves by looking for subsidized tenants during a recessionary period. Examples include the HUD voucher program, social security income, retirement income, and other subsidized income coming from a fairly stable source. Properties located in the lower socio-economic neighborhoods tend to be considered riskier than those located in higher socio-economic neighborhoods, and for this reason, real estate investors generally require a higher **capitalization rate** because of the greater perceived risk of the investment. Capitalization rate is defined as the rate of return (return on investment) investors will achieve if they *pay all cash to purchase a property*.

> "As a landlord, your clients may be able to protect themselves by looking for subsidized tenants during a recessionary period."

Worst case scenario, if the economy moves toward either an **economic depression with deflation**, or the other extreme: **hyperinflation**, then real estate investors may want to consider single-family rental properties located in lower socio-economic areas. The question for tenants is *where* they are going to live and *how much* rent they are willing to pay. Their low rents combine with the old adage, "Everyone's gotta have a place to live" to help provide a more stable real estate investment scenario than experienced by investors in other quadrants during a turbulent economy.

As the real estate market moves into an upward-trending sellers' market, your clients will find their inexpensive houses located in lower socio-economic areas will not appreciate as fast as single-family homes located in higher socio-economic areas. Sometime during the upward-trending sellers' market, you may want to have your clients consider selling these cash flow properties and perform a 1031 exchange into better-located single-family homes that will experience higher price appreciation rates. If the higher socio-economic single-family home market is increasing in value or is expected to increase, then you may want to have your clients consider moving their equity into these types of homes and placing a loan on each property to take advantage of potential leverage.

Story of Simon

Simon owned a single-family home located in a lower socio-economic neighborhood. The property had 3 bedrooms and 1 bathroom and a detached two car garage that was not connected to the home.

The property was an REO property that a bank had in its portfolio of foreclosed

Story of Simon (continued)
properties and wanted to sell it for the highest possible price.

The property had sold five years earlier for $310,000 and the bank had made a 100% loan-to-value loan for the purchase. Five years later the bank had listed the property with a real estate agent for $82,950.

Simon placed an offer for $83,000 to purchase the home. The bank accepted the offer and Simon closed the deal thirty days later. He was elated. He had purchased a home for over $200,000 less than its price only a few years earlier.

Simon renovated the property with new paint inside and out, new carpet, new flooring in the kitchen, new appliances, repaired the roof, and cleaned up the backyard. His payments were $445/month principal and interest, $80/month property taxes, $45/month homeowner's insurance, totaling $570/month PITI. This same house five years earlier would have cost Simon $1,665/month principal and interest, $300/month property taxes, and $45/month homeowner's insurance, totaling $2,010/month.

Simon purchased this older property that was located in a lower socio-economic neighborhood because of the attractive price. The price had declined so dramatically since the market had peaked five years earlier, he could now afford to buy the home. Simon's gross income was $2,500 per month. After taxes, his net income was approximately $1,800/month. After paying his loan payment of $570/month plus water/sewer/garbage, electricity, natural gas, telephone, and cable TV he was actually able to afford the home and have some discretionary income left over for entertainment and fun.

Simon could also expect to see slow appreciation over a long period of time. The appreciation of his home may not be as fast as homes located in higher socio-economic neighborhoods; however, he bought the home for such a good price, he could really afford to wait out the market while paying his really low loan payments.

III. Overview

An Inexpensive Place to Live

As we fall into an economic recession, most people will look at food and shelter as their two primary concerns. Inexpensive homes located in lower socio-economic areas tend to rent well during these types of recessionary markets. As mentioned earlier, this is usually due to the large number of people who can afford to pay, for example, $500 to $1,000 per month versus $2,500 to 3,000 per month in rent.

There are generally many tenants available to rent homes located in lower socio-economic neighborhoods. Many former tenants who lived in higher socio-economic neighborhoods may find themselves living in lower socio-economic neighborhoods because economically that's all they can afford. In fact, during a tough economy there may be a general lowering of the standard of living for many people around the country. The **median net worth** for a family living in the U.S. dropped from just a little over $100,000 in 2006 to $66,000 in 2012. That's close to a 33% drop in net worth.

As the economy tanks, home values usually decrease to a point where home loans are greater than home values. People start losing their jobs and may eventually lose their homes to foreclosure; or be forced to short sell them and become renters. This drives up the demand for rental housing, which usually bodes well for landlords because rents usually increase and decrease as a function of the supply and demand of suitable housing in a local real estate market.

Location, Size, and Age

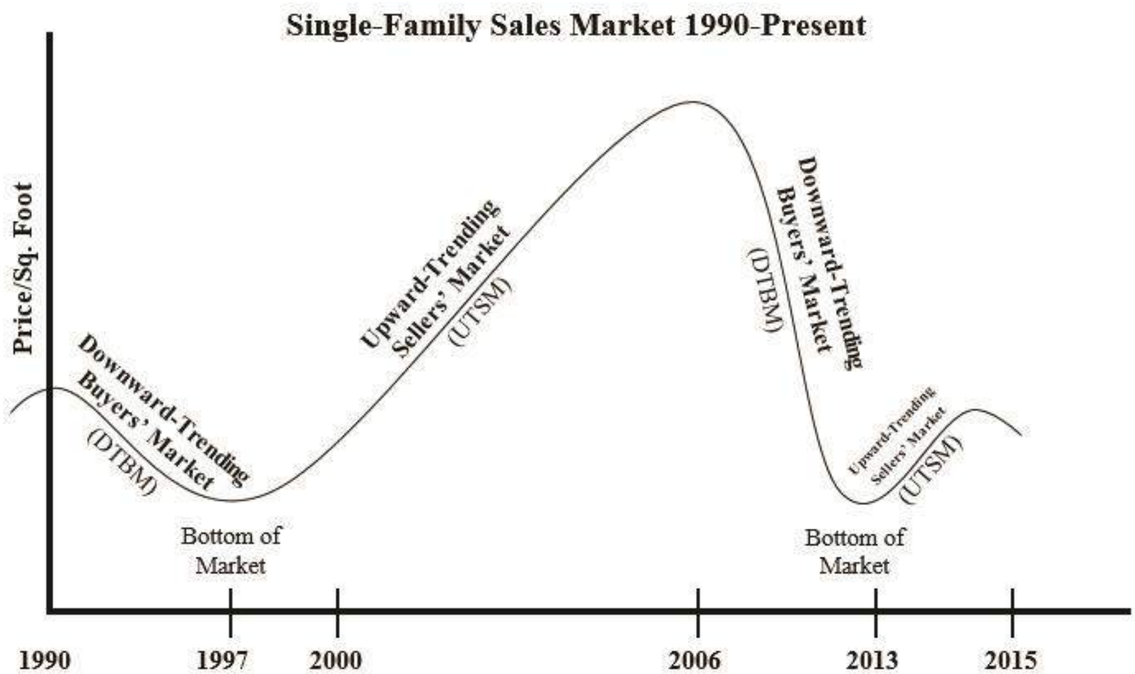
Your clients will continually be faced with decisions among location, size, and age of a single-family property. For example, your client may be able to purchase a 1,200 square foot home located in a high socio-economic area for $200,000. At the same time, your client can purchase a 2,000 square foot home located in a lower socio-economic area for the same price. Your clients must decide whether neighborhood location or size of the home is the most critical factor when deciding to purchase a property. The age of the home comes into play with maintenance and styling issues possibly devaluing the property. Older homes

Flickr / Prayitno

Figure 3.4 Small Ocean Front Home

generally have more maintenance issues, smaller rooms, and less closet space than newer homes. Your client must decide which factor is most important to tenants and future homebuyers.

Real estate investors consider location and market timing to be the two most critical element when investing in real estate. During an upward-trending sellers' market, homes located in higher socio-economic neighborhoods tend to appreciate in value at a higher rate than homes located in lower socio-economic neighborhoods. Accordingly, during a downward-trending buyers' market homes located in higher socio-economic neighborhoods tend to depreciate in value at a lower rate than those located in lower socio-economic neighborhoods.



With this in mind, let's take a look at some existing single-family homes.

4

PHYSICAL CHARACTERISTICS OF EXISTING SINGLE-FAMILY HOMES

"The fellow who owns his own home is always just coming out of a hardware store." -Kin Hubbard

A single-family home will usually have a fairly long **useful life.** The Internal Revenue Service (IRS) allows real estate investors to depreciate improved properties over a 27.5 year useful life. However, many homes remain structurally sound well past this period of time. With replacement of the roof; heating, ventilating, and air conditioning system (HVAC); water heater; and appliances, the home could last quite a while before it needs to be renovated.

> "The greatest loss of value may come from styling issues, or what appraisers call functional obsolescence."

Over time, the greatest loss of value may come from styling issues, or what appraisers call **functional obsolescence** or becoming "dated," rather than items wearing out, or what is called **physical deterioration**. It is easier to repair or replace worn out fixtures, carpet, and other physical items than it is to move walls and change the functionality or "look" of a single-family home.

Electrical Systems

The electrical system in a single-family home may need to be updated if the electrical panel contains fuses instead of circuit breakers. Many older homes located in California have had their fuses replaced with modern circuit breakers.

Occasionally, a home built in the 1940's or earlier may still have fuses, but these property types are rare in today's real estate market.

Plumbing Systems

Plumbing systems may need to be updated, especially if the sewer lateral contains asbestos. Tree roots can easily permeate old sewer liens and they generally will need to be replaced when the sewer continues to clog up. Older homes may still have older sewer lines. In fact, a real estate investor may pay thousands of dollars to replace an old sewer lateral running from the property to the main sewer line. The longevity of real estate investment properties really depends upon the quality of the materials used in construction and how well a prescribed maintenance schedule has been adhere to by both the tenant and the landlord.

Maintenance

Older homes generally require more maintenance than newer homes because of their age and **normal wear and tear**. Some real estate investors try to buy newer single-family rental properties because they are less expensive to operate during the holding period. However, depending upon market timing this may or may not be a good idea. Older homes may be the only properties that provide an adequate cash flow and achieve a desired overall rate of return.

Newly constructed homes may have problems during the first couple of years after construction. The new systems may need adjustment and/or replacement, and all the "bugs" need to be worked out. Once a newly constructed home has been "dialed in," there should not be too many maintenance issues looming in the near future.

Physical Deterioration

Physical deterioration may occur if a single-family investment property has not been properly maintained. Many older homes need a considerable amount of renovation to bring them up to a livable condition. This can be very costly and may reduce the value of the home accordingly. Older poorly-maintained homes can also be difficult to finance because lenders generally do not like to make loans on questionably maintained properties. If they are forced to foreclose in the future, they may not get all their money back.

"Physical deterioration may occur if a single-family investment property has not been properly maintained."

Roofs

Flickr / Gleeblie
Figure 4.1 Synthetic Tile Roof

When buying either a new or existing single-family rental property, roofs can be an important issue when considering the best home to purchase. Some newer homes, that are located outside heavy snow areas, may have **synthetic tile roofs**. These roofs generally are expected to last 40 years or more before they need to be replaced.

Other homes may have **composition shingle** (comp) or **dimensional composition** (dimensional comp) roofs that are generally expected to last 20 years or less. The **expected life** of a roof depends upon the harshness of the surrounding environment. The harsher the climate, generally the shorter the life span of the roof.

Flickr / Tim Green
Figure 4.2 Composition Shingle Roof

Extreme sun exposure and extreme snow loads seem to be the most destructive to roofs. A comp roof located in the Mojave Desert may have a much shorter useful life than one located along California's North Coast. Along the same line, a home located near Lake Tahoe may experience ice build-up during the winter season. This could cause damage to the composition shingles and reduce the useful life of the roof accordingly. A commercial grade heat strip may be used to rectify the situation. It melts the snow and prevents ice from accumulating on the roof. This is called "**Ice Bridging**". Installing metal sheets over the comp roof from the eaves to about four feet up the roof is another method designed to combat a difficult winter environment.

Professional Home Inspection and Roof Inspection

When purchasing an existing single-family rental property, a buyer should always get a home inspection provided by a professional home inspector. This usually costs $400 or more, and is generally money well spent. A projected useful life for the roof should be provided with the home inspection report.

> "Extreme sun exposure and extreme snow loads seem to be the most destructive to roofs."

If the home inspector has doubts regarding the roof's condition, he may refer the buyer to a professional roofing contractor for an opinion. Try to find a reputable roofing contractor who will provide an honest opinion of the roof's true condition. This may seem like a daunting task, because roofing contractors usually derive their revenue and profits from roof installations, which usually cost approx. $4,000 - $10,000+, not from paltry roof inspections—which cost approx. $75 - $100. An honest roofing contractor will tell the truth whether a roof actually needs to be replaced or not, as well as provide a projected useful life. A dishonest roofing contractor will say the roof needs to be replaced, whether it actually does or not.

Aging Wood Shake Roof Problem

Another problem is aging wood shake roofs. As these roofs become older, real estate investors are usually forced to choose among the following three alternatives: (1) replace the wood shake roof with another wood shake roof; (2) replace the wood shake roof with a synthetic tile roof, depending upon load factors; or (3) replace the wood shake roof with a dimensional comp roof.

The first option, replacing the aging wood shake roof with another wood shake roof, is more expensive than option #3 (comp), and has some fire issues. Wood shake roofs are generally more susceptible to fire than synthetic tile and comp roofs. The second option, synthetic tile, is difficult to install in place of a wood shake roof because of its weight—called "load factor". The third option, a comp roof, seems to be the most common replacement alternative—but may cause a loss of value to the home and the surrounding neighborhood as well.


Flickr / Gerry Kichok
Figure 4.3 Aging Wood Shake Roof

A real estate investor was inspecting the wood shake roof on a single-family rental property and found an expended bottle rocket that had obviously landed on the roof during the last Fourth of July celebration. This is a big concern to real estate investors because the property could have burned to the ground and the tenants were at risk from the use of these illegal fireworks. It's always a good idea to check smoke detectors within residential properties to make sure they are working properly, especially if the property has a wood shake roof.

Many newer homes have synthetic tile roofs that have a longer useful life than wood shake roofs and generally do not have as high a fire danger. Synthetic tile roofs generally have a useful life of approximately 40 years versus a composition roof that will last approximately 20 years or less.

Replacing an existing wood shake roof with a new dimensional comp roof is usually cheaper than replacing it with another wood shake roof, but it does have its challenges. The main challenge is that the narrow 1”x 2” wooden slats under the wood shake roof will usually not support a dimensional comp roof. Plywood or **Oriented Strand Board** (OSB) sheets may need to be installed over the wooden slats before the underlayment and dimensional comp shingles can be installed.

In the past, some roofing contractors placed a new comp roof directly over the existing old wood shake roof. This was a less expensive method, however, it had the possibility of increasing the roof load factors past safe levels, especially in areas with heavy snow loads. It did not look very good either. Moss tended to grow where the two roofs came together at the eaves.

Today, placing one roof over another is generally not as common as it was in the past. Many roofing contractors usually tear off the existing wood shake roof and install plywood or OSB under a new dimensional comp roof.

A new dimensional comp roof may be a fast, cheap, and easy alternative to an existing worn out wood shake roof; however, it may cause a reduction in the value of the home. A dimensional comp roof generally has a lower perceived **aesthetic value** or curb appeal than wood or synthetic tile roofs. It also may reduce the **intrinsic value**, or overall perceived value of a home as well.

> “A new dimensional comp roof may be a fast, cheap, and easy alternative to your existing worn out wood shake roof; however, it may cause a reduction in the value of the home.”

Many homes located within lower socio-economic neighborhoods have dimensional comp roofs. Homes located within higher socio-economic neighborhoods may have wood shake or synthetic tile roofs. Installing a new comp roof in place of a wood shake roof for a house located within a higher socio-economic neighborhood may cause a “stigma” and change a neighborhood’s desirability—thus reducing corresponding home values as homeowners replace their wood shake roofs with dimensional comp roofs.

Savvy real estate investors tend to avoid buying single-family rental properties located within changing neighborhoods. When the real estate investor decides to sell the property to an owner-occupied homebuyer at the top of the next upward-trending sellers' market, the buyer may not be able to obtain a loan for the entire purchase price because the property may not appraise for the sale price. The real estate investor will be required to either reduce the sale price or ask the buyer to increase their down payment to make the deal. Since most homebuyers are using all of their savings to buy a home, they generally do not have extra money available to increase the amount of the down payment. Therefore, the price will usually be reduced in response to the appraiser's low appraisal that may be partly caused by an inferior quality roof existing on the subject property.

A dimensional comp roof generally indicates medium to lower-end construction in most California real estate markets. However, in areas with high snow loads, a dimensional comp roof (or a much more expensive metal roof) may be the *only* roof types that can handle the snow load.

As mentioned earlier, dimensional comp roofs are susceptible to ice bridging where the ice builds up on the roof and may leak into the house, especially during the spring thaw. Quality **metal roofs** are generally more expensive than dimensional comp roofs, however, they do not usually experience ice bridging problems and generally have a longer useful life.

The Story of Craig
Craig owned a log home with a metal roof. He found out how dangerous these roofs can be when temperatures fluctuate between freezing and thawing in the Sierra Nevada Mountains. When the snow on the roof melted and then refroze, it turned into a large sheet of ice with an edge that was as sharp as a knife. Craig discovered this fact when he emerged from his home one spring morning to find his favorite Ponderosa Pine tree cut in two by a huge chunk of ice that had slid off the roof!

Heating, Ventilating, and Air Conditioning Systems

Heating, Ventilating, and Air Conditioning (**HVAC**) systems usually have a useful life of between seven and twenty years. It really depends upon the quality of the unit, maintenance schedules, weather conditions, and amount of usage.

One potential problem that may arise in California is replacing the HVAC system in a single-family rental property. The real estate investor may find that existing HVAC **ducts** leak too much air to pass inspection for a new **building permit**. This can be a serious problem because the HVAC installer may not be able to obtain a permit for the new unit. This will be a material fact and must be disclosed to any potential buyers in the future.

The "We Need $1,000 to Fix Your Ducts" Routine

HVAC salespeople may not mention the poor ducts located inside the home during the bidding process and then mysteriously "discover" the duct leaks after the new unit has already been installed. It may cost another $1,000 or more to have the ducts replaced or the HVAC system may not qualify for a new building permit. The real estate investor will be more likely to pay the extra $1,000 to replace the ducts because they are stuck in limbo between the old unit and the new un-permitted unit. If the real estate investor had known about these problems ahead of time, he or she may not have replaced the old unit at all. Many real estate investors in California are now keeping their HVAC units going as long as possible because of potential duct leakage problems.

Flickr / Brownpau
Figure 4.4 HVAC System

The "Net Price" Routine

Another ploy used by HVAC salespeople is quoting a NET price after all rebates from local utilities and other entities have been factored into the equation. The property owner will be required to pay the entire amount of the HVAC unit and then receive a rebate in the future. Some contractors try to increase the size and/or price of the HVAC unit and then back it out with rebates. Unfortunately, most of these rebates are designed for <u>owner-occupied</u> homeowners, so real estate investors may <u>not</u> qualify.

A real estate investor received one bid that was $9,000 for a 900 square foot home! After all the rebates and incentives (the rental home did <u>not</u> qualify for), the net cost was $7,200. Another bid was received from a different HVAC contractor for $4,200, with no rebates. There may be a big difference in prices between HVAC contractors, so it is generally a good idea to use a trusted contractor who has repeat business riding on the job or get multiple bids from several different contractors whenever an HVAC unit is replaced.

Electrical Systems

Another area of concern is **electrical systems**. As mentioned earlier, really old homes may occasionally continue to use **fuses** instead of modern day **circuit**

breakers. Because of serious fire safety concerns, fuses should be changed to circuit breakers as soon as possible.

Ground Fault Circuit Interrupter

Ground Fault Circuit Interrupter (GFCI) duplex receptacle outlets are required wherever water and electricity have the potential of coming into contact with each other. GFCI outlets are required in the kitchen, bathrooms, and the exterior of single-family homes. They are designed to protect owners and tenants from electrical shock and electrocution wherever water and electricity have the possibility of interacting together. Older homes may not have GFCI circuits installed in them and may be a serious safety risk to tenants and a liability concern for landlords.

> "Ground Fault Circuit Interrupters are designed to protect owners and tenants from electrical shock and electrocution wherever water and electricity have the possibility of coming into contact."

Some areas in California may require **Arc-Fault Interrupter** duplex receptacle outlets that add an added degree of safety by detecting unintended electrical arcs and shutting off the power before the arc starts a fire.

Ungrounded Electrical Outlets

Another safety concern is **ungrounded electrical outlets** with only two plugs instead of three. Older homes with only two plug receptacles should be changed to three plug outlets. Real estate investors may want to consider updating their investment properties to more modern 12-3 or 14-3 gauge electrical wiring at the same time. This will accommodate the greater electricity requirements of modern-day electronic equipment.

Ceiling Fans

Ceiling fans are usually a good idea because they circulate air throughout the home and can be configured to move air upward or downward depending upon the angle of the fan blades. This may be an energy-saving amenity because it can significantly reduce heating and cooling costs in the home. Warm air rises and cool air falls. So, fan blades can be configured to move air upward or downward as needed in the home.

Combination Ceiling Light and Fan

One problem that may occur during a home renovation project is installing a combination ceiling light and fan in place of an existing old ceiling light fixture.

An older home may be wired with only 14-2 wiring that has two wires instead of 12-3 or 14-3 wire that has three wires and is used in most modern day homes. A real estate investor may be forced to rewire the home before he or she can install a ceiling fan with lights. Light switches will need to be reconfigured for a ceiling fan/light combo and dimmer switch.

Electrical Contractor vs. Do-It-Yourself Homeowner

An electrical contractor may be the best choice to rewire a single-family rental property. The possibility of fire is too great for the "do-it-yourselfer" with limited electrical experience, to attempt to rewire the home. Even worse, the real estate investor's apprentice electrician brother-in-law, who electrocuted himself while installing a light bulb, now attempts to rewire the home using his "extensive" electrical experience. Both "do-it-yourself" scenarios could lead to a fire in the property and added risk to the tenant. A more costly electrical contractor is generally a better choice.

More Plumbing Issues

Asbestos Sewer Laterals

As mentioned earlier, many homes built before or during the 1940's may have asbestos sewer laterals leading from the house to the main sewer line that is usually buried in the middle of the street in front of the property or just outside the back property line. Asbestos sewer laterals can become a problem if the old sewer pipe is dug up, cut, and exposed to the outside air. Asbestos particles can become airborne and anyone who breathes the airborne asbestos particles into their lungs might be inhaling this potentially carcinogenic/cancer-causing substance.

Acrylonitrile Butadiene Styrene (ABS) Pipe

Homes built around the year 1985 may have received some brands of **ABS plastic plumbing pipe** that were defective. Some ABS pipe manufacturers produced defective pipe during this time period. The glue that was used to connect the pipe to the joint fittings caused the pipe to crack and leak over time. This was the basis of a class action lawsuit and continues to be a disclosure issue for homes built during the mid-1980s.

A Problem Now Will Be a Problem Later

Property defects or existing problems in a single-family home will continue to be a problem when the home is sold many years down the road. Your clients should consider them now, because future buyers will certainly be considering them. A problem now will be a problem later.

The Story of the Load-Bearing Wall Being Held Up by Wires

A husband and wife listed their home for sale. They would not give their real estate agent a key to the door locks nor allow a lockbox to be placed on the property. This was a little strange because the home was vacant and not a high-end property. Strange or not, the agent moved forward marketing the property for sale. After there was an accepted offer, the buyer arranged for a home inspector to inspect the property. The home inspector found a previously removed master suite wall was in fact a **load-bearing wall** and was being held up by wires!

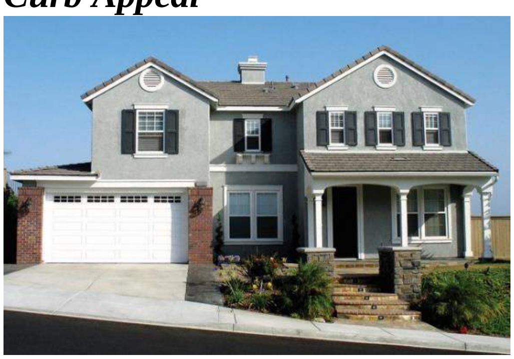
The agent immediately smelled a rat. The sellers had been very careful describing the number of rooms to be represented in the MLS listing data for the property. At the time this occurred, the agent thought they were acting a bit strange and maybe a little weird, but not enough to adversely affect the sale.

It was now apparent the sellers knew about the load-bearing wall being held up by wires and had probably purchased the home for a reduced price because of it. They were now trying to sell the home without making the estimated $2,500 in required repairs to bring the property up to the present building code.

When the agent was leaving the property during the inspection, the sellers started following her car—thinking she was going to the building department to turn them in. At this point the sellers went from weird to creepy. Their agent got out of her car and informed them that she was no longer their agent. She did not want to be around when the litigation hit. What a mess.

There are several additional factors that affect both property desirability during the holding period and overall market value when the property is sold.

Curb Appeal


Flickr / Allan Ferguson
Figure 4.5 Home with Curb Appeal

A buyer's first impression of a single-family home is called "**curb appeal**" and has a tremendous effect on value. A potential buyer may not bother to look inside the home if it is old and dreary with weeds growing in the front yard. The real estate investor must make sure that, even if the home is in poor condition today, it can be transformed into the well-painted and well-landscaped property that will exude a good first impression and command respectable rents and top-of-the-market prices when it is sold in the future

Size of the Backyard

Many families want a backyard that is large enough for their children to enjoy. Retired **empty nesters** may want small backyards with low maintenance desert-style landscaping. The type of backyard really depends upon the investor's target market for renting the home and selling it in the future.

Tenants and Owner-Occupied Homebuyers

Once a tenant or potential homebuyer has decided to see the inside of a single-family home, it must be similar in condition to the first curb impression. Otherwise, the tenant or buyer will be disappointed and the emotional letdown will most likely prevent the rental or sale of the property.

If a real estate investor is selling the property at the top of an upward-trending sellers' market, demand for homes may be so extreme that curb appeal really does not matter because buyers are just glad to find a home to purchase.

Emotional Purchase Decision

Buying a home is as much an emotional purchase decision as a rational one. It is like buying a new car. A home signifies who a person is—both where they live and the condition of the home. These are good things to remember when selling a rental property near the top of an upward-trending sellers' market or buying at the bottom of a downward-trending buyers' market.

When buying, a real estate investor needs to decide whether a single-family home can be transformed into a property that will appeal to a highly desirable market segment in the future. Will these market segments have the desire and ability to pay top-dollar for a home in a particular condition and neighborhood? If not, the real estate investor should continue looking for a property that will better fit specific target markets and overall investment parameters.

> "Buying a home is as much an emotional purchase decision as a rational one."

Age

A single-family home's age is many times a determining factor regarding components such as the roof, electrical wiring, HVAC, and plumbing replacement. As a comp roof ages, the sun tends to bleach the color out of it. A real estate investor may be able to look at the fading color in a comp roof and project (ball park idea) the amount of remaining useful life existing in the roof.

"A single-family home's age is many times a determining factor regarding components such as the roof, electrical wiring, HVAC, and plumbing replacement."

As mentioned earlier, a professional home inspection usually includes a roof inspection, and is always a good idea prior to buying any investment property. Your clients can get a separate **roof inspection** performed by a professional roofing contractor, especially if the home inspector has some doubts about the roof.

Older Plumbing

Older homes may <u>not</u> have garbage disposals nor built-in dishwashers. Modernizing the plumbing of an older home can be a costly endeavor, but possibly worth it when the property is sold at the end of the holding period. Original homes built before or during the 1950's may continue to have wall-mounted faucets that can be expensive to update.

In neighborhoods where all of the older homes may <u>not</u> have garbage disposals or built-in dishwashers, the real estate investor may be able to rent the property for a decent rental amount *without* making any of these improvements. If the real estate investor sells the property near the top of the next upward-trending sellers' market, he or she may be able to sell for a price very near to the price of surrounding already updated properties. Buyers may overlook the functional obsolescence issues of a missing garbage disposal and built-in dishwasher and buy the property at the higher price anyway.

It is easier to make changes to a single-family home that is built on a **raised foundation** than one that is located on a **concrete foundation**. A plumber may be able to crawl into the crawl space underneath the home (raised foundation) and make plumbing changes without significant excavation costs. A bathroom can be added more easily than with a concrete slab foundation.

Flickr / Jesus Rodriguez
Figure 4.6 Raised Foundation

However, older homes with raised foundations can be a problem because floor supports tend to deteriorate over time and a defective foundation may be a very expensive item to repair in the future.

A concrete slab foundation may require jack hammering and a lot of extra work to replace plumbing, renovate the kitchen, or add a bathroom. However, concrete slab foundations tend to remain stable over the years and may be less repair costs in the long-run.

Additional issues regarding the inside of a single-family rental property include layout, kitchen, bedrooms & bathrooms, painting, flooring, energy efficiency, and the overall atmosphere of the property. Accordingly, even a home's walls and floors can have an impact on potential rents and future value of a property.

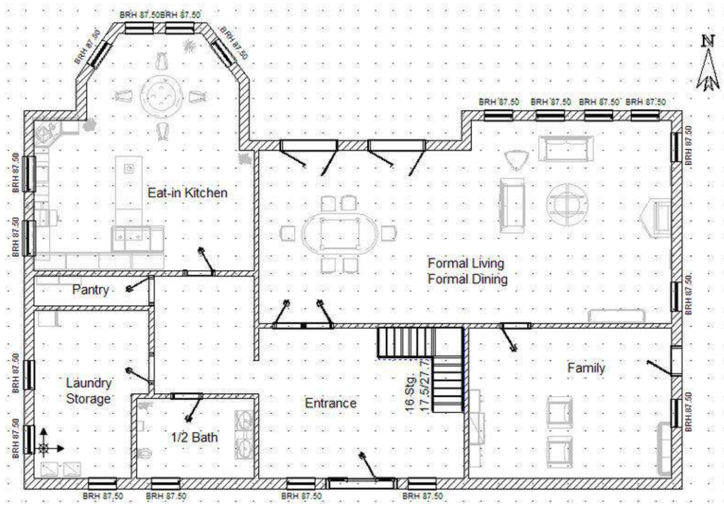
Layout and Floor Plan

One of the most important aspects real estate investors should consider in a floor plan is **traffic flow.** Generally the better the traffic flow, the more a future homebuyer will pay to acquire the property. "Choppy" rooms and "closed off" kitchen and family rooms tend to be less in demand than "open" floorplans that allow family members to converse while preparing a meal.

A single-family home should have the correct number, size, and room types in light of total square footage of the home. Garage space is generally <u>not</u> included in house square footage estimates in California. However, the size and number of spaces in the garage are usually important considerations for tenants and buyers and will affect the overall desirability and value of a property.

Traffic Flow

Real estate investors should start their analysis by examining the property's **floor plan** to determine how well it flows between rooms. Does the master bedroom open directly into the living area? There should be a hallway between the two spaces. Is there an entry foyer, or does the front door open directly into the front yard? The front door should be set back from the front of the home, otherwise the property will look like a mobile or manufactured home. Admittedly, there is nothing wrong with either type of investment; however, a real estate investor does not want a home that looks like a mobile or manufactured home surrounded by single-family homes. This can devalue the property because homeowners usually want a property that looks like the homes surrounding it.



Wikimedia Commons / Boereck
Figure 4.7 Floor Plan

Real estate investors should identify whether hallways are too wide or too long because there may be a significant amount of wasted space. If the hallways are too narrow, the house could feel like a maze.

Real estate investors should look at a home's potential susceptibility to functional obsolescence. In other words, will the floor plan become outdated in the near future? For example, tenants and homeowners may want an open kitchen where they can interact with people located in the adjoining family room, yet the property has a "choppy" floor plan where the kitchen is entirely separated from the living area. A loss of value can be caused by functional obsolescence in the property.

Number, Type, & Size of Rooms in Relation to Square Footage of Living Space

1. 1,200 to 1,400 Square Foot Single-Family Home
   Smaller single-family homes that have floorplans between 1,200 and 1,400 square feet are usually single-story construction with three bedrooms, two bathrooms, and a standard-size 400 square foot two-car garage. The master bedroom may be much smaller in size than those seen in larger single-family homes. Accordingly, the home is not large enough to offer a formal living room or formal dining room; instead, it may have a great room concept where the family room and kitchen are combined into one living space. The overall size of the lot may be around 5,000 square feet and two story homes built on such small lots are usually "patio homes." They may also have a zero lot line where the next door neighbor's home is actually a part of the property's fence line.

2. 1,800 Square Foot Single-Family Home
   Single-family homes in the 1,800 square foot size range may be large enough to accommodate a separate living room and family room. Two story single-family homes start to become more prevalent in this square footage range. Real estate investors may be able to find a four bedroom home within this square footage range, however, they will probably have to give up a formal living room to get it.

3. 2,500 Square Foot Single-Family Home
   As your clients reach the 2,500 square foot range, you may be able to find them a single-family home that contains close to everything a tenant or owner-occupied buyer desires in a home. It may include a formal living room, formal dining room, family room, nook area, laundry room, and storage areas throughout the home. A fourth bedroom is usually attainable in this square footage range, and 600 square foot three car garages are common.

4. 3,500 Square Foot Single-Family Home
   As real estate investors move into the 3,500+ square footage range, they find single-family homes with five or more bedrooms, three or more bathrooms, a bonus room, and larger rooms in general. The master bedroom could be huge, with a large walk-in closet and master bathroom with separate tub and shower. Double sinks located in the master bathroom tend to be very common. Three car garages are a must and four or more car garages are common.

Your clients should be aware that builders who build homes near the top of an upward-trending sellers' market may try to pass off large-size homes with <u>only two car garages</u>. This is definitely a styling (functional obsolescence) issue and will probably reduce the future value of the home. At the end of the investor's holding period, it may sell for significantly less money than homes with three or more car garages.

Pantries
Pantries located in the kitchen are fairly common for all square footage ranges in today's real estate markets. Older homes, however, may not have pantries and storage may be a big concern for all single-family home sizes.

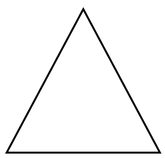
Utility Bills
Electrical bills during the summer and gas bills during the winter are usually considerably higher for larger single-family homes than smaller ones. This is especially true for newer two-story homes that have an open entry, as well as older vaulted-ceiling type properties that were built in the 1980s.

Target Markets
The size and style of a single-family home generally indicates the type of person who is going to rent or buy it. Homes with a large number of bedrooms tend to attract families with children. Smaller single-story homes, with two or three bedrooms, may be popular with empty nesters. Each market segment generally requires a different type of single-family home to fit their needs.

Kitchen

Communication between the family room and kitchen is important for most tenants and homeowners. Many newer homes use a large island to link the family room and/or nook area with the kitchen. The sink or cook top may be located on the island. This allows the person who is working in the kitchen to communicate with other family members.

The Triangle



Each kitchen usually has a triangle that is formed among the sink, refrigerator, and range. Each item should be close enough to the other to be convenient, yet provide enough room to move about. The exact dimensions are not as important as how they flow in actual practice.

Countertops and Stainless Steel Appliances

Granite countertops with stainless steel appliances seem to be the most marketable and acceptable amenities found in today's modern kitchens. Granite or stone countertops can provide a high-end look for a home, without as much cost as might be imaged.

Storage Space

Cupboard space and one or more pantries are important in a kitchen because storage space is always critical to the functionality of a kitchen. As mentioned earlier, older single-family homes typically have less storage space in the kitchen than newer homes.

Bedrooms and Bathrooms

In an attempt to overcome the possibility of a single-family home becoming out-of-style or dated, three and four bedroom homes with two or three bathrooms have been popular during recent years. An additional fourth bedroom is generally a big plus. It may result in higher rents, and possibly a higher sale price because of its greater desirability for large families.

Many one bathroom single-family homes have become functionally obsolete, making the second bathroom a key feature. However, at the top of an upward-trending sellers' market, older one bathroom single-family homes located in lower socio-economic neighborhoods may sell very close to the price of two bathroom properties located in the same geographical area. This is because of the extreme competition for single-family homes that occurs as the market nears the top of an upward-trending sellers' market. Buyers may be willing to overlook the absence of one of the bathrooms and appraisers may understand this fact and appraise the home close to the values of two bathroom homes. Again, it all comes down to market timing.

> "In an attempt to overcome the possibility of a single-family home becoming out-of-style or dated, three and four bedroom homes with two or three bathrooms have been popular during recent years."

> Selling at the top of an upward-trending sellers' market, performing a 1031 exchange or cashing out and placing the money in the bank, and buying single-family rental properties at the bottom of the next downward-trending buyers' market may help your investor clients to preserve their equity over the long-term.

Painting the Inside of a Single-Family Rental Property

New real estate investors may be running on a very tight budget and may well need to use some "**sweat equity**" to complete necessary renovations. It may be easier to roll the inside walls with a roller than try to spray it with a paint sprayer. Professionals can tape and spray a home very quickly. On the other hand, an amateur real estate investor will take much longer to tape the windows and get the place ready to spray. For this reason, rolling may be a faster, cheaper, and easier alternative to spraying the inside of a home. Investors can buy a roller, pan, paint, and they're in business. The thicker rollers are a little more expensive; however, they are easier to use, hold more paint, and can be used on both rough and smooth surfaces.

Rolling the inside walls will save an investor the costs of renting or buying a professional paint sprayer, learning how to use it, and spending the time necessary to thoroughly clean it after each use. Otherwise, the sprayer may not function correctly in the future and will end up a wasted equipment investment.

Since it is somewhat sloppy to paint with a roller, investors may want to paint the inside walls <u>before</u> they replace the flooring, especially carpet. They may need to place plastic sheets or tarps down on the floor to protect it if it is not going to be replaced. Always wear a good paint respirator when rolling or spraying the inside or outside of a home.

Painting the Outside of a Single-Family Rental Property

Painting the outside of a single-family home can be easier with a rented or purchased paint sprayer than with a roller. Taping the outside windows is usually a lot easier than taping the inside windows and the actual spraying doesn't take a rocket scientist. Read the directions on the sprayer, make sure the paint doesn't run, and have at it. It may be easier to paint the trim with either a roller or paint brush, than try to tape and spray it.

Of course, as new real estate investors become more affluent and acquire more and more rental properties, they probably will not have the time or inclination to do the renovation work themselves, so a professional painter may be hired to paint the inside and outside of the rental properties.

Flooring

Floor coverings may include **carpet**, **linoleum**, **tile**, **engineered laminate**, and **engineered wood**. The question your real estate investor client should ask is, "Do the floors *really* need to be replaced? Tenants in lower socio-economic neighborhoods tend to beat up single-family rental properties over time and usually do not have a problem tracking oil and grease onto the carpet that your client just paid $2,000 to purchase and install. For this reason, savvy long-term real estate investors may install tile in the property. It will be initially more expensive, however it may save money in the long run. **Diamond cut tile** is too expensive and is not required in single-family rental properties located in lower socio-economic neighborhoods. **Square cut tile** is less expensive to install and tends to work better in these areas.

Carpet

If the previous occupants were smokers, an extremely thorough carpet cleaning and deodorizing program should be considered prior to moving a new tenant into the property. However, new carpets will generally obtain a better return if they are installed *just prior* to <u>sale</u>. If your client can rent the property without having to replace the existing carpet, this will save a considerable amount of money during the holding period.

Linoleum Floors

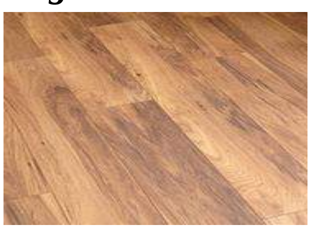
Linoleum flooring generally comes in sheets or tiles. Lower grade linoleum is fairly inexpensive and generally does not last very long when compared to other flooring alternatives. Higher grade linoleum is available at higher prices, however, an engineered wood or laminate floor may be a better selection for the same amount of money. Engineered wood and laminate flooring is usually installed after the old linoleum has been removed.

Tile Floors

Sometimes real estate investors install tile in single-family rental properties located in warmer climates. Tile is usually fairly durable and can be easily re-grouted prior to sale. In cooler climates, tile tends to be colder during the wintertime, so carpet or wood/laminate floors may be a better option in these climates.

In custom homes located in higher socio-economic neighborhoods, real estate investors sometimes use a diamond cut that requires more cutting and is also more expensive as a result of the extra labor needed to install this type of floor. However, it gives the home a real "high end" look and may increase its value when it is sold at the end of the real estate investor's holding period.

Engineered Laminate Floors



Flickr / Floorsmk
Figure 4.8 Engineered Laminate Floors

Engineered laminate and real wood floors have become less expensive and easier to install than they were in the past. Laminate flooring does not easily scratch, is fairly easy to install, and generally has a long useful life. For these reasons, engineered laminate floors can be a good choice when a tenant or owner has a dog that lives inside the home.

Engineered Wood Floors

Engineered wood floors generally have a higher-end look and "feel" than laminate floors; however, they tend to scratch more easily and are generally more expensive.

Flickr / Maurogunandl
Figure 4.9 Engineered Wood Floors

With both laminate and wood floors, the joints should be very tight without any lines existing between the individual floor boards. The joint lines should run toward the sun. So, whichever direction the sun is shining, the joints should run in that direction.

5

SINGLE-FAMILY HOME INSPECTIONS AND DISCLOSURES

"You've got to go out on a limb sometimes because that's where the fruit is." -Will Rogers

Energy Efficiency

Some local areas have adopted residential energy audit and conservation regulations. These regulations vary among cities, counties, and states. Eight possible areas of compliance are presented below.

Energy Efficiency:

1. Minimum R-19 attic insulation. This indicates 19 inches of insulation in the attic between the ceiling and roof. R-19 insulation is also used between the 2"x 6" exterior walls of a single-family home and is generally considered standard insulation for homes located in colder climates. Homes located in both cold and warm climates may use R-38 or higher insulation in the attic. This prevents warm air loss in cold areas and cool air loss in warm areas. A whole house fan can be used to blow warm air out of a house and attic.
2. Weather stripped no-flow type doors reduce airflow into and out of a home. Sometimes outside doors are difficult to open and close; however, the difficulties experienced are probably minor compared to the savings in energy costs.
3. Minimum R-6 insulated water heater that reduces natural gas, propane, and electricity costs. A tank-less hot water heater may be an alternative to a

traditional tank hot water heater and may initially cost more; however, the energy savings over time may ultimately save money. Of course, having unlimited hot water is nice too.

4. Minimum R-5 HVAC duct insulation. This can be a problem for older homes because ducts tend to wear out and replacing them can be expensive. As mentioned earlier, if your client replaces a heating, ventilating, and air conditioning (HVAC) unit for a home located in California, a duct test may be required to obtain a building permit for the new unit. If the ducts leak more air than is allowed by law, your client will be forced to pay thousands of dollars to repair or replace the ducts.
5. Minimum R-4 insulation for the first five feet of a hot water tank line. This saves energy by preventing heat loss.
6. No broken windows or holes in the outside walls. Bullet holes may be a problem in rougher neighborhoods. One real estate investor noticed two bullet holes in the front living room window of a single-family rental property. Both bullet holes were located at the bottom of the window where the curtains parted and was obviously intended for someone who was kneeling and peering out the window. Scary neighborhood.
7. Maximum three gallon per minute shower heads. Saves water and energy costs; however, it may take a while to take a shower.
8. Wall outlets and switch plates fitted with insulation gaskets. This prevents heated or cooled air from escaping into or out of the walls past the electrical outlets.

The Story of No Attic Insulation

A husband and wife decided to sell their 4,100 square foot single-family home located in Northern California. The buyer ordered a home inspection and discovered there was no insulation in the entire attic area above the second floor. The builder had missed it and so had the building inspector. Prior to close of escrow, the builder sent a subcontractor over to install insulation where it was supposed to have been in the first place. The sellers had been living in the property for over two years and could not understand why their heating and cooling bills were so high. Now they knew.

Some single-family homes may no longer “fit” into their surrounding neighborhood. This can be due to owner-builder room additions, **garage conversions**, and other amateur building activities. Problems can occur when owner-renovators do not obtain building permits when renovating a property.

Most one-to-four unit residential properties located in California require the seller to disclose a lack of building permits in the **Real Estate Transfer Disclosure Statement** (TDS). There are several exemptions to this requirement, so make sure to follow the current law when helping your clients buy and sell these smaller residential properties in California.

Over the years there have been two predominant methods for sellers to handle the disclosure of un-permitted room additions, garage conversions, and other amateur building activities:

1. ***TDS in More Regulated Areas***
   In more regulated areas of California, the seller may need to obtain a "**Pre-Sale Report**" from the local building department prior to selling a single-family home. This report is used to verify there are no **un-permitted additions** or code violations affecting the property being sold. A seller may want to think twice before buying a property with an un-permitted addition if it is located in one of the more-regulated areas.

2. ***TDS in Less Regulated Areas***
   In some less-regulated areas of California (aka, the "Wild West"), the norm is to have a home inspector inspect the home and verify the property addition is of high quality construction and is up to generally accepted building standards. After the seller discloses on the TDS form that the building addition is <u>not</u> built with necessary building permits, the buyer can go ahead and buy the property knowing that it is built correctly. Lenders in the past have not had a problem making loans on a property that lacks building permits, as long as it appraises for the sale price and there are no code violations or construction defects. When the property is sold in the future, the seller discloses the un-permitted addition to the new buyer through a new TDS, they get a new loan, and the cycle repeats itself.

In counties where a presale report is not required, a real estate investor may be in trouble if the county changes its policies regarding un-permitted additions and starts requiring a pre-sale report prior to sale. The investor may be stuck with a home that is worth significantly less than its value before the policy change.

Another risk is if lenders change their loan underwriting policies and are no longer willing to make a loan on a property that has an un-permitted addition. This might be in response to new county policies or a basic change in loan underwriting criteria. Either way, the investor may end up with an un-saleable property or one that has lost a significant amount of value. The property may have a higher rate of return as a long-term rental than it would if it were sold at the end of the holding period.

Swimming Pools

A swimming pool is usually a much sought-after amenity for single-family homes and condos located in hot dry areas. In temperate areas like San Francisco, the residents who live there might consider a swimming pool an “eccentric addition” that is really not necessary due to San Francisco’s mild climate. A pool might need to be heated to be used with any regularity, even in the summer. Mark Twain summed it up best when he said, “The coldest winter I ever spent was a summer in San Francisco.”

With the advent of cost-effective **solar heating systems** in single-family homes, many swimming pools are now installed with solar heating that extends the time when a pool can be used by tenants or owners. They may get an extra month on each end of the summer, and it usually makes the kids happy too.


Flickr / Chris Potter

LOCAL GOVERNMENT AND ROOF TOP SOLAR ENERGY SYSTEMS

California Assembly Bill 2188, Effective September 30, 2015

Required, on or before September 30, 2015, every city, county, or city and county to adopt an ordinance that <u>creates an expedited, streamlined permitting process for small residential rooftop solar energy systems.</u>

Purpose of the Bill

This bill requires every city and county to adopt an ordinance that creates an expedited permitting process for small, residential rooftop solar energy systems, alters the definition of what is a reasonable restriction on a solar energy system, and makes additional changes to the Solar Rights Act.

By improving the efficiency of solar permitting statewide, AB 2188 will help lower the cost of solar installations and further expand the accessibility of solar to more California homeowners who want to control their electricity bills and generate their own clean energy.

In addition, making solar more affordable will help the state reach its


Flickr / Chris Potter

LOCAL GOVERNMENT AND ROOF TOP SOLAR ENERGY SYSTEMS *(continued)*

California Assembly Bill 2188, Effective September 30, 2015

renewable energy and greenhouse gas reduction goals, and create more jobs while maintaining the safety of solar systems.

Many real estate investors do not like to purchase single-family homes that have pools because of maintenance and liability issues that exist during the time a tenant is occupying the property. Pool equipment can stop working, tenants can destroy the pool itself, and there may be some liability issues if a tenant or guest is hurt while swimming in a swimming pool located on the property.


Flickr / Chris Potter

OWNER HAS LIABILITY FOR HARM TO GUESTS OF TENANT

Johnson v. Prasad (2014)
California Court of Appeal, 3rd Appellate District, decided 2/25/14

Issue: Whether a landlord who rents out a single family residence with a pool has a duty of care to prevent injury to a child guest of the tenant who drowned in the pool.

Holding: A landlord has a duty to prevent injury to a child guest of a tenant that might result from a pool on the property. Although the pool was built before safety measures were required by statute (1996), the general duty of care applied to the landlord to prevent injury. A question of fact existed on the issue of whether the failure to secure the pool was the proximate cause (legal cause) of the child's injury.

*Facts***:** A tenant rented a property through a property manager who was a license real estate broker. The property had an older pool built in 1970 and was fenced with no access from the outside. The sole entrance was through a kitchen door that was not self-closing and not self-locking.

The tenant had a party and a four-year old child was brought to the party by his grandmother. The child, his grandmother, and father were in the pool area.

Flickr / Chris Potter

OWNER HAS LIABILITY FOR HARM TO GUESTS OF TENANT

Johnson v. Prasad (2014)

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As guests started to leave the pool area, the kitchen door was left open so people could go inside. A short time later the four year old child returned to the pool and was later found drowned. The child's mother sued the property manager, landlord, and others. The trial court initially granted a summary judgment to the property manager and landlord—thus dismissing the case. The child’s mother appealed and the appellate court reversed the trial court’s findings and that there is a “common law duty of care to prevent small children from drowning in a pool on property rented to a tenant.” The appellate court found the foreseeability of harm as being high, preventative measures are strictly a cost and time issue, and there is the availability of insurance. The case against the property manager, who was a licensed real estate broker, was dismissed. The landlord had liability for the child’s death, *but the broker was not held liable because pool safety locking devices were first required in 1996 and the pool was built in 1970.*

After this court case, it appears that real estate brokers may want to take a careful look at safety locking devices for swimming pools built since 1996.

The Reality of Built-In Swimming Pools

A built-in swimming pool can increase or decrease the intrinsic value of a single-family home. It depends upon the age of the pool, neighborhood where the property is located, and desires of tenants and owners.

A built-in swimming pool constructed in a new subdivision home is probably worth approximately 50% of the cost to build the pool. For this reason, it may not be a good financial decision to have a built-in swimming pool installed on a property. The smart real estate investor buys a home with a built-in pool *already installed* on the property, thus taking advantage of the previous homeowner(s)’ mistake and resulting financial loss.

An older pool located in an older neighborhood may actually reduce the value of a home because of the needed renovation of the pool itself, as well as inevitable deterioration of pool equipment.

The Story of Lori

Homebuyer Lori was considering buying a home that was built in the early 1960s. The home had a built-in swimming pool that had been constructed at about the same time as the home. Lori placed an offer on the property and it was accepted by the seller. According to the purchase contract between her and the seller, she had seventeen days to inspect the property and make a decision whether to buy the home or not.

Lori scheduled a **home inspection** with a professional home inspector during the seventeen day physical inspection contingency period. The home inspector thought the home was in good condition; however, the pool was a major area of concern. The home inspector recommended that Lori hire a professional pool inspector to look at the pool and make a separate report.

The professional pool inspector informed Lori that she would need to refinish the pool exterior in the very near future—if she intended to use the pool at all. The professional pool inspector recommended hiring a professional pool equipment inspector to take a look at the older pool equipment and determine its projected useful life.

The pool equipment expert informed Lori that she would probably have to replace the pool equipment in the very near future. With the reports from the home inspector, pool inspector, and pool equipment inspector, Lori realized that the pool would have to be extensively renovated.

Having thorough inspections prior to purchasing a single-family investment property can save a lot of headaches in the long run. Your clients will understand the true condition of the home before it is purchased. Real estate investors need to discover problems with the property *before* close escrow—not after. Otherwise, correcting the problems may significantly reduce profits over the holding period.

An investor's options for an old swimming pool are:

1. Renovate the pool
2. Fill in the pool with soil
3. Do nothing and use it as an eyesore.

Since Lori's pool was rectangular in shape, a common shape for pools built many years ago in the U.S. and still a common shape in many countries around the world, it has some functional obsolescence issues causing a reduction in value.

Most modern swimming pools located in the U.S. have curved sides; however this pool was obviously rectangular, old, and outdated. Lori negotiated a much lower purchase price than the home would have been worth if it had a modern swimming pool built in the backyard. The negotiated price was actually *less* than what the investor believed the home was worth without a pool! Because of the age of the pool, the home's intrinsic value declined by as much as $75,000.

The Story of the Home Warranty Policy
A seller decided to sell a semi-custom single-family home located in a higher socio-economic neighborhood. The home had a fairly nice built–in swimming pool located in the backyard. The house, pool, and pool equipment were approximately twenty-five years old.

The real estate investor was wise to obtain a **home warranty policy** for the home and pool equipment prior to close of escrow. Exactly one day after close of escrow the pool equipment stopped working. The seller had obviously been keeping it "limping along" during the escrow period.

The home warranty policy had an endorsement that covered the pool equipment, so the real estate investor ended up with new pool equipment.

As mentioned earlier, it is generally best to purchase a newer home that already has a built-in swimming pool constructed on the property. The previous owner—and not your client—will take the loss of approximately 50% of what they paid to construct the pool.

For example, if a real estate investor paid $50,000 to install a built-in swimming pool, the resale value of the pool will be approximately $25,000. Therefore, an investor would probably receive approximately $25,000 more for the property than a person who owned the same property and did not have a comparable built-in swimming pool.

Stock.xchange / Asif Akbar
Figure 5.1 Modern Swimming Pool

In large super custom homes located in dry Mediterranean-type climates, such as Southern California and Northern California's inland valley areas, a pool may be an expected amenity by an owner-occupied homebuyer. Many large homes will come with a pool, and if not, the buyer may look elsewhere for a home that does have one. Unfortunately, an above-ground pool adds virtually no value to a single-family home.

One custom home builder believed that a built-in swimming pool in his upscale market was an expected amenity and a cost of doing business. He installed a built-in swimming pool in every property he built.

Another area of concern to single-family home investors is pest infestation and dry rot. Extensive pest infestation caused by subterranean termites and dry rot caused by bacterial decay are two of the most common problems experienced by homeowners in California.

Pest Infestation and Dry Rot

Flickr / U.S. Department of Agriculture
Figure 5.2 Subterranean Termite

A pest inspector generally looks for signs of **pest infestation** within a single-family home. Two primary areas of concern are **subterranean termites** and **dry rot** (bacterial decay). Termites are particularly active in warm, wet areas—such as the coastal areas of California; however, they are prevalent throughout most of the state. Cold, high elevation areas in California usually do not have termites. Everywhere else they seem to be a continual problem for real estate investors, homeowners, and real estate agents.

Wikimedia Commons / Mates II
Figure 5.3 Dry Rot

Wikimedia Commons / Jim Conrad
Figure 5.4 Mud Tubes

When there is **earth-to-wood contact**, termites may be able to actually eat the wood in the home. Even if the wood is a reasonable distance from the soil, termites can build tubes between the soil and the wood and travel up them into the home. However, they generally have a difficult time consuming wood without the direct earth-to-wood contact.

When a builder leaves wood scraps in the crawl space under a single-family home, his actions can attract termites. The earth-to-wood contact may allow termites to enter through the soil and eat the wood scraps. From there, the termites may be able to build mud tubes from the soil to the wood in the house. These scraps may be removed from the crawl space to prevent this potential downward spiral of termite destruction. During an upward-trending sellers' market, it is amazing to see how many scraps of wood are "discovered" by pest inspectors deep under the house.

Pest Infestation Report

A **pest infestation report** is a written report indicating whether a home has termite damage, water damage, or dry rot. The pest inspector may also look within and under bathrooms and kitchen areas for signs of termite infestation, as well as water damage. The inspector may look for dry rot damage under bathrooms and under the eaves of the home. Older homes with raised foundations are particularly susceptible to dry rot damage under the bathroom(s) and kitchen areas.

Pest Repairs

When a real estate investor uses a real estate agent to help with the purchase of a single-family rental property, the agent will most likely use real estate contracts and addendums that were written by a local or state Realtor association. These contracts and addenda may or may not refer to a pest inspection, the repairs to be made, and who is going to pay for the inspection and any subsequent repairs.

