

# KEEP ME CERTIFIED

## REAL ESTATE SALESPERSON EXAM PREP COURSE MATERIAL

# DRAFT

Massachusetts Real Estate License Course Material

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# **Chapter 1 Introduction to Real Estate**

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Welcome to the world of real estate. You are embarking on a journey that will open the doors to a nearly endless variety of professions and real estate fields. Holding a real estate license is so much more than helping sellers sell, and buyers buy. Real estate agents are the first line of defense in the battle against real estate fraud, market bubbles, class discrimination, and unscrupulous entrepreneurs. Real estate agents serve and protect their clients. It is a position of honor, but one of great responsibility.

## **Section 1. The Real Estate Industry Network**

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Real estate agents are independent contractors, but that does not mean that they work independently. The real estate industry is much broader than merely an agent bringing a buyer to a seller and then showing them where to sign. The real estate field has numerous players that interact in nearly every transaction. Closing a real estate deal will involve the participation of many different specialized services.

- **Real Estate Brokerages** support individual agents who are licensed to buy, sell, exchange or, lease real property for others.
- **Real Estate Appraisers** are the neutral third party that determines a property's market value. They help to ensure the sales price is not inflated beyond what the market can bear.
- **Property Managers** are hired by property owners who desire less day-to-day management of their income properties. They protect an owner's investment through property maintenance and generating the highest possible income stream through leasing.
- **Lenders** supply the mortgage funds to make the volume of real estate transactions possible. Their lending requirements help to protect the market from unnecessary foreclosure.
- **Professional Home Inspectors** conduct an in-depth visual survey of the site and all improvements. Their observations and conclusions help to reduce investment risk and identify health or safety hazards. If needed, other more specialized inspectors can assist, including environmental inspectors, licensed contractors, electricians, or pest inspectors.

## **Section 2. Real Estate Areas of Specialty**

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Trade organizations have provided immeasurable assistance to the real estate industry. Through training, they offer professional designations to brokers, sales associates, appraisers, home inspectors, and others. They have also worked to establish a Code of Ethics and standards of professional behavior.

The association that has had the most significant impact on the activities of real estate agents is the **National Association of REALTORS® (NAR)**. NAR is a national organization of real estate agents that was created to promote the real estate profession and foster professional behavior in its members. An agent that becomes a member of the local association of REALTORS® automatically becomes a member of the National Association of REALTORS®. Membership is often automatic when joining a local multiple listing service. Members of NAR carry the designation of REALTORS® or REALTOR-ASSOCIATES®. Their website [www.realtor.org](http://www.realtor.org) offers assistance to members and the public.

Affiliation with NAR allows a licensee to earn additional license designations in an area of specialty.

Before a licensee can consider areas of specialty, they must first get their sales

### **NATIONAL ASSOCIATION OF REALTORS® DESIGNATIONS**

<b>Designation</b>	<b>Sponsoring Organization</b>	<b>Website</b>
CRE Counselor of Real Estate	The Counselors of Real Estate	<a href="http://www.cre.org">www.cre.org</a>
CCIM Certified Commercial Investment Member	CCIM Institute	<a href="http://www.ccim.com">www.ccim.com</a>
ABR Accredited Buyer's Representative	Real Estate Buyer's Agent Council	<a href="http://www.rebac.net">www.rebac.net</a>
ALC Accredited Land Consultant	REALTORS® Land Institute	<a href="http://www.rliland.com">www.rliland.com</a>
CIPS Certified International Property Specialist	National Association of REALTORS®	<a href="http://www.realtor.org">www.realtor.org</a>
CPM Certified Property Manager	Institute of Real Estate Management	<a href="http://www.irem.org">www.irem.org</a>
CRB Certified Real Estate Brokerage Manager	Real Estate Business Institute	<a href="http://www.crb.com">www.crb.com</a>
SRS Seller Representative Specialist	Real Estate Business Institute	<a href="http://www.crb.com">www.crb.com</a>
CRS Certified Residential Specialist	Residential Real Estate Council	<a href="http://www.crs.com">www.crs.com</a>
GRI Graduate, REALTOR® Institute	National Association of REALTORS®	<a href="http://www.realtor.org">www.realtor.org</a>
SRES Seniors Real Estate Specialist	SRES® Council	<a href="http://www.sres.realtor">www.sres.realtor</a>

associate license. This course is designed to teach you everything you need to know to pass the real estate licensing exam – and more.

Pay particular attention to **words in bold**. These are essential vocabulary words that you will need to know and understand in order to pass the exam. The **CONFUSING WORD PAIRS** boxes will help you to learn the difference between confusing vocabulary words. Watch out for **WARNING!** boxes. These will remind you of specific events that could result in disciplinary action. There are also **MEMORY HELPER** boxes throughout the text. Pay particular attention to these. They will help you to remember key points that are going to show up on the state exam.

# **Chapter 2 Real Estate License Laws**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the three levels of real estate licensing,
- the requirements to become licensed,
- the steps necessary to obtain a real estate license, and
- the laws governing real estate practice.

**OVERVIEW:** This chapter is going to introduce real estate as a profession. We will discuss the laws governing real estate licensure and the requirements to obtain a license.

## **Section 1. History and Purpose of License Laws**

---

Archeologists have unearthed sheets of papyrus that resembled present-day deeds or property transaction bills of sales. Trading land for compensation is nearly as old as man himself. There have always been buyers and sellers. The problem is that both are looking to satisfy their personal interests – and often at any cost.

The Romans called it *caveat emptor*, a Latin expression meaning “let the buyer beware.” This expression was a warning to the buyer that he was on his own, and the seller cannot be trusted to disclose the true condition of the property. Over the years, the public has seen the need to create the position of a real estate salesperson to provide individual representation for buyers and sellers.

### **Purpose of Licensure Laws**

The government stepped in to protect the consumer by requiring real estate salespersons to be trained, licensed, and held to high ethical standards. This helped to protect buyers and sellers from unethical and dishonest agents. They have also required sellers to complete mandatory disclosure forms along with regulating lending practices.

The regulation and licensing of real estate agents occur at the state level. Each state has created a commission, department, division, board, or agency under the executive branch of the Governor. Regulatory agencies have the authority to issue licenses and enforce statutory real estate laws. In addition to state laws, there are a couple of dozen federal legislatorial acts that affect the residential real estate market. The Dodd-Frank Act and the Fair Housing Act are two very familiar ones.

To become a licensed real estate salesperson, an applicant will have to pass both the federal and the state portion of the licensing exam. The state section will require applicants

to know the details about their state regulatory agencies, including the individual levels of authority and their licensing requirements.

### What a Real Estate License Allows

There are limitations to a real estate license – even a broker’s license. A licensed real estate agent must not step outside their area of expertise. While they may have experience in legal matters, agents are not attorneys and should *never* give legal advice. While licensees may value real estate, they may not complete a real estate appraisal. Stepping outside licensure boundaries can result in state disciplinary action, lawsuits, and a whole heap of professional trouble.

### What Your Real Estate License Allows

<i>You Can Be a...</i>	<i>You Are Not a...</i>
✓ Real Estate Agent	X Real Estate Appraiser
✓ Property Manager	X Property Assessor
✓ Property Developer	X Home Inspector
✓ Real Estate Investor	X Environmental Assessor
✓ Real Estate Advisor	X Mortgage Broker
	X Lawyer
	X Lender

## Section 2. Real Estate License Categories

There are three levels of licensure: sales associate, broker associate and broker.

### Sales Associate

A **sales associate** is also known as a sales agent or real estate salesperson. They hold a real estate license and values, auctions, sells, exchanges, buys, or rents real estate for compensation under the supervision of a licensed real estate broker. *All sales associates must work under the direction of a state licensed broker.* Sales associates are not limited to individuals; they can include limited liability companies and corporations. Within a brokerage firm, however, a sales associate cannot be registered as a member, manager, officer, general partner, or director of a brokerage firm. To do so, they must first obtain a broker’s license.

## Broker Associate

A **broker associate**, or associate broker, is qualified to be licensed as a broker but operates as a sales associate in the employ of another broker. Broker associates are not limited to individuals; they can include limited liability companies and corporations. Because a broker associate works under a broker, like a sales associate, they cannot be registered as a member, manager, officer, general partner, or director of a brokerage firm.



### CONFUSING WORD PAIRS

**BROKER:** a real estate agent who holds a state-issued real estate broker's license.

**REALTOR:** a licensed real estate professional who is a member of the National Association of Realtors

*The public often uses the terms broker and realtor interchangeably, but there's a significant difference.*

## Broker

A real estate **broker** values, auctions, sells, exchanges, buys, or rents real estate for compensation and has met the state-required qualifications to be licensed as a broker. A broker can be an individual, partnership, limited liability partnership, limited liability company, or corporation. A broker can also be a member, manager, officer, general partner, or director of a brokerage firm. All brokerage firms must also be licensed as a broker and have at least one individual with a broker's license. A broker can work independently and also manage other sales or broker associates. If a broker supervises a sales or broker associate, they are then known as a **managing broker** or supervising broker.

### Real Estate License Categories

	Sales Associate	Broker Associate	Broker
State license required	✓	✓	✓
Must be supervised by a broker	✓	✓	
Can work independently			✓
Values, auctions, exchanges real estate	✓	✓	✓
Sells, buys, or rents real estate	✓	✓	✓
Licensing includes LLC and corporations	✓	✓	✓
Licensing includes limited liability partnerships			✓
Can be registered as a member, manager, officer, general partner, or director of a brokerage firm.			✓

## **Section 3. Licensure Requirements**

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All applicants that desire to become a licensed real estate sales associate must meet the following requirements before taking the state licensing exam.

- **Age:** All licensees must be at least 18 years old.
- **Nationality:** Applicants do *not* have to be a United States citizen, but they must have a U.S. Social Security number.
- **Education:** The minimum education requirement is having a high school diploma or a GED equivalent.
- **Experience:** No prior experience is necessary to apply for a sales associate license. Any sales associates that would like to advance to a broker's license must have at least 36 months of real estate experience within the most recent five year period. They must have been licensed as a sales associate and worked under the supervision of a three out of the past five years.
- **Character:** The applicant must be honest, truthful, trustworthy, of good character, and be known for dealing fairly with others.
- **Competence:** The applicant must be competent and qualified to manage real estate transactions and conduct negotiations while maintaining a relationship of trust and confidence.

## **Section 4. The Pre-Licensure Process**

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If an applicant meets the licensure requirements, they will need to complete the following steps in order to obtain their sales associate license.

- **Pre-Licensure Education:** You must complete the state-approved pre-licensure course and pass the final exam.

*(Note: Some states waive the education requirement if the applicant is licensed with the state bar association. The state can also waive education if the applicant has taken equivalent real estate related college courses or they hold a four-year degree in real estate.)*

Licensed sales associates that wish to work in another state may be able to apply their prior state licensure education and experience towards obtaining an equivalent license in the new state. This is called **mutual recognition**. They will, however, have to pass the state exam.

- **State Application:** After you have passed the pre-licensure final exam, you will need to apply to the state to obtain a real estate sales associate license. Most applications are accepted as long as the applicant has met the pre-licensure requirements. There are, however, some reasons why the state could deny a license:

- **Absenteeism:** The applicant was absent for more than 10 percent of the pre-licensure class.

- **Prior License Denied, Revoked or Suspended:** If in the past, a license in real estate or a related profession was denied or a license was revoked or suspended, the applicant can be denied licensure until they meet the state requirements.
- **Guilty of Wrong Conduct:** A license may be denied if the applicant was found guilty of wrongful conduct.
- **Practicing Without a License:** Within the past year, the applicant illegally worked in the real estate profession without a license.
- **Under Investigation:** An application will be denied if an applicant is under investigation in any state or a foreign country. They can re-apply after the investigation is complete, and the applicant has responded to any disciplinary actions or restrictions.
- **State Examination:** After the state application is approved, you will need to pass the state licensing exam. If you did well on your pre-licensure final exam, then you will do well on the state exam. If you fail, you can retake the exam.
- **Activate the License:** After you have passed the state exam, you will need to activate your license. Activation is usually processed online. Similar to a new credit card, your license is not valid until it has been activated.
- **Continuing Education:** All states require their licensees to complete continuing education. Some states require annual continuing education, and others will only require a certain number of classroom hours per renewal period. For example, Massachusetts requires 12 hours of continuing ed every two years to maintain an active broker or salesperson real estate license. MA Attorneys in good standing are exempt from the continuing ed requirement and this attorney exemption is common across many states.
- **Renewal Fees:** Licensees are required to pay a renewal fee for each new licensure period.
- **Maintaining Active Status:** A real estate sales associate license must maintain an active status. Some conditions could cause a license to become inactive, and that will prevent an agent from engaging in any licensed real estate activities.
  - **Involuntarily Inactive License:** Failure to renew a license at the end of each license period will deactivate the license. If too much time passes before license renewal, an agent can lose their license and will then have to go through the whole pre-licensure process again.
  - **Voluntarily Inactive License:** Failure to be affiliated with a broker will deactivate the license. A sales associate *cannot perform a real estate transaction unless they are working under the guidance of a licensed real estate broker*. If a sales associate is not working with a broker, they must register this fact with the state. They are required to take continuing education and pay renewal fees in order to keep their license.



### WARNING!

Many real estate wholesalers are unlicensed. They skirt licensure by saying they're selling a contract and not actual real estate.

Many states are now actively prosecuting unlicensed wholesalers for practicing real estate without a license.

Once you have met all of these steps, you will then be considered a real estate sales associate with all the benefits and responsibilities. A real estate licensee is someone that has satisfied the requirements of a state real estate board and received a state-issued license.

## **Section 5.      Becoming a Broker**

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While you can legally practice real estate with only a sales associate license, there are several benefits to advancing your license to the level of a broker. You will need more experience and considerably more education, but most will agree that the benefits outweigh the additional requirements. Consider the following:

- **Freedom:** Once you have a broker's license, you will no longer need to work under the supervision of a broker. You have the freedom to start your own real estate business and keep all of the commission.
- **Reputation:** Brokers have a better reputation in the public's eyes than a sales associate. Brokers can take on larger clients and commercial listings.
- **Sponsoring:** Being a broker gives you the option of managing a real estate business. You can bring on your own sales associates and earn a portion of their commission.

## **Section 6.      Laws Covering Licenses**

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Each state has a real estate division that is responsible for licensing real estate agents, regulating the real estate profession, and administering disciplinary actions. The state can create and enforce laws that govern the activity of real estate licensees. Many of these laws are very similar in content and context.

### **All Licensees**

- It is a license violation to:
  - to exercise influence on a client for financial gain that benefits the licensee or a third party;
  - fail to report to the state, in writing, that a licensee has been convicted or found guilty of a crime in any jurisdiction;
  - render an opinion on the title of a property without first consulting a licensed attorney; or
  - fail to immediately place in escrow any monies that have been entrusted to the agent while practicing real estate.
- It is illegal to:
  - work as a sales associate or broker without a valid and active license;
  - obtain or renew a license by bribery or misrepresentation;

- share or pay a commission to an unlicensed person for any services that would require a real estate license, including the referral of real estate businesses, clients, prospects, and customers;
- practice real estate beyond what the license level permits; or
- become involved in a real estate transaction if the licensee knows they are not competent or qualified to perform it; or
- practice real estate in a way that is fraudulent, deceptive, untrue, or misleading.

### Sales Associates

- It is illegal to:
  - work as a broker if they only have a sales associate license, or
  - collect money from a real estate transaction unless it is in the name of the broker or licensed business.

### Brokers

- It is illegal to:
  - employ an unlicensed sales associate;
  - operate an unregistered or unlicensed real estate brokerage.

The state licensing authority has the right to issue disciplinary action if a licensee is found guilty of any of the actions mentioned above. They can deny the renewal of a license; place a license on probation; suspend the license for up to ten years; revoke the license, and impose a considerable fine on the licensee.

## **Section 7. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What does *caveat emptor* mean?
  - A forewarning to leaders.
  - Let the buyer beware.
  - Let the seller be cautious
  - Let the agent work hard.
2. What are the duties of the state's real estate department?
  - To license real estate agents.
  - To regulate the profession.
  - To administer disciplinary actions.
  - All of the above.
3. What are the three levels of real estate licensing?
  - Sales Associate, Broker, Broker Associate
  - Sales Broker, Broker Associate, Sales Agent
  - Sales Associate, Associate Agent, Broker

- d. Broker Agent, Sales Agent, Broker
4. True or false. All real estate applicants must be United States citizens?
- a. True
  - b. False
5. A license must be at least \_\_\_\_\_ years old.
- a. 17
  - b. 18
  - c. 21
  - d. 25
6. An agreement between two states that provides for the recognition of each other's real estate license education is called \_\_\_\_\_.
- a. license sharing
  - b. mutual respect
  - c. mutual recognition
  - d. licensing recognition
7. An Involuntary Inactive License classification occurs if...
- a. A licensee does not renew their license at the end of the license period.
  - b. A licensee has not closed on a sale within the past 12 months.
  - c. The agent's broker has fired the licensed salesperson.
  - d. The licensee is unemployed.
8. A voluntarily inactive license classification occurs if...
- a. A licensee does not renew their license at the end of the license period.
  - b. The licensee has not completed their continuing education at the end of the license period.
  - c. The licensee is not affiliated with a broker, developer or real estate company.
  - d. None of the above.
9. True or false. It is legal to work as a real estate agent under a real estate broker if you are not licensed.
- a. True
  - b. False
10. True or false. It is illegal to share a commission or pay compensation to an unlicensed person for any services that would require that person to have a real estate license.
- a. True
  - b. False

## Quiz Answers

1. What does *caveat emptor* mean?
  - b. Let the buyer beware. – This is a Latin-based principle in commerce that means without a warranty the buyer takes the risk.
2. What are the duties of the state's real estate department?
  - d. All of the above. – The duties of the state's real estate department include licensing, regulating and administering disciplinary action.
3. What are the three levels of real estate licensing?
  - a. Sales Associate, Broker, Broker Associate – A sales associate can also be called a sales agent.
4. True or false. All real estate applicants must be United States citizens?
  - b. False – An applicant must have a social security number but does not have to be a U.S. citizen.
5. A license must be at least \_\_\_\_\_ years old.
  - b. 18
6. An agreement between two states that provides for the recognition of each other's real estate license education is called \_\_\_\_\_.
  - c. mutual recognition
7. An Involuntary Inactive License classification occurs if...
  - a. A licensee does not renew her license at the end of the license period.
8. A voluntarily inactive license classification occurs if...
  - c. The licensee is not affiliated with a broker, developer or real estate company.
9. True or false. It is legal to work under a real estate broker if you are not licensed.
  - b. False
10. True or false. It is illegal to share a commission or pay compensation to an unlicensed person for any services that would require that person to have a real estate license.
  - a. True

# **Chapter 3 Real Estate Business Operations**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- how a brokerage is structured,
- how to calculate commissions and fees;
- what is the MLS; and
- how to reduce business liability.

**OVERVIEW:** The objective of this chapter is to learn how a real estate brokerage is structured. You will learn brokerage procedures, hiring guidelines, recordkeeping requirements, and legal entity choices. We will also discuss the importance of employment contracts and how to split sales commissions.

## **Section 1. The Structure of a Brokerage**

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A real estate business is known as a **brokerage**. Every brokerage must register as a broker. They must have a licensed managing broker that is responsible for the activities within the brokerage. A brokerage can have more than one broker and many sales associates. A brokerage can have more than one branch office, and most states will require that each have a managing broker.

A brokerage can be owned privately or be part of a franchise. RE/MAX, Coldwell Banker, Keller Williams, Century 21, Sotheby's International Realty, and Realty ONE Group are examples of real estate **franchises**. Franchises are purchased upfront, and fees are charged based on a percentage of the revenue. The benefits of a franchise are brand recognition, business structure, training, and ongoing support.

### **Legal Structures for Brokerages**

A brokerage must have a legal structure to function as a business. Four legal structures can function as a brokerage:

- **Sole Proprietorship:** This is the simplest business structure. All the assets and liabilities of the business are also the assets and liabilities of the single business owner. All profits and losses pass to the business owner.
- **Partnership:** When there is more than one business owner, the owners can create a partnership. A general partnership holds each general partner personally liable for all debts and obligations. A limited partnership places the liability on only the partners who actively participate in the business. All profits and losses are passed to the individual partners.
- **Corporation:** A corporation creates a barrier between business and personal assets and liabilities. There are two types of corporations: C corporations (C-corp) and S corporations (S-corp). A C-corp pays taxes on business income, and shareholders pay taxes on the distributed profits. An S-corp is a "small" corporation where both

the profits and losses pass through to the shareholders. Real estate brokerages prefer to use an S-corp rather than a C-corp to avoid double taxation.

- **Limited Liability Company (LLC):** An LLC is more straightforward than a corporation, and it offers more asset protection and tax benefits than a sole proprietorship. They are easy to form and manage. LLCs are a popular brokerage option.

## Broker and Licensee Responsibilities

Within a brokerage, there will be a managing broker that supervises sales and broker associates. A managing broker establishes their team's duties and responsibilities. They are responsible for the real estate-related actions of their sales associates. All sales associates function as agents of their employing broker, and they receive compensation *only* from their broker. Sales associates cannot create contracts or receive compensation directly from buyers, sellers, or other agents. Everything must go through their broker.

### Real Estate Assistants

A brokerage may also have various real estate assistants that help with business operations. An assistant may manage the office or work for a specific agent. If the assistant is unlicensed, all in the office must be careful never to ask the assistant to do any duties that would require a license. An unlicensed assistant can handle clerical tasks, office management, and marketing, but they should not deal directly with the public.

#### **UNLICENSED ASSISTANTS CAN:**

- Give out electronic links or printed information about a property;
- Confirm information in an advertisement;
- Answer the phone, take messages, and schedule appointments;
- Upload information into the MLS;
- Prepare marketing information with the broker's approval;
- Gather information including recorded documents;
- Perform secretarial duties;
- Provide bookkeeping services;

#### **UNLICENSED ASSISTANTS CANNOT:**

- Represent themselves as a real estate agent;
- Host an open house;
- Conduct a showing;
- Draft contracts or agreements;
- Explain or interpret any listing information, leases, or other contracts;
- Negotiate contracts;
- Offer advice to clients;
- Fail to state they are working on behalf of a licensed broker;
- Be compensated based on sales volume

A sales associate can pay unlicensed assistants. Licensed assistants, however, must be paid by the managing broker regardless of their employer. If you hire an unlicensed assistant, you and your managing broker are liable for their actions. If they practice real estate without a license, even with

good motives, you, your broker, and your assistant can be held liable under state licensing law. Make sure your assistant knows where the license boundaries are and why they should never cross them.

### Real Estate Teams

Many brokerages set up real estate teams to handle different parts of each transaction. A team can include licensed agents and unlicensed assistants. Members of the team are assigned specific tasks. One might handle all the showings; another may work on marketing; another focuses on closings. Being a member of a team is an excellent environment for mentorship. It allows newer agents to master individual areas of the real estate profession and profit from higher sales volume. In most cases, team members split the commissions earned based on agent qualifications, experience, and participation.

## Section 2. Compensation and Commissions

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Getting paid as a licensed agent is very different from most professional jobs. Income is earned from commissions and not from hourly wages or salaries. Agents must be financially prepared to cope with an irregular income stream.

### Employment Contracts

According to real estate licensing laws and IRS guidelines, all sales associates are required to have a written employment agreement with their managing broker. It needs to define both the financial relationship for tax purposes and the working relationship.