Sometimes the purchase agreement will refer to one or more pest reports and repair addendums to the contract. Other times everything related to pest reports and repairs will be contained within the purchase agreement.

During an Upward-Trending Sellers' Market

Pest reports and repairs can be "interesting" during an upward-trending sellers' market. Sellers usually have a lot of equity and can usually afford to pay for pest inspections and resulting work required to "clear" the report. A **clear pest report** describes a home as being free of pest infestation, including termite damage, and dry rot/bacterial decay.

During an upward-trending sellers' market, pest companies tend to want to "participate" in the seller's good fortune by charging a higher price to clear the home of pest infestation and dry rot than they would charge during a downward-trending buyers' market.

As soon as a real estate investor lists a single-family rental property for sale, the listing agent should recommend ordering a pest inspection. If your client is a new single-family investor, they may not have any industry contacts and may not know how to pick a pest inspection company. The real estate agent can be a valuable resource having probably worked with several pest companies in the past. Some real estate agents in California may not want the liability that goes with recommending a pest inspection company, so they may provide a list of pest inspection companies from which to choose or possibly not recommend anyone at all. Other agents may recommend a trusted pest inspection company to do the inspection. This same company may or may not be used to do the pest repairs. It depends on county custom and whether the company provides quality repairs for a reasonable price.

> "A **clear pest report** describes a home as being free of pest infestation, including termite damage, and dry rot/bacterial decay."

Referrals from a real estate agent can be a good way to select a pest inspection company. Since the agent may be using the pest company on a frequent basis, the pest company will probably have future pest reports and (possibly) pest repair work riding on agent referrals. Small real estate investors, on the other hand, may be a "one-shot deal." They do not represent future business to the pest company and will probably be treated accordingly—if they don't have a real estate agent's future business backing them.

An experienced real estate investor may already have industry contacts, including a pest inspector and pest company that have been used in the past. Since the pest company realizes that the investor may be using them for more inspections in the future, they may not be as willing to "load up" the repair work like they would if it were only one inspection.

The Rabbit In Charge of the Lettuce Patch

Many pest inspection companies perform inspections and do the corrective work as well. Pest inspectors are usually paid a commission based upon the amount of pest work they can generate from their own pest reports. This is similar to the rabbit being in charge of the lettuce patch. For this reason, you really need to refer an honest pest inspector, or at least one whose future business income will be adversely affected by "gouging" your client on this inspection and resulting corrective work.

The Story of Vic
Vic decided to sell his California single-family rental property after reaching the top of an upward-trending sellers' market. He immediately ordered a pest inspection, but his usual pest inspector was on vacation that week, so another "stand in" inspector was assigned to take his place. Vic was not aware of this change at the time, or he would have used one of his other "trusted" pest inspectors from another pest company.

The "stand in" inspector found $18,000 in corrective work. Vic called the owner of the pest company and asked him, "Doesn't this bid have too many zeros?" The owner's reply was, "Yeah, you're right. How about $1,800?" This is a true story.

Rather than call the pest company owner and negotiate the costs of repair, we may wonder why Vic did not wait until his "trusted" pest inspector returned from his vacation to have him do an inspection and provide a subsequent report.

The answer is that after the first report had been generated, this report is now a material fact and must be disclosed to <u>all</u> future buyers. With the large amount of corrective work that was needed, it would have detrimentally affected the sale of the home. Therefore, negotiating the report and corrective work was Vic's best course of action to get the property sold and not have to worry about potential future litigation resulting from not disclosing the first pest report.

The Home Sprayer Mistake
One home seller mistake is to use the same pest spraying company, that has been spraying the home for pests on a regular basis, to do the pest inspection. On the surface this seems like a good idea. However, the pest spraying company most likely specializes in pest spraying, not pest inspections. Also, the owner may hope they will not find any pest infestation because, after all, they have been spraying the rental property for years. Wrong! They may actually find *more* infestation than a company that specializes in pest inspections and repairs. In addition, they may not be able to perform the corrective work themselves, so the owner may need to find a contractor to perform the work. The pest spraying company may make it difficult to obtain a clearance, especially when the pest spraying company realizes how much liability they have generated—with little return.

The pest company that specializes in inspections and repairs knows how to play the game. A smart real estate investor may inform the pest inspector, "I know you're going to get me, just don't get me too badly." This lets the inspector know that the investor will provide some leeway, especially during an upward-trending sellers' market where there is equity in the home, but don't overdo it and gouge too much or this will be the last time they are used for pest inspections and repairs.

The "Your Relative the Contractor" Mistake

Many single-family home sellers have a relative who is a contractor. When they receive a pest inspection and estimated repair work from the pest inspection company, they may decide to use a licensed contractor relative to do the repair work. On the surface this seems like a great idea. The seller can save money on the repairs and give the relative some business. However, in reality it may kill the deal.

> The pest inspector will probably charge an inspection fee of between $75 and $125, however, this varies by geographical market. Pest inspectors usually make their big money from the commission income generated from pest repairs, not from pest inspection fees.

For example, a seller hires a contractor who is one of their relatives to repair five items on a pest inspection report. These items need to be repaired before the seller can obtain a clear pest report from the pest inspector. The relative completes all five items, and then the seller calls the pest inspector for a re-inspection. This costs another $75 - $125 pest inspection fee and the inspector finds three items on the report have been repaired, however, there are two items that remain to be "satisfactorily" completed. The relative returns and completes the two items and the seller orders another re-inspection, and pays the $75 - $125 fee. The pest inspector finds one of the items is still not satisfactorily completed and the seller must call the relative back out to the property…and the game continues. The pest inspector is penalizing the seller for not using his company to do the repair work and causing him to lose the resulting repair income.

The inspector is trying to increase his inspection income to compensate for the loss of revenue caused by the relative doing the corrective work—instead of using his company. More importantly, the inspector may delay the close of escrow. If a clear pest report is required in the purchase contract, which is very common during an upward-trending sellers' market, the buyer's loan rate lock may expire. If interest rates have increased during the rate lock period, usually in place for 30 to 45 days, the buyer's loan payment may increase. This may cause the buyer to not qualify for the anticipated loan, escrow closing may be delayed, and the whole deal may fall apart.

Pest Reports

Pest reports are usually comprised of Section 1 and Section 2 items. Section 1 items are items that are in existence at the time of the report. Section 2 items are items that are "deemed likely" to lead to infestation. As mentioned earlier, during an upward-trending sellers' market most buyers will require a clear pest report as a contingency to the purchase contract. Buyers may also ask the seller to pay for a clearance of both Section 1 and Section 2 items. If the seller has obtained a pest report *before* the offer from the buyer comes in, the exact costs to complete both Section 1 and Section 2 repairs will be known ahead of time and can be used in the negotiation. It will be easier for the seller to calculate net proceeds from the sale of the property and either accept, counter, or reject the buyer's offer.

If a pest report has not been obtained prior to receiving the buyer's offer, the seller will be "in the dark" regarding how much it is going to cost for Section 1 and Section 2 pest repairs. The seller can limit the amount of money that will be paid for each section of the report, however, this does not take into account the problem of clearing the home of pest infestation and may end up a mess when the pest repair work is more than the amount the seller has agreed to pay. The extra pest repair work, that the seller did not agree to pay, may kill the deal because many owner-occupied lenders will <u>not</u> allow the buyer to pay for pest work, yet may require clearance of both Section 1 and Section 2 items. When the buyer cannot pay the difference between the actual amount of repairs and the amount limited in the purchase contract; and the seller is not willing to pay it, the deal may fall out of escrow and the seller will be forced to find another buyer for the property.

When to Order a Pest Report

Many real estate agents wait until they have an accepted contract before ordering a pest inspection. There are several reasons for this. First, during a slow downward trending buyers' market the home may be on the market for a long period of time and the buyer's lender may not accept the pest report if it is too old. The lender may require an updated report, with accompanying re-inspection fees, from the pest company. Another reason is that the report will be old when the buyer realizes how many days-on-the-market (DOM) it has taken to sell the property. The buyer may think there is something wrong with the property.

New Homes and Newer Homes

Pest inspections are usually not needed with new homes. Accordingly, with a newer home that is only a few years old and has a concrete slab foundation, there will probably not be very much corrective work required to obtain a clear report.

Older Homes

Older homes, especially with raised foundations, may contain a considerable amount of pest infestation and dry rot. The repairs could easily total $5,000 to $10,000 or more. An unscrupulous real estate agent will know this and wait until there is an accepted offer before ordering a pest inspection on an older home. This obligates the seller to pay for the repairs *before* they can move forward with the sale. If the seller had seen the pest inspection report before accepting the buyer's offer, it may have been decided to not go forward with the sale. However, after the seller has an accepted contract there is greater incentive to pay the $5,000 - $10,000+ in corrective work and close the deal.

"Older homes, especially with raised foundations, may contain a considerable amount of pest infestation and dry rot."

This seems to be a blatant breach of fiduciary duty to the seller, yet seems to be a common practice in some real estate markets. A seller should get a pest inspection ordered as soon as the property is listed for sale, and take the guess-work out of the pest inspection and resulting repair work.

During a really hot upward-trending sellers' market the seller may be dealing with multiple offers on their single-family property and the "cleaner" the offer the better the chances it will be accepted. Some real estate investors may not include any pest inspection or repair contingencies to the contract, while owner-occupied buyers may want to include a clear pest report (both Section 1 and 2) as a condition to funding the loan. This is especially true with government insured and guaranteed loans. If the seller is aware of the amount of pest work required to obtain a clear pest report, it will be easier to consider the seller net proceeds of one offer against another to find the buyer who will provide the greater net return to the seller and be able to close the deal for the contract price and on time.

During A Downward-Trending Buyers' Market

During a downward-trending buyers' market, there may be a large number of homes in **pre-foreclosure**, **foreclosure**, and **post foreclosure**. Pre-foreclosure homes have not had a notice of default (NOD) recorded against them. The seller may or may not be late with his or her loan payments and may be attempting to obtain a loan modification or short sale for the home.

Foreclosure homes have had NODs recorded against them and are on the way to foreclosure. In California, it is usually through a trustee's sale. Post Foreclosure homes have already been foreclosed and are being held by the foreclosing lender as a "Real Estate Owned" or REO property.

Banks many times employ professional executives who know how to play the game. The bank generally will not pay for any pest inspections or repairs during this type of market. This poses a problem for owner-occupied homebuyers, but not for real estate investors. If an owner-occupied homebuyer includes a request for a pest inspection and clear pest report in the purchase agreement, the lender—who is making the new loan to the buyer—will generally make a clear pest report a condition to making a loan on the property. When the seller is a bank, they will most likely not agree to pay for a pest report or clearance. Therefore, if the buyer is not able to pay for the inspection and corrective work, the purchase may not go through. This is especially true when a buyer is attempting to procure an FHA-insured or VA guaranteed loan.

> "During a downward-trending buyers' market, there may be a large number of homes in pre-foreclosure, foreclosure, and post foreclosure."

Sometimes the seller's lender will add the pest inspection and repair costs onto the purchase price of the home and hope it will appraise high enough (for the buyer's lender) to cover the additional costs. If it does not appraise for the higher amount, the seller's lender may be required to reduce the purchase price or absorb these expenses to close the deal.

As a real estate investor, especially with all cash, your clients can purchase one of these properties and not require a pest inspection or repair work at all. Real estate investors may not mention a pest inspection or corrective work in the purchase agreement. Then during escrow, they may have one of their trusted pest inspectors provide a report. If the home does not look like it has active infestation, the investor will usually postpone all corrective work until the property is sold at the top of the next upward-trending sellers' market.

Bottom of a Downward-Trending Buyers' Market

As mentioned earlier, a real estate investor will be competing with owner-occupied homebuyers at the bottom of a downward-trending buyers' market. Since owner-occupied homebuyers are making an emotional purchase decision, they may pay whatever it takes to acquire the property. Of course the home will have to appraise for this amount, or the deal may fall through. Some smart real estate agents will write up a higher than market value purchase offer, have it accepted by the seller, and then when it does not appraise for this amount—renegotiate the purchase price downward during escrow. This is especially true when there are multiple offers on the property.

A real estate investor is making an unemotional purchase decision that will derive the greatest total return over the holding period. In other words, the investor wants to purchase the property for a price that is as low as possible. Going up against owner-occupied homebuyers is not a good way to reduce costs when acquiring a single-family rental property.

During a downward-trending buyers' market, a good real estate agent may be able to maneuver owner-occupied home buyers around any pest inspection and repair obstacles. The agent may obtain advice from a loan officer regarding how to write up this type of offer before submitting it to the seller. **Federal Housing Administration** (FHA) insured loans, **Department of Veteran's Affairs** (VA) guaranteed loans, and conventional loans each have different underwriting criteria and a knowledgeable real estate agent should be able to structure the purchase to fit their loan parameters.

In addition, the agent may not make a clear pest report a contingency to the contract. This will assure the owner-occupied homebuyer will have the best chance of closing escrow when using a conventional loan. Of course, real estate investors who are selling a single-family home to an owner-occupied buyer near the top of an upward-trending sellers' market will enjoy the benefits of a possibly higher sale price and increased seller net proceeds resulting from these astute home buyers.

The Tale of Two Pest Control Reports

Some sellers try the "I'll call another pest company and get a second opinion" routine. Remember, that first report must be disclosed to all future buyers. There are several court cases in California to confirm this requirement.

The sellers who try the “two pest report routine” will many times remove the first pest inspector’s date of inspection sticker from the garage wall, so the next inspector will not know about the existing report. Removing the pest control sticker off the garage wall is illegal in California. Pest reports are supposed to be kept on file with the Structural Pest Control Board for two years in California, so it’s fairly easy to obtain the first inspector’s report.

This can be a liability concern for a seller. If the market changes from an upward-trending sellers’ market to a downward-trending buyers’ market, homebuyers may experience a loss in the value of the home. If they discover that the seller did not disclose a previous pest report, they may be able to file a lawsuit and ask for **compensatory damages**.

If the seller used a real estate agent to sell the property, the buyer may be able to file suit against the listing agent, if he or she knew about the existence of the first pest report, for breach of fiduciary duty. This may open up potential **punitive damages** and **benefit-of-the-bargain damages** against the real estate salesperson and broker.

The Story of Earl

Earl liked to find beat up properties that do not fit FHA and VA loan programs. If the property has been on-the-market for more than sixty days, so much the better for Earl. He liked to purchase single-family homes with all cash, or a low loan-to-value conventional loan, perform a cosmetic renovation to get the property into a rentable condition, rent it out, and collect cash flows until the top of the next upward-trending sellers’ market, when he performed a 1031 tax deferred exchange and moved the equity from the property into another single-family home located in a different geographic area. Preferably an upward-trending sellers’ market that had not yet peaked and had some price appreciation potential.

Earl liked to pay all cash for a single-family property, perform a 1031 exchange as the upward-trending sellers’ market starts to move upward, and then move the equity into a higher socio-economic neighborhood with a high loan-to-value ratio loan. This reduced Earl’s cash flow, but allowed him to capture more price appreciation because of the property’s location in a better neighborhood.

The other alternative was for Earl to do a non owner-occupied cash out

The Story of Earl (continued)
refinance of his existing properties and buy single-family homes located in the higher socio-economic neighborhoods. In this case, he will need to be able to cover the debt service for the loans on the existing homes located in lower socio-economic neighborhoods, as well as the newly acquired single-family homes located in higher socio-economic neighborhoods. As the upward-trending sellers' market moves upward, Earl liked to keep these properties until he neared the top of the next upward-trending sellers' market and then sell everything, pay the capital gains taxes (always painful for Earl), and put the money in a bank for safekeeping.

In addition to a pest report, a real estate investor should consider the possibility that a home may have hazardous waste materials in or around it.

Hazardous Waste Materials

The following is a partial list of hazardous waste materials that may affect your clients' real estate investments:

- Asbestos
- Formaldehyde
- Lead
- Radon
- Geotechnical hazards
- Methane gas
- Electromagnetic fields
- Nuclear sources
- Mold
- Fungus

Asbestos

Until 1978, many homes with blown "**popcorn" type ceilings** contained asbestos. Asbestos was a common insulator and its potential carcinogenic qualities were mostly unknown to the general public before 1978. When a ceiling becomes old and starts to flake, asbestos can become airborne and may be inhaled by a tenant or homeowner. Of course, it is always best to consult an environmental expert whenever asbestos or any other hazardous waste materials are involved.

In older homes built before 1978, the popcorn ceiling can be removed by an asbestos abatement contractor wearing a "moon suit." This protects the contractor against airborne asbestos particles that result from scraping off the hazardous ceiling materials.

Some property owners have tried to seal up their popcorn ceilings with paint or other spray-on materials designed specifically for this purpose. Both types of materials seal up asbestos from the air, but do not remove the problem itself.

The Story of the Doc and the RN
A real estate agent was representing a husband, who was a medical doctor and a wife, who was a registered nurse in the purchase of a single-family home. The doc wanted an older home for a lower purchase price. The wife wanted a brand new home for a very high purchase price. You can guess who won that argument.

They initially looked at older homes located in middle to higher socio-economic areas. After looking at several properties, the doc asked his real estate agent about the blown popcorn ceiling in one of the homes. The real estate agent explained that homes built in 1978 or before may contain asbestos in the blown ceiling materials. The doc nodded his head as they headed to the next home. Later, the real estate agent asked the wife about the doc's specialties. She told him that the Doc was an internationally-renown cancer research doctor.

The doc and his wife bought a brand new home that was $100,000 more than the doc wanted to spend, and about a million (or two) less than he could afford. By the way, he asked the real estate agent to accompany them to the design center to make sure his wife didn't go "hog wild" with upgrades.

After consulting with the wife, who made it very clear she didn't need a real estate agent to help pick out upgrades, the agent suggested to the doc that, "A happy wife is a happy life." The wife got the Doc for another $80,000 in upgrades at the design center. This was in addition to the extra $100,000 he paid for the home. As far as the agent knows the wife's still happy too.

Lead-Based Paint

Until 1978 many paint manufacturers used lead in their manufacturing process. If window sills in a single-family home have been painted with "lead-based paint," and a child bites the window sill, lead may be ingested into the body.

Ingesting lead has been known to cause learning disabilities and other illnesses in children and adults.

There may be several layers of paint on the inside walls of older homes located in California, making it difficult to determine whether a single-family home contains lead-based paint. To compound this problem, home inspectors do not usually investigate potential lead-based paint hazards during the home inspection, so the homeowner will need to have the home tested specifically for lead based paint. Lead-based paint is usually mitigated by scraping off all the lead-based paint and repainting with modern non-toxic paint.

> "Until 1978 many paint manufacturers used lead in their manufacturing process."

Radon

Radon may exist in soil located in certain areas of the U.S. As Radon gas, it may become airborne and accumulate in single-family homes that have crawl spaces or basements. Due to a possible pressure gradient between the crawl space or basement and the rest of the house, radon gas may move into the home and become a potential carcinogenic problem for tenants and homeowners.

A radon inspector captures air within a crawl space or basement, and then uses a spectrometer to measure the amount of radon in the air. If the resulting test indicates more radon gas than is legally allowed, the homeowner will need to hire a radon abatement contractor to mitigate the problem. This may cost $1,500 or more and usually consists of the abatement contractor drilling holes into the concrete slab of the basement, or no holes at all if the home has a crawlspace, and venting (with a fan) the radon gas out of the home and into the outside air. The vent usually looks like a down spout from a water drain, with a big bulge that contains the fan near the surface of the ground. It vents the radon gas out above the roof line and into the outside air.

Geotechnical Hazards

A **geotechnical report** can be used by builders to make sure the soil is stable enough to hold the foundation of a new single-family home. **Geotechnical engineers** perform the analysis by bringing a backhoe onto the property, digging a hole to a predetermined depth, examining the soil horizons (layers) under the surface, and then producing a report with recommendations whether the builder can safely build a home on the parcel of land. In steep, hilly country homebuilders greatest concerns are usually slope stability and the potential for landslides. A geotechnical report costs $1,500 or more and examines how natural earth materials will interact with a single-family home foundation system. The geotechnical engineer examines how a new foundation will react to landslides, earthquakes, liquefaction, erosion, weathering, and other environmental factors that may affect a new single-family home.

Methane Gas

Methane gas is commonly produced in wetlands and can be very dangerous to tenants and homeowners. It is extremely flammable and if breathed into the lungs can cause shortness of breath and, when combined with oxygen, can cause asphyxiation and usually results in death.

Natural gas is approximately 97% methane. **Carbon monoxide** (CO) is a byproduct of methane gas (when it is burned) and is very dangerous to tenants and homeowners because it is odorless, colorless, and tasteless. This is especially true with natural gas furnaces.

If a tenant or homeowner breathes in carbon monoxide, symptoms may include headache, dizziness, nausea, rapid heartbeat, unconsciousness, and immediate death. A carbon monoxide detector is required to be installed in single-family homes to detect carbon monoxide problems.

Methane detectors are also available to detect the existence of methane gas in the air of a home. Carbon monoxide and methane detectors can be installed, along with **smoke detectors**, to make sure tenants and homeowners are safe living in the home.

A natural gas leak may be detected by the odor of the natural gas. Methane does not have an odor, however, for safety reasons natural gas has had an odor (rotten eggs) added to it—so tenants and homeowners can detect it if there is a leak. When natural gas permeates throughout a single-family home, it can be devastating. An explosion is generally extremely violent and may bring the entire house and surrounding neighborhood to the ground.

Electromagnetic Fields

There has been an on-going debate whether very low frequency electromagnetic fields (EMF) surrounding power lines and electrical devices have potential health risks. It appears to depend upon the frequency and intensity that a tenant or homeowner is subjected to an EMF. Some studies have shown an increased likelihood of childhood leukemia when children live near high power lines.

However, the study was inconclusive and scientists are hesitant to declare high power lines a definite health risk. The studies relate to the extremely tall high power lines that reach two hundred feet or more above the ground, not the small power poles that are approximately thirty feet in the air and are located in many older neighborhoods.

Nuclear Sources

Proximity to a **nuclear power plant** can be a definite disclosure issue during the sale of a single-family home. Being downwind of one of these plants can be especially unnerving, especially since the Chernobyl Disaster of 1986. A reactor vessel ruptured at the Chernobyl Nuclear Power Plant and a series of explosions sent a plume of **radioactive fallout** into the atmosphere. Over 336,000 people were evacuated from the immediate area. It is unknown how many people will eventually die from exposure to the fallout. Another example is the **earthquake**, **tsunami**, and **nuclear melt-down** in Northern Japan in 2011.

Mold


Wikimedia Commons / Nordhorner
Figure 5.5 Black Mold

When **mold spores** become airborne, they can cause serious health problems. A tenant or homeowner may experience an allergic reaction, asthma flare-up, eye irritations, nose and throat problems, sinus congestion, infections, and other health problems. Some molds excrete toxic compounds called **mycotoxins**. If there is high enough exposure, some of these mycotoxins can be lethal to humans.

A water leak in a single-family home may have mold growing in it. A mold inspector looks for over a hundred different varieties of mold, with only a few strains toxic to humans. The inspector can be used to determine if mold in the home is one of the harmful varieties, and provide guidance with having it removed.

Fungus

One type of airborne fungus is called **Cryptococcus Gattii**. It is usually found in tropical regions, however, since 2006 it was discovered on Vancouver Island in Canada and has steadily worked its way south through Washington, Oregon, and Northern California. The new strain affects healthy people and, at last report, has a 25% mortality rate. The fungus ties itself to certain trees and releases into the air. Symptoms may occur two weeks to several months or more after exposure, and may include a cough that lasts for weeks, sharp chest pain, shortness of breath, headache, fever, nighttime sweats, and weight loss.

Overall, single-family home buyers are well-advised to have a home inspection performed by a professional home inspector. The home inspection will provide a home buyer with knowledge of whether the property has structural and other problems that may not be readily apparent from a cursory inspection by a normal buyer. Seller and agent disclosures are used by the home buyer to help determine whether the property has any existing issues that may cause the buyer to not buy the property.


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SHAM REAL ESTATE TRANSACTION

Olague v. Klimenko and Martinez (2015)

Court of Appeals of California, Second District, Division One
February 24, 2015

JOHNSON, J.
Defendants Wladimir John Klimenko and Ruben Martinez, parties to a sham real estate transaction in which a naive and trusting landowner was defrauded into relinquishing ownership of real property, appeal from adverse judgments for fraud and declaratory relief, respectively. Klimenko contends the fraud judgment against him is barred by the doctrine of res judicata or, alternatively, that there is insufficient evidence to support the judgment. Martinez argues there is no basis upon which to award declaratory relief against him. We affirm.

In 1998, Theodosia Olague (Theodosia) created the Theodosia A. Olague living trust, dated April 28, 1998 (trust) of which she was trustee. Her home on Tilmont Avenue in Pico Rivera (Tilmont property) was an asset of the trust. Theodosia's son, Edward Olague, Sr., (Olague) was designated as successor trustee upon Theodosia's death, resignation or incapacity, and he and his brothers were the beneficiaries of the trust.

Sometime before 2005, Theodosia became incapacitated by dementia and, as successor trustee, Olague assumed management of trust assets. Theodosia continued living at the Tilmont property, where she was cared for by one of her sons and his wife.

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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

However, by 2005, Theodosia's family determined that her health and mental state had deteriorated to the point that she required additional care in an assisted living facility. Because Theodosia's social security income was insufficient to fund her care, Olague, with his brothers' approval, decided to sell the Tilmont property to generate additional funds.

Klimenko is a licensed, experienced real estate agent familiar with the Pico Rivera area who was a friend of the Olague family. Olague and his brothers trusted Klimenko and believed he had their best interests in mind.

In February 2005, Klimenko and Olague discussed prices, listing and sales arrangements in connection with Olague's desire to sell the Tilmont property. Klimenko told Olague that he wished to purchase the Tilmont property himself. After discussing the matter with his siblings, Olague agreed to sell Klimenko the Tilmont property for $290,000. Olague and his brothers agreed to Klimenko's terms, which were: the trust would lend Klimenko the entire purchase price and, in return, receive interest-only payments through a 30-year promissory note secured by a deed of trust.

The written agreement between Olague, as successor trustee, and Klimenko, as buyer, was memorialized in a written agreement dated March 24, 2005, on a standard California Association of Realtors contract form for residential purchase agreement and joint escrow instructions. It specifies a purchase price of $290,000, with no deposit or down payment. The seller was to carry back the full purchase price at 6.5 percent interest, in exchange for a 30-year promissory note secured by a trust deed.

The agreement called for Klimenko to make interest only payments ($1,570.84 per month) through the 30-year term, with the principal due as a balloon payment in 2035. The note was due and payable in the event of Theodosia's death or if Olague required additional funds to cover his mother's expenses. Klimenko also gave Olague a June 14, 2005 installment note. With the exception of a $0.01 difference in the monthly payment, that note tracked the terms of the purchase agreement, and contained a provision that the

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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

principal would become due and payable if Klimenko sold or alienated the Tilmont property. Klimenko provided Olague a first trust deed to secure the promissory note. Olague gave Klimenko a grant deed for the Tilmont property.

Klimenko testified that Olague agreed to terms that clearly favored Klimenko (lender financing, interest-only payments and no down payment) in order to ensure Theodosia maintained her eligibility for Medi-Cal by receiving limited cash transfers. The trial court gave that explanation no credence.

Instead, the court credited Olague's testimony that he and his siblings planned to cover their mother's expenses without Medi-Cal benefits. The court found Olague agreed to terms that clearly favored Klimenko because Olague:

(1) deferred to Klimenko's expertise as an experienced real estate agent, trusted him and regarded him as a loyal family friend;
(2) was a retired mechanic with a high school education, who had very limited experience in real estate and was naive and unsophisticated;
(3) did not fully understand the terms of the sale or documents he signed;
(4) was primarily concerned about securing a source of income to cover his mother's expenses, and the idea of a regular income stream for the rest of her life appealed to him; and
(5) was assured by Klimenko that the terms were beneficial for him and his mother because they needed to limit Theodosia's income to maintain her future Medi-Cal eligibility.

On June 17, 2005, Olague and Klimenko signed the various real estate purchase documents for the Tilmont property before Elena Vanegas, a notary public. Vanegas had been an escrow officer since 1992, and operated La Costa Escrow. She rented space in a commercial building in Downey owned by Klimenko (Downey property). Vanegas had handled many escrows for Klimenko. She did not open an escrow for Klimenko's purchase of the Tilmont property.

On June 17, 2005, after Olague provided her a "`Statement of lnformation,'"


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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

Vanegas notarized the signed deed of trust, grant deed and certification of trust. Those documents, together with the purchase agreement and promissory note were delivered to a title company. On June 22, 2005, the title company processed the documents and recorded the grant and trust deeds without a formal escrow, concluding the sale.

Klimenko moved onto the property, and made monthly interest payments of $1,570.83 to Olague from July through December 2005. Klimenko's checks each contained "Tilmont" on the memo line.

In fall 2005, Michael and Susan Claburn, holders of a third trust deed on Klimenko's Downey property demanded payment on their note of $50,000, and threatened to foreclose. Klimenko decided to sell the Tilmont property, in part, to generate funds to pay off notes and clear secured interests on the Downey property. In addition to Michael and Susan Claburn, Klimenko owed $183,852.57 to Beuford and Renata Claburn, who held a second trust deed on the Downey property.

Klimenko sold the Tilmont property to Martinez. On November 9, 2005, Vanegas opened an escrow. On November 14, 2005, Vanegas prepared escrow instructions specifying a purchase price of $360,000, with payment of $288,000 secured by a first trust deed, and payment of $72,000 secured by a second trust deed. The escrow instructions do not reflect that Martinez paid any deposit or earnest money.

On November 22, 2005, on behalf of Klimenko and in order to clear title to the Tilmont property, Vanegas sent Olague a letter requesting delivery of the June 2005 $290,000 promissory note and deed of trust. <u>The letter did not mention Klimenko's sale of the Tilmont property to Martinez.</u>

On December 29, 2005, Vanegas notarized a grant deed by Klimenko to Martinez for the Tilmont property, and a first deed of trust by Martinez for $288,000 in favor of Countrywide to secure an interest in the Tilmont property.


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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

On January 4, 2006, Vanegas notarized a full reconveyance by Olague, releasing his first trust deed for the Tilmont property. At Vanegas's request, Olague also returned Vanegas's November 2005 letter requesting the note and reconveyance, and the original promissory note from Klimenko for his purchase of the Tilmont property in June 2005.

On January 4, 2006, Vanegas notarized a second trust deed, dated June 14, 2005, by Klimenko in the amount of $290,000 in favor of Olague, ostensibly securing an interest in Klimenko's Downey property.

On January 5, 2006, Vanegas caused to be recorded the grant deed, Countrywide's first and second deeds of trust and the reconveyance, and closed the escrow for Klimenko's sale of the Tilmont property to Martinez.

The second deed of trust from Klimenko in favor of Olague for the Downey property was never recorded.

The escrow settlement statement prepared by Vanegas on January 5, 2006 shows in relevant part that Martinez paid no money into escrow, and that the lenders paid $360,000 into escrow, $242,145.33 of which was allocated to Klimenko (consisting of all escrow and closing fees including Martinez's share, $183,852.57 to Beuford and Renata Claburn and $50,000 to Michael and Susan Claburn).

Klimenko received the balance of $117,854.67 from the $360,000 in cash.

At trial, Klimenko and Martinez each testified that Martinez was an independent, bona fide purchaser of the Tilmont property, that Martinez lacked knowledge of the transaction between Olague and Klimenko, and that Martinez purchased the Tilmont property in good faith and planned to live there and pay for the property without Klimenko's involvement.

The trial court did not find this testimony credible. Instead, the court found that:

(1) Martinez was Klimenko's pawn, who purchased the Tilmont property at

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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

Klimenko's direction and obtained financing for the purchase with Klimenko's help;

(2) Martinez paid no money to purchase the property;

(3) Klimenko remained involved with the Tilmont property after Martinez's purchase, in that he stored a vehicle in the garage, lived with Martinez on the property and paid him money, and assisted Martinez in trying to avoid foreclosure after he defaulted on his loans. The court found Martinez was not a bona fide purchaser for value.

Klimenko testified that:

(1) he fully advised Olague about the terms of the sale to Martinez, and gave Olague a new promissory note for $290,000 relating to the Downey property;

(2) Olague willingly and knowingly released his promissory note and security interest in the Tilmont property by signing and delivering the reconveyance to Vanegas;

(3) knew, understood and willingly agreed that Klimenko would transfer his security interest from the trust deed for Tilmont property to the second trust deed for the Downey property;

(4) knew, understood and willingly agreed that Klimenko would substitute the promissory note for the Tilmont property with the new promissory note for the Downey property; and Olague received valuable consideration for the transaction. The court rejected this testimony.

Instead, the court found credible Olague's testimony that:

(1) he had not known about Klimenko's sale of the Tilmont property to Martinez;

(2) Klimenko did not explain the content or meaning of the reconveyance to him;

(3) he did not knowingly agree to release the security interest in the Tilmont property;

(4) he did not knowingly accept a security interest in the Downey property;

(5) he did not intend to modify the original agreement with Klimenko as to the Tilmont property;

(6) he did not understand the reconveyance letter from Vanegas or the


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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

reconveyance instrument; and

(7) he never received nor was he aware of Klimenko's promissory note and second trust deed for the Downey property.

The trial court found that Klimenko:

(1) misrepresented the terms of reconveyance for the Tilmont property;
(2) needed to sell the Tilmont property in order to generate funds to repay the Claburns who were threatening to foreclose on the Downey property;
(3) never gave the promissory note or second trust deed for the Downey property to Olague;
(4) had two versions of the promissory note for the Downey property, neither of which was legitimate and neither of which were ever given to Olague; and
(5) never intended to record Olague's second trust deed for the Downey property.

The court further found that Olague signed the reconveyance and surrendered the promissory note for the Tilmont property under the mistaken understanding that Klimenko would continue making payments and that Olague maintained a security interest in the Tilmont property.

Both the purchase agreement and promissory note for the Tilmont property stated that the entire principal was due upon sale or alienation of the Tilmont property. The trial court found that Klimenko deliberately defrauded Olague of the benefits of this provision, and deliberately concealed from Olague his sale of the Tilmont property to Martinez in order to avoid his obligation to pay the principal.

Klimenko claimed that he provided Olague valuable consideration in exchange for Olague's reconveyance and release of his security interest in the Tilmont property, and that Olague received the promissory note and second trust deed for the Downey property.

However, a couple of days after January 5, 2006, Klimenko was reminded that he had been enjoined him from encumbering the Downey property by the


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SHAM REAL ESTATE TRANSACTION (*continued*)

Olague v. Klimenko and Martinez (2015)

family court overseeing his marital dissolution proceeding.

Klimenko explained this dilemma to Olague, who agreed that Klimenko need not record the second trust deed for the Downey property. Again, the court found Klimenko not credible. The court concluded that the transaction between Klimenko and Olague regarding the Downey property was a sham, that Klimenko obtained Olague's release of his security interest in the Tilmont property by fraud, and that Klimenko never intended to provide Olague with an enforceable security interest in the Downey property.

Indeed, Klimenko knew a second trust deed on the Downey property was worthless because of the restraining order in his divorce proceeding, and knew on January 4, 2006 that he was prohibited from encumbering the Downey property with a second trust deed in favor of Olague.

Olague testified that he never signed the reconveyance for the Tilmont property, and that his signature had been forged. The court rejected this testimony. The court also rejected Olague's contention that when he signed the reconveyance on January 4, 2006, he was tricked into signing a completely different document than the one he meant to sign.

However, the court did find that Klimenko made misleading representations about the documents Olague signed on January 4, 2006 and that he concealed from Olague important information about his transaction with Martinez.

The court also found that Olague had not understood the import of the reconveyance documents he signed and delivered to Vanegas on January 4, 2006, and that Vanegas told Olague he was signing documents relating to the Tilmont property, and that Olague carelessly failed to read or understand those documents before signing and delivering them to Vanegas. Although Olague knew the general nature of the documents he signed on January 4, 2006, Klimenko misled him about their meaning, effect and importance.

Even after he sold the Tilmont property to Martinez, Klimenko continued to make monthly payments of $1,570.83 to Olague from January 2006 through

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November 2007. Just as he had done before the sale to Martinez, Klimenko continued writing "Tilmont" on the memo line of each check.

The trial court found that by concealing his sale of the Tilmont property and giving Olague the false impression that Klimenko was abiding by the original agreement, Klimenko avoided the obligation to pay the principal balance due upon sale.

In 2007, Theodosia's health worsened and it became necessary to move her to a skilled nursing facility. In ostensible accordance with the terms of the Tilmont property purchase agreement, which Olague mistakenly believed gave him the right to increase payments if Theodosia's expenses increased, he asked Klimenko to increase his monthly payments. Klimenko agreed and, in December 2007, began paying Olague $2,600 per month. Olague and Klimenko agreed that $1,029.17 (the amount in excess of the interest-only payment of $1,570.83) would be applied to the principal due on the note.

Klimenko agreed to this arrangement even though no obligation for the increased payments existed under the $290,000 promissory note for the Downey property. Klimenko paid Olague $2,600 per month from December 2007 through September 2008. Klimenko continued to include the notation "Tilmont" on his checks to Olague. Again, the trial court found that by the giving Olague false impression that he continued to abide by the original Tilmont agreement, and by agreeing to increase his monthly payments after Theodosia's expenses increased, Klimenko concealed the sale of the Tilmont property and avoided his obligation to pay the principal balance.

In summer 2008, Klimenko began having difficulty paying $2,600 per month and fell behind in his payments to Olague. From October through December 2008, Klimenko resumed paying Olague interest-only monthly payments of $1,525.38.

Because of the financial strain caused by Theodosia's increased expenses, and Klimenko's financial troubles, Olague applied for Medi-Cal benefits for Theodosia. That application was approved in November 2008. After receiving


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the Medi-Cal approval, Olague agreed to resume accepting interest-only payments on Klimenko's obligation under the promissory note for the Tilmont property.

After discussing the matter, Olague and Klimenko agreed the principal balance was $280,534.24, and that Klimenko's interest-only payment on that balance would be $1,519.56 per month. Klimenko made monthly interest-only payments of $1,519.56 from January through July 2009, and continued noting "Tilmont" on each check.

The trial court found this constituted further evidence that Klimenko concealed his sale of the Tilmont Property to Martinez and avoided his obligation to pay the principal upon sale, by giving Olague the false impression that he was still abiding by the original Tilmont agreement.

Theodosia passed away in February 2009. On April 20, 2009, Olague notified Klimenko of her death and demanded payment of the remaining principal due under the note and deed of trust for the Tilmont property.

In response, Klimenko did not disclose his sale of the Tilmont property to Martinez. Rather, in letters written in May, June and July 2009, Klimenko observed that real estate values had declined, enclosed comparable sales data for the Tilmont property and asked Olague to modify the original agreement. Olague refused that request. Klimenko made his last payment to Olague on July 7, 2009.

Olague refused that request. Klimenko made his last payment to Olague on July 7, 2009.

By early August 2009, Olague had consulted an attorney regarding the transaction with Klimenko. Only then did Olague learn that in January 2006 Klimenko had transferred the Tilmont property to Martinez and had obtained Olague's signature on a reconveyance releasing his secured interest in the Tilmont property.

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In 2009, Martinez fell behind on his loan payments for the Tilmont property. A notice of default was served on Martinez and recorded against the Tilmont property on June 30, 2009.

On October 14, 2009, Martinez was served with a notice of trustee's foreclosure sale which was recorded against the Tilmont property. To avoid foreclosure Martinez executed and recorded grant deeds, conveying a one-eighth interest in the Tilmont property to five fictitious individuals. Both Martinez and Klimenko testified that Klimenko was not involved in the transfers, which Martinez claimed he made at the direction of a paralegal.

The court did not find this testimony credible.

The court found "compelling evidence" that Klimenko and Martinez worked together to make and record these fictitious transfers, in part because Klimenko had employed the same ruse for a property he owned. To avoid foreclosure of a property in Compton, Klimenko had executed and recorded grant deeds, conveying a one-eighth interest to four fictitious individuals.

The deeds from Martinez and Klimenko shared key things in common: all the deeds conveyed a one-eighth interest; three deeds were prepared on the same date and used the same grantees; and the same notary was used for all of Klimenko's deeds and three of Martinez's deeds.

Further, at trial, neither Martinez or Klimenko could identify the paralegal they claimed to have used. When asked by the court to explain the multiple common features of the two sets of deeds, Klimenko responded that the commonalities were merely "coincidental."

common features of the two sets of deeds, Klimenko responded that the commonalities were merely "coincidental."

The court found the testimony by Klimenko and Martinez was "false and deliberately misleading," reflected "consciousness of guilt by Klimenko" and constituted "evidence that Martinez was not a bona fide purchaser for the

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SHAM REAL ESTATE TRANSACTION (*continued*)

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Tilmont property."

After a bench trial, the trial court found in favor of Olague on the fraud claim. The court awarded damages of $280,534.24, plus prejudgment interest, punitive damages of $70,000, and costs and attorney fees.

The court also found in favor of Olague on the cause of action for declaratory relief, declaring that Martinez was not a bona fide purchaser of the Tilmont property and that Olague's interest in that property was superior to Martinez's interest, but inferior to Mellon's. All remaining claims were dismissed.

Klimenko and Martinez filed this timely appeal.

Disposition: The judgment is affirmed. Edward H. Olague, Sr., as trustee, is awarded costs on appeal.

CHANEY, Acting P. J. and BENDIX, J. concurs.

Next is a look at how socio-economics and age affect single-family real estate investment properties.

6

SINGLE-FAMILY NEIGHBORHOODS

"I came from a real tough neighborhood. I put my hand in some cement and felt another hand." -Rodney Dangerfield

Concentric Growth Pattern

A **Concentric Growth Pattern** is one of the most common growth patterns seen in urban areas located throughout the U.S. It generally occurs when the path of progress moves outward in a concentric ring from the **Central Business District** (CBD).

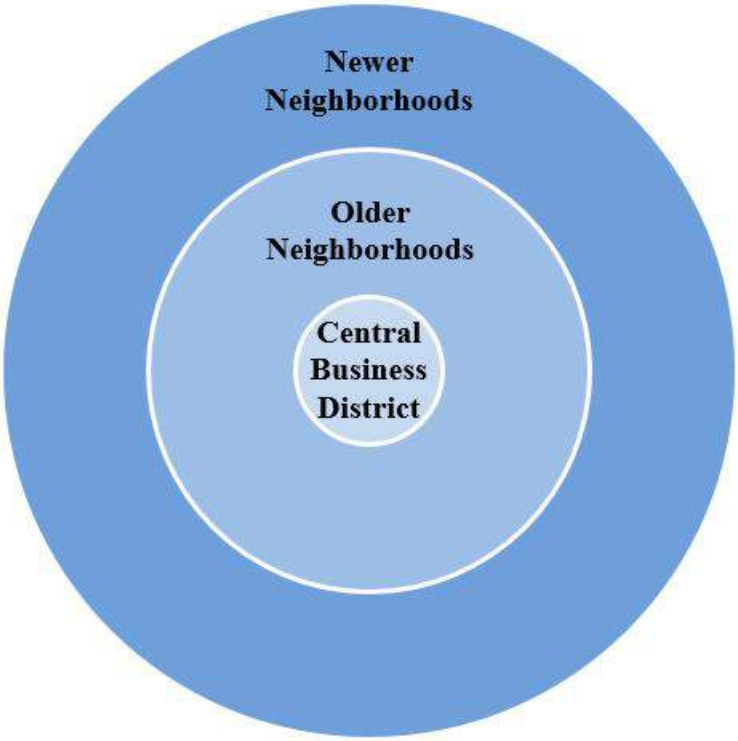

Figure 6.1 Concentric Growth Pattern

As the path of progress moves outward from the center of the CBD, as seen in Figure 6.1, newer more desirable properties will usually be built in the outlying areas. As a result, older properties located near the CBD may become less desirable as homeowners move into newer outlying areas. Many homeowners elect to sell their homes located near the CBD and move into the outlying **suburban areas**. This has given rise to the term **"suburbs."**

The newer areas located within the outside concentric growth rings may range from Newer Homes located in Higher Socio-Economic Neighborhoods (Quadrant #1) to New Homes located in Lower Socio-Economic Neighborhoods (Quadrant #3).

Properties located near the CBD remain in or near the center of the growth pattern and range from Quadrant #2—older properties located in higher socio-economic neighborhoods to Quadrant #4—older properties located in lower socio-economic neighborhoods Many times the CBD is comprised of office buildings and retail, as well as some high-density residential condos and apartments.

Gentrification

Over time, single-family neighborhoods tend to change from higher socio-economic owners to lower socio-economic owners. Lower socio-economic neighborhoods may receive a resurgence through the **gentrification process**, and move back toward a higher socio-economic status. Some economic development agencies have attempted to "gentrify" neighborhoods, yet have been only marginally successful.

Nodal Growth Pattern

The other predominant type of growth pattern is the **Nodal Growth Pattern**. A Nodal Growth Pattern has nodes that develop outward from the CBD.

Villages take shape outside the CBD. However, physical geography may have an impact on the overall growth that actually develops within these areas. Natural and man-made barriers may have an impact on where growth develops in an area. **Natural barriers** may include bays, rivers, and mountains. **Man-made barriers** may include freeways, railroad tracks, and major roads.

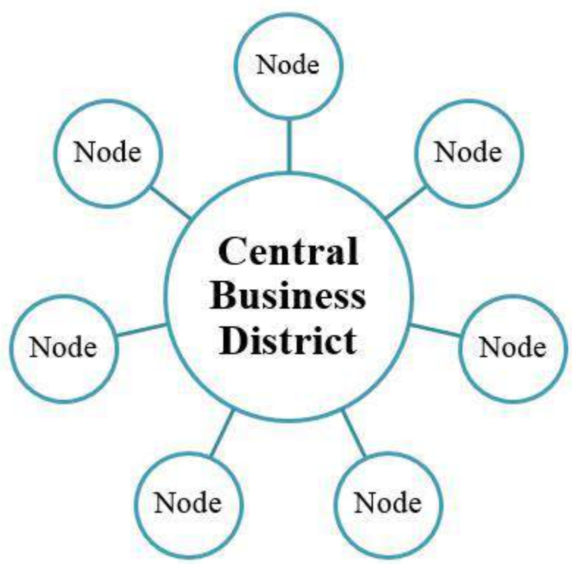

Figure 6.2 Nodal Growth Pattern

San Francisco

San Francisco has a system of streets that run in a seemingly haphazard manner in all directions. San Francisco has the Pacific Ocean on the west side and San Francisco Bay on the north and east sides. Growth in the City of San Francisco has occurred in very distinct areas called districts. Each district has its own distinct cultural flair.

The cities that have developed around San Francisco Bay have followed a nodal growth pattern. They are generally linked to the City of San Francisco by a system of bridges and a rail system called Bay Area Rapid Transit or BART. It is similar to the New York subway system and Chicago's elevated train system.

However, each outlying city around San Francisco has its own different socio-economic characteristics and distinct cultural differences. Of course, the City of San Francisco has cultural amenities that make it a world-class destination location in its own right.

Location, Location, Location

As mentioned earlier, there are five variables that generally will affect the value of a home: price, terms, condition, location, and market timing. The first three variables can be changed, however, location and market timing cannot be changed. They are two of the most critical factors that determine whether a home will increase in value in the future. Let's take a look at some factors that may affect the location of a single-family home.

Cul-de-Sac

Cul-de-sac is a nice word for a "dead end street." Cul-de-sac locations tend to be preferred by families due to child safety concerns. A homeowner may be able to allow their children to play in the front yard without worrying too much about them being hurt by passing cars. The larger lots that are usually located at the end of a cul-de-sac, are generally a huge amenity for families with children, and that is why builders like to build their largest two-story models in these locations. Not only can the kids play in the front yard, but the large-size backyard can be used as well.

> "Cul-de-sac locations tend to be preferred by families due to child safety concerns."

If a homeowner has a single-family home located in a cul-de-sac, they usually enjoy an easier time backing out of the driveway than if it were located on a busy street. This is because of the reduced amount of traffic generally seen in a cul-de-sac and slower vehicle speeds as drivers near the end of the street.

Many times builders, during an upward-trending sellers' market, will charge a **lot premium** for lots located in a cul-de-sac. You should make your clients aware that they will generally not recoup this lot premium when the property is sold in the future. The home may sell faster than other homes located on smaller and less desirable lots, however, it probably will not sell for a considerably higher price.

Feng Shui

There have been many books written about **Feng Shui** (pronounced "Fung Shway). Many Feng Shui nuances seem to be based on good practical advice. For example, according to Feng Shui a homebuyer should not purchase a home located where one street ends into another street. Car headlights may shine into the front windows at night, thus disturbing a homeowner's peace and tranquility…or the home may be the final resting place for a criminal who didn't make the turn while fleeing the cops.

Flood Zone

If a home is located within a **100-year flood zone**, there is the possibility of becoming a flood victim. When potential homebuyers or investors are made aware of this fact, they may decide to purchase a home that is not located within a flood zone.

"If the entire city is located within a flood zone, anyone who wants to live in that particular city will probably be required, usually by their lender, to obtain flood insurance."

Many lenders require **flood insurance** if a home is located within a **designated flood area.** Flood insurance will usually cover the house when it becomes flooded, however, it may not cover a tenant or homeowner's personal belongings. Renters or homeowner's insurance may be needed to take care of this problem.

If the entire city is located within a flood zone, anyone who wants to live in that particular city will probably be required, usually by their lender, to obtain flood insurance. If all the houses located in the city require flood insurance, then "everyone is in the same boat." Your client will not have to worry about tenants or future buyers buying another property within that city because it is not located within a flood zone. *All* the homes are located in a flood zone.

A prospective buyer may decide to buy a home located in an outlying suburban area that is not within a flood zone. If this is the case, the suburb is usually located a greater distance from work sources that usually lie within the city. For this reason, suburban homeowners generally have longer commute times to work sources than urban city dwellers. In other words, if a tenant or homeowner wants to avoid a flood zone that is located in a city, they will most likely have to pay for it through longer commute times. Rents and property prices will usually reflect these issues because tenants and homebuyers are usually pretty smart when it comes to the trade-off between location and commuting time.

The Story of Sacramento, CA

Most of the city of Sacramento is located within a 100-year flood zone, so literally everyone who purchases a home located in the city will probably need flood insurance. Property prices of homes located in the higher socio-economic neighborhoods within the city tend to be some of the highest per square foot costs in the area. Homes located in higher socio-economic suburban neighborhoods tend to cost less per square foot than those located in urban areas. This is generally because of the smaller sized homes and close proximity to job sources downtown.

Property sizes tend to be larger in the outlying suburbs and do not require flood insurance; however, the commute time to and from Sacramento can range from thirty minutes to one hour or more. Homeowners must decide whether a larger house located outside the flood zone is worth the extra time needed each day to commute to and from their job. Property values and rents tend to reflect this disparity as well.

Insurance Agents

An insurance agent can help determine whether a home is located within a flood zone, and if so, what the annual premium will be to insure the property. The agent can also help determine whether the home has had previous insurance claims against it. If this is the case, it may preclude a new homeowner from obtaining insurance for the property. Insurance agencies usually get extremely nervous if there was a water-related claim in the home during the previous five year period. The insurance agent can consult the **CLUE report** and determine if there will be a problem obtaining insurance for the home. It is a good idea to do this during the normal physical inspection contingency period prior to close or escrow.

Greenbelt

A **greenbelt** adjacent to a home can be a very desirable amenity because of the visual aesthetics tenants and homeowners enjoy when using the backyard. It may provide the home with a "woodsy" feel and builders like to charge lot premiums for lots located adjacent to a greenbelt. Unfortunately, burglars may have an easier time burglarizing this type of property because they can enter and exit the property through the greenbelt. For this reason, a good alarm system and a big dog are good ideas.

Undesirable Critters

A greenbelt may be a problem if snakes and other undesirable critters do not receive the memo that a new home has been built in *their* neighborhood. This may result in unwanted visits by the old-time "neighbors" during the first few years of a new home's existence. Field mice and other rodents will have direct access to the home through the greenbelt. A good "mouser" can be invaluable...as long as it does not drag any "prizes" into the home. On a more sober note, another homeowner found a large rattlesnake slithering around in the backyard. He was glad his small children didn't find the reptile before he did.

> *The Hungry Mountain Lion Story*
> One homeowner had a disturbance in his backyard and went to investigate. He found his Brittany Spaniel cowering in a corner of the yard with a large mountain lion sizing him up for a meal. This was in a suburban area and became a disclosure issue when the homeowner told all the neighbors about it.

Noise

A single-family home located in an area where loud noises affect the tranquility of tenants and homeowners can cause a loss in both rents and property values. The following are three specific examples of noise issues which include airports, busy roads, and traffic congestion near the home.

Airports

If a single-family home is located near a civilian or military airport, this can be a negative factor due to excessive noise levels. This will adversely affect rents and reduces the amount a prospective homebuyer will pay to purchase the home in the future.

Busy Roads

Proximity to freeways, toll roads, and other busy roads can be a traffic and noise problem. Car and truck traffic noise can be minimized through sound walls, speed bumps, stop signs, traffic lights, roundabouts, and speed limit signs. However, there may not be much a homeowner can do if their home is located near a freeway or truck route. The resulting noise may be minimized by installing a water fountain or water fall in an attempt to "drown out" the undesirable noises.

Traffic Congestion

If there is heavy traffic between the home and normal job sources, excessive commute times can make the home less desirable than other better-located properties. This in turn will probably cause reduced rents and cause a loss of value to the home.

The "Too Quiet" Neighbors Story

If the greenbelt next to a home turns out to be a cemetery, they may have the quietest neighbors ever experienced by a tenant or homeowner. Of course, these neighbors may actually devalue the home because of the proximity to the cemetery. Some homeowners do not like having a cemetery so close to their home because it reminds them of death. When these greenbelt homeowners say "the air is as still as death"…they really mean it.

Public Transportation

Proximity to rapid transit and light rail stations that regularly travel to and from a city's central business district can be a big positive factor for a single-family home. It usually decreases commute time and costs to and from local job sources. This proximity tends to drive demand for single-family homes upward causing higher rents and greater values when the property is sold in the future.

Proximity to bus stops going to and from local neighborhood shopping centers, regional malls, and the Central Business District can also be seen as a desirable amenity. Proximity for elderly people to medical facilities and casinos that are accessible by bus or cab is a definite plus. A tenant or homeowner never knows when the urge to pull a "one armed bandit" may hit them.

Schools

It is generally a good idea to use the internet to check school ratings in the area(s) where your client is considering buying a single-family rental property. Schools with the highest ratings seem to always be located within the zip codes that correlate to the most expensive homes in the area. Each state has different ways of measuring, or conveniently not measuring, school "effectiveness." Some states have tests that measure each school's ability to teach to their standardized test that is given each year. As a result, each school strives to teach to the test and, thereby increase their school's "ratings." The higher the school's test scores the "better" the school ranking. Even though this score may only measure a school's ability to teach to the test, it is usually a general indicator of a school's perception within the local community.

> "Schools with the highest ratings seem to always be located within the zip codes that correlate to the most expensive homes in the area."

Perception is many times reality when looking at home values, and especially resale home values. If the local residents consider a school or school district to be the "best," then it *is* the best. It does not matter whether the school actually is good or bad. Ask a few mothers with children where the "best" schools are located and that may be the place a real estate investor should buy during an upward-trending sellers' market.

Many tenants will pay higher rents to live in this type of **upscale neighborhood**, and owner-occupied buyers are usually willing to pay considerably more money than real estate investors to live there too. For these reasons, real estate investors may want to consider buying rental properties located in lower or middle socio-economic neighborhoods during a downward-trending buyers' market and collecting good cash flows during the holding period.

> "Perception is many times reality when looking at home values, and especially resale home values."