**Financial Relationship.** The managing broker will decide if the sales associate is going to be an employee or an independent contractor. An employee is usually required to work a certain number of hours each week and must adhere to office routines and other requirements. The employer is required to withhold Social Security, unemployment, and income taxes. An employee may also receive benefits such as health insurance, worker's compensation, and profit-sharing plans.

Sales associates are usually classified as **independent contractors**. In this case, the employer does not exercise the same degree of control over the agent. The employer *is not* responsible for withholding any taxes, and there are no employee benefits. The sales associate is responsible for all income taxes. They receive payment based on services rendered or earned commissions rather than by an hourly wage.

The employment contract must clearly state the financial relationship for Internal Revenue Service (IRS) reporting. The IRS considers a *qualified real estate agent* to be a non-employee if they meet these three requirements:

1. The individual has a current real estate license.
2. The written employment contract states that the individual will not be treated as an employee for federal tax purposes.
3. A substantial portion of the real estate professional's income is based on sales production or other output and not on the number of hours worked.

**Working Relationship.** Regardless of the financial relationship, state licensing laws hold the managing broker liable for the actions of the sales associate - just as an employer is responsible for the actions of all their employees. The managing broker has the authority to specify the participation and activities of the sales associate.

## Earning Commissions

Compensation is usually in the form of a **commission** or broker's fee. The commission is based on a percentage of the sales price. Compensation can also be paid as a flat fee or on an hourly rate – though this is less common. Commission rates are negotiable, and it is a violation of state and federal laws to impose a uniform commission rate among all brokers in an area.

Federal law requires the payment of a real estate commission to meet the following three criteria: (1) the agent must be a licensed real estate *broker*; (2) the agent was employed by the buyer or seller under a valid contract; and (3) there is a procuring cause of sale. **Procuring cause** means that the agent started an uninterrupted chain of events that resulted in a sale. As a listing agent, she negotiated the listing contract, conducted the open house, marketed the listing, and then negotiated with a buyer for the purchase. This chain of events fulfills the contract with the seller and qualifies her for compensation.

Each brokerage must create a commission policy. Some firms pay their sales associate 100% of the commission earned, and then require the associate to pay a monthly service charge that covers the office space, equipment, and support services. Other brokerages pay their sales associates graduated commission splits. In the beginning, the broker might split the commissions 50/50. As the associate gains experience, the split can increase in favor of the sales associate. Some top producers can reach an 80/20 or even a 90/10 split. Some firms base their splits on the total annual earnings. As the sales associate earns more commissions, their share increases. Remember that regardless of how the commissions are paid, the broker is always responsible and liable for the actions of the sales associate.

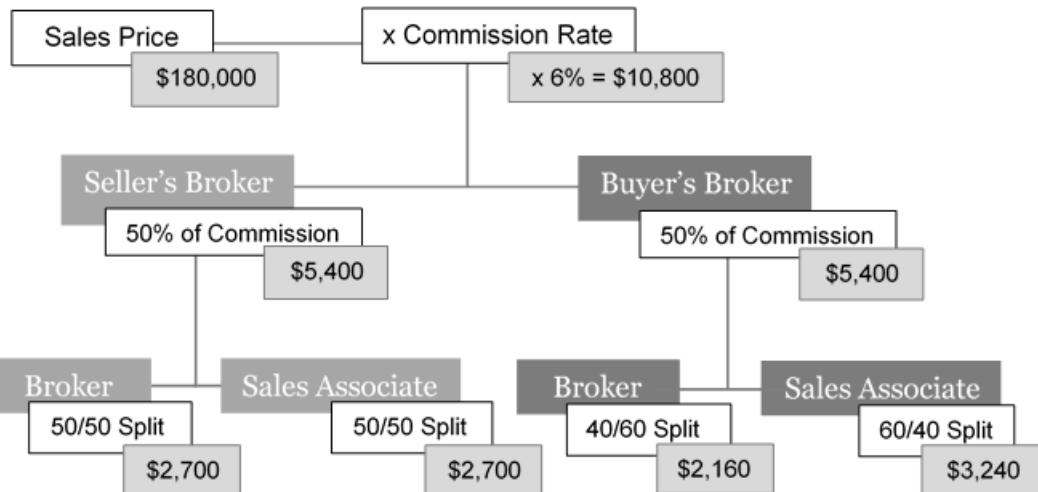
Even before the broker pays the sales associate, the listing broker will split the commission with the buyer's agent. In most cases, the buyer does not pay their agent. They receive a portion of the listing broker's commission. Splitting the commission encourages other agents to cooperate in locating

a buyer and quickly closing the deal. Just remember, the managing broker collects the commission, and then they pay the sales associate.

**PRACTICAL APPLICATION:** An agent and their managing broker list a home, and the seller agrees to pay an eight percent commission. A broker from another brokerage submits a purchase offer that is accepted by the seller. In exchange for finding a buyer, the managing broker will split the commission between all agents who participated in the transaction. The buyer's broker receives four percent, and the sales associate and their broker split the remaining four percent according to the terms in their employment agreement.

## MATH

The percent of the commission is established in the listing contract with the seller. It is paid by the seller to their broker at closing. The seller's broker then splits the commission with the buyer's broker. Each broker then splits their share of the commission with any participating sales associates.



## Finder's Fees

Pete, a local wholesaler or bird dog, calls to pass along a great lead. He gives the agent the name and number of a potential seller. The agent follows up on the interest and ends up getting a listing out of it. When the house sells, Pete expects to get paid a finder's fee. A **finder's fee**, referral, or bird dog fee is an amount paid to an individual who makes a deal possible by bringing together two parties in a transaction. Can the agent legally pay a finder's fee?

It depends. It depends on state law. Most states will only allow brokers to pay fees to other licensed real estate agents. If Pete is unlicensed and advertises that he sells contracts, not real estate, he cannot legally receive a finder's fee. Some states, however, have a workaround. As long as Pete did not do any work that requires a license, then he may share in the commission. If, however, he is

soliciting clients as a “real estate professional,” then he is practicing real estate without a license, and that cancels his right to a finder’s fee.

On the other hand, it is not illegal to offer the seller a partial refund of the commission if they agree to accept a lower offer. Because the seller is not doing any work that would require a license, the refund is legal.

Even though the state may allow finder fees, the federal **Real Estate Settlement Procedures Act (RESPA)** states that if a *mortgaged* property has less than four units, then it is illegal to pay any referral fees in connection with settlement services. Section 8(c), however, contains an exception allowing the payment of cooperative fees, including referral fees, between real estate licensees.

Agents need to know both the federal and state laws before sharing their commission. What is more, federal law trumps state laws every time, and a managing broker can set even stricter company policies.



### CHECK THIS OUT

The Real Estate Settlement Procedures Act of 1974 (RESPA) governs the real estate mortgage settlement process for one-to-four family residential properties.

The Act helps borrowers shop for mortgages. It also eliminates kickbacks and referral fees between real estate brokers and all settlement service providers including title companies, attorneys, surveyors, property inspectors, home warranty companies, or services rendered by a real estate professional.

## Section 3. Reducing Business Liability

Real estate is a service-oriented business. Whenever someone works with the public, they must take pro-active measures to reduce liability. Each brokerage needs to create policies and procedures to protect their agents and their clients.

### Trust Accounts

Real estate law requires that there is a separation between brokerage and client funds. This is accomplished by creating a trust account (also called an escrow account). A trust account *only* holds client funds. Money held in a trust account is not available for personal or brokerage use. Also, no client funds can be ever placed into the general brokerage account.

Trust accounts offer clients added security than a standard savings account. The Federal Deposit Insurance Corporation (FDIC) insures each beneficiary in a trust account up to \$250,000. A regular savings account held in an FDIC-insured bank is insured up to \$250,000 per account.

### Protect Confidential Information

Protecting personal and financial information is a company priority. An agent can do much in this regard. Never leave a client unattended in the office. While they may look innocent enough, the temptation to make off with private information may be too high. Also, take measures to protect

computer data, including regular off-site backups, keeping it locked when not in use, and encrypting all conversations and messages sent over the internet.

## **Errors and Omissions (E&O) Insurance**

Agents make mistakes. It happens to the best of us. One of those days it is going to be a big mistake that is going to affect others, and even cost them money. When that happens, an agent may get sued by the injured party. This is where errors and omission insurance (E&O) comes to the rescue. Some states require all agents to carry E&O insurance. At times, brokerages will offer policy coverage to their agents by carrying an umbrella policy that covers the whole agency.

E&O insurance is liability insurance that defends individuals against claims of negligence, omission, or inadequacy. They will cover any judgments or settlement amounts up to the policy limits. An E&O policy is similar to physician malpractice insurance. The policy will not cover dishonest or criminal actions, fraud, violations of civil rights and antitrust laws, claims concerning contaminated property, or property damage.

## **Record Management**

One of the best defenses is having a solid paper trail for each transaction. Maintaining accurate records is often part of local state statutes for businesses in general. The number of years an agent should preserve their transactional records changes from state to state. In Massachusetts the minimum is three years in Massachusetts. The number of years changes depending on the state where a licensee operates, but it is most commonly 3 years. If there was any civil action, then add two more years from the settlement of the case, including any appeals. The clock starts from the date when either a broker is engaged under a written agreement, or the broker receives some transactional funds.

**PRACTICAL APPLICATION:** *A broker entered into a buyer's agency agreement one year ago. The seller accepted an offer, but the transaction never closed due to unresolved issues. The seller sued both brokers for breach of contract. The judge found no evidence of agent negligence and dismissed the case. Because the two additional years for a civil action suit fall within the original five, the broker needs to store the records for only a total of five years.*

What should be kept in the transaction file? Keep everything that would be needed to prove innocence and due diligence. The transaction file should include all contracts, addendums, opinions of value, inspection notes, communication logs, and bookkeeping records.

To save storage space, consider using digital scanning equipment. There are now free apps that can digitize a paper trail in the snap of a button. You will thank yourself if you ever are called to testify about your actions.

## **Section 4. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What form of business ownership provides brokerages the most protection and tax benefits?
  - a. Sole Proprietorship
  - b. Partnership
  - c. Corporation
  - d. Limited-Liability Company (LLC)
  
2. What is an added benefit of using a trust account?
  - a. The FDIC insures each beneficiary up to \$250,000.
  - b. Funds are not available for personal use.
  - c. It forms a separation between business expenses and client monies.
  - d. All of the above.
  
3. True or false. Most states allow finder fees to be paid to unlicensed wholesalers.
  - a. True
  - b. False
  
4. True or false. Most states allow finder fees to be paid to other licensed agents.
  - a. True
  - b. False
  
5. True or false. Federal laws on paying finder fees are subordinate to state laws.
  - a. True
  - b. False
  
6. How does the Real Estate Settlement Procedures Act (RESPA) affect the payment of finder fees?
  - a. Finder fees can only be paid to licensed agents.
  - b. Finder fees are illegal when paid on a commercial transaction.
  - c. Finder fees are illegal with transactions involving a mortgaged residential property.
  - d. Finder fees are legal if acknowledged in writing by both parties.
  
7. True or false. Most real estate agents are classified as an independent contractor.
  - a. True
  - b. False
  
8. True or false. IRS Guidelines require that real estate agents working as an independent contractor have a written contract between them and their broker.
  - a. True
  - b. False
  
9. What is the minimum amount of time a Massachusetts agent is required to keep their transaction files?
  - a. Two years.
  - b. Three years.
  - c. Five years.
  - d. Seven years unless involved in litigation.

10. True or false. Once a sales associate has registered their license with a brokerage, they can work independently.
- True
  - False

## Quiz Answers

- What legal form of business ownership provides real estate owners the most protection and tax benefits?
  - Limited-Liability Company (LLC) – a Limited-Liability Company features the tax benefits of a partnership but the liability protection of a corporation.
- What is an added benefit of using a trust account?
  - All of the above.
- True or false. Most states allow finder fees to be paid to unlicensed wholesalers.
  - False – most states require that finder's fees are only paid to a licensed agent.
- True or false. Most states allow finder fees to be paid to other licensed agents.
  - True – many states allow other licensed agents to receive a finder's fee.
- True or false. Federal laws on paying finder fees are subordinate to state laws.
  - False – state laws are always subordinate to federal laws.
- How does the federal Real Estate Settlement Procedures Act (RESPA) affect the payment of finder fees?
  - Finder fees are illegal when paid in a transaction involving a mortgaged residential property.
- True or false. Most real estate agents are classified as an independent contractor.
  - True
- True or false. IRS Guidelines require that real estate agents working as an independent contractor have a written contract between them and their broker.
  - True – to qualify for the status as an independent contractor, there must be a written contract between the broker and the agent.
- What is the minimum amount of time an agent is required to keep a transaction file?
  - Three Years. – Massachusetts agents should keep transactional files for a minimum of three unless there was litigation and then they must keep them for at least two years after the conclusion of the civil action. The IRS can request up to 7 years worth of financial records related to your business.
- True or false. Once a sales associate has registered their license with a brokerage, they can work independently.
  - False - All sales associates function as agents of their employing broker, and they receive compensation *only* from their broker.

# Chapter 4 Real Estate Ethics

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain:

- the difference between what is legal and what is ethical;
- what constitute unethical actions;
- how the Code of Ethics impact real estate transactions; and
- the penalties of failing to act ethically.

**OVERVIEW:** The objective of this chapter is to define and explain an agent's ethical responsibility to their client, the public, and other agents. We will also identify actions that violate ethical standards and their repercussions.

## Section 1. Overview of Ethics

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The real estate industry is built on a foundation of trust. Buyers and sellers trust that their agent is working on *their* behalf and in *their* best interests. This trust goes beyond simply complying with federal and state laws. An agent can obey the letter of the law and yet, at the same time, violate their client's trust. Real estate agents must have strong **ethics** that adhere to a system of higher moral principles and standards of conduct.

### The Cause of Unethical Behavior

Real estate salespersons have struggled to maintain a good reputation in the industry. An agent's in-depth knowledge of the real estate market makes it easy to put their self-interests and financial gain ahead of the needs of their clients. They have the skills to crush the competition without mercy, regret, or conscience while skirting legal requirements and license obligations. Some agents feel that due to the short-term nature of the broker-client relationship, they can pitch ethics out of the window in exchange for a quick profit.

They fail to remember that real estate agents exist in the industry to *protect* the interests of their clients – not to take advantage of their clients for their personal profit. This type of attitude poses a serious threat to the real estate industry. Unethical behavior is the primary reason why ethics is now a required topic for real estate licensure in many states.

### The Impact of Unethical Behavior

The impact of unethical behavior will be felt long before being caught by authorities or sued by an irate client. A real estate business is built almost entirely on referrals. Imagine the repercussions if a client realizes that their agent violated their trust and took advantage of their wealth in order to increase their commission. While the deal may still close, and perhaps the client may never sue, they will talk to their friends, and their bad reputation will spread like gangrene. If it ends up in the press, the agent might as well either move to a new state or change professions. If it comes to the attention

of the state's real estate commission or licensing board, they could lose their license, be fined and even prosecuted.

Now imagine how building a solid reputation of trust, honesty, and integrity can create a rock-solid and immensely profitable business. Positive word-of-mouth will also travel and create compounding repeat business. Nothing draws a client to a service-orientated business more than trust. The goal of every agent is to build such a high level of client trust that they sing their praises to all their family, friends, and associates.

## The Difference Between Legal and Ethical

An action can be unethical and still be legal. A lender who encourages a borrower to opt for an interest-only loan knowing full well that they cannot handle the payment increase in three years is hardly ethical. A listing agent who pockets low-ball offers in lieu of a higher-priced one is hardly acting ethically.

Any agent who only focuses on not *breaking* the law may forget to understand the underlying principle or *reason* for the law. Licensed agents should not look for legal loopholes or creative business approaches that even border on the unethical or dishonest. Ethics is not so much a set of rules as it is a way of conducting ourselves.

## Acting in Good Faith

Licensed agents are expected to deal honestly and act in good faith with others. All contracts contain an implied duty of good faith and fair dealing. While honesty has to do with a person's *actions*, good-faith concerns a person's *intentions*. Acting in **good faith** means being fair with others – including both clients and the public. We can define good faith as "a sincere belief or motive without any malice or desire to defraud others."

**PRACTICAL APPLICATION:** You submit an offer from your buyer, and the seller accepts it. Two weeks later, the buyer finds a home he likes better. Wanting to get out of the contract, the buyer instructs you to call the seller and say the home inspection revealed problems, and they are withdrawing their offer. You know that the inspection revealed no such problems. If you obey the wishes of your client, you are being dishonest and not acting in good faith. Acting in good faith involves not only the client but all parties to the transaction.

You have two choices: First, you could advise the client to consult with a real estate attorney to see if there is a legal way to get released from the contract; or second, you could inform your client that while they have the right to break the contract, they do not have a valid reason to demand the full return of the escrow deposit.

## **Section 2. Dishonesty and Unethical Actions**

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Several practices are dishonest and gross violations of real estate ethical conduct. An agent needs to not only be able to identify these practices, but also recognize the actions that lead to ethical violations. The three most common forms of real estate dishonest is misrepresentation, omission, and exaggeration.

### **Misrepresentation**

The practice of distorting the facts to mislead or deceive someone is called **misrepresentation**. Often misrepresentation is not a lie; instead, it intentionally leads the listener to a wrong conclusion.

**PRACTICAL APPLICATION:** *An advertising states a house has three bedrooms except one of the “bedrooms” has no window and you must pass through another bedroom to reach it. While technically you could put a bed in the room, legally, it is not a bedroom. The advertising is misrepresenting the true condition of the property.*

There are three types of misrepresentation: innocent, negligent, and fraudulent. Negligent misrepresentation includes the failure to disclose a material fact that the agent was ignorant of but should have known. Licensed agents are accountable for errors out of ignorance. Fraudulent misrepresentation is purposeful hiding of a material fact that a client would rely on when making a purchase.

### **Omission**

Leaving out key information to deceive someone, either intentionally or not, is called **omission**. When critical information is omitted, the client cannot make an educated decision based on all the facts. If the client had known the true facts, they may have made a different decision.

**PRACTICAL APPLICATION:** *The buyer’s agent notices that a large tree is growing close to the foundation and the roots are causing it to crack, but she decides not to mention it. She decides to leave the disclosure to the professional home inspector.*

### **Exaggeration and Puffing**

The **exaggeration** of a material fact or property benefit is called **puffing**. There is a fine line between lying and puffing. Exaggerating a property’s benefits may be legal, but it definitely is *not ethical*. Puffing is more of an opinion than a fact. If a client has relied on that opinion when making a decision, the statement could be interpreted as fraudulent.

**PRACTICAL APPLICATION:** *While showing a home to a potential buyer, you exclaim, “This is got to be the best kitchen in this price range!” To encourage the buyer to submit an offer, you add, “If you ever sold the house, you could easily get another \$5,000 for the kitchen.” Both are examples of puffing. If, however, the buyer relied on the second statement, and it is found to be untrue, the buyer could be of fraud.*

## Fraud

**Fraud** is the intentional misrepresentation of a material fact that takes advantage of another or causes harm. Fraud can include making a false statement, failing to disclose, or intentionally concealing material facts or information that a client would rely upon to make a decision. Here are some classic examples of real estate fraud and misrepresentation:

- Failure to inform a buyer of a price reduction before submitting an offer;
- Misrepresentation of the property's true market value;
- Failure to disclose known problems with a property, even if not readily visible;
- Failure to reveal the actual size of the land or improvements;
- Omitting the existence of managerial or financial problems with the Homeowner's Association;
- Failure to disclose easements, environmental issues, title problems, or renovations without a permit; and
- Failure to disclose a dual agency.

## Section 3. NAR Code of Ethics

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The state is responsible for licensing regulation, education, and enforcement – but not necessarily ethical behavior. The National Association of Realtors® (NAR) has established a written Code of Ethics that advise, guide, and regulate the behavior of all its members. These obligations set a higher level of service than what is mandated by law.

All the members of the NAR are designated as Realtors, but not all licensed agents are Realtors. Abiding by the NAR Code of Ethics is required of all Realtors, but not all agents. These codes, however, help to establish and preserve an honest and trustworthy relationship with the public, clients, and other agents. Regardless of membership, all licensed agents should abide by ethical standards as a way of doing business.

The Code of Ethics is divided into 17 articles that are broad statements of ethical principles and business conduct. The practical application of each of the articles within the code is known as Standards of Practice. The Code of Ethics covers all areas of real estate practice. The following list will summarize the portions that directly affect ethical behavior.

### Duties to Clients and Customers

- **Article 1:** Protect the best interests of the client and treat all parties honestly.
  - Do not deliberately mislead the owner
  - Submit all offers and counter-offers objectively and as quickly as possible until the termination of the agency agreement

- Consent from both parties is required to represent both sides of a transaction
- Preserve client confidentiality even after terminating the agency relationship.
- Obtain seller approval before disclosing to others the existence of offers and their source.
- Disclose the brokerage's policy regarding agency cooperation and compensation before entering into an agency agreement.
- Before a seller enters into a listing contract, disclose the potential and circumstances that would cause a dual agency or transaction brokerage.
- Manage client property with due regard for personal rights, safety, and health.
- **Article 2:** Refuse to misrepresent, exaggerate, or hide facts about a property.
  - Do not disclose confidential information defined under an agency relationship
- **Article 3:** Unless it is not in the best interest of the client, all Realtors should cooperate.
- **Articles 4 - 5:** Disclose any personal or immediate family interest in a property.
- **Articles 6 – 8:** Refuse kickbacks or non-disclosed financial benefits. Client funds must be kept separate from personal or brokerage funds.
  - Disclose to the client all sources of financial benefits associated with the transaction.
  - Receive written consent from the client and disclose to all parties before accepting compensation from more than one party.
- **Article 9:** Present to buyers and sellers all documents related to a transaction in understandable terms.

## Duties to the Public

- **Article 10:** An agent cannot deny services based on race, color, religion, sex, handicap, familial status, national origin, sexual orientation, or gender identity.
  - Do not volunteer information regarding the racial, religious, or ethnic composition of a neighborhood.
- **Article 11:** Provide competent services to clients only within a Realtor's professional scope.
- **Article 12:** Do not use false or misleading advertising.
  - If advertising that services are without cost, disclose to prospects or clients any source of compensation.
  - Clearly disclose the terms and conditions when offering premiums, prizes, merchandise discounts, or other inducements.
  - Disclose agent ownership and real estate licensing on all properties advertised for sale.
  - Do not offer or advertise a property for sale or lease without authority.
- **Article 13:** Do not break the law.

- **Article 14:** If charged with a violation, cooperate with the Realtor board's investigative proceedings.

## Duties to Realtors

- **Article 15:** Do not make false or misleading statements about other Realtors.
- **Article 16:** Do not solicit clients that have an exclusive listing agreement with another Realtor.
  - Seller or landlord consent is needed to place listing signs on the property.
- **Article 17:** Allow the Realtor Board to mediate or arbitrate contractual disputes.

## Section 4. Enforcement of the Code of Ethics

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A client who believes that an agent behaved improperly should first be encouraged to discuss the matter with their broker. A client's next choice is to either file a complaint with the local realtor association or the state licensing board. Licensing commissions, however, do not handle ethics complaints unless it includes a violation of a specific state statute or licensing requirement. NAR handles complaints about ethical behavior. In more severe cases, a client seeking punitive damages for fraud can file a civil lawsuit.