When the real estate market changes from a downward-trending buyers' market to an upward-trending sellers' market, this is the time to sell rental properties located in lower and middle socio-economic neighborhoods and exchange them into larger single-family homes located in higher socio-economic neighborhoods. Cash flow will be significantly reduced, however, price appreciation will usually be greatly enhanced.

School Overcrowding

School overcrowding may cause a reduction in property values and reduced rental amounts because children may not be able to attend the local public school system.

Older Public Schools

Older schools may not be wired for the most up-to-date internet connectivity and this may hinder full utilization of internet tools provided by present-day textbook publishers. Another reason is that the schools are old. Why place a child in an old school when, for the same money, a tenant or homeowner can place them in a new school with all the latest amenities available to teachers? The quality of the teachers may not be affected by the age of the school, however, socio-economics may affect teacher recruitment and retention.

Septic System

A home may utilize a **septic system** where solid wastes are collected in a tank usually located in the front or backyard of a home and then they are pumped out each time the tank fills up. Liquid waste products flow out of the tank and into **leach lines** or **dry wells** and filter back into the soil.

Prior to close of escrow, septic tanks are usually pumped out and inspected by a **professional septic inspector** to determine the condition of the septic tank, leach lines, and/or dry wells. Leach lines are usually approximately 100 feet in length and run horizontal about six feet beneath the surface of the ground. Dry wells usually run straight downward perpendicular to the earth's surface. Most houses have at least two leach lines or dry wells.

Septic tanks usually have one or two lids that may or may not be marked. A professional inspector will probably know where to look to find the lid(s). Sometimes, home plans or the county where the property is located may have a schematic showing where the lid(s) is/are located. After pumping out the septic tank, the inspector will usually place **yeast** in the tank to help the deterioration of solid waste material in the future.

The Story of the Fourteen Foot Leach Lines

A real estate investor purchased a single-family home that had a septic tank buried in the backyard. He had the tank inspected by a professional septic inspector, pumped out, and yeast placed in the tank to help break down the solid wastes.

About six months after the purchase, the tenant called to inform the real estate investor that the septic tank was full and needed to be pumped out. The investor called the septic tank company that had originally inspected the tank and asked them to find out what caused the tank to fill up. The investor found

The Story of the Fourteen Foot Leach Lines (continued)
that the two leach lines that ran under the surface of the ground and helped the grey water percolate back into the soil, were only 14 feet long! They were supposed to be at least 100 feet long. This was why the septic tank had filled up so quickly. The investor was forced to pay $5,000 to have the leach lines extended to their proper length.

This was a material fact the seller should have disclosed to the buyer. However, the 85 year old seller had built the house himself and only used it as a vacation home. The leach lines were designed for a vacation home and not full-time use. The good news is the real estate investor eventually sold the property at the end of his holding period for a nice profit.

Water

Water has always been a key issue in California. Many areas have instituted restrictions on water usage requiring mandatory cutbacks with designated water days and regulatory "water cops" to enforce the laws.

For example, canals presently bring water into Southern California from Northern California and the Colorado River Valley in Arizona; however, it is not enough to keep up with the large population in Southern California. As a result, Southern California has been desperately trying to find other water sources to supply their needs.

Public Water Service

Smart real estate investors like to build rental properties on vacant lots that are serviced by a **public water system**. Even though there are usually some steep **impact fees** that must be paid during hook up, it is generally less risky than drilling a well. Wells have the uncertainty of depth, cost, finding water, and the need of a **pressurized holding tank**.

Water meters measure water usage and bill the property accordingly. An un-metered public water service may be considered a positive factor, while water meters a negative one. As soon as a homeowner receives the water (meter) bill from watering a luxurious front yard during the month of August, this may trigger a decision to change the landscaping to a more “low maintenance desert-style motif.”

Wells

It is usually a good idea for rural single-family homes with a well located on them to have a **draw down test** performed during the **due diligence period** prior to close of escrow. A draw down test determines the number of gallons of water per minute the well is able to pump out of the ground. It is determined by pumping the well dry and then observing how long it takes for the water to replenish itself. If the well does not replenish itself fast enough, the homeowner may want to consider installing a pressurized storage tank on the well. If there is a loan being used to purchase the property, a pressurized tank may be a loan condition placed by the lender and must be completed prior to loan funding and close of escrow.

Potability Test

A **potability test** can be performed to make sure well water is suitable for drinking. The lender may require a buyer to obtain a sample of the well's water and place it in a small plastic bag, similar to a zip-lock sandwich bag. The owner will send it to a lab to look for harmful bacteria and other microorganisms existing in the water. A copy of the report is usually provided to the buyer and lender. If the well water contains any **dangerous microorganisms**, the lender will most likely not fund the loan until the water is made safe to drink. This type of due diligence on the lender's part may save the homebuyer from buying a home with a defective well.

There are many issues that affect the desirability and subsequent value of single-family neighborhoods. Accordingly, sometimes duplexes can act like single-family homes and allow the owner the flexibility of living in one side of the duplex and renting the other side to a tenant, or completely moving out of the property and renting both sides to tenants.

A Duplex Can Act Like a Single-Family Home

Flickr / NNECAPA

Figure 6.3 Duplex

A **duplex** is two attached units located on one lot. Your clients can live in one side and rent the other side to a tenant. A duplex has the benefit of less debt service because your clients can rent out the other side of the duplex, thus reducing monthly out-of-pocket expenses. Both sides of the duplex can also be used as a rental property in the future—if your clients move into a larger single-family home.

Occupy One Side and Rent the Other Side to a Tenant

Since your clients are occupying one side of the duplex, the good news is that they may be able to obtain **owner-occupied financing** for the entire property. This could allow a smaller down payment and higher loan-to-value ratio than they would have with non owner-occupied investment property financing.

Owner-occupied financing generally has a lower **interest rate** than non owner-occupied financing. Lenders generally perceive less risk from an owner-occupied homeowner defaulting on a loan than they do from an investor. Investors look at a property as an investment. Homeowners look at a property as their home. When things become financially difficult, a homeowner is more likely to keep making the loan payments on his or her own home. An investor on the other hand, can walk away from a bad investment without significantly affecting the family's lifestyle. Investors are typically more astute than homeowners and are more likely to use a strategic foreclosure as a means to end a bad investment. Conversely, homeowners will typically continue making loan payments to stay in their home.

With a lower interest rate and the other side of the duplex rented to a tenant, your clients will usually have a lower cost of housing than their counterparts who own traditional single-family homes. This can be a big help if cash is tight and every dollar of saved disposable income (income used to pay for basic living expenses) will convert into discretionary income (income used for other things such as entertainment, investment, etc.).

Tenant Proximity Issues

One of the negative factors associated with purchasing a duplex and living in one side, is the proximity of the tenant to your client's home. It is generally <u>not</u> a good idea to inform a tenant that the landlord is living right next door. This is really difficult if your clients are managing the property themselves. If the tenant is aware that the landlord lives next door, he or she may receive a large number of "toilet calls" during the middle of the night. Also, if your clients get into a dispute with their next door tenant, the tenant will know where to throw the rotten eggs.

> "It is generally <u>not</u> a good idea to inform a tenant that the landlord is living right next door."

The Story of Gus
Renting to "partiers" who are active during the nighttime hours is a potential nuisance problem. Gus ran into this situation with a duplex he owned. He lived in one side and rented the other side to a tenant. After asking his tenant to quiet down on several occasions, Gus decided to call the police. The police showed up and told the noisy tenant to quiet down. The next door tenant became rather upset and started calling in bogus "toilet calls" to penalize Gus for "calling the cops."

P.O. Box
If your client personally manages the property, one solution is use a P.O. Box as their contact address. Have the tenant mail rent checks to the P.O. Box and not hand-deliver it to the home. This may insulate your client from potential problems caused by having a tenant living next door.

Tenants who do not have a Checking Account
Many tenants who live in lower socio-economic areas do not have checking accounts and routinely pay their rent in cash. Your clients will have to make a decision how to handle this type of situation. Of course, a careful screening of tenants may help alleviate problems like this before they start.

Separate Cellular Telephone Number
A separate cellular telephone number can be used as a primary contact number. They are easily cancelled, especially if the cell phone is used exclusively for tenant calls. Definitely, do not give the tenant a home telephone number and do not call the tenant on a home telephone, because many people have caller ID capabilities and can obtain a home telephone number by this means. It is generally best to limit tenant accessibility, so email, a cell phone, and/or voice mail tends to do the job fairly well.

Risk of Fire
The risk of fire becomes apparent when tenants are living next door and there is only one common wall to separate the two living spaces. As with condominiums, a good smoke detector is definitely needed in every room on both sides of the duplex. A carbon monoxide detector installed in each side of the duplex is generally a good idea as well. Of course, both smoke detectors and carbon monoxide detectors are a good idea for <u>all</u> residential properties.

The Story of William

William had a fairly high-end tenant named Max who asked William to include him as a friend on Facebook. William did not mix business with his personal life and refused to do so. Max shortly thereafter called in a "problem" with the electrical system that eventually cost William $400 to repair. It looked pretty suspicious to William. He believed that Max was penalizing him for not including him as a "friend" on Facebook. Max's family later caused recurring problems to the property, so William gave Max notice to leave.

It is generally a bad idea for an investor or property manager to get too friendly with their tenants. Friendship can get in the way of business. Accordingly, it is almost always a bad idea renting to friends and family.

Tenants' "friends of friends" can also be a real problem. They may steal things and vandalize a property without the tenants being aware of it. A landlord should consider this situation before selecting a tenant as their next door neighbor. A little old lady may be more desirable than three "party-animal college students" with more money than brains.

Month-To-Month Lease vs. Long-Term Lease

Sometimes a month-to-month periodic tenancy can be more favorable than a long-term lease. This is especially true during an upward-trending sellers' market where the owner wants to be able to move quickly and sell the duplex at or near the top of the real estate market. This is generally true if an owner-occupied buyer is willing to pay top dollar to buy the duplex and live in one side, while renting the other side to a tenant.

Longer-term leases generally work well during a downward-trending buyers' market where the landlord does not intend to sell the duplex until well into the future. Tenants are looking for stability, especially with many homes being foreclosed around them. So a long-term lease can be a win-win for both parties.

> "Longer-term leases generally work well during a downward-trending buyers' market where the landlord does not intend to sell the duplex until well into the future."

After an owner lives in their duplex for a while, they may decide to buy a single-family home near the bottom of the next downward-trending buyers' market. They may be able to rent the entire duplex (both sides) at a positive cash flow, receive **depreciation** on the improved portion of the duplex—this is usually around 75 - 80% of the purchase price divided evenly over 27.5 years— and then move into their new single-family home. Of course, always advise your clients to see a **Certified Public Accountant** (CPA) and attorney prior to any investment endeavor.

Sometimes two single people, who each own their own single-family home, will decide to get married and move into a newly purchased home. They both may not be able to rent each of their homes to tenants at a positive cash flow, so they may decide to sell both of the homes and purchase a larger one. The costs and real estate sales commissions for both properties can be significant. In addition, they may not have timed their marriage commitment with the local real estate market. Doesn't everyone time their marriage around real estate markets?

For these reasons, if they had purchased a duplex when they were single, they could rent the entire duplex to a tenant and use it as an income property. Both newlyweds would own a nice single-family home *and* a duplex rental property. If both people owned duplexes, they would own two income properties, along with their new home.

Let's see...buy a duplex...find a spouse who owns a duplex...get married at the start of an upward-trending sellers' market…hit the lottery... Yeah, that's really going to happen.

Investment Strategy and Financing

Your clients must look at their investment strategy. How long are they going to hold the duplex? If they are going to keep it for a long period of time, do they get a conservative 30 year or 15 year amortized fixed-rate loan. Can they obtain a break-even cash flow with the higher payment that results from a 15 year loan payment schedule, rather than paying it off over 30 years? Or do they want a huge cash flow now and intend to sell the property before the market heads back downward? Should your clients consider an adjustable rate loan that has a low initial interest rate and sell the duplex before interest rates go up in the future?

Duplexes are generally surrounded by three interesting dynamics:

1. When single-family sales market prices increase, some "would be" single-family buyers opt to purchase duplexes—so duplexes may track the single-family market (rather than real estate investment market) and usually increases during an upward-trending sellers' market.

2. Single-family homes are generally impacted by the supply and demand of single-family homes, prevailing wages in the local area, unemployment, and loan interest rates/loan underwriting guidelines. Conversely, larger residential income properties tend to track the financial markets, which mainly include treasuries, certificates of deposit, money markets, stocks, bonds, and precious metals. Investors look at the risk-return tradeoff for all investment markets and select an investment vehicle that provides the highest return with the least perceived amount of risk. Duplexes are unique in that they can be used as owner-occupied, a rental property, or both at the same time. This allows the duplex owner to rent the property with a good cash flow, and sell it as an owner-occupied property at the end of the holding period—thus providing a greater overall return to the investor.
3. When a duplex owner decides to sell at or near the top of a single-family sales market, he may be able to obtain "top dollar" for the property and, similar to single-family homes, NOT have to rehab it at all. Near the top-of-the-market, un-rehabbed properties many times sell near the price of rehabbed properties. This is due to intense competition from buyers in the owner-occupied housing market.

At the top of an upward-trending sellers' market, owner-occupied buyers generally will pay a higher price for a duplex than investors. Appraisers are usually caught up in the "rocket to the moon" syndrome happening during a hot real estate market and appraise the duplex at a higher level than its true worth as a rental property. If this happens, your client may be able to buy the duplex during a downward trending buyers' market, rent it out, ride the next single-family upward-trending sellers' market to the top, and then sell the duplex to an owner-occupied buyer at prices close to single-family home appreciation levels.

Single-family homes can be a solid investment vehicle if bought at the right price and in the right location. Good deals can many times be found during a downward-trending buyers' market through distressed property sales, such as short sales and trustee's sales.

7

DISTRESSED PROPERTIES: SHORT SALES AND TRUSTEE'S SALE

"Wherever I go, people are waving at me. Maybe someday they'll use all their fingers." -Unknown Lender

As we move through a downward-trending buyers' market, more and more single-family homes tend to become "underwater." The loan amount is greater than the value of the property and many homeowners decide to stop making their scheduled loan payments. Homeowners may try to either refinance their loan(s) with another loan that has more favorable terms or, if they do not have enough equity to qualify for a loan refinance—due to their loan-to-value ratio being too high—they may be forced to look at other options. Let's take a look at some of a homeowner's options.

Homeowner Options with Equity

1. Do Nothing

The homeowner makes the loan payments, no matter how difficult, and sticks it out until the real estate market comes back around and equity returns to the property. The homeowner needs a home to live in, and as long as the payments continue to be affordable—who cares how much the home has declined in value? Time usually heals, so the homeowner will wait the real estate market out.

2. Refinance the Loan

This may be a problem if the property is underwater. Which is generally the case during a downward-trending buyers' market, especially where new homes have recently been built in the area. Builders tend to over-price and over-supply the market, thus causing a severe future correction during a downward-trending buyers' market.

3. Sell the Home with Equity (Normal Sale)

If the property has equity, a normal sale may be possible with no damage to the homeowner's credit rating. Unfortunately, during a downward-trending buyers' market many homes are underwater and a homeowner may be required to pay the difference between the sale price and the loan amount to be allowed to complete a normal sale. For this reason, most transactions during a downward-trending buyers' market involve homes that are without equity—which include short sales, trustee's sales, and lender-owned Real Estate Owned or REOs.

> "If the property has equity, a normal sale may be possible with no damage to the homeowner's credit rating."

Homeowner Options without Equity

1. Loan Modification

The homeowner can attempt to obtain a **loan modification** from the existing lender, including terms that are acceptable to both parties. The loan modification must be a win-win situation for both parties, otherwise the lender will most likely have to foreclose on the property in the future.

> Loan modifications can reduce the interest rate, principal balance of the loan, or both. Lenders generally look at a proprietary net present value formula and if they are in a better future financial position after modifying the loan, they may go ahead and modify it. Otherwise, they will let the home go into foreclosure.

Homes with first and second loans are extremely difficult to modify because the owner must get both lenders to agree to the terms of the loan modification. Each lender usually desires the other one to take the loss. If both loans are with the same lender, the homeowner may have a better chance of modifying the loan.

2. Sell the Home without Equity (Short Sale)

If the loan amount is greater than the value of the home, then the seller's lender(s) may voluntarily forgive part of the debt. This is called a "**Short Sale**" and generally requires several months to complete. A homeowner's credit rating will usually be detrimentally affected by either a **trustee's sale** (foreclosure) or a **short sale.**

When purchasing short sales, it is generally a long and drawn out process that may take several months, and then may not go through at all. There is nothing "short" about it. These properties are not as deliverable as REOs, and for this reason, investors can sometimes get a "screaming deal" buying them.

Real estate investors usually understand the situation and may go after REOs instead of short sales. This is because REOs may be closed within 30-60 days—depending upon the speed escrow and title can get the documents together and research the title to the property.

3. Lender Accepts a Deed in Lieu of Foreclosure

A lender may allow a borrower to deed the property directly to them. This is especially true when there is only one loan on the property. If there are any junior (2^{nd} deeds of trust are the most common) loans on the property, then the primary (1^{st} trust deed) lender will usually be responsible for any junior loan(s) if they accept a deed in lieu of foreclosure. For this reason, if there is more than one loan on the property, most lenders will move forward and foreclose on the 1^{st} loan, thus either wiping out any junior loans on the property or forcing the lender of the junior loan to assume the 1^{st} loan, pay all arrearages (back interest), and hold onto it until the real estate market comes back around—thus disposing of the asset near the top of the next upward-trending sellers' market.

4. Lender Accepts a Deed in Lieu of Foreclosure with Rent Back Provision and Equity Participation Agreement

Lenders may allow a homeowner to deed the property over to them and then rent the property back at below-market rental rates. At a designated time in the future, the property will be sold or refinanced and the lender will receive their money back and split the profits with the former owner, who is now the tenant.

Prior to the subprime crisis, lenders were not allowed to speculate with their foreclosed and deed in lieu of foreclosure properties. There were laws in place that forced them to sell the asset within a year or so. However, in response to the Subprime Crisis that started in 2008, "too big to fail" lenders were bailed out by the federal government and apparently were able to keep their foreclosed REO properties longer than was required in the past.

If lenders implement an equity participation program, there will be fewer foreclosed properties coming onto the market for real estate investors to purchase. In addition, the equity participation tenants who are renting the properties from the lenders would normally become a tenant for normal real estate investors. This will reduce the demand for single-family home rentals in an area and possibly reduce rents as well. With fewer single-family REO properties coming on the market, prices of homes may artificially increase due to supply and demand.

5. Bankruptcy

Chapter 7 liquidation and **Chapter 13 restructuring bankruptcy filings** may be used to temporarily stop the foreclosure of a home. However, when the borrower comes out of foreclosure, or if the bankruptcy trustee decides to move them out, they will generally go back to the status they were at prior to filing for bankruptcy protection. The lender(s) may ask the federal bankruptcy court for a "Request for Relief from Stay" to effectively remove the home from bankruptcy protection and allow the lender(s) to foreclose.

During a downward-trending buyers' market, homeowners may file Chapter 13 restructuring bankruptcies and strip-off or **cram down** 2nd deeds of trust and mortgages from their property, especially Home Equity Lines of Credit (HELOCs). It is always best to see a bankruptcy attorney for details regarding this option.

The Story of the Creative Bankruptcy Debtors

Some bankruptcy debtors have been very creative over the years. One debtor caused his kitty litter box to overflow and really stink up the house. The bankruptcy trustee called him and told him to "clean up" his act.

Another debtor informed the bankruptcy trustee that his home was worth $200,000 and provided sales comparables on the same street where his home was located. When the real estate broker ran the sales comparables, she found that the property was actually worth approximately $350,000. She listed the property for this price and shortly afterward sold it for full list price. The street where the property was located ran through a very high-end neighborhood on one end and into a fairly low-end neighborhood on the other. Depending upon which end of the street a person lived, the same size home could be worth anywhere from $200,000 to $350,000. The debtor obviously knew this and was trying to pull one over on the bankruptcy court. The real estate broker was instrumental in bringing an additional $150,000 to the estate and pay back the creditors.

6. Sue the Lender(s)

Many attorneys have litigated lenders for predatory lending, **Truth-In-Lending** violations, and mistakes in the mechanics of the foreclosure process. Lenders used the **Mortgage Electronic Registration System** (MERS) to assign loans from one entity to another. Since promissory notes and deeds of trust/mortgages are usually required to be recorded in the county where the property is located, the legality and legitimacy of many of these MERS loan documents have come into question. Many loans were not signed by the correct people at MERS and many loan documents were mysteriously "lost," so lenders could not provide promissory notes, deeds of trust, mortgages, good faith estimates, and other important documentation.

These lawsuits are generally filed when the lender is not willing to modify the loan, yet may be liable for compensatory and possibly punitive damages because of their actions while originating and/or foreclosing the loan. Since most homeowners have already stopped making their loan payments by the time they file the lawsuit, the attorney filing the suit may charge approximately ½ of the homeowner's normal loan payment as a retainer to file the lawsuit. Attorneys usually have a base amount they require each month. One attorney charged ½ of the homeowner's loan payment, with a $950 per month minimum retainer. The homeowner can usually afford ½ of the loan payment, rather than the exorbitantly high re-casted and re-adjusted loan payment they were required to pay to the lender. This is one way an attorney can be paid to file and proceed with a lawsuit. Unfortunately, many of these cases resulted in rulings in favor of the lenders, not the borrowers. So, a lot of money was wasted on legal fees.

"Since promissory notes and deeds of trust/mortgages are usually required to be recorded in the county where the property is located, the legality and legitimacy of many of these MERS loan documents have come into question."


Flickr / Chris Potter

DEFECTIVE TRANSFER: ROBO-SIGNER

Mendoza v. JP Morgan Chase Bank (2014)

California Court of Appeal, Third Appellate District, filed 7/22/14

Can a borrower set aside a completed foreclosure sale because of problems in the assignment of the promissory note and deed of trust? This includes a signature on the transfer documents by a robo-signer.


Flickr / Chris Potter

DEFECTIVE TRANSFER (*continued*)

Mendoza v. JP Morgan Chase Bank (2014)

Juan and Maria Mendoza borrowed $540,600 from Chase Bank in November 2007. On March 7, 2011, the assignee of the trustee under the deed of trust, California Reconveyance Company, recorded a Notice of Default. Once the foreclosure was completed, a trustee's deed was recorded on July 5, 2011.

Colleen Irby signed the substitution of trustee but the Mendoza's claim she had no authority to sign the document since she worked for California Reconveyance Company and not Chase Bank.

The Mendoza's brought suit alleging the transfer of a promissory note and deed of trust from one lender to another through a robo-signer is a defective transfer.

The appellate court held that an illegal transfer of the promissory note and deed of trust had no effect on the Mendoza's losing their property. Their property was lost by their own loan default.

7. Foreclosure: Trustee's Sale with Property Sold to a Real Estate Investor
This is through either a judicial or non-judicial foreclosure. **Non-judicial foreclosure** through a trustee's sale is generally used in California, and other states that use deeds of trust, as the primary security device for real estate loans. A deed of trust, however, can be foreclosed non-judicially through a trustee's sale, or judicially through the courts.

Trustee's Sale Foreclosure
An involuntary foreclosure in California usually has the lender foreclosing through a trustee's sale. This is generally a non-judicial foreclosure which is not through the courts. The beneficiary (lender) usually bids the amount of money they have out on the property. This is usually the loan amount plus costs of the trustee's sale and arrearages (back interest that is due). Real estate investors then bid above the loan amount—if the property is valued more than the loan. Sometimes the lender places the starting bid well below the loan amount. If this occurs, the lender has made the decision to sell the property and take the loss in value at the trustee's sale.

If the property is underwater, real estate investors will usually not bid above the current market value at the trustee's sale. When this occurs, the property will usually be sold to the lender for the loan amount and other costs and expenses they have incurred during the foreclosure process. The property will usually be placed in the lender's REO portfolio and sold as an REO property.

There are two problems with buying directly from a trustee at a trustee's sale:
(1) Investigation of the existing encumbrances on the property, and
(2) Obtaining a policy of title insurance.

Encumbrances are categorized as either money encumbrances (liens) or non-money encumbrances that limit the use of real property. About 20% of the time, real estate investors who purchase distressed properties at a trustee's sale find one or more undisclosed encumbrances remaining on a foreclosed property.

If an investor has a good relationship with a title insurance company, they may be able to get them to research the title prior to purchase. This may be in the form of a preliminary title report, or as a "binder" from the title insurance company to provide a title insurance policy after a trustee's sale purchase.

"Encumbrances are categorized as either money encumbrances (liens) or non-money encumbrances that limit the use of a property."

Real estate investors may want to perform their due diligence by researching online databases, microfiche, and other non-electronic records located at the county recorder's office. In addition, the real estate investor will most likely buy the property <u>without</u> title insurance. Thus, an unknown title issue could raise its ugly head and devalue the property in the future.

It is difficult to obtain a preliminary title report for trustee sale properties. A preliminary title report is an offer from a title insurance company to issue a policy of title insurance. This is a laundry list of items relating to the recorded title to the property. Since the title company may have no intention of providing a title insurance policy for the property, the real estate investor may have a difficult time obtaining a preliminary title report for trustee's sale properties.

Experienced real estate investors, who regularly purchase properties at trustee's sales, like to say: "If you can pay all cash for the property, bull doze it to the ground, and it doesn't change your lifestyle, then you should consider buying distressed properties at trustee's sales." If not, then why take the chance? Why not buy the property *after* the lender has taken the loss at the trustee's sale—and you receive a title insurance policy as well?

Judicial Foreclosure

Most **judicial foreclosures** occur in states where a mortgage is used as the primary security device. Approximately 38 states use mortgages, and the balance of the states use deeds of trust, except Louisiana—they use a Napoleonic Code document that no one really understands. Be sure your clients see an attorney for a full explanation of foreclosure procedures and possible anti-deficiency laws applying to a particular situation. When in New Orleans, however, don't be surprised if they may have a palm reader as part of the team too.

"Most judicial foreclosures occur in states where a mortgage is used as the primary security device."

8. Foreclosure: Trustee's Sale with Property Sold to the Lender

When a property is sold at a trustee's sale and no investors bid more than the lender's initial bid, which may be the loan amount plus costs and fees, then the lender will "win" the bid and acquire the property as collateral for the real estate loan that was initially made to the borrower who originally purchased the property. Lender acquired properties are usually moved into their "Real Estate Owned" or REO property portfolio.

During the downward-trending buyers' market that occurred in the 1990s, lenders were required by law to sell their REO properties within a prescribed period of time. The reason was because lenders were supposed to be lenders—not real estate investors. In sharp contrast, the downward-trending buyers' market that began in California in 2006-7, and later in other parts of the U.S., the "too big to fail" lenders seemed to be able to keep their REO properties as long as they desired—and without legal repercussions.

As the real estate market moves into a downward-trending buyers' market, properties will become upside down or underwater. Both of these terms simply mean the property loan is greater than the value of the single-family home. When this occurs, borrowers will become discouraged and want to get out of their bad investment. Three things usually happen: pre-foreclosure (short sale), foreclosure (trustee's sale), and post-foreclosure (real estate owned or REO).

Pre-Foreclosure: Short Sale

When the loan balance is greater than the value of the home, the borrower may ask the lender to voluntarily take a loss. This is called a pre-foreclosure or short sale. The owner usually finds a buyer who is willing to buy the property at or within 10% of the property's market value. The borrower then asks the existing lender(s) to voluntarily take the loss now rather than in the future. If the lender(s) wait until the trustee's sale, especially during a downward-trending buyers' market, the loss may be significantly more than if they had sold it as a short sale. In other words, take the loss now rather than later and save some money in the process.

"When the loan balance is greater than the value of the home, the borrower may ask the lender to voluntarily take a loss. This is called a pre-foreclosure or short sale."

Pricing of **short sales** is usually accomplished when the real estate listing agent comes up with a price she thinks will move the property. If the price is considerably below the present actual market value of the home, the bank may not accept it and the short sale may not go through.

With REOs, the bank usually has already considered the price and has made a decision to sell the property at that price. Conversely, with short sales the lender has not made a decision on the price they will accept for the property. Deliverability of short sales comes into question at this point.

Investing in short sales generally takes several months to complete and can be quite tedious dealing with uncooperative lender(s) and an anxious seller. The seller's lender generally informs the real estate broker of the amount they will accept for the property.

A general time line for the process is as follows:

- 7-10 days after sending the short sale package to the lender, the lender will acknowledge receipt of the package.
- 30-45 days after submitting the short sale package, the lender will perform a Brokers Price Opinion (BPO).
- 2-3 weeks after the BPO is completed, the lender will review and approve or disapprove the terms of the short sale. If the loan was previously sold to an institutional investor, the investor must approve the terms of the short sale, as they are usually motivated to recoup as much money as possible.

- Approval of the short sale may be name specific to one buyer or a general approval that can be used by anyone. As lenders move through a downward-trending buyers' market, they generally become more efficient in handling short sales and more of their approvals tend to become non-name specific and can be sold to anyone. A real estate investor may be able to obtain a good deal if he or she can close fairly quickly on an "approved" short sale.

If there is more than one loan existing on the property, the short sale may not go through at all. This is especially true if the lender on the second loan (e.g., junior lien holder) is different from the lender on the first loan. The **junior lien holder** may <u>not</u> be willing to accept a small amount of money to voluntarily release the loan and complete the short sale.

Of course, the lender on the second loan may receive nothing if the property goes into foreclosure. It becomes a negotiation among all of the parties involved. That is why a good short sale negotiator is worth their weight in gold during the short sale process.

Some advantages to the homeowner/seller regarding a short sale are:

1. Seller is in control during the short sale process.
2. There may not be a "foreclosure" on the seller's credit report when a short sale is used. Foreclosures must be disclosed on future employment and loan applications, short sales may be able to escape this requirement.
3. The seller may not be required to be late on loan payments; however, many lenders require the seller to be delinquent or at least have a "hardship" prior to allowing a short sale. This can generally be:
   a. Property underwater
   b. Adjustable Rate Loan (ARM) adjustment
   c. Unexpected major home maintenance expenses (sewer line breaks, etc.)
   d. Unemployment/Loss of second income
   e. Job demotion/Pay cut
   f. Death/Death in the family
   g. Divorce
   h. Illness/Medical emergency
   i. Excessive debt obligations/Bankruptcy (Chapter 7 liquidation or Chapter 13 restructuring)

In short, a hardship could cause a 30% or more drop in the seller's FICO (Fair Isaac and Company) score. The seller may not be able to purchase another home for at least 3 to 5 years into the future. This time requirement tends to change over time, so a seller should consult a lender to determine loan underwriting guidelines for conventional and FHA loans at the time.

Short Sale Mistakes

Some short sale mistakes include:

1. Home is priced incorrectly
    - Listing agent prices property through a “pie in the sky” pricing program, instead of using solid sales comparables and performing a comparative market analysis. Lenders will generally require a BPO performed by a broker to see what the home is really worth. Lenders will generally allow the real estate broker to sell the home for up to 10% below list price, but probably not much more than that. They want to obtain the most amount of money from the sale in light of the fastest market time.
2. Inexperienced listing agent
    - The listing agent does not understand the short sale process, how to negotiate with lenders, and how to close these fairly complicated transactions. They are much more complicated than a regular single-family home transaction; however, not nearly as difficult as most large commercial real estate deals.
3. Showing restrictions
    - Anytime the seller limits when a home can be shown to potential buyers, she invariably increases the days on the market and reduces the final sale price. There is a direct correlation between showing restrictions and price.
        - Savvy real estate investors look for short sale properties that limit availability for showings. This fact, plus 60 days or more on-the-market may indicate a good deal.
        - The lender must approve the sale price. Accordingly, 60 days or more on the market may convince the lender that the real estate investor’s offer is a good one and he or she can get a good deal on a plumb property. The same thing may happen with REOs as well.
4. No photos of the Property
    - Similar to showing restrictions, having no photos of a property will lose a significant number of buyers who may have been interested in the home had they seen some pictures. Real estate investors may not want to take the time to drive by a property, especially when curb appeal is so important to the purchase decision. If a property has poor curb appeal, investors may not be interested in buying it—unless it’s a fire sale—then it could look like an old dog house and investors would be interested in buying it. Everything has its price.

- Real estate investors may become suspicious when the listing agent is not willing to upload pictures of the property. The property may have issues that the agent does not want to reveal to potential buyers until they see the entire property. The agent may be smart to take some nice digital pictures and upload them when the listing is entered into the multiple listing service (MLS). This is usually the best way to obtain the highest possible purchase price during the shortest possible marketing time.

5. Poor property condition
   - Many times short sales and REOs are in poor physical condition. This can significantly reduce their value.
6. Seller does not provide the listing agent/short sale negotiator with financial information, nor a hardship letter.
   - Sometimes sellers do not provide a short sale negotiator with the tools needed to handle the short sale. The lender may require a hardship letter, as well as a seller's financial information before making a decision to sell the property.
     - One theory is that the lender is checking tax returns against represented items in the original loan application. Lenders have been hard-pressed to go after the discrepancies because of the amount of regulation, fines, and lawsuits that have come their way as a result of their past lending practices.
     - Another theory is that lenders sold loans directly to investors using a dubiously legal assignment process called "Robosigning." Many of the lenders did not have copies of any of the loan documents that were signed by the borrower(s) and may have been trying to patch their files together.

Reasons a Lender Rejects a Short Sale

1. Price is too low. Again, banks aren't stupid.
2. Short sale package is incomplete. All the documents are not in the package. The lender will ask for more and more information and the process could go on for a long time.
3. Seller does not qualify for a short sale. What are the alternatives? Foreclosure? Bankruptcy? Lenders usually end up losing more money when the property is *finally* foreclosed in the future.
4. Buyer does not qualify for the new loan. This is especially true as a downward-trending buyers' market continues downward. The short sale process may take several months to complete and the property may be worth significantly less than the original contract price entered into several months earlier. If the property appraisal is less than the new lower sale price, then the deal will not go through.

Since Jan 1, 2011 lenders cannot require sellers to sign a promissory note for the difference between the loan balance and sale price of the short sale. In the past, many lenders asked the seller to sign a promissory note to pay back the loss in the future. This was many times slipped into the short sale documents at the last minute, just prior to close of escrow. The lender was trying to move its non-performing assets from secured to unsecured on their balance sheet.

This was a good way for the lenders to "hide" the fact that they were in trouble. Also, they could come back in the future, when the homeowner buys another home that has equity in it, and ask for their money. Many real estate experts were warning sellers not to sign these dubious promissory notes.

Also since January 1, 2011 the law in California for short sales reads: "Unless otherwise exempt, no judgment shall be rendered for a deficiency for a first trust deed lender of one-to-four residential units if the borrower sells for less than the amount owed with the lender's written consent." When the lender signs for the short sale, this is supposed to be written consent. However, there has been some contention regarding what *really is* written consent. Home equity lines of credit (HELOCs) and 2nd loans are generally <u>not</u> covered by many of these laws. So lenders may try to collect on them, especially the HELOCs. It might be a good idea to always have an attorney review all short sale documents prior to signing them.

As mentioned earlier, lenders have asked homeowners to provide them with a large amount of personal financial information prior to allowing a short sale. It has come out that many of these lenders purchased these loans and did not have copies of the promissory notes, deeds of trust/mortgages, or loan applications.

This was a way for the lenders to obtain this information from the sellers. Why does the lender need two years tax returns to determine whether a borrower can qualify for a loan modification or short sale? A current pay stub should be enough to determine whether the seller qualifies for the short sale. Their credit is probably already trashed, so what is the point?

Some brokers started providing above-market BPOs so they could get the REO listing from the lender. Of course, lenders discovered this ploy rather quickly when the REO properties eventually sold for less than was expected. If the lender had received a better BPO, they might have been better able to recoup more money by selling it as a short sale several months earlier.

Of course, this does not take into account all the incentives that the government was paying lenders to reimburse them for their foreclosure costs. With these government subsidies, it might have been more lucrative for the lender to foreclose, rather than accept a short sale.

The Story of Gas Pipes Being Used for Water Lines
One short sale seller conveniently forgot to mention that a car had crashed through the front wall of his house and came to rest inside his living room. Even worse, the seller pocketed the insurance money and replaced the damaged water pipes with gas pipes! No kidding. The next big freeze caused the pipes to break and water flowed into the home. The seller then tried to pocket the insurance check this time around too!

Foreclosure: Trustee's Sale

The following is a general foreclosure time line for deeds of trust in California:

1. Trustor (borrower) stops making loan payments.
2. Beneficiary (lender) uses the acceleration clause in the deed of trust to call the entire loan balance immediately due and payable.
3. If the loan is not paid current, then the trustee (a third party who sits between the trustor and beneficiary, allowing a non-judicial foreclosure which is not through the courts) is instructed to record a Notice of Default (NOD). This lets everyone know the property is on the way to foreclosure.
4. The beneficiary and trustee must wait 3 months, all the while hoping the borrower will pay the loan current.
5. If the loan default is not paid current, the trustee records a notice of trustee's sale in a newspaper of general circulation once each week for three weeks.
6. Up to five days before the trustee's sale, the trustor may be able to reinstate the loan by paying all the arrearages and costs incurred by the lender.
7. The trustee sells the property on the court steps through a Trustee's Sale. Again, this is a non judicial foreclosure—*not* through the courts.

California Foreclosure Laws

According to California foreclosure laws, once the trustee records the **Notice of Default**, the following time line begins. Within 10 business days a copy of the recorded Notice of Default is sent by certified and regular mail to the borrower(s). Within 30 days a copy of the Notice of Default is sent certified and regular mail to all the beneficiaries for the loan(s) on the property. This includes any junior lien holders. A Trustee's Sale Guarantee Report is ordered from the title company. This provides all title information to the lender. All parties then wait 60 days to allow the borrower time to pay all of the loan interest that is due, plus all the back interest/arrearages. If he or she does this, then the time line goes right back to the start and if the borrower falls behind again, the lender must start the whole foreclosure process over again.

At the end of the 60 day period (90 days total), if the borrower has not paid the loan up to a current basis, then the trustee—by direction of the lender—publishes a **Notice of Trustee's Sale** in a newspaper of general circulation in the city where the property is located. The Notice of Trustee's Sale is published once each week for three weeks. The actual Trustee's Sale is calculated by adding 20 days to the date that the Notice of Trustee's Sale was first published. In addition, the Notice of Trustee's Sale is also posted on the property and in a public place (e.g., county courthouse bulletin board).

After all publication requirements have been met, the property can be sold to the highest bidder for cash totaling the full amount of the debt—plus foreclosure fees and other expenses associated with the sale. The winning bidder receives a **Trustee's Deed Upon Sale**, which is a form of grant deed that is recorded in the county where the property is located.

The seller/lender has the right to require every bidder to show evidence of their ability to pay the full purchase price. This can be by cash, cashier's check, or certain bank checks. Each bid to purchase a foreclosed property at a Trustee's Sale is an irrevocable offer to purchase the property. Each higher bid cancels the previous lower bid. It is unlawful, and a bidder could receive a fine of up to $10,000 and one year in prison, to offer anyone consideration to refrain from bidding or restrain the bidding process in any manner. Lastly, borrowers have a right to reinstate the loan up to five days prior to the Trustee's Sale. This is usually accomplished by paying all the interest and arrearages that are due, thus bringing the loan current.

"After all publication requirements have been met, the property can be sold to the highest bidder for cash totaling the full amount of the debt—plus foreclosure fees and other expenses associated with the sale."

If there are no bidders at the Trustee's Sale, then the property automatically reverts back to the beneficiary (lender) for the debt. A Trustee's Deed Upon Sale is recorded in the county where the property is located. This actually transfers title from the borrower to the lender. This lender originally loaned the money to the borrower to either purchase the property or refinance an existing loan on the property. It also allows the lender to market the property in order to recover the debt.

Trustee's Sales usually take place on the court steps between 9am and 5pm on any business day Monday through Friday. Junior lien holders may try to protect themselves by either: (1) advancing funds to bring the senior loan payments current, then foreclosing for the sums advanced—because they are in second position behind the senior loan; (2) bidding at the foreclosure sale so the price will be sufficient to pay off the senior and junior liens (i.e.,, pay both lenders back); or (3) acquire the property by bidding at the trustee's sale.

Judicial vs. Non-Judicial Foreclosure

Another legal concern is the difference between a judicial and non-judicial foreclosure. In California, lenders may be able to foreclose a deed of trust through the courts—instead of through a trustee's sale—and go after a deficiency judgment (the difference between the loan amount and the value of the property) from the trustor (borrower). There are several anti-deficiency laws in California that are intended to protect purchase money owner-occupied homeowners. A purchase money loan is a loan that was instituted when the home was purchased and is not a refinance. In any case, homeowners generally have greater protection against deficiency judgments than do real estate investors. As always, your clients should see an attorney prior to any real estate investment endeavor.

Tax Implications

Borrowers have historically received a 1099 for the amount of debt forgiveness, which was the difference between the fair market value of the foreclosed property at a trustee's sale and the loan amount. Usually the trustor was in a downward spiral, so why not kick him some more on the way down? These laws were enacted to keep people from refinancing their home by pulling money out through a "cash out refinance," and then walking away with the money.

Recently, some laws have been enacted to eliminate this tax because of the predatory nature of the loans made by lenders between 2001 and 2006. This debt forgiveness tax may come back in the future, so make sure your clients see a CPA prior to any tax planning or investment endeavor.

Home Equity Lines of Credit (HELOC) Foreclosures

Home Equity Lines of Credit (HELOCs) were many times used by portfolio lenders (lenders who loaned out their own depositors' money) to make junior home loans. These junior loans were usually in second position behind a 1st loan if there was a foreclosure. .

A deed of trust is a lien against a specific property, conversely a HELOC is usually personally guaranteed by the borrower. For this reason, HELOCs have been difficult to eliminate through foreclosure. Lenders knew this when they made the HELOC loans in the first place. When the real estate market inevitably tanked, they knew they would have a better chance of collecting their money in the future if the borrower was personally liable for the loan. If they had used a 2nd deed of trust instead of a HELOC, the borrower may have been able to eliminate this loan through a trustee's sale foreclosure.

With the lenders using HELOCs instead of 2nd deeds of trust, it tends to point to the fact that they knew the market was going to head downward, even when they were making 100% LTV option ARM loans to people who couldn't afford a cell phone. This is probably the basis for the bankruptcy court allowing debtors to strip off HELOC loans during the Chapter 13 (restructuring) bankruptcy process.

Bankruptcy attorneys have found a way to strip off HELOCs for the benefit of the debtors. Sometimes this is called a "cram down" where the bankruptcy attorney attempts to reduce the debtor's real estate loans on his home. At the same time, the bankruptcy court is required to maximize the amount of proceeds to the estate (creditors). This has mostly been seen in Chapter 13 restructuring cases. Have your clients see a bankruptcy attorney for details.

Disclosure Exemptions

An REO lender is generally exempt from many of the disclosures that are required by a seller in a normal real estate transaction. Since the REO lender has probably not seen the property, this is one way the law protects them from disclosure requirements. However, according to common law in California, a lender has a duty to disclose material facts if they are known.

Some of the disclosures an REO lender is *exempt* from include: Real Estate Transfer Disclosure Statement, Natural Hazards Disclosure, Mello-Roos Disclosure, Supplemental Property Tax Notice, Notice of Private Transfer Fee, and Homeowner's Guide to Earthquake Safety.

"Broker and Salespersons (collectively called "agents") involved in brokering REO properties must continue to conduct a reasonably competent and diligent visual inspection of all accessible areas of the property."

Some of the disclosures that an REO seller is NOT exempt (and must provide) include: Smoke Detector Disclosure, Water Heater Disclosure, Lead-Based Paint Disclosure, Megan's Law, Foreign Investment in Property Tax Act of 1980 (FIRPTA), and California's 3 1/3% withholding requirement for foreign sellers.

Broker and Salespersons (collectively called "agents") involved in brokering REO properties must continue to conduct a reasonably competent and diligent visual inspection of all accessible areas of the property. This applies to most 1-4 unit residential properties, both owner-occupied and non owner-occupied in California.

Agents are also required to provide an agency disclosure and confirmation of agency relationship disclosure for all 1-4 unit residential properties when an agent is involved.

Buying at a Trustee's Sale

Real estate investors can find some really good deals at trustee's sales—and they can also lose their shirt. The following are some reasons why and why not to buy single-family homes at trustee's sales:

Reasons for a Real Estate Investor to buy at a Trustee's Sale

1. Can get a really good deal.
2. Can buy properties before they hit the market.
3. Dealers can buy in bulk at less than wholesale prices and then resell to wholesale buyers for all cash and fast closes OR buy at less than wholesale and sell at retail prices
4. Able to flip properties for a nice profit

Reasons for a Real Estate Investor <u>not</u> to buy at a Trustee's Sale

1. It can be difficult to get inside the properties to inspect their condition prior to the trustee's sale.
2. A computer search may not provide all the necessary data needed to make an informed decision regarding an appropriate purchase price for the property. Real estate investors may need to research encumbrances and

other title issues at the county recorder's office or other locations where public records are kept. This is a slow and time-consuming process. Even with a thorough records search, approximately 20% of the time investors do not find all the hidden encumbrances pertaining to the property. Consequently, real estate investors must have deep-enough pockets to absorb all the unexpected costs (encumbrances and title issues) that may surface after the trustee's sale has been completed. These surprises can ruin an otherwise good investment opportunity.

3. A new investor may not be able to obtain a professional title search prior to buying a property at a trustee's sale. Liens and other non-money encumbrances may be well hidden and unknown to the buyer until they surface well *after* the trustee's sale. Experienced real estate investors and dealers who buy and sell properties on a continuing basis may have close relationships with escrow officers and title companies that may allow them to obtain title searches at minimal cost.
4. Lenders that are selling properties through a trustee's sale are exempt from many disclosures that are required for normal real estate transactions. According to common law (case law) in California, lenders are required to disclose anything they know about the property. Most of them have never personally entered the property, so there is usually nothing to disclose.
5. There may be a good ol' boy network of bidders and shills that congregate around trustee's sales. Much to the delight of the good ol' buys, an inexperienced investors may be suckered into paying too much money for an over-encumbered property.

A Trustee's Sale 'Take Over' Story: The Battle of the Door Locks

An experienced real estate investor purchased a single-family home at a trustee's sale. The trustee violated its duties to the foreclosing lender by <u>not</u> notifying them of the trustee's sale.

The next day the real estate investor, <u>who now *owned* the property</u>, arrived to start renovations and begin looking for a qualified tenant. The investor changed the door locks to prevent any previous owners or tenants from entering the property while it was being renovated and rented out to a new tenant.

Two days after the trustee's sale, the lender dispatched a maintenance person to check on the property. The maintenance person discovered the door locks had been changed, so he changed the door locks and notified the lender of the

A Trustee's Sale 'Take Over' Story: The Battle of the Door Locks (continued)
new locks installed on the property.

Three days after the trustee's sale, the investor arrived back at the property and discovered that the locks had been changed. He wondered what was going on, but went ahead and changed the door locks (again) and installed new ones.

Four days after the trustee's sale, the lender sent a maintenance person to the property to perform some needed maintenance, when it was discovered that new door locks had (once again) been installed on the property. The lender instructed the maintenance person to change the door locks (again) and ask the next door neighbors to call the police if anyone is seen entering the property.

Five days after the trustee's sale, the real estate investor arrived at the property and discovered the door locks had been changed once again! The investor changed the door locks while continuing to wonder who was trying to play a joke on him. This time a next door neighbor called the police and the real estate investor was almost arrested for breaking and entering into his own property! It took another week to finally straighten out the paperwork and keep the real estate investor out of jail.

Someone Must Take the Loss

When the real estate home loan is greater than the value of the property, *someone* must take the loss. This is generally the lender who made the loan in the first place, or a loan investor who purchased the loan from the original lender. The lender will probably take the loss through an involuntary foreclosure (usually a trustee's sale in California) or a voluntary loss through a short sale. Under the Dodd-Frank law, the lender who sold the loan to an investor may be held liable if it can be shown that the borrower's default risk was greater than was represented by the lender. In any event, someone is going to take the loss—lender or investor—when the homeowner decides to stop paying debt service on the loan.


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JUNIOR TRUST DEED SALE

Poon et al., v. George Realty The Heights, Inc., et al. (2015)

Court of Appeals of California, Second District, Division Two
Filed January 29, 2015.

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JUNIOR TRUST DEED SALE (*continued*)

Poon et al., v. George Realty The Heights, Inc., et al. (2015)

Plaintiffs sued defendants, real estate brokers and agents, after plaintiffs purchased a property and fixed it up to resell it, only to discover that they acquired the property at a junior trust deed sale. Plaintiffs lost their entire investment when the senior trust deed was foreclosed.

Plaintiffs alleged that defendants advised them the purchase was suitable for their needs and did not warn them that the property was subject to a senior trust deed.

The trial court sustained defendants' demurrer without leave to amend on the bases that plaintiffs' claims were barred by the statute of frauds and plaintiffs failed to allege a breach of duty.

We reverse.

Plaintiffs and appellants Jennie Poon, Jacob Poon, Nancy Fong, Jonathan Poon, Bryson Fong, and Danny Wong filed suit against defendants and respondents George Realty The Heights, Inc. (George Realty), High Ten Partners, Inc. (High Ten), and Mei-Miao Kuo in August 2012.

Briefly, the complaint alleged that plaintiffs engaged defendants to advise in finding and purchasing a house to fix up and resell at a profit.

Plaintiffs identified a house in Cerritos for potential purchase at a trustee's sale, and defendants advised plaintiffs that the house was suitable for their needs.
Only after acquiring the property and remodeling it did plaintiffs learn from defendants that they had purchased the property at a junior trust deed sale, and that the property was still subject to a large senior trust deed.

The senior trust deed was subsequently foreclosed, and plaintiffs lost their entire investment.

Plaintiffs sued defendants for professional negligence, breach of fiduciary duty, breach of oral contract, and breach of implied-in-fact contract.

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JUNIOR TRUST DEED SALE

Poon et al., v. George Realty The Heights, Inc., et al. (2015)

High Ten filed a demurrer, arguing that there was no agency relationship between it and plaintiffs, and that plaintiffs failed to allege that High Ten owed them a duty. High Ten further argued that the statute of frauds (Civ. Code, § 1624) barred any oral or implied contract.

The trial court sustained the demurrer, finding that plaintiffs failed to allege a duty based on the lack of a written agreement and insufficient allegations of an oral agreement creating an agency relationship.

The court also found that the statute of frauds barred plaintiffs' contract claims.

Plaintiffs were family members who were inexperienced in real estate. They decided to secure the services of a real estate broker and agent to advise them on suitable properties, to assist in the purchase of a property, and finally to assist in an "owner" sale of the property or to list the property if the owner offering was unsuccessful.

Plaintiff Fong requested and defendants agreed to perform these services, with the understanding that:

(i) plaintiffs would compensate defendants a "reasonable amount" for their assistance in a sale by owner,

(ii) defendants would have the opportunity to list and sell the house if the owner offering was unsuccessful, and

(iii) Fong would refer potential real estate clients to defendants.

Defendants knew that plaintiffs were inexperienced in real estate dealings, and, over a period of months, defendants advised Fong in locating, identifying, and acquiring a suitable property.

Plaintiffs and defendants discussed the strategy of purchasing a property at a first trust deed foreclosure sale, and, on at least one occasion, defendants advised Fong that a particular property was not suitable because it involved the foreclosure of a junior trust deed.

Plaintiffs considered purchasing the Cerritos property by bidding at a trustee's


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sale, which they thought to be based on a first trust deed. Defendants advised plaintiffs that the property was suitable, even though defendants were aware or should have been aware that plaintiffs were only interested in acquiring properties at first trust deed sales and the Cerritos property involved the sale of a junior trust deed subordinate to a large first trust deed.

Defendants also failed to explain the implications of purchasing the property under a junior trust deed.

Plaintiffs acquired the Cerritos property at the junior trust deed sale in September 2010. They then spent a considerable amount of money fixing it up.

When plaintiffs asked defendants to research comparable property sales for resell purposes, defendants discovered the senior trust deed and informed plaintiffs.

Defendants then essentially stopped communicating with plaintiffs. The senior trust deed was foreclosed, causing plaintiffs to lose all interest in the property and their entire investment of over $150,000.

Four causes of action:
(1) professional negligence,
(2) breach of fiduciary duty,
(3) breach of oral contract, and
(4) breach of implied-in-fact contract.

The trial court found that plaintiffs' allegations of equitable estoppel were inadequate. Judgment was entered in favor of defendants in January 2014.

Plaintiffs timely appealed.

The statute of frauds requires that a contract be in writing and subscribed by the party charged if the contract involves, in pertinent part, an "agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate, . . . or to procure, introduce, or find a purchaser or seller of

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real estate. . . for compensation or a commission."

The rule that an agreement for the purchase of real estate, or for finding a buyer of real estate, be in writing and signed. The agreement alleged by plaintiffs here is clearly subject to the statute of frauds.

Brokers undergo extensive training and education to acquire and maintain their licenses, and therefore are presumed to know the statute of frauds' requirements.

In contrast, plaintiffs here were unlicensed and inexperienced in real estate matters. To hold them to the same standard as a licensed broker would not promote the "primary purpose" of Civil Code section 1624, subdivision (a)(4), which is "to protect real estate sellers and purchasers from the assertion of false claims by brokers for commissions."

Construing the allegations liberally, we find that a trier of fact could determine that plaintiffs suffered unconscionable injury due to their reliance on the alleged agreement with defendants. Plaintiffs alleged that they spent a considerable amount of money fixing up the Cerritos property after being told by defendants that it was a suitable purchase for their needs. Plaintiffs then lost their entire investment after the senior trust deed was foreclosed.

With respect to the first cause of action for professional negligence and second for breach of fiduciary duty, defendants argue that they did not owe a duty to plaintiffs.

According to defendants, plaintiffs failed to establish an agency relationship. Plaintiffs only needed to allege the existence of a relationship with defendants that gave rise to a duty; they were not required to actually establish a duty at this stage of the proceedings.

A real estate broker is required to exercise reasonable skill and care in the performance of duties for a client (*Wilson v. Hisey* (1957) 147 Cal.App.2d 433, 438), Brokers owe their clients fiduciary duties (*Saffie v. Schmeling* (2014) 224 Cal.App.4th 563, 568).

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JUNIOR TRUST DEED SALE

Poon et al., v. George Realty The Heights, Inc., et al. (2015)

The existence of an agency relationship is generally a question of fact. (*Zimmerman v. Superior Court* (2013) 220 Cal.App.4th 389, 401.)

Plaintiffs alleged that defendants agreed to:
1. Advise them on suitable properties,
2. Assist in the purchase of a property, and
3. Assist in a sale or listing of a property.

Plaintiffs further alleged that they were to compensate defendants a "reasonable amount" for their assistance in a sale by owner, or to allow defendants to list the property, entitling defendants to compensation upon its sale.

Based on these allegations, a trier of fact could find that defendants agreed with plaintiffs to act as their agents and/or brokers, which would lead to imposition of a duty to give competent advice.

The judgment in favor of defendants is reversed and remanded with directions to the trial court to vacate its order.

Plaintiffs are awarded costs on appeal.

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WRONGFUL FORECLOSURE

Rosenberb v. Chase Bank, N.A. et al. (2015)

Court of Appeals of California, First District, Division Four
February 25, 2015

The appellant contends that the trial court erred in dismissing his case because he stated a cause of action for wrongful foreclosure based on Chase's failure to communicate with him at least 30 days prior to filing the notice of default as required by Civil Code section 2923.5.

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WRONGFUL FORECLOSURE (*continued*)

Rosenberb v. Chase Bank, N.A. et al. (2015)

We disagree and affirm.

Appellant is presently the owner of a three-unit real property located in Healdsburg, California (the property), which he obtained in 2006.

The property was purchased through Washington Mutual Bank, N.A., predecessor-in-interest and an agent, affiliate, or subsidiary of respondent Chase.

In connection with the loan, appellant executed a promissory note in the sum of $1 million, which was secured with a deed of trust in the property. CRC is the trustee under the deed of trust.

Due to the severe downturn in the economy in mid-2010, appellant was unable to make his mortgage payments to Chase.

Appellant applied for a loan modification through the Home Affordable Foreclosure Alternatives (HAFA) program. Appellant submitted the documentation for the HAFA program by December 2010. He acknowledges he spoke with Aaron McCarthy at Chase, who advised him the application was complete, and Chase would contact him shortly.

On or about February 15, 2011, CRC recorded a notice of default in the Sonoma County Recorder's Office.

At this point, appellant was $42,082.26 in arrears on his mortgage.

On or about March 4, 2011, appellant received a letter from Chase advising him that he could also be eligible for a new program to sell the property through a short sale.

Appellant contacted Chase and advised it that he would like to pursue a short sale.

A buyer was located for the first trust deed on the property with a standing offer of $650,000.

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WRONGFUL FORECLOSURE (*continued*)

Rosenberb v. Chase Bank, N.A. et al. (2015)

Chase advised appellant that it would consider the short sale and would contact him with a response after receiving the necessary documents.

Appellant's agent, Alan X. Reay, a licensed real estate broker, provided Chase with what he believed was all of the necessary paperwork to evaluate the short sale.

On or about April 27, 2011, Chase sent appellant a notice that his HAFA application was denied because the unpaid principal balance on the loan exceeded the threshold amount for consideration under the HAFA program, and because Chase had been unable to verify his claim that he occupied at least one of the three units of the property.

Between May 2011 and December 2011, appellant, his real estate agent, and appellant's counsel contacted Chase dozens of times to follow up on the rejection of his HAFA application, and get an update on Chase's consideration of the short sale offer.

Chase was unresponsive to these inquiries.

On or about December 19, 2011, CRC moved forward with the nonjudicial foreclosure proceedings by recording a notice of trustee's sale in the Sonoma County Recorder's Office, scheduling a sale date in January 2012.

On December 27, 2011, after the property had been set for a foreclosure sale, Chase sent appellant notice that it could not evaluate the short sale because it lacked sufficient documentation.

The written communication contained no explanation of what documentation was missing or needed.

After receipt of the notice of sale, appellant and his counsel repeatedly contacted Chase to seek further explanation regarding Chase's December 27, 2011 communication.

Finally, on January 10, 2012, appellant's counsel spoke with Mr. Helix, a

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WRONGFUL FORECLOSURE (*continued*)

Rosenberb v. Chase Bank, N.A. et al. (2015)

representative for Chase. Mr. Helix advised appellant's counsel that Chase was willing to accept the $650,000 short-sale offer, but the third-party lienholder would not release the lien, which was preventing the sale.

Mr. Helix advised appellant's counsel that Chase would not postpone the foreclosure sale to allow appellant time to attempt to clear up the problems preventing the short sale.

Appellant then initiated this litigation by filing a complaint on the eve of the foreclosure sale, January 18, 2012.

The only cause of action relevant to this appeal is appellant's first cause of action alleging section 2923.5 was violated. At all relevant times, in pertinent part, this statute provided that no less than 30 days before they record a notice of default a "mortgagee, beneficiary, or authorized agent shall contact the borrower in person or by telephone in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure."

The statute also required a notice of default to include "a declaration that the mortgagee, beneficiary, or authorized agent has contacted the borrower" or "has tried with due diligence to contact the borrower as required by this section. . . ."

Appellant alleged Chase "has not even minimally complied with the requirements" of section 2923.5 and "cannot, therefore, proceed with a foreclosure action. . . ."

After hearing oral argument, the trial court ordered a dismissal signed on February 25, 2013. The court found in pertinent part: The plaintiff does not state a cause of action for a violation of [Civil Code section] 2923.5.

The defendant alleges that the parties have, in fact, been in communication. The plaintiff simply argues that the communication was `insufficient' and he did not like the outcome of the communication. . . .

Under the current reading of Civil Code section 2923.5, this communication


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WRONGFUL FORECLOSURE (*continued*)

Rosenberb v. Chase Bank, N.A. et al. (2015)

was probably sufficient to satisfy the statute. The Defendants had no other obligation. . . ."

This appeal followed. Section 2923.5 provides the procedure that a mortgagee, trustee, beneficiary, or authorized agent must follow before a notice of default can be filed pursuant to section 2924.

As noted, at the time in question section 2923.5, subdivision (a) provided that, unless a specified exception applies, a lender must *either* "contact the borrower in person or by telephone in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure" *or* "satisfy" specified "due diligence requirements" in an attempt to make such contact.

Section 2923.5, subdivision (b) provides that, before it may record a notice of default, a lender must include in the notice of default a "declaration" that the lender "has contacted the borrower, has tried with due diligence to contact the borrower . . . or that no contact was required. . . ."

"A borrower may state a cause of action under section 2923.5 by alleging the lender did not actually contact the borrower or otherwise make the required efforts to contact the borrower despite a contrary declaration in the recorded notice of default.

The judgment of dismissal is affirmed. Respondents are entitled to their costs on appeal.

RIVERA, J. and BOLANOS, J., concurs.

Real estate investors buying single-family homes are generally smart enough to know that buying properties when someone has already taken the loss is the best way to find a good deal. Single-family homes, that have already been foreclosed and are being sold by the lender out of their nonperforming asset portfolio, are usually either REOs or short sales. Both investment types are usually good ways to purchase real estate properties near the bottom of a downward-trending buyers' market.

8

DISTRESSED PROPERTIES: REAL ESTATE OWNED

"Recession is when a neighbor loses his job.
Depression is when you lose yours." -Ronald Reagan

Post-Foreclosure: Real Estate Owned (REO) Properties

If no one bids above the starting price set by the lender at a trustee's sale, the lender will generally receive the property as a "Real Estate Owned" or REO property. Lenders are usually motivated to sell REOs to recoup as much money as possible from the sale of the asset.

Lenders, however, do not want to flood the surrounding real estate sales market with REO properties and cause market values to decline in the process. For this reason, lenders may trickle REO properties onto the real estate market in an attempt to keep supply at a constant level, thus keeping property prices up by matching the demand for single-family purchases with the supply coming onto the market.

> "Lenders, however, do not want to flood the surrounding real estate sales market with REO properties and cause market values to decline in the process."

Lenders generally survive by making real estate loans, not as real estate investors holding REO properties in their portfolio. In today's real estate market, there is potential for lender speculation when there is price appreciation through real estate cycles, economic growth, or even price inflation. In fact, inflation fears and mortgage-backed security compliance issues may cause lenders to head in the opposite (too conservative) direction and only make loans to the most highly qualified borrowers.

The REO mechanics involved in selling real estate properties being held in a lender's portfolio of non-performing assets are as follows:

REO Mechanics

The lender's asset manager may list a property for sale with a real estate broker. The broker is usually required to submit a resume and application to the asset manager, thus ensuring that the real estate broker is experienced and able to effectively handle the sale of REO properties. REO listing agents usually must do a fairly high volume of transactions to be able to make a decent profit. They may have an organization of assistants who do all the busy work during the listing and selling process, while the real estate broker oversees the entire operation. The real estate broker is usually required by the lender/seller to list the property for sale in the local MLS to obtain maximum exposure for the property.

"The lender's asset manager may list a property for sale with a real estate broker."

Single-family investors may tend to favor REO properties because the lender has already made the decision to take a loss on the real estate loan when it is listed for sale with a local real estate broker. REO properties are generally *more deliverable* than short sale properties because short sale lenders have generally not made the decision to take a loss on the property.

The pricing decision has already been made by the lender for an REO property and a buyer is usually able to close escrow within thirty to sixty days. Both owner-occupied and non owner-occupied buyers may be attracted to REO properties because of the greater deliverability over short sales.

After the REO property has an accepted contract, the buyer generally has seventeen days (this varies) to remove the physical inspection contingency to the contract. This is a common physical inspection time period seen in purchase contracts provided by the California Association of Realtors. The actual time period for contingencies to a contract vary at the discretion of the buyer and seller, and can be longer or shorter depending upon the real estate market and property type.

During an upward-trending sellers' market, multiple offers may occur with every property that comes on the market. This, in turn, may cause smart buyers to tighten up (reduce) contingency periods to entice the seller to take their offer. It should be noted that commercial properties generally have much longer contingency periods due to their size and complexity.

During the seventeen day physical inspection contingency period for single-family homes, the buyer should perform due diligence inspections to determine the true physical condition of the property. A home inspection, pest inspection, and other specialized inspections may be used to provide the buyer with critical information used to decide whether to move forward with the purchase or not remove the physical inspection contingency and not purchase the property.

If the property is going to be financed with a loan, the buyer's financing contingency period may be written into the contract so it coincides with the seventeen day physical inspection contingency period or until the loan is funded. Smart buyers will negotiate a financing contingency period that is removed when the loan is funded. However, some real estate contracts have allowed the financing contingency only to remain in effect for the first seventeen days after entering into the contract. This tightening of the contingency period tends to benefit the seller more than the buyer, thus providing the buyer with fewer avenues of escape from the purchase contract when nearing the end of the escrow period.

If the financing contingency can be removed right up until the loan is funded, the buyer may have the ability to escape the contract right up until the very last moment before funds are wired into escrow. Anything that will cause the lender to <u>not</u> make the loan (e.g., change in FICO score resulting from the buyer buying a new car during the escrow period) may cause loan funding problems from the lender.

The buyer may want to consider checking the box in the purchase contract, or write in: "The loan contingency will remain in effect until the buyer's loan is funded." The buyer will have more time to arrange financing and it also provides the buyer with a possible way to get out of the deal—especially if a deal-breaker is discovered *after* the seventeen days physical inspection contingency period has been removed. It should be noted that if a seller amends a Real Estate Transfer Disclosure Statement AFTER the physical contingency period has ended, the buyer will usually have 5 days to rescind (get out of) the contract.

Passive contingency removal usually occurs when the buyer does nothing and the contingency is removed—thus taking away one means for the buyer to get out of the contract. Active contingency removal requires the buyer to initial and/or sign the removal of each contingency to the contract.

Therefore, savvy real estate investors like to keep their loan contingency in effect until the loan is funded, thereby not risking their earnest money deposit until the lender has actually funded the loan. Real estate investors are usually buying single-family homes during a downward-trending buyers' market—when everyone is crying the blues. The real estate market is about as loose as it can get during these periods, so a loan contingency that will be removed when the loan is funded near the end of escrow, and not through the seventeen day contingency removal period, may be the best option.

REO Pest Inspections

Pest inspections are generally handled differently during an upward-trending sellers' market than during a downward-trending buyers' market. During an upward-trending sellers' market, a normal seller usually has considerable equity in the property and can pay for the pest inspection and most of the corrective work needed to clear the pest report.

Conversely, during a downward-trending buyers' market, where only a few people have equity in their single-family homes and most sellers are REO lenders, pest inspections and corrective work are usually paid by the buyer.

As mentioned earlier, most REO seller/lenders are professionals and know how the pest companies operate. For this reason, they usually will not pay for pest inspections or any corrective work, unless they receive a higher sale price to counteract the added costs of providing the pest inspection and work. An REO seller/lender will usually try to end a bad loan situation with as little damage as possible. The lender usually only cares about the net proceeds coming from the sale of the asset.

Factors to Consider When Purchasing an REO Property

Some factors to consider when purchasing an REO property include: deliverability, good title, title insurance, property condition and potential renovation costs, faster close of escrow, REOs may have a lower purchase price than short sales, less REOs are available on the market, and real estate investors may buy REOs directly from the lender.

A. Deliverability

REO properties tend to be more **deliverable** than short sales. As mentioned earlier, REO properties have already been foreclosed by the lender and the bank is holding them in their REO portfolio. Since lenders are in the business of lending, they do not generally like to become property managers for their own portfolio of foreclosed properties.

Lenders are usually motivated to sell their REO properties to get them off their books and move forward making money—rather than losing it. The lender has made the decision to sell the property and has gone through the **broker's price opinion (BPO) process** and understands the property's market value and potential loss that will be incurred when it is sold. Consequently, during the early stages of a downward-trending buyers' market, REO properties have more deliverability than short sales. Short sale lenders must go through a similar process and voluntarily decide to take a loss on the sale of the property. Conversely, lenders have already made this decision with REO properties and may be more inclined to sell the property and take their losses.

> "REO properties tend to be more deliverable than short sales."

B. Good Title: REO vs. Trustee's Sale

(1) REO

Purchasing single-family REO properties located in California is similar to a normal real estate transaction and good title is usually accomplished through a **grant deed** and insured by a policy of **title insurance**. In other states, title may be conveyed using a **warranty deed** or **special warranty deed**, however, they are seldom used in California.

(2) Trustee's Sale

When a real estate investor buys a single-family home at a trustee's sale, a Trustee's Deed Upon Sale may be used to convey title from the trustee to the buyer. Researching existing liens and other encumbrances prior to purchase continues to be a real estate investor's greatest concern when buying properties through a trustee's sale.

C. Title Insurance

One advantage REO properties have over trustee's sale properties is the ability to obtain a title insurance policy. This is a major advantage for real estate investors who purchase REO properties.

(1) Trustee's Sale

At a trustee's sale, the buyer may need to perform their own research and try to determine if there are outstanding loans, liens, and other encumbrances existing on the property. The title search will usually start with a search of property records on the internet, then proceed to a physical check of records at the county recorder's office, county courthouse, or other locations where recorded documents may exist in the county where the property is located.

If a real estate investor has a good rapport with a title insurance company, which usually results from a large number of closed transactions with them, then the real estate investor may have access to preliminary title reports and other records research that is provided by the title company's title plant. Title insurance companies may issue a **binder policy** to an investor, agreeing to provide a permanent title policy after the property has been purchased at the trustee's sale.

(2) Real Estate Owned (REO)

In contrast, REO properties have already gone through the foreclosure process (trustee's sale) and are now owned by the lender. A buyer may be able to use a standard purchase contract that contains normal contingency periods that include physical inspection, financing, and appraisal contingencies. It may allow the buyer to obtain a title insurance policy at the time a property is purchased.

Of course, some lenders may start using their own one-sided purchase contracts instead of CAR provided contracts that have already been reviewed by the title company. When this happens, an investor may want to have their own legal counsel review lender-required contract provisions prior to use. Lender-required contracts should not preclude an investor from obtaining a title insurance policy for an REO property; however, it may delay the closing process if the title insurance company's lawyers must review the contracts prior to the issuance of the policy.

In California, title insurance will usually consist of a **California Land Title Association (CLTA) owner's policy** and/or an **American Land Title Association (ALTA) lender's policy.** If the real estate investor pays all cash to purchase an REO property, the investor may ask for an ALTA owner's policy. With this in mind, next is a look at common title insurance coverage for CLTA and ALTA policies.

(3) CLTA vs. ALTA Policies of Title Insurance

CLTA title policies usually cover items in the chain of recorded title, including forgeries, incompetence, capacity, and improper delivery of a recorded deed. ALTA extended coverage title policies generally cover all of the items covered in a CLTA policy, *plus* some unrecorded encumbrances and property line issues according to a formal survey. This survey is for the title insurance company's own use, and it not provided to the buyer.

The primary difference between the two policies is the ALTA title policy may include an on-site inspection, while the CLTA policy usually only examines the legal records of the subject property. Be aware, however, that title insurance companies may exclude many of the extended-coverage provisions, such as unrecorded encumbrances and property lines, from the ALTA policy.

(4) Preliminary Title Report

A **preliminary title report** or "prelim" is an offer from the title insurance company to issue a policy of title insurance. A preliminary title report provides a real estate investor with a laundry list of existing liens and other encumbrances that may affect the title to the property. Many encumbrances may need to be paid and/or removed from title prior to the title insurance company issuing a policy of title insurance. There may be exclusions that the title insurance company will not cover, so an investor should examine the preliminary title report carefully prior to purchasing the property.

D. Property Condition and Potential Renovation Costs

Many properties purchased at trustee's sales or as REOs are in poor physical condition at the time they are finally sold to an investor. Many homeowners, who were upset by the extensive lender fraud that ran rampant from 2001 through 2008, did not hesitate to remove fixtures from their foreclosed homes. Some foreclosed homeowners have been known to remove entire kitchens, along with light fixtures, wiring, copper plumbing pipes, and even the light bulbs.

"Many properties purchased at trustee's sales or as REOs are in poor physical condition at the time they are finally sold to an investor."

Some foreclosed homeowners poured rice down the house drains to extract some measure of revenge from the lenders who made their lives miserable for so long. Rice tends to expand and really clog up the plumbing in a home. For this reason, many properties purchased through trustee's sales and as REOs needed major renovations. One problem with trustee's sales is trying to get inside a property to determine renovation costs to either flip the property for short-term profits or hold it as a long-term rental.

REOs, on the other hand, are generally much easier to access because they are usually listed by a real estate broker and are vacant with a lockbox. The more difficult the home is to get inside, the longer it will usually take to sell it—and usually for a lower price.

(1) REOs in Poor Condition May Not Qualify for Financing

REOs may not qualify for FHA insured, VA guaranteed, or conventional financing. When this occurs, it drastically reduces the number of competing buyers for a property and adversely affects the price. When supply goes up and demand does down, this usually results in a lower purchase price. Most buyers will be savvy all-cash real estate investors rather than overly-emotional owner-occupied homebuyers.

Low sale prices impact sales comparables surrounding a subject property and reduce property values. It may become a downward spiral as more distressed properties come on the real estate market and depress values even further—with lenders losing money at every turn. Lenders may lose money through short sales, trustee's sales, and REO properties.

The Story of the Triple Hurt

A real estate investor decided to purchase an REO property from one of the big national lenders. The lender had made a $320,000 loan on the property in 2005. In 2010, the real estate investor purchased the REO property for $80,000, so the lender lost more than $240,000 on the property. In addition, the real estate investor paid all cash to purchase the REO and withdrew funds from the same lender (bank) who was selling the property! So, the lender lost the interest rate margin between the interest rate paid to the real estate investor for money on deposit in the bank and the interest rate charged on one of their real estate loans. As if this were not bad enough, the national lender was not able to make the new loan on the property. Of course, many REO lenders in the past did not want to make loans on their own REOs—no use placing salt on an open wound and possibly lending good money after bad.

E. Faster Close of Escrow

REOs are usually much faster to close than short sales. The average REO usually requires between 30 and 60 days from the contract date to the close of escrow. However, this varies due to many factors out of a real estate investor's control. The largest obstacle is escrow and title. The escrow officer must acquire and arrange all the documents so the terms and conditions of the escrow have been met.

The title insurer usually investigates the liens and other encumbrances affecting the property and issues a policy of title insurance. The title insurance company may provide one or more updated preliminary title reports as more encumbrances are discovered during the escrow period.

As mentioned earlier, some lenders and asset manager may "require" a real estate investor to use an escrow company and title insurance company selected by them. Legally, they cannot do this. However, to expedite close of escrow many REO investors will go ahead and use their selected company or companies—since they most likely already have many of the documents needed to close escrow and issue a policy of title insurance. It will probably speed up the closing process.

A buyer can use anyone they choose to handle escrow and title services. This can be difficult, however, when a seller receives multiple offers on a property. Real estate investors generally do not like to negotiate for escrow and title services. Successful real estate investors know where to fight their battles, and escrow and title services may not be the place to fight with a seller (lender). Price and other more tangible issues may be a better place to negotiate.

"A buyer can use anyone they choose to handle escrow and title services."

Escrow and title insurance prices are usually fairly uniform throughout California. The quality of the work can be anywhere from awesome to horrible, depending upon the professionalism of the company.

Real estate brokers can ask for a copy of the seller net sheet or **HUD-1 Settlement Statement** to review buyer costs and seller net information prior to close of escrow. The broker can ask for necessary corrections and escrow officers can easily make these changes on their computer. Title insurance companies search the records in their own title plant to reduce, if not eliminate, all title issues covered by their policy of title insurance. If they miss an item that is included in coverage, they will most likely have to pay for the real estate investor's loss.

The Story of the Crooked Law Firm Performing Escrows

As mentioned previously, one large REO lender required real estate investors to use a law firm they designated to perform escrow services for their REO properties. The real estate investor realized there were multiple offers coming in on the property and he really wanted it. So he went along with the lender's escrow requirements. The real estate investor was paying all cash to purchase the property and the attorney performing the escrow actually floated the buyer's entire purchase price for over two weeks prior to closing escrow. The real estate investor suspected that the law firm was in financial trouble and was using *his* money to pay their own bills. The law firm may have delayed the close of escrow until they were able to accumulate enough money to reimburse the escrow. The real estate investor considered turning the law firm into the California State Bar, but realized that the law firm was performing escrows for all of a particular national bank's properties. He did not want problems buying more of this lender's REO properties in the future.

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REOS CANNOT DICTATE ESCROW AND TITLE COMPANIES

California Senate Bill 1051 – Effective January 1, 2015

In California, the nonjudicial foreclosure process begins with the filing of a Notice of Default and concludes with a trustee's sale where the property is sold to the highest bidder. If there are no bids over and above the opening bid, the property reverts back to the lender or servicer who placed that opening bid (thus, becoming a bank owned property). Those lenders are then left with an abundance of properties that may then be sold or auctioned off at a later date.

In 2009, AB 957 (Galgiani, Chapter 264, Statutes of 2009) enacted the statute, in order to prevent the seller (the foreclosing lender or servicer) from requiring a buyer to purchase title insurance or escrow services from a specific company. In doing so, the bill partially codified a prohibition in the RESPA that, with respect to federally related mortgage loans, prohibits sellers from requiring a buyer to purchase title insurance from a particular title company.


Flickr / Chris Potter

REOS CANNOT DICTATE ESCROW AND TITLE COMPANIES (*continued*)

California Senate Bill 1051 – Effective January 1, 2015

In response to opposition concerns raised in earlier iterations of the bill, AB 957 included a sunset date of January 1, 2015, in order to allow for the Legislature to revisit the policy issues.

According to the bill's author: since the last major bout of foreclosures during the downturn of the 1990's, a practice was developed in the foreclosure market that was having significant consequences to many groups, including home buyers.

The Buyer's Choice Act was put in place to prevent certain business arrangements that may involve unlawful referral fees to third-party risk management companies. The BCA enables homebuyers to have more freedom of choice.

This new law removes the sunset date for the existing law, so it will continue into the future with no sunset date.

Federal Law

Existing federal law, the federal Real Estate Settlement Procedures Act (RESPA):

1. Regulates transactions between buyers, sellers, and mortgagees (lenders) involving "settlement services" (including title insurance and escrow services). RESPA generally requires that borrowers receive certain timely disclosures relating to the costs of those settlement services, and prohibits certain practices on the part of a mortgagee that increase the costs of settlement services.
2. Provides that no seller of property that will be purchased with the assistance of a *federally related mortgage loan* (which includes the Federal Deposit Insurance Corporation (FDIC) insured lenders, FHA, VA, and Cal-Vet) shall require, directly or indirectly, as a condition to selling the property, that title insurance covering the property be purchased by the buyer from any particular title company. Any seller who violates that provision is liable to the buyer in an amount equal to three times (treble damages) all charges made for such title insurance. In addition, any person


Flickr / Chris Potter

REOS CANNOT DICTATE ESCROW AND TITLE COMPANIES (*continued)*

California Senate Bill 1051 – Effective January 1, 2015

who violates its provisions shall be deemed to have violated his/her license law and shall be subject to discipline by his/her licensing entity.

California State Law

Existing state law, the Escrow Law, provides for the licensing of escrow agents by the Department of Corporations, and states that any person subject to the Escrow Law who violates any provision of RESPA, or any regulation promulgated thereunder, violates the Escrow Law.

1. Prohibits a seller from directly or indirectly, as a condition of receiving offers or selling residential real property to a buyer, requiring the buyer to purchase title insurance or escrow services in connection with the sale of that property from a *company chosen by the seller*.
2. Defines "seller" as a mortgagee or beneficiary under a deed of trust who acquired title to residential real property improved by four or fewer dwelling units at a foreclosure sale, including a trustee, agent, officer, or other employee of any such mortgagee or beneficiary. This is commonly called a "Real Estate Owned" property of "REO."
3. Provides that a transaction shall not be invalidated solely because of the failure of any person to comply with any of the provisions.
4. Sunsets on January 1, 2015, unless a later enacted statute deletes or extends that date. This bill deletes the sunset date of the Buyer's Choice Act. In other words, it will continue on into the future with no sunset date.

F. REOs May Cost Less than Trustee's Sales or Short Sales

During the early part of a downward-trending buyers' market, lenders have usually not made the decision (or faced reality) to take a loss on an upside-down and underwater property. For this reason, they may not accept short sale offers that come in less than their existing loan amount, causing many of the properties to be sold through the non-judicial trustee's sale process.

Lenders may continue to be in denial of the existing downward-trending buyers' market and set initial trustee's sale bids at the loan balance plus accrued interest (back interest plus interest on interest) and the costs of the trustee's sale (which can be $1,500 or more). As the downward-trending buyers' market continues downward, lenders usually wake up and realize they will *lose more money* if they do not sell their properties as soon as possible through a short sale or a trustee's sale (by lowering initial bid amounts).

Lenders will usually start to accept short sale offers below the loan amount, and in so doing, take the loss now—rather than in the future—where it may be much larger. Trustee's sale opening bids, usually determined by the lender, may be set at a lower amount during this time period, as lenders try to sell their nonperforming properties before they lose more value.

> If the lender is not able to sell the property through a short sale or trustee's sale, it will become a real estate owned (REO) property, placed in the lender's portfolio of nonperforming properties, and sold at a much lower price in the future. This is where real estate investors can get a good deal during the early parts of a downward-trending buyers' market.

As the downward-trending buyers' market runs for a while and lenders begin to understand how to dispose of their nonperforming assets in a more expeditious manner, more are sold as short sales and at trustee's sales than as REOs. Real estate investors realize how the market has changed and start purchasing short sale properties instead of REOs.

As the downward-trending buyers' market continues downward, competition among investors will heat up as they continue purchasing reasonably priced short sales, and start buying trustee's sales at close to market prices.

If an investor purchases a single-family home at a trustee's sale and accepts the risks of unknown liens and other encumbrances on the property, a lower purchase price is generally considered a reward for accepting this risk. However, near the bottom of a downward-trending buyers' market competition for distressed properties becomes so intense that investors may begin buying properties through higher-risk trustee's sales for close to what they would sell on the open market through a regular sale.

Savvy investors should have already made their purchases through REOs and then short sales earlier in the downward-trending buyers' market. If real estate investors wanted to flip properties during this time period, there were not many owner-occupied buyers who were buying single-family homes at that time, so their best option was to rent the property to a tenant, hold it through the next upward-trending sellers' market, and then sell to an owner-occupied buyer at the top-of-the-market.

Lender Strategies

At the same time that investors are trying to buy these distressed properties at the best deal possible, lenders may start buying time while trying to keep their businesses running without going into Chapter 11 bankruptcy. It becomes a balancing act, as lenders look at the speed of the downward-trending buyers' market in light of timing the foreclosure of non-performing assets (loans).

It may be in a lender's best interest to push out the foreclosure process of non-performing loans if the lender is making more money during this time period (from other lender operations) than they are losing from lack of income from the nonperforming loans. If this is the case, lenders may be in a better position foreclosing in one or two years, rather than immediately and taking the loss on the present year's books.

Another strategy is for lenders to <u>not</u> start the foreclosure process at all during the initial stages of a loan default. The lender continues to carry the loan on their balance sheet as a normal *performing asset* and it does not show up on their financial statements. **Balance sheets**, **income statements**, and other financial statements are important for lenders who are publically traded on the securities markets. Investors and bank regulators (FDIC) look at these documents to help determine whether a lender is in financial trouble and should be given greater scrutiny in the future.

G. Investors Can Buy REO Properties Directly from the Lender

Pricing of REO properties may have been decided and the property disposition process already started by the lender. In other words, the REO lender knows the market value of the property and has already made a business decision to sell it at or near that price. Most REO lenders want to stay within 10% of the price they have agreed upon when the property is listed for sale with a real estate broker.

A real estate broker determines the probable selling price of an REO property by considering sales comparables of similar properties that have recently sold in the same geographical market. This can be performed quickly and usually accurately with tract homes in a subdivision by using one of the many property pricing computer programs available to real estate agents or REO lenders.

Some distressed sales may not be used as sales comparables during the analysis because they may <u>not</u> represent a true open market where the buyer and seller are both not under any duress to buy or sell a property. An open market occurs when a seller does not need to sell the property and a buyer does not need to buy it. The bad news is that during a downward-trending buyers' market, *all* of the sales comparables may be distressed short sales, trustee's sales, and REOs.

(1) Lenders that Own Too Many REO Properties

During a downward-trending buyers' market, lenders may involuntarily acquire a large number of REO properties during a short period of time. In response, the lenders may sell them to investors via a "tape." The lender may send the tape to real estate investors who have the ability to purchase several million dollars in REO properties at one time. These real estate investors usually purchase the properties at 65 cents or less on the dollar, and then resell them to wholesale investors for approximately 85 cents on the dollar. The wholesale real estate investors then put the properties on the market and sell them at full retail prices—thus pocketing the profits.

(2) REOs can be Dangerous Investments for Investors Who Flip Properties

REOs can be dangerous investments because lenders typically are interested in selling large bundles of REO properties when a downward-trending buyers' market is moving downward at a very rapid pace. By the time real estate investors are able to flip the properties, the real estate market may have declined in value so much that the property is now upside-down or underwater.

REO lenders are usually corporations run by corporate executives who understand the **risk-return tradeoff theory**. If there were huge returns available with minimal risk, lenders would take the profit themselves and not "give" them to real estate investors. Again, the money chases the good deals and bad deals chase the money.

Some REO lenders may require investors to purchase the entire bundle of REO properties that appear on the tape. The real estate investor will be required to accept the good properties along with the bad ones. Conversely, other REO lenders may allow investors to select the best properties and buy only the ones they want. It really depends upon market timing and lender motivations.

Speaking of lender motivations, as the real estate market continues to move downward through a downward-trending buyers' market, real estate investors may find properties becoming so far underwater that the best deals may actually occur *after* REO assets have been on the market for a long period of time, and lenders are forced to make huge price reductions to get rid of them.

As mentioned earlier, lenders may end up taking a larger loss than they were willing to accept at the trustee's sale. Most of a lender's managers probably have not lived through prior downward-trending buyers' markets and do not understand the necessity of taking a loss now versus taking a greater loss in the future. As lenders move through their own learning curve, they begin realizing that taking the loss now through a short sale may be preferable to taking greater losses in the future at a trustee's sale; or experiencing <u>even greater losses</u> if it is sold much later as an REO. Patience can be a virtue for real estate investors and an expensive lesson for inexperienced lenders during a downward-trending buyers' market.

"Patience can be a virtue for real estate investors and an expensive lesson for inexperienced lenders during a downward-trending buyers' market."

When a lender lists an overpriced REO with a real estate broker and it sits on the market for a long period of time, this is when a real estate investor may be able to get a good deal. When the lender starts allowing price reductions, the real estate investor may be able to negotiate a good deal—and with title insurance too!

One axiom real estate investors' use is, "If the lender can accept one price reduction, they can just as easily accept another." The lender may be ripe for a low-ball offer that may be accepted. Remember, of course, that as the real estate market continues downward, a screaming deal today may turn into a bad deal tomorrow. This is why it is critical to purchase investment properties near the bottom of a downward-trending buyers' market.

REO Investor Mistakes

REO investor mistakes include: making a low-ball offer at the wrong time; not providing proof of funds (for all-cash buyers) or a pre-approval letter (for cash-to-new-loan buyers) in the offer; owner-occupied first looks; one-sided contracts; and being pressured by multiple offers.

A. Making "Low-Ball" Offers to Lenders at the Wrong Time

If a property has been on the market for sixty days or longer and the REO lender (seller) is sufficiently motivated to sell it, a below-market offer may be effective in acquiring the property. Otherwise, everyone may be wasting their time. The REO lender may reject the offer and you are back to square one.

B. Not Providing Proof of Funds or Pre-Approval Letters in the Offer

For all cash offers, many REO lenders require a copy of the buyer's most recent bank statement(s) that prove there are funds available to close the deal. If the property will be financed, the REO lender may require a pre-approval letter from a reputable lender, as well as proof of funds for the down payment.

Pre-Approval Letter

A **pre-approval letter** informs the REO lender that the buyer has applied for a loan and the lender (for the new loan) has run the borrower's credit and loan application through underwriting and obtained conditional loan approval. Loan conditions may require the buyer to qualify with a new credit report just prior to loan funding, as well as the property appraising for the sale price. As long as the lender is reputable, a preapproved loan may be considered similar to having actual cash in hand.

> "As long as the lender is reputable, a preapproved loan may be considered similar to having actual cash in hand."

Pre-Qualification Letter

A **pre-qualification letter**, on the other hand, merely informs the REO lender that the borrower has contacted the lender (for the new loan). The new lender may send out a letter that states, "Based upon unconfirmed information we may be able to make the loan, but maybe not." This letter is of little value to an REO lender who is selling the property. Most REO lenders will require a pre-approval letter prior to acceptance of a buyer's offer. There are usually a large number of "ready and willing" buyers in the marketplace; however, far fewer "able" buyers who can actually perform by paying the down payment, obtaining a new loan, and closing the deal.

C. Owner-Occupied First Looks

Some REO lenders may have an **owner-occupied first look provision** that allows owner-occupied buyers to have the first opportunity to purchase an REO property. You may want to direct your real estate investor clients away from these properties, unless they have been on the market over 60 days and can be purchased at a very attractive (low) price.

Owner-Occupied Home Buyers vs. Real Estate Investors

Most of the time owner-occupied buyers may be willing and able to pay more money than real estate investors for the same property. The reason is that they are buying a home. It is usually an emotional purchase decision, and as long as the property will appraise for the purchase price, buyers are looking at their loan payments and not the actual price paid for the property. In contrast, real estate investors are taking a cold, hard look at the property and are making an unemotional decision to purchase it.

As mentioned earlier, many real estate investors tend to look at rehab REO properties that will not qualify for owner-occupied FHA, VA, and some conventional financing. Real estate investors want properties that are so beat-up they require all cash to purchase them. Demand for these types of properties tends to diminish because owner-occupied buyers cannot qualify to purchase them. Real estate investors are the only people who can afford to buy them because all cash is needed to complete the purchase. For this reason, this is where your clients can get some really good deals.

"No Flip" Provisions

One of the largest Government Sponsored Entity (GSE) REO lenders in the U.S. likes to place a three month "no flip" condition on the title. A real estate investor, who purchases an REO property from this lender, cannot resell it for at least three months from the close of escrow date. A "no flip" provision limiting real estate investors who are flipping properties, will cause less investor demand for these properties and, hence even lower prices for long-term investors.

Long-term hold investors seem to be okay with "no flip" conditions on the title because they are going to keep the property for a long period of time and the "no flip" provisions are not a factor. The no flip provisions will remain in the chain of recorded title to the property, but usually only affects title to the property during the immediate three months after close of escrow. Future buyers generally need not worry about these provisions on the title. Of course, always see an attorney and CPA prior to buying or selling any real estate property.

D. One-Sided Contracts

As real estate investors move into a downward-trending buyers' market, REO lenders usually have had enough time to devise their own one-sided contracts used for selling their own REO properties. REO lenders generally insist on contracts and addendums that are slanted heavily in their favor. Some of these have per diem (per day) penalties if the buyer does not close escrow on time—even if the delay is caused by the REO lender!

Robo-Signing and Mortgage Electronic Registration System (MERS)
Sometimes the REO lender may not have the loan existing on a property properly documented (e.g., Robo-Signing) or they may not actually have the promissory note and deed of trust in their possession. Yet they penalize the buyer for both of these things that are out of their control.

Both Robo-Signing and MERS were used during the lending boom that occurred between 2001 and 2008. Due to the volume of business during this time period, lenders allowed their employees to automatically sign their names on promissory notes and deeds of trust. This practice called into question the validity of many of the promissory notes and deed of trusts executed during this period.

MERS also called into questions those same loans when it became apparent that existing loans were sold from lender to lender, without a proper assignment of trustee at the county recorder where each property is located. Lenders used a nation-wide electronic system to circumvent the existing legal system that they considered too time-consuming and expensive for their needs. Amazingly, many of the courts that litigated both Robo-Signing and MERS cases have ruled in the lenders' favor and allowed them to get away with both of these practices.

"Both Robo-Signing and MERS were used during the lending boom that occurred between 2001 and 2008."

Slanted Real Estate Clause
A slanted real estate clause seen in REO lender contracts is a stipulation that the electricity does not need to be turned on for inspections during the escrow period. Real estate investors need to do a thorough inspection of the property and make sure all the appliances, HVAC, and other electrical systems work properly prior to close of escrow.

The Story of the Methamphetamine Lab Cover Up
A listing agent listed for sale an REO property located in a fairly nice neighborhood. A real estate investor placed an offer on the property and scheduled a home inspection less than a week after going into contract with

The Story of the Methamphetamine Lab Cover Up (continued)
the seller/lender. When the home inspector arrived, he found the electricity and gas turned on, as promised, by the listing agent's assistant's assistant's assistant—you get the picture. The real estate investor was never able to talk directly with the listing agent, however, the home had a faint smell of pet urine. The buyer asked the home inspector to look in the crawl space under the house to see if he could find any indication that animals had been living there. The home inspector looked under, around, and through the house, but could not find any indication of animals causing the smell.

New carpet had been installed throughout the property and the real estate investor wondered if this had been a methamphetamine lab in the past and the listing agent or REO lender had decided to not disclose it and cover it up with new carpet.

According to real estate law, the REO lender is generally not required to provide a Real Estate Transfer Disclosure Statement (TDS) for the sale of REO properties. However, the REO lender remains obligated by common law to disclose any material facts (facts that would cause the buyer to not buy the property) they are *aware of* existing in the property. Since most REO lenders have not physically seen or been inside the property, they generally have nothing to disclose to a new buyer.

E. Pressured by Multiple Offers

A real estate investor should not fall into the trap of being pressured by arbitrary deadlines set by either the REO lender or the real estate agent(s) on the other side of the transaction. Any sense of urgency is generally not in a real estate investor's best interests. Real estate investors should take their time and, if they are being pushed into buying a property, think twice before making any moves.

Real Estate Investor Willing to Walk Away

Some real estate agents price a property below the existing real estate market to develop interest and then use multiple offers to bid the property upward in price. The real estate investor must know how much they are willing to pay for the property and be willing to walk away if the price increases above that amount.

If it is a downward-trending buyers' market, buyers are usually in control and there are usually a lot of properties available for purchase. The investor has the ability to wait and not be rushed into a bad deal.

Real Estate Investor Must Move Quickly

During an upward-trending sellers' market, there are usually many competitors attempting to buy distressed single-family homes, so a real estate investor may need to move quickly when a good deal comes on the market. Prices are driven up due to supply and demand. When the demand for single-family rental properties increases, and supply stays the same, prices will generally rise. As more investors jump on the "band wagon," prices may continue to rise.

The smart real estate investor was the one who bought single-family rental properties during the start of the last upward-trending sellers' market, thus taking advantage of the fact that there were fewer investors competing to buy REO properties.

Other Distressed Properties

During an upward-trending sellers' market, Federal Bankruptcy Court debtors who are filing Chapter 7 liquidations, as opposed to Chapter 13 restructurings, may find their property exemptions are not enough to protect the equity in their homes. This leaves the bankruptcy trustee with the task of selling the property on the open market and disbursing the proceeds into the debtor's estate. Creditors are generally paid in the order of their priority, depending on the type and timing of their claim on the debtor's estate. **Federal Bankruptcy Court trustees** have been entrusted by the Federal Bankruptcy Court to handle the processing of bankruptcies, with the Federal Bankruptcy Court judge involved in the final approval of the sale of assets and final disposition of the bankruptcy.

"When a buyer makes an offer that the bankruptcy trustee believes is within 90% of the market value of the property, the bankruptcy trustee will usually authorize the sale of the property."

When a buyer makes an offer that the bankruptcy trustee believes is within 90% of the market value of the property, the bankruptcy trustee will usually authorize the sale of the property. Most disclosures used during a normal real estate sale are exempt for bankruptcy properties, thus a buyer must be diligent when inspecting the property during the physical inspection contingency period.

A key difference between Chapter 7 bankruptcy sales and normal real estate sales is the sale must be approved by the Federal Bankruptcy Court. Other bidders are allowed to appear in bankruptcy court at the time of court confirmation of the sale and bid <u>above</u> the accepted offer already signed by the bankruptcy trustee.

The reason this can occur is because the contract between the bankruptcy trustee and buyer states, “This contract is subject to Bankruptcy Court approval.”

A contract provision of this nature allows the bankruptcy court to accept a higher bid at the confirmation hearing and not confirm the sale to the original buyer. The original buyer has the ability to bid above the new offer—thus starting a bidding war. The problem with a bidding war for an expensive property such as a house, is proving to the Federal Bankruptcy judge that the bidder has good funds available to purchase the property. Buyers who bid against the original accepted contract are usually required to provide a bank or cashier’s check in the amount of the bid at the time it is made in front of the Federal Bankruptcy judge.

The Story of a Federal Bankruptcy Court Bidding War

A young couple discovered a for sale sign placed in the front yard of an older home located in a higher socio-economic area. It was a Chapter 7 asset disposition through the Federal Bankruptcy Court and was being sold by a real estate broker who was hired by the bankruptcy trustee who was handling the case for the court. The buyers made an offer to purchase the property and it was accepted by the bankruptcy trustee. Even though the debtors still owned legal title to the home, the bankruptcy trustee is given the ability to sell the property to recover as much money to the estate as possible. There was a considerable amount of equity in the home and the debtors exemptions were not enough to save the home from being sold to repay their debts.

The purchase contract stipulated a 45 day close of escrow, after which the buyers were to have removed physical inspection, financing, and appraisal contingencies to the contract. Near the end of the 45 day escrow period, the entire transaction was required to be approved by a Federal Bankruptcy Court judge. When the buyers appeared in front of the judge, along with the bankruptcy court trustee and real estate broker who listed the home for sale on behalf of the bankruptcy court, another real estate investor bidder appeared in court and made a bid that was $5,000 higher than the original offer that was accepted by the bankruptcy court trustee. The real estate investor brought a bank check in the amount of the higher bid and provided it to the bankruptcy court judge for examination.

The judge was a grizzled old veteran who ran his courtroom like an assembly line, so it wasn’t often that he was dumbfounded. After considering his options for a long moment, he decided to give the parties one week to figure

The Story of a Federal Bankruptcy Court Bidding War (continued)

out what they were going to do and appear back in court to resolve the matter. One week later the buyers appeared, along with the real estate investor who made the competitive bid, and the judge had to make a decision. Both bidders had decided not to increase their bids.

The judge realized that he was required by bankruptcy law to accept the bid that provided the greatest return to the estate, so he accepted the real estate investor's bid that was $5,000 higher than the original owner-occupied buyers' accepted contract. The reason the Federal Bankruptcy Court judge was able to accept a higher bid at the court confirmation hearing was because the purchase contract contained the phrase, "Subject to bankruptcy court approval." The confirmation process allows the bankruptcy court to verify that the asset is being sold for at least 90% of fair market value. In this case, the court increased the amount to the estate by $5,000.

The Story of the "Tricky Doc"

A real estate broker was performing Chapter 7 asset dispositions for the Federal Bankruptcy Court. One debtor, who was a medical doctor, filed for bankruptcy protection and then attempted to devalue his home so the bankruptcy trustee would not be able to sell it and obtain any money to the estate.

The first thing the "Tricky Doc" did was flood his front yard with water to make it difficult for real estate agents to get to the MLS lockbox. The real estate broker quickly remedied this problem by placing stepping stones from the walkway through the mud up to the lockbox.

The Tricky Doc then removed all the flooring in the kitchen and bathrooms. He said he was "remodeling." This was a custom home in a fairly high socio-economic neighborhood; however, it did have a concrete foundation. The doc pointed out water stains on the floor in the kitchen. He said water had been bubbling up from beneath the floor for a long time.

The doc also informed the real estate broker that the roof was leaking and the 4 foot square hole in the garage wall was there because his sailboat did not fit in the garage. The bankruptcy trustee never did find the boat.

The Story of the "Tricky Doc" (continued)
The doc recently had a "drive by" shooting at the property, even though he couldn't produce a police report. The doc placed a "cheesy" car port cover in the front driveway, and when that didn't seem to be slowing down the sale of the property, he had a boyfriend and girlfriend pose as potential buyers and ask specific questions about the leaks in the floor and roof.

The real estate broker became suspicious and notified the bankruptcy trustee that the debtor was probably going to try to go after the real estate broker personally for nondisclosure of a material fact. Of course, bankruptcy properties are exempt from most, if not all, of the disclosures required for normal residential sales. The real estate broker did not think the Tricky Doc understood this fact.

The couple, who were posing as buyers, used leading questions to try to get the real estate broker to say that the doc was having problems with people knowing about his bankruptcy. This was a blatant attempt to get the real estate broker to say something derogatory that could be used in a defamation suit (slander). The real estate broker wisely said nothing.

Sure enough, the Tricky Doc appeared in court with his attorney and tried to use the nondisclosure issues and defamation cause of action as a means of keeping his house from being sold. The bankruptcy judge was not sympathetic and informed the Doc and his attorney that he might want to start looking for a new place to live.

Homeowners, who purchased homes during the lending bubble that occurred between 2001 and 2006 in California, may have had their individual FICO scores adversely affected when loan payments increased due to adjustable rate mortgage adjustments and loan recasts. Not being able to buy another home was the least of these shell-shocked borrowers concerns. The main concern was how a short sale or trustee's sale may affect their ability to obtain a job in the future.

Former Homeowners Disclosing a Foreclosure on Their Record

Many employment and loan applications ask applicants to disclose whether they have had a home foreclosed in the past. This fact can be damaging to a person's employment prospects, as well as their ability to obtain credit cards (although this may *not* be a bad thing in the long run) or a personal loan. Fortunately, this time around the lending market has been marred by extensive lender fraud, so most employers are aware of this fact.

A short sale is generally not considered a foreclosure, so it may not have to be disclosed on employment applications and loan applications in the future. It may, however, detrimentally affect a consumer's credit rating similar to a foreclosure, and cause a potential borrower to wait 3-5 years or more before they are able to obtain a new real estate loan.

Consumer Credit Reports

Lenders have been responsible for the existence of credit reporting agencies in the past. Bad credit generally equates to a higher loan interest rate and more revenue to the lenders. To stay in business, lenders may need to reduce their underwriting standards to make loans to people who have had a foreclosure on their record, and/or change the FICO score formula to make it easier for a consumer to obtain a good FICO score. Next is a look at a wrongful foreclosure case.

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SELECTING ESCROW AND TITLE

Arlante and Severo v. Deutsche Bank National Trust Company, Trustee for Indymac INDX Mortgage Trust (2015)

Court of Appeals of California, Second District, Division Five
Filed February 26, 2015

Plaintiffs Ramon Arlante and Nelida Servero sued Deutsche Bank National Trust Company (the "Bank"), as trustee for IndyMac INDX Mortgage Trust 2005-AR27, following the sale of their residence at a nonjudicial foreclosure sale.

Plaintiffs did not dispute that their loan was in default, but maintained that, for various reasons, including the ineffective "securitization" of the loan, neither the Bank which had initiated the foreclosure nor the substituted trustee which carried it out was authorized to do so.

The trial court sustained the ruling that the recorded documents of which it took judicial notice established that plaintiffs were not entitled to relief.

We agree with that conclusion, and so affirm the judgment.


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SELECTING ESCROW AND TITLE (*continued*)

Arlante and Severo v. Deutsche Bank National Trust Company, Trustee for Indymac INDX Mortgage Trust (2015)

In August 2005, plaintiffs obtained a loan in the amount of $277,600 (the "Loan") from E-Loan, Inc. ("Lender") to purchase the real property located at 330 N. Howard Street in Glendale (the "Property").

The Loan was secured by a deed of trust (the "Deed of Trust") on the Property, which contained a power of sale in the event of plaintiff's default.

Pursuant to the Deed of Trust, Mortgage Electronic Registration Systems, Inc. ("MERS") as nominee on behalf of the Lender and its successors and assigns was named the original beneficiary.

Starting in or about June 2011, plaintiffs were not able to make their regular mortgage payments. Plaintiffs sought assistance from the mortgage servicer, IndyMac Mortgage Servicing, but "<u>could not make any meaningful contact with any of IndyMac's agents</u>."

On August 27, 2012, MERS assigned its beneficial interest under the Deed of Trust to the Bank ("Assignment").

On September 7, 2012, the Bank substituted Aztec Foreclosure Corporation ("Aztec") as the trustee of the Deed of Trust.

On August 31, 2012, Aztec caused to be recorded a Notice of Default and Election to Sell Under Deed of Trust.

A Notice of Trustee's Sale pursuant to the Deed of Trust was recorded on November 28, 2012.

A second such notice was recorded on May 28, 2013, designating a foreclosure sale date of June 20, 2013.

On that date, Preferred Group Properties purchased the Property at the foreclosure sale.

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SELECTING ESCROW AND TITLE (*continued*)

Arlante and Severo v. Deutsche Bank National Trust Company, Trustee for Indymac INDX Mortgage Trust (2015)

Aztec executed a Trustee's Deed Upon Sale, which was recorded in the Los Angeles County Recorder's Office on July 2, 2013.

On July 5, 2013, plaintiffs filed this lawsuit for wrongful foreclosure, breach of contract, violation of Business and Professions Code section 17200, and declaratory relief.

After the Bank filed a complaint bringing causes of action to set aside the trustee's sale, to cancel the trustee's deed of sale, and for wrongful foreclosure and unfair and unlawful business practices.

The Bank again demurred, arguing that the gravamen of the allegations concerning the Bank was simply a challenge to the Bank's authority to commence foreclosure proceedings, an action a borrower is not entitled to bring--pursuant to the holding of Gomes v. Countrywide Home Loans, Inc. (2011) 192 Cal.App.4th 1149.

The Bank also contended that the recorded documents, which were subject to judicial notice, refuted all of plaintiffs' claims.

The trial court granted the Bank's request for judicial notice of the recorded documents and, in a written order filed on November 5, 2013, sustained for "failure to state facts sufficient to constitute a cause of action for the reasons argued." The court granted plaintiffs 10 days' leave to amend.

On November 15, 2013, plaintiffs, now represented by counsel, filed against the Bank and others for wrongful foreclosure, violations of Civil Code section 2923.5 and the Business and Professions Code, breach of contract and of the implied covenant of good faith and fair dealing, and to set aside the trustee's sale and to quiet title.

The critical factual allegations which formed the basis of plaintiffs' claims were that the "Defendants, by virtue of their actions to securitize Plaintiffs'


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SELECTING ESCROW AND TITLE (*continued*)

Arlante and Severo v. Deutsche Bank National Trust Company, Trustee for Indymac INDX Mortgage Trust (2015)

loan, had no legal authority to execute the foreclosure process which culminated in the non-judicial trustee sale of Plaintiffs' home on June 20, 2013."

This is so because the agreement governing the IndyMac Trust which held the securitized loans "required that all mortgage files transferred to the trust be delivered to the trustee or initial custodian of the IndyMac Trust, before the closing date of October 28, 2005.

The remainder of the causes of action alleged were grounded in the allegation that the Bank initiated the foreclosure proceedings on the Property without the requisite authority to do so, due to the faulty "securitization" of the Loan and Deed of Trust.

Finally, the Bank contended that plaintiffs could not state a claim for quiet title or to set aside the sale because they failed to allege that they tendered payment of the indebtedness to the Bank, an essential element of those claims.

The trial court entirety dismissed the action. Plaintiffs timely appealed the order of dismissal.

"The elements of a claim for wrongful foreclosure are:

(iv) the trustee or mortgagee caused an illegal, fraudulent, or willfully oppressive sale of real property pursuant to a power of sale in a mortgage or deed of trust;

(v) the party attacking the sale (usually but not always the trustor or mortgagor) was prejudiced or harmed; and

(vi) in cases where the trustor or mortgagor challenges the sale, the trustor or mortgagor tendered the amount of the secured indebtedness or was excused from tendering."

The complaint alleges that the Bank violated the provisions of Civil Code section 2923.5 by failing to contact plaintiffs in person or by telephone prior


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SELECTING ESCROW AND TITLE (*continued*)

Arlante and Severo v. Deutsche Bank National Trust Company, Trustee for Indymac INDX Mortgage Trust (2015)

to filing a notice of default in order to assess their financial situation and explore options to avoid foreclosure.

Plaintiffs alleges that they were thus denied the opportunity "to avoid foreclosure by renegotiating the terms of [their] mortgage, or by tendering payments in arrears according to a mutually agreeable repayment o[r] forbearance plan. Had Plaintiff[s] been aware of said options, [they] would have made [their] best effort to cure any default."

However, as the court in Mabry, supra, 185 Cal.App.4th 208 held, when a lender fails to comply with the requirements of Civil Code section 2923.5, "the *only* remedy provided is a postponement of the sale before it happens." (Mabry, supra, at p. 235.)

The complaint's remaining causes of action are based on theories which we have determined do not support a claim for relief. Accordingly, we affirm the trial court's order and entry of judgment of dismissal.

The judgment is affirmed.

TURNER, P.J. and KRIEGLER, J., concurs.

Next is a look at long-term single-family investments versus flipping for short-term profits.

9

LONG-TERM SINGLE-FAMILY INVESTMENTS VS. FLIPPING FOR SHORT-TERM PROFITS

"If you want to be successful, it's just this simple. Know what you are doing. Love what you are doing. And believe in what you are doing." -Will Rogers

Single-Family Homes: Long-Term Holds vs. Flipping

Single-family real estate investors usually make money flipping homes or keeping them for a long period of time. **House flipping** allows the investor to capture immediate active income, while **long-term investors** look for annual cash flows in addition to price appreciation of the asset over the holding period.

"House flipping allows the investor to capture immediate active income, while long-term investors look for annual cash flows in addition to price appreciation of the asset over the holding period."

House flippers are constantly looking for good deals, buying them, renovating, and then selling for a profit. This is a high energy business that requires the house flipper to get in and out of markets quickly before interest rates increase or the local real estate market starts moving in a downward direction.

Conversely, single-family investors looking at a long-term hold are looking for a property that will yield a reasonable annual return derived from rental income, and then sell for a profit at the end of the holding period. Long-term investors have one thing going for them: time usually heals. If they make a property or market timing mistake, they may be able to keep the asset for a longer period of time and possibly recoup their investment and make a profit.

A real estate flipper likes to purchase a single-family home, renovate it, and then sell it. This "flipping" mentality can make money; however, it is dangerous because the house flipper can also just as easily lose money during a downward-trending buyers' market. In addition, flipping properties may classify your client as a dealer who must pay taxes on the gains generated by flipping properties. This is generally considered active income by the U.S. Internal Revenue Service (IRS) and can have a higher tax rate than passive income received from long-term real estate investment properties. **Passive real estate investments** may be able to defer capital gains taxes through an IRC 1031 tax-deferred exchange. Of course, always have your clients see a CPA and attorney prior to any investment endeavor.

Many of the best deals tend to occur during a downward-trending buyers' market when single-family homeowners are in trouble. So how do real estate investors make the most money over time?

Advantages of Long-Term Holds

Long-term holds have an advantage over flipping properties: the real estate investor can avoid many of the transactional costs inherent in buying and selling single-family homes. With a long-term hold the investor can consider buying when the real estate market is down and sell when it is up. The single-family home market can be tracked and real estate investors usually have plenty of time to plan their moves.

Advantages of House Flippers

A factor that may positively affect a house flipper's success when flipping single-family homes, is when the market increases during an upward-trending sellers' market. It is like swimming downstream. When the demand for single-family homes exceeds supply, prices tend to rise.

"When the demand for single-family homes exceeds supply, prices tend to rise."