The NAR Code of Ethics is enforced by the 1,200 local Realtor Associations across the country. While the public can file complaints, Realtors usually submit the complaint when they concerned about protecting the public from the unethical practices of a fellow agent or require arbitration.

The association's Grievance Committee screens complaints. If they identify a violation, it is passed up to the Professional Standards Committee. The committee will gather a panel of three to five committee members to verify that the violation occurred and to decide on the type of disciplinary action. Disciplinary actions may include a warning, a letter of reprimand, mandatory attendance at an education course, and a fine that does not exceed \$15,000. The NAR does not have any legal jurisdiction meaning that they cannot revoke a license, though they can suspend it for up to six months. The objective of disciplinary action is to "raise the consciousness of members to the meaning and significance of the Code," and education is the primary means of resolving ethical violations.

## Section 5. Quiz

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What are three common forms of real estate dishonesty?
  - a. Misrepresentation, Omission, and Exaggeration
  - b. Exaggeration, Lying, Theft
  - c. Misrepresentation, Deception, and Extortion
  - d. Omission, Lying, Money Laundering, and Denial

2. Who is responsible for establishing and enforcing the Code of Ethics?
  - a. The individual licensed agent
  - b. Your broker
  - c. State Government
  - d. National Association of Realtors®
3. What does the Code of Ethics and Standards of Practice of the NAR cover?
  - a. Duties to clients and customers
  - b. Duties to the public
  - c. Duties to other realtors
  - d. All of the above.
4. True or false. An agent can accept a commission, rebate, or transaction bonus without their client's consent.
  - a. True
  - b. False
5. True or false. An agent can accept a commission, rebate, or transaction bonus from more than one party without notifying the other parties to the transaction.
  - a. True
  - b. False
6. True or false. As long as an agent has their seller's approval, they can disclose the existence of offers on the property.
  - a. True
  - b. False
7. Agents must disclose that they are a licensed real estate agent when \_\_\_\_\_ makes an offer on a property.
  - a. The agent
  - b. a member of the agent's immediate family
  - c. an entity in which the agent or their immediate family has an ownership interest in
  - d. All of the above.
8. True or false. After a closing, the agent no longer has the duty of confidentiality to their client.
  - a. True
  - b. False
9. True or false. Before entering into a listing contract, the agent must advise their client of the potential and the circumstances that would cause a dual agency or a transaction brokerage.
  - a. True
  - b. False
10. What is fraud?
  - a. The use of client funds without permission.
  - b. Exaggerating a material fact.
  - c. The unintentional misrepresentation of a material fact that causes
  - d. The intentional misrepresentation of a material fact that causes harm.

## Quiz Answers

1. What are three common forms of real estate dishonesty?
  - a. Misrepresentation, Omission, and Exaggeration
2. Who is responsible for establishing and enforcing the Code of Ethics?
  - d. National Association of Realtors®
3. What does the Code of Ethics and Standards of Practice of the NAR cover?
  - d. All of the above.
4. True or false. An agent can accept a commission, rebate, or transaction bonus without their client's consent.
  - b. False – An agent cannot accept any commission, rebate, or profit on client expenses without the client's knowledge and consent.
5. True or false. An agent can accept a commission, rebate, or transaction bonus from more than one party without notifying the other parties to the transaction.
  - b. False - During a real estate transaction, accepting compensation from more than one party, even if permitted by law, must be disclosed to all parties and have written consent from the client.
6. True or false. As long as an agent has their seller's approval, they can disclose the existence of offers on the property.
  - a. True – An agent needs seller approval, to disclose the existence of offers on the property and from where the offers were received.
7. An agent must disclose that they are a licensed real estate agent when \_\_\_\_\_ makes an offer on a property.
  - d. All of the above. – An agent must disclose any personal or immediate family interest in a property.
8. True or false. After a closing, the agent no longer has the duty of confidentiality to their client.
  - b. False – An agent must preserve client confidentiality even after terminating the agency relationship.
9. True or false. Before entering into a listing contract, the agent must advise their client of the potential and the circumstances that would cause a dual agency or a transaction brokerage.
  - a. True - Before a seller enters into a listing contract, disclose the potential and circumstances that would cause a dual agency or transaction brokerage.
10. What is fraud?
  - d. The *intentional* misrepresentation of a material fact that takes advantage of another or causes harm.

# **Chapter 5 Real Estate Legislation**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain:

- laws and guidelines on advertising;
- actions that violate antitrust laws;
- the application of Fair Housing Laws; and
- what constitutes an illegal fair housing practice.

**OVERVIEW:** Real estate agencies deal with the public daily. There is strict legislation that clearly defines discriminatory actions and behaviors. All licensed agents must understand what constitutes discrimination and how to avoid it.

## **Section 1. Advertising Laws**

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In an effort to curb misleading, deceptive, and fraudulent advertising practices, the Consumer Financial Protection Bureau (CFPB) formed the *Mortgage Acts and Practices Advertising Rule*. The Federal Trade Commission (FTC) enforces these rules. It was created to preserve honesty and eliminate deliberate deception in real estate and mortgage advertising. The requirements affecting real estate agents are very similar to NAR's Internet Data Exchange policy. All agents should carefully follow these regulations and stipulations:

- All advertising must be accurate and true.
- Advertising that is false, misleading, and dishonest is illegal.
- It is unethical to advertise a property by a non-listing agent on any other media except their website.
- It is prohibited to create blind ads that imply the absence of a real estate agent.
- The agent's name, the registered name of the brokerage, and the office address, and city, must be included in all electronic communications.
- If a website page contains any advertisements, all real estate licensees must disclose their license status on that page.
- A sales associate must include their sponsoring broker's name on all advertising materials.
- All advertisements related to a property listing must include the address of the property, including the city.
- When advertising on short-message social media, any linked material must include full disclosure, as stated above.
- If an agent is selling a property that he or she owns or has an interest in, then the term "owner/agent" must be included in all advertising materials.
- Team advertising should clearly identify their associated brokerage.

The name of the brokerage firm needs to be on all advertising materials, and it must be “clear and conspicuous.” Also, the name of the brokerage cannot be abbreviated (except for standard abbreviations such as Corp. or LLC). Using only a logo does not qualify as including the name of the brokerage firm.

### ✓ CORRECT

John Doe, Sales Associate  
May Flower, Managing Broker  
**Awesome Real Estate Corp.**  
123 Parkway St, Anywhere, WA

### ✗ WRONG

John Doe, Agent  
Awesome R.E., 123 Parkway St.  

- ✗ Incorrect license designation
- ✗ No named managing broker
- ✗ Brokerage name is too small
- ✗ Brokerage name is abbreviated
- ✗ Missing Brokerage's city and state

## National Do Not Call Registry

The Federal Communications Commission created the National Do Not Call Registry in 2003, and the Federal Trade Commission (FTC) manages the list. The registry is a list of telephone numbers from consumers who have indicated their preference to limit telemarketing calls. The Do Not Call Improvement Act of 2007 prevents businesses from making telemarketing calls to people in other states. It allows real estate professionals to call a prospect for up to three months after an inquiry or application submission. They can also call clients up to 18 months after the client's last purchase, delivery, or payment - even if the individual is on the do not call registry. If the individual asks the agent not to call, they must cease all calls.

In addition to the federal legislation that limits interstate marketing calls, each state may also have additional regulations that apply to in-state telemarketing.

## Section 2. Antitrust Laws

**Antitrust laws** have been created to control business activities that create monopolies and restrict trade in a competitive marketplace. Antitrust laws are established at both the federal and state level. These laws govern the use of contracts and business practices among competitors to control the market.

The Sherman Act is the foundation for all federal antitrust laws. Any contract, agreement, or conspiracy to restrain free trade is a violation of the Sherman Act. Real estate agents must learn how to recognize actions that lead to antitrust violations. Let us consider the most common ones.



### WARNING!

The federal **Sherman Antitrust Act** makes it illegal to create any type of agreement that restricts fair trade. The act works to maintain an open and free market.

## **Price-fixing**

**Price-fixing** occurs when competing businesses come together and agree to set rates and prices to restrict competition. Instead of allowing supply and demand to set pricing, competing businesses join together to control the market. This happens within the real estate market when brokerages, multiple listing services, or trade associations mutually agree on a commission rate. *Setting a market commission rate is illegal.* Each brokerage must independently set their commissions and fees, and it should never be a subject of discussion among members of competing brokerages. A brokerage is allowed to impose a standard commission rate on all transactions handled by the sales associates in their employ. This is *not* a violation of antitrust laws.

**PRACTICAL APPLICATION:** You are meeting with a prospective seller. You are discussing your brokerage's commission rate, and you say, "Our commission rate is the standard rate in the marketplace. You will find that other brokerages will have the same rate. It is our client service that makes us stand above the crowd." You are giving the seller the impression of price-fixing, which violates antitrust laws.

## **Tying Agreements**

If a business will only sell a product or provide a service if the buyer also purchases another product or service, they have created an illegal tying agreement (or tie-in agreement). Combining services is legal, but using coercion to force the second purchase is illegal.

**PRACTICAL APPLICATION:** A developer wants to put an offer on a large plot of land owned by a licensed broker. The broker agrees to sell the property to the developer only if the developer agrees to list the new lots with the broker. These types of arrangements are illegal.

## **Group Boycott**

If two or more businesses join together and refuse to deal with a type of customer, service provider, or competing business, they are said to be engaging in a **group boycott**. Group boycotts are used on businesses to force a change in business practice. If a brokerage lowers their commission rate or offers a non-traditional commission arrangement, brokerages within the same area may try to either force them to change or drive them out of the marketplace. This is an example of an illegal group boycotting.

**PRACTICAL APPLICATION:** There is a local real estate appraiser that always seems to set the market value below the purchase price. It has been causing all sorts of problems getting deals to close. A group of brokerages decides to pressure lenders not to use this appraiser – even threatening to send their buyers to a different lender. This action is illegal and a clear violation of antitrust laws.

## Bid-rigging

**Bid-rigging** is an antitrust violation that can happen at a property auction. When buyers work together to control auction prices, this restricts an open and fair market. If licensed agents participate in this action, they can lose their license and be subject to disciplinary measures.

**PRACTICAL APPLICATION:** *A group of real estate investors gets together before a tax auction to decide who will get what properties. Each investor chooses one or more properties. The other investors agree not to bid on each other's properties to keep the price low. This is bid-rigging, and it is illegal.*

## Market and Customer Allocation

Businesses that agree to divide their market area and work only in their assigned territory to reduce competition are participating in **market allocation**. Businesses that segment their clients between competing businesses are engaging in **customer allocation**. This limits an open and competitive market, and it can lead to price increases due to a lack of competition. Both actions are illegal. While a brokerage is free to focus on a specific market area and even specialize in certain property types, they cannot conspire with other brokerages to control the marketplace.

**PRACTICAL APPLICATION:** *Two brokerages decide to divide the town in half. Brokerage A takes the north section of town, and Brokerage B takes the south side. They steer clients to the brokerage within their market area. That action is illegal.*

The penalties for violating antitrust laws can be severe. There can be both civil and criminal penalties. In a civil case, the penalty is three times the plaintiff's actual damages plus attorneys' fees and costs. In a criminal case, an individual can be fined up to \$100,000 and receive three years in prison. Corporations can be fined up to \$1 million for a breach.

## Section 3. Anti-Discrimination and Fair Housing

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Licensed real estate agents must be cautious never to discriminate or even give the impression of discrimination. The **Civil Rights Act of 1866** prohibits discrimination based on race in every property transaction. The **Civil Rights Act of 1968** prohibits discrimination based on race, color, national origin, religion, sex, familial status or disability that involves financial assistance from the federal government, including any federally funded housing projects or programs.

**PRACTICAL APPLICATION:** *A buyer who recently immigrated from an Asian nation asks you to locate an area of town that has a sizable population from the same region. Can you obey their request? In *Hannah v. Sibcy Cline Realtors*, 769 N.E. 2d 403 (Ohio Ct. Ap. 2001), the court stated that "Imposing a duty on real estate agents or brokers to give information about the ethnic makeup of a neighborhood, even for benign purposes..., would prove detrimental to the goal of fair housing" and that "it would not be in the best interests of an agent or broker to do so." A strict interpretation of the Fair Housing Act says that an agent may not provide any*

*information that could be construed as discriminatory – even if asked by their client. You may, however, direct your clients to resources to look up the information themselves.*

In 1975, the **Age Discrimination Act** was passed, making it illegal to discriminate on the basis of age in any program or activity that receives federal funding. The act covers all age groups, young and old. The only exception to this rule is for senior housing programs designed for persons age 55 or older.

In 1995, the **Housing for Older Persons Act (HOPA)** allowed certain properties to be age-restricted. At least 80% of units must be occupied by someone 55 or older, but they no longer need to have “significant facilities and services” for seniors.



## WARNING!

According to the **Fair Housing Act** it is illegal to discriminate based on:

- ✗ Race
- ✗ Color
- ✗ National Origin
- ✗ Religion
- ✗ Sex
- ✗ Familiar Status
- ✗ Disability

The **Fair Housing Act** expands on discrimination. It prohibits discrimination based on race, color, religion, sex, national origin, familial status, and disability. It also prohibits discrimination against individuals that are associated with persons in any of the protected classes. The Fair Housing Act also covers disabled tenants to have a service or companion animal, even if the rental property has a no-pet policy. To qualify as a disabled person, they must establish that their disability substantially limits major life activities. The Fair Housing Act, however, does not cover citizenship. Asking rental applicants for citizenship documentation or proof of legal immigration status is not considered discriminatory, nor does it violate the Fair Housing Act. The law applies to residential housing, including rental properties. Some exceptions not covered by the Fair Housing Act are:

- Owner-occupied properties with no more than four (4) units.
- Single-family homes that are rented or sold *without* the involvement of a licensed real estate agent or a real estate investor.<sup>1</sup>
- Housing designated for seniors is exempt from the familial status requirement but must adhere to all the others.
- Private clubs or organizations that limit occupancy of their managed housing to members – as long as membership is open to people of all races, colors, or national origins.
- Religious organizations that own housing and restrict residency to members of the same religion – as long as membership is open to people of all races, colors, or national origins.

The **Department of Housing and Urban Development (HUD)** administers the Fair Housing Act. They can establish rules and regulations for real estate practices based on the fair housing law. All

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<sup>1</sup> A real estate investor is someone who owns three or more residential homes at the same time and/or they sell more than one home every two years. HUD expects that investors should comply with fair housing laws even if they are not licensed as a real estate professional.

brokerages are expected to prominently display HUD's equal housing opportunity poster, and a failure to display the poster can be used as evidence of discrimination.

U. S. Department of Housing and Urban Development



EQUAL HOUSING  
OPPORTUNITY

**We Do Business in Accordance With the Federal Fair  
Housing Law**

(The Fair Housing Amendments Act of 1988)

**It is illegal to Discriminate Against Any Person  
Because of Race, Color, Religion, Sex,  
Handicap, Familial Status, or National Origin**

- In the sale or rental of housing or residential lots
- In advertising the sale or rental of housing
- In the financing of housing
- In the provision of real estate brokerage services
- In the appraisal of housing
- Blockbusting is also illegal

Anyone who feels he or she has been discriminated against may file a complaint of housing discrimination:

1-800-669-9777 (Toll Free)  
1-800-927-9275 (TTY)  
[www.hud.gov/fairhousing](http://www.hud.gov/fairhousing)

**U.S. Department of Housing and  
Urban Development**  
**Assistant Secretary for Fair Housing and  
Equal Opportunity**  
**Washington, D.C. 20410**

In 1990, the **Americans with Disabilities Act (ADA)** required that commercial buildings and employers with a minimum of 15 employees make reasonable accommodations to ensure that disabled persons have an equal opportunity for access and employment. This includes public buildings such as hotels, restaurants, convention centers, convenience stores, and government-owned housing. The Fair Housing Act covers residential housing and is not required to comply with ADA. Tenants are permitted to make, at their expense, reasonable modifications to properties they rent, such as installing handrails or lowering door handles. It is illegal discrimination not to allow such modifications.

Even though the ADA act is not part of housing law, agents need to be aware of the guidelines because they operate a public brokerage and because they may be involved with a commercial transaction. Rental properties with five or more units are classified as commercial property. All public areas must comply with the Americans with Disabilities Act Accessibility Guidelines (ADAAG), and individual units must comply with the Fair Housing Act.

## **Section 4.      Illegal Fair Housing Practices**

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Real estate agents need to be able to identify actions that violate both fair housing and civil rights laws. This is an area where laws and ethics intermix. Several real estate practices are both unethical and completely illegal.

### **Redlining**

**Redlining** is the act of refusing a mortgage or insurance policy because of where the applicant lives rather than their creditworthiness. It is as if the lender drew a red line around neighborhoods where they refuse to write loans. This action is often racially motivated. Lenders and insurers are allowed to refuse loans based on environmental risks such as the locations of flood plains or fault lines but not based on the racial makeup of a neighborhood.

### **Blockbusting**

**Blockbusting** is the illegal practice of scaring homeowners into selling their homes because a protected class of people is moving into the neighborhood under the assumption that it will lower home values. Profit is a typical motivator for this action. The blockbuster intends to purchase the property at below market value and then profit when they turn around and resells the property for a higher price. Real estate agents need to be careful about how they word their advertising to avoid any accusation of blockbusting.

**PRACTICAL APPLICATION:** *An agent makes cold calls on homeowners after noticing an influx of people of color into the neighborhood. She tells the property owners that the neighborhood is declining, and they can expect to quickly see an increase in crime and dramatic loss of property values. The agent encourages the homeowner to list their property now while prices*

are still high. This marketing tactic is blatant discrimination against a protected class, and it is a violation of fair housing.

## Steering

**Steering** is the illegal practice of channeling buyers or renters into areas that are primarily composed of people of their own race or ethnicity. It also includes others from buying or renting in that neighborhood. It is unethical to limit a client's choices and illegal to discriminate against a protected class.

**PRACTICAL APPLICATION:** *The landlord has instructed a property manager only to rent his apartment building to white middle-class families. Because they manage a number of other properties, the property manager directs other ethnic groups to their other rentals. Even though it is the landlord who is steering, the property manager is just as guilty because their obedience to their client is violating fair housing laws.*

## Discriminatory Advertising

Agents have to be particularly careful when advertising not to imply that they are favoring a particular group or limiting access to other groups. The implication can come not only from the wording but also from the marketing distribution. For example, advertising a home to only Spanish speaking people is excluding others and can be construed as steering.

Here are some basic advertising guidelines:

- Do focus advertising on the amenities of the property and *not* on who should purchase or rent it. Example: Good – “Two-bedroom fixer-upper.” Wrong – “Ideal starter home for a young family.”
- Do not make statements that exclude persons or express a preference for a protected class. Example: Good – “Centrally located, close to shopping.” Wrong – “Exclusive neighborhood, near the Catholic church.”
- Do include the “Equal Housing Opportunity” graphic on your advertising.
- Do not exclude families, racial groups, ethnic backgrounds, or persons with disabilities. Example: Good – “Open floor plan, wheelchair accessible.” Wrong – “Senior designed retirement housing.”
- Do use graphics that represent a wide variety of ethnic groups of various ages in all advertising media if deciding to use human models at all.
- Do not use catchwords like “restricted, exclusive, elite, private, integrated, or traditional.” Example: Good – “Quiet residential gated community.” Wrong – “Exclusive neighborhood with no children.”



## **Section 5. Disciplinary Actions**

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Under the direction of HUD, the Office of Fair Housing and Equal Opportunity administers the Fair Housing Act. HUD can file complaints against people or organizations. A person can also file a grievance within one year after an alleged discriminatory act. HUD investigates all complaints, and within 100 days from the filing, they will determine if there is reasonable cause to press charges.

Resolution is the first remedy. HUD will try to help both parties resolve the complaint through a voluntary conciliation agreement. The agreement provides assurances that the individual or business at fault will remedy the violation and take steps to prevent future discriminatory actions. The government can also pursue a civil judgment which would provide compensation to an injured party.

The injured party can pursue an administrative hearing in front of an administrative law judge (ALJ) who can award actual damages, issue injunctions, and impose penalties. Penalties can reach \$16,000 for a first offense and up to \$70,000 for the third violation within seven years. Additionally, injured parties can also pursue civil action in federal court within two years from the discriminatory act. Federal courts can award actual damages plus unlimited punitive damages and injunctions.

Because states and municipalities have the right to set their own fair housing laws, HUD often refers complaints to the local authorities – as long as the state's fair housing policy is equivalent to federal law.

If an agent is found guilty of discrimination by a state or federal authority, the licensing board can also take action, including assessing penalties or suspending or permanently revoking the license.

*Remember, an unintentional act of Fair Housing discrimination is still illegal.*

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## **Section 6. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What is required to be included in all advertising materials?
  - a. Agent's name, Brokerage and office address.
  - b. Property address, Brokerage name and address including the city.
  - c. Agent's name, Broker's Name, and Brokerage.
  - d. Only the property address and the brokerage's phone number.
  
2. True or false. An agent does not have to disclose their ownership interest until after receiving a purchase offer.
  - a. True
  - b. False

3. The Do Not Call Improvement Act of 2007 allows agents to make telemarketing calls to people in other states for up to \_\_\_\_\_ months after an inquiry or application submission.
- One
  - Three
  - Five
  - Six
4. What is the purpose of antitrust laws?
- To control business activities that create monopolies.
  - To restrict trade in a competitive marketplace.
  - Govern the use of contracts and business practices among competitors.
  - All of the above.
5. What are the most common antitrust violations?
- Misrepresentation, puffing, and exaggeration.
  - Price fixing, group boycotts, and market allocation.
  - Fraud, bid-rigging, and fabrication.
  - All of the above.
6. According to the Fair Housing Act, it is illegal to discriminate based on
- Race, color, national origin, religion, sex, and familial status.
  - Race, national origin, religion, disability and sex.
  - Citizenship, legal status, race, color, religion, and familial status.
  - Race, color, national origin, religion, sex, familial status and disability.
7. True or false. The Fair Housing Act only applies to residential housing.
- True
  - False
8. True or false. Only property managers are required to display HUD's Equal Housing Opportunity poster.
- True
  - False
9. What three actions violate both fair housing and civil rights.
- Redlining, blockbusting, and steering.
  - Blockbusting, puffing, and fraud.
  - Redlining, steering, and telemarketing.
  - Market driving, blockbusting, and black booking.
10. True or false. An unintentional act of Fair Housing discrimination is illegal and the violator can be found guilty of discrimination.
- True
  - False

## Quiz Answers

1. What is required to be included in all advertising?
  - c. Agent's name, Broker's Name, and Brokerage. If the advertising is related to a property listing, then it must also include the address of the property.
2. True or false. An agent does not have to disclose their ownership interest until after receiving a purchase offer.
  - b. False
3. The Do Not Call Improvement Act of 2007 allows agents to make telemarketing calls to people in other states for up to \_\_\_\_\_ months after an inquiry or application submission.
  - b. Three
4. What is the purpose of antitrust laws?
  - d. All of the above. Antitrust laws have been created to control business activities that create monopolies and restrict trade in a competitive marketplace. These laws govern the use of contracts and business practices among competitors to control the market.
5. What are the most common antitrust violations?
  - b. Price fixing, group boycotts, and market allocation. Other antitrust violations include bid-rigging, customer allocation and tying agreements.
6. According to the Fair Housing Act, it is illegal to discriminate based on
  - d. Race, color, national origin, religion, sex, familial status and disability.
7. True or false. The Fair Housing Act only applies to residential housing.
  - a. True - The law applies to residential housing, including rental properties.
8. True or false. Only property managers are required to display HUD's Equal Housing Opportunity poster.
  - b. False
9. What three actions violate both fair housing and civil rights.
  - a. Redlining, blockbusting, and steering. Redlining is the act of refusing a mortgage or insurance because of where the applicant instead of creditworthiness. Blockbusting is the illegal practice of scaring homeowners into selling their homes because a protected class is moving into the neighborhood. Steering channels buyers or renters into areas that are primarily composed of people of their own race or ethnicity.
10. True or false. An unintentional act of Fair Housing discrimination is illegal and the violator can be found guilty of discrimination.
  - a. True - An unintentional act of Fair Housing discrimination is still illegal. If an agent is found guilty of discrimination by a state or federal authority, the licensing board can also take action, including assessing penalties or suspending or permanently revoking the license.