House flippers may be interested in flipping properties during an upward-trending sellers' market; however, the competition for suitable properties generally becomes so heated that they are sold long before they reach the Multiple Listing Service. Conversely, near the bottom of a downward-trending buyers' market there are generally very few competitors flipping houses, so a house flipper may have time to find appropriate properties, get them into contract, and close escrow before competitors know what is going on. A house flipper, who incorrectly judges the real estate market, will usually become a long-term investor hoping time will rectify their mistake.

Issues with House Flippers

Success in flipping single-family homes is generally predicated on buying a home for a below-market price, renovating it as fast as possible with as little out-of-pocket expenses as necessary, and then selling it for as high a price as possible. There are many variables that can detrimentally affect a single-family home flipping plan. If the real estate single-family home market is moving downward at a faster pace than the house flipper can renovate the property and get it back on the market, then the house flipper may actually lose money on the deal.

Dealers vs. Long-Term Investors

Dealers and long-term investors generally have completely different motivations and investment philosophies. The long-term investor may be looking for positive cash flow during the holding period of the asset and an increase in value when it is sold at the end of the holding period.

Dealers, on the other hand, may be looking to make money buying and selling single-family homes. They are only concerned with what they are paying for the property and what they can sell it for—and as quickly as possible. Some dealers look to acquire a property, do a quick rehab, and then sell it. Others look to buy several properties (in bulk) at wholesale prices and sell them individually at retail prices, without performing any renovations at all.

Speculators

Speculators can drive single-family home prices up, similar to a Ponzi scheme, with no sound basis for the price increases—except finding another buyer who is willing to pay more money for the property. This occurs when speculators descend upon an area and drive single-family home prices above the affordability level of local owner-occupied buyers. Prevailing wages in the local area do not support real estate investor-inflated prices and, under normal loan underwriting guidelines, owner-occupied buyers cannot afford the debt service payments. This is especially true if borrowers have adjustable-rate loans and interest rates increase over time. Consequently, when the speculators leave the market, so do the home values. In the long run, a real estate market will generally adjust to a level that is affordable for local homeowners with normal loans, not speculators looking for quick profits.

The main difference between long-term real estate investors and house flippers is **investment philosophy**. Long-term investors are willing to let the real estate market and time do the work of providing cash flows and price appreciation over a projected holding period. House flippers, on the other hand, are willing to use their own time, skill, and efforts to produce short-term profits. House flippers will most likely be considered real estate dealers and their income will be considered active, so they will pay an income tax rate that is *usually* higher than passive investment income. Conversely, even though a long-term investor's annual cash flows will be taxed at the active income tax rate, long-term capital gains tax rates (for properties usually held over one year) *may* be less than active income rates. In addition, long-term real estate investors may be able to utilize an **IRC 1031 tax-deferred exchange** to move equity out of one real estate property and into one or more other properties located in advantageous markets located within the U.S. and its territories. Active income house flippers generally cannot use the 1031 exchange option to defer gains. Of course, have all of your clients see a CPA and attorney prior to any investment endeavor.

"House flippers will most likely be considered real estate dealers and their income will be considered active, so they will pay an income tax rate that is usually higher than passive investment income."

Long-Term Holds

One of the best ways to invest in real estate over the long-term is to purchase a single-family home during a downward-trending buyers' market. The real estate investor can perform some cosmetic work, including painting and landscaping, and then rent the property to a good quality tenant who will (hopefully) live there during the entire holding period.

The real estate investor has the choice of personally managing the property or hiring a professional property manager. Then, when the market changes direction and moves into an upward-trending sellers' market, the real estate investor will usually wait until the top of the real estate market to sell it.

At this point, the real estate investor may either perform a 1031 tax-deferred exchange and exchange their equity (and deferred capital gains taxes) into another real property—possibly located in a geographic market that has not yet peaked; or sell the property and cash out—thus paying all the capital gains taxes that are due at that time.

The real estate investor may place the sale proceeds in a "safe" bank located somewhere in the U.S. and wait until the next downward-trending buyers' market nears the bottom. . .and do it all over again. It should be noted that as of July, 2014 it became much more difficult to wire funds outside of the U.S.

Some real estate investors have been known to invest their cash in the stock market between the time they sell a property, and the time they purchase their next long-term hold property at the bottom of the next downward-trending buyers' market. The investor may be able to obtain a greater return on their money while it is in the stock market, than if it were earning interest in a bank.

However, the stock market can be dangerous. In 2008, a huge stock market adjustment resulted in many investors losing a significant amount of their net worth. The key is to navigate between rising and falling real estate and stock markets in an attempt to maintain earned equity and preserve an investor's wealth.

Long-Term Hold Renovation Scenario

The next story looks at a renovation scenario where the buyer performs a cosmetic renovation, holds the property until the top of the next upward-trending sellers' market, and then sells it for a nice profit.

The Story of Gary

Gary was interested in purchasing a single-family home located in a retirement resort community at approximately 4,000 feet elevation and between San Francisco and Lake Tahoe. He checked the local multiple listing service and found several properties that were on-the-market and all of them well over-priced. This is very common during a downward-trending buyers' market.

The Story of Gary (continued)
Most sellers do not understand that during this type of market it is <u>ALL about the price of the property.</u> If the property is over-priced, it is going to sit and sit and sit. . . and always be priced ABOVE and selling BEHIND the real estate market. A seller needs to be in FRONT of the real estate market—not behind it. Many property owners have a difficult time coming to grips with the reality of dropping their property list price to get in front of the market—thus preventing a lot of wasted time for everyone involved, and netting more money for the property.

When a seller insists on over-pricing a listing, real estate agents have a couple of choices: they can decide not to accept the listing or they can take the listing and watch it sit on the market for a long period of time—while chasing the market downward. Experienced real estate agents understand that a for sale sign located in the front yard of the property will attract buyer calls.

Since the subject property is over-priced, sometimes the listing agent will be asked to find a potential buyer a different property that is priced correctly. The agent then sells them a similar property that is priced within the market. The for sale sign turns into a marketing platform for the agent; however, if the seller had went along with the agent and priced the property in *front* of the downward-trending buyers' market, the buyers may have purchased the subject property. Instead, the buyers purchased another property where the seller listened to the listing agent and the property was sold.

Gary was looking at one of the over-priced homes, when he noticed a home located across the street with an old "For Sale by Owner" sign sitting in the front yard. Gary figured this was either going to be a total wild goose chase or a really good deal.

Gary called the faded telephone number that was listed on the sign and an elderly woman answered the telephone. He asked her "How much do you want for your home?" She told him the price that she and her husband were asking was $140,000. Gary immediately asked if he could see the inside of the home.

Gary arrived at the home at the appointed time and really looked it over—inside and out. He saw an ugly green exterior paint color, 3 bedrooms/2.5 baths, both electric and propane heaters, central air conditioning, public water,

The Story of Gary (continued)
septic tank, good floor plan, and it looked like custom construction. When he asked the couple about the construction, he discovered that the husband had personally built the house twenty years earlier and they had used it as a vacation home ever since. They had built the home for their son who was killed in a car accident before he could move into the home.

Whenever Gary hears of a personal tragedy like this, he feels sorry for the parents. It really must have been hard on them. However, from a business standpoint he could see that the couple had an emotional attachment to the home and really had not wanted to sell it in the past. That was why the “For Sale by Owner” sign in the front yard was faded and the home had not sold.

The couple had only put the property on the market in a half-hearted way. Since they had not previously listed the home with a broker, Gary was concerned about deliverability. They may not, deep down, really want to sell the property because of the memories of their son who had died twenty years earlier.

Gary really wanted the home. He assumed that an older couple with memories may want the home to go to someone who they liked and their son would have liked as well. It appears they liked Gary enough to sell him this wonderful renovation project.

The first thing Gary did, after closing escrow, was paint over the ugly green paint currently on the exterior of the home. He picked a light tan earth tone color at a local paint store. When he started spraying it on the home, it turned out to be off white!!??!! His new neighbors started giving him strange looks. They were probably wondering why he had changed from ugly green to ugly off white. Gary explained that this was the “primer coat.” What else could he say, and the “real paint would look much nicer.” Gary went straight to another local paint store and asked to see the paint before he purchased it. This time he got a nice “woodsy” earth tone color that everyone, including his neighbors, seemed to appreciate.

The next phase of the renovation was painting the inside of the home. The guest bathroom was presently painted yellow, the master bathroom was painted blue, and the ½ bath in the utility room was painted orange. Gary’s wife jokingly said, “The house was built in the 80’s, but decorated in the 60’s.”

The Story of Gary (continued)
After painting the entire inside of the home, Gary then started to concentrate on the light fixtures. He went to Lowe's, where they generally have a good selection of light fixtures, and purchased several new light fixtures and installed them throughout the home. This really made a big difference. He also installed new fans with lights in all three bedrooms.

His next phase was to renovate the kitchen. He purchased and installed a new range with oven and new countertops. Spending money in the kitchen is probably one of the best places to spend it, because the kitchen is a critical part of the home. Homeowners generally spend a lot of time in the kitchen.

The next thing he did was install a new laminate floor in the kitchen and utility room. He then installed new windows in the sun room and new carpet throughout the rest of the house.

The last thing he did was paint the outside decks, reinforce supports, and install downspouts for proper water drainage. A small retaining wall was constructed to stop any further soil erosion.

Gary's son was about five years old at the time of the renovation and was "helping" him paint the deck a nice redwood color. Gary heard a yell and discovered that his son had painted himself into a corner and didn't know what to do. They still laugh about that one.

The "paint and landscape" routine usually works well for long-term holds. If not careful, an investor can really over-improve a single-family home. Too much of a renovation too early in the holding period can become a waste of money if tenants beat up the property and destroy the renovation.

Savvy real estate investors like to purchase a home, hold onto it through an upward-trending sellers' market, and then perform a complete renovation just prior to selling it at the top-of-the-market. As mentioned earlier, if the market is *really hot*, the real estate investor may be able to sell the property for a very high price and <u>not</u> perform the renovation at all. It all depends on the market timing.

The Story of Chris

Chris purchased a home located near beautiful blue Lake Tahoe. It had 2 bedrooms/2 bathrooms and was near a popular ski resort. The home had good curb appeal, however, the inside of the property needed to be renovated. The orange countertops really made it look “dated.”

After purchasing the property during the start of an upward-trending sellers’ market, Chris replaced the counter tops in the kitchen, all of the light fixtures throughout the home, and insulated the bottom floor by placing rolled fiberglass insulation under the bottom of the floor to the home. His initial intention was to use the home as a vacation rental. Unfortunately, the vacation rental property management fee was 35% of the gross collected rents and the property management company he selected did a really lousy job managing the property.

Chris could have used one or more of the vacation rental websites specifically designed for owners, such as Vacation Rentals by Owner (VRBO), but he really did not want the management intensity that went along with renting a vacation home.

Homes located in vacation areas are many times priced much higher than surrounding “normal” market areas. This is generally due to their destination locations close to places like Lake Tahoe, Maui, or Park City, Utah; along with their desirability as second homes. A home located in a resort area may derive a higher return as a vacation rental than it will as a permanent rental.

The Lake Tahoe house cash flowed better as a vacation rental than as a permanent rental. Chris had paid too much for the property for it to cash flow as a permanent rental. However, because he was looking at a long-term hold while riding the upward-trending sellers’ market upward, he decided to rent it out as a permanent rental anyway.

He sold the home a year or so after his purchase and made a nice profit. He had completed an extensive renovation and was able to sell it for a nice price. Timing was critical to his entire decision process.

Investing in resort areas can be tricky. It really depends upon the client’s investment objectives. If an investor is looking for cash flow, he may find properties located in destination locations to be far inferior to properties located in average urban areas. Resort areas tend to hold their values well over time and are a good place to "park" some of an investor's wealth. However, the investor should not expect much of a cash flow. The real estate investor will most likely make the most money through long-term price appreciation.

If an investor is looking for cash flow and a good overall return on equity, buying homes located in low to medium socio-economic neighborhoods near solid year-round job sources may be a better investment alternative. Rents tend to be higher in relation to the purchase price of these types of homes, and the investor will not be forced to overpay in order to control the asset during the holding period.

Vacation-type properties located in destination locations usually require a lot of management intensity to derive an adequate return as a vacation rental, and/or it must be justified by its use as a second home. As mentioned earlier, permanent rentals generally do not cash flow very well for vacation homes located in resort areas because of high acquisition costs. Property owners in the area may effectively price permanent rentals out of the market.

The Story of Miriam

Miriam bought a 3 bedroom/2 bath single-family investment property with a two car attached garage. It was painted pink on the outside, had metallic blue shag carpet throughout the inside, and needed a total cosmetic renovation throughout. On top of this, someone had died in the home. If a person dies inside a home located in California, the seller must disclose this fact to all buyers within three years of the death. After three years, the seller is not required to disclose this fact.

In addition, there was a potential prescriptive easement issue on one side of the property. The seller had removed 20 feet of fencing to allow his neighbors to come onto his property and pick lemons from his lemon tree. If the neighbor could show that the access to the 20 foot strip along the side of the house was: open and notorious, uninterrupted for at least 5 years, the neighbor had a claim of right, and it was hostile to the property owner's intent, then the neighbor may have acquired a prescriptive easement allowing the neighbor use the 20 foot strip of land. The owner of the property with the 20 foot strip of land on it would have to allow the neighbor to come onto his property and pick lemons from his lemon tree. A prescriptive easement can be lost by nonuse for five years, or a reasonable length of time.

The Story of Miriam (continued)

Miriam considered the fact that the property was painted pink, had blue shag carpet, a death disclosure issue, and a prescriptive easement problem. For these reasons, she offered the seller a very low purchase price. The seller accepted her offer and Miriam thought she had negotiated a pretty good deal.

She painted the outside of the home a nice earth tone color, replaced the blue shag carpet with a neutral-colored carpet, and replaced the missing fence. She explained to the neighbors that the new fence was going to be used "to keep the dogs out." She then rented out the home and waited for the real estate market to take off.

Three years after she purchased the home, the death disclosure "expired" and she was not required to disclose the death in the home. Five years after her purchase she was relieved to know that the prescriptive easement had been terminated by nonuse and was not a material fact that needed to be disclosed to a new buyer.

Once Miriam's neighbor had the prescriptive easement, Miriam may not have been able to stop him from continuing to use her property to pick the lemons located on the lemon tree in her yard. This is the only type of easement that is gained by use and lost by non-use, and usually does <u>not</u> appear in the chain of recorded title by way of a preliminary title report.

Miriam eventually sold the home for a nice profit. She was able to purchase the home at a very low price, cosmetically renovate it, rent it to a tenant, and ultimately rode the upward-trending sellers' market upward and sell at the top-of-the-market.

Miriam was smart with her renovation. Renovating a single-family home that will be held for a long period of time is very different from rehabbing a home that will be immediately sold or "flipped." A long-term home renovator usually completes just enough work to get the home in a livable and rentable condition, but not much more than that.

Too nice of a renovation can many times end up a huge waste of money. The investor may have to (once again) replace many of the appliances and other items as they wear out or are destroyed before the property is sold at the end of the holding period. Depending upon market timing, this could be many

The Story of Miriam (continued)
years down the road.

A better strategy might be to wait until the end of the investor's holding period to perform a complete and expensive renovation that will attain a high sale price for the home. However, the real estate investor must be very careful. As mentioned earlier, in really hot markets, as the market nears the top of an upward-trending sellers' market, buyers will many times become so desperate to purchase a home that they will pay top dollar for a property <u>without</u> the investor having to complete an expensive renovation.

And that's what Miriam did. She lived in the home while the market moved upward, and then sold it in its present condition and without an expensive renovation. Because she had sold the property at the top-of-the-market, she received close to what she would have received if she had actually performed the renovation.

It should be noted that many appraisers become caught up in the "roller coaster to the moon" syndrome. Appraisers think the market will continue going upward forever, and get caught up in it by appraising the property as if it were already renovated.

Accordingly, appraisers have been mistakenly blamed for many of the United States' financial problems over the years. They received the blame for the savings and loan debacle that occurred during the mid-1980s; the downward-trending buyers' market that occurred in California from 1991 through 1997; and financial system woes caused by the 2001-2006 "subprime" lending and collateralized debt obligation fiasco. Most of the problems were caused by the bankers themselves, not the appraisers. Appraisers are not saints, however, they definitely are not solely responsible for causing the near collapse of the entire U.S. financial system.

Death Disclosure Story
One homeowner did not know what to do about a possible death disclosure issue for the sale of his home. A Cessna 172 airplane had crashed into his house. The fuselage was sitting inside the home, while the tail assembly was sticking up in the air outside. The homeowner could not determine whether the pilot died *before* or *after* he flew it into the home. It is probably a good

Death Disclosure Story (continued)
idea to disclose this fact to any buyers who buy the home. If the seller does not disclose it, the first thing the neighbor's will say to the new homebuyer when they meet is, "Did you know about the airplane that crashed into your house?" The buyer's next call will be to their real estate attorney to file a lawsuit for nondisclosure of a material fact.

During a downward-trending buyers' market, there will continue to be some homes that contain equity. Most of them are older homes that are paid off by the borrower or have very small real estate loans. A real estate investor can find good deals if there is a motivated seller. The seller may be able to carry the loan on the property himself. This is called seller financing, owner financing, seller carry, or owner carry. This type of loan tends to do well if:

(1) Interest rates have risen to very high levels on the open market;
(2) Lenders are not making very many loans;
(3) The borrower has "banged up" credit—due to being sucked into the 2001-2006 subprime crisis.

Seller Financing

A seller who personally carries a loan on a home with considerable equity in it, may be able to obtain a higher price if it is sold during a tight lending market—when lenders are making high interest rate loans or not making loans at all.

In fact, some real estate investors who purchased REO properties with all cash near the bottom of a downward-trending buyer's market, have found a way to owner finance their own investment properties and thus receive a much higher-than-market purchase price.

Since there is no appraisal required when a home is owner-financed, real estate investors can receive above-average returns without having the responsibilities of owning, managing, or maintaining the properties. If the buyer defaults on the loan, the real estate investor will usually foreclose on the seller-carry deed of trust and either sell the property again or rent it to a tenant—whichever is more advantageous to the investor at the time. This many times depends on market timing.

One little problem with this strategy is that real estate investors are artificially inflating the sale prices of owner carry properties because of the lack of cheap, low interest rate financing available in the overall real estate market. The actual value of single-family homes in the market is usually based on the total underwriting guidelines used by regular institutional lenders, not owner-financed loans. For this reason, the real estate investor is not really able to "capture" the increased equity until the loan is actually paid off in the future. With the possibility of inflation kicking in and making these above market gains now worth less in the future than they were at the time the loan was made, becoming a lender may not be as good a strategy as being a real estate investor.

"The money extended as a seller-carry loan may be worth significantly less in the future if inflation kicks in before the loan is paid off."

The money extended as a **seller-carry loan** may be worth significantly less in the future if inflation kicks in before the loan is paid off. As property values increase due to inflation, the property owner may be the winner because he owns the hard tangible asset—the home. When the lender receives the funds back at the end of the loan period, inflation can make the funds worth significantly less than they were worth when the loan was originally made.

All-Inclusive Trust Deeds (AITD) and Wraparound Mortgages

Another tactic that has been used by real estate investors during increasing interest rates is the **All-Inclusive Trust Deed** (AITD) or "**wraparound mortgage**." The owner sells the property to an investor and wraps the existing loan with an AITD.

The AITD is actually a junior lien—2nd loan—that is usually greater in value than the existing loan, which is the 1st loan. One problem with AITDs and wraparound mortgages is that due-on-sale clauses will make the existing 1st loan all due and payable when the grant deed conveying title is recorded.

Some investors have circumvented these clauses through an instrument called a **land contract**, also called contract of sale or installment contract. An unrecorded land contract is used to transfer **equitable title** (possession) of the property to the buyer/vendee. Since the document is not recorded, it will not trigger the **due-on-sale clause** in the existing 1st loan. The land contract allows the seller/vendor to usually keep the **legal title** to the property until the land contract is paid off. At that time, the seller/vendor will use a grant deed to transfer legal title to the buyer/vendee.

Be very careful with land contracts. If the seller dies while the land contract is in effect, the security may become “stuck” within the seller’s estate. When a buyer/borrower pays it off, they may have a difficult time obtaining legal title. For this reason, it is best to refer unrecorded land contracts to a real estate attorney who specializes in these types of transactions.

Subject To

When a buyer takes a property “**subject to**,” she is taking title to the property and taking over payments of the existing loan on the property. This is without the existing lender’s approval. **Subject to assumptions**, also called Simple Assumptions, were allowed by the Department of Housing and Urban Development (HUD) for Federal Housing Administration (FHA) loans instituted up until 1986. In fact, due to ambiguities in the law, they actually continued making many of these loans until as late as 1989. The reason they were allowed by HUD was because they did not have an effective due-on-sale clause in the deed of trust or mortgage that would cause the loan balance to become due and payable upon the sale of the property. HUD wanted the buyer to be able to easily and cheaply escape the loan if needed.

> “Today, virtually all real estate loans have due-on-sale clauses that prohibit subject to assumptions.”

Today, virtually all real estate loans have due-on-sale clauses that prohibit subject to assumptions. However, with FHA insured loans HUD (and not the lender) may be the one who must enforce the due-on-sale clause. See a real estate attorney for details.

Lease Options

Whenever the real estate market turns from an upward-trending sellers’ market to a downward-trending buyers’ market, property owners will usually start to become underwater as their loans become more than the values of their homes. Most property owners will have loan payments that are significantly greater than what their property will rent for, and for this reason may be receptive to a lease option agreement.

A **lease option** agreement can derive above-market rents because the tenant/buyer agrees to pay market rents plus an additional amount to the seller/**optionor** each month. The additional amount over the market rents will be held by the seller/optionor and used as a down payment when the tenant/buyer exercises the option to purchase the property. The purchase amount of the lease option is set and the tenant/buyer then begins making payments to the seller/optionor.

Since it is generally during a downward-trending buyers' market when the property owner agrees to this type of arrangement, by the time the option expires—which is usually anywhere from two to five years in the future—the property's value will typically end up being much *less* than the option price. The tenant/buyer will probably <u>not</u> exercise the purchase option because she cannot get an appraisal that will appraise for the higher purchase price indicated in the option agreement. So, the owner/seller keeps the extra option money paid by the tenant/buyer and uses it to subsidize his existing underwater loan during the two to five year option period while the real estate market is in decline.

Sellers offering lease options tend to prey upon uneducated buyers who are desperately trying to buy a home during a time that is not advantageous for them to do so. The owner/seller generally is more knowledgeable than the tenant/buyer and is able to persuade the tenant/buyer to pay above market rents, while knowing all along that the property will probably be worth significantly less than the option price agreed upon in the option agreement.

In one instance, the property value actually *increased* during the lease option period. When the tenant/buyer was coming close to the end of the lease option period, the owner/seller "referred" the tenant/buyer to his "trusted" lender. The lender, of course, strung the tenant/buyer along until the lease option period expired and the tenant/buyer was not able to exercise the option because he did not obtain a loan during the time period specified in the option. After the lease option period expired, the owner/seller then sold the property to another buyer for the higher market value and took the profits. The unsuspecting tenant/buyer had no idea what happened. He had paid several thousand dollars more than the market rents during the lease option period, and then was not able to capture the increase in value at the end of the option period. Of course this is because the lender conspired with the owner/seller to defraud the tenant/buyer. The moral to the story is watch out for lease-options. They generally favor the owner/seller and a tenant/buyer may be left holding the bag. A better place for an aspiring buyer to save for a down payment is a tenant's own bank account, rather than into a slick owner/seller's pockets.

Holding real estate for a long period of time and then selling at the end of the holding period has historically been a good way to acquire wealth in California. Some real estate investors have been able to buy homes for a good price, renovate to current market styles, and then sell quickly—capturing quick profits that can be used to buy more properties, and the cycle continues until the house flipper believes they are nearing the top of the upward-trending sellers’ market. In this case, the smart house flipper will put his profits in the bank and sit out the downward-trending buyers’ market—waiting for the start of the next upward-trending sellers’ market to start flipping houses again.

10

LONG-TERM MANAGEMENT OF SINGLE-FAMILY RENTAL PROPERTIES

"If you think nobody cares if you're alive, try missing a couple of payments."
-Earl Wilson

California real estate brokers and salespersons who manage single-family properties must understand real estate agency relationships, fair housing laws, contract law, and rental agreements. They must have a working knowledge of property management business practices, credit and background checks, people searches, property maintenance, insurance, trust fund accounting, advertising, real estate economics, and even some knowledge of real estate taxation.

"One of the best ways to understand property management is to look at the day-to-day life of a property manager."

One of the best ways to understand property management is to look at the day-to-day life of a **property manager**. The day tends to fall into two categories: reactionary tasks that occur as a result of various tenant problems and action-oriented tasks that are designed to move the property management business forward by implementing the property management plan. A property manager's job is hectic to say the least, with many tasks requiring hands-on attention by the property manager.

1. Initial Walk-Thru

The property manager must walk through the property and note items that need to be repaired before it will be ready to rent out again. The property manager calls the maintenance guys and schedules the items that need to be repaired or replaced. She must remember to get bids ahead of time and decide what to do and how to do it. So, let's take a look at the lease up of one property in the property manager's portfolio of properties under management.

2. Turn on the Electricity

The property manager calls or uses the internet to turn on the electricity to the property. This sounds easy, however it can be very time consuming trying to change the electricity from a tenant's name into the property manager's name, then into another tenant's name after the property is re-rented out. Some property managers move the electricity into the owner's name rather than their own. It really depends upon the customs in the area where the property is located.

If the previous tenant skipped out leaving a large unpaid electric bill, the electric company may give the owner some problems turning on the electricity to the property. This is not supposed to happen; however, it does happen—especially if the owner is managing more than one single-family property in the same neighborhood—which is a high likelihood. The electric company may put two-and-two together—especially when the property manager's name continues to show up on electricity name change orders. Many times the internet may not work during this type of situation because there may be a “hold” on the account that will slow up any internet changes because they must be approved by a supervisor. The property manager will be forced to call the electric company, wait in their queue until she gets a hold of a live person, and then explain the situation.

The electric company may have to send a person out to the property to make sure the gas is turned off and there is no furniture sitting in the property, otherwise they will not turn on the electricity. If the gas is not turned off, the electric company will generally not turn the electricity on because of the threat of fire—or even worse—the whole house may blow up from a natural gas explosion. If there is furniture in the property, even items that the previous tenant left behind, the electric company may not turn the electricity on to the property as well.

When in-between tenants to a property located in California, the property manager may consider turning the electricity on in his own name, and later billing the landlord for the amount paid out of future collected rents. This really saves the owner's time because getting electricity hooked up is imperative, so the maintenance guys can do their work by using modern electrical tools (better than using a noisy generator that uses a lot of fuel).

Time is saved also when the electric company must be called to turn on the power to the property. The property manager will have to stay on the telephone, wasting time trying to get power turned on to the property. The electric company will usually send a person out to the property when the electricity is turned on to turn the master switch (in the main breaker box) on to start electricity flowing into the house.

If the electric company drags their feet too long, the owner may have to consider other alternatives to provide electricity to the maintenance guys—so they can do their jobs. One alternative is to borrow a neighbor's electricity and use an extension cord to power your maintenance guys' power tools and lights.

Another alternative is to use a gasoline generator. One drawback with generators is that some of the less expensive ones are very noisy. Honda generators are fairly quiet, but rather expensive. The owner will need to weigh the cost versus noise of a generator in light of potential rental income lost by the owner. Typically, the owner does not have any choice, especially if she has a loan on the property and must pay debt service payments each month, and will be forced to get the property into a rentable condition as soon as possible—one way or the other.

> "The owner must make sure the natural gas stays off until a new tenant moves into the property."

If a refrigerator comes with the property, having the electricity turned off for an indeterminate period of time can become a problem, especially if the previous tenant was a poor housekeeper. They may not have removed the contents from the inside of the refrigerator or have left the inside clean and useable.

3. Make Sure the Natural Gas to the Property is Turned Off (and Stays Off until a New Tenant Moves into the Property)

The owner must make sure the natural gas stays off until a new tenant moves into the property. A gas leak can be very dangerous, so having it turned off while performing repairs is generally safe and therefore a really good idea. The gas company can many times light the pilot light(s) for the tenant. Some single-family homes have a pilot light located in the gas forced air heating unit (central HVAC) and one in the gas hot water heater. For electricity, the owner must make sure the new tenant has changed the electricity over into their own name. The gas was probably never changed over into the property manager's name, so the tenant can turn that on as soon as they get it set up and move into the property.

4. Check out Rural Property LP Propane Tank

If the property uses a large propane tank of **liquid petroleum gas** (LP) sitting in the back or side yard of the property, it will have to be monitored to make sure it is full—especially if the property is located in the mountains and it is the beginning of the winter season. The propane tank itself is usually leased from the propane company. The tenant is usually billed by the property manager for their propane usage. A normal size tank usually lasts 4-6 months, depending upon tenant usage, weather conditions, and the R-value of insulation in the property. The higher the R-value the greater the resistance to heat flow, so R19 in the walls will be better than R10 or less. Another major issue with propane tanks is snow. If snow fall is so deep that it entirely covers the propane tank, there is a very good chance the propane tank will blow up. The property manager will need to explain this to the tenant in writing during move-in, and then keep an eye out during the winter to make sure snow does not pile up too high on the tank.

Water, Sewer, and Garbage
Water, sewer, and garbage bills were not mentioned previously because if they are not paid, they will become a lien on the property. The property manager will probably end up paying these bills on behalf of the owner at some time in the future. This is why many property managers increase their rental amount and then pay the water, sewer, and garbage bills themselves. Of course, if there is strict water metering occurring, the property manager may decide to pay the sewer and garbage, and bill the tenant for their actual water

5. Place a For Rent Sign in the Front Yard

Place a "For Rent" sign (with or without a flier box) in the front yard of the single-family rental property. Professional property managers may use a sign delivery and installation company to install For Rent signs or do it themselves as required.

If an owner is managing the property herself, she will probably install the sign herself. An owner may use a small metal sign frame, with a For Rent sign installed inside it, and stick it into the ground in the front yard hoping to attract a prospective tenant to rent the property. Hopefully she will also consider using informational fliers that are placed inside an attached flier box to help market the rental property. The owner will need to design and print 30-50 "For Rent" fliers and place them in the flier box.

The owner must then decide whether she wants to attach an application to each flier, or place some applications where she can instruct prospective tenants to go find them if they are at the property and are interested in submitting an application. This is especially important in lower socio-economic neighborhoods where most of the tenants do not have access to the internet or fax machines and may not be inclined to use one of the local office supply stores or internet cafes.

Conversely, professional property managers usually manage a large portfolio of properties and may not use flier boxes and fliers because they like to talk directly to prospective tenants to determine whether their income and credit rating will fit the particular home being rented. For example, if a prospective tenant does not have enough income to qualify to rent a particular home they called about, the property manager may be able to find them a less expensive home for which they can qualify.

> In California if a property manager is taking applications and charging application and credit report fees, he must have a specific property that is ready to be rented to a tenant. If the property manager has a property "coming up" but does not have it ready to move in, he is not supposed to charge an application fee or credit report fee while trying to get a "list of qualified applicants". If he does do this, he will be in violation of the law.

Another reason professional property managers are effective renting single-family homes to tenants is because they must keep up with the ever-changing landlord-tenant laws in California. A professional property manager is hired to keep the owner from violating landlord and tenant laws she didn't know existed in the first place and thereby keep her out of legal trouble.

6. Fielding Telephone Inquiries

The property manager will now be ready to start fielding telephone inquiries from prospective tenants. This can be a daunting task if the property is located in a fairly nice neighborhood without too many drive by shootings, and has fairly good curb appeal (at least the bullet holes cannot be seen from the street).

As calls from prospective tenants start coming in, the property manager must decide how to answer the calls, handle rental applications, and schedule prospective tenants to see the inside of the property.

Most owners do not have access to an online application process because of the infrequency of needing it precludes the cost, so they usually use printed applications or email. The goal is to get the application into a prospective tenant's hands without wasting too much of the owner's time. Some owners attach a blank application to each For Rent flier, while others place a stack of printed applications on the kitchen counter and give them to prospective tenants after they view the inside of the property. Some owners email or fax applications to tenants, however, giving a prospective tenant your personal email is probably not a good idea. The same goes with personal fax numbers. Owners may not rent out properties frequently enough to justify having a separate email address or fax number for tenants.

Professional property managers, on the other hand, do this for a living and have all the systems in place to make the lease-up task as efficient, effective, and stream-lined as possible.

Amazingly, some of the lower socio-economic tenants may not have a computer, internet access, an email address, or a fax machine to complete a rental application and supply needed documentation to enable the property manager to make an informed rental decision.

They may not have a checking account, so they end up paying the rent by cash or money order each month. For these types of payments, the owner may need to set up a P.O. Box at the closest U.S. Post Office or a mailbox at one of the small shipping stores to handle mailed-in rental checks. This requires the owner to take the time to frequently go by their P.O Box or mailbox to pick up checks that have come in by mail. The other alternative is to drive to the property each month and collect the rent in person. This is time consuming, but does have the added benefit of being able to keep an eye on the property each month.

The owner does not want the tenant to know where she lives. Otherwise, if the owner must evict the tenant in the future the tenant may egg the owner's house or cause other trouble. Professional property managers generally have an office location, so the tenant can take up the disagreement at the property manager's office—and not at the owner's personal residence.

Of course, a professional property manager will already have systems in place to receive and screen prospective tenant calls. Property management employees will answer dedicated telephone lines, have a website with on-line applications available for prospective tenants, business email accounts, a business address to mail applications and pay the rent in the future, and a dedicated business fax line that may or may not move everything received into a digital format.

The point is that the professional property manager has a synergy already in place that makes finding and showing properties to prospective tenants time-efficient and cost-effective when compared to the owner's occasional use of these services for her own properties. Tenants who pay their rent in cash and at the last minute (unfortunately very common), tend to drop cash off in the property manager's mail slot at the office. They do not want to send several $100 bills through the U.S. Mail, so they bring it in person and place it in the property manager's mail slot or drop box.

"The professional property manager has a synergy already in place that makes finding and showing properties to prospective tenants time-efficient and cost-effective."

7. Showing the Property to Prospective Tenants

Property managers like to pre-qualify prospective tenants prior to showing them available properties. The reasons include not wasting everyone's time and not showing criminals there next burglary target.

Property managers who attempt to show their property while existing tenants are in the process of moving out face other unique challenges. The property manager should ask the tenant if it is okay to show the property to prospective tenants during the last month of their tenancy. If the tenant says "no," the property manager is going to have a difficult time getting into the property to show it. The landlord can generally give a 24 hour notice to the existing tenants and then enter the property; however, doing so with a hostile tenant pointing out everything that is wrong with the property, both real and imagined, can really be a bad idea.

Some tenants do not want their quiet enjoyment disturbed by a bunch of people coming through the property and possibly casing the place to rob it. If the property manager has a hostile tenant situation, it may be a better idea to lose one month's rent and wait until the tenant is out of the property before trying to rent it up again.

The property manager can enter the property when the tenant is present, or with the tenant not present, if the property manager provides the tenant with a 24 hour notice of the inspection.

Prospective tenants should completely fill out the **rental application**. The property manager should look to avoid partially completed rental applications because the blank areas most likely indicate negative items the tenant probably does not want the property manager to know about.

Property Manager Must Be Careful to Not Violate Fair Housing Laws
There are many laws in California that are designed to protect tenants from landlord abuse. It is difficult for a property manager to keep up with the new legislation at the local, county, state, and federal levels; along with all the common law appellate court decisions at the state and federal levels. Professional property managers must keep up with all the changes to landlord-tenant law because their clients are relying on them to stay within the boundaries of the law. A property manager's membership in property management trade organizations usually provides this information.

8. Screening Tenants

Since the property manager is only interested in renting out this particular property, she will most likely pick the prospective tenant that appears to be the best choice and then proceeds to do a background check on the tenant. There are many background check companies that can be found using internet search engines, and they usually cost between $15 - $50, depending on the amount of services required.

The property owner most likely does not have established **vendor contacts**, so she will generally try to find one that has good reviews on the internet and is not too expensive for her budget. Unfortunately, some companies may stage positive reviews. So, if the reviews tend to be too "canned" with extraordinarily raving reviews about the company, you may want to call some of their references before using their services.

In addition, competitors may be guilty of placing negative reviews that can be misleading and make it difficult for the property manager to correctly determine which company is the best for her needs. Some advertising companies are masquerading as rating companies, and will provide a good review if you buy their advertising. Some property managers use Angie's List to find many of their vendors, relying on their customer reviews to weed out the weaker companies. A property management company will most likely already have trusted vendors in place.

Once the property manager has a good screening company she can trust, it can be placed on her "team" and used for future tenant screenings. Most of these companies charge between $15 and $50 for their services, depending upon the depth of the report the property manager requires.

The property manager must make sure not to charge application fees that are more than is allowed by California law. A quick look at one of Nolo Press' books and/or their website (www.nolopress.com) can give the property manager an idea of the maximum amount she can charge at that time. Nolo has some really good books on California landlord-tenant law and eviction procedures. A new property manager would be well advised to read both of their California-specific property management books cover-to-cover before starting their new career in real estate property management. Joining a local property management association is another way to keep up with changing real estate laws.

"The property manager must make sure not to charge application fees that are more than is allowed by California law."

Most property managers tend to charge an **application fee**. This tends to separate the serious tenants from the tire kickers. Some owners, who manage their own properties, may not charge the tenant an application fee and go ahead and pay the background check costs themselves. It really depends upon the rental price range of the property, type of tenants, neighborhood socio-economics, and condition of the local rental market at the time.

Once the property manager has a signed **written approval authorization to release information** about the prospective tenant, she can order credit, criminal history, and eviction reports. The credit report tends to work well in middle and higher socio-economic areas, but is not as useful in lower-socio economic areas because many of the tenants may not have much of a credit history. For these types of tenants, the property manager may want to use the criminal history report and an eviction report to help make her decision.

Illegal activities seem to be a problem in many lower socio-economic neighborhoods. Drug dealing seems to be the most common illegal activity. The manufacture of met amphetamines was a big problem in Northern California a few years ago. Now most of the "Crystal Meth" is manufactured in Mexico and transported into the U.S. market for distribution.

The Story of the "Haunted" Rental House

A landlord rented a home to a female member of a Native American tribe that owned a casino. Each member of the tribe received a portion of the casino profits. The tenant had stable income and good credit, so this looked like a guaranteed "slam dunk" to the landlord. Unfortunately, the best laid plans of mice and men. . .

After signing the lease agreement and moving into the home, everything went well for a couple of years. Then the tenant married a man of dubious background (i.e. drug dealer), and moved him into the property. There was already a local drug dealer who lived two doors down from the landlord's property.

The landlord knew this because he had been looking the local drug dealer over a little too closely and almost ended up in a fight with him. So there was no love lost between the landlord and the local drug dealer.

With the new husband competing with the local drug dealer, things got a bit out of hand in a hurry. The local drug dealer shot a hole through the front door of the landlord's rental property, right next to the peep hole where the new husband head would have been while looking out through it. The wife immediately went ballistic and moved her family out of the home--less the drug dealing husband-- during the middle of the night and left no forwarding address (for the landlord *or* the husband).

The tenant's sister called the landlord and asked if she could rent the home. She was receiving the same amount of income from the casino proceeds and could pay the rent. She also said she did not have a drug-dealing husband. The landlord agreed, and collected the rent.

The next month when the rent came due, there was no word from the sister. The landlord drove over to the property and discovered everyone had moved out—except a pit bull that was being held within the fenced-in front yard.

The landlord called Animal Control and asked them to remove the dog from the premises. The sister had moved out of the property and had apparently

The Story of the "Haunted" Rental House (continued)

abandoned the dog at the home. Animal control said they would leave a notice on the door and be back in five days to pick up the dog. One of the neighbors took exception to the landlord calling animal control on his friend's cute, cuddly little pit bull and tried to start a fight with the landlord. The way things were going, the landlord thought boxing lessons and marksmanship training might be useful skills while managing properties in this neighborhood.

The landlord decided he really needed to get this property repaired and rented out to someone who was not involved in the drug trade. The next day the landlord arrived at the home and the pit bull was gone. Evidently whoever owned the pit bull got the message. The landlord discovered, from some of the nicer neighbors, that the sister's brother (who was not on the lease) owned the pit bull and had been staying at the property after the sister had been scared off by "things moving in the night." The neighbors said the brother thought the house was "haunted." The landlord wondered if the "things moving around in the night" were bullets being shot through the front door by their drug dealing competitor.

The brother left several pennies with the head side down (i.e. trying to place bad luck on the property) and had a "ghost consultant" contact the landlord to help him "rid the house of ghosts." The landlord got a good laugh at the ghost consultant.

He rented the home to tenants who already lived on the same street and already knew about the local drug dealer. As the landlord was driving away from the property after renting it to the new tenants, the local drug dealer walked out into the road with a "cat that swallowed the canary" look on his face. He apparently thought the landlord was a drug kingpin and was behind all the illegal activities that had been going on at the property. In fact, the landlord was an honest person trying to make a living. If he keeps buying properties in these types of neighborhoods, investing in a good bullet-proof vest might be a good idea too.

If the prospective tenant has a job that pays a gross amount of 2.5 to 3 times the rental amount, he may be a good prospective tenant. In California, however, the property manager must be careful not to discriminate against prospective tenants, so a visit to one of Nolo Press' landlord and tenant books and/or their website is probably a good idea if she is going to provide a prospective tenant with a reason for not renting to them.

A property manager, who is renting to lower-socio economic tenants during uncertain economic times, my want to look more closely at government-subsidized tenants, and those receiving government housing allowances or government entitlement programs. This is usually fairly easy to substantiate by requiring each prospective tenant to provide written documentation verifying their income. If a prospective tenant has a job, then an original copy of their latest pay stub may prove their income.

Another group to look at is members of a local Native American tribe who own a casino. In the past, gambling has survived bad economic times fairly well, after all, people look for an escape when the economy is bad. So a trip to the local casino can brighten up an otherwise dreary day and put a smile on the face of a gambler. It will also put a smile on the face of the property manager, when the tribe member receives their casino dividend each month. Depending on the prospective tenant's percentage of lineage in the tribe, their dividend can be quite substantial.

After the property manager has performed thorough credit and background checks on the prospective tenants, a call to their past landlords is usually a good way to determine whether the tenant consistently paid their rent on time and how they left the property after move out. The property manager may not want to call the tenant's present landlord because he may provide a good reference to get rid of a poor tenant. Previous landlord(s) may not want to say anything, however, due to fears of breaking California's anti-discrimination laws. If the prospective tenant has lived in their present property for a long period of time, they may list their present landlord as a reference—and she may not be too happy losing her tenant. However, long-term tenants tend to be very desirable to landlords because they reduce the property manager's vacancy costs by not moving very often. They usually pay their rent on time, or the previous property manager would have already given them notice to leave or have evicted them from the property.

"Long-term tenants tend to be very desirable to landlords because they reduce the property manager's vacancy costs by not moving very often."

If everything checks out with the prospective tenant, then the property manager is now ready to sign the lease agreement and allow the tenant to move into the property. Important information that should be negotiated prior to signing the lease agreement include:

1. When will the tenant move in?
2. Is the rental market soft and requires a rental abatement of free rent for part of the lease term?
3. What is the amount of the security deposit?

In medium to higher socio-economic neighborhoods, many tenants will have the money available to pay a security deposit on their new rental home, while waiting up to 21 days to receive the security deposit returned from their previous landlord.

Conversely, tenants who are located in lower socio-economic neighborhoods many times do not have this money available. They are living paycheck to paycheck and will need to get their security deposit back from the previous landlord before they will have the money available to pay the new security deposit. For this reason, the property manager may accept a small deposit of approximately $200 or less to *hold* the property until the move-in date, with the balance of the security deposit due at the time of move-in.

The property manager accepts the $200 deposit in cash and provides a receipt to the tenants specifying that the additional amount of the security deposit is due at move-in, along with the first month's rent—and last month's rent if required. If the tenant cannot come up with the balance of the holding deposit nor the first month’s rent, then a landlord may refund the $200 holding deposit to make sure California's landlord-tenant laws are not broken. The landlord will then start looking for another prospective tenant to rent the property.

“A landlord has twenty-one (21) days to return the unused portion of a tenant's security deposit.”

A landlord has twenty-one (21) days to return the unused portion of a tenant's security deposit. A tenant's security deposit can be considered nonrefundable if it is only used to repair damage to the property that was caused by the tenant.

A. Landlord Requirements

(1) Finding the Best Quality Tenant Available

After the property manager has shown the property to a pool of prospective tenants, interested tenants will usually complete a rental application. The next step for the property manager is to go over the rental applications and find the best quality tenant available. <u>The goal should be to find a tenant who pays rent</u>

on time, does not destroy the property, and will stay in the property for a long period of time. Long-term tenants reduce vacancy costs and tend to increase the owner's long-term return on the property.

B. Tenant Requirements

A prospective tenant may consider their budget, location, property condition, type and layout of the property, proximity to key amenities, and type of residential lease agreement that will meet the needs of the tenant when deciding whether to rent a property over other competing properties.

(1) Budget

Most prospective tenants have an affordability range where they can pay the monthly rent and have enough remaining disposable income to pay for food and other necessities. Their gross monthly income usually needs to be between 2.5 and 3 times the rental amount to be able to pay the rent on time each month, and be able to live a reasonable lifestyle.

(2) Location

Location usually determines whether a tenant can afford to live in a low, medium, or high socio-economic neighborhood. Rent generally increases when moving from a lower socio-economic neighborhood into a higher socio-economic neighborhood. Tenants may be faced with a decision between a large home located in a lower socio-economic neighborhood versus a small home located in a higher socio-economic neighborhood; This type of trade-off is common and tenants need to decide which of the two is the most important for their family.

> "Location usually determines whether a tenant can afford to live in a low, medium, or high socio-economic neighborhood."

(3) Property Condition

Condition of a property is important to most tenants. The property manager may want to renovate the property just enough to be able to attract a high quality tenant, but not so much that the property is "over-improved" and more money is spent on the renovation than will be recouped from the rental income.

When remodeling a rental property located in a lower socio-economic neighborhood to a very nice condition, tenants may overlook the surrounding neighborhood and stay in the property for a long period of time.

(4) Proximity to Key Amenities

A property that is close to schools, child care, retail—especially mass merchandisers like Walmart, and public transportation tends to be viewed as desirable for most tenants. Additionally, mountains, water, climate, resources, diversified economy, job situation, exciting downtown, education, universities, hospital/medical services, recreation/parks, transportation systems, governments, professional sports teams, culture, affordability, and safety are all generally considered desirable amenities.

(5) Type of Rental Agreement or Lease

Month-to-month periodic tenancy vs. **Estate for years type lease**

It really depends on how long the tenant expects to stay in the property. Market savvy tenants may see the rental market tightening and want to lock in their lower rental amount for the duration of the lease period. This allows them to *not* worry about rent increases. If this were the case, the tenant would seek a one or two year lease agreement rather than a six month lease or a month-to-month periodic tenancy.

Along the same line, if the real estate market for resell single-family homes starts moving upward and the tenant does not want to be displaced from the property, the tenant may want to enter into a longer term lease agreement. This will prevent the owner from selling the property to an owner-occupied buyer near the top of the upward-trending sellers' market. The owner will <u>not</u> be able to end the tenants' tenancy and force them to move out of the property.

With a long-term lease in place, the owner may be able to sell the property but it will be subject to the existing lease on the property. Any owner-occupied buyers who buy the property will be required to honor the lease term and will not be able to move into the property until the lease term expires.

9. Sign the Lease Agreement, Pay the Rent, and Provide a Security Deposit

The property manager will ask the tenant to sign the lease agreement and pay the first month's rent and security deposit. She should have already provided a copy of the unsigned lease agreement to the tenant for review prior to move-in. This may have been a pdf download from their property management website.

The property manager may want to be careful with social media, because tenants can easily find out where they live. One landlord received a friend request from a tenant and declined the request. A week or so later, a suspicious electrical issue cost the landlord a $500 service call—more than likely this was an attempt to penalize the landlord for not accepting the tenant as a social media "friend." Accordingly, renting to friends and relatives is usually a really bad idea as well. The property manager may end up evicting the friend or relative and suffer the consequences of their wrath for many years to come.

A smart property manager will have two already signed copies of the lease and ask all tenants to sign both lease agreements. One copy is given to the tenant and the other is kept by the property manager for her records. If the property manager only has one copy of the signed lease, the property manager will need to make a copy of the signed lease agreement and mail it to the tenant. This is assuming the property manager provided an unsigned copy of the lease agreement to the tenant prior to their meeting to sign the agreement.

The property manager will usually provide a set of keys to the tenant. This is usually one key for each adult tenant on the lease agreement and residing in the property. At this time the tenant may be given garage door remotes, instructions regarding how to operate the heating, ventilating, and air conditioning (HVAC) thermostat, and any other items required to live in the house.

The property manager's maintenance guy should have already adjusted the front and backyard sprinklers for location, times, and duration. This can be particularly true if there is a water shortage happening in the area.

The maintenance guy should have installed a new (HVAC) filter, leaving some others in the hall closet for the tenant to use if he wants to replace the filter before the next scheduled HVAC air filter replacement maintenance call. The maintenance guy should change them periodically and inspect the property at the same time for other items that may be in disrepair.

10. Property Manager Meets with Tenant to Provide Occupancy

The property manager will usually arrive before the tenant and make sure everything that was scheduled to be repaired or replaced by the maintenance guys has been completed. It seems like everyone now carries a cell phone with a built-in digital camera. Just prior to providing occupancy to the tenant, the property manager should take still-photographs of the entire inside and outside of the property. If she has to evict a non-paying tenant, video can be a problem in court because it takes up too much of the judge's time trying to get it going and may be hard to follow. Still pictures are easier for the judge to look at and can be printed out and provided to the judge along with the court documents.

The property manager's pictures should be downloaded or emailed to a separate file with the address of the property and date easily identified. These photographs can be crucial if the tenant in the future claims "bad faith retention" of the security deposit by the landlord.

In California, tenants have many rights so if it comes down to the property manager's word against theirs, the property manager could very well lose. The pictures are irrefutable proof of the condition of the property during move-in. It is also a good idea to take pictures of the inside and outside of the property at the time of move-out, so the judge can easily see the differences when they are laid out side-by-side on printed paper. The property manager needs to provide the judge with invoices for the work that was completed, so keeping invoices is always a good practice. If the owner performed some of the work herself, she will not be able to deduct it from the tenant’s security deposit.

11. Go over Details with the Tenant

The property manager must make sure the tenant knows where to pay the rent when it is due each month, along with applicable late charges if the rent is not paid on time. Other specifics include garbage day, where to call to change the gas and electric over into the tenant's name, and whether they are paying for water, sewer, and garbage (as negotiated in the lease agreement), or is it being paid by the landlord.

> In some areas of California, property managers pay for water, sewer, and garbage. The amount is included in the rent. In areas that have water meters, property managers may pay sewer and garbage and allocate a certain amount to the water bill each month. Other areas may bill the tenant directly for water costs, with either the tenant or property manager paying the sewer and garbage costs. The reason there is so much variability is that <u>utility companies in California will place a lien on the property if the water, sewer, and garbage bills are not paid</u>. So if the property manager agrees to a reduced rental amount, thereby charging the tenant for water, sewer, and garbage; and the tenant moves out and these bills are not paid by the tenant, they will become a lien on the property and must be paid by the property manager before the utility lien can be removed from the property.

The tenant should be provided with the property manager's office number to call if problems develop. Many times tenants will test property managers to see if they can get away with paying the rent after the due date. With most professional property managers the tenants will hit a brick wall. The sooner the tenants know the rental business is not a charity, the better for everyone involved.

This is where a professional property manager comes in handy. He is running a property management business and looks objectively at tenants and their requirement to pay the rent on time, not beat up the property, and stay there for as long a period of time as possible.

A property manager will make sure the tenants know that if they do not pay their rent on time, they will be **evicted**. A **3 day notice to pay or quit** usually lets the tenants know the property manager means business. This may be delivered by a process server or the property manager through a "nail and mail" type notice. The property manager posts a copy of the 3 day notice on the tenant's front door and mails a copy in the U.S. Mail. At this point the property manager will be well advised to hire an attorney who specializes in evictions. Costs will generally range between $700 and $1000 or more to evict a non-paying tenant in California. Some property managers may offer the tenant "cash for keys," paying the tenant to immediately leave and surrender occupancy of the property. In California, this may be the cheaper way to go.

When a property manager and a tenant mutually agree to cancel a lease agreement, this is called **surrender**. In other words, if the tenant will agree to move out of the property, the property manager will agree not to demand any further payments of rent from the tenant.

Story of the Unknown Subtenants
A property manager had used a non-standard lease agreement that did not contain a clause that would prevent the tenant from subleasing the premises. The tenant **subleased** the property to two **subtenants**, collected as much money from them as possible, and then stopped paying rent and moved to another city. The tenant was willing to destroy his credit rating in return for a couple of months of subtenants' rent.

After the preceding explanation of property management procedures, the client may well understand why 10% of gross collected rents as a property management fee is usually well worth the money. Some property managers charge a "lease up" fee of usually 1/2 to 1 month's rental amount along with a property management fee. It really depends upon the normal customs in each particular geographical market.

Most owners do not have the time available or inclination to deal with the day-to-day issues involved in managing a single-family rental property. For these people, a professional property manager is worth their weight in gold. Understanding why investors buy real estate, rather than stocks, bonds, precious metals, gems, and other investment vehicles, is critical to helping clients realize their investment goals.

Property managers are an integral part of the real estate investor's team. Their job is to take the property from acquisition to disposition while experiencing the greatest cash flows during the holding period. In addition, the property manager must maintain the property in a condition that enhances and increases its value when it is sold in the future.

A Tough, Honest Property Manager is an Asset to the Owner

A real estate property manager provides toughness to deal with tenants. Many owners who start off managing their own properties tend to allow tenants to pay their rent late, inconsistently collect late charges, and allow the tenants to dictate how they want to pay their rent and maintain a property. A professional property manager considers the tenant as just another one of the many tenants that occupy their properties under management and will treat the tenant accordingly. Once the tenant understands that the professional property manager is not flexible regarding late rental payments, usually caused by a prompt three-day notice to pay the rent or quit the property, the tenant will usually pay their rent on time in the future or know they will be evicted.

A Poor Quality Property Manager is a Liability to the Owner

Poor quality property managers may charge below market rents, needlessly spend the owner's money to make life easier for the property manager, accept illegal referral fees from vendors and suppliers, and illegally float an owner's money.

1. Charges below Market Rents

Less scrupulous property managers may use under-market rents to rent the property up quickly and save the property manager's time, at the expense of the owner's lower-than-market income.

The property manager may charge below market rents to speed up the rental process and save the property manager's time. Of course, this is at the risk of providing under market rental income and violating the property manager's fiduciary duty of utmost care, integrity, honesty, loyalty, truth, confidentiality, and competence to the real estate investor. Charging below market rents is not a truthful way to do business. It produces a win-lose situation where the property manager wins and the real estate investor loses. This is not conducive to long-term real estate investor relations and retention.

Property managers should perform a complete rental comparable analysis to determine the market rents for the subject property being managed. These are rental properties that are as close as possible in type, size, condition, and location to the subject property—and provide both the real estate investor and property manager with a good indication of rental prices in the area. Rent that is received for a comparable space in an open market is called economic rent.

2. Needlessly Spends Owner's Money to Make Their Job Easier

For properties located in lower socio-economic areas, a property manager may want to over-improve the kitchen and bathroom(s) to make it easy to find a good tenant. This will save the property manager time showing the property, but cost the owner more money than if she managed it herself, did not over-improve it, and spent the time needed to find the right tenant.

On the other hand, some property managers may want to improve a property to make it faster and easier to rent up with better quality tenants, providing less management intensity, and reduced physical damage to the property. The property manager may be spending the owner's money a bit excessively, but there is a fine line between "over improvement" and enough improvement to attract a good quality tenant.

3. Accept Illegal Referral Fees from Vendors and Suppliers

Older properties generally incur a tremendous amount of maintenance costs to keep them in a rentable condition. A poor property manager may accept undisclosed referral fees from vendors who provide maintenance and repair services. Undisclosed referral fees paid from vendors to property manager are illegal in California if they are not disclosed by the property manager to the owner.

However, the costs to the owner, after paying the vendor for a service call including a small referral fee to the property manager, will probably be very close to what the owner would pay for the services if they were contracted directly from the vendor. The property manager's volume of business usually allows him to obtain better vendor prices.

4. Illegally Float an Owner's Money

A good property manager collects rents and pays the owner promptly. A poor property manager may "float" an owner's money to pay their own bills that are past due. This is considered commingling and is illegal in California. In fact, commingling is routinely investigated by the California Bureau of Real Estate and is the number one reason property managers lose their real estate license in California.

Whether real estate investors decide to manage their properties themselves or hire a professional property manager, property management over the long-term is not an easy job. There are a multitude of things that can go wrong and cost the real estate investor cash flows and profits. With this in mind, next is a look at lower maintenance new single-family homes.

11

NEW SINGLE-FAMILY HOMES

"Home is where you can say anything you please, because nobody pays any attention to you anyway." -John Moore

Sometimes, it can be more profitable to build a new home and then sell it during an upward-trending sellers' market, as opposed to buying an existing single-family home, renovate it, and then sell during the same upward-trending sellers' market. This is especially true if a builder bought vacant land for a good price during a downward-trending buyers' market, held it until the market changed into an upward-trending sellers' market, and then built and sold near the top of that market.

Single-family homebuilders are usually attracted to higher socio-economic neighborhoods where profits are greater than building and selling in lower socio-economic areas. The key is to get into and out of the market as quickly as possible—before the market turns into a downward-trending buyers' market.

When the real estate market turns downward, most builders are not willing to face reality by reducing their home prices and thus stay *ahead* of the downward-trending buyers' market. They tend to trail behind a downward-trending buyers' market as it moves downward, dropping their prices *behind* the market and are never able to sell their homes. Builders will not be able to close many of the new homes because lender appraisals will come in *below* the contract price.

The best way for builders to handle this situation, is to sharply discount each single-family home price and keep dropping the price until the property is sold and closed. The builder may make a profit, but not as much as he would have received had he sold before the real estate market started moving downward. Greed can be dangerous during a downward-trending buyers' market. When the builder needs to unload the property, he needs to unload the property. It's as simple as that.

The Story of How Emotion, Ego, and Greed Can Destroy a Homebuilding Business

A builder built a 4,000 square foot single-family home located in a high socio-economic area. After completion of the home, the builder's wife decided she wanted to live in the home. The builder explained that it was now an upward-trending sellers' market and the home should be immediately sold to capture the existing profits in the property. The wife said she didn't care, she wanted to move into her "dream" home.

The builder and his wife had been living in a 2,000 square foot home the builder had completed the year before. Obviously, emotion, ego, and greed got the best of the wife as she wanted to increase the size and location of "her" home to impress her friends and relatives. So, they rented the 2,000 square foot home they were living in to a tenant and obtained a long-term 30 year amortized loan to replace the construction loan on the new 4,000 square foot home.

Unfortunately, the builder had a difficult time obtaining a loan that had low enough payments for them to afford the home <u>and</u> be able to build more properties. Accordingly, he selected a Pick-a-Payment Option ARM loan that allowed him to pay a low negative amortization payment. This type of loan allows the borrower to pay such a low loan payment that no principal is paid on the loan, not all the interest that is due is paid by the borrower, and the principal balance of the loan *increases* over the life of the loan! Pick-a-Payment Option ARM loans were common from 2001 through 2008.

The wife came up with a brilliant plan to stay in the 4,000 square foot home as their primary dwelling for at least two years, and then "consider" selling it at that time—allowing the married couple to take up to $500,000 in capital gains that were exempt from paying capital gains taxes. This would allow them to pay off the dangerous Option ARM loan with the proceeds of the sale and allow her to live in a wonderful house that could be sold in the future, thus capturing all the equity legally tax free.

The Story of How Emotion, Ego, and Greed Can Destroy a Homebuilding Business (continued)

The builder asked his wife if she knew when the existing upward-trending sellers' market was going to shift to a downward-trending buyers' market, she replied that "it didn't matter." They would still have plenty of equity in the home to pay off the loan, even if they entered a downward-trending buyers' market.

Against the builder's frustrated protests, he understood the old saying, "A happy wife is a happy life," so they moved into the new larger home immediately after receiving a certificate of occupancy from the county where the property was located.

Approximately 6 months later, the upward-trending sellers' market abruptly turned into a downward-trending buyers' market and prices started falling at an alarming rate. The builder advised the wife that they should immediately place the property on the market and get whatever they could for it. Her response was "she didn't want to move out of 'her home'."

Sure enough, the market continued downward and the wife's 4,000 square foot home soon became underwater, where the loan amount was significantly greater than the value of the property. At the same time, the Option ARM negative amortization loan piled up more and more deferred interest onto the balance of the loan. In addition, the loan payment adjusted into an interest only loan, as well as increased due to an increase in the underlying loan index, thus increasing the loan payment higher than the builder and his wife could afford.

They were forced to stop making loan payments, that were now $800 per month more than when they originated the loan, and the home soon went into foreclosure. The wife could not handle the stress of not knowing when she would be displaced through a trustee's sale, so she gave her tenants in the 2,000 square foot home notice to leave and they moved back into the smaller home.

It took the lender 12 months to foreclose through a trustee's sale and the property was sold to an investor as an REO property. The builder and his wife had their excellent credit score demolished by the foreclosure, thus precluding them from obtaining any more construction or permanent loans for a few

The Story of How Emotion, Ego, and Greed Can Destroy a Homebuilding Business (continued)

years. The builder stopped building homes, the wife again lives in the "tiny" 2,000 square foot home, and both learned a valuable lesson about how emotion, ego, and greed can derail a profitable homebuilding business.

Land Values

The value of the underlying land is what increases and decreases when single-family homes fluctuate in value. Building costs generally do not fluctuate as much as land values, however, material costs may fluctuate due to supply and demand factors inherent during an upward-trending sellers' market. Subcontractors (electrical, plumbing, etc.) tend to raise their prices during a hot real estate market and "cry the blues" (usually caused by having to charge less money) during a cooling buyer's market. Suppliers of building materials also experience heavy demand for their products during an upward-trending sellers' market, so prices tend to increase as well. For example, during the 2005 U.S. building boom there was a huge demand for cement in China and this drove the price of cement through the roof in the U.S.

"Historically, the U.S. starts coming out of a recession when builders start seriously building homes again."

When the real estate market changes from an upward-trending sellers' market to a downward-trending buyers' market, single-family homebuilders generally reduce homebuilding activities until market absorption rates (i.e., months needed to sell the existing total inventory of homes) catch up with the existing supply of homes. This generally signifies a recession is looming on the horizon.

Historically, the U.S. starts coming out of a recession when builders start *seriously* building homes again. They employ people to build homes, these people spend money in the local economy, and this usually starts a genuine economic recovery.

New Single-Family Home Developments

A new homebuyer may want to take a look at a new home built to their own personal tastes or a "quick move in" standing inventory home that is already built and is looking for an owner.

I. NEW HOME BUILT TO A BUYER'S OWN PERSONAL TASTES

During an upward-trending sellers' market, most new home buyers purchase a home that has not yet been built. The builder has completed the off-site improvements, which include streets, sidewalks, and utilities; and a few model homes have been built. Your clients will see a vacant lot where their new home is scheduled to be built.

A good thing to remember is that builders are *professionals* and are looking to maximize profits from each home they build in their subdivision. For this reason, the following ideas will help a new home buyer reduce building costs and maximize value in their new single-family home.

The external environment existing *outside* a subdivision should be examined to determine if there are any existing or future uses that may adversely affect the value of a property.

Outside the Subdivision

If there are vacant areas surrounding the **subdivision**, your clients may want to try determining the property types that will be developed there. If there are any vacant lots, "yet to be developed" outside the subdivision, your clients should:
(1) Research existing zoning for the lots in question, and
(2) Ask the builder's sales agent what is planned to go into those areas.

A future loss of value may result from buying a home located within a subdivision that is adjacent to questionable vacant areas. For example, a home may be located next to, and/or downwind from, a garbage dumpster placed behind the new retail shopping center and adjacent to the subdivision.

> "A future loss of value may result from buying a home located within a subdivision that is adjacent to questionable vacant areas."

Accordingly, if the subdivision is located close to anything that will cause a loss of value in the future, your clients may want to think twice about buying in that particular subdivision. Some problems can include industrial areas, high schools, freeways/major roads, high power lines, dump/waste disposal sites or sewage treatment facilities—especially upwind of the home, flood zones, and military ordnance areas. Although, there are many more problem areas that can occur around a new single-family home purchase, these are a few important ones to consider prior to buying a home located within a subdivision.

Industrial Areas Located Near the Home

An industrial area located next to a subdivision can cause large trucks to come into and out of the area at all times of the day and night. This is a possible noise problem. In addition, your clients may have to deal with speeding cars (employees leaving their work source at the end of their shift) and resulting excessive traffic congestion on the surface streets located outside the subdivision.

High School Located Near the Home

A high school located near a single-family home can cause nuisance issues which include: inexperienced drivers speeding, traffic jams, parking problems (especially during special events), students on foot, illegal drug sales and use, alcohol, vandalism, theft, and general mayhem. Unfortunately, middle schools tend to have similar problems, but without the young driver issues.

An Elementary School Located Near the Home

An elementary school can be a <u>big problem</u> if it is located *too near* a home. Your clients may want to buy a home located around the corner from the elementary school, so it is close by—but not too close. An elementary school located directly across the street from a single-family home may be a little too close. Your clients could experience traffic congestion and parking problems resulting from parents dropping off and picking up their children. A short walk to school can be a nice amenity.

Major Roads

Make sure the home is not located near a major road, such as a freeway or heavily traveled main artery into and out of a local area. If the home backs up to a main arterial road, it is probably a good idea to buy elsewhere. Noise from a heavily traveled road can be a big negative factor for homebuyers when they resell the home in the future. It is usually a good idea to walk around a property at different times of the day and night, especially during rush hour, and listen for potential noise problems.

High Power Lines

High power lines located near a home can be a negative factor when the home is sold in the future. If your client can stand in the center of their lot, while looking in a 360 degree circle around the home site, and see any high power lines protruding into the sky, the property is probably too close to the power lines and

Wikimedia Commons / Andrew Smith
Figure 11.1 House with Power Lines

this may have a detrimental effect on the home's future resale value. It will be in your client's best interests to buy elsewhere.

Waste Disposal Dump

A **waste disposal dump** located upwind from a new single-family home can be a serious problem. Your clients may experience obnoxious odors when the wind blows in their direction, especially during the warm summer months. When you sell the home for them in the future, they will need to disclose this fact to potential buyers. Bad smells may reduce potential rental amounts and devalue the home's future sale price.

Sewage Treatment Facility

A **sewage treatment facility** located upwind from a home can be a "stinky" proposition. A survey of the surrounding neighborhoods and an analysis of prevailing winds can help discover if this problem exists in the area surrounding a subject property. There are several free aerial mapping programs available on the internet that can be used to obtain a general idea regarding what is located around a proposed new home purchase. However, in rapidly growing areas they may be a few years old and of limited use.

Flood Zones

Flood zones are usually disclosed in the **Real Estate Commissioner's Public Report** that is required for all new subdivisions (5 or more parcels). You should have your clients read this document thoroughly before buying a new home in a subdivision. Flooding issues are supposed to be disclosed within this report and if the property has the propensity to flood every few years, flood insurance may be required by a lender if the home will be financed. If there are severe flooding issues, your clients may want to consider looking elsewhere for a new home. Of course, if all the homes in the surrounding area are located in a flood zone, then everyone will be in the same "overcrowded boat" and property values may not be as severely affected.

Military Ordnance

There was an instance in Southern California where an apartment builder built an apartment building over a site that had been used for military bombing practice in the past. One day an unexploded bomb lying under one of the apartment buildings exploded, obliterating the apartment building and several tenants with it. If the subdivision is being built in an area where there has been military ordnance dropped in the past, this could be a very important disclosure issue.

One area of California had some Vietnam-era bombs that exploded in 1972 while on railcars in the railway station. Approximately 30 years later, it was discovered that several of these unexploded bombs were still buried in the same rail yard. This became a material fact that had to be disclosed to all future buyers of properties in the area.

After your clients have taken a look at potential problems that may occur outside a subdivision, an examination of areas *within* the subdivision can be used to determine whether the builder has any vacant lots or quick move-in standing inventory homes that will maintain and/or increase desirability and subsequent values of homes located in the area.

Inside the Subdivision

A cul-de-sac location, size of the lot, whether it backs to an interior road in the subdivision, and zero lot lines are some important factors that must be considered when purchasing a new home.

Cul-de-Sac Location

A **cul-de-sac location** is generally considered to be one of the best locations within a new home subdivision because of the lack of traffic flow. Families usually like cul-de-sac locations because they tend to be a much safer place than busy streets for their children to play. Fewer cars travelling along the street, usually equates to greater safety for children when they are playing in the front yard. A cul-

Wikimedia Commons / Francisco Anzola
Figure 11.2 Cul-de-Sac

de-sac can also be a nice amenity when your client tries backing out of their driveway and onto the street.

Homebuilders generally understand the desirability of cul-de-sac lots and many times charge “lot premiums” when these well-located properties are sold. It really depends upon the real estate market at the time of the sale. If it is a downward trending buyers’ market, the builder may not charge a lot premium at all, he is just glad to sell the home. Conversely, during an upward-trending sellers’ market he may charge a significant lot premium because he knows he can get it.

Unfortunately, most home buyers will <u>not</u> recoup the cost of a lot premium when they resell the home many years down the road. The home generally will sell faster, but not for a significantly higher price.

A cul-de-sac location has an interesting phenomenon that occurs due to its shape. At the back of the cul-de-sac, where the street ends, the lots are generally very large in size. Moving toward the front or neck of the cul-de-sac, lots tend to become smaller in size. The larger lots located at the back of the cul-de-sac tend to attract families with smaller children because of perceived safety issues when playing in the front yard, as well as the larger-sized backyards. In an upward-trending sellers’ market, these properties will generally sell quickly and for top-of-the-market prices.

Lot Size

A home built on a large size lot will usually sell faster than one built on a smaller size lot. However, it may not resell in the future for a higher purchase price than a smaller size lot with the same size house built on it. This is because single-family homes usually are valued by square footage of the living space. Builders may also charge larger lot premiums as the size of the lot increases. An over-size garage can positively affect the value of a property as well.

Many new home builders do <u>not</u> landscape the backyards of properties they sell. They leave this responsibility to the homeowner, who may landscape the backyard according to any existing **Covenants, Conditions, and Restrictions** (CC&Rs) or their individual whim at the time. Builders generally like to landscape front yards because it helps sell their homes during future phases of construction. In extremely hot-selling real

> “A home built on a large size lot will usually sell faster than one built on a smaller size lot.”

estate markets however, some national builders have been known to <u>not</u> landscape front yards either.

Backs to a Road

Make sure the lot does not back to a road that runs through the subdivision. There are potential noise problems and security issues where burglars can ingress/egress the home. If the only lot a builder has available is one that backs to a road, it is best to wait for the next construction phase to open up and buy a lot that does not back up to a road. Your clients can also wait for a well-located lot to fall out of escrow and become available. A problem now will become a problem later when the property is resold.

Zero Lot Lines

Some smaller homes and patio homes have zero lot lines. The fence line will include the neighbor's house or garage wall. This is used in areas where land is scarce and small-size lots are the norm. Resale value may be affected by a zero lot line, unless all the homes located in the immediate area have zero lot lines. In this case, it will probably be the norm and may not be a problem in the future.

After your clients have investigated the outside and inside of a subdivision, they need to consider which home they would like to build on the lot.

Building the Home


Flickr / Scott Lewis
Figure 11.3 Home under Construction

After your clients have settled on a lot that meets their requirements, they must pick which model home they want the builder to build on the lot. Builders generally do not like to build the same model home <u>next to each other</u> within a subdivision, because they usually like a variation of models throughout the subdivision. This tends to enhance the future values of all the homes located throughout the neighborhood. Therefore, the builder may not be willing to build the particular floor plan desired by your clients because there are too many homes of that particular model already existing on the street.

The setback requirements and size of the lot may dictate the maximum footprint size for the home. Setback requirements usually prescribe how far from the property lines the home must be built and the footprint is the exterior dimensions of the home, including garage.

Model Homes

When selecting a model home, your clients will need to consider the number of bedrooms and bathrooms that will provide the greatest rents during the holding period and highest sale price when the property is sold at the end of that holding period. Minimum sizes for the children's bedrooms should be approximately 10'x10', however 12'x12' or larger rooms tend to be more user-friendly in larger homes.

A good floor plan is in the eye of the beholder. One of the most important things for your clients to understand is the fact that homes sell by square footage of the home, <u>not</u> including garage space. So, your clients should <u>not</u> get carried away with builder upgrades. Typically, a homeowner will recoup only 50% or less of builder upgrade costs when the home is resold in the future. The home may sell faster, but not for a significantly higher sale price.

Upgrades

The biggest mistake your clients can usually make when purchasing a new home is installing too many upgrades. A little-known secret in the industry is that production builders, who build tract homes, make most of their profits from upgrades. Many builders have a full-time staff devoted to selling upgrades to "unsuspecting" new home buyers. Hopefully, your client will not be one of them.

Architectural Upgrades

Architectural upgrades may change the structure of a home. For this reason, builders generally require the entire amount of the architectural upgrade to be paid upfront when the purchase contract is signed. So if the buyer decides not to purchase the home, the builder will be forced to sell the property with these structural-type upgrades already installed, thus providing less flexibility for any subsequent buyers. The builder will most likely keep all or most of the deposit money to mitigate the losses resulting from these architectural changes. In reality, however, the builder may be able to sell the property as standing inventory and charge a higher price for the existing architectural upgrades, especially if they are highly desirable ones—such as an extra bathroom or upgraded kitchen.

The "B and C Elevation" Routine
One notorious upgrade is the "Elevation B or C upgrade" routine. The builder will build Elevation B for $10,000 more than the cost of standard Elevation A; or Elevation C for $15,000 more than Elevation A. It really does not cost the builder very much more money to build the B or C elevations than it does to build the A elevation, so the extra $10,000 to $15,000 is really increased profits to the builder. More importantly, when the buyer sells the home in the future it will sell by the amount of square footage in the home and not whether it has A, B, or C elevations. Buyers will not know the difference among the different elevations, nor will they care. More money down the drain and no way to get it back.

Extra Bathrooms
Adding an extra ½ or full bathroom can be a good upgrade that can actually pay for itself when the home is sold in the future. Additional bathrooms are generally considered desirable amenities and tend to increase the value of a home, as long as they do not take away from valuable bedroom and closet space.

Replacing a Window in the Downstairs Master Bedroom with a French Door or Sliding Glass Door
Replacing a window with a French door or sliding glass door in the downstairs master bedroom can be a good upgrade because it provides access to the backyard. A portable or in-ground spa can be located off the master bedroom, and your clients might recoup this door upgrade when they sell the home in the future. It might, however, merely sell faster but not for a higher price.

An investor will probably not be able to obtain higher rents because of the existence of the French door or sliding glass door. However, if the buyer will be living in the new home and the French door or sliding glass door makes them happy, then that is all that matters.

Cosmetic Upgrades
Cosmetic upgrades are generally upgrades to carpet, pad, paint, and many other items that do not affect the structural integrity of the home. Your clients may be required to deposit 50% or more of the cost of the cosmetic

"Your clients will probably recoup 50% or less of the money spent on upgrades when the home is sold in the future."

upgrades at the time they sign the contract to start building the new home building process. As painfully mentioned earlier, the cold hard truth is that your clients will probably recoup 50% or less of the money spent on upgrades when the home is sold in the future.

Carpet

Carpet and pad upgrades allow new home buyers to increase the grade of carpet and pad for several thousand dollars more than it would cost to have the local carpet store install the same grade carpet and pad. If the buyer asks the builder to simply, "not install the carpet and pad and they will have it installed after close of escrow." The builder will inform them that he is required by the building department to install carpet in the home prior to obtaining the final inspection and certificate of occupancy. He is absolutely correct too.

Real estate investors may want to install base-priced FHA-grade carpet and pad in the new home if it is going to become a rental property. Tenants generally are not very picky about carpet, especially if it is new. The investor may have to replace the carpet several times before the property is finally sold many years down the road.

If the buyer is going to live in the new home, then a better grade carpet and pad may be a good choice. However, this is a real pain in the neck (and other places too) because, to accommodate removal of the existing carpet and installation of the new one, the furniture must be moved out of the home and then back in again.

The other alternative is to direct the builder to install the upgraded carpet during the building phase and pay the extra money at close of escrow. Builders generally understand a homeowner's dilemma and price their carpet and pad upgrades just low enough to entice the buyer to pay for the carpet upgrade now, rather than moving the furniture twice in the future.

Other Information on Single-Family Homes

Two Story Homes and Garages

Two Story Homes

It usually costs a builder less per square foot to build a two-story home than it does to build a one-story home. The builder usually experiences reduced construction costs, usually due to not having to construct and pay for a foundation for the square footage that is located on the second floor of the home. Builders *may* pass this cost savings on to home buyers in the form of a lower per square foot purchase price versus those of comparable single-story homes.

During a future upward-trending sellers' market, existing two-story homes will many times sell at a price per square foot that is very close to the one-story homes located in the same geographical area. In other words, two-story homes may be less expensive to purchase from the builder when they are new and, during a future hot upward-trending sellers' market, may sell for close to the same per square foot price as one-story homes.

In addition, two-story homes will generally have a smaller foot print for the same square footage than one-story homes. For this reason, your clients may experience a larger backyard with a two-story rather than with a one-story home, especially if the home is located at the end of a cul-de-sac. Most builders will only build two-story single-family homes at the end of the cul-de-sac because of the greater profits generated from lot premiums and upgrades. Some builders may offer built-in swimming pools as an upgrade to the home.

Flickr / Cary Peterson
Figure 11.4 Garage

Garage Size
In some areas of California, two-car garages are the norm—especially where homes are built on smaller-than-normal size lots (e.g., 6,000 square foot lots versus normal 8,000+ square foot lots). Yet in other areas, three car garages may be the norm. For this reason, your clients should watch out for builders who try to increase their profits by subdividing into smaller-than-normal lot sizes and building two car garages, when everyone else is building 3+ car garages.

Functional obsolescence may occur in the future as homebuyers want three car garages and actively avoid two car garages, except at a much lower purchase price. In other words, the resale value of the home may be significantly affected by having a two car garage rather than a more desirable three car garage. Of course, functional obsolescence can sometimes be minimized by selling at or near the top of a hot upward-trending sellers' market where buying pressures can cause buyers to overlook some of a home's deficiencies. The buyers may be happy to actually find a home to purchase.

As mentioned earlier, home floor plan square footage estimates are generally given without the garage included. Since the size of the garage may not be apparent when looking at the floor plan, your clients may need to physically inspect the size of the garage before buying the home. The model home garages are many times locked up, so your clients may need to get them unlocked by the sales staff or take a look at the garage of a home that has already been built.

A Note on Portable Spas

Wikimedia Commons / Veronicabirola
Figure 11.5 Portable Spa

A portable spa may be a tenant liability issue and usually will not increase rents or the value of the home when it is sold at the end of the holding period. For this reason, it might be a good idea to sell the spa in the local newspaper or on Craigslist before the home is placed on the market in the future. Another alternative is to leave it where it is and disclose to the buyer that it is a portable spa and is considered personal property that will be going with the home. Personal property can usually be transferred with a bill of sale.

Builder Sales Office

When your client first walks into a builder's sales office, it will probably be located in either a temporary trailer or in the garage of one of the model homes. If it is in a temporary trailer, your clients may be early enough in the build-out process to get a good deal. If the market is starting to move upward or has been moving upward, your clients may be buying during the "First Phase" of construction and may be able to get a property into contract before any future price increases.

Builders usually subscribe to a market research service that measures the new home sales market on a weekly basis. So they will know more than your clients about the market's direction, pricing, and number of properties being sold. This gives the builder a tremendous advantage during negotiations.

During a downward-trending buyers' market, the builder may not have any homes sold and does not want to put up the money necessary to build the model homes—at least until there are a few more signed purchase contracts with accompanying earnest money deposits.

California Bureau of Real Estate (CalBRE)

The CalBRE closely regulates subdivisions that are located in California and requires a set procedure regarding earnest money deposits for new homes. The builder cannot use any of the earnest money deposits to help build the properties. These deposits must be held in a separate trust account or neutral escrow account. The main reason is if the builder becomes insolvent and declares bankruptcy, your clients may have a difficult time obtaining their earnest money deposit and any architectural and cosmetic upgrade deposits that are required to be returned to them. Builders usually ask for at least 5% of the purchase price as an earnest money deposit, so this could be a significant amount of money.

After a builder has several model homes completed, your client may be more assured that the builder will be able to fulfill his financial commitments to the development and build the home during the time period allotted by the contract.

Moreover, California subdivisions (of five or more parcels) fall under the Subdivided Lands Law which provides for the California Real Estate Commissioner to approve all subdivisions located in the state of California and issue a public report. The Commissioner's Final Public Report is a list of disclosures and other information pertinent to the subdivision and must be provided to every homebuyer who buys a home in the subdivision.

New Home Completion Times

New home completion times may vary between 6-12 months or more, depending on the size of the builder and type of real estate market existing at the time of construction. A serious problem may occur if the builder does not complete the home during the contracted time period. If real estate loan interest rates increase, the homebuyer may be forced to accept a higher interest rate than was initially negotiated with the lender. It is very difficult to lock a loan for more than 45 days on the open market, so trying to lock a loan for between six and twelve months is especially difficult. Most homebuyers will be forced to pay the higher market interest rate and may have significantly higher loan payments. One problem is homebuyer loan qualification. If, based upon market interest rates at the time the home receives its notice of completion, the homebuyer may not qualify for the new loan. The builder may be forced to step in and pay discount points to "buy the loan down" and reduce the interest rate to a level where the homebuyer can qualify for the loan.

The other alternative is for the homebuyer to not remove the loan contingency to the contract and not go forward with the deal. The homebuyer will usually receive all of the earnest money deposit, however, they may not receive any of the architectural or cosmetic upgrade deposits back to them. Architectural deposits are used to pay for changes to the home that the original homebuyer wanted, but were not able to close escrow. As mentioned earlier, the builder uses the architectural deposit to pay for these changes and any loss of value that may be caused when selling the home with these changes. Of course, in many cases the home may sell for a higher price and/or faster by having these upgrades.

If the builder has several model homes already built and has completed several homes for previous homeowners, then your clients will have the ability to not only take a look at the model homes, but try to talk with the existing home owners who have already purchased one of the builder's homes. Your clients may want to see what level of service they received before, during, and after construction of their home. Any negative responses may be an indication that your clients may need to look elsewhere for their new home.

Another indication of builder problems is if you or your clients ask for a copy of the subdivision public report and it shows "completion bonds" in the report. This indicates the builder may not have fulfilled commitments to past home owners. For this reason, the California Real Estate Commissioner may have required the builder to pay completion bonds as a condition of approving the subdivision.

Once your clients feel confident the builder will be around for a while and does a good job in all aspects of the homebuilding process, then it may be time to move forward and purchase the property.

Builder Purchase Agreements

A homebuilder will usually require a prospective buyer to get pre-approved with a lender before signing a contract to start the homebuilding process. Prequalification is used to make sure the buyer is *able* to purchase the property. Many buyers are ready and willing, but much fewer are actually able to purchase a home.

This will generally occur before the builder accepts an offer to purchase one of his homes. Many builders have their own mortgage company that is usually an affiliated business arrangement. The builder may require the buyer to get pre-approved with "his" lender; however, he cannot require the buyer to use his lender to

"Many buyers are ready and willing, but much fewer are actually able to purchase a home."

purchase the property. This violates the Real Estate Settlement Procedures Act (RESPA).

Builders generally like to control the financing to make sure the buyer can actually qualify to buy the home. If the buyer is using an outside lender, who is not affiliated with the builder, the outside lender has a fiduciary duty not to reveal anything negative about the buyer to the builder. The builder knows this, so he may offer incentives of up to $5,000 or more to induce the buyer to use *his* lender. The incentives are generally used by the buyer for closing costs and upgrades.

The builder's affiliated lender usually gets his loan funds at wholesale rates that are below par or market pricing. His out-of-pocket hard costs are usually significantly less than the actual financing incentive paid to the buyer. This is especially true when the incentive is used to pay for upgrades. The builder's huge profit margin on upgrades results in reducing his actual out-of-pocket costs for the financing incentive even further.

Watch out, though. One national builder provided $5,000 in incentives, and then his affiliate lender charged significantly more loan fees and discount points at closing than was initially negotiated prior to the buyer signing the good faith estimate. This was a sneaky way to recoup the builder's hard costs—while providing incentives to control the buyer's loan. This is called a "bait and switch" routine and is illegal. Builders and lenders are having a more difficult time pulling this little routine during today's tough regulatory environment.

Real estate investors coming in with all cash offers may need to show the builder a copy of their bank statement(s) to prove they have the money in the bank.

Time Periods

There is really not much for a buyer to do during the 6-12 month building process. New home buyers are generally not supposed to enter the building site during construction. However, buyers have found more than one mistake that has been made during the construction process. For this reason, it may be a good idea to hire a professional home inspector to periodically inspect the home during the construction phase and during the walk-thru inspection after it has been completed.

Walk-Thru Inspection

Most new home buyers assume that their home is going to be in "perfect condition" when the builder calls to schedule the walk-thru inspection.

Unfortunately, this may not be the case. Many new homes have "bugs" (small problems, not pests) that have to be worked out during the first year of ownership. Builders generally employ a "Dilly Dally Don" to take care of little things that come up during the first year or so of the home's existence.

The "We're Ready to Schedule Your Move In" Routine

One trick that builders like to use is the, "We're ready to schedule your move in" routine. First, the builder calls the home buyer to schedule a walk-thru date. The buyer then schedules moving vans and everything seems to be fine. When the buyer arrives for the final walk-thru inspection, they find many small details remain unfinished. Yet the builder's representative asks them to sign the walk-thru form (as if the home is completed) and then close escrow on the home anyway. The builder says, "We'll get everything done after close of escrow." This is generally a really bad idea. Because of construction loan issues, the builder is generally highly motivated to complete the unfinished items prior to closing. After closing, the buyer will inevitably be placed on the back burner and may need to threaten litigation to get anything done. One new homebuyer signed the closing documents and it took over a year to get the promised work completed. It is generally best to wait until everything is completed, then sign the walk-thru form and close escrow.

The builder most likely has used a construction loan to build the home. He usually pays interest on the amount of funds drawn against the construction loan. At the end of construction, the loan balance is usually fairly substantial. For this reason, the builder is generally *highly motivated* to close escrow so he can stop paying the interest that is due on the outstanding balance of the construction loan. If the buyer does not sign the walk-thru inspection form and does not move forward to close escrow, the builder will probably allocate enough resources to make sure everything is completed on the home. At this point, after everything has been completed per the contract with the builder, the buyer should consider signing the walk thru form, loan documents, and escrow instructions to close escrow.

Home Warranty Policies

Many new home builders stand behind their products and may provide a home buyer with a ten year home warranty against defects in construction and workmanship. Builders may also provide a home warranty policy issued by an outside company to protect against items such as a range, dishwasher, HVAC, or other mechanical items becoming inoperable during the first year of home ownership. A happy customer is critical to a builder's long-term success. He usually loves referrals from existing homeowners.

One problem a home buyer may encounter when purchasing a new home is loan interest rates. Since it will probably take the builder 6-12 months to complete construction of a new home, prevailing market interest rate could increase over this time period. If a home buyer thinks interest rates are going to increase in the future, they may want to consider quick move-in homes that are already built and can be closed within a short period of time.

II. QUICK MOVE-IN HOMES

The second type of new home is a quick move-in home that builders call "Standing Inventory." A home buyer may decide not to go forward with a new home purchase. With a 6-12 month average build-out period, this is a recurring problem for builders. For this reason, builders like to collect a sizeable earnest money deposit when the contract is signed to build a new home.

The Real Estate Market Changes From an Upward-Trending Sellers' Market to a Downward-Trending Buyers' Market

Home cancellations usually become a big problem when the real estate market changes from an upward-trending sellers' market to a downward trending buyers' market. Home prices start to decline and new home buyers tend to cancel their contracts as the real estate market moves downward.

Builders may be left with all of the architectural upgrade deposit and possibly half or more of the cosmetic upgrade deposit when a buyer decides not to go forward with a home purchase. During this period of time many builders' only source of income may be keeping buyers' deposits. This usually leads to a large number of finished or partially finished homes left standing in the builder's inventory.

"Home prices start to decline and new home buyers tend to cancel their contracts as the real estate market moves downward."

These "Quick Move-In" homes are usually ready to go and can be a really good deal. The main reason is the builder usually has a construction loan on the home. As mentioned earlier, construction loans charge interest on the materials and labor costs that go into the home. At the end of the building process, the builder usually has a significant amount of building materials contained in the home and is paying interest on all the material costs. In addition, many of the builder's draws may have been used to pay his direct labor costs and payments to subcontractors. For this reason, the builder is usually highly motivated to sell the home.

During an upward-trending sellers' market, the builder probably can sell the home fairly quickly and for a good price. However, during a downward trending buyers' market the builder may have a difficult time finding a buyer. Home buyers can offer less than the asking price and have a good chance of it being accepted. The home may contain upgrades that the buyer will get for bargain prices. The builder may forego the profits on the upgrades in order to sell the property. This is especially true if the buyer has a pre-approved loan and can close quickly. Of course, all cash offers are always good too.

The "Incentives In Lieu of Price" Routine

Be careful accepting "incentives" in lieu of a reduced purchase price. It may be in a buyer's best interest to insist on a lower purchase price, rather than accepting a higher purchase price with "incentives" to reduce net out-of-pocket costs.

By accepting the builder's incentives in lieu of a price reduction, the home buyer may end up with a higher loan amount than if they had insisted on a lower purchase price. Over the life of this loan, they may pay more than if they had negotiated a lower purchase price and refused to accept the builder's "incentives."

Builders will try to keep home prices up, especially during downward trending buyers' markets, because a price reduction will affect the appraisals of homes already in escrow. This is a "lose-lose" situation for the builder. He is losing profits with each price reduction, and the homes he has in escrow may fall out when they do not appraise for the contract price.

Appraisers will generally use the most recent sales comparables, which are prices of the builder's homes that have recently sold. They will also look at the builder's current asking prices listed on any sales brochures. If the asking price for the same model home is lower than the contract price already in escrow with the buyer, the appraiser will most likely reduce the appraised value of the home accordingly. Therefore, any builder price reductions may cause a reduction in the sales price of ALL of his properties that are in escrow. That is why builders many times will offer incentives to artificially "prop up" sale prices and help close the properties that are currently in escrow. They will also make home price lists difficult to obtain from their salespeople. If you look like an appraiser, the sales office will probably be "out" of home price lists when you ask for one.

Your Clients Do Not Have To Pay List Price

As mentioned earlier, paying list price may be the norm during an upward-trending sellers' market; however, it is usually not a requirement during a downward-trending buyers' market. Buyers can make the builder an offer and see what happens. Looking at the home purchase without emotion will usually obtain the best results. If a buyer gets emotional about a home purchase, the builder will sense it and any chance she had of negotiating a "screaming deal" will be out the window. Experienced real estate investors generally have an advantage over owner-occupied buyers in this area.

Real Estate Investors

Some builders may not want to sell a new home (that has yet to be built) to a real estate investor. To preserve their owner-occupied homeowners that have already purchased from the builder during earlier phases of construction, as well as loan qualification for future owner-occupied buyers, the builder may make it difficult for an investor to purchase a home from him. An investor will be placing a tenant in the home and this can devalue owner-occupied single-family neighborhoods. This is especially true in lower socio-economic neighborhoods.

"Too many investor-owned properties can hinder future owner-occupied buyers from getting the financing and appraisals necessary to close on the new homes being built."

Too many investor-owned properties can hinder future owner-occupied buyers from getting the financing and appraisals necessary to close on the new homes being built. Of course, the presence of owner-occupied homeowners will usually increase the value of a single-family home when it is sold at the end of the holding period.

Your clients may be able to get around this builder policy by purchasing the home as owner-occupied, and later converting it to a rental; or buying a quick move-in/standing inventory home that has already been built. Builders usually have more motivation to sell the quick move-in homes to investors because of the existing construction loan that is probably costing him a lot of money. Quick move-in homes generally occur near the end of the building phase(s), so the builder will probably be more willing to sell to an investor because he does not have future home sales riding on the decision.

Real Estate Agent Commissions

During an upward-trending sellers' market, many builders are not willing to pay a real estate agent's commission for the sale of their homes. They have so many buyers wanting to purchase their homes, they do not need to pay real estate commissions. If they do pay a commission, they usually make the agent prove she accompanied the buyer on their first visit to the model homes. They usually use a registration card to accomplish this requirement.

Conversely, during a downward trending buyers' market many builders are usually willing to pay a real estate commission to anyone who even remotely looks like they have a real estate license. It is much easier for an agent to get paid during this type of market.

As mentioned earlier, when a buyer makes an offer to purchase through one of the builder's own salespeople, the salesperson will be able to get a reading of their "emotional motivation." This will probably hurt the buyers during the negotiation process. Using a real estate agent who works for the client (but is paid by the builder) to help negotiate the deal, can save the client a lot of money by removing them from the negotiation process. The builder will not be able to "read" the buyer's motivation level and adjust negotiation tactics accordingly. Builders are professional home sellers who are experts at building and selling single-family homes. So, hiring a professional negotiator, such as an experienced real estate agent, is in the new home buyer's best interests when dealing with professional builders.

As the downward-trending buyers' market continues downward, real estate investors will notice that single-family home values will start falling below the amounts of existing home loan(s). This situation is called "underwater" or "upside down."

Real estate investors start to watch the real estate market rather closely to see if any potential deals start to materialize. Real estate investors generally want to realize cash flows from rental properties, as well as appreciation from an increase in property values over the holding period.

Next is a look at a recent court case where the builder was held liable for un-compacted fill underneath a new home that was built. When a builder must bring in soil to increase the grade (height level) of the lot where the home will be built, many times this soil remains loose and causes cracks in the concrete foundation where the house sits.

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HOMEBUILDERS AND FRAUDULENT CONCEALMENT

Stofer v. Shapell Industries, Inc. (2015)

Court of Appeals of California, First District, Division Five
January 15, 2015

Plaintiff Donna Stofer (plaintiff) purchased a home from Dr. Marcus F. Laux. Almost two years later, she sued the homebuilder, Shapell Industries, Inc. (Shapell), for strict liability, negligence, and fraudulent concealment.

Plaintiff claimed Shapell built the home on unstable and uncompacted "fill" soil and with an inadequate foundation, causing "substantial differential movement" and numerous defects such as cracked floors, walls, and ceilings.

Shapell moved for summary judgment, contending it did not conceal any material information and plaintiff did not have standing to sue because her claims accrued while Dr. Laux owned the home.

The trial court granted the motion as to plaintiff's fraudulent concealment claim.

It denied the motion as to plaintiff's other claims, concluding there was a triable issue of material fact regarding whether plaintiff "own[ed] . . . any claims regarding defects in the design and construction of the home[.]"

The court held a bench trial on the accrual issue, and entered judgment for Shapell, concluding plaintiff had "no standing to sue" because her claims accrued when Dr. Laux owned the home and <u>he did not assign the claims to plaintiff.</u>

Plaintiff appeals.

She contends the order granting summary adjudication on her fraudulent concealment claim must be reversed.

We agree.

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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

Construing the facts in a light most favorable to plaintiff and resolving evidentiary doubts in her favor, we conclude there is a triable issue of material fact regarding whether Shapell fraudulently concealed information about the property's soil conditions.

Accordingly, we reverse the grant of summary adjudication on plaintiff's fraudulent concealment claim.

Plaintiff also contends the judgment must be reversed because she was entitled to have a jury determine the disputed factual issues of "when and to whom the causes of action accrued."

We agree.

A trial court may decide whether a cause of action for construction defect accrues to the plaintiff where the facts underlying that determination are undisputed.

But where — as here — the material facts regarding accrual turn on disputed facts or require credibility determinations, the jury must make these factual findings "before the trial court decides whether the facts, as determined by the jury" establish ownership of the causes of action as an issue of law.

Accordingly, we reverse the judgment for Shapell.

WHAT HAPPENED
Shapell built a home on Velvet Leaf Circle in a residential subdivision in San Ramon for Timothy Alan Wright, then Shapell's Assistant General Superintendent and Assistant Vice President of Construction.

Wright oversaw the construction of the home and he and his wife purchased it from Shapell in December 2002.

The transaction was informal: Shapell transferred title to the property without


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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

"formal disclosures that would be transmitted in a more conventional transaction." (See Civ. Code, § 1102 et seq.)

Wright and his wife sold the home to Dr. Laux in 2004.

In the Real Estate Transfer Disclosure Statement prepared as part of the sale to Dr. Laux, Wright stated he was unaware of the presence of fill soil on the property. When he owned the home, Dr. Laux submitted multiple warranty repair requests to Shapell for problems ranging from cracked sidewalks and exterior stucco to issues with the home's windows and doors.

Dr. Laux sold the home to plaintiff in 2008.

In 2010, plaintiff sued Shapell for strict liability, negligence, and fraudulent concealment, alleging "defective soil conditions" heaved the home's foundation and damaged "all of the structures on the lot."

The operative complaint alleged the soil conditions were defective in part because the property contained "25 to 30 feet of highly differential fill; the soil at the Property has unusually high plasticity; the fill at the Property fails to meet minimum engineering compaction standards."

The operative complaint also alleged the home suffered from numerous defects, including cracked floors, walls and ceilings, un-level floors, and problems with the pool and pool deck.

Plaintiff alleged she noticed these "dramatic changes" *after* she purchased the home.

The fraudulent concealment cause of action alleged Shapell hired ENGEO Incorporated (Engeo) as a soil engineer and that Engeo advised Shapell of the "highly differential, high plasticity fill soil conditions" on the property in 1995 and 1999 reports.

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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

Plaintiff alleged Shapell concealed this information from its structural engineer, *Shaer-K Engineering (Shaer-K)* and, as a result, Shaer-K "did not take into account these soil conditions when designing the foundations" for the structures built on the property.

Because Shapell intentionally concealed the soil conditions from Shaer-K, all of the buildings on the property were "built on fill without using a proper design methodology to provide the buildings the proper support."

Plaintiff also alleged Shapell had a duty to disclose "highly differential fill soil conditions and the inadequate foundation" to Wright but concealed this information from him to induce him to buy the property.

Defendant Shapell argued:
(1) there was no evidence it concealed or suppressed the Engeo reports from Shaer-K or Wright; and
(2) the soil conditions were disclosed to plaintiff before she bought the home.

Shapell supported its motion with following evidence:
Shaer-K's sole owner and employee, Karen Serke, contracted with Wright in April 2002 to provide architectural engineering and design services for the construction of the home.

The contract required Wright to "provide surveying and/or geotechnical engineering services upon request . . . to support the structural design."

Serke received unspecified Engeo "soils reports for the project and used them in preparation of [her] structural calculations for . . . Wright's residence."

Wright knew the property contained fill, had been graded, and was not "in a natural state" when construction began.

He provided Serke with whatever information she requested, including the building plans and Engeo's "soils sheet."


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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

Plaintiff signed a statewide buyer and seller advisory form before she purchased the home advising her "real estate in California is subject to settling, slippage, contraction, expansion, subsidence . . . and other land movement.

The Property may be constructed on fill or improperly compacted soil and may have inadequate drainage capability. Any of these matters can cause structural problems to improvements on the Property.'"

Plaintiff also signed a buyer's inspection advisory from the California Association of Realtors advising her to investigate the entire property, including "Soil Stability: Existence of fill or compacted soil, expansive or contracting soil, susceptibility to slippage, settling or movement, and the adequacy of drainage. (Geotechnical engineers are best suited to determine such conditions, causes and remedies)."

Before she bought the home, plaintiff received a professional real estate inspection report (prepared in 2004, when Wright sold the home to Dr. Laux) stating the home was "located in an area where the soil condition is of an expansive nature. We believe that some building and site concrete movement will always occur as the soils moisture content changes from season to season. The method of construction used when this structure was built seems to have the inherent characteristic of slight structural movement."

The final subdivision public report lodged with the California Bureau of Real Estate in 2001 stating some lots in the subdivision "contain[ed] filled ground in excess of two feet. The information concerning filled ground and soil conditions is available at the City of San Ramon Building Department."

In opposition, plaintiff argued Shapell knew of the existence of fill on the property and failed to disclose the information to Shaer-K or Wright.

She contended the statements in the statewide buyer and seller advisory, 2004 professional real estate inspection report, and final subdivision public report

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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

were "no substitute for proper disclosure of specific information known to Shapell" regarding the property.

She offered the following evidence in opposition:
1. Engeo's September 1992 and September 1999 reports notifying Shapell of the property's soil condition.

The September 1992 report stated a "`major area of concern regarding the project is the expansive nature of the native soil and bedrock. The clayey soil and claystone at the site display moderate to high Plasticity Indices which is an indication of moderate to extremely high potential for shrink-swell behavior.'"

The September 1999 report stated "differential fill subexcavation was not performed within these subdivisions. Differential fill conditions on [the property] will need to be addressed during foundation design review."

The September 1999 report referenced Engeo's May 1999 report, which stated the property contained up to 24 meters of fill and also advised "differential fill conditions . . . will need to be addressed during foundation design review."

Serke destroyed the file she maintained when she designed the home's foundation, did not possess copy of "any soils reports" related to the property, and could not identify which Engeo soil reports she received regarding the property.
Serke averred "Wright did not inform [her] that differential fill was present" on the property and stated she was "unaware that differential fill was present at [the property]" when she designed the home's foundation.

Wright knew the property had been "cut" and "graded" but not to "what extent."

Wright was aware the property "wasn't in a natural state. . . . whether it was cut down to get there or it was brought back up" but he "just never paid


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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

attention."

He knew there was fill in the lots in the subdivision, but not the depth of the fill because another Shapell department "dealt with" that issue.

After she moved into the house: (1) a hairline crack in the pool decking became a fracture, other cracks surfaced, and the coping at the pool buckled and separated; (2) standing water appeared on the property and began to roll toward the house; (3) cracks appeared in exterior tiles and in drywall; (4) window seals broke and windows separated from their frames; (5) a hairline crack in the stucco "substantially increased" and additional cracks appeared; (6) doors stopped closing and locking and a sliding glass door cracked and started "to seize[;]" and (7) an iron fence separated.

Dr. Laux did not believe there was a problem with the foundation or soil conditions when he purchased the home from Wright and his wife. He did not know there was up to 20 feet of fill soil under the foundation of the house.

While Dr. Laux owned the home, he submitted warranty requests for "punch list" or "minor" problems with the home "`that were not perfect, less than perfect'" but he never thought there was an underlying soil or foundation condition causing the problems.

Dr. Laux did not think he needed to hire experts to investigate the problems on the property. He gave plaintiff a $2,000 credit against the sale of the home for minor repairs, not because of a perceived deficiency in the condition of the soil or foundation.

Dr. Laux was sincere when he wrote plaintiff a letter expressing his love for the home.

Bench Trial and Judgment for Shapell

Shapell then requested a bench trial on accrual, claiming it was "a legal issue" for the court — not the jury — to determine.

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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

As Shapell explained, the "issue of the party which owned the property at the time the work was performed or when the damage occurred and whether any rights were transferred or assigned . . . are questions of law for the court to determine."

Shapell also argued a bench trial on the threshold and dispositive issue of accrual would promote judicial economy.

In opposition, plaintiff claimed she was entitled to a jury trial because "[t]he question of when a claim accrued is one of fact" and "[t]here is substantial and significant evidence for the jury to determine the cause of action against Shapell accrued during [her] ownership[.]"

Plaintiff claimed a jury should determine whether she owned the causes of action against Shapell because the parties disputed the "predicate facts underlying that determination."

After reviewing the parties' extensive briefing and holding several hearings, the court decided to conduct a bench trial on whether plaintiff had "standing to sue . . . Shapell for defective construction, i.e. whether or not the cause of action accrued during the time the property was owned by Dr. Marcus Laux."

Following a nine-day bench trial, the court entered judgment for Shapell.

The court concluded the claims asserted in plaintiff's lawsuit "accrued to Dr. Laux" because it was "undisputed that physical manifestation of problems occurred and existed during ownership of the property by Dr. Laux (between 2004 and 2008)."

In addition, the court determined the "[d]amages to the property complained of by Plaintiff were similar and some identical to (but not fundamentally different from) those complained of by Dr. Laux."

The court concluded plaintiff had "no standing to sue" because the "items of


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HOMEBUILDERS AND FRAUDULENT CONCEALMENT (*continued*)

Stofer v. Shapell Industries, Inc. (2015)

damage" claimed by plaintiff "represent damages which belonged to Dr. Laux and he elected not to pursue them."

DISPOSITION

The order granting summary adjudication for Shapell on plaintiff's fraudulent concealment cause of action is reversed. The judgment for Shapell is also reversed. Plaintiff shall recover costs on appeal. (Cal. Rules of Court, rule 8.278(a).)

Simons, J. and Bruiniers, J., concurs.

This court case moves product liability issues in California back to the builder, even if the property has been owned by multiple people. Builders will need to make sure fill soil is compacted enough to properly sustain a home they build for years into the future.

Your clients can find some good deals when buying new homes during the start of an upward-trending sellers' market. After the market has run for a while, good new home deals may be hard to find as prices continue to climb, peak, and then head into a downward-trending buyers' market.

As single-family real estate markets increase in value, peak, and then cool off; at some point in time the cost to buy an existing home will be *less* than the cost to build a new one. This is when a real estate investor can start looking for good quality existing home deals. Next is a look at the financial aspects of single-family homes.

12

FINANCIAL ANALYSIS OF SINGLE-FAMILY RENTAL PROPERTIES

*"There are three types of people in this world: those who **make** things happen, those who **watch** things happen, and those who **wonder** what happened."*
-Unknown Investor

The financial analysis of single-family rental properties can be accomplished through the investigation of sales comparables, rental comparables, and taking advantage of owner-occupied financing. The chapter will end with an examination of a typical single-family home investment scenario.

Sales Comparables

A sales comparable or "sales comp" is the documented sale price, terms, and other pertinent information for the sale of a specific parcel of real property. For a sales comp to be effective, it should be as close as possible in geographic location, size, condition, and construction to the subject property. It should also be as recent as possible.

"For a sales comp to be effective, it should be as close as possible in geographic location, size, condition, and construction to the subject property."

Sales comparables can generally be obtained from the country recorder in the county where the property is located, the county property tax database, a local title insurance company's title plant, and/or a local Multiple Listing Service (MLS) database. Many title insurance companies will perform customer service work for real estate agents at no charge. The title information generated from computerized databases is usually fairly accurate and tends to make sales comparables easy to locate.

A real estate investor usually bases sales price on the market data appraisal method, which uses sales comparables. In contrast, the income approach is generally not appropriate for use with single-family income properties because real estate investors are usually competing with owner-occupied buyers who have different financing terms and psychological motivations for purchasing single-family homes than real estate investors. When a real estate investor sells a single-family home at the end of the holding period, it will most likely be to an owner-occupied buyer who will pay more money for the property than another real estate investor.

Accordingly, owner-occupied homebuyers are usually buying on emotion and generally have lower interest rates and higher loan-to-value ratios than real estate investors. For these reasons, they can and will pay more money for a single-family home than a real estate investor who is not emotional and is looking at the property strictly as an investment vehicle.

An investor may utilize a tax record search to verify the represented owner REALLY is the owner of the property. A preliminary title report can be used to provide more extensive title information than a tax record search for the owner(s) of a property.

The Story of the Crooked Husband & His Fraudulent Girlfriend

There was one occasion when a man tried to have his girlfriend pose as his wife while conveying a single-family home to a buyer. His wife had divorced him, remarried, and then died; yet she still remained as a joint tenant with him on the title to the property. He was not knowledgeable about real estate closing procedures and did not realize that this fraud would surface when the notary public asked for his "wife's" driver's license and right thumb print. The girlfriend may have been able to produce a forged driver's license, however, the thumbprint would have most likely produced a very long "rap sheet."

Owner-occupied buyers tend to drive the prices of homes up and down as a function of available housing in a local geographic area, employment sources, prevailing wages, and owner-occupied single-family loan interest rates.

Real estate investors generally look at single-family rental properties as an investment vehicle that will derive a projected rate of return at an acceptable level of risk over a projected holding period. Therefore, a real estate investor may base investment decisions on projected appreciation of single-family homes in a particular geographic area and NOT on projected increases in income derived from increased rents. This is one of the main differences between single-family and multi-unit residential investment properties.

Next is a look at a new law that requires the Documentary Transfer Tax to not be kept a secret for the sale of real property. The result of this law will provide more information regarding sales comparables from local county tax record databases.

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DOCUMENTARY TRANSFER TAX NOT KEPT A SECRET

California Assembly Bill 1888
Effective Jan. 1, 2015

The Documentary Transfer Tax Act (Act) allows counties to levy a tax upon the recording of documents that transfer interests in real property. All 58 counties in California impose a Documentary Transfer Tax, which is levied at a rate of $.55 per $500 (or $1.10 per $1,000) of the value of the real property or interest being transferred.

The bill repeals the requirement that a county recorder, upon the request of a party submitting a document for recordation, must show the amount of Documentary Transfer Tax due on a separate paper which must be affixed to the document by the recorder after the permanent record is made and before the original is returned.

County recorders administer Documentary Transfer Taxes. State law prohibits a recorder from recording a document subject to the Documentary Transfer Tax unless the tax is paid at the time of recording. Generally, every document subject to the Documentary Transfer Tax, when it is submitted for recordation, must show on its face the amount of tax due.

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DOCUMENTARY TRANSFER TAX NOT KEPT A SECRET (*continued*)

California Assembly Bill 1888
Effective Jan. 1, 2015

If the amount of tax paid is shown on a page that is separate from the recorded document, no one can find out how much tax was paid simply by looking at the recorded copy of the document.

The bill's author states, "Every time a property is sold an updated deed is filed with the county recorder and transfer tax is paid. The change in ownership and the amount of transfer tax paid is understood to be public information.

For decades an outdated statute has permitted parties to request that transfer tax information be shown on a separate document from the recorded deed transferring ownership of the real property, effectively shielding the amount of transfer tax paid from public inspection.

The only purpose for this provision is an attempt to keep others from knowing the purchase price of the property, which can be reliably deduced from the amount of transfer tax paid.

AB 1888 updates the law to provide for *transparency* in the administration of California's Documentary Transfer Tax law, resolve an issue relating to the availability of transfer tax information, and ensure that real estate appraisers have access to transfer tax information in order to accurately appraise real property."

Documentary Transfer Tax Explained

It should be noted that the Documentary Transfer Tax is taxed on the amount of "new money" coming into the transaction. This can be cash, the down payment, or new loan funds. If there is a loan assumption, the amount of the assumed loan is NOT taxed. The good news is that loan assumptions have been less likely to occur during recent years of low interest rates and the Documentary Transfer Tax has been a reliable source for sales comparables.

Historically, lender have not allowed the assumption of fixed rate loans because it is not in their best interest to have below market rate loans continuing to loan maturity. However, lenders have been more amenable to allowing adjustable rate loans to be assumed by qualified borrowers. An adjustable rate loan allows the loan interest rate to adjust to the market level through an adjustment of the underlying index that measures the cost of money on the international monetary exchanges.

> The only advantage a borrower may have when assuming an adjustable rate loan is moving further out on the amortization curve, so more of the principal is paid each month than would have occurred if the borrower had obtained a new loan.