# Chapter 6 Agents and Agency Relationships

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- laws that govern authorized relationships,
- the four types of brokerage relationships, and
- how to disclose and change an agency relationship.

**OVERVIEW:** The objective of this chapter is to understand agency relationships that are formed between a real estate agent and their client. The agency relationship is the foundation of the real estate practice and one that is carefully regulated.

## Section 1. Historical Perspective

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Since the 1920s, sellers have been on the winning side of representation. They would contract with an agent to sell their property and agree to some form of compensation. Buyers, on the other hand, suffered under *caveat emptor*, a Latin expression meaning “let the buyer beware.” Even if the buyer had an agent helping them, legally speaking, their agent was representing the seller in a cooperative sub-agent arrangement with the seller’s broker.

This left the poor buyer at the mercy of the seller with little, if any, genuine and honest representation. Finally, in the 1990s, the industry began to question the legality and fairness of the **sub-agency** relationship. Soon defined roles were established to represent and protect the interests of both sellers and buyers. Now we have nearly equal protection for both parties in a real estate transaction.

## Section 2. Laws that Govern Agreements

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The U.S. government has created three types of laws that govern contracts and agreements. There are designed to provide different levels of protection to the parties.

- **Statutory laws** apply to specific cases and are organized and codified into laws. They are passed on the federal and state level. Building ordinances and real estate license laws are two examples of statutory laws.
- **Common laws** are also called case law because they are laws based on precedent, whereas statutory laws are based on written legislation. Common laws can be created in two ways: (1) when a judge interprets an existing law and applies it to a new situation; or (2) when a previous ruling sets a precedent and that precedent is applied to the current court case. When we site a court case, we are speaking about common law.
- **Administrative laws** are rules and regulations created by an administrative agency that regulates procedures, operations, and conduct. The Food and Drug Administration regulates pharmaceutical companies through administrative laws, just like real estate commissions regulate real estate agents.

## **Section 3.      Parties to a Brokerage Relationship**

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There are two parties to any brokerage relationship: the agent and their client. The client can be a seller, buyer, landlord, tenant, or even a broker. Before an agent can conduct business with a client, *they must establish a brokerage relationship with them.* An agreement clearly defines the duties and responsibilities of both parties.

### **The Agent**

An **agent** is a person that is authorized to act on behalf of their client or principal when dealing with another party. The broker becomes an agent of the seller when they sign a listing agreement. The sales associate becomes an agent of the broker when they enter into an employment contract.

There are three different types of agents: a universal agent, a general agent, and a special agent. Each designation has a different level of activity or authority.

- A **Universal Agent** is authorized to perform any and all legal actions that the client can perform. A universal agent has virtually no limitations on what they can do on behalf of their client. A court-appointed guardian or someone with a general power of attorney are examples of universal agents. Real estate agents are rarely appointed as a universal agent.
- A **General Agent** is authorized by the client to perform any acts associated with the operation of an activity or a business over an extended period. Property managers are a general agent for the landlord. Sales associates are usually general agents of their broker.
- A **Special Agent**, or limited agent, can only represent their client in one specific action or transaction over a short time. When a broker signs a listing agreement with the seller, he or she becomes a special agent. They are granted authority to market and locate a buyer for a particular property within a specific time.

The three types of agency designations come with different levels of accountability. There is a significant difference between being a general agent and a special agent. A special agent is granted limited authority over the client's affairs, and the client has limited control over the actions of the agent. Hence the liability for any misconduct or wrongful acts will fall on the agent, not the client.

**PRACTICAL APPLICATION:** *If you fail to provide the buyer with a copy of the lead paint disclosure and the buyer sues for misrepresentation, you and your broker will be held accountable - not the seller.*

A general agent has more accountability than a special agent. The client grants more authority to a general agent, and the relationship is expected to extend over a longer period. In this case, the client can be held accountable for the actions of their agent. Employment agreements between a sales associate and their managing broker create a general agency.

**PRACTICAL APPLICATION:** *A broker asks you to show a buyer several houses that meet their criteria. Because the buyer is from a racial minority group, you only show properties from*

*neighborhoods that are predominately made up of the same ethnic group. Both you and your broker have violated the Fair Housing Act.*

## The Client

The agent is one party to an agreement. The client is the other. A **client** includes individuals, groups, or businesses that have created a contractual relationship with an agent. Once the contract to create a single agency relationship is signed, the client now becomes the agent's **principal** or primary responsibility. Examples of clients are buyers, sellers, landlords, or tenants who have established a single agency relationship.

## The Other Participants

A **customer** is a participant in a transaction who received information, services, or benefits, but one that does not have a contractual relationship with the agent. In a real estate transaction, customers can include tenants in a building managed by the agent, home inspectors hired by the buyer, or another broker's client who calls for information. An agent works *for* the client and *with* a customer.

A **prospect** is someone who has not entered into a contractual relationship with the agent but has the potential to do so. Prospects include visitors to an open house who are not represented by an agent or someone who responds to a marketing campaign.

## Section 4. Fiduciary Responsibilities

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Once a broker establishes an agency relationship with a principal, they now have the responsibility to represent the best interests of their client. This, however, does not limit a broker's capacity to create agency relationships with other clients, as long as it does not create a conflict of interest.

An **agency** is the fiduciary relationship between the agent, the **fiduciary**, and their principal, or client. **Fiduciary duties** are the highest duties known to law; they establish legal duties and ethical responsibilities of a real estate agent to their client. To fulfill the responsibility of being a fiduciary, the agent will need to be of good moral character, demonstrate ethical actions, and work in the best interests of their client.

In an effort to create a higher degree of real estate professionalism, state licensing boards, in conjunction with the National Association of Realtors (NAR), have established six fiduciary duties that are binding on all Realtors. The easiest way to remember these duties is to remember the acronym "**OLD CAR.**"



## MEMORY HELPER

### OLD CAR

- |                       |                            |
|-----------------------|----------------------------|
| <b>O</b> - Obedience  | <b>C</b> - Confidentiality |
| <b>L</b> - Loyalty    | <b>A</b> - Accounting      |
| <b>D</b> - Disclosure | <b>R</b> - Reasonable Care |



### Obedience

An agent is obligated to promptly obey all lawful instructions of their client under the contract. The agent, however, may not obey any instructions that are unethical, conflict with real estate standards, or violate common or statutory law.

**PRACTICAL APPLICATION:** *The seller does not want any public advertising. If you post the information in your local multiple listing service (MLS) and it subsequently gets uploaded to Realtor.com, you have violated their fiduciary responsibility of obedience. You are not required, however, to obey the seller's request not to show the house to minority groups because it violates fair housing laws.*

### Loyalty

Loyalty is one of the most fundamental duties owed to a client. In application, it means that the agent must act at all times in the best interests of their principal to the exclusion of all other interests - even their own. Increasing the commission must take a back seat to serving the client's best interests. An agent must be careful not to place themselves in a position that creates a conflict of interest.

**PRACTICAL APPLICATION:** *You enter into a silent partnership to purchase one of your listed properties. You do not disclose your participation in the purchase. You have violated your fiduciary responsibility of loyalty to your client.*

### Disclosure

One of the agent's primary duties is to disclose to their client all relevant information or material facts relating to the transaction regardless if it is favorable or unfavorable to the client's position. Disclosure includes not only the facts that the agent already knows but also information that they should discover in the course of acting as their client's agent. The agent also has a broader responsibility to the public to disclose to non-principals any known material facts that affect the value and are not readily observable. We will discuss the different types of disclosure forms in a future chapter.

**PRACTICAL APPLICATION:** As the listing agent, you inspect the property and notices a crack in the foundation. You should disclose your observations to the seller, even if it means reducing the listing price. You should also make sure the seller discloses the foundation problems in the Seller Disclosure Form. This does not violate your fiduciary duty of loyalty to your client but rather fulfills your duty of disclosure to the public and protects yourself from misrepresentation.

## Confidentiality

The client is always going to expect that their agent will protect their confidentiality. As their fiduciary, the agent is required to safeguard any information that could otherwise weaken their client's bargaining position. Unless the client has provided written authorization, the agent may not disclose to others the motivation, personal data, or financial information of their client.

**PRACTICAL APPLICATION:** You receive a call from another brokerage that they have a potential buyer, but they need to know the "seller's best price." You know that your client is considering a substantial price reduction. If you disclose that information, you have violated your fiduciary responsibility of confidentiality.

It is crucial to understand that while an agent is obligated to protect the confidentiality of their client, they may not, in any way, mispresent any material facts in order to protect their client - including facts about the condition of the property. An agent must always act in good faith. Unless waived in writing, an agent cannot disclose the following to any other party to the transaction:

- The seller will accept a price less than the listed price;
- The buyer will pay a higher price than contained in a written offer;
- The seller or buyer will agree to financing terms other than what was offered;
- The buying and selling motivation of any party; or
- Any information that was requested to remain confidential by a party.

It is important to note that under NAR, a Realtor's responsibility of confidentiality is indefinite – it does not end when the contract ends.

## Accounting

Keeping a careful and accurate account of all money or property that a client has entrusted to the agent or their brokerage is a fiduciary responsibility that spans all brokerage relationships. State laws will stipulate how long to preserve all transactional records. It is illegal to co-mingle personal and business funds with trust or escrow funds. Agents must safeguard any money, deeds, or other documents related to the transaction.

**PRACTICAL APPLICATION:** You receive a down payment on an offer late one Saturday. You decide to deposit the money into your personal account just for the weekend and then transfer the funds first thing on Monday morning. You have illegally co-mingled funds and violated the fiduciary duty of accounting.

## **Reasonable Care**

Exercising reasonable skill, care, and diligence while dealing honestly and fairly with others is a fiduciary responsibility that spans all brokerage relationships. Reasonable care includes promptly presenting all offers to their clients.

Licensed and trained agents are expected to know the facts involved in a transaction and be able to discern the probability of harm based on those known facts. Failure to exercise reasonable care and diligence can make an agent liable for any losses resulting from the agent's negligence or carelessness.

**PRACTICAL APPLICATION:** You advertise a property as having road frontage, but in reality, both the legal description and a survey indicate a driveway easement across the neighbor's property. You have been negligent and failed to exercise reasonable care when researching facts about the property.

Reasonable care also means that an agent does not work outside the scope of their expertise or license. Brokers and sales associates are not attorneys, certified public accountants, appraisers, loan officers, engineers, or home inspectors, and nor should they give advice as if they were.

**PRACTICAL APPLICATION:** You are showing a house to your buyer. He asks, "Hey, the roof looks old. Do you know if it leaks?" You reply, "No, the roof is fine. There are no water spots on the ceiling." However, you have not checked the seller disclosure form, the attic, or called the listing agent before answering the question. Nor did you recommend that the buyer include a home inspection contingency as part of their purchase offer. You are no longer acting in good faith and have violated the fiduciary duty of reasonable care.

In the following section, we are going to go over the different types of brokerage relationships. Each type of brokerage relationship will have different legally binding fiduciary duties. The duties of accounting and disclosure are binding on all agents in all authorized brokerage relationships. All six fiduciary responsibilities are only binding on a single agent relationship.

## **Section 5. Types of Brokerage Relationships**

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A brokerage relationship becomes "authorized" when a real estate agent begins working with a potential buyer or seller. A broker can form a brokerage relationship in the absence of a written agreement, but it is good business practice to establish all brokerage relationships in writing. It will significantly reduce problems – legal and otherwise – by establishing a contractual relationship as soon as the prospect becomes the client.

**PRACTICAL APPLICATION:** You meet a prospective seller to discuss their property and the services your brokerage offers. At this point in the relationship, no contract is needed. You can share information about your qualifications, company policies, marketing goals, and resources. If the seller agrees to have you sell their house, then you need to create an authorized brokerage relationship.

There are specific situations that do not require a brokerage relationship:

- Conducting an open house or showing a model home
- Sharing information about yourself, your firm, and the services you offer
- Responding to general questions from a prospect or customer
- Providing listing information to a buyer that is already represented by another agent
- Negotiating about price, terms, or condition of a potential sale
- Renting or leasing properties that do not have a purchase option
- Auctioning property

A brokerage relationship with a seller is formed with they sign the listing agreement. If a buyer wants an agent to locate a property for them, then they should get them into a buyer agency agreement. Not only will this comply with administrative law, but it will reduce liability and increase customer loyalty.

In a real estate transaction, there are three types of brokerage relationships:

- Single Agency Relationships
- Transaction Brokerage Relationships
- Dual Agency Relationships (not allowed in all states), and

## Single Agency Relationships

A **single agent** represents, as a fiduciary, *either a buyer or a seller, but not both*, in a real estate transaction. They are an exclusive agent for only one party to a real estate transaction. Single agency is the relationship that offers the most protection to principals and obligates the agent to meet *all of the fiduciary duties*. This is the relationship that clients expect when working with a real estate agent. When a single agency is created, the client becomes the principal. The remainder of this text will refer to the second party in all contractual relationships with an agent as the client. If a single agency brokerage exists, the second party is both the client *and* the principal.

### Fiduciary Duties of the Single Agent

A *single or exclusive agent* must adhere to *all* fiduciary duties:

- **Obedience:** Follow all instructions of the principal as long as they are legal and ethical.
- **Undivided Loyalty:** Acting at all times in the best interest of the client.
- **Full Disclosure:** Full disclosure of all relevant and material information.
- **Complete Confidentiality:** Provide complete confidentiality of all the client's personal, financial, or confidential information that could weaken the client's bargaining position.
- **Accountability:** Account for all funds entrusted to the agent or brokerage.
- **Reasonable Care:** Use skill, care, and diligence. Deal honestly and fairly. Present all offers promptly unless directed otherwise in writing.

Remember the acronym “OLD CAR” for obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care.

## Transaction Brokerage Relationship

If a broker facilitates a real estate transaction by helping out the buyer, seller, or both but is not representing either party as “their” single agent, then they are representing their client(s) as a **transaction broker**. Some states call this a real estate facilitator or a non-representation broker. The agent is working for the transaction - not the client. They are assisting the buyer and seller to complete the sale.

### Fiduciary Duties of the Transaction Broker

Because the agent is only helping the buyer and seller to complete the transaction, there are limitations to the fiduciary duties. Neither the buyer or the seller can expect complete obedience, undivided loyalty, or full disclosure. These limitations, however, do not allow the agent to represent one party to the detriment of the other.

A transaction broker must adhere to the following fiduciary duties:

- **Partial Loyalty:** Acting at all times in the best interest of the transaction and not the agent’s interests.
- **Limited Disclosure:** Disclose all known material facts that affect the value and that are not readily observable to the buyer.
- **Limited Confidentiality:** Provide limited confidentiality to prevent disclosure of the motivation or financial information of either party.
- **Accountability:** Account for all funds entrusted to the agent or brokerage.
- **Reasonable Care:** Use skill, care, and diligence. Deal honestly and fairly. Present all offers promptly unless directed otherwise in writing.

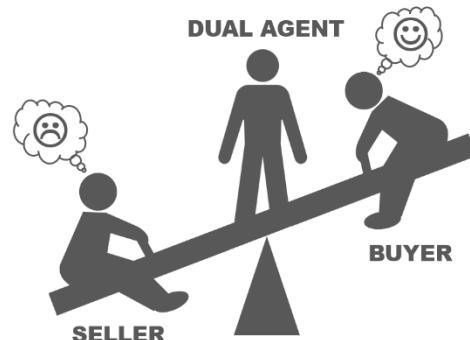
The transaction broker must clearly explain their duties to both the buyer and the seller. The parties in the transaction must understand that the agent cannot act at all times in the best interests of both the buyer or the seller. The agent is more like a neutral third-party mediator rather than the client’s advocate.

**PRACTICAL APPLICATION:** *If working as a transaction broker, you learn that the seller would be willing to pay the closing costs, you cannot disclose this information to the buyer or their agent. If you find evidence of moisture in the basement, you must disclose this to the buyer because it is a material fact that would affect the value.*

## Dual Agency Relationship

A broker who acts as a fiduciary agent to *both the buyer and the seller* in a real estate transaction is a **dual agent**. In the past, dual agency used to be very commonplace, but now it is illegal in many states because representing both parties at the same time creates a conflict of interest. The position of the dual agent can be compared to standing on the pivot point of a seesaw. The agent cannot negotiate the highest and best price for the seller while at the same time negotiating the lowest and best price for the buyer.

There are two types of dual agents. A broker creates a **Single-License Dual Agency** when they represent both the buyer and seller in a transaction. A **Dual-Licensed Dual Agency** or **Designated Agency** exists when agents from the same brokerage represent both the buyer and seller. Both the agents become designated agents, and the managing broker becomes the dual agent.



**PRACTICAL APPLICATION:** Consider some situations that create a dual agency: you find a buyer for one of your listings; a fellow agent from the same brokerage finds a buyer for your listing; you find a buyer for an in-house listing; or agents from the same brokerage are representing the buyer and seller of the same property.

### Fiduciary Duties of the Dual and Designated Agent

The problem with functioning as a dual agent is that the broker will have knowledge of confidential information from both parties and thus is unable to fulfill the fiduciary duty of full disclosure and undivided loyalty.

A *dual agent* must adhere to the following *limited* fiduciary duties:

- **Partial Loyalty:** Acting at all times in the best interest of the transaction and not the agent's interests.
- **Limited Disclosure:** Disclose all known material facts that affect the value and that are not readily observable to the buyer.
- **Limited Confidentiality:** Provide limited confidentiality to prevent disclosure of the motivation or financial information of either party.
- **Accountability:** Account for all funds entrusted to the agent or brokerage.
- **Reasonable Care:** Use skill, care, and diligence. Deal honestly and fairly. Present all offers promptly unless directed otherwise in writing.

In a dual agency relationship, the fiduciary responsibilities of full disclosure and undivided loyalty are not possible. It is illegal to disclose any information to either party that will harm the other. Being a dual agent does not waive that requirement. Even if the state allows dual agencies, most brokers will not allow their sales associates to enter into a single-license dual agency.

A designated agent must adhere to *all* of the fiduciary duties:

- **Obedience:** Follow all instructions of the principal as long as they are legal and ethical.
- **Undivided Loyalty:** Acting at all times in the best interest of the client.
- **Full Disclosure:** Full disclosure of all relevant and material information.
- **Complete Confidentiality:** Provide complete confidentiality of all the client's personal, financial, or confidential information that could weaken the client's bargaining position.
- **Accountability:** Account for all funds entrusted to the agent or brokerage.
- **Reasonable Care:** Use skill, care, and diligence. Deal honestly and fairly. Present all offers promptly unless directed otherwise in writing.

The designated agent must remember that one of their fellow licensees is exclusively representing the other party in the transaction. The agent must be careful to not inadvertently disclose information about their client to other in-house agents that would weaken their client's bargaining position.

**PRACTICAL APPLICATION:** A prospective buyer just called on one of your listings. They want to see the house and are not working with any other agents. If you show your listing to this potential buyer, you've just entered into a non-disclosed dual agency. You are now representing both the seller and the buyer in one transaction. Because you have not disclosed this in writing to both parties – you have now broken the law! You need to make one of four choices **before** the showing. Your broker could:

- 1) create a designated agency;
- 2) end the single agency with the seller and create a single-license dual agency, in writing, with both parties (if it is legal in your state);
- 3) end the single agency with the seller and create transactional broker relationships with both the buyer and the seller; or
- 4) refer the buyer to an agent that is unaffiliated with your brokerage.

Consider why this would be necessary: What will you do when your buyer asks what is the lowest price the seller will accept? You may know the answer, but if you tell the buyer, you have just violated your fiduciary responsibility of confidentiality to the seller. If you lie and tell them you don't know, then you just violated your fiduciary responsibility of reasonable care to your buyer. Whose side will you fight for if the seller wants more money than offered, but the buyer wants to pay less than the listing price? How can you negotiate the best price for both your clients at the same time? Will the buyer feel wronged if you negotiate a higher price knowing that your commission increases as well? Being a dual agent can quickly become a very complicated situation that taxes the skills of even the most experienced agent.

## **FIDUCIARY DUTIES for BROKERAGE RELATIONSHIPS**

		Transaction Broker	Dual Agent	Designated Agent	Single Agent
<b>OBEDIENCE</b> <b>O</b>	Follow all instructions of the principal as long as they are legal and ethical			✓	✓
	Undivided loyalty by acting at all times in the best interest of the client			✓	✓
<b>LOYALTY</b> <b>L</b>	Partial loyalty by acting at all times in the best interest of the transaction and not personal interests.	✓	✓		
	Full disclosure of all relevant and material information			✓	✓
<b>DISCLOSURE</b> <b>D</b>	Disclose all known material facts that affect the value and are not readily observable to the buyer	✓	✓		
<b>CONFIDENTIALITY</b> <b>C</b>	Complete confidentiality of all the client's personal, financial, or confidential information that could weaken the client's bargaining position.			✓	✓
	Limited confidentiality to prevent disclosure of motivation or financial information.	✓	✓		
<b>ACCOUNTABILITY</b> <b>A</b>	Account for all funds entrusted to the agent or brokerage.	✓	✓	✓	✓
	Use skill, care and diligence	✓	✓	✓	✓
<b>REASONABLE CARE</b> <b>R</b>	Deal honestly and fairly	✓	✓	✓	✓
	Present all offers in a timely manner unless directed otherwise in writing	✓	✓	✓	✓

## **Section 6. Forming a Brokerage Relationship**

All agency relationships must be in writing. If a state allows dual agency, then the agent must have written consent *from both parties*. It is illegal in every state to be an undisclosed dual agent. The client should clearly understand the level of fiduciary responsibilities based on the brokerage relationship and how it will impact the transaction.

An agency relationship can be created one of two ways: through an implied agency or an express agency agreement. An **implied agreement** is created unintentionally or accidentally by the behavior or actions of one or both of the parties. When both parties act like they have an agreement, an implied agreement has been formed. Implied agreements can be either legal or illegal.

**PRACTICAL APPLICATION:** You are conducting an open house for your client. You call the seller with a verbal offer that you just received from a prospect. Because you do not have a written buyer's broker agreement with the prospect, by submitting the offer, you have just created an illegal implied dual agency.

Implied agreements open up all sorts of legal problems. Because the agent has not established written duties and responsibilities, there is a much greater likelihood that the client will be dissatisfied. If a problem arises, the law nearly always sides in favor of the client. For example, if an agent does not create an agency agreement with their buyer, the agent cannot guarantee the buyer undivided loyalty because they have become a sub-agent of the seller under an implied agency.

The second type of agency is the **express agreement**. An express agreement is created when both parties formally express their intention to create a brokerage relationship either orally or in a written contract. Some states will not recognize oral agreements.