In other words, lenders are business people and will not allow a loan assumption that deprives them of market yields for the loans they make. Therefore, the likelihood of formal loan assumptions, as opposed to unauthorized simple assumptions and unrecorded land contracts, will be quite low in the future and the Documentary Transfer Tax should continue to be a good indicator of property sale prices.

Rental Comparables

To perform a rental comparable analysis, a single-family investor may physically inspect the local geographic area around the subject property. A few calls to "For Rent" signs or advertisements in Craigslist will usually provide a general idea of the rental range for the property. Calls to a few local property management companies may be helpful in determining market rents as well. A conservative estimate is usually the best course. Savvy single-family home investors usually plan for the lower end of a rental range and then are pleasantly surprised when they are able to achieve higher rents for the property.

A Single-Family Home is converted to a Rental Property

When an owner-occupied homeowner decides to purchase a new home and rent their present home to a tenant, they may be able to use part of the rental income from the existing home to qualify for a loan on the new home. This really depends upon the loan underwriting guidelines of the lender for the new home.

The existing home, that will become a rental property, may have a fairly high loan-to-value ratio because it was purchased with owner-occupied financing. Lenders generally regard owner-occupied buyers as having less default risk than real estate investors. Owner-occupied homebuyers need a place to live and will usually try to avoid foreclosure more frequently than investors—who look at a home strictly as an investment vehicle and a loan default as a business decision.

If a single-family investment has not worked out, real estate investors typically make a business decision to cut their losses and walk away from the property. For this reason, lenders generally charge real estate investors a higher interest rate and require a larger down payment than they do homeowners buying owner-occupied properties.

In this particular case, the rental home was originally purchased with owner-occupied financing and the homeowner (now turned real estate investor) may have paid as little as 5% down payment and financed the remaining 95%. This is considered a 95% loan-to-value (LTV) loan, and is well above the 80% maximum LTV most lenders feel comfortable loaning to owner-occupied buyers in a normal real estate market. Most lenders want the borrower to have some "skin in the game," so if there is a foreclosure, the borrower will have enough equity at stake to make an honest attempt to keep the property—rather than walk away at the first sign of trouble.

"PMI companies are generally fairly active during upward-trending sellers' markets—because property values are increasing and they have less risk than what exists during a declining market."

If the borrower has an exceptionally good credit rating and stable income, a private mortgage insurance (PMI) company may step in and insure the 15% (95%-80%= 15%) the lender does not want to loan. PMI covered loans are generally used for owner-occupied single-family home loans, and may not be available for non owner-occupied home loans.

An owner-occupied lender is usually comfortable with 80% LTV exposure; however, the 15% insured by the PMI company must be paid to the lender by the PMI company if there is a foreclosure. PMI companies are generally fairly active during upward-trending sellers' markets—because property values are increasing and they have less risk than what exists during a declining market.

Conversely, PMI companies may be practically nonexistent during a downward-trending buyers' market. PMI companies ask themselves, "Why insure a 95% LTV loan when the market is heading downward?"

A loan with PMI insurance will allow the owner to lose their 5% down payment; however, the lender may actually come out in fairly good shape as the PMI company must pay for the lender's loss-up to 15% of the loan amount (the amount of the down payment the borrower was not required to pay because the PMI company insured it). This amount, of course, is the amount of the down payment that the borrower did not make and the lender did not want to lend. So, the PMI insurer usually pays for this loss.

The Story of Wealth Building

Year 0

A husband and wife purchase a $110,000 single-family home located in Chico, California. The buyers can qualify for $180,000, however, their loan payments will be greater than what the house will rent for in the future (when the property becomes a rental). Therefore, the husband and wife purchase less house, put their egos on the back burner, and plan for the future. They pick a middle socio-economic neighborhood, instead of the more affluent neighborhoods where their friends live and their income qualifies them as a dual income household.

Property purchase example:

$110,000	Purchase price
$11,000	Down payment (10%)
$99,000	Promissory note secured by a 1st deed of trust, 7.0% fixed rate (example only), 30 year amortization rate, due in 30 years.

Monthly Payment:

$658.65	Principal and Interest
$ 92.00	Property Taxes
$ 30.00	Homeowner's Insurance
$ 40.00	Private mortgage insurance (PMI)
$41.25	Property management fee (5% of gross collected rents paid when the property becomes a rental and may be as high as 10% of gross collected rents plus one month's rent as a lease up fee.)
$861.90	Principal, Interest, Taxes, Insurance, (PITI) + PMI+ Property Management Fee (PM)

The husband and wife must first perform a market rental analysis for single-family homes in the area where they intend to purchase. Example:

Break-Even Analysis

Monthly Net Operating Income	=	$875
Monthly Debt Service (PITI+PMI+PM)	=	$861.90

If the husband and wife do not achieve a break-even cash flow, they will generally continue to bring the purchase price downward and increase the down payment until this balance is achieved.

If the appropriate single-family homes are located in too low of a socio-economic neighborhood, they may expect destructive tenants in the future, and they may want to consider halfplexes, townhouses, and condominiums located in higher socio-economic neighborhoods.

In our example:

Real Property Purchase Information

Scheduled Gross Income (annual)	$10,200
<u>Less</u> Vacancy (5% is normal, but is not considered here)	$-0-
Effective Gross Income	$10,200
<u>Less</u> Operating Expenses	
$1,104 Property Taxes (1.15-1.25% of sale price)	
$ 360 Property Insurance	
$ 480 Private Mortgage Insurance (PMI)	
$ 495 Property Management Expenses	
Total Operating Expenses	$2,439
Net Operating Income	$7,761
<u>Less</u> Debt Service (no principal reduction considered)	$7,903
Before Tax Cash Flow	($ 142)

<u>This is very close to a break-even cash flow.</u>

Year 4

The husband receives a promotion and must move to the San Fernando Valley in Southern California. The real estate market nationally has rebounded, but not in Southern California. It is two years or more behind the rest of the U.S. and still trying to recover from earthquakes, floods, fires, riots, tsunamis, and celebrity drunk drivers.

The single-family residential property the investors bought in Year 0 may have lost some of its value because of the economic recession. However, since they purchased an entry-level home, their devaluation is not nearly as severe as the homes in the higher $180,000 "move-up" price range.

The new value of this Chico home is $100,000. Since their loan is $99,000 (less four years of principal reduction which is not considered in this example), the employer will be required to step in and purchase the house from the husband and wife, sell it, and pay the difference (loss). The difference can be significant because closing costs and sales commissions will be approximately $10,000. Total out of pocket to the employer will be approximately $11,000.

When the employer purchases the employee's home, the employee will go to Southern California with more salary income, but without any equity in his pockets nor control of any assets that may produce equity in the future. He and his wife will be starting over. They will become renters once again. Independent wealth and early retirement will remain the same distance away as it was in Year 0.

The other alternative is to turn the Chico home into a rental property. By purchasing below their means and not making the usual homeowner over-improvements, they may be able to rent the property near a break-even cash flow and in a “not too spruced up” rentable condition. Many home improvements do not increase the rental value of a home.

Interior and exterior paint and trimmed landscape are usually the most cost-effective improvements a landlord can make to a property. It might be best to make all the major renovations (new carpet, appliances, and fixtures) just prior to selling the home at the end of the holding period many years down the road. As mentioned earlier, if an investor really times the market correctly he may be able to sell the property at the top-of-the-market without performing an extensive rehabilitation of the home at all.

It is usually a good idea to purchase a home built after 1978 because of potential hazardous materials that may exist in the home. Many pre-1978 homes contain asbestos in their ceiling materials and lead-based paint throughout the interior walls of the home. This can be a potential liability problem to both sellers and real estate agents. Older homes tend to have increasingly more expensive maintenance costs as appliances, sinks, fixtures, HVAC systems, and other items wear out over time and must be replaced.

Since the husband and wife have been living below their means in Chico, they should have been able to save some of their income. This takes discipline and solid budget planning.

During year 4, when the husband and wife move to Southern California, they may have enough money for a down payment on a Southern California home. In addition, loan qualification may be enhanced as the husband's new position probably pays more money and the wage scale for the wife's job is much higher in Southern California.

The husband and wife perform the same financial analysis as in Chico, trying to find a property that will have a future break-even cash flow when it is rented out. When the husband and wife qualify for the new loan on their new home, they most likely will be required to absorb the negative cash flow from the rental in Chico. However, with a verifiable lease agreement, the lender may credit up to 75% of the rental amount toward loan qualification on the new home. This varies depending upon loan underwriting guidelines, so make sure your clients see a professional lender prior to any investment plan or endeavor. To qualify for owner-occupied financing, the husband and wife will be required to actually live in the Southern California home.

Since the husband and wife's intent is a long-term hold for the property, they should look at loan interest rates. Since interest rates were 7% fixed (example) in Year 0 and may go up in the future, a fixed rate loan may have been a good idea in Year 0. If they thought interest rates were going to go down, an adjustable rate loan may have been the answer. It really depends upon the husband and wife's tolerance for interest rate risk.

Four years later, interest rates have (for example) increased to 11%. They should do a cash flow analysis over the holding period before deciding to purchase a property.

Year 8

The "Hot Shot" executive husband is promoted again. This time to New York City. The cost of living index in Chico is 100 (examples), San Fernando Valley 130, and New York City 235. Even with the one spouse's incredible income, the husband and wife can only afford to purchase a home three hours commuting distance from the office location in New York City. The husband pays for this promotion with commuting time and stress. The husband and wife may be able to purchase their third home with owner-occupied financing. They will probably not have enough income available to purchase a fourth home with this type of financing in the future. They will probably be forced to purchase future homes through non owner-occupied financing, seller financing, or other methods.

Year 12
The husband is promoted again. This time to Chicago. The national economy is peaking. The husband and wife purchase their fourth home with a large down payment and a seller-carry loan at the prevailing market interest rates.

Year 16
The husband and wife's loans have started to amortize with significant principal reduction (especially true if they used 15 year amortization schedules instead of 30 years, although the higher payments may have been too high to provide a break-even cash flow and additional equity has built up through price appreciation in the homes in their "real estate investment portfolio."

If the husband and wife are able to acquire ten homes over their careers, they could have close to $1 million in equity as they reach age 55. This is in addition to retirement accounts and other more passive securities investments. This strategy is not a bed of roses, however. Even with a professional property manager managing the property, the husband and wife will continue to deal with the headaches of being a landlord.

The Story of an Inexpensive Home Located in a Lower Socio-Economic Area
A real estate investor paid $65,000 all cash to purchase a 3 bedroom/1 bathroom home located in North Highlands, CA. The home was built in 1953 with a concrete slab foundation, thus making it difficult to add a second bathroom to the property. However, the concrete slab foundation may have more durability than a raised foundation because the wood piers and columns in the raised foundation tend to wear out over time. Consequently, the concrete slab foundation may not have as many water leakage issues in the bathroom and kitchen versus a raised foundation.

For example,
$65,000 purchase price
3 bedrooms/1 bathroom

Located in North Highlands, CA near Sacramento, good proximity to State of California workers, easy freeway access, and a predominately blue collar neighborhood.

Long-term economic outlook is good. Job sources include the State of California, High Tech Industries, Medical, and Service businesses.

The home rents for $1,000 per month, with rents projected to increase in the future as demand for single-family homes increases. This will probably be due to projected population growth resulting from a high quality of life and solid median household income levels. This tends to cause long-term increases in rents and price appreciation for single-family homes in the area.

Tenants living in lower socio-economic neighborhoods, however, are generally more difficult to manage than higher-end tenants living in higher socio-economic neighborhoods. This is because lower socio-economic tenants typically have less income than tenants living in higher socio-economic neighborhoods, so feeding the family may come before paying the rent.

The numbers:
$65,000 All Cash purchase price
$1,000/month rents x 12 months/year = $12,000/yr.

Therefore,

Scheduled Gross Income		$12,000	
Less Vacancy		$ -0-	
Effective Gross Income		$12,000	
Less Operating Expenses			
Property Taxes	$ 813		(1.25% of purchase price)
Insurance	$ 425		(Owner Liability/Tenant OLT)
Water, Sewer, Garbage	$1,500		($125 per month)*
Maintenance	$1,000		(based on age of property)
Total Expenses		$3,738	
Net Operating Income		<u>$8,262</u>	

*Water, sewer, and garbage may become a lien on a property if the tenant does not pay the bill. This means that the landlord will be stuck paying the bill no matter what happens with the tenant. With this in mind, many landlords pay the water, sewer, and garbage bills themselves and increase the rental amount accordingly to cover it.

Price x Capitalization Rate = Net Operating Income

In other words, Capitalization Rate is the return a real estate investor receives if he pays all cash to acquire the property. In this situation, we use the following formula to calculate the capitalization rate:

Price (Value) x Capitalization Rate (Rate) = Net Operating Income (Income)

We solve for the Capitalization Rate (R):

Net Operating Income (I) divided into Capitalization Rate (R) = Price (V)

Therefore,
$8,262/? = $65,000
$8,262/$65,000 = 12.71% Capitalization Rate

In addition to a 12.71% return on your client's all cash investment, he may also experience price appreciation during the holding period. If he purchased the home during an upward-trending sellers' market, he may experience price appreciation that will increase the return when the property is sold in the future.

Your clients may receive depreciation, which is a paperwork loss the IRS may allow them to take on their income taxes, from the property over the holding period. The IRS generally allows real estate investors to depreciate residential income properties over a 27.5 year period. Always have your clients see a CPA before any real estate investment.

Leverage

If single-family homes start to appreciate in value over the holding period, your clients may decide to pull out some of their equity through a cash-out refinance. This allows them to leverage the investment with financing and purchase more properties in the future. It really depends upon market timing. This strategy tends to work well during a strong upward-trending sellers' market. However, it generally does not work very well during a downward-trending buyers' market.

Amortization

A single-family home investor can pay off some of her loans through amortization. This is the systematic liquidation of a debt obligation over a period of time. The total principal and interest payment for a fixed rate loan never changes. Each payment is part principal and part interest. The portion of the total payment that is principal increases and the portion that is interest decreases with each payment. Therefore, your clients are probably paying off part of the loan amount with each payment and the principal reduction can be factored into the calculations and is called a "Broker's Rate of Return."

Single-family homes have been the most desirable type of property where both tenants and owners enjoy living. Knowledge of single-family escrow, title, and closing costs allows a real estate investor to reduce costs and increase profits.

13

CLOSING COSTS, ESCROW, AND TITLE INSURANCE FOR SINGLE-FAMILY HOMES

"It takes considerable knowledge just to realize the extent of your own ignorance." -Thomas Sowel

There are many closing costs associated with a real estate transaction. They can be grouped into **recurring** and **non-recurring** closing costs. Recurring closing costs occur more than once. Examples include property tax impounds and homeowner's insurance impounds. Non-recurring closing costs occur only once. Examples include escrow and title insurance fees.

Real estate practitioners deal with closing costs on a daily basis. For simplicity sake, we will include loan fees, discount points, and other lender-related costs within our closing cost explanation. The following are common closing costs: loan origination fees, discount points, document preparation/administration fee, appraisal fee, credit report fee, tax service fee, private mortgage insurance, mortgage insurance premium, VA funding fee, county transfer tax, city transfer tax, recording fees, home warranty costs, pest report and clearance, commissions, tax impounds, wire service fee, notary fee, prepaid interest, drawing fee, prepayment penalties, beneficiary demand costs, deed of reconveyance costs, home inspection, security deposits, prepaid rent prorations, homeowner transfer fee, flood certification costs, courier/FedEx/Email fees, escrow fee, and title insurance fees (CLTA and ALTA).

Loan Origination Fees

Real estate transactions incorporating a new loan or a loan assumption may contain a loan origination fee. Loans originated by mortgage brokers and mortgage bankers usually contain a one percent (1%) or more loan origination fee. In other words, one percent (1%) of the loan amount is paid to a loan originator as her commission for making the loan.

Some savings banks and other institutional lenders do not charge a loan origination fee; however, their loan interest rates are sometimes higher than mortgage brokers and mortgage bankers to compensate for this fact.

Discount Points

Many times a borrower would like to reduce the interest rate on a loan that is being originated on a property being purchased. The lender may allow the borrower to reduce the loan interest rate by paying money up-front. This up-front money is called **discount points** or "points."

In other words, a borrower can pay a lender one percent (1%) of the loan amount (one discount point) for every approximately one-eighth percent (1/8%) reduction in the loan interest rate, however this varies.

The break-even (not taking into account the time value of money) may be 4.33 years from origination of the loan. In other words, if the borrower intends to keep the loan for more than 4.33 years, it may be a good idea to pay loan discount points to reduce the loan interest rate. There are also some tax advantages to consider when paying discount points on a loan (always see a CPA). Lenders realize that most borrowers will sell or refinance their loans within five years, thus they may allow borrowers to pay points to reduce their loan interest rate.

If a borrower is willing to pay a slightly higher interest rate (over par), a lender will usually pay the loan officer points. The funds received from the points are above par (0) and are called **yield spread** or **rebate pricing**. Funds received by the lender can be used to pay the borrower’s closing costs and provide extra income to the loan officer. All rebates must be disclosed to the borrower on a HUD-1 (Uniform Settlement) Statement.

Document Preparation/Administration Fee

Document preparation and administration fees are also called "garbage fees" in the real estate industry. Lenders throw these fees in to increase their yield on loans.

Appraisal Fee

Most lenders require an independent appraisal performed on a property prior to purchase. Single-family appraisals usually cost $400 or more, depending upon the size of the property. Commercial narrative appraisals can cost thousands of dollars.

Credit Report

Lenders usually require a credit report for a prospective borrower to determine that person's attitude toward debt. Loan underwriters place a considerable amount of emphasis on a buyer's attitude toward past debt obligations to determine default risk and whether it is a good idea to make a loan to the borrower. FICO scores can be used to determine a borrower's attitude toward debt.

Tax Service Fee

Lenders generally require a borrower (or in some cases a seller) to provide a tax service to keep track of the property taxes due on the property. A tax service protects a lender's interest in a property and usually costs $55 - $100.

Private Mortgage Insurance (PMI)

Lenders usually require private mortgage insurance, called PMI on high loan-to-value (LTV) loans (usually over 80% LTV). Lenders many times require up-front fees in addition to annual renewal premiums.

Mortgage Insurance Premium (MIP)

Mortgage Insurance Premium, also called MIP is the mortgage insurance paid on FHA insured loans. MIP is also called Mutual Mortgage Insurance (MMI). MIP is approximately 3 to 3.5% of the loan amount and can generally be paid up-front or financed with the loan. FHA also charges a monthly MIP premium.

Veterans Administration (VA) Funding Fee

The Department of Veteran's Affairs, also called VA, guarantees loans made by approved lenders. VA loans require a funding fee, usually one to three percent (1%-3%) of the loan amount, to make a VA guaranteed loan. Some of their loans allow a veteran to place no (or very little) money down. A VA appraiser must appraise the property up to at least the sale price (Certificate of Reasonable Value or CRV) or the veteran may usually terminate the transaction without penalty.

County Transfer Tax

County Transfer Tax is also called *Documentary Transfer Tax*. This tax is decided by the county where the property is located. Maximum amount is $.55 per $500 (or $1.10 per $1,000) on all new money coming into a transaction. Cash and new loans are taxed, loan assumptions are not.

City Transfer Tax

Some cities in California levy a transfer tax on all properties located within the city limits. Amounts vary, usually as a percentage of the sale price. Do not miss this one, or you could be paying it out of your commission!

Recording Fees

The County Recorder where a property is located will record a grant deed conveying the property and a trust deed for the loan (if applicable). Costs average around $10 - $20 per document, usually split between the buyer and seller. The seller usually pays for recording the grant deed and buyer usually pays for recording the trust deed.

Home Warranty

A home warranty policy is many times split between the buyer and seller; however, it is negotiable. A home warranty takes effect before and/or after close of escrow. Costs usually range from $275 - $500+ depending upon coverage.

Pest Report, Clearance, and Repair Work

“A pest clearance is many times required by a lender and specified as a condition of the contract.”

A pest report is also called a Structural Pest Control Report. It is usually ordered by the seller, with approval of the pest company by the buyer. Inspection costs are usually $100+. Most inspectors are paid on a commission basis for repair work generated. For this reason, a reputable pest company is crucial to reducing repair costs to a seller and reducing fraud by the pest company.

A pest clearance is many times required by a lender and specified as a condition of the contract. A pest company inspects a property and notes any termite damage or dry rot that must be repaired before a pest clearance can be issued. The pest company may give the seller a bid to complete required repair work. If the seller uses the pest company to complete the repair work, then there is usually no re-inspection fee. If the seller elects to use an outside entity to complete the repair work, then the pest company must re-inspect, charge another inspection fee, and then (possibly) issue a clearance. For these reasons a reputable pest company is crucial in protecting the seller's interests and keeping the deal together.

Commission

Real Estate sales commissions usually range between 5% and 6% of the sale price of the property. The commission may be split between cooperating brokers and their salespersons. The sales commission is usually paid by the seller. A broker sends a broker demand to escrow specifying the amount of commission to be paid to the broker. Escrow companies generally wait until confirmation of the grant deed being recorded before releasing commission funds to the broker. After the commission check has been received, the broker then pays their salesperson's portion of the commission.

Tax and Insurance Impounds

Some lenders require funds to be impounded each month to pay a buyer's property taxes and homeowner's insurance. Loans with LTV's over 80% usually require impounds.

Twice per year property taxes are paid by the lender from an impound account. Homeowner's insurance is paid once each year from the same account. Lenders many times require additional reserves in the first year of the loan.

Wire Transfer Fee

A wire transfer fee pays wire charges for wiring funds from a lender to an escrow holder. Fees average $20+.

Notary Fee

An escrow holder is many times also a notary public who can acknowledge and verify (notarize) signatures on documents. A photo ID and thumbprint are usually required to notarize documents. Notary fees usually average $10 - $20 per signature.

Prepaid Interest

Interest on real estate loans is paid in arrears. It is the opposite of rent, which is paid in advance. For example, when a borrower makes a loan payment on June

1st, he is paying the mortgage interest for May, not June. Whether a buyer closes at the end of the month or at the beginning of the month matters only in the time value of money and whether a buyer has enough funds to close escrow. A buyer does not "save" money by closing at the end of the month (like some people think). The buyer merely pays the same amount at a later date. This can be helpful with first-time homebuyers who a short on cash to close the deal.

Other Fees

- **Drawing Fee** is a fee charged to draw loan documents (usually averages $70+).
- **Prepayment Penalty** is a penalty that a lender may impose on a borrower if she sells or refinances a property within a certain specified period of time after the loan has been made. Residential loans may have prepayment fees of six months interest if the loan is paid off prior to two or three years from the original loan date (varies). Commercial loans can have huge prepayment penalties over many years.
- **Beneficiary/Demand Fee** is charged when a lender of an existing loan sends a payoff amount to escrow and escrow pays off the loan (usually $75 - $100).
- **Reconveyance Deed/Reconveyance Deed** is a deed a trustee sends to a trustor when a loan has been paid off. It moves legal title from the trustee to the trustor (borrower) and eliminates the deed of trust from title (removes the lien). It is usually $50 to $100.
- **Home Inspection** costs average $300 - $500 depending upon the size of the property and is usually paid by the buyer.
- **Security Deposits** from tenants of income properties are usually prorated and paid to the buyer at close of escrow.
- **Prorated Rents** (from income properties) are rents that have already been paid in advance to a seller and must be credited to a buyer at close of escrow. These can be quite substantial if close of escrow is in the middle of the month.
- **Homeowner's Transfer Fee** may be charged by a homeowner's association to transfer ownership from a seller to a buyer. Fees can be $200+.
- **Flood Certification Fee** may be charged to determine whether a property is located in a flood zone. FHA insured loans sometimes require a flood certification. Flood zone disclosures are many times included in the Natural Hazards Disclosure.
- **Courier Fee/Federal Express Fee/E-Mail Fee** may be incurred when sending documents. Examples include inter-spousal grant deeds and power of attorney forms.

Other closing costs may also be incurred by the buyer and seller. Knowing all the closing costs before close of escrow will reduce mistakes made by an agent and eliminate surprises to a buyer. Remember: surprises kill deals.

Escrow and Title Insurance

Buying or selling a home or other parcel of real estate usually involves the transfer of large sums of money. It is imperative that a transfer of these funds and related documents from one party to another be handled in a neutral, secure, and knowledgeable manner. For protection of the buyer, seller, and lender the escrow process was developed.

What is An Escrow?

Buyers and sellers want to make certain all conditions of a purchase agreement have been satisfied before the property and money change hands. The technical definition of an escrow is, "a transaction where one party engaged in the sale, transfer, or lease of real or personal property with another person delivers a written instrument, money, or other items of value to a neutral third person, called an escrow agent or escrow holder. The third person holds the money or items for disbursement upon the happening of a specified event or the performance of a specified condition."

Simply stated, an escrow holder impartially carries out the written instructions given by the principals (buyer and seller). This includes receiving funds and documents necessary to comply with escrow instructions, completing or obtaining required forms, and handling final delivery of all items to the proper parties upon the successful completion of the escrow.

The escrow must be provided with the necessary information to close the transaction. This may include:

1. loan documents;
2. property tax statements;
3. fire and other insurance policies;
4. title insurance policies;
5. terms of the sale (usually evidenced by a purchase agreement);
6. terms of seller-assisted financing; and
7. requests for payment for various services to be paid out of escrow funds.

If a transaction is dependent upon arranging new financing, it is the buyer's responsibility (or the buyer's agent) to make the necessary arrangements.

Documentation of the new loan agreement must be in the hands of the escrow holder before a transfer of the property can take place.

When all the instructions in the escrow have been carried out, the closing can take place. At this time, all outstanding funds are collected and fees (title insurance premiums, real estate commissions, termite charges, etc.) are paid. Title to the property is then transferred (from the seller to the buyer) under the terms of the escrow instructions (usually using a grant deed) and appropriate title insurance is issued.

Payment of funds at close of escrow should be in a form acceptable to the escrow holder. These are usually certified funds, since out-of-town personal checks can cause delays in processing the transaction.

North-South Differences

In Southern California, escrow is handled by a separate escrow company. Title insurance is issued by a separate title insurance company. Escrow instructions are usually signed <u>early</u> in the transaction in Southern California.

In Northern California, escrow is handled by the title insurance company who also issues both concurrent title insurance policies. Escrow instructions are usually signed near the <u>end</u> of the transaction in Northern California. Please be aware that over the last several years escrow procedures have been moving toward the Northern California way of doing business.

Escrow Holder Duties

An escrow holder completes the following:

1. Serves as the neutral "stake holder" and the communications link to all parties in the transaction.
2. Prepares escrow instructions.
3. Requests a beneficiary statement to pay off an existing loan or if the debt or obligation is to be taken over by a buyer.
4. Complies with lender's requirements, which are specified in the loan documents.
5. Receives purchase funds from the buyer.
6. Prepares or secures a grant deed and other related documents to an escrow.
7. Prorates taxes, interest, insurance, and rents according to escrow instructions.

8. Secures releases of all contingencies or other conditions as imposed on the particular escrow.
9. Records grant and quitclaim deeds and any other documents as instructed.
10. Requests issuance of a title insurance policy or concurrent policies.
11. Closes escrow when all instructions of buyer and seller have been carried out.
12. Disburses funds as authorized by instructions, including charges for title insurance, recording fees, real estate commissions, and loan payoffs.
13. Prepares final statements for disposition of all funds deposited in escrow.
14. Requests a preliminary title search to determine the present condition of title.

An escrow holder does not offer legal, tax, or investment advice. In addition, an escrow holder does not get involved in the negotiations of the transaction.

Title Insurance

Title insurers, unlike property or casualty insurance companies, operate under the theory of risk elimination. Title companies spend a high percentage of their operating income each year collecting, storing, maintaining, and analyzing official recorded information that affects title to real property. Their technical experts are trained to identify the rights others may have in a subject property. These rights may be evidenced by recorded liens, legal actions, disputed interests, rights of way, or other encumbrances affecting title. Before closing a transaction, a title company will proceed to "clear" the encumbrances the buyer does not wish to assume.

This theory is much different from other types of insurance, where the rates and anticipated losses are based on actuarial studies and premiums are pooled on the assumption that a certain number of claims will be made. Medical and casualty insurance premiums in contrast, are usually paid to insure against an unpredictable future event, knowing that claims will occur.

"Title companies spend a high percentage of their operating income each year collecting, storing, maintaining, and analyzing official recorded information that affects title to real property."

This distinction is important because title insurance premiums are paid to identify and eliminate potential risks and claims before they happen. Furthermore, title insurance is a one-time premium, paid at close of escrow. In contrast, property, casualty, and medical insurance require annual renewal premiums.

The goal of title insurance companies is to conduct such a thorough search and evaluation of public records that no claims will ever arise. Of course, this is impossible because we live in an imperfect world. Human error and changing legal interpretations make one hundred percent (100%) risk elimination impossible. When claims arise, professional claims personnel are assigned to handle each claim according to the terms of the title insurance policy.

Each title insurance company's rates are filed with the California Department of Insurance. Each title insurance company is required to publicly post its schedule of fees. As in all competitive business environments, rates vary from title insurance company to title insurance company. Real estate agents can help buyers and sellers select an appropriate title insurance company.

In addition to title insurance companies' effectiveness in insuring against clouds and defects in title, these companies also provide many helpful customer services designed to help real estate agents do their job more effectively. Research is one of these activities.

The issuance of a title insurance policy is very labor intensive. The title insurance company maintains a title plant (library of title records) with records dating back well over one hundred years. Each day, recorded documents affecting real property and property owners are posted in these title plants, so that when a title search on a particular parcel is requested, the information is already organized for rapid and accurate retrieval.

"The goal of title insurance companies is to conduct such a thorough search and evaluation of public records that no claims will ever arise."

In California, most of the larger title companies have been converted to computer-based title plant systems which provide retrieval from remote locations, further speeding the process of delivering a title search to a customer.

Investment in skilled personnel and advanced data processing represents a major part of a title insurance premium cost. Proper title plant maintenance, research, evaluation, and legal interpretation are the foundations upon which a title insurance policy rests.

Types of Title Insurance Policies

There are two types of title Insurance policies commonly used in California: California Land Title Association (CLTA) policy and American Land Title (ALTA) policy.

California Land Title Policy (CLTA)

A CLTA policy is also called a standard coverage policy, as well as an owner's policy. A CLTA policy can be used to cover an owner or a lender's interest. However, owner's predominantly use this policy, hence the name "owner's policy." It is the standard policy of title insurance in California.

A CLTA policy is calculated on the sale price of the single-family home and usually covers:

1. Ownership of a property.
2. All recorded matters affecting title are shown in the policy in order of their priority.
3. There is access if the property abuts upon an open, public, or dedicated street.
4. There are no forgeries or failed conveyances in the chain of title.
5. The insured has a marketable interest in the real property.

A CLTA policy usually does NOT cover:

1. Matters which a correct survey would show.
2. Unrecorded matters.
3. Matters which a physical inspection of a property would disclose.
4. Rights of parties in possession.
5. Unpatented water and mineral rights.
6. Matters known, created, or assumed by an insured.

American Land Title Association Policy (ALTA)

An ALTA policy is also called a "lender's policy," and is usually calculated on the loan amount. Lenders usually require the use of this policy because it affords greater protection than a CLTA policy. An ALTA policy usually covers all of the CLTA coverage plus the following:

1. Mechanics liens arising out of work done on the property.
2. Major encroachments. The insured buyer is protected from forced removal of an existing structure (other than a boundary wall or fence) because it extends onto adjoining land or onto an easement.
3. Unrecorded interest arising from off-record leases, contracts, or options.
4. Zoning compliance.

5. CC&R compliance.

An ALTA policy is usually paid by the buyer on a single-family transaction, and is issued concurrently with the CLTA policy. If a property has been insured for title insurance within the previous five years, it may be eligible for a short-term fee schedule that will reduce the title insurance premiums.

Flickr / Chris Potter

REAL ESTATE AGENT AND GRAND THEFT

The People v. Neelam Bhatia (2015)

Court of Appeals of California, Second District, Division Three
Filed January 22, 2015

Appellant Neelam Bhatia appeals from the judgment entered following her convictions by jury on six counts of grand theft of personal property exceeding $400 in value with findings she took property exceeding $200,000 in value and the crimes had the material element of embezzlement and involved a pattern of related felony conduct involving the taking of more than $500. The court sentenced appellant to prison for nine years eight months. After reconsideration of this matter we affirm the judgment.

Appellant was a real estate agent with Click and List Realty, Inc. (Click) located in Granada Hills. Click also handled escrows. A California Secretary of State form reflected appellant was the chief financial officer (CFO) and secretary of Click. Codefendant Leroy Sennette was the broker and chief executive officer of Click.

As of May 2008, appellant and Sennette were signatories on Click's operating account at Bank of the West (West).

In April 2009, appellant was removed as a signatory.

In October 2008, Nilesh and Dahshita Patel agreed in writing to buy property in Northridge from Shapell Industries, also known as Porter Ranch Development Company (Porter).

Appellant, the Patels's real estate agent, chose Click as the escrow company.

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REAL ESTATE AGENT AND GRAND THEFT (*continued*)

The People v. Neelam Bhatia (2015)

On December 8, 2008, a title company wired $573,253 into Click's operating account at West, and the Patels became legal owners of the property.
Porter never received the amount due for the property. Appellant committed grand theft of money exceeding $400 in value (grand theft) by embezzling the money.

In January 2009, Rodrigo Garcia-Alonso (Garcia-Alonso) and his wife, Maria Martinez, agreed in writing to buy a house in Northridge.
Appellant represented the seller.

On January 19, 2009, Garcia-Alonso, using money he had saved over 20 years, gave to appellant at her office a $19,800 deposit check, payable to Click.

On January 28, 2009, the check was deposited into Click's operating account at West.

On March 24, 2009, Martinez gave appellant a $112,200 cashier's check, payable to Click for the balance of the down payment.

The cashier's check was deposited that day into the same account.

Appellant committed grand theft of the proceeds of the deposit check and cashier's check.

In April 2009, Amir Bidgoli and his wife, Fatemeh Houshmand, agreed in writing to buy a house in Porter Ranch.

Appellant was the seller's agent.

Appellant told the seller to choose Click as the escrow company.

On April 10, 2009, Houshmand gave appellant a $42,000 deposit check.
Appellant then gave the check to Joe Panichi, Click's escrow officer.


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REAL ESTATE AGENT AND GRAND THEFT (*continued*)

The People v. Neelam Bhatia (2015)

On April 14, 2009, the check was deposited into Click's operating account at West.

On August 19, 2009, Houshmand, at the direction of appellant and Panichi, wired $198,238, the balance of the down payment, into Click's operating account at J.P. Morgan Chase Bank (Chase).

Appellant committed grand theft of the proceeds of the deposit check and of the $198,238.

About July 2009, Ross Shelden agreed to buy a house in Calabasas.

A Click employee represented the seller.

On July 22, 2009, Shelden wrote a $39,000 deposit check to Click and List Escrow.

On July 23, 2009, the check was deposited into Click's operating account at West.

In September 2009, Shelden received a deposit receipt indicating his money had been deposited into Comerica Bank.

Appellant committed grand theft of the proceeds of the check.

In September 2009, Michael Lewis agreed in writing to buy two Lancaster duplexes appellant had listed.

Each was $75,000.

On September 12, 2009, Lewis gave appellant two $20,000 deposit checks, payable to Click.

On September 14, 2009, the checks were deposited into Click's operating

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REAL ESTATE AGENT AND GRAND THEFT (*continued*)

The People v. Neelam Bhatia (2015)

account at Chase.

In November 2009, appellant told Lewis to bring the final funds for one of the duplexes.

Lewis did so, giving appellant a $55,000 check. Appellant committed grand theft of the proceeds of the two deposit checks.

In defense, appellant claimed others were responsible for the fraudulent transfers of funds and, asserting a claim-of-right defense, she maintained that money transferred from Click's account to her T. D. Ameritrade (Ameritrade) account represented commissions owed to her.

Los Angeles Police Officer Eugene Tapia, the investigator in this case, testified that during his investigation he never found out who wired the money in the accounts. The court asked, "Counsel just asked you did you determine who forwarded the money to those accounts and you said you didn't know; but they were *all accounts in the defendant's name, correct, and no one else*?"

The court later asked, "Well, where do you think the money came from that went into the Click and List operational account *that . . . you were dipping into to trade to Ameritrade* or wire to Ameritrade?

Still later, the prosecutor asked, "On the 25th, there was only $800 in your account at the T.D. Ameritrade, after $82,000 was deposited on the 25th, is that correct . . . ?" Appellant replied yes.

During its final charge to the jury, the court instructed the jury, "You must decide what the facts are. It is up to all of you, and you alone to decide what happened, based only on the evidence that has been presented to you in this trial."

The prosecutor commented to the effect (1) appellant testified she was entitled to the money because she was entitled to commissions, but (2) the real crux

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REAL ESTATE AGENT AND GRAND THEFT (*continued*)

The People v. Neelam Bhatia (2015)

of the case was appellant did not introduce a single document to support that testimony.

The prosecutor commented, “it's been a long time coming, there is a lot of people that are hurt in this." He also commented, “What is worse about it is that *the defendant in this case needs to be held accountable for a variety of reasons. And one of them is because of the amount of people that she harmed.*

I don’t know what is worse, literally hurting someone physically or hurting them financially for the rest of their life. . . . Neither one is good. But they are certainly comparable."

The judgment is affirmed. The trial court is directed to forward to the Department of Corrections an amended abstract of judgment reflecting appellant's total prison sentence is nine years eight months.

ALDRICH, J and KLEIN, J., concurs.

Escrow and title insurance are virtually part of every real estate transaction. For this reason, knowledge of escrow and title processes will minimize problems and increase closed escrows for the informed real estate professional.

14

CONDOMINIUMS VS. SINGLE-FAMILY HOMES

"Some people flip condos and make millions.
Others couldn't flip burgers." -Unknown Philosopher

Whether your clients buy a single-family home or a **condominium** (condo) really depends upon the intended use and location of the property. Where land is scarce and thereby expensive, condos generally tend to do fairly well. Conversely, when land is plentiful and cheap, condos usually do not do as well as single-family homes.

Location

Since condos have the ability to maximize the financial return of a well-located parcel of land, condos are generally better located than single-family homes—especially for the price. In other words, the number of condos that can be built on a particular parcel of land is more than one single-family home. The combined value of the condos is generally greater than the value of one single-family home. This brings up the appraisal principal of highest and best use. For a well-located parcel of land, a condo may be a higher and better use than a single-family home.

For example, your clients' purchase a vacant ocean front lot. If they build ONE single-family home on the lot, it will have a value of $1 million (example) and may have a limited market of buyers who can afford to purchase the home.

In contrast, there are several buyers in the market who have the desire and can afford to pay $500,000 for a home with the same splendid ocean front location. Your clients could build four condos on the same lot and each condo would be worth $500,000 each. The resulting total value of the condo development is $2 million. Of course, condos may cost a bit more to build than one single-family home, however, the resulting profit to the builder will be greater for the condos than for the planned single-family home. Market demand may be greater for well-located condos than single-family homes because of the greater number of buyers willing and able to purchase them.

Condominium Zoning Issues

Zoning is a public restriction regarding what can be built on a vacant parcel of land. Single-family homes and condominiums generally have different zoning. Changing the zoning from single-family homes to condos can be a difficult task. Your clients may need to go to the local county Board of Supervisors or other regulatory entity and jump through a bunch of hoops to get the zoning changed.

One builder tried to obtain a **zoning change** and it took well over one year and cost several thousand dollars. The builder was required to mail a notice out to all the owners of the properties surrounding the subject property. This was to make sure the owners did not object to the proposed condominium use. A problem can occur if ALL the surrounding properties are multi-million dollar single-family homes and the builder is proposing to build $500,000 condos in the same area. There may be enough objections to stop the zoning change and kill the project.

> "Zoning is a public restriction regarding what can be built on a vacant parcel of land."

Parking

Single-family homes may have an advantage over condos because they generally have a garage. In areas where snow and ice are prevalent, this can be a huge amenity. Condos might have an assigned parking space, covered parking, or possibly a small garage, although the price of the condo will usually increase accordingly.

Depending upon the number of bedrooms in the condo, the number of allocated parking spaces may become an issue. For example, a 3 bedroom/2 bath condo may rent for $1,500 per month and have one assigned parking space. If the tenant(s) have more than one car, and that's a good possibility with a 3 bedroom condo, then the second and third cars must park in unassigned parking spaces somewhere within hiking distance to the condo.

A single-family home will most likely have an attached or detached garage or carport. If it has a garage, it may hold two or more cars. Your clients will very rarely get a decent-size garage when they buy a condo. When taking into account parking issues, **Home Owner Association** (HOA) fees that seem to continually go up, and other condo-related privacy factors, a single-family home—even though it is more expensive—may be a better choice in the long-run.

Garage Safety

As mentioned earlier, many condos do not have garages, so your tenant may be forced to park under a carport or the open sky and walk to her condo. This is where a tenant is generally the most vulnerable to attack. Condos that have garages many times are not attached to the condo and the tenant must exit the garage and be exposed to the dangers of attack.

Conversely, many single-family homes have attached garages. This allows the tenant to exit the car, with the garage door in the down position, and go directly into the home. A single-family home or condo with an attached garage in a gated community can be one of a tenant's safest bets.

Security and a Second Floor Condos

Many single women like second-floor condos better than first-floor condos and single-family homes. This is because of security factors. A second floor or higher condo is perceived by many women as being safer than ground floor condo units or single-family homes. It seems to be more difficult for an intruder to enter a second floor or higher window than one located on the ground floor.

Gates and Security Services

Some condos are located behind electric security gates and provide a greater degree of perceived safety for tenants and owners. If a criminal cannot effectively plan his escape, he may not commit the crime in the first place. The good news is that the HOA will most likely pay for gate maintenance and security through the monthly HOA fees paid by the investor. Some single-family subdivisions have gates and security services as well.

Fire Danger

Condos generally have common walls between each unit that may be a fire risk for a tenant. If a fire started in an adjoining condo unit, it could quickly spread to your client's unit. Occupants of the other units around your property may not be as careful as your tenant when it comes to pyrotechnics and just plain common sense. There is no way to gauge their ability to prevent burning their own unit, themselves, and your tenant up in a firey blaze of smoke and ash.

> *The Story of Mr. Bottle Rocket and His Family of Pyromaniacs*
> During a Fourth of July celebration, one tenant watched his condo neighbor start lighting illegal bottle rockets. As the bottle rockets shot into the air, he wondered if his neighbor had really considered the possibility that his little pyrotechnic show might actually burn the entire condominium complex to the ground. As his bottle rockets started landing in the dry oak trees around their units, he heard a cry of alarm from several of his neighbors. It was lucky his neighbors were home to stop his illegal fireworks show, or they may have arrived home to find only charred ruins.

One advantage of single-family homes over condos is the ability to minimize the possibility of fire. At least the owners will have *some* control over their own destiny when living in a single-family home. Condo owners may be placed at the mercy of surrounding condo owners and their tenants who may or may not be responsible in their use of fire. A good smoke detector installed in every room and a good carbon monoxide detector are always good ideas (and required by law) for both condos and single-family homes.

Noise

Due to the close proximity of neighbors, noise may be more noticeable in a condo than in a single-family home. Condos are usually freehold ownership where the owners own the airspace fee simple, which is the highest form of ownership, and the common areas are owned in common (freehold ownership as well) with all the other condo owners together. Condo *owners* tend to be a little more serious and more mature than young and more boisterous apartment dwellers.

Condo *tenants*, on the other hand, are similar to apartment tenants. The real difference between condos and apartments is that condos typically have more amenities (pools and workout facilities) and may be built to “condo specs.” This means that each condo is individually metered for electricity and possibly water via a water meter. In addition, each condo has its own assessor’s parcel number (APN number) so it can be individually sold. Apartments are usually sold under one assessor’s parcel number.

Condo tenants generally come from the same socio-economic background as apartment tenants. However, they may be willing to pay more money to rent a condo because of the greater amenities.

The Story of Alfred "The Party Animal" Condo Owner
Alfred was visiting a condo that he owned as a second home. He stayed there for a week while arranging for some renovation work to be completed in the condo. While he was there, he met some really nice neighbors who were barbequing near the pool. Alfred was invited to attend their Thursday night party and they were having a pretty good time.

About 10pm the complaints started coming in from the owners and tenants in the surrounding condo units. Alfred and his friends were having "too good of a time" and they were being much too loud. The manager showed up and informed them that the security guys were on the way and it might be a good idea for them to beat it. They left, just in front of a couple of huge guys who looked like they could take care of themselves—and Alfred too.

Alfred was upset. Being a very affluent single-family homeowner, he wasn't accustomed to being treated like a common criminal—for having a good time at his own property. On the other hand, this type of enforcement was good for future condo values. Alfred visited his condo for only ten days and he was glad to go home. The other condo owners were glad he went home too.

Real Estate Markets and Appreciation/Depreciation Rates

During an upward-trending sellers' market, single-family homes tend to experience higher appreciation rates than condos. This is probably due to the desirability of single-family homes over condos.

During a downward-trending buyers' market, single-family homes tend to experience a slower depreciation rate (loss of value) than condos. Single-family homes seem to go up faster than condos in an upward-trending sellers' market, and down slower than condos during a downward-trending buyers' market.

Condominium Covenants, Conditions, and Restrictions (CC&Rs)

CC&Rs are private restrictions that limit the use of a property. They are designed to protect an owner from a neighbor's stupid moves to their home—therefore causing a loss of value to all the homes in the surrounding area. Through the appraisal principle of regression, a substandard home located next to your client's home will most likely cause a loss in value to their home.

Condos generally have more restrictive CC&Rs than single-family homes and a homeowner's association (HOA) to enforce them. When there are tight CC&Rs and an active HOA, it is more difficult for condo neighbors to cause a loss of value to a neighbor's property.

Covenant

A covenant is a breach of a promise. It is a minor breach that is remedied by monetary damages. If a condo owner or tenant parks an old inoperable car in the parking lot, the homeowner's association may cite the owner or tenant and give them a certain amount of time to remove the car. The owner or tenant has the ability to pay money (monetary damages) and have the car towed away, thus making everyone happy again.

Condition

The breach of a condition is a major breach that usually results in loss of title to the property. For example, your client owns a condo that has very tight CC&Rs. The client decides to expand their condo by moving the rear wall back to the outside edge of the balcony. If this violates a condition in the CC&Rs, the Architectural Control Committee, which is usually part of the HOA, may have the ability to force your client to sell the property to them. They will then convert the condo back to the way it was before the ambitious room addition and preserve the values of surrounding condos.

"The breach of a condition is a major breach that usually results in loss of title to the property."

Private Deed Restrictions

The breach of a private deed restriction is somewhat minor when compared to the breach of a condition. If an owner begins burning garbage on the balcony of their condo, the homeowner's association may be able to obtain an injunction to force the owner to stop burning garbage on the balcony. An injunction is a court order used to stop the violation of a private deed restriction, and is not nearly as severe as a condition that results in the owner losing title to the property.

Single-family homes sometimes have enforceable CC&Rs with an aggressive homeowner's association (HOA); however, they are generally located in higher socio-economic neighborhoods where the homeowners pay monthly fees to cover the costs of enforcement. In many newer middle socio-economic single-family home subdivisions the CC&Rs seem to have a lot of teeth; however, without an actual and active HOA to enforce them with warnings, fines, and injunctions they are really not much protection to a homeowner.

Tenant Violations

If a condo is rented to a tenant who violates specific CC&Rs, the HOA board of directors—which is usually comprised of condo owners who live in the complex and are adversely affected by the violations—may be able to levy fines against the owner. The owner can end up paying fines for their tenants' bad manners. A tenant usually gets a warning, with a copy sent to the owner. If the violations continue, the tenant will usually be fined—as well as the owner.

The Story of the Bad Mannered Tenants

A condo tenant placed an old mattress and box springs in a dumpster located on the property, rather than taking them to the dump. Violation notices were sent to both the tenant and the owner. The tenant did not want to pay the cost of hauling the items to the dump, so they were placed in the dumpster. The owner informed the tenant that being cheap and lazy was no excuse.

Another of condo tenant started parking his car backwards (front end out) in his parking space. Both the tenant and owner received violation notices requiring the tenant to park the car correctly or get fined. The owner told the tenant that needing "a fast get away" was no excuse.

Yet another owner was cited for not installing the "correct style" security door on her condo. A couple of years earlier, she had purchased and installed a security door for the tenant. The HOA met sometime after the security door was installed and decided that only two security door designs were going to be allowed in the condo complex—and the owner's door wasn't one of the "approved" designs. The owner was given sixty days to replace the security door or receive a fine. The owner waited until a day or two before the sixty days were up to install a new security door with the correct design.

The Story of the Out-Of-Control Welcome Home Party

A military tenant arrived home from Afghanistan, but his "welcome home" party at the condo was a little over-the- top and ran past 10pm. The property manager informed him that, "A rule is a rule" and fined him for "excessive celebration." When the owner heard about it, she paid the fine and bought him another case of beer for his next "welcome home" party. People who are

The Story of the Out-Of-Control Welcome Home Party (continued)
serving in the U.S. military and protecting the country deserve to be commended for a job well done, not fined for returning in one piece. So, the tenant is now well supplied for his next welcome home party. . .and the owner said she's going to pay the fine on his next party too!

The Story of the "Crazy Lady and the Junk Man"
A home seller decided to sell a single-family home. The neighbor across the street was a problem because the home was a real mess. The wife was locally known as "The Crazy Lady" because of her frequent trips to the mental hospital. All the neighbors were convinced that her husband, "The Junk Man" was the cause of all her troubles. The Junk Man was a real character. One of his goals in life was to own a junkyard, and he was successful—in his own backyard! He liked to store old, beat-up used tires and his one apparent ambition in life was to one-up the notorious Wesley Tire Fires that occasionally occur east of San Francisco.

He always kept at least five old jacked-up cars in his front yard because, according to him, he didn't have room in the backyard because of all the tires. He also kept an old beat-up RV in the front yard where his relatives could stay, and frolic, and maybe never go home.

It was impossible to determine the outside color of The Junkman's home—because it had been so long since it had been painted—if ever, and it was built during the 1960s. The Junkman also liked to keep a couple of incredibly huge, mangy, and vicious mongrels running around to protect his treasure trove from "thieves." This was another name for the county authorities who were constantly trying to get him to clean things up.

With neighbors like The Crazy Lady and the Junk Man you might think that some stiff CC&Rs might be used to get him to clean up his place—or sell it and move away. However, the subdivision where he was located had been built many years ago and had very weak CC&Rs. There was also no HOA, or provision for one, to enforce the CC&Rs. The Crazy Lady and the Junk Man's neighbors were powerless to enforce the CC&Rs and get him to clean up his home. The Crazy Lady and the Junk Man's mess caused a lot of homes located in the area to lose value because of the appraisal principle of regression. Houses located around The Crazy Lady and the Junk Man tended to seek the

The Story of the "Crazy Lady and the Junk Man" *(continued)*
level of the Junkman's house and reduce in value. The local authorities repeatedly asked him to clean up his place, but he ignored their requests and was as stubborn as ever.

The authorities next tried to get his attention by levying fines against him for his infractions. Since he didn't have any money to pay the fines, he laughed at that too. The last straw was when the authorities placed liens against his home. He still did nothing and let the fines accumulate. He said he wasn't intending to sell the property anyway, so who cares about a bunch of pesky little fines? The neighbors were never able to get The Crazy Lady and the Junk Man to clean up their property. Their home still remains in the same dilapidated condition. Someone said that "Death and taxes are the only two certain things in life." It appears The Junkman has so far been able to escape both.

The Story of the "Got Paint" Lady
A discount house painter came into a neighborhood of semi-custom single-family homes with weak CC&Rs and really no way to enforce them. One of the homeowners decided she wanted to paint her house purple—and she did! This devalued all the houses located in the entire neighborhood. Many of the neighbors tried to talk some sense into her, but she was adamant about her purple house. How many millions of dollars in lost value she caused is difficult to estimate. One anonymous homeowner used some white chalk to write on her driveway, "Got Paint?"

If she had consulted a real estate agent, the agent would have suggested that she paint her home a nice gentle earth tone and the neighbors would still be talking to her. There are many very nice purple homes located in France, Latin America, and the Caribbean, but it generally doesn't work very well in the U.S.

A Double-Edged Sword
Sometimes an active HOA with tight CC&Rs can be a "double-edged sword." On one hand, the active HOA has the ability to maintain home values in a neighborhood by protecting homeowners from people like The Junk Man. On the other hand, the active HOA may become a little overactive and start enforcing the rules a little overzealously. This can breed a "Nazi" type atmosphere in the

neighborhood and can really get out of hand. “HOA Nazis” may start enforcing every little detail and infraction against the CC&Rs. This style of HOA enforcement can really infuriate homeowners because their little transgressions don’t really affect the values of the surrounding homes and it becomes a power-ego problem with the people enforcing the CC&Rs.

For example, in one community with tight CC&Rs, if you leave your garbage can out on the street a little too long you will be cited and receive a fine. This borders on ludicrous. However, some homeowners like this type of “orderly” feel, regimentation, and control. Others just think their crazy.

Researching CC&Rs

As soon as a home buyer opens escrow on a property, they will usually receive a copy of the preliminary title report, along with a copy of the CC&Rs (if existing on the property). The buyer should read both documents carefully prior to moving forward with any condo or single-family home purchase. With new condos and new single-family homes, the buyer may be able to obtain a copy of the CC&Rs from the builder prior to making an offer to purchase a property. This is the best scenario, but not always possible.

Many older single-family homes have CC&Rs, however they are many times very vague and generally unenforceable. Newer single-family homes may have more up-to-date and enforceable CC&Rs, as well as more active HOAs to enforce them. Builders generally originate and establish the CC&Rs for the single-family neighborhoods where they build. In addition, they usually enforce the CC&Rs until there are enough homeowners to perform this function themselves.

Privacy

Single-family homes have a distinct advantage over condos when it comes to privacy. Single-family homes may have large private yards where a homeowner can relax and get some peace and quiet or entertain guests. Condos, on the other hand, generally do not have large yards and usually do not provide much privacy. A balcony or lanai with exterior blinds may be the total extent of outside privacy in a condo.

Exterior Maintenance

A condo’s HOA is supposed to hold in reserve a certain amount of the monthly HOA fees to be used to replace roofs, parking lots, exterior painting, pest repairs, and other exterior maintenance items.

Conversely a single-family homeowner must perform all of these maintenance items on their own. Condo HOA maintenance costs seem to be more than a single-family home when it comes to maintenance items. A single-family owner, who is responsible for their own maintenance, has the flexibility of performing it when desired, not when a condo manager needs more referral fees from contractors so he can pay his own rent.

The single-family owner can also shop around and obtain several bids for the work, thus reducing costs. On the contrary, a condo owner generally does not have this flexibility because the HOA makes the maintenance decisions, not the owner.

Single-family homeowners can also defer some maintenance items into the future. As mentioned earlier, single-family homes with deferred maintenance will many times sell for the same price as more cosmetically pleasing homes located in the same neighborhood. This is especially true during an upward-trending sellers' market. Single-family homes may get away with a little less maintenance than condos, especially if they are sold during an upward-trending sellers' market. However, good market timing remains extremely critical for both single-family homes and condos.

Exterior and Interior Insurance

> "Some condo HOAs require condo owners to get their own unit coverage in addition to the master insurance policy provided by the HOA."

A condo's HOA usually pays for **fire and liability insurance** for the entire complex. It does not, however, normally cover personal contents, nor liability insurance within each condo unit. If a guest is hurt while visiting a condo unit, the HOA insurance will generally not cover the owner or tenant.

If an owner desires insurance that will cover personal contents and liability inside their unit, they should consider getting a separate policy from a reputable insurance carrier. They are generally fairly inexpensive, especially when compared to single-family home policies. Some condo HOAs require condo owners to get their own unit coverage in addition to the master insurance policy provided by the HOA.