Putting all brokerage relationships in writing is a primary way to reduce liability. The disclosure of the brokerage relationship is part of the state-approved listing or buyer broker agreements. As a rule, properties should not be listed or shown to clients without establishing a brokerage relationship.

## Broker Determined Relationships

Because the managing broker is responsible for the actions of their sales associates, they are responsible for establishing the brokerage relationship with all clients. A brokerage relationship is formed between the *managing broker and the client*. Since the sales associate has established a general agency agreement with their broker, they are authorized to act on their broker's behalf as an agent to the buyer or seller. All sales associates must uphold the same level of responsibility to the principal as their broker.

Some brokers will only allow their agents to work as transaction brokers while others will allow single agency relationships. In the event that the buyer and the seller are both clients of the same brokerage, the managing broker will decide on the type of brokerage relationship and designate the licensee(s) involvement. An agent who has been assigned by the broker is called a **designated sales associate**.

## Agency Disclosure

States-established disclosure laws require agents to disclose their client relationship with all customers and clients who are participating in a transaction or possible transaction. As soon as the agent shares information about their client, their property, or the transaction, the agent needs to disclose their agency relationship. The disclosure should be in writing. Some



### WARNING!

If you fail to disclose your agency relationship to others involved in the transaction with your client, you have violated real estate license law.

states have created a form specifically for this. If an agent changes their agency relationship, then they will need to re-disclose the change to all clients and customers in the transaction.

## **Section 7.      Changing a Brokerage Relationship**

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There are going to be situations where the brokerage relationship will need to be changed. A broker may need to change the relationship from a single agent to a transaction broker or from a single agent to a designated agent. This is handled under the direction of the managing broker. When working as a single agent, here are some common situations that will require a change in the brokerage relationship:

- A seller's agent wants to submit a purchase offer from an agent that works with them in the same brokerage.
- An agent's client wants to purchase a property that is listed by their brokerage.
- An agent has found a buyer for one of their listed properties, and they want to submit an offer to their seller.

A single agency relationship is binding on the sales associate, the managing broker, and all the other agents in the same brokerage firm. Because confidential information can become known by the other agents in the firm, a brokerage cannot guarantee confidentiality if an agent in the same brokerage represents another party in the transaction. The best solution is for the agent to reduce their fiduciary responsibilities to their client by becoming a transaction broker.

Any changes to the brokerage relationship will affect the fiduciary responsibilities towards the client. It needs to be clearly explained to the client, and their consent must be in writing. The new broker relationship must be established *before* the agent starts to act in the new role.

## **Section 8. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What is an example of statutory law?
  - a. Real estate license laws and rules.
  - b. The ordinances passed by towns and cities.
  - c. Rules created by the Association of Realtors.
  - d. Both answers A and B.
  
2. What is an example of common law?
  - a. Codified laws passed by federal legislature.
  - b. The interpretation of an existing law.
  - c. A law based on precedent.
  - d. Both answers B and C.
  
3. Property managers are an example of what type of agency?
  - a. Universal agency
  - b. General agency
  - c. Special agency
  - d. Non-disclosure agency
  
4. A licensee who has a listing agreement with a seller is an example of what type of agency?
  - a. Universal agency
  - b. General agency
  - c. Special agency
  - d. Non-disclosure agency
  
5. When does a client become a principal?
  - a. Before there is an accepted offer.
  - b. When you are working as a universal agent.
  - c. When a dual agency relationship is formed.
  - d. When the licensee has entered into a single agent relationship with the client.
  
6. What is a real estate customer?
  - a. A party to a real estate transaction who receives information or services but has no contractual relationship with the agent.
  - b. A potential buyer who comes to an open house.
  - c. A real estate agent from another office.
  - d. The real estate customer is the same as your client.
  
7. If an agent does not create an agency agreement with their buyer, which of the following is true:
  - a. The agent becomes a sub-agent of the seller.
  - b. The agent cannot guarantee the buyers undivided loyalty.
  - c. The agent has entered into an implied agency.
  - d. All of the above.
  
8. What type of brokerage relationship needs to be established if a seller or a buyer wants full representation by a real estate agent?
  - a. Transaction Broker Agency

- b. Single Agency
  - c. Dual Agency
  - d. Designated Agency
9. What brokerage relationship offers buyers and sellers the lowest level of fiduciary responsibility?
- a. Single Agency Relationship
  - b. Transaction Broker Relationship
  - c. Dual Agency Relationship
  - d. Both Dual Agency and Transaction Broker Relationships
10. What is the memory aid that lists the fiduciary duties required of a single agent?
- a. OLD WIFE
  - b. OLD CAR
  - c. NEW CAR
  - d. CAR PARTS

## Quiz Answers

1. What is an example of a statutory law?
  - d. Both answers A and B. – it includes codified laws and ordinances.
2. What is an example of common law?
  - d. Both answers B and C. – Common law includes a judges' interpretation of an existing law and judgments based on prior cases.
3. Property managers are an example of what type of agency?
  - b. General agency – a general agent is an individual who is authorized by their client to perform all acts associated with the on-going operation of a business.
4. A licensee who has a listing agreement with a seller is an example of what type of agency?
  - c. Special agency – this is created when the relationship is expected to last only a short period of time and the agent only needs limited authority to perform a set of specific acts such as sell property.
5. When does a client become a principal?
  - d. When the licensee has entered into a single agent relationship with the client. – The client is your “principal” or primary responsibility.
6. What is a real estate customer?
  - a. A party to a real estate transaction who receives information or services but has no contractual relationship with the agent.
7. If an agent does not create an agency agreement with their buyer, which of the following is true:
  - d. All of the above. - Without a buyer agency agreement, the agent becomes a sub-agent of the seller when an offer is submitted. This impacts the fiduciary responsibility due to the buyer and could create an illegal implied agency without a written agreement with the buyer.
8. What type of brokerage relationship needs to be established if a seller or a buyer wants full representation by a real estate agent?
  - b. Single Agency - Single agency is the relationship that offers the most protection to principals and obligates the agent to meet all of the fiduciary duties.
9. What brokerage relationship offers buyers and sellers the lowest level of fiduciary responsibility?
  - d. Both dual agency and transaction broker relationships – This is the lowest form of representation and creates a limited fiduciary relationship between the agent and their client.
10. What is the memory aid that lists the fiduciary duties required of a single agent?
  - b. OLD CAR – Obedience, Loyalty, Disclosure and Confidentiality, Accounting, Reasonable Care and Diligence

# **Chapter 7 Contracts and Contract Law**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain:

- the types of contracts that are used in real estate;
- the five requirements for a valid contract; and
- how to handle contract breaches.

**OVERVIEW:** The objective of this chapter is to help a licensee to understand the need to put their agency relationship in writing and how disclosures protect both parties in a transaction. A basis in understanding general contract law will reduce liability and provide better service to participants in a real estate transaction.

## **Section 1. Overview of Contracts**

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Contracts are as fundamental to business as money is to banks. This is even more so in real estate where the contract involves a considerable sum of money. This chapter is going to help agents to understand the factors that make a contract legal. We are also going to show what types of contracts are needed when working with both buyers and sellers.

### **Contracts Used in Real Estate**

A real estate agent relies on contracts every single day. There are a variety of situations that will call for the creation of contracts within a real estate brokerage:

- Broker Employment Contracts,
- Client Representation Agreements (listing and buyer-broker agreements),
- Real Estate Sales Contracts (purchase agreements and options, disclosure forms),
- Property Management Agreements,
- Lease Agreements, and
- Financing Contracts (mortgages, promissory notes, and land contracts).

Be aware that the preparation of legal documents *is not* part of the duties of any licensed real estate agent – including brokers. Preparing contracts is part of the practice of law and should be handled by an attorney.

Some frequently used real estate contracts such as brokerage representation agreements, property disclosure forms, and some real estate sales contracts will be prepared by either the state's licensing board or the local real estate trade association as a preprinted fill-in-the-blank form. If special provisions or specific conditions are not covered in the preprinted form, the parties should be advised by their agent(s) to have their attorney draft any addendums or attachments.

## Section 2. General Contracts

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Before we discuss specific real estate related contracts, an agent should have a basic understanding of contracts in general. A **contract** is a voluntary agreement between two or more parties to perform or refrain from performing a legal action. Let us examine what makes a contract legal and enforceable and the different types of general contracts.

There are several different types of contracts. To make a contract enforceable, *it must be in writing*. This cannot be overemphasized. Oral contracts should never exist in a real estate practice. A commitment from at least one participant is required in every contract. In real estate, there are four levels of commitment in a legally binding contract.

- **Unilateral Contract.** When only one party is accountable for the fulfillment of the contract, it is called a **unilateral contract**. There are no performance obligations from the other party. An open listing is an example of a unilateral contract. The seller agrees to pay commission to the first real estate agent who brings a buyer, but it does not obligate performance from any specific agent.
- **Bilateral Contract.** When two parties have exchanged promises of performance, then it is called a **bilateral contract**. This is the most common form of contract. Both parties must complete an action to fulfill the contract. In a purchase agreement, the buyer agrees to pay money, and the seller agrees to transfer the title into the buyer's name. A listing agreement is also a bilateral contract.
- **Multilateral Contract.** Where there are more than two parties, and each have exchanged promises of performance, it is called a **multilateral contract**. A listing agreement with multiple co-owners is an example of a multilateral contract.
- **Option Contract.** An **option contract** gives one party the option to participate in the contract at some time in the future, but not the obligation to do so. A lease with an option to buy is an example of both a bilateral and an option contract. The lease between the tenant and the landlord is a bilateral contract (rent is exchanged for possession), and the option to buy is an option contract that may or may not be implemented by the tenant in the future.

## Section 3. Contract Law

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To create a legally enforceable contract, it must meet the requirements established through contract law. Specific elements must be included in a legal contract. Certain actions can also void a contract.

### Elements of a Legally Valid Contract

There are five elements that create a legally enforceable contract: offer, acceptance, consideration, capacity to contract, and legal purpose. These elements can be found in every contract – from a marriage license to a real estate purchase agreement. Let us take a look at these individually:

- **Offer.** A contract must have an offer. An offer is a promise made by one party. The offer is the primary substance that brings the two parties together. It could be the agent's offer to sell an

owner's house or the buyer's offer to purchase the property from a seller. Three elements make up the offer.

- Identification of the person who receives the offer;
  - Statement of the intent to enter into a contract; and
  - The terms of the contract.
- **Acceptance.** The first party submits the offer, but the contract is not valid until the second party consents or accepts the offer. A contract becomes valid, legally binding, and enforceable when both parties accept the contract by signing it. If the second party makes any changes to the contract or submits a counteroffer, the original contract is void. The new contract is not valid until the other party accepts it. The acceptance section of a contract will contain:
    - An expiration date that terminates the offer.
  - **Consideration.** All legal contracts must have some form of consideration. It is an exchange of two items of value. An employment contract exchanges wages for services. A listing agreement exchanges the services of the agent for a commission of the sale. A purchase agreement exchanges property for something of equal value. Usually, the consideration is money, but that is not a requirement. A contract must have some form of consideration, even if it is only "love and affection." The consideration section of a contract will have three elements:
    - Amount of consideration;
    - Payment terms; and
    - Time consideration or expiration date.
  - **Capacity to Contract.** Another requirement to create a legally binding contract is that the parties must have the capacity to contract and enter the agreement of their own free will. They must be of legal age and sound of mind. This is why contracts made with minors, the mentally disabled, or individuals under the influence are unenforceable and voidable. Contracts formed under misrepresentation, fraud, or undue pressure are also voidable.
  - **Legal Purpose.** A contract cannot include illegal acts or involve fraud. It must comply with statutory, common and administrative law. For example, the property can only be transferred to a buyer by the legal owner.

## Contract Status

Contracts are like humans; they come in two states: alive or dead. A contract that is in the process of being fulfilled is a living or **executory contract**. A current lease agreement is an example of an executory contract.

A contract that has been fulfilled by each of the parties is an **executed contract**. An executed contract is dead. After closing, the purchase agreement becomes an executed contract. A fully performed and executed contract can also be said to be discharged.

A contract can also be transferred or assigned to another party. When some or all of the rights and obligations are transferred to a third party, it is called a **contract assignment**. Wholesalers enter



### WARNING!

The **statute of frauds** requires that all contracts for the sale of real property or an interest in real estate be in writing and signed by both parties. This includes lease agreements.

into a purchase contract with a seller, and then they assign the contract to a buyer. The wholesaler relinquishes their rights and obligations and legally transfers them to the buyer. Contracts can include clauses that limit or forbid contract assignment. A lease that prohibits subletting is an example of this.

A new contract can be substituted in place of the original contract. This is called **novation**. All parties must accept the new contract to be legal. An example of a contract novation is when an original contract becomes damaged, illegible, or lost. A new contract is drawn up and signed by all of the parties.

## Contract Validity

There are four ways to describe the validity of a contract:

- **Valid.** A valid contract meets all of the five elements of a legal and enforceable contract;
- **Void.** A void contract is lacking one or more of the five elements and has no legal force or effect. A listing contract that lacks the names of all the co-owners is void.
- **Voidable.** A voidable contract satisfies all of the five elements on the surface, but there exist factors that could make the contract legally unenforceable by one or both parties. A purchase contract with a minor is voidable.
- **Unenforceable.** An unenforceable contract appears to satisfy all of the five elements, but it cannot be enforced in court, and neither party can sue for performance. An unenforceable contract can be legally executed and remain valid between the parties to the contract. An example of an unenforceable contract is an oral purchase agreement.

## Contract Performance

Once a contract is an executory contract, the contract now enters into the **performance of contract** phase whereby both parties must fulfill their commitments and obligations as stated in the contract. When one party does not complete all of their contractual duties, or they do not complete them on time, it is called **specific performance**. In the event of a contract default, the innocent party has the right to sue for specific performance, which will legally require the other party to fulfill their contractual responsibilities. In the event that some uncontrollable circumstance has rendered performance by one or more of the parties impossible, the contract can be voided due to an **impossibility of performance**. A buyer who suddenly receives a job transfer to a new state can seek to be released from the contract due to an impossibility of performance. A house that burns down before closing is another example.

## Section 4. Contracts with Sellers

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The representation agreement with a seller is called the listing agreement or seller agreement. It creates an authorized brokerage relationship between the agent and the seller. Notice how it meets the legal requirements for a contract:

- **Offer:** The agent agrees to market the property and locate a buyer for the seller.

- **Acceptance:** The seller accepts the offer when they sign the contract.
- **Consideration:** The seller agrees to pay the agent a commission from the sale.
- **Capacity to Contract:** Both the agent and the seller are of legal age and of sound mind.
- **Legal Purpose:** The agent is licensed as a real estate broker, and the seller is the legal owner of the real property.

Even though the sales associate will be working directly with the seller, the managing broker is the agent in the listing agreement – not the sales associate. **All states require listing agreements to be in writing in order to be legally enforceable.** There are five different types of contracts that can establish a brokerage relationship with the seller. Each contract has different levels of responsibility for each party.

- **Exclusive Right to Sell:** This is the listing agreement that provides the most security to the broker. In this agreement, the listing broker becomes the sole agent of the seller. Additionally, the seller guarantees to pay the broker *regardless of who finds the buyer*. Even if the seller finds the buyer, they still must pay the agent their commission.
- **Exclusive Agency:** This listing agreement balances the benefits between the broker and the seller. The listing broker is the sole agent of the seller. The seller agrees to pay commission to the broker *unless the seller locates a buyer*. If another agent finds the buyer, the seller is obligated to pay the commission to the listing broker, who may split it with the buyer's broker.
- **Open Listing:** The listing agreement that provides the least security to the broker is an **open listing or non-exclusive listing**. The seller does not have a sole agent. They instead contract with multiple brokers at the same time. The seller guarantees to pay *only the broker who locates the buyer* who completes the purchase. If the seller finds a buyer for their property, they are not obligated to pay commission to any of the agents.
- **One-Time Show Listing:** This is a listing agreement that is limited to a specific buyer. The seller agrees to pay the broker a commission if the named buyer completes the purchase within a specific time. Typically, this agreement is only used when an agent wants to show their buyer a for-sale-by-owner (FSBO) listing.
- **Net Listing:** This listing agreement allows the broker an open commission rate. The seller allows the broker to keep all proceeds above and beyond the seller's list price. This agreement encourages agents to place their interests ahead of their clients, inflate market prices, and pressure buyers, appraisers, and lenders. *Net listings are illegal in most states.*

Most states have approved pre-printed listing agreements that agents can use. The agent will fill in the areas that are specific to the listed property. Using these state-approved forms reduces agent liability and ensures contract uniformity.

All agents *must obtain written consent* from their sellers to include their property in the local **multiple listing service (MLS)**. The MLS is a database service used by licensed real estate professionals to provide joint access to member property listings. The state-approved listing agreement forms

include the multiple listing clause. Once the broker places the property in the MLS, all member agents can access the listing information and supply it to their buyers.

## Section 5. Contracts with Buyers

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When an agent enters into a representation agreement with a buyer, it is called a buyer agreement or buyer-broker agreement. Notice how it meets the legal requirements for a contract:

- **Offer:** The agent offers to locate a property for the buyer.
- **Acceptance:** The buyer accepts the offer when they sign the contract.
- **Consideration:** The buyer agrees to pay the agent if the seller's agent does not split their commission with the buyer broker.
- **Capacity to Contract:** Both the agent and the buyer are of legal age and of sound mind.
- **Legal Purpose:** The agent is licensed as a real estate broker, and the buyer is physically, mentally and financially able to purchase real property.

Remember that just like seller contracts, the managing broker is the agent- not the sales associate, and each contract has different levels of responsibility for both parties. **All states require that buyer-broker relationships be in writing to be enforceable in court.** There are three different types of contracts that establish a broker relationship with the buyer.

- **Exclusive Right to Represent:** This agreement provides the most security to the broker. The broker becomes the sole agent of the buyer. The buyer agrees to pay compensation to the broker *regardless of who finds the property for the buyer*, as long as the agent is not receiving compensation from another source, such as the seller's agent. This agreement is also called an exclusive buyer representation agreement.
- **Non-Exclusive Right to Represent:** This agreement balances the benefits between the broker and the buyer. The buyer agrees to pay compensation to the broker *only if the broker supplied knowledge of the property*, and the agent is not receiving compensation from another source. If the buyer purchases a property that was presented by another agent and the buyer broker never supplied it, the other agent receives the compensation.
- **Non-Exclusive/Not for Compensation:** This agreement provides the least broker security. The buyer does not have a sole agent but instead contracts with multiple brokers at the same time. This agreement does not obligate the buyer to pay any compensation to the broker. The seller's listing agent must provide compensation.

In most real estate transactions, the listing broker will split their commission with the buyer's broker. The buyer broker agreement needs to clearly define the type and source of compensation. Compensation can be in the form of a commission of the purchase price, a flat fee, or even an hourly rate. In some cases, the buyer will pay a retainer fee up front and then have it deducted from the compensation paid at closing.

Buyer brokerage relationships are not always as defined as relationships with the seller. In some states, it is allowable to establish a relationship that is less than an agency. In these cases, the broker's agent is, in reality, a sub-agent of the seller with reduced fiduciary responsibilities to the buyer. **In the absence of a written buyer representation agreement, the agent becomes a sub-agent of the seller.** In states where this is still allowed, it is not a recommended course of action. The buyer will always expect their broker to be their advocate - not the seller's agent.

## **Section 6. Terminating a Contract**

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An agency agreement with a client is a limited one. Eventually, it will come to an end and be discharged or terminated. There are several conditions or events that can cause a contract to terminate:

- Both the parties have **tendered performance** and fulfilled the terms of the contract. After a property closing, the listing contract has been fulfilled, and the relationship ends.
- If there was **partial performance** of the contract terms and both parties agree that performance was sufficient, the contract can be discharged.
- If one party has tendered **substantial performance** that is enough to force the other party to tender full or partial compensation, the contract can be discharged with possible adjustments for damages or losses suffered from the other party.
- The contract has **expired** before a party could accomplish the goal of the contract. The contract is terminated unless a new contract is created or there is a written extension signed by both parties.
- The contract has been **rescinded** or terminated. The mutual written consent of both parties is called **mutual rescission**. If one party cancels the contract, without the consent of the other, it is called **unilateral rescission**.
- One party **unilaterally revokes** the contract. They can be held liable for damages caused by the end of the brokerage relationship. State-approved brokerage agreements contain terms and conditions that make it difficult for the client to terminate the agreement without just cause.
- An unexpected economic **hardship** could create a situation where one party can legally back out of the contract. A buyer finds out that the company he works for has just filed bankruptcy, and all employees have been immediately laid off. The buyer no longer qualifies for the mortgage that was a contingency of the purchase.
- There could be the **impossibility of performance** that invalidates or cancels the contract. The law allows a party to excuse themselves from a contract if they are unable to fulfill the contract due to no fault of their own. A buyer may suddenly get a job transfer to another city and must withdraw from the purchase agreement. Because they will no longer live in that town, there is no objective reason to purchase the property. A tornado destroys the house before the closing. The buyer no longer wants the property. The buyer dies before completing the purchase.
- There has been a **breach of contract** by one of the parties. If one of the parties has violated the terms or conditions of the contract, the other party has legal or equitable remedies. A

breach of contract allows the injured party the right to terminate the contract, accept partial performance, or sue for monetary damages or specific performance.

- The contract can be terminated due to an **operation of law**. In this case, the contract is invalidated due to a violation of the law, such as fraud or misrepresentation. Exerting undue influence or forcing a contract under duress voids the contract under the operation of law.
  - Contracts that are grossly one-sided, unfair, or completely unreasonable are affected by **unconscionability**. Because the actions within a contract are unfair, the unconscionable contract can be unenforceable under law. An example of unconscionability is a residential lease with option to buy that has a very high non-refundable option payment and a minor lease violation voids the option. If the court decides the contract is unconscionable, it will act to prevent the landlord from benefiting from their unfair behavior.
  - A misunderstanding or misconception about an untrue fact does not void a contract, but it could make it voidable. Examples of **mistakes of fact** include typographical errors or incorrect identification of a party to the contract.
  - A *failure to disclose* a material fact or making an incorrect or misleading statement about a material fact is called **misrepresentation**. Negligence can result in unintentional misrepresentation. Misrepresentation makes a contract voidable if the other party suffered a loss from relying on the information.
  - The *intentional* misrepresentation of a material fact that takes advantage of or harms others is **fraud**. Fraud includes intentional fraudulent nondisclosure, concealing material facts, or making false statements.

## Statute of Limitations

Contract law has established a limited amount of time that an injured party can file for legal action. This is called the **statute of limitations**. Each state is allowed to set limitations on fraud, misrepresentation, or a breach of contract. Generally, the statute of limitations extends between three to ten years from the event.

## **Section 7. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What are the five contract requirements needed to create a legal contract?
  - a. Offer, Consideration, Parties, Capacity, Legal Purpose
  - b. Offer, Acceptance, Consideration, Capacity, Legal Purpose
  - c. Terms, Contingencies, Consideration, Capacity, Contract
  - d. Consideration, Offer, Terms, Capacity, Legal Purpose
  
2. A listing agreement is which type of contract?
  - a. Unilateral
  - b. Bilateral
  - c. Multilateral
  - d. Either B or C
  
3. True or false. An option contract requires that one party fulfill their part of the contract at a later point in time.
  - a. True
  - b. False
  
4. When are contract assignments not allowed?
  - a. When there is an option contract.
  - b. When the buyer is under foreclosure.
  - c. When the contract prohibits it.
  - d. If the seller does not want an assignment.
  