Schools

School considerations are usually not very different between single-family homeowners and condo owners. Both are fee simple owners who actually own the property, as opposed to tenants who have a possessory interest to occupy a space for a very short period of time. This possessory interest is called a leasehold estate. The estate that is owned by both single-family homeowners and condo owners is called a freehold estate and is the highest form of ownership a person can own in land.

Fitness Center

Along with a swimming pool, a condo complex may also have a fitness center located in the common areas. If this is not the case, an owner or tenant may need to join a local gym and that, of course, will cost more money. Rental rates and property values may decrease accordingly.

Disclosures

In California, single-family homes require a large number of disclosures that are required by law. The following is a fairly comprehensive list of required disclosures:

- Real Estate Transfer Disclosure Statement
- Agency Disclosure
- Death Disclosure
- Homeowner's Guide to Earthquake Safety
- Commercial Property Owner's Guide to Earthquake Safety
- Natural Hazards Disclosure (including mold and airport proximity)
- State Fire Responsibility Area Disclosure
- Environmental Hazards and Earthquake Safety Booklets
- Energy Rating Program and Booklet
- Lead-Based Paint Disclosure/Lead Hazard Pamphlet
- Smoke Detector Compliance
- Alquist-Priolo Special Studies Zones—California has enacted the Alquist-Priolo Special Studies Earthquake Zones Act to control development of homes located in the vicinity of hazardous earthquake faults. Earthquake insurance can be purchased to protect against the possibility of an earthquake destroying the home. The Alquist-Priolo Special Studies Earthquake Zones Act relates to homes that were built prior to 1960. Many of these older homes did not have anchor bolts attaching the home to the foundation. In California, there is an earthquake disclosure form sellers are required to complete for homes built before 1960. It is a one-page disclosure form that asks the seller several questions about his property. Most sellers usually don’t know how their home is built. Therefore, the seller will usually answer “don’t know” to all of the questions on the disclosure form,

sign it, and deliver it to the buyer. For this reason, the disclosure may not be very helpful. Spending $400 or more for a good home inspection seems to be a better way to determine whether the home lacks anchor bolts or other construction defects that may affect its ability to withstand an earthquake.

- Subdivided Lands Law
- Common Interest Subdivision Conversion
- Mello-Roos Disclosure
- Military Ordnance Disclosure
- Seller Financing Disclosure
- Notice of No Policy of Title Insurance
- Blanket Encumbrance on Subdivisions

California condominiums require most, if not all, of the previously named disclosures required by single-family homes plus several others:

- Articles and Bylaws of the condo association
- HOA operating expenses
- CC&Rs
- Minutes to the last twelve months HOA meetings
- As well as several others.

Potential Litigation Problems

There are many condo associations that are in litigation against the builder who built the property. Many of these lawsuits have resulted from inferior construction and other construction defects.

For example, one condo HOA sued their builder due to faulty foundations underlying all of the buildings. The court ruled in favor of the condo HOA against the builder, and required the builder to repair all of the foundations located in the complex. Needless to say, all the condo owners may have a very difficult time selling their properties during the litigation period. In California, there is a legal requirement to disclose any existing or pending litigation that is or will be occurring against a seller's condo. This, of course, will probably scare potential buyers away from buying defective condos. It will also probably scare lenders away from making loans, at least until the defects are repaired.

Stairs and Elevators

One thing about condos that are well-located and have ocean views is that they are usually built with multiple stories. If a client has a second story or higher condo and there is <u>not</u> an elevator, this can be a functional obsolescence issue. In other words, buyers may not want to pay top dollar for a condo they must climb an excessive amount of stairs to reach.

> *The Story of Tori*
> Tori owned a second-home condo located in San Diego. It had 83 steps from the parking lot to the third floor where the condo was located. Every time friends used Tori's condo, they usually said some unpleasant things about the number of steps leading up to the unit. . .until they got inside and saw the incredible panoramic ocean view. Then all was good again.

Single-family homes with a two-story floor plan may also be difficult for older people, especially if the master bedroom is located on the second floor. Single-family homes with the master bedroom located on the bottom floor are a little more functional for older people. This seems to be the case for one story homes and two story homes with the master bedroom located on the bottom floor. Accordingly, some well-located homes have a reverse-floorplan where the kitchen and living space are located on the second floor and bedrooms are located on the bottom floor.

For the average family, a two story home with all the bedrooms located upstairs tends to have more of a sense of security for the children. A bad guy would be required to climb up the outside of the home and enter through a second story window to gain access to the home; or break into the bottom floor and use the stairs. If the parent's master bedroom is located on the top floor and near the head of the stairs, they may have a chance to protect the family.

Too Many Non Owner-Occupied Condos in the Complex

When an investor sells a condo at the end of the holding period, an owner-occupied condo buyer may have a problem obtaining a loan if there are too many investors who own condos in the same complex. Different lenders have different loan underwriting criteria, so it is imperative to make sure the buyer will be able to get a loan on the purchase of the condo. Having the buyer get pre-approved for the loan is usually a good idea. However, the investor percentage issue will probably not surface until after the appraiser has determined the percentage of owner-occupants residing in the condo complex. So, the owner may want to consult a list of HUD-approved condo complexes and determine if their condo is on the approved list.

Sometimes FHA insured and VA guaranteed loans may not be possible due to investor issues. A conventional loan may be the only way to finance the condo. This type of financing may require a larger down payment than the buyer has at the time, and the deal may fall through.

How the Percentage of Investors is Calculated

When you have an accepted purchase contract and the buyer is trying to get a loan on the condo, the lender will usually hire an appraiser to appraise the property. The appraiser's job is to make sure the property is sufficient collateral for the lender's loan. If the lender must foreclose due to a buyer defaulting on the required loan payments, the lender will probably have a good chance of getting most of their money back. The cost of this type of appraisal is approximately $400 and is usually paid by the buyer.

In the appraisal report, the appraiser will generally provide a percentage of the condo units that are owner-occupied. If this amount is too low (sometimes under 70% owner-occupied is too low, and other times under 50%—it really depends upon the type of financing), then the lender will probably not be willing to make a loan to purchase the property. This may affect the values of all the units located in the complex.

For investors, the more owner-occupied condos the better. Owner-occupants tend to maintain their properties better than tenants, thus helping future buyers obtain financing and pay top-of-the-market prices near the top of an upward-trending sellers' market and the end of the investor's holding period.

Condos Located on Leased Land

An investor does not own the land under a condo that is located on leased land. At some point in the future, the lease on the land will expire and the investor will lose the condo! No kidding!!! The investor may be required to purchase the land in the future, when land prices may be much higher, or they will lose the investment. Fortunately, most condos located in California and the balance of the U.S., are sitting on freehold land where the condo owners own the land as well as the condo. Hawaii seems to have quite a few condos located on leased land, especially on the island of Oahu.

Hotel-Type Condos

Some condos are hotel-type properties called "**condotels**" because they were used as hotel rooms in the past. A builder may have bought the property and subdivided each of the rooms into its own parcel number, added kitchens, and then sold them to individual owners. Many of the existing hotel amenities, such as a front desk and concierge service usually remain in place and are available to condotel owners. A condotel owner may be able to rent their unit on a daily, weekly, or monthly basis—whenever they are not using it.

Lenders may be a bit nervous financing this type of property. So, a buyer may have difficulty obtaining reasonable financing for the unit, at least that has been a problem in the past. It's hard to say what lenders are going to do in today's market.

Stock Cooperatives

A **stock cooperative** is an apartment building where each owner owns stock in their own individual unit located in the building. When an owner wants to sell a unit, stock is transferred to the new owner—rather than using a grant deed or warranty deed (like condos). One problem with stock cooperatives is if the other owners do not pay their debt service and go into default, a foreclosure may cause every owner to lose their unit as well. Next is a look at a statutory law and a court case that affects agency and Real Estate Transfer Disclosures in California.


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DISCLOSURE REGARDING AGENCY RELATIONSHIPS NOW REQUIRED FOR COMMERCIAL PROPERTY

California Assembly Bill 1171 – Effective Jan. 1, 2015

Existing law:

1. Requires specified disclosures by listing and selling agents to be provided to a buyer and seller of residential real property and defines the duties owed by the agents to the buyer and seller.
2. Requires those listing and selling agents to provide the seller and buyer with a copy of a specified disclosure form and to obtain a signed acknowledgment of receipt from that seller or buyer as follows:
   A. The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement;
   B. The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form;
   C. Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be


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DISCLOSURE REGARDING AGENCY RELATIONSHIPS NOW REQUIRED FOR <u>COMMERCIAL</u> PROPERTY (*continued*)

California Assembly Bill 1171 – Effective Jan. 1, 2015

furnished to the seller by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his/her last known address, in which case no signed acknowledgment of receipt is required; and

D. The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer.

3. Provides that in any circumstance in which the seller or buyer refuses to sign an acknowledgment of receipt of the disclosure form, the agent, or an associate licensee acting for an agent, shall set forth, sign, and date a written declaration of the facts of the refusal.
4. Provides a specified form detailing the fiduciary duties of care owed by the listing or selling agent and the agent's conflict of interest disclosures that the agent is required to give to the seller or buyer.
5. Requires the listing or selling agent to disclose to the buyer and seller whether the selling agent is acting in the real property transaction exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and the seller. This relationship is required to be confirmed, as specified, in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the selling agent prior to or coincident with execution of that contract by the buyer and the seller, respectively.
6. Prohibits a selling agent in a real property transaction from acting as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction.
7. Provides that the payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation


Flickr / Chris Potter

DISCLOSURE REGARDING AGENCY RELATIONSHIPS NOW REQUIRED FOR COMMERCIAL PROPERTY (*continued*)

California Assembly Bill 1171 – Effective Jan. 1, 2015

or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship.

8. Prohibits a dual agent from disclosing to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. Prohibits the dual agent from disclosing to the seller that the buyer is willing to pay a price greater than the offering price, without the express written consent of the buyer.
9. Provides that a listing agent is not prohibited from also being a selling agent, and the combination of these functions in one agent does not, of itself, make that agent a dual agent.
10. Defines real estate listing and selling agent, buyer, seller, and specifies that "real property" means any estate in property which constitutes or is improved with one to four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobile homes, when offered for sale or sold through an agent.

This bill:

1. Adds "commercial real property" to that definition of "real property," thus applying all of the above disclosure requirements to commercial property sales.
2. Defines "commercial real property" to mean all real property in this state except single-family residential real property, residential rental units, mobilehomes, or recreational vehicles.

Background

Prior to 1984, the law required a real estate broker to disclose to a buyer, material defects known to the broker but unknown to and unobservable by the buyer. In 1984, case law provided that the broker also owed a duty to disclose defects which the broker should have discovered through reasonable diligence.

In Easton v. Strassburger (1984) 152 Cal.App.3d 90, the court held that real

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DISCLOSURE REGARDING AGENCY RELATIONSHIPS NOW REQUIRED FOR COMMERCIAL PROPERTY (*continued*)

California Assembly Bill 1171 – Effective Jan. 1, 2015

estate licensees owed certain duties of care to the property buyers, including while representing the sellers in a residential home transaction. That court refrained from extending these duties to commercial property transactions, stating in dictum: "unlike the residential home buyer who is often unrepresented by a broker, or is effectively unrepresented because of the problems of dual agency a purchaser of commercial real estate is likely to be more experienced and sophisticated in his dealings in real estate and is usually represented by an agent who represents only the buyer's interests."

After the Easton decision, there was extensive discussion in the real estate industry on how those duties were to be interpreted. SB 453 (Robbins, Chapter 223, Statutes of 1985) clarified the duties of real estate brokers and buyers in real property transactions. However, the law was still unclear as to whether real estate brokers had disclosure duties to buyers.

In Smith v. Rickard (1988) 205 Cal.App.3d 1354, 1360, the court, after examining statutory construction and the Easton case dictum, held that real property brokers had a duty to inspect the property and to disclose to the plaintiff any material defects affecting the value or desirability of the property.

In 1995, the Easton decision was further clarified and codified in SB 467 (Leonard, Chapter 428, Statutes of 1995) to require real estate listing and selling agents of residential property to provide specified disclosures to buyers and sellers. Those disclosures require the real estate listing and selling agents to disclose whether the agent represents the buyer, the seller, or both the buyer and seller (known as dual agency).

The next court case examines the requirement of using a Real Estate Transfer Disclosure Statement for the transfer of a commercial mixed use building.


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REAL ESTATE TRANSFER DISCLOSURE STATEMENT REQUIRED FOR 1-4 UNIT RESIDENTIAL PROPERTIES CONTAINING COMMERCIAL BUILDINGS (MIXED USE)

Richman v. Hartley (2014)

California Court of Appeal, 2nd Appellate District, Division 6
Filed 3/20/14

All one-to-four unit residential properties, that fall within the scope of the Real Estate Transfer Disclosure law, require a seller to provide the Real Estate Transfer Disclosure Statement even if the property is used for commercial purposes.

Next is a look at real estate financing for single-family homes.

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REAL ESTATE FINANCING

"It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning." -Henry Ford

Most real estate agents will agree that **financing drives deals**. Many real estate purchases use financing to leverage a transaction. For this reason, the loan is usually the determining factor in whether a transaction is completed and the broker receives a commission.

To fully understand the lending process, your clients must understand why loans are originated. Borrowers may be a first-time home purchaser, refinancing their existing home, or an ultra-sophisticated commercial investor. Each has similar lending requirements; however, all have different reasons for wanting a loan:

1. A first time home purchaser wants a home for the family. Obtaining a loan is the only way they are going to be able to purchase their family's first home.
2. A refinancing home owner usually wants to reduce the interest rate on their existing loan. The existing loan is paid off and a new loan is originated at a lower interest rate.
3. An ultra-sophisticated commercial investor is usually looking for a solid return on investment. They are not interested in a home or a roof over their heads, but want to purchase an asset that will return a specific amount over a holding period.

Why is someone willing to loan money to a borrower? What type of guarantee does a lender have that they will be paid back by the borrower, and including interest?

A lender requires **collateral** for a loan. This is something a borrower places with a lender as a guarantee for repayment of the loan. Since it is very difficult for a new home buyer to place (for example) $160,000 cash as collateral for a $160,000 loan, lenders have allowed borrowers to place the home itself as security for a loan (collateral).

Placing a home as security for repayment of a loan is called hypothecation and comes in two forms: mortgage and deed of trust (also called trust deed).

Both mortgages and deeds of trust hypothecate a piece of real property as security for a loan. However, deeds of trust are used almost exclusively in California. If a borrower does not repay the loan (with interest), then the lender will foreclose the property and sell it to repay the debt.

"Both mortgages and deeds of trust hypothecate a piece of real property as security for a loan."

An appraisal is generally required by a lender when a property is purchased, and this appraisal is important because it assures the lender that the property is actually worth the loan amount. Otherwise, a lender will lose the difference between the value of the home and the loan amount.

A borrower is usually required to pay a part of the purchase price known as the **down payment**.

For example,
$200,000 purchase price of home (sales price)
$40,000 down payment (20% of purchase price)
$160,000 loan

If the down payment is substantial (20% of more of the purchase price or appraised value, whichever is lower), then the lender may feel somewhat secure that the borrower will make every attempt to make the loan interest payments and not lose their initial $40,000 down payment. In other words, the borrower has enough money at stake so he will not walk away from the debt obligation.

As the down payment decreases to less than 20%, the lender will become very nervous and worried that the borrower does not have enough money at stake to prevent walking away from the debt obligation. The borrower may stop making interest payments and allow the lender to foreclose the loan.

Private Mortgage Insurance (PMI) companies have stepped in to help lenders solve this problem. PMI insures a lender for the amount of the loan over 80%. For example:

$200,000	Purchase/sale price
$10,000	Down payment (5%)
$190,000	Loan

This is a 95% loan-to-value (LTV) loan. A lender is usually comfortable with an 80% LTV loan. The PMI company insures the 15% down payment the borrower did not make toward the purchase price.

Therefore,

(80% LTV)	$160,000	Lender assumes the risk of borrower default, unless PMI covers this also.
(15%LTV)	$ 30,000	PMI company assumes the risk of borrower default.
(95%LTV)	$190,000	Total loan made toward purchase of property
(5% down)	$ 10,000	Down payment
TOTAL	$200,000	Purchase/Sale price of property

A promissory note is secured by a deed of trust:

Promissory Note *= Evidence of the loan*

secured by

Deed of Trust *= Collateral for the lender*

A first deed of trust has been recorded first and usually has priority over other subsequently recorded deeds of trust and liens. However, there are three exceptions: mechanic's liens, taxes, and subordinated loans. Make sure your clients are aware of these three exceptions.

Mechanic's Liens

Mechanic's liens can present a problem for real estate lenders when materials are delivered or work is started on the property prior to recordation of the construction loan by the lender. When this occurs, the contractor may be in first position ahead of a construction loan. This is not a good situation for a lender because if the property must be foreclosed, the lender may not receive all of their loan funds.

Taxes

Taxes are always paid first. **Property taxes** are paid before **federal income taxes**. If there is any equity left over in the property, it will go to the most senior lien—which hopefully will be the lender.

Subordinated Loan

A deed of trust that contains a subordination clause supersedes the rule: "First to record is first in right." A **subordination clause** in a deed of trust is evidence that the lender agrees that a future obtained (2nd) deed of trust may be prior to the existing (1st) deed of trust. In other words, when a borrower institutes a 1st trust deed they may ask the lender to "subordinate" in the future. This means that the lender has agreed to place a subsequent 2nd trust deed in first position if there is a foreclosure. Therefore, the 2nd trust deed lender will be paid first if the property has to be foreclosed and the 1st trust deed lender will be paid second. The 1st trust deed is subordinate to the 2nd trust deed. This type of loan is commonly used when there is a construction loan.

> A subordination clause in a deed of trust is evidence that the lender agrees that a future obtained (2nd) deed of trust may be prior to the existing (1st) deed of trust.

Deed of Trust

A deed of trust is comprised of:

- **Trustor** (Borrower/Buyer)
- **Trustee** (3rd party who holds naked legal title to the property
- **Beneficiary** (Lender)

The deed of trust is "in favor of" either:

- lender if a new loan is instituted**,** or
- seller if the seller extends credit and carries a loan on the property

A formal assumption of an existing deed of trust makes a buyer personally liable for repayment of the loan. The buyer becomes the trustor and the seller (former trustor) is removed from liability for repayment of the loan.

In the past, some FHA loans instituted prior to 1986 (and some up until 1989) have allowed buyers to take over a loan *Subject To* (also called a simple assumption). Subject To allows a buyer to purchase a property without loan qualification and the seller remains primarily liable for repayment of the loan for five years after the property is sold!!!

Subject To assumptions were initially designed to help distressed homeowners sell their properties quickly with minimal costs (usually only $25). However, investors saw a way to make a quick profit and many times did not disclose to a seller that they were personally liable for repayment of the loan for five years after the sale. Many homeowners sold their properties and did not know they were still liable for the loan on their old property!

Today, FHA loans instituted after 1989 are not assumable under a Subject To assumption. They may be assumable as a formal assumption, which releases a seller from liability. However, some investors may try to assume them "Subject To" anyway. HUD usually must enforce the due-on-sale clause, not the lender.

Foreclosure

If a trustor (borrower) stops making payments on a loan (evidenced by a promissory note), the beneficiary (lender) must institute a foreclosure proceeding against the trustor. This procedure can be either judicial or non-judicial in nature.

Judicial foreclosure allows a deficiency judgment and a redemption period for the borrower. However, most foreclosures in California are by non-judicial *trustee's sale* foreclosure. A trustee's sale has no deficiency judgment and no redemption period.

Trustee's Sale

Trustee's sale example:

\$150,000	Original sales price of the property
\$100,000	Loan secured by a 1st deed of trust on the property
\$ 30,000	Loan secured by a 2nd deed of trust on the property
\$ 20,000	Cash down (by buyer)

If the property value decreases to $100,000 and the trustor stops making loan payments, then the beneficiary (lender) on the 1st TD will institute a foreclosure action and direct the trustee to initiate a trustee's sale. The trustee records a Notice of Default and (approximately) three (3) months and twenty-one (21) days later a trustee's sale occurs on the property.

If there are no higher bids than the loan amount received at the trustee's sale, the beneficiary will obtain the property and place it in their portfolio of "Real Estate Owned" properties, called REO's. The lender will then attempt to sell the property and recoup as much of the original $100,000 loan as possible.

The beneficiary (lender) of the 2nd TD will lose all of their money loaned to the trustor (buyer). The 2nd TD beneficiary may assume the 1st TD and take over the property, thereby attempting to recoup the $30,000 2nd TD loan when the property increases in value in the future. The trustor (buyer) will lose the $20,000 cash down payment in either case.

If a lender agrees to accept less than the loan amount prior to a trustee's sale, it is called a short sale and will affect a seller's credit similar to a foreclosure. In a declining market, short sales are usually very common.

Amortization

Amortization is the systematic liquidation of a financial obligation over a period of time. Long-term thirty (30) year and fifteen (15) year installment loans are usually amortized over these periods.

Fixed Rate vs. Adjustable Rate Loan

A **fixed rate loan** has interest rates that remain fixed during the life of the loan. In contrast, an **adjustable rate loan** (ARM) adjusts to a predetermined index during the life of the loan. This allows lenders to minimize interest rate risk because, as market interest rates increase so do the interest rates. Of course, decreases in interest rates will cause a reduction in interest paid to the lender and are an inherent risk to lenders.

An example of an ARM loan is a $100,000 loan with a 4% interest rate for the first 6 months of the loan. This is called a **teaser rate**. This low rate does not last long and "teases" the borrower with its low initial rate.

After 6 months the loan "kicks in" to a **fully indexed note rate** of 2% over the Cost of Funds, Cost of Savings Index, London Interbank Offered Rate (LIBOR), or other treasury index. This increase in loan interest payment is called **rate shock**.

A borrower may also experience **negative amortization**. The interest portion of the loan payment is so small that it does not cover the interest due to the lender. Consequently, the principal balance of the loan increases during the life of the loan.

Maximum Movement

Maximum movement is the maximum interest rate increase or decrease over a given period of time. Maximum rate increase is also called a **rate cap** or **rate ceiling**. A maximum rate decrease is called a **rate floor**.

An example is a 7% fully-indexed note rate. Maximum movement is 2% per year, with a **lifetime cap** of 13%. This adjustable rate loan can increase a maximum of 6% from its initial fully-indexed rate.

Balloon Payment

> "Many adjustable rate loans (as well as some fixed rate loans) have a balloon payment due sometime in the future."

When a final loan payment is significantly larger than previous installment payments, this is called a **balloon payment.** Many adjustable rate loans (as well as some fixed rate loans) have a balloon payment due sometime in the future. An example is a $100,000 loan at a 7% fully-indexed note rate, amortized over 25 years, due in 10 years. The loan is due in 10 years and this is the balloon payment date.

Interest only loans by definition have a balloon payment at the end of the loan period. Many second (2^{nd}) trust deeds have interest only payments with a balloon payment due at the end of the loan period, usually no more than five (5) years from the origination date.

Buydown

A seller or real estate builder/developer may subsidize a buyer's loan payments with a **buydown program**. A common buydown program is a "2-1 buydown." It results in 2% of the buyer's interest rate payment being paid by the seller or developer in the first year of the loan.

Example: $100,000 loan @ 8.5% market note rate, 30 year amortization schedule, principal and interest payment is $768.91/month.

Year One: The seller/developer pays 2% of the buyer's interest payment.
8.5% - 2% seller/developer buy down = 6.5% paid by the buyer = $632.07.

The seller/developer pays the difference between $768.91 and $632.07 = $136.84/month. Therefore, $136.84/month x 12 months =$1,642.08 total paid by seller/developer for year one.

Year Two: The seller/developer pays 1% of the buyer's interest payment.
8.5% - 1% seller/developer buy down = 7.5% paid by the buyer = $699.21 (not taking into account principal reduction in years one and two).

The seller/developer pays the difference between $768.91 and $699.21 = $69.70/month. Therefore, $69.70 x 12 months = $836.40 total paid by seller/developer for year two.

Seller/developer's total contribution is:
$1,642.08 + $836.40 = $2,478.48

A total of $2,478.48 will be placed in an escrow account. Each month the appropriate amount will be taken from the escrow account and added to the buyer’s payments. This allows the buyer to qualify for a more expensive home and subsequent loan, since the lender may allow the borrower to qualify at the buydown rate of 6.5%. It depends upon the lender and their qualifying criteria at the time of the loan application. It is assumed that the homebuyer's income will increase over the first three years of the loan.

Loan fees typically encompass **loan origination, document processing, administration fees, wire transfer fees, notary fees,** and **recording fees** (for grant deeds and trust deeds), as well as several other stipulated fees.

Loan Origination

A **loan origination fee** is usually approximately one percent (1%) of the loan amount (varies considerably). This is the commission or fee paid to a loan originator, who is usually a mortgage banker, mortgage broker, or institutional lender.

A **Mortgage Banker** is an entity that provides their own funds in making real estate loans. Mortgage Bankers may sell originated loans on the Secondary Mortgage Market through entities such as Fannie Mae, Freddie Mac, and Ginnie Mae.

A **Mortgage Broker** is an entity that sells originated loans to mortgage bankers and institutional lenders that resell them on the Secondary Mortgage Market. Mortgage Brokers generally do NOT lend their own funds.

Institutional lenders are commercial banks, savings banks, and insurance companies who lend their own funds and may or may not sell them on the Secondary Mortgage Market.

Processing Fee

A **Loan Processing Fee** is used to cover costs of processing the loan. Many times a loan officer originating a loan pays for the actual processing from the one percent (1%) loan origination fee.

Wire Transfer Fees, Notary Fees, and Recording Fees

Wire transfer fees are incurred when a lender wires funds into escrow after all loan documents have been signed and all loan conditions have been satisfied by a buyer. Most lenders wire funds into escrow.

Notary fees are charged by a notary public ("notary") when a buyer and seller sign escrow instructions and all the supporting documents in the escrow closing process. A notary verifies the acknowledgment (signature) of the buyer and seller and requires a photographic identification of each party to the transaction. Costs range from $10 to $50. Most notaries require a thumb print as well.

Another Tip to Make Life Simpler

When the buyer and/or seller are scheduled to sign escrow instructions and other documents, remind them to bring their driver's license or photo ID card with them when they come into the escrow office. The escrow officer will not be able to notarize the documents, and thereby close the escrow without a photo ID.

Discount Points

Discount points are also called "points" and are calculated as one percent (1%) of the loan amount. If a borrower would like to decrease the interest rate on a loan, she can pay the lender a certain amount of money at the time of loan origination and decrease (discount) the loan interest rate.

Generally, a borrower will pay one percent (1%) of the loan amount (one discount point) for every one-eighth percent (1/8%) decrease in the loan (note) rate. Amounts vary however, depending upon many variables and risks perceived by the lender.

"If a borrower would like to decrease the interest rate on a loan, she can pay the lender a certain amount of money at the time of loan origination and decrease (discount) the loan interest rate."

For example:
8% fixed rate loan, at par (0 points).
Borrower would like a 7.5% fixed rate loan.
Therefore, 1/8% interest rate decrease = 1 point
4/8% = 1/2% rate decrease (8%-7.5%) = 4 points
$100,000 loan x 4 points = $4,000 paid by the borrower to receive a 7.5% fixed rate loan (1/2% loan rate reduction).

Not taking the time-value of money into consideration or tax implications, a borrower's break-even is usually between four and five years. If the borrower plans to keep a property more than four or five years and interest rates are fairly high, he may want to consider paying some amount of discount points and reducing the loan interest rate in his favor. With low interest rates, discount points are not as commonly used as a financing strategy.

Contingencies to the Contract

A **contingency** is a contract provision that requires a happening of a certain event before a "contract" is binding upon both parties. Generally, obtaining an earnest money deposit, down payment, and other closing costs are NOT contingencies unless specified in the purchase agreement.

Common contingencies include:

- Financing;
- Physical Inspection;
- Appraisal; and
- Tenant estoppel certificates (commercial leased investments only).

A **financing contingency** is best defined as a requirement for a buyer to obtain a loan commitment from a lender before the purchase agreement becomes a binding contract.

A **physical inspection contingency** is best defined as a requirement that a buyer physically inspect and approve a property before the purchase agreement becomes a binding agreement.

An **appraisal contingency** stipulates that a property must appraise for at least the purchase price or the buyer my elect not to remove the contingency and not go forward with the contract.

Tenant Estoppel Certificates are used with leased investments to verify lease terms and amounts represented by a seller. The tenants must sign, under penalty of perjury, that the lease amounts represented by the seller are indeed true and correct.

FHA Financing

The Federal Housing Administration (FHA) is part of the Department of Housing and Urban Development (HUD). FHA insures loans made by approved lenders and does not originate loans.

Since conventional loans may require a twenty percent (20%) or more down payment, not considering private mortgage insurance, FHA has instituted low down payment loan programs with both fixed rate and adjustable rate programs.

FHA loan programs have significantly affected single family loan programs throughout California. Places like the San Francisco Bay Area and parts of Southern California have not been able to use these programs because the prices of homes exceed maximum FHA loan amounts.

FHA is designed to protect the borrower. When a property is appraised by an FHA approved appraiser, it is inspected by him also. The inspection assures the buyer that he is purchasing a home within HUD's minimum construction standards. An appraiser may require a broken window to be repaired, missing window screens to be replaced, and missing closet doors to be installed before FHA will insure the loan. These repairs must be completed prior to loan funding and close of escrow.

"Conventional loans usually do not require appraiser-related repairs."

Conventional loans usually do not require appraiser-related repairs. Therefore, for FHA loans to be competitive in today's lending environment it may be necessary for an FHA buyer to pay a higher purchase price than a conventional buyer—resulting in the same net to a seller.

VA Financing

The Veterans Administration guarantees loans made to qualified veterans. A VA-approved appraiser performs an inspection to determine the condition of a property. The VA issues a Certificate of Reasonable Value (CRV) determining a maximum value for the property. If the maximum value is LESS than the price stipulated in the purchase agreement, then the veteran may elect to cancel the purchase agreement and NOT go through with the transaction. VA allows a no down payment type loan for qualified veterans. This allows the veteran to purchase a property with no down payment and no closing costs. The VA does, however, usually charge a funding fee that may be financed. A veteran typically will increase the purchase price to cover the many costs he will incur.

All Cash Offers

Buyers using all cash to purchase a property do not require a financing contingency or appraisal contingency because they will not be obtaining a loan on the property. These types of buyers usually require only a physical inspection contingency to complete a transaction.

A seller may require some sort of verification that a buyer does indeed have the funds available. This verification can be provided by a bank officer or bank statements.

Loan Application and Tentative Qualification Letters

A seller may ask a buyer to show some evidence that she has started the loan process. A lender may be required to send a tentative qualification letter to a seller within a certain specified time period (usually 15 days, but this varies). The lender letter usually states, "Based upon unconfirmed information we believe we may be able to make the loan." This letter merely informs the seller that the buyer has started the loan process. The letter is not a loan commitment and explains this very specifically.

If the buyer's lender does not provide a tentative qualification letter, or if the letter does not tentatively qualify the buyer, then the seller may be able to cancel the transaction and terminate the contract and escrow.

Prequalification

Prequalification is generally a term used to describe a buyer who has met with a lender (prior to finding a property to purchase) and the lender has made a preliminary analysis of the buyer's situation; as well as a determination regarding whether a loan can be made and at what price level.

Many buyer's agents require their buyers to be prequalified before they will spend time showing them properties. Buyers must be ready, willing, and (most importantly) able to purchase a parcel of real property.

Remember, loans drive deals. If a buyer is not able to purchase a property, a considerable amount of time will have been wasted with an unqualified prospect.

Generally, if a prospect is not willing to take the time to meet with a lender prior to looking at properties, then the agent should not take the time to work with the prospect.

Preapproved loans indicate that the borrower has met with a lender and the lender has preapproved the borrower for a certain loan amount. The lender has run the borrower’s credit and submitted a loan application and supporting documentation to the lender’s underwriter. The underwriter has given tentative loan approval, subject to certain funding conditions, which include an appraisal and the borrower’s credit standing is maintained at its current level.

Seller Financing

Seller financing occurs when a seller provides the financing for a transaction. A buyer may be required to complete a loan application (1003 FNMA/FHLMC Uniform Residential Loan Application), provide a very recent credit report, and supply any other pertinent documentation required in the purchase agreement.

Required seller financing terms may include:

1. Request for Notice of Default
2. Request for Notice of Delinquency (must be negotiated in the contract)
3. Acceleration Clause
4. Late Charge
5. Title Insurance

Required seller financing terms may include: *(continued)*

6. Tax Service
7. Fire Insurance
8. Written Consent for Assignment
9. Social Security or Tax Payer ID Numbers

Loan Assumptions

When a buyer assumes or takes over an existing conventional or government loan it is called a **loan assumption**. A seller usually has a specified period of time to give a buyer copies of:

1. existing promissory notes (evidence of the debt obligation);
2. trust deeds (that secure the note(s) with the property);
3. loan balances;
4. interest rates (for adjustable rate loans); and
5. existing principal and interest (p+i) payments.

Any difference between estimated and actual loan balances can be paid by a buyer or seller with cash, seller-carry financing, or other equitable means (boats, cars, airplanes, etc.). If there are existing impound accounts, they can be either assigned to a buyer or debited/credited to a buyer or seller as appropriate.

An **impound account** occurs when a lender collects property taxes and homeowner's insurance payments each month and pays property tax bills and homeowner's insurance as they become due.

Since property taxes are due in two installments (1st installment due Nov. 1st and delinquent December 10th; the 2nd installment is due Feb. 1st and delinquent April 10th) the lender usually pays them (from impounds) before they become delinquent.

Homeowner's insurance is generally paid once each year. A lender collects a monthly amount that is calculated to pay the total insurance amount at the beginning of each year. Many times FHA-approved lenders collect up to fourteen (14) months insurance up-front at close of escrow in addition to the collected monthly impound amounts. They may also collect up to six (6) months property taxes in addition to the collected monthly impound amounts. For these reasons, the impound account may contain much more money in it than what is required to pay the taxes and insurance.

A homeowner can write a letter at the end of the year requesting that the additional funds in the impound account be returned to her. The lender is required by law to return excess amounts in the impound account anyway, without requiring a letter from the borrower. The lender or servicing company collecting the impound funds usually receives interest on the funds.

For example, a lender or servicing company collecting property taxes and homeowner’s insurance, in addition to a loan payment of principal and interest, may realize the following scenario:

\$750/month	principal and interest
\$ 50/month	property taxes (approximately 1% to 1.15% of the property sale price).
\$ 30/month	homeowner’s insurance (usually fire and homeowner's liability)
\$830/month	total collected (PITI)

Another Tip to Make Life Simpler. . .

If a loan is having property taxes and homeowner’s insurance impounded each month and a borrower would like to make additional principal payments to reduce the loan amount, the borrower should write a <u>separate check</u> and mark on the check, "<u>Principal Only</u>." This will prevent the lender from placing the extra funds into the impound account.

Where do loans come from? Let’s take a look.

Loan Origination

A person who meets with a borrower and starts the loan process is called a **loan officer** or **loan originator**. A person who processes all of the resulting paperwork and prepares the loan package for review is called a **Loan Processor.** The person who reviews the loan package and makes a final lending decision is called a **loan underwriter.**

A Loan Officer and Loan Processor document whether a borrower meets Investor Green's lending requirements. These requirements are called **underwriting guidelines**.

Underwriting guidelines are set by investors, such as Investor Green, to insure the loans they purchase on the Secondary Mortgage Market fit their prescribed lending requirements. In other words, they are not higher risk borrowers than their interest rate reflects and their default risk is within specified investment parameters.

Since it requires (theoretically) $1,000,000 to be able to sell loans in the Secondary Mortgage Market, only a small number of large loan originating companies were able to participate. In response to this problem, small lenders have been allowed to participate in the Secondary Mortgage Market through a **loan correspondent** program.

For example, Lender Smith has $1,000,000 in cash he uses to make mortgage loans. Lender Smith is located in Dallas, Texas. The lending market in San Francisco shows a strong demand for loans. Therefore, Lender Smith approves Broker Jones to institute loans in San Francisco on his behalf. Broker Jones SELLS these loans to Lender Smith. Broker Jones is called a Mortgage Broker and Lender Smith is called a Mortgage Banker.

Borrower Allen comes to Broker Jones for a mortgage loan for the purchase of a $200,000 single-family home in San Francisco (if he could find one for this price!). Broker Jones originates Borrower Allen's loan, processes all the documentation required by the underwriter, and sells the loan to Lender Smith.

If all documents are in order and fit underwriting guidelines, Lender Smith purchases and funds the loan. He then pays Broker Jones a predetermined fee called a **commission**.

An advantage of a mortgage banker is their direct funding in the secondary market. They are not required to "sell" their loans. A disadvantage is their limited number of underwriters and private mortgage companies. Since loan underwriting is very subjective, a choice of several underwriters may be a better course for problem borrowers. Also, mortgage bankers many times have a very limited number of private mortgage insurance companies available to them.

"An advantage of a mortgage banker is their direct funding in the secondary market."

An advantage for mortgage brokers is that larger mortgage brokers are usually approved with forty or more lenders (like Lender Smith) who are called **mortgage wholesalers**. Mortgage brokers are able to "shop" a loan package until an underwriter is willing to loan the funds needed to complete the transaction.

"Mortgage brokers are able to "shop" a loan package until an underwriter is willing to loan the funds needed to complete the transaction."

Mortgage brokers can also shop private mortgage insurance companies. A disadvantage of mortgage brokers is that they do not lend their own funds and can go in and out of business rather frequently. This is why mortgage brokers are regulated by the California Bureau of Real Estate and all mortgage loan brokers must have a real estate license to originate loans in California.

Mortgage bankers and brokers hire individuals to originate loans. They are called **loan officers.** After a loan application has been completed and the necessary loan documentation has been requested from a borrower, the loan is turned over to the loan processor.

A loan processor is not normally licensed by the California Bureau of Real Estate. This person handles follow-up on all documentation required by the underwriting guidelines (which come from Investor Green).

It is usually thirty (30) to sixty (60) days, depending upon the loan type, from the time the loan officer initially meets with the borrower to when the loan is normally funded. A loan processor has control over all of the loan documents used during the loan process and is responsible for compiling required documents into a designated format called a **loan package**.

Loan processing is a key element in the loan process. All the required forms must be in the correct sequence for the underwriter to review.

After the loan package has been completed, it is then submitted to an underwriter. This will be an in-house underwriter if it is a mortgage banker. It may be several different underwriters if it is a mortgage broker.

An underwriter examines the loan package and compares it to underwriting guidelines for a particular type of loan. An underwriter also looks at **compensating factors** which include borrower credit rating (FICO scores) and job stability. FICO scores rate a borrower's attitude toward debt. The underwriter makes a determination with the following possible outcomes: acceptance, acceptance with conditions, need more information, or denial. When a loan underwriter accepts a loan, **loan documents** (called "loan docs") are drawn up by the lender.

Whether a new loan is a purchase or a refinance, loan processing requirements are the same (except a purchase requires a purchase agreement, Real Estate Transfer Disclosure for FHA insured loans, and pest report). The loan officer meets with potential borrowers and completes a Form 1003 Uniform Residential Loan Application.

A loan originator will ask prospective borrowers for the following documents:

1. Purpose of loan letter (if a refinance).
2. Approval to obtain a credit report and collect the fee for the report.
3. Signed Rental History Verification form (if presently renting) to be sent to the landlord.
4. Signed Verification of Employment form, sent to present employer(s) to verify employment and length of employment.
5. Current pay stubs.
6. W-2's for the last two years.
7. Federal income tax returns for the last two years.
8. Signed Verification of Deposit form for each existing bank account. This will be sent to each bank or financial institution.
9. Current bank statements.
10. Rental agreements for rental properties and existing home if it will become a rental (existing home, not the home being purchased).
11. Purchase agreement for purchases.
12. Pest report for purchases.
13. Divorce documents (decree), if applicable.

After a loan officer obtains the above information, she may "shop" wholesalers for the best program to fit a borrower’s needs. This involves scanning rate sheets and qualifying criteria from several different lenders.

Loan Documents

Loan documents are drawn by a lender after approval by a loan underwriter. Loan documents are then sent to the escrow holder. The escrow holder may be an escrow company, title company, attorney, real estate broker, or bank. Generally, escrow companies handle the escrow in Southern California (Fresno, south to the Mexico border) and title companies handle escrow in Northern California (north of Fresno). An escrow holder prepares the loan documents for signature by the borrower(s). Brokers can handle escrows for their clients and their own transactions; however, this is usually similar to a dermatologist performing brain surgery. . .probably not a good idea even if it is legal.

A borrower signs the loan documents and the escrow holder sends these documents back to the lender. A lender's *Loan Funder* reviews the documents for completeness and, if everything looks okay, sends the loan funds to the escrow holder. The funds are generally sent via wire or check.

If a loan is in conjunction with a purchase, the escrow holder disburses funds per the escrow instructions that were signed by the buyer and seller. These funds are not disbursed until an executed grant deed has been recorded by the county recorder in the county where the real property is located.

If a loan is a refinance of an existing property, the escrow holder disburses the funds per the agreement with the lender.

Secondary Mortgage Market

Many years ago, lenders made a loan and then held it until it was paid off by a borrower. For example:

1. Lender Smith has $1,000,000 cash in his local bank.
2. He takes the money out of the bank and makes five loans, each loan totally $200,000.
3. Lender Smith collects initial loan origination fees (and other loan fees), as well as interest throughout the duration of the loans; until they are paid off (sold or refinanced) and the loans retired. This gave cash rich areas an advantage over cash poor areas.

> To equally distribute loans throughout the nation, the United States Federal Government instituted the Federal National Mortgage Association (FNMA), also called "Fannie Mae." Today this organization is a public entity that performs a vital function for the U.S. economy. Other similar entities are the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) which is also public. The Government National Mortgage Association (GNMA or Ginnie Mae) is a government agency that takes pools of mortgages originated by FNMA and FHLMC and passes them through as mortgage-backed securities. This gives institutional investors on Wall Street the ability to invest in securities that are collateralized (backed) by existing mortgage loans.

FNMA and FHLMC have instituted a **Secondary Mortgage Market** that purchases bundles of similar mortgage loans and sells them to investors. Since Investor Green (for example) did not originate the five loans, he would like to know how risky these borrowers are, and the probability of their defaulting on the loans.

Fortunately, Lender Smith has received underwriting guidelines specifying exactly what information Investor Green requires to make a decision to purchase the loans.

Investor Green has $1,000,000 in cash to invest and would like to make as high a return on his money as possible, he requires a return at least equal to the interest rate and default risks of each loan.


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REAL ESTATE BROKER AND UNLAWFUL ACTS

Haena v. Martin (2015)

Court of Appeals of California, Third District, Sacramento
January 12, 2015

Defendant Chad Martin, a real estate broker, entered into a series of transactions involving promissory notes with plaintiffs Brian Haena, Karen Haena, Bernard Haena, Sonia Haena, Murray White, and Joanne White.

In the aftermath of fallout from the transactions, plaintiffs filed suit against Martin, alleging various unlawful acts, including violation of Business and Professions Code section 17200, fraud, misrepresentation, and negligence. Following a court trial, the court found for plaintiffs and awarded a variety of damages.

Martin appeals, arguing (1) the trial judge should have recused himself, (2) the court erred in awarding damages, and (3) no violation of section 17200 occurred.

We shall affirm the judgment.

Martin, a licensed real estate broker, became acquainted with Brian Haena in the late 1990's.

Brian referred several potential real estate clients to Martin and in 2002 referred Murray and Joanne White to Martin.

Martin acted as the Whites' agent in their purchase of a home.


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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

Martin in 2005 or 2006 discussed with Brian Haena and his wife Karen the prospect of investing $100,000 in a promissory note secured by a deed of trust on a residence.

The Haenas borrowed $100,000 and invested in the note, which paid a higher interest rate than the financing loan supporting it.

When the principal on the note was paid off, Martin retained the proceeds in his brokerage account for reinvestment in a future project.

The Haenas, with Martin's assistance, invested in a 60-acre development. The investment consisted of a promissory note (the Smith Note) secured by a deed of trust on real property.

The Whites also invested in the Smith Note.

Both couples received interest payments on the note and recouped their investments.

Martin again kept the Haenas' and Whites' principal funds from the Smith Note in his brokerage account.

In 2007 Martin told Brian that Martin was part owner of the "Svensek Note" and that one of the other investors wanted to sell his $25,000 interest in the note.

According to Martin, the Svensek Note arose from a $408,000 loan he made to a man named Svensek.

The loan was to finance the development of 12 townhouses.

Brian stated that his parents, Bernard and Sonia Haena, might be interested.

Martin stated the Svensek Note was secured by a deed of trust on 12 parcels


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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

being developed as townhouses.

Four of the townhouses were almost finished and the note had second priority position.

Bernard and Sonia invested $25,000 by purchasing the third parties' interest in the note.

In June 2007 Martin sent the Haenas and the Whites several e-mails regarding the investment.

In one e-mail Martin stated: "I have quite a few notes secured by real estate in the greater Sacramento area which have been earning me an interest return of 10% or better.

Though I hate to give up the security, I do need to look at this as an opportunity to introduce you all to the availability for great returns out there.

Since our banks pay us about 2% on our money, this should be a `no brainer.'. . .

"I am looking for investors who are willing to invest $10,000 to $75,000. In most cases, you would invest with me, not just through me. This is a way to watch your money build, and know that I'm right there with you on the deal."

In another e-mail, to Murray, Martin explained the project secured by the Svensek Note: "$408,000 2nd position against 6244 Filbert Avenue, Orangevale. We are behind a first of approx. $330K. 12 townhomes to be built, 4 are nearly completed, and the next 4 should be under construction soon. This loan may be rewritten to allow for additional construction expenses, but only once we are placed into first position overall. The first 4 units have been contracted for sale and are expected to close for $385K each. Upon completion of these 4 townhomes, we want to continue our 2 year + venture with Frank Svensek (borrower) to see all homes built and sold. Our return upon each closing will increase as the inventory and value in the

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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

property is lessened. . . .

". . . I will still consider managing each loan, depending on the buy-out arrangements, which will allow for any and all payments to be filtered through my office. Monthly invoices and statements as well as annual tax forms will be handled through my office as well. Any legal complications shall be addressed by us, so you as the investor won[']t have to deal with such items."

Finally, Martin e-mailed Murray that "The townhomes in Orangevale have been solid for me, and could become an even more profitable project very soon. . . . I think the return is solid, and the borrowers have been solid for the past couple of years."

Subsequently, Brian authorized Martin to "roll my $100,000 into the townhome deal that you have at 12%."

Brian also told Martin that Murray wanted to invest. Martin transferred $243,000 to himself—$100,000 from Brian and Karen, and $143,000 from the Whites—in return for interests in the Svensek Note.

Martin also told the Whites, Brian, and Karen that he would be forwarding service agreements to them, under which he would undertake certain obligations regarding the servicing of the loan in return for 2 percent of the payments.

Four months after plaintiffs invested in the Svensek Note, the first lienholder foreclosed on its deed of trust on the complex.

After the foreclosure, plaintiffs discovered Martin no longer had any stake in the Svensek Note, having sold his interest to plaintiffs.

The Svensek Note secured the construction and sale of eight townhomes, not twelve. In 2006 Martin had reconveyed his interest in the four developed townhomes to Svensek, allowing the developer to obtain another construction


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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

loan.

At the time plaintiffs invested in the Svensek Note, the developer was already in arrears on his note securing the senior lien against the property. Although Martin, in an e-mail, stated the first secured lien was for $330,000, the original lien amount was for $265,000. The $330,000 amount included Svensek's default, interest, and penalties. Nor did Martin inform plaintiffs that Svensek was a licensed house painter with no experience in property development.

A notice of default was prepared and signed on January 15, 2008, when Svensek ceased making his payments.

However, Martin did not record the notice until March 20, 2008.

Prior to the recording, the senior lienholder recorded a notice of default and foreclosed on the property.

No one bid at the June 6, 2008, trustee's sale, and the property reverted to the senior lienholder, extinguishing plaintiffs' interests in the Svensek Note.

Plaintiffs filed suit against Martin and Svensek.

The suit alleged causes of action for breach of contract, fraud based on intentional misrepresentation, fraud based on negligent misrepresentation, constructive fraud, fraud based on concealment, breach of fiduciary duty, violations of section 17200, and negligence.

A court trial followed.

The court found in favor of plaintiffs and issued a statement of decision. Concluding the elements of fraudulent misrepresentation were met, the court found that defendant's statements regarding the facts surrounding the Svensek loan "were meticulously constructed to present an enticing but highly inaccurate picture of the status of the loan in which Martin had invested, the

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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

status of the senior loan, and the extent and nature of the security"; that this was done in order to induce plaintiffs to buy out Martin and to assume the role of Svensek's lender

in place of Martin; and that Martin's communications were carefully crafted to present the impression he was selling only part of his investment in the Svensek loan, creating the illusion he was "staying in the deal," when in fact he was "`selling out.'

"The court further found Martin did not inform plaintiffs that he had twice previously extended the deadline for Svensek's balloon payment under the note and misrepresented that the four completed lots were included in the property securing the note. The court found Brian and Karen's and the Whites' reliance on Martin's representations was reasonable. In addition, the court found plaintiffs met their burden of proof on the causes of action for concealment and negligent misrepresentation.

As for the causes of action for breach of fiduciary duty and constructive fraud, the trial court concluded that "as of the dates of the communications accompanying the sale of the Svensek Note, defendant was acting as an agent for [Brian and Karen] and [the] Whites in relation to the Smith Note.

In each instance defendant was holding funds derived from his administration of this loan under the terms of written `Investor Service Agreements' prepared by defendant. Those agreements authorized defendant— in his capacity as a Broker— to act on plaintiffs['] behalf in a variety of ways, including all acts deemed necessary to the collection and servicing of the loans. Defendant advised plaintiffs with respect to these loans and held the funds on plaintiffs' behalf. As to these activities, he plainly acted in an agency, and hence fiduciary, capacity."

The court concluded that, at all times, the parties anticipated that Martin would continue as their agent, interacting with Svensek, and collecting and holding funds on their behalf. This, the court determined, "was an integral


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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

component of the investments" that Martin was soliciting. Martin also took a 2 percent loan servicing fee as compensation for servicing the loan under the "`Independent Servicing Agreement.'"

The court acknowledged that being a licensed real estate agent does not in itself give rise to a fiduciary duty. Rather, "The fundamental question is whether a real estate broker, who is indisputably acting as the agent for a principal in connection with a first transaction, and who then utilizes his knowledge of the real estate market to entice his principal into a further investment as to which the broker will thereafter continue to act as the agent of the principal, is freed of his fiduciary responsibility during that intermediate segment of the transaction that consists of replacing the first investment with one theretofore owned by the broker.

The answer is necessarily `no.'" Given the facts surrounding the Svensek Note, the law imposed upon Martin all of the obligations of a fiduciary to the Whites and to Brian and Karen. However, this fiduciary relationship did not exist between Martin and Bernard and Sonia.

As for the cause of action for negligence, trial testimony established that Martin's affirmative representations and knowing omissions fell below the standard of care and were a cause in fact and proximate cause of plaintiffs' losses.

Finally, given the court's findings on plaintiffs' causes of action for fraudulent misrepresentation and concealment, plaintiffs had established a violation of section 17200.

The court rejected Martin's claim that any fraudulent conduct was "`personal'" and not a "`business'" practice.

The court again referenced the "Investor Service Agreements" prepared by Martin, which authorized him to act on plaintiffs' behalf in the collection and servicing of the loans.

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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

The court noted: "The investment in the Svensek Note was the next step in defendant[']s business, which as he openly acknowledged, involved placing clients in `secure, positive cash flow investments.'. . .

Many of the communications included defendant's business in the signatory block, indeed the individuals who received the solicitations did so because they were included in the `Chad's Business' email folder.

The evidence thus established that the events adjudicated here were part of defendant's ongoing business activities."

The court awarded Brian and Karen and the Whites benefit-of-the-bargain damages for their intentional misrepresentation, concealment, and constructive fraud claims.

Brian and Karen were entitled to recover $106,000 and the Whites $151,580. Bernard and Sonia were entitled to recover only their "out-of-pocket," or actual, expenses.

Brian and Karen and the Whites were also entitled to recover their principal investment amounts under the "out-of-pocket" damages standard for their negligent misrepresentation and negligence claims.

Brian and Karen and the Whites were entitled to recover their principal investment as restitution damages for the violation of section 17200.

Since the damage awards were duplicative, the total amount of damages that each respondent may collect is "$106,000 for [Brian and Karen], $151,580 for the Whites and $25,000 for Bernard and Sonia Haena."

Following entry of judgment, Martin filed a notice of appeal.

DISCUSSION

1. Judicial Recusal

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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

Martin contends the trial court judge, Judge Kevin R. Culhane, should have recused himself. According to Martin, Judge Culhane did not accurately describe his involvement in a prior case against Martin's father.

When the facts are undisputed, we review a trial court's decision not to recuse himself or herself to determine whether a reasonable member of the public at large would fairly entertain doubts concerning the judge's impartiality so as to require disqualification. This presents a question of law for our independent review.

Martin claims that after hearing testimony which revealed the identity of Martin's father, Tom Martin,

Judge Culhane disclosed that a firm he was formerly associated with had been involved in a lawsuit with the elder Martin. Judge Culhane stated he did not try the case, did not take any depositions, and did not know Tom Martin's status in the case.

Martin argues Judge Culhane was not entirely forthcoming about his involvement in the case, since Judge Culhane "authored and signed the Complaint against Martin's father." Plaintiffs concede that Judge Culhane signed the 2007 complaint.

We cannot find that Judge Culhane's signing of a complaint involving Martin's father years before the current litigation would cause a reasonable person to entertain doubts about the judge's impartiality.

During the trial, Judge Culhane described his involvement in the previous case as minimal. Nothing in Martin's argument leads us to question Judge Culhane's version of events or find he erred in not recusing himself. The previous case involved Martin's father, not Martin. Nor does Martin point to any instances during trial illustrative of Judge Culhane's alleged bias based on the preceding case.


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REAL ESTATE BROKER AND UNLAWFUL ACTS (*continued*)

Haena v. Martin (2015)

Plaintiffs filed a motion for sanctions on appeal, asserting that the recusal claim is totally frivolous. While the contention is without merit, we decline to find that it is totally frivolous. Accordingly, the motion is denied.

2. Measure of Damages for Fraud, Negligence, and Negligent Misrepresentation

Martin challenges the trial court's award of damages. He contends the court's award of benefit-of-the-bargain damages to the fraud claims was error, arguing no agency relationship existed between him and Brian, Karen, and the Whites when they invested in the Svensek Note. He also argues the court erred in awarding Bernard and Sonia the amount of their investment without proof of the market value of the Svensek Note.

A. Benefit-of-the-Bargain Damages to Brian, Karen, and the Whites

The trial court found Martin acted as Brian, Karen, and the Whites' agent in securing their funding for the Svensek Note. Therefore, Martin owed them a fiduciary duty. Accordingly, the two couples could recover benefit-of-the-bargain damages on the causes of action for breach of fiduciary duty and constructive fraud. Constructive fraud requires proof that the defendant engaged in a breach of duty by which he, without fraudulent intent, gained an advantage over a person by misleading another to his or her prejudice. Constructive fraud requires the demonstration of a fiduciary or confidential relationship.

The trial court found Martin was not in a fiduciary relationship with Bernard and Sonia, so benefit-of-the-bargain damages could not be awarded.

Instead, the court awarded the couple their out-of-pocket damages in the amount of $25,000, their investment in the Svensek Note.

DISPOSITION

The judgment is affirmed. Plaintiffs shall recover costs on appeal.
NICHOLSON, J. and ROBIE, J., concurs.

This is an overview of the lending process that is important to real estate transactions. Remember, loans drive deals and lenders drive loans. That is why it is imperative for an agent to refer their clients to a very professional loan officer.

This concludes our thirty (30) hour Real Estate Update course in Consumer Protection.

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