5. What listing agreement do real estate agents prefer to use with their clients?
  - a. Exclusive Agency Listing
  - b. Open Listing
  - c. Net Listing
  - d. Exclusive Right to Sell Listing
  
6. What are some circumstances that would *not* require a buyer to pay their agent commission?
  - a. The agent will receive the commission from the seller's side of the transaction.
  - b. If the buyer finds the property under a Nonexclusive Right to Represent Contract.
  - c. They signed a Nonexclusive Not for Compensation Contract.
  - d. All of the above.

7. A contract that is grossly one-sided, or unfair, has \_\_\_\_\_.

- a. objective impossibility
- b. unconscionability
- c. committed fraud
- d. misrepresented

8. True or false. Misrepresentation is worse than fraud.

- a. True
- b. False

9. If an agent withholds information that could cause a buyer to suffer a loss, she has committed \_\_\_\_\_.

- a. fraudulent misrepresentation
- b. unilateral mistake
- c. unconscionability
- d. fraudulent nondisclosure

10. True or false. If there has been a breach of contract, the party guilty of committing the breach can sue for specific performance.

- a. True
- b. False

## Quiz Answers

1. What are the five (5) contract requirements needed to create a legal contract?
  - b. Offer, Acceptance, Consideration, Capacity, Legal Purpose
2. A listing agreement is which type of contract?
  - d. Either B or C – It depends on how many parties there are to the contract. There must be a minimum of two (bilateral).
3. True or false. An option contract requires that one party fulfill their part of the contract at a later point in time.
  - b. False – An option contract gives one party the *option* to fulfill the contract but not the obligation to do so.
4. When are contract assignments not allowed?
  - c. When the contract prohibits it. – Some contracts have a clause that prohibits the contract being assigned to another party.
5. What listing agreement do real estate agents prefer with their clients?
  - d. Exclusive Right to Sell Listing – this contract guarantees the agent compensation no matter who sells the property.
6. What are some circumstances that would *not* require a buyer to pay their agent commission?
  - d. All of the above. – All buyer contracts do not require the buyer to pay their agent commission if the agent is getting paid out of the seller's commission.
7. A contract that is grossly one-sided, unfair, or unreasonable has \_\_\_\_\_.
  - b. unconscionability
8. True or false. Misrepresentation is worse than fraud.
  - b. False – Misrepresentation is a failure to disclose, but fraud is an intentional misrepresentation that causes harm.
9. If an agent withholds information that could cause a buyer to suffer a loss she has committed \_\_\_\_\_.
  - d. fraudulent nondisclosure – nondisclosure of a known material fact that could another party to suffer loss is still fraud.
10. True or false. If there has been a breach of contract, the party guilty of committing the breach can sue for specific performance.
  - b. False – Only the innocent party can terminate, accept or litigate against a breach of contract.

# Chapter 8 Physical Characteristics of Real Property

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- four physical characteristics of land;
- fundamental ownership rights of land, air, and water;
- differences between real estate, real property, and personal property; and
- how property is partitioned and legal descriptions created;

**OVERVIEW:** Now that you understand all of the practical and legal aspects of being a real estate agent, it is time to learn about real estate. The first step is to understand the basic concept of real estate – what it is, what it includes, and how it is divided.

## Section 1. The Concept of Land

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Real estate agents tend to focus their attention on the buildings. Let us, however, step back and look down. It is the earth beneath our feet that is in such high demand. Before an agent can learn how to buy and sell houses, they need to know about the land.

### Three Physical Characteristics of Land

Owning land has some unique physical characteristics that make it different from anything else that can be owned. There are three physical characteristics of land:

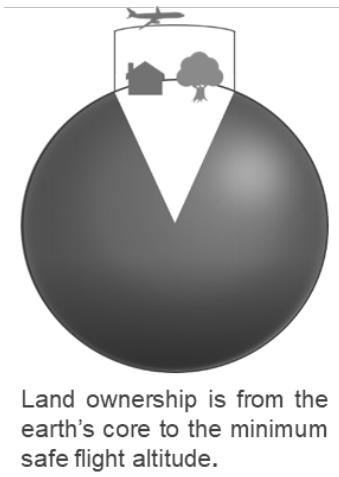
- **Immobility.** Real estate is fixed. It is not going anywhere. While dirt can be hauled off the land, the trees can be cut down, and the improvements can be scraped off; the geographical location of the property is fixed, immobile, and permanent.
- **Lack of Similarity.** Every parcel of land on this planet is unique. Even in a subdivision where all the parcels are precisely the same size, there are topographical differences, differences in flora and fauna, and above all, differences in location.
- **Indestructibility.** Land is indestructible, has and will be around forever. It can be bombed, strip-mined, or even washed away in a flood, but the ownership of the parcel remains constant.

The permanence of land is key to why real estate retains value regardless of the passage of time or the effects of economics.

There is, however, a small degree of risk in owning land. While a person has title to a specific geographical area, the contents within that area can change. **Erosion** gradually wears away at the land through natural forces such as wind and water. A sudden loss of land is called **avulsion**, and this can be caused by an earthquake, mudslide, or a hurricane. In some cases, a property owner could gain land over time. This is called **accretion**. Often this occurs as rivers deposit soil or when volcanoes extend shorelines.

## Land Rights and Ownership Boundaries

A property owner has the right to use the space above and below the surface of the land. The ownership rights that apply to the surface of the land are called **surface rights**. The right to use the space above the land is known as **air rights**. **Subsurface rights** or **mineral rights** cover the rights to any natural resources below the surface. If a property contains or borders a body of water, there are also water rights. **Riparian rights** allow the use of a river or stream. **Littoral rights** allow the use of adjacent lakes, seas, and oceans.



Land ownership is from the earth's core to the minimum safe flight altitude.

Legally speaking, air rights extend from the land's surface all the way up to the outer edge of the earth's atmosphere – well, at least until the invention of airplanes. The United States Supreme Court ruled in 1946 that a “landowner owns at least as much of the space above the ground as he can occupy and use in connection with the land.” (*United States v. Causby, 1946*). Then Congress got involved and placed a ceiling on top of that statement when they established a minimum safe flight altitude of 300 feet. While we technically own the airspace up to 300 feet, local zoning ordinances and building codes will limit what can be done with that air space.

Subsurface rights below the ground are a little trickier. As long as the property owner retains all the mineral rights, they own a sliver of the planet all the way down to the earth's core. If they do not, then they own the surface of the land, and someone else owns some or all of the natural resources below their feet. An oil or gas lease gives a company permission to conduct extraction operations. The oil or gas company will pay the property owner an annual flat fee. If the company ever finds any oil or gas in the future, the property owner will receive a percentage of its value.

A landowner can sell any of these rights to a third party. Buyers should be aware that a property can be deeded without some of these rights. State and local regulations, however, regulate what an owner can do with their rights and how it can impact surrounding properties.

**PRACTICAL APPLICATION:** A landowner can sell his air rights to a nearby airport or a company that places a cell phone tower or a wind turbine on his property. He then could turn around and also sell the subsurface rights to an oil company. When deeding the property to a buyer, the owner can retain his rights to any coal deposits. In this case, the new owner would only own the right to part of the property's surface area and any improvements located in that area. Others own all the other rights to the land.

The state determines the level of riparian rights to rivers and streams. Generally speaking, riparian rights grant unrestricted use of the water as long as the owner does not contaminate, interrupt, or

alter the flow of the water. Ownership of streams and rivers that are unsuitable for commercial boat traffic (non-navigable rivers) extend to the middle of the waterway. The state owns commercially navigable rivers, and adjacent landowners possess only up to the water's edge.

Properties that border commercially navigable lakes, seas, and oceans are subject to littoral rights. Similar to commercial rivers, the property owner has unrestricted use of these bodies of water, but ownership only extends to the average high-water mark. It is not trespassing if the public walks along the shore of someone's private property as long as they walk in the surf or below the high watermark.

## Section 2. The Concept of Improved Land

Owning dirt is nice, but owning a building on that dirt is even better. Let us now focus on the concept of improved land.

### Real Estate vs. Real Property

"Real estate" and "real property" are often used interchangeably, but there is a significant difference.

**Real estate** is a parcel of land *plus* all the permanently attached improvements. A house, garage, driveway, well, septic, and fence are all examples of an improvement. **Real Property** is a parcel of land *plus* all the permanently attached improvements *plus* all the interests, benefits, and rights that come with the ownership.



### CHECK THIS OUT

#### REA ESTATE

Land  
+ Improvements

#### REAL PROPERTY

Land  
+ Improvements  
+ Ownership Rights

Even though there is a technical difference between real estate and real property, in practice, the terms are used interchangeably.

Real estate agents are technically selling real property not real estate, because the transaction includes the rights to sell, use, possess and control the property. Do not stress about the terminology too much because few clients will ever know the difference.

### Personal Property vs. Fixtures

Real property is the land plus the improvements. The furniture, pots and pans, artwork, and all the other stuff is called **personal property** or **chattel**. Personal property does not transfer with the real property unless it is individually listed in the sales contract. Personal property is transferred through a bill of sale.

When personal property is permanently attached to the real estate, it becomes a **fixture**. The act of converting personal property into a fixture is called **annexation**. Unlike personal property, a fixture does transfer with the real property.

Land fixtures include anything that is permanently rooted to the ground like trees and shrubs. Building fixtures include mechanical systems, built-in appliances, kitchen cabinets, faucets, and light fixtures. If a fixture is removed, then it becomes personal property. When real property is turned into personal property, it is called **severance**.

**PRACTICAL APPLICATION:** *If the buyer wants the washer and gas dryer, which are both considered personal property, they will need to request them in the purchase contract. This goes for all items that could be considered as personal property such as draperies, bookcases, and kitchen appliances. A lot of time and money can be tied up in the courts because the buyer and seller did not identify specific items in the sales contract.*

Annual crops, known as **emblents**, are also considered personal property. Crops belong to whoever planted them, even if they cannot be harvested until after the property is sold. Perennial crops, such as vineyards and orchards, are permanently affixed to the property, and as such, they transfer with the land.

Commercial **trade fixtures** are handled a little differently. Because a business cannot operate without the business equipment, the trade fixtures are considered personal property and transfer with the going concern, or business, and *not* with the commercial real estate. An example of trade fixtures are the coolers in a grocery store; the booths in a restaurant, or the conveyors in a factory. Any trade fixtures that would be impractical to remove would be considered a building fixture. An example may be the ventilation system in a kitchen or the recessed lighting in a gallery. If a trade fixture is left in the building after a business vacates, it then becomes real property by means of **accession**.

So how do you know if it is a fixture or personal property? The court system uses five basic tests. The answers to the following questions can quickly identify personal property.

1. **Method of annexation:** Can the item be removed without causing severe damage to the property? Removing the kitchen cabinets would cause significant property damage.
2. **Adaptability:** Could the removed item be reasonably adapted to be used somewhere else? Is it being used as personal property? A built-in dishwasher that matches the kitchen cabinets cannot easily be adapted to a new location.

3. **Relationship:** What is the relationship to the item? Because the chandelier has been in the family for three generations, it has an added relationship to the seller and could be considered as personal property.
4. **Intention:** Was the installation intended to be permanent or temporary? The difference between the placement of a lamp and a ceiling light is an example of intention.
5. **Agreement:** Is there an agreement between the buyer and the seller as to whether it is personal or real property?



## MEMORY HELPER

### MARIA

- M – Method**
- A – Adaptability**
- R – Relationship**
- I – Intention**
- A – Agreement**

## Tangible vs. Intangible Property

Personal property can be divided into two categories: tangible property and intangible property. **Tangible property** are physical items such as a sofa, car, or filing cabinet. **Intangible property** represents items that do not have a physical form yet has a value such as stocks and bonds, a business name, or a land contract. Both tangible and intangible property can be valued and sold.

## Manufactured Homes vs. Modular Homes

As a real estate agent, it is vital to know the difference between a manufactured home and a modular home. Both are factory-built housing, but they are very different products.

A **manufactured home** is pre-constructed in a factory and is supported by a fixed steel chassis and detachable wheels. Back in the day, they were known as mobile homes and trailers. Over time the quality of construction was dramatically improved. The Federal Housing and Urban Development (HUD) govern the construction of manufactured homes, and they are registered with the Department of Motor Vehicles. They come in three standard sizes: single-wide, double-wide, and triple-wide. Most manufactured homes are considered personal property and are transferred like a car.



### WARNING!

Do not assume a manufactured home is part of the real property – most are not.

Seek the opinion of a home inspector or an appraiser to know for sure.

Your buyer's financing may depend on it!

There are, however, some exceptions to this rule. A manufactured home can become real property if it meets these two qualifications: (1) it is permanently attached to a fixed foundation; and (2) the certificate of title has been surrendered, and the owner filed an affidavit with the local lands department. A manufactured home is classified as real property if it is included in the property taxes. That does not mean, however, that it can be mortgaged. Much depends on state law and the lender.

A **modular home** is also constructed in a factory and is assembled on-site on a permanent foundation. These homes must conform to all local, state, and regional building codes. Modular homes are almost indistinguishable from on-site

stick-built homes. Because they are permanently attached to the land, they are classified as a real estate improvement and transfer within the property deed.

## **Section 3. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What are the three physical characteristics of land?
  - a. immobility, lack of similarity, and indestructibility
  - b. Permanence, salability, development, lack of similarity
  - c. Immobility, indestructibility, permanence
  - d. Long life, salability, functionality
2. What is another term for subsurface rights?
  - a. Air rights
  - b. Riparian rights
  - c. Mineral rights
  - d. Land rights
3. True or false. A landowner can sell a portion of their subsurface rights.
  - a. True
  - b. False
4. True or false. Property ownership extends up to the edge of the atmosphere and down to the core.
  - a. True
  - b. False
5. What is the definition of real estate?
  - a. An identified parcel or tract of land.
  - b. An identified parcel or tract of land, including any improvements.
  - c. The land, the improvements, plus the interests, benefits, and rights inherent in the ownership of real estate.
  - d. An identified parcel or tract of land, the improvements, rights, and personal property.
6. What is the definition of real property?
  - a. An identified parcel or tract of land.
  - b. An identified parcel or tract of land, including any improvements.
  - c. The land, the improvements, plus the interests, benefits, and rights inherent in the ownership of real estate.
  - d. An identified parcel or tract of land, the improvements, rights, and personal property.
7. When does personal property become a fixture?
  - a. When it is left in the house after the owner moves out.
  - b. When it is part of the deed.
  - c. When it is permanently attached to the land or the improvements.
  - d. When it is connected to the buildings electrical supply.

8. Give an example of intangible property.
  - a. Stocks
  - b. Lease Agreements
  - c. Business Names
  - d. All of the above.
9. True or false. Modular homes are always part of the real property.
  - a. True
  - b. False
10. What is the difference between a manufactured home and a modular home?
  - a. Manufactured homes and modular homes are both pre-constructed in a factory.
  - b. Manufactured homes are supported by a fixed steel chassis and modular homes are assembled on a permanent foundation.
  - c. Most manufactured homes are considered personal property and modular homes transfer within the property deed.
  - d. Both B and C.

## Quiz Answers

1. What are the three physical characteristics of land?
  - a. immobility, lack of similarity, and indestructibility
2. What is another term for subsurface rights?
  - c. Mineral rights - Subsurface rights or mineral rights cover the rights to any natural resources below the surface.
3. True or false. A landowner can sell a portion of their subsurface rights.
  - a. True – A landowner can sell any of their subsurface rights to a third party.
4. True or false. Property ownership extends up to the edge of the atmosphere and down to the core.
  - b. False – Vertical property ownership is limited by airspace rights and zoning ordinances and building codes. To own to the core, a property owner must also retain the mineral rights.
5. What is the definition of real estate?
  - b. An identified parcel or tract of land, including any improvements.
6. What is the definition of real property?
  - c. The land, the improvements, plus the interests, benefits, and rights inherent in the ownership of real estate.
7. When does personal property become a fixture?
  - c. When it is permanently attached to the land or the improvements. Examples of fixtures are appliances, curtain rods, blinds, shades, light fixtures, dishwashers, and faucets.
8. Give an example of intangible property.
  - d. All of the above. Intangible property is personal property that is not physical in nature but represents something of value.
9. True or false. Modular homes are always part of the real property.
  - a. True - Because they are permanently attached to the land, they are classified as a real estate improvement and transfer within the property deed.
10. What is the difference between a manufactured home and a modular home?
  - d. Both B and C. Manufactured homes are supported by a fixed steel chassis and are considered as personal property. Modular homes are assembled on a permanent foundation and transfer within the property deed.

# Chapter 9 Economic Characteristics of Real Property

**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the four economic characteristics of real estate;
- the rights of owners and tenants;
- forces that limit property rights; and
- how different types of liens impact the title.

**OVERVIEW:** We have discussed many of the physical aspects of real estate, but understanding the economic characteristics is even more critical. The economic characteristics of property ownership have just as much of an impact on value as the physical characteristics – if not more.

## Section 1. Four Economic Characteristics

There are four economic characteristics of real estate that make it different from most other things an individual can own. The four economic characteristics are scarcity, location, improvements, and permanence of investment.

- **Scarcity.** The limited amount, or scarcity, of land area on the planet, impacts the supply and demand and, thus, the price of real estate.
- **Location.** A property's location and characteristics can rightly be considered the most important economic characteristic.

**PRACTICAL APPLICATION:** Two identically sized parcels are located on an inland lake. One parcel is full of marshlands and lacks a defined shoreline. The other is elevated above the shore on the east side and offers a panoramic view of the lake. No one would dare say they are worth the same just because they share a similar location.

- **Improvements.** The improvements placed on the property impact the value and the use of the land. Imagine the difference in value between a 20-acre pig farm versus a newly constructed estate home complete with riding stables.
- **Permanence of Investment.** The return on the capital and labor to develop real estate has more permanence than other non-tangible investments. Even in the face of a natural disaster, the improvements can be recovered or reconstructed – unlike the stock of a bankrupt company.



### MEMORY HELPER

#### SLIP

**S** – Scarcity

**L** – Location

**I** – Improvements

**P** – Permanence of Investment

## Section 2. Four Elements of Value

For real estate to have value or monetary worth, it must possess these four characteristics: demand, utility, scarcity, and transferability.

- **Demand.** There must be a need, desire, or interest in the property along with the financial means to it.
- **Utility.** The property must be able to satisfy an intended use.
- **Scarcity.** There must be a limited supply.
- **Transferability.** The owner must have the ability to legally transfer ownership rights from one person to another without difficulty.



### MEMORY HELPER

#### **DUST**

**D** – Demand

**U** – Utility

**S** – Scarcity

**T** – Transferability

## Section 3. Supply and Demand

The real estate market is always in flux. Statements such as “this is a buyer’s market” or a “seller’s market” are, in reality, measuring the supply and demand within the market. It is supply and demand that creates a short-term change in property values.

- Prices **increase** when **demand increases** and the **supply decreases**. This creates a seller’s market. Because there are more buyers than there are available properties, buyers are willing to pay a higher price to get the property. This causes value inflation.
- Prices **decrease** when **demand decreases** and the **supply increases**. This creates a buyer’s market. Because there are more properties than available buyers, sellers are willing to accept a lower price to move the property. This causes value deflation.
- Prices are **stable** when the **demand is satisfied by the current supply**. Offering prices and purchase prices are consistent, and listings remain on the market for a reasonable time.

The market must shift from one stage to the other. A seller’s market will always eventually turn into a buyer’s market and then return to a seller’s market. As property developers see a rise in the demand, for say apartment units, they begin to construct the units to satisfy the demand. As more developers jump into the market, eventually the supply will exceed the demand. Prices drop to encourage more market activity. Thus, the cycle starts all over. As long as each cycle is not too long or too severe, the market will continue to strengthen through each cycle.

### Factors that Affect Supply

- **Labor** – A shortage in the labor force will reduce the creation of the supply.
- **Materials** – A shortage of building materials will also reduce the construction of more supply.
- **Governmental Controls** – Rising real estate taxes, high construction permit fees, strict land use controls, and governmental monetary policy affects not only the cost of a product but also the available mortgage financing necessary to create the product.

## Factors that Affect Demand

- **Population** – As populations increase or decrease, demand does too.
- **Demographics** – Family size, age, income, and lifestyle contribute to the demand for specific products and economic services.
- **Employment and Wages** – Decisions to buy are directly related to employment and wages. As unemployment rises, there is a proportionate reduction in the demand for new products.

A skilled real estate agent will examine not only the activity in their local or micro-market but also the activity in the national economy. It is important to follow economic trends and anticipate the pendulum effect of supply and demand.

## Section 4. The Bundle of Property Rights

The definition of real property includes the rights inherent to ownership. There are five legal rights included in real property – commonly known as the bundle of property rights.



**Bundle of Property Rights**

- **Disposition.** An owner has the right to sell, rent, or transfer ownership of the property.
- **Exclusion.** An owner has the right to exclude others from using the property.
- **Enjoyment.** An owner has the right to enjoy the legal use of the property.
- **Possession.** The owner has the right to own or possess the land and improvements.
- **Control.** The owner has the right to control the use of the property.



### MEMORY HELPER

#### **DEEP + C**

**D** – Disposition

**E** – Enjoyment

**E** – Exclusion

**P** – Possession

+

**C** – Control

*"Look **DEEP** to **C** your property rights."*

The owner of the real property has the right to give some or all of the “sticks” to others. A lease agreement legally hands over some of the bundle of rights to the tenant. The tenant now has the right to possess the property, enjoy the use, and control it. The property owner has reduced their property rights. At the end of the lease, these rights revert to the property owner.



## Section 5. Limitations to Property Rights

There are, however, limitations to an owner's property rights. Just because a person holds title to the property does not mean that they can do anything they want with it. While this may seem like an unfair limitation, it protects us from our neighbors building a pig farm in a subdivision or a meth lab downtown. There are four governmental powers and four public powers that limit our ownership rights.

### Four Governmental Powers

Governmental authorities on a local, state, and federal level exercise the greatest amount of control of ownership rights. Governmental controls protect the welfare of the public rather than the rights of the individual. Their authority comes in four forms: police power, eminent domain, taxation and escheat.

#### Police Power

The government's right to protect the safety, health, and welfare of the public by restricting property ownership rights is called **police power**. Local governments, such as a city or county, have the authority to create building codes, environmental laws, and zoning ordinances. These limit an owner's right of enjoyment and control.

Building codes protect residents from careless building practices. Environmental laws protect natural resources, such as land, air, and water. Zoning ordinances regulate land size, building density, and property use. Zoning ordinances are set at the local level. There is no such thing as a state or national zoning code, but most follow similar land classification systems.

## Eminent Domain

The government's right to take private property for public use with just compensation is called **eminent domain**. There are, however, restrictions on the government's use of eminent domain. There must be a valid public use, such as installing utility lines, widening public roads, or the construction of public buildings. The government must also provide the owner with fair compensation as guaranteed under the Fifth Amendment. Usually, the property owner will negotiate with the government for a fair price. If an agreement cannot be reached, the government can forcibly take the property under eminent domain. This is called **condemnation**. Fair compensation must still be provided. The power of eminent domain legally removes all of the owner's property rights.

## Taxation

The government's right to levy ad valorem taxes based on property value is called taxation. Taxation provides income to the government to enforce their police power. It also provides services that support our ownership rights such as public utilities, roads, schools, and the like. The government assesses three types of property taxes: annual real estate taxes, taxes on the sale of a property, and special assessments to finance short-term development projects. The power of taxation affects an owner's right of enjoyment.

## Escheat

The government's power to acquire ownership of a property when an owner dies without an heir, valid will, or living trust is the power of **escheat**. The name is fitting as it "cheats" an owner out of their right of possession. Since the owner is deceased and there are no legal owners of the property, the government becomes the owner. This prevents the property from being ownerless and abandoned. The government can publicly sell the property or use it as they see fit.

## Three Public Powers

The public can also impact an owner's bundle of property rights. There are three ways the public sector can affect property rights: nuisance claims, deed restrictions, and liens.

### Nuisance Claims

Individuals have the right to report a **nuisance** to the police. This is a public action that affects a property owner's *right to enjoyment*. There are two types of nuisance claims. A private nuisance affects another's right. A neighbor that blasts their music until 2 a.m. could be a reason for filing a private nuisance. A public nuisance jeopardizes the safety of the public and breaks the law. A neighbor who



### MEMORY HELPER

#### **PETE**

**P** – Police Power

**E** – Eminent Domain

**T** – Taxation

**E** – Escheat

*"PETE can look  
DEEP to C how to  
control your  
property rights."*

runs a dog fight out of their garage or teenagers shooting fireworks off in a residential neighborhood are reasons for filing a public nuisance.

## Deed Restrictions

A **deed restriction** (or restrictive covenant) is a limitation or covenant written into a deed to restrict the control, occupancy, or use of a property. A deed restriction “runs with the land,” meaning that it will apply to all future owners. Anything that runs with the land is called an **appurtenance**. Land developers create **covenants, conditions and restrictions (CC&Rs)** or master deeds that govern the rights of all the property owners within a community, subdivision, condominium, cooperative, or planned unit development. A CC&R could restrict an owner from permanently parking their boat on their property, hanging their laundry outside, or even the color they can paint their house. Covenants, conditions and restrictions create property uniformity and help to preserve market value. All buyers should receive a copy and review the CC&R before closing.

Individual property owners can also place a deed restriction on their property. An example would be a deed restriction that limits any future division of the property or one that requires that a specific tree not be cut down. Private deed restrictions can be removed, but it can be a complicated process. Deed restrictions can limit some or all of an owner’s bundle of property rights.

A *lis pendens* is a notice filed in public records of a pending legal action that affects the title or possession of the property. A *lis pendens* creates a cloud on the title which may prevent the property from being sold or further encumbered. Once the owner resolves the dispute, the party who filed the *lis pendens* will record a release to clear the title.

## Liens

A creditor can place a **lien** against the title of a property that bars the sale or transfer of the property until the creditor is paid-in-full. If a contractor has not been paid for work done on a property, he may place a contractor’s lien (also known as a mechanic’s lien or a construction lien) on the property. A recorded mortgage creates a lien on the property. If a property owner fails to pay their real estate taxes, a tax lien can be levied against the property. All liens restrict the property owner’s right to disposition. There are several types of liens.

- **General liens** affect all real and personal property of a debtor and include judgments, estate and inheritance taxes, decedent’s debts, corporate franchise taxes and IRS debts.
- **Specific liens** affect only the property that is used as collateral and include liens from vendors, contractors, mortgages, real estate tax, and special assessments.
- **Voluntary liens** are created intentional by the property owner. A mortgage loan is an example of a voluntary lien.
- **Involuntary liens** are created by law and are not a matter of choice. An IRS lien is an example of an involuntary lien.

A title search is the easiest way to identify if there are any public restrictions on a property. A real estate agent must identify all the factors that affect the bundle of property rights as this will impact, positively or negatively, the market value of the property.

## **Section 6. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What are the four economic characteristics of land?
  - a. Location, immobility, lack of similarity, improvement
  - b. Permanence, improvement, location, salability
  - c. Salability, location, immobility, property value
  - d. Scarcity, location, improvements, permanence of investment
  
2. Name the four elements of value.
  - a. Salability, location, immobility, property value
  - b. Demand, utility, scarcity, transferability
  - c. Durability, usefulness, salability, trust
  - d. Scarcity, transferability, accountability, demand
  
3. True or false. A seller's market is created when demand increases and supply decreases.
  - a. True
  - b. False
  
4. What is included in the bundle of property rights?
  - a. Disposition, Enjoyment, Exclusion, Possession, and Control.
  - b. Build, Use, Sell, Posses and Control.
  - c. Ownership, Enjoyment, Exclusion, Possession, and Sale.
  - d. Disposition, Use, Control, Lease, Sell.
  
5. True or false. A lease agreement legally hands over some of the bundle of rights to the tenant.
  - a. True
  - b. False
  
6. What are the four governmental powers that affect property rights?
  - a. Police Power, Cheat, Arrest, and Taxation.
  - b. Police Power, Eminent Domain, Taxation, and Escheat.
  - c. Eminent Domain, Taxation, Arrest, Escheat.
  - d. Police Power, Covenants, Restrictions, Taxation.

7. What are the three public powers that impact an owner's property rights?
  - a. Easements, mortgages, lawsuits
  - b. Court cases, title clouds, and mortgages
  - c. Nuisance claims, deed restrictions, and liens
  - d. Property taxes, deed restrictions, and contractor liens
8. What types of properties carry covenants, conditions, and restrictions?
  - a. Condominiums
  - b. Subdivisions
  - c. Planned Unit Developments
  - d. All of the above.
9. True or false. A deed restriction runs with the land.
  - a. True
  - b. False
10. True or false. Liens can be attached to the deed.
  - a. True
  - b. False

## Quiz Answers

1. What are the four economic characteristics of land?
  - d. Scarcity, location, improvements, permanence of investment
2. Name the four elements of value.
  - b. Demand, utility, scarcity, transferability
3. True or false. A seller's market is created when demand increases and supply decreases.
  - a. True - Prices increase when demand increases and the supply decreases. This creates a seller's market.
4. What is included in the bundle of property rights?
  - a. Disposition, Enjoyment, Exclusion, Possession, and Control. – Remember the memory aid DEEP + C.
5. True or false. A lease agreement legally hands over some of the bundle of rights to the tenant.
  - a. True - The tenant now has the right to possess the property, enjoy the use, and control it.
6. What are the four governmental powers that affect property rights?
  - b. Police Power, Eminent Domain, Taxation, and Escheat. – Remember the memory aid PETE.
7. What are the three public powers that impact an owner's property rights?
  - c. Nuisance claims, deed restrictions, and liens
8. What types of properties carry covenants, conditions, and restrictions?
  - d. All of the above. Covenants, conditions, and restrictions are common in most subdivisions, condominiums, cooperatives and planned unit developments.
9. True or false. A deed restriction runs with the land.
  - a. True - Deed restrictions “run with the land,” meaning that they apply to all future owners of the property.
10. True or false. Liens can be attached to the deed.
  - a. True – a lien can be recorded and attached to the deed which bars its sale or transfer without paying off the creditor.

# **Chapter 10 Property Ownership**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain:

- the three types of possessory freehold estates;
- the three types of possessory leasehold estates;
- the four types of non-possessory interests; and
- the seven forms of ownership.

**OVERVIEW:** This chapter will discuss the levels of property possession and the different forms of ownership. It will also explain how others can have a legal interest or right to use the property even though they do not possess the title.

## **Section 1. Estates in Land**

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For real estate to have value, there must be a form of ownership and rights to the property. Real property offers many different types of ownership and possessory interests. While an individual can receive deeded possession of a piece of property, they can also receive a nonpossessory interest in the property.

The term **estate in land** is the degree, quantity, nature, or extent of a person's possessory interest in real property. An example of an estate in land includes ownership of a property deed or the possession of a lease. The rights granted to the possessor will vary depending on the type of estate that has been granted to the individual. There are two types of possessory estates: a freehold estate and a leasehold estate.

A **freehold estate** grants an indefinite possessory ownership interest in real property. They are "free to hold" on to the title for as long as they want. That right is transferred by means of a deed. A **leasehold estate**, also called an estate for years or a non-freehold estate, grants a limited bundle of rights (tenant rights) for a limited period. The tenant "holds a lease" for only a relatively short period of time. The rights granted under a leasehold estate are transferred by means of a lease agreement.

## **Section 2. Types of Possessory Freehold Estates**

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The key here is possession. A freehold estate gives deeded possession of real property and the rights and privileges that come with that possession. In the previous chapter, we discussed the bundle of ownership rights. Remember to "look DEEP to C your ownership rights" of disposition, exclusion, enjoyment, possession, and control. The number of deeded ownership rights establishes the type of possessory estate. There are three types of possessory estates: fee simple, life estate, and a leased fee estate.

## **Fee Simple Estate**

A **fee simple absolute estate**, or **fee simple** for short, is the highest form of a possessory freehold estate. A fee simple estate grants indefinite and absolute ownership. It includes the full bundle of property rights that can only be limited by law, a private restriction or police power.

A **fee simple defeasible estate** is formed when there is a private deed restriction that is limited to an event or an occurrence. As *long as the limitation is in force*, the owner keeps the property. If the special limitation in the deed is ever violated or ceases to exist, then the property will automatically revert to an heir or successor without any legal intervention. A **fee simple determinable estate** is a defeasible estate that may be inherited.

**PRACTICAL APPLICATION:** Mrs. Thompson donates land to a church on the condition that it can only be used for religious purposes. In the future, if the church no longer has a use for the land, the title will automatically revert to Mrs. Thompson without needing a court judgment.

A grantor can also place a condition of ownership in a deed. When this happens, it is called a **fee simple subject to a condition subsequent**. If the owner does not meet the condition stipulated in the deed, then ownership can be terminated, and the title will revert to the grantor or successor though a court judgment.

**PRACTICAL APPLICATION:** John deeds property to his son with the contingency that he must obtain a four-year college degree before the age of 30. If he fails to meet the requirement, the property returns to John after it has been proven in court that the condition was not met, and the grantor has the right to reacquire the property.

### Limitations to a Fee Simple Estate

In some cases, fee simple ownership can be limited to a portion, section, or some other aspect of the whole real property.

**Condominium.** A condominium unit owner has fee simple ownership of only the airspace and inner surface of their unit's floors, walls, and ceilings plus an undivided interest in the common areas. The common areas include everything else in a condominium – the walls, hallways, entrances, foundation, and land. All the owners form a condominium association that is managed by a board of directors.

**Planned Unit Development (PUD).** A planned unit development is condominium-style ownership of a subdivision or mixed-use development. A unit owner has fee simple ownership of a parcel of land and all of the improvements on top of it. Everything else in the development is owned by a homeowner's association (HOA). All the unit owners are members of the HOA and pay dues.

**PRACTICAL APPLICATION:** The owner of a townhouse in a PUD owns his half of the structure and the ground the structure sits on (called the footprint). They share the common wall with

*their neighbor. The rest of the land outside the unit footprint is held in common by all the owners.*

**Fractional Timeshare.** A deeded fractional timeshare is a form of fee simple ownership whereby multiple owners hold an equal interest in the whole property. This type of ownership is used mainly for vacation homes. Each owner purchases a fractional share that allows private use of the property for that fraction of the year. The use of the timeshare can be either be for a fixed period each year or on a floating basis. There is another way to purchase an interest in a timeshare. It is called a shared lease ownership interest. The lease creates a possessory interest, but no deeded ownership. We will talk more about that later.

**PRACTICAL APPLICATION:** Joe wants to take his family on a month-long vacation each year. They love the West Banks, but they cannot afford to buy a house there. Instead, he buys into a deeded timeshare. He buys a 4/52 interest. This gives him the deeded right to stay in the property for four weeks each year. He regularly pays fees to cover the property management and all operational costs.

## Life Estate

A **life estate** is a limited freehold estate for the duration of the life of a designated person. The person that retains the right to live on the property is called the life tenant. The life tenant enjoys all of the benefits and responsibilities of owning the property until their death. At death, the rights of the life tenant transfer to the property owner. The party that has the future right to possess the real estate has a **future interest**. There are two ways to create a life estate:

- **Remainder interest:** The original owner becomes the grantor and designates himself or another person(s) to become the life tenant. The grantor also selects a beneficiary or remainderman who will become the new owner in the future. The beneficiary has an interest in the title but must wait until the death of the life tenant to gain fee simple ownership of the property. The new owner gets the “remainder” of the property after the death of the life tenant.

**PRACTICAL APPLICATION:** Grandma wants to bequeath her estate to her favorite grandson, but she wants to keep living in the house. She creates a new deed. In the deed, grandma grants a possessory interest to herself for the remainder of her life. She also names her grandson as the remainderman who will receive ownership of the property after her death. Grandma still owns the property, but her grandson now has an equitable interest in it and will own the property only after grandma dies.

- **Reversionary interest:** The original owner deeds the property to another but retains a life estate. The original owner designates himself or another person(s) to become the life tenant. The new owner holds the title, but the life tenant has a possessory interest in the property until their death. The property will “revert” to the new owner upon the death of the life tenant.

**PRACTICAL APPLICATION:** Grandma decides she wants to deed her estate to her favorite grandson right now, but she wants to keep living in the house. Rather than writing a will and having the property end up in probate, she deeds the property to her

*grandson but retains a life estate. Her grandson owns the property, but grandma has possession until her death.*

If the length of the life estate is based on the life of someone other than the life tenant, it becomes a **life estate pur autre vie** – “for the life of another.” This allows an estate to pass to their heirs as long as the designated person is alive.

**PRACTICAL APPLICATION:** Grandma has two sons, Bill and John. Bill is disabled and needs daily care. Grandma deeds her property to John, but grants a life estate *pur autre vie* to Bill’s children as long as Bill is alive. Grandma hopes this is enough incentive for Bill’s children to take care of their father for as long as he lives. If Bill’s children die before he does, Bill’s grandchildren will inherit the house – that is until their grandfather Bill dies. Once Bill passes away, John receives possession of the property.

A **statutory life estate**, or a legal life estate, can be created by a state’s common law when certain events occur. If the property owner died without leaving a will or a widow or widower contests the fairness of the will or they were not named on the deed, the state could designate a life estate. In these cases, most states recognize the Uniform Probate Code (UPC), which gives a surviving spouse an elective share of the property which is usually one-third of the estate. Some states will grant the widow or widower a life estate to one-third or one-half of the interest in the real property - even if the property was willed to another. Other states base the share on the length of the marriage. A few states still recognize the archaic dower and courtesy rights. Dower rights refer to a widow’s property rights and courtesy refers to a widower’s property rights.

Another statutory life estate is the right of homestead. **Homestead** creates a life estate that protects the family residence from all unsecured creditors. If the state allows a foreclosure sale of the property, the owner will receive the homestead exemption amount. The remainder is used to pay off any debts secured by the property, such as mortgages, home equity loans, mechanic’s liens, and any unpaid property taxes. Unsecured debts are then paid off with any remaining sales proceeds. In some states, the entire homestead is protected under a statutory life estate.

## Leased Fee Estate

When a freehold property owner relinquishes some of their property rights to a tenant, they have created a leased fee estate. A **leased fee estate** is the reduced ownership interest a landlord has under a lease agreement. A lease temporarily removes a property owner’s rights of possession, enjoyment, and control and legally gives them to the tenant. The owner has a freehold estate. They are “free to hold” the title or estate, but their property rights

## CONFUSING WORD PAIRS

**LEASED FEE:** the landlord’s legal interest in the real property.

**LEASEHOLD:** the tenant’s legal interest in the real property.

*Remember that the landlord gets the “leased fee” or rent and the tenant “holds the lease.”*

are limited for the term of the lease agreement. The tenant receives a **leasehold estate** or **leasehold interest**.

## Section 3. Types of Possessory Leasehold Estates

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When a property owner relinquishes a portion of their bundle of property rights to a tenant, this creates a possessory interest for the tenant called a **leasehold estate**. The tenant “holds the lease,” giving him a temporary possessory interest in the property – but not ownership.

### Tenancy

Different types of tenancies can be created under a leasehold estate.

- An **estate for years, tenancy for years or fixed-term tenancy** has a fixed lease term from a few days to many years. There are specific starting and ending dates. When the lease expires, the leasehold estate ceases to exist, the tenant no longer has any legal rights to the property, and the tenant must vacate. The landlord is not required to provide prior notice of the lease expiration.
- An **estate from period to period or periodic tenancy** is a lease for an indefinite time. It is commonly called a month-to-month lease. Rent is paid to cover a specific interval such as a week, month, or even a year, and that continues indefinitely until either party supplies a written termination notice. In the absence of a written contract, a periodic tenancy can be created under an implied contract. A **holdover tenancy** is created when the original lease expires, the tenant remains in possession, and the landlord continues to accept rental payments. If after the expiration of the original lease, the landlord continues to accept rental payments, the court will defend a tenant’s right to holdover for a term equal to the original lease or one year, whichever is less, unless the terms of the periodic tenancy were part of the original lease agreement.
- An **estate at will** or **tenancy at will** is similar to an estate from period to period, but there is no written agreement and no length to the tenant’s duration. Both parties can terminate an estate at will at any time.
- There is also an **estate at sufferance** or **tenancy at sufferance**. This leasehold estate is created when a tenant remains in possession of the property *without the landlord’s consent*. The tenant remains bound by the terms of the original lease, including the payment of rent. The difference between an estate at sufferance and the other estates is the absence of the landlord’s permission to remain on the premises. An estate at sufferance often occurs when a tenant ignores an eviction notice.

Besides the typical residential or commercial lease agreements, there are a couple of other leasehold estates that create a possessory interest in the real estate.

## Cooperatives

In a **cooperative**, there are units similar to a condominium, but the units are all owned by a corporation that is managed by shareholders. The corporation sells shares and then provides its shareholders with an indefinite proprietary lease to a specific unit in the complex. The price of the share is equivalent to the price of the unit. Shares are classed as personal property. Hence the “owners” do not own the real estate but instead, they have a leasehold interest in their designated unit and the common areas.

The corporation’s bylaws dictate how shares may be sold or transferred and how property management expenses, including mortgage payments, are covered by the shareholders. Often the bylaws require that the board of directors must first approve all prospective shareholders. It is the combined shareholders that carry the financial burden of managing the property. If a shareholder defaults on their payments, the other shareholders carry the financial responsibility. A mortgage foreclosure could result in the dissolution of the stock and a loss to all the shareholders. Because the sale of a “unit” is, in reality, the sale of a share of stock, these types of transactions may require a securities license. The state may not allow a real estate salesperson to represent any of the parties.

## Leased Timeshare Ownership Interest

There are two different types of timeshares. We have already discussed freehold fractional timeshares. Leased timeshares provide the purchaser a *leasehold interest* in the real estate through the purchase of a lease, license, or membership. There is no property ownership; rather, the buyer is purchasing a fixed-term leasehold right-to-use the property for a certain period each year. Unlike a freehold fractional timeshare, the right to use the property will eventually expire. Leased timeshares are expensive to maintain, hard to sell, and have a lower market value than deeded fractional timeshares. The appeal is in the ability to “exchange” the weeks used or even the timeshare property with other “owners” in the same management organization.

The laws governing the development and sale of leased timeshares are very complex and well beyond the scope of this course. Timeshares can also be subject to federal security laws and hence would require a securities license.



### CONFUSING WORD PAIRS

**CONDOMINIUM:** each individually owned unit includes the airspace and the surface of the interior walls within each unit plus an undivided interest in the common areas.

**COOPERATIVE:** a corporation owns the whole real estate and sells shares that include an indefinite lease for a specific unit and the rights to use the common areas.

*Both will have dues or fees that cover the expenses associated with the whole complex.*

## **Section 4. Types of Non-Possessory Interests**

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In addition to possessory estates, there are also nonpossessory interests. A **nonpossessory interest** gives the holder the right to use land that is owned by another. It does not grant the user any legal possession of the property. The interest can be granted by the property owner or by law. In doing so, the owner's bundle of property rights diminishes by varying degrees, depending on the type of nonpossessory interest given. There are four types of non-possessory interests: easement, *profit à prendre*, covenants, and licenses.

### **Easement**

An **easement** provides a legal right-of-way to use or cross a parcel of land owned by another. An easement can be for a limited time or an indefinite term. Indefinite easements are recorded and encumber the legal description of the parcel containing the easement or servient estate or servient tenement.

### **Profit à Prende**

An easement that includes the right to remove oil, minerals, water, or something of value from the property is called ***profit à prendre*** or simply just profit. It is French for the “right of taking.” More than one party can hold a profit in the same parcel of land, and the owner can limit what can be removed, the quantity, and the time allowed for taking.

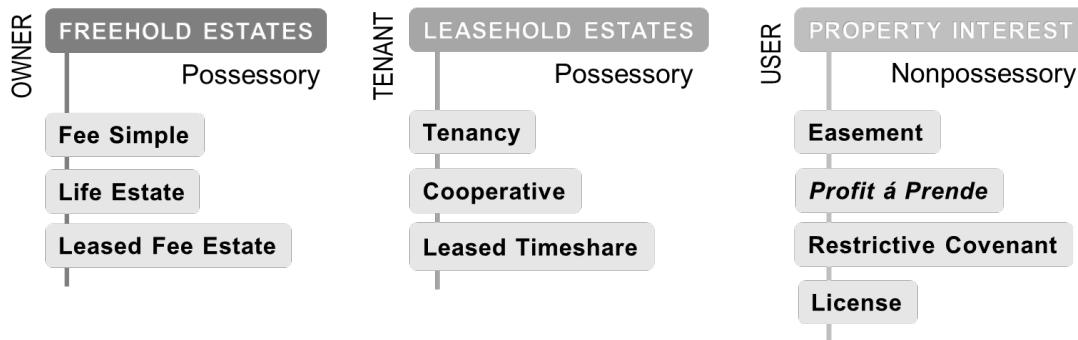
### **Covenants**

A deed restriction that creates a nonpossessory interest in the land is called a **covenant**. A covenant is going to restrict or control the use of the property in some form. Condominiums, subdivisions, and PUDs create homeowners' associations (HOAs) that establish rules and regulations on what an owner can or cannot do with their property. The rules are called **covenant, conditions, and restrictions (CC&Rs)**. The limitations that it places on the bundle of property rights create a nonpossessory interest in favor of the HOA.

### **Licenses**

A license allows a second party to enter the land of another for a specific purpose, such as hunting or fishing or some other temporary use. It is much less permanent than an easement. A license is not recorded, and thus, it does not encumber the title of the property. The property owner can cancel it at any time.

## PROPERTY OWNERSHIP AND INTERESTS



## Section 5. Forms of Ownership

Up to this point, we have been talking about the type or estate of property ownership. An estate establishes the bundle of property rights. Now we need to discuss the different *forms* of ownership. The form of ownership defines *who* has access to that bundle of rights. The form of ownership will affect the owner's ability to transfer the real property. It also has federal and state tax implications.

### Tenancy in Severalty

If only one entity, such as an individual or corporation, has absolute and sole ownership of the property, then they have a **tenancy in severalty** or ownership in severalty. The term "severalty" means that all others are severed or cut off from ownership.

### Tenancy in Common

If two or more individuals have an equal or unequal undivided ownership interest, then they have created a **tenancy in common**. If the deed does not specify each party's amount of ownership interest, then all owners hold equal shares. Regardless of the fractional share of ownership, all decisions related to the property must be made collectively. All owners also have the right to possess and use the property. Each owner may sell, convey, or mortgage their share without the consent of the other co-owners. If one owner dies, their share is conveyed to their heirs, not the other owners.

**PRACTICAL APPLICATION:** *Property in San Diego, California, is expensive and out of the reach of the newly married Jones family. They hear that their friends, the Smiths, also want to buy, but their mortgage approval amount is too low. The four of them decide to pool their resources and buy a duplex as tenants in common. Each co-owner has a 25 percent share in the property. Each couple can now afford to get a mortgage on their combined 50 percent ownership interest.*

### Joint Tenancy with Rights of Survivorship

Two or more parties can create a **joint tenancy** if they meet the following four qualifications. Each party must receive (1) an equal, undivided ownership interest at (2) the same time with (3) the same

deed, and all have (4) an equal right to control and possess the property. If a deed fails to specify that the co-ownership is a joint tenancy, then it will be implied and assumed that the property is owned as tenants in common. A joint tenancy cannot be implied or created without the consent of all co-owners. To preserve a joint tenancy, none of the joint owners can mortgage or sell their interest without the consent of the other owners. If an owner dies, the other owners have the right of survivorship, and the share of the deceased is automatically divided among the surviving co-owners – not the heirs. No legal action or court approval is required.

**PRACTICAL APPLICATION:** *The Hendersons both have children from separate marriages. Mrs. Henderson owned a house before marrying her current husband. She decides to create a new deed and establish a joint tenancy with her children. Eventually, Mrs. Henderson dies, and her interest in the house passes to her children, not her surviving husband. In this way, she has ensured that her children receive their full inheritance.*

A joint tenancy can be broken if one of the co-owners conveys or sells their interest. When that happens, the new owner becomes a tenant in common with the other remaining joint tenants.

**PRACTICAL APPLICATION:** *After Mrs. Henderson died, each of her four children held an undivided 25 percent interest in the house. One of the children decides to sell their share to their step-father. Mr. Henderson now has a 25% interest in the property as a tenant in common. Two of the siblings die together in an auto accident. Each of their 25 percent shares is passed down to the remaining sibling. Mr. Henderson owns 25 percent, and the remaining sibling owns 75%. Because only one of the original joint tenants remain, the property now becomes a tenancy in common with Mr. Henderson. The remaining sibling can now will his share of the property to his heirs if he so desires.*

## Tenancy by the Entirety

In certain states, if a married couple has an equal and undivided co-ownership, then they can create a **tenancy by the entirety**. The term “entirety” goes back to the prevailing view that a married couple was viewed as one legal entity. Both parties have an equal right to the property, and both must sign the deed at the time of a transfer. They have the right of survivorship, meaning the property passes to the surviving spouse, not any heirs.

## Community Property

Only nine states recognize community property (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington). **Community property** is real estate or personal property that was acquired by either spouse *during* the marriage. The whole property can only be conveyed or mortgaged with the signature of both spouses. Each spouse has a 50 percent ownership interest in the property, but there is no automatic right of survivorship. Upon the death of a spouse, the deceased share passes to the surviving spouse or the decedent’s heirs, depending on state law. Nevertheless, the surviving spouse continues to own their 50 percent share.

## Land Trusts

Property can also be held in a trust, which is a legal entity created by a trustor and held by a trustee for the benefit of another called the beneficiary. Properties are placed in a trust by deeding the property to the trustee. The same individual can hold more than one position in the trust. There are five main types of trusts:

- A **living trust** is created by the trustor while they are still alive.
- A **testamentary trust** is created by a will and activates after the death of the trustor.
- A **revocable trust** can be modified or terminated by the trustor.
- An **irrevocable trust** can never be modified or terminated by the trustor.
- A **real estate investment trust (REIT)** is created to hold land for a group of investors.

Trusts are set up for a variety of reasons, including restricting land partitioning, sharing property ownership, estate planning, and as a gifting platform.

**PRACTICAL APPLICATION:** *The Mayberry family has held their 200 acres in the family for the past four generations. Grandma Mayberry is worried that the next generation may sell off portions of the property after she passes. To protect the land, she places all 200 acres into a living trust that prohibits any future property divisions. Grandma is both the trustor and the trustee of the deed. The Mayberry family is the beneficiary.*

## Business Ownership

Individuals are not the only owners of real property. Businesses can also take legal ownership. The real estate can be owned by the business entity or through direct ownership by the investors. There are several types of legal entities, and land ownership is handled differently with each one.

- A **partnership** has two or more co-owners of the business. Ownership of the land is held jointly, and all the owners share the profits, losses, and liabilities. A limited partnership limits the participation of investors whereas a general partnership shares ownership and responsibilities evenly. If the business defaults on the mortgage, the general partners are personally liable, whereas the limited partners are not.
- Property owned by a **corporation** is managed by a board of directors who are selected by shareholders. The corporation can own property in severalty or as a tenant in common with another party. Corporations protect the personal assets of shareholders from business liability. If the corporation defaults on the mortgage, the shareholders are not personally liable.
- A common legal form of business land ownership is a **limited liability company (LLC)**. An LLC combines the tax advantages and flexible management structure of a partnership with the limited liability of a corporation.

Each buyer must decide on the form of ownership. Remember that agents are *not* attorneys, and choosing a form of ownership is a legal decision best left to an attorney.

## FORMS OF PROPERTY OWNERSHIP

### TENANCY IN SEVERALTY

One owner

- Sole ownership
- Can sell, convey, mortgage or bequeath

A  
100%



### TENANCY IN COMMON

Two or more owners

- Can sell, convey, mortgage or bequeath shares with co-owner consent
- At death, shares conveyed to heirs

A  
1/2      B  
1/2



A  
1/2      C  
1/4  
D  
1/4

### JOINT TENANCY w/ SURVIVORSHIP

Two or more owners

- Formed at same time, in same deed
- Can sell, convey, and mortgage shares with co-owner consent (fractures joint tenancy)
- At death, shares conveyed to co-owners

A  
B      C



A      C

### TENANCY BY THE ENTIRETY

Spousal equal co-ownership

- Can sell, convey, mortgage or bequeath with spouse's signature
- At death, conveyed to spouse, not heirs

A  
1/2      B  
1/2



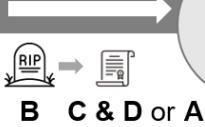
A  
100%

### COMMUNITY PROPERTY

Property acquired during marriage

- Only recognized in nine states
- Can sell, convey, and mortgage with spouse's signature
- At death, conveyed to spouse or heirs

A  
1/2      B  
1/2



A  
1/2      C  
1/4  
D  
1/4  
or  
A  
1/2

### LAND TRUSTS

Legal entity to benefit others

- Trust created by trustor, managed by trustee to the benefit of the beneficiary.
- Type and terms of trust stipulate use, conveyance or encumbrances

Trustor

Trustee

Beneficiary

Trust

### BUSINESS OWNERSHIP

Levels of limited personal liability

- Partnership – joint ownership, limited liability protection
- Corporation – full liability protection to shareholders
- LLC – joint ownership, full protection

Partnership  
A   B   C

Corporation  
Shareholders

LLC  
A   B   C

## **Section 6. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. Which statement is true about a fee simple absolute estate?
  - a. It is the highest form of indefinite real estate ownership.
  - b. It grants the owner the full bundle of rights, limited only by law or private restriction.
  - c. It is called a possessory estate.
  - d. All of the above.
  
2. When a buyer purchases a condominium, what does his ownership include?
  - a. The inner surfaces of the walls, ceilings, and floors
  - b. The airspace
  - c. Access to all the common areas.
  - d. All of the above.
  
3. What are the ownership rights in a planned unit development?
  - a. Fee simple ownership of the lot, building, or unit plus joint ownership of the common areas.
  - b. Tenants in common ownership of the association.
  - c. Leased fee ownership of the lot, building, or unit plus access to the common areas.
  - d. Fee simple ownership of the homeowner association.
  
4. What are two types of timeshare ownership?
  - a. Fee simple fractional share and tenants in common.
  - b. Fee simple fractional share and leased ownership interest.
  - c. Cooperative and leased ownership interest.
  - d. Leased fee estate and freehold estate.
  
5. True or false. A life estate grants an equitable interest in the freehold estate for the life of the designated person which terminates upon their death.
  - a. True
  - b. False
  
6. What is the definition of a leasehold estate?
  - a. The owner's legal interest in the property.
  - b. The tenant's legal possessory interest in the property.
  - c. Fee simple absolute ownership.
  - d. The legal term for the effect that a lease agreement has on the owner's bundle of rights.
  
7. What is the definition of a leased fee estate?
  - a. The owner's legal interest in the property.
  - b. The tenant's legal possessory interest in the property.
  - c. The legal term for the effect that a lease agreement has on the owner's bundle of rights.
  - d. Both A and C.

8. What are the four types of nonpossessory interests?
  - a. Leased fee, leasehold, freehold, and tenancy in common
  - b. Cooperative, condominium, planned unit development, timeshare
  - c. Easement, Covenant, *Profit à Prende*, and License
  - d. Ownership in severalty, tenancy in common, joint tenancy, and tenancy by the entirety.
9. What form of joint ownership have the right of survivorship?
  - a. Ownership in Severalty
  - b. Tenancy in Common
  - c. Joint Tenancy
  - d. Tenancy by Survivorship
10. The party that has the future right to possess the real estate has a \_\_\_\_\_.
  - a. possessory estate
  - b. future interest
  - c. fee simple ownership
  - d. tenancy in common

## Quiz Answers

1. Which statement is true about a fee simple absolute estate?
  - d. All of the above. – Fee simple ownership is the highest form of indefinite real estate ownership. It grants the owner the full bundle of rights, limited only by law or private restrictions and it is called a possessory estate.
2. When a buyer purchases a condominium, what does his ownership include?
  - d. All of the above. – Condominium ownership includes the inner surface of the walls, ceilings, floors, and the airspace between them. It also includes access to all the common area.
3. What are the ownership rights in a planned unit development?
  - a. Fee simple ownership of the lot, building, or unit plus joint ownership of the common areas.
4. What are two types of timeshare ownership?
  - b. Fee simple fractional share and leased ownership interest.
5. True or false. A life estate grants an equitable interest in the freehold estate for the life of the designated person which terminates upon their death.
  - a. True
6. What is the definition of a leasehold estate?
  - b. The tenant's legal possessory interest in the property.
7. What is the definition of a leased fee estate?
  - d. Both A and C. – It includes the owner's legal interest in the property and it is the legal term for the effect that a lease agreement has on the owner's bundle of rights.
8. What are the four types of nonpossessory interests?
  - c. Easement, Covenant, Profit à Prendre, and License
9. What form of joint ownership have the right of survivorship?
  - c. Joint Tenancy – the right of survivorship exists with joint tenancy which means that a deceased owner's interest automatically passes on to the other surviving joint-tenants and not the heirs.
10. The party that has the future right to possess the real estate has a \_\_\_\_\_.
  - b. future interest – Her right to possess the property may be contingent upon a certain condition, date, or event.

# Chapter 11 Transfer of Title

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the difference between a title and a deed;
- the nine elements required in a deed;
- the two main methods used to transfer real estate; and
- the different types of deeds used to transfer property.

**OVERVIEW:** In this chapter, you will learn about the many different types of deeds that can be used to transfer the ownership of property. You will also learn how to identify the parts of a deed.

## Section 1. Title vs. Deed

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It is common for people to use the term “deed” and “title” interchangeably, but they actually refer to two separate legal concepts. **Title** is the right of ownership to real property. The title to a property creates the union of the legal rights of ownership, possession, and custody. A **deed** is the legal document used to transfer the title from one party to another.

It is important to understand the difference. When a property owner says that they have “title to the property,” they mean that they have the legal ownership rights to that property. If a property owner says they hold the “deed to the property,” they mean that they have the written document as proof of title.

The title to real property can be split into legal and equitable title. **Legal title** represents the actual *legal* ownership of real property. **Equitable title** represents the *right* to obtain full ownership or an interest in a property. A person holding equitable title has a *financial interest* and the *right to benefit* from the property. Equitable title is not true ownership, nor does it grant the right of possession. Consider three common situations that split the title into its legal and equitable parts:

- **Land Trust:** The trustee holds the legal title to the property in their name. The beneficiaries to the trust have equitable title to the property. They have a financial interest in the property and reap benefits from the property.
- **Land Contract:** Property is sold to a buyer who agrees to pay the seller periodic payments. The seller holds the legal title until the buyer pays for the property in full. The buyer lives on the property and benefits from the property under an equitable title.
- **Purchase Contract:** When the seller accepts a purchase offer, the buyer acquires equitable title to the property. They now have a financial interest in the property. At the closing, the buyer will also gain the legal title.

## Section 2.      Contents of a Deed

Title agencies and attorneys prepare deeds – not real estate agents. An agent, however, needs to understand what makes up a deed and how it conveys property. In order for a deed to become a legal document, it must be in writing. This is a requirement under the Statute of Frauds. There are nine essential elements that must be in every deed.

### 1. Grantor and Grantee

The owner or seller is called the **grantor**. There can be more than one grantor. A grantor must be of legal age, legally competent, and of sound mind. If a person is declared legally incompetent, their property can only be conveyed with the court's approval. The grantor's name must be spelled correctly throughout the deed. If the owner's name were changed after the title was initially acquired, both names would need to be on the deed. For example, if Bonnie Jones married and became Bonnie Smith, then the deed should indicate both names such as "Bonnie Smith, formerly Bonnie Jones."



#### CONFUSING WORD PAIRS

**GRANTOR:** the person who conveys title to real property. They are the owner or seller.

**GRANTEE:** the person who receives title to real property. They are the buyer or receiver.

*Remember that ORs have more and EEs receive.*

The buyer or the receiver of the title is called the **grantee**. There can be more than one grantee. The grantee must be clearly stated on the deed. They do not have to be legally competent or reached the age of majority. In the case of more than one grantee, the deed should also state the form of ownership, such as tenancy in common or joint tenancy.

### 2. Consideration

In Chapter 7, Section 3, we learned that all legal contracts must have some form of **consideration**. In a deed, there must also be an exchange of something of value. Usually, consideration is stated in dollars, but if the real property is conveyed as a gift, then "love and affection" can be classified as consideration. The consideration section is usually introduced with the phrase "for good and valuable consideration of the sum of..." Because deeds become a matter of public record, at times, the actual price is hidden under the phrase "ten dollars and other valuable consideration."

### 3. Granting Clause

A **granting clause or act of conveyance** is the formal statement that the grantor has the intention to transfer the title to the grantee. The granting clause will read something like "does hereby bargain, grant, deed, and convey to..." or "quits any and all claims to said premises..." .

## **4. Habendum Clause**

A **habendum clause** is a Latin phrase meaning “to have and to hold,” and it describes the limits of the estate being granted. It often follows the granting clause. When there is a conveyance of a fee simple estate, look for a statement such as “to have and to hold same, together with all the buildings, improvements, and appurtenances thereto, if any, to the Grantee, its heirs, successors or assigns forever.” A life estate is conveyed to the buyer “for the duration of their natural life.”

## **5. Legal Description**

The **legal description** is a geographical description of the land. It identifies the precise location, boundaries, and permanent easements that are used in legal documents. The legal description provides identification of precisely what is being conveyed. A street address is not a legal description.

## **6. Limitations and “Subject To” Clause**

All deeds are subject to real estate taxes, assessments, and road right-of-ways. An acknowledgment of the right of police power is stated in this section. If a deed has a specific limitation or subject to clause, it will be found here. Deed restrictions and references to recorded easements are here as are other covenants, conditions, reservations and restrictions of record.

## **7. Signature of the Grantor**

All deeds must be signed or executed by all grantors. The grantor can also permit someone with the power of attorney to sign legal documents on their behalf. This can be useful if a co-owner cannot be present at the closing. Some states will require witnesses to validate the signatures. Depending on state laws and the type of ownership, a grantor’s spouse may be required to sign the deed in order to waive any homestead or marital rights. In many cases, the grantee is not required to sign the deed.

## **8. Acknowledgment and Recording**

An **acknowledgment** is the grantor’s formal declaration that they are conveying the title voluntarily and that their signature is valid. A notary public or an authorized public officer, such as a justice of the peace, judge, attorney, or another qualified person, must verify the identity of the grantor(s) and sign and stamp the document. A deed cannot be recorded in public records without an acknowledgment, but depending on state law, it may still be a binding document. Recording the deed at the county or city level protects the grantee’s ownership of the property. It also establishes a chain of title and the priority of real estate interests.

## **9. Delivery and Acceptance**

As discussed in a previous chapter, all legal contracts must have delivery to and acceptance by the grantee or their appointed agent. Title is said to pass only when a deed is delivered and accepted.

The date of delivery is the date of the transfer of title within the deed itself. When a deed is recorded, delivery and acceptance are assumed.

Deeds must follow state laws. It is necessary to consult a qualified attorney to assist in corporate conveyances. For all other title transfers, it is highly recommended that an attorney is involved. Title agencies often handle property closings, and they should have an in-house attorney who will draw up standard deeds. This does not, however, prohibit either party from consulting their attorney.

**WARRANTY DEED**

WARRANTY DEED, made this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_\_, by and  
between \_\_\_\_\_ of the City of \_\_\_\_\_, and County of \_\_\_\_\_ ("grantor"), and \_\_\_\_\_ ("grantee"), whose  
mailing address is \_\_\_\_\_.

THE GRANTOR, for and in consideration of the sum of \_\_\_\_\_  
DOLLARS (\$\_\_\_\_\_), the receipt and sufficiency of which is hereby acknowledged and received,  
and for other good and valuable consideration, does hereby grant, bargain, sell and convey unto the grantee his/her  
heirs and assigns, the following described premises located in the County of \_\_\_\_\_, State of \_\_\_\_\_,  
described as follows (enter legal description): \_\_\_\_\_.

Also known as street and number \_\_\_\_\_  
Tax Parcel ID# \_\_\_\_\_

TO HAVE AND TO HOLD the said premises, with its appurtenances unto the said Grantee his/her heirs and  
assigns forever. Grantors covenant with the Grantee that the Grantors are now seized in fee simple absolute of said  
premises; that the Grantors have full power to convey same; that the same is free from all encumbrances excepting  
those set forth above; that the Grantee shall enjoy the same without any lawful disturbance; that the Grantors will, on  
demand, execute and deliver to the Grantee, at the expense of the Grantors, any further assurance of the same that  
may be reasonably required, and, with the exceptions set forth above, that the Grantors warrant to the Grantee and  
will defend for him/her all the said premises against every person lawfully claiming all or any interest in same, subject  
to real property taxes accrued by not yet due and payable and any other covenants, conditions, easements, rights of  
way, laws and restrictions of record.

IN WITNESS WHEREOF, the grantor has executed this deed on the date set forth above.

Grantor \_\_\_\_\_      Grantor \_\_\_\_\_

Witness (if required) \_\_\_\_\_      Witness (if required) \_\_\_\_\_

STATE OF \_\_\_\_\_ )  
COUNTY OF \_\_\_\_\_ ) ss:  
The foregoing instrument was acknowledged before me, \_\_\_\_\_, a notary  
public in and for the state of \_\_\_\_\_ by \_\_\_\_\_  
on the \_\_\_\_\_ day of \_\_\_\_\_, 20 \_\_\_\_\_.  
Witness my hand and official seal

NOTARY PUBLIC \_\_\_\_\_  
My commission expires \_\_\_\_\_

[NOTARY SEAL]

Real property can be conveyed using several different types of deeds. The choice of the deed will depend on the rights and warranty that are included with the real estate. It will also depend on whether the deed of transfer was voluntary or involuntary.

## Section 3. Transfer by Voluntary Alienation

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When a grantor is willing and able to convey the property, the transfer is called **voluntary alienation**. The grantor can transfer the title during their lifetime through a deed or after their death by a will.

### Transfer by Deed

A deed carries with it promises or warranties that the grantor makes in connection with the transfer of title. The number of warranties will determine the type of deed.

#### General Warranty Deed

A general warranty deed, or simply warranty deed, offers the grantee the broadest title guarantees. It is the most protective form of property conveyance. This is the deed of choice for buyers. A warranty deed grants six warranties or promises:

- **Covenant of Seisin.** Meaning the grantor has freehold possession of the land. If this covenant is broken, the grantee can recover damages up to the purchase price.
- **Covenant of Right to Convey.** The grantor is promising that they have the legal capacity to convey the title. If this covenant is broken, the grantee can recover damages up to the purchase price.
- **Covenant against Encumbrances.** The grantor also promises that there are no encumbrances against the title except those in the public record or stated explicitly in the deed. If this covenant is broken, the grantee may sue for the cost of removing the encumbrances.
- **Covenant of Quiet Enjoyment.** The grantor is assuring the grantee that there is not a defect in the title that could limit the right to use the property. It also guarantees that there are no claims of superior title. If the title becomes inferior to a third party's claim, the grantor can be sued for damages.
- **Covenant for Further Assurances.** This is a promise from the grantor that if there are any defects in the title, they will perform whatever acts are necessary to clear the title for the grantee.
- **Covenant of Warranty.** This covenant or promise states that the grantor will warrant, defend, and cover any loss of the title against the lawful claims of others at any time in the future.

#### Special Warranty Deed

A special warranty deed, which is also called a limited warranty deed or grant deed, offers slightly less protection than a general warranty deed. Instead of offering six guarantees or warranties, it offers only two:

- **Covenant of Seisin.** The grantor warrants that they hold legal title and that they have the right to transfer it.
- **Limited Covenant against Encumbrances.** The grantor warrants that *they* have not encumbered the title during their ownership, other than what has been stated in the deed.

The significant difference between a general warranty deed and a special warranty deed is the length of guarantees. A general warranty deed covers *all* prior owners, whereas a special or limited warranty deed *only covers the actions of the grantor*. They agree to defend the title against their actions, but not the actions of anyone else. Anything that happened to the title before the grantor owned it is the grantees problem.

Special warranty deeds are used by property owners that have limited authority to warrant against the acts of prior owners. These would include trustees, corporations, estate executors, and other fiduciaries or, in some cases, owners of tax sale properties. The best way to protect the title under a limited warranty deed is to purchase title insurance.

### Bargain and Sale Deed

A bargain and sale deed offers less protection than a special warranty deed. It maintains the following:

- **Implication of Title.** The grantor *implies* that they hold title and legal possession.
- **No Warranties or Covenants.** The grantor does not warrant that they hold legal title, or have the right to transfer it, or that they or anyone else has placed any encumbrances on the title.

The grantor may attach additional warranties, but they are not required. After closing, any claims or title issues are the grantees problem. This is a true “buyer beware” deed. The buyer’s only form of protection will be with title insurance. This type of deed is used in foreclosures and tax sales.

### Quitclaim Deed

A quitclaim deed conveys only the interest the grantor has in the real property. There are *absolutely no warranties*. It provides the grantees with very little protection. If the grantor has full fee simple interest in the property, a quitclaim deed can convey it to the grantee – but without any warranties or covenants. However, if the grantor does not have any ownership interests, then a quitclaim deed will give the grantees nothing at all.

**PRACTICAL APPLICATION:** Anyone can legally give a quitclaim deed to the Brooklyn Bridge. It can even be recorded in public records. Because they do not have any legal title to the bridge, the quitclaim deed conveys nothing. All the quitclaim deed does is declare that they are relinquishing their claim on the property. It does not guarantee that they ever had a claim or that the grantees has title.

Even though they offer no warranties, quitclaim deeds can be useful documents. They are frequently used to clear up a **cloud** on the title. A cloud is an objection on public record or a potential defect in the title that may hinder or prevent its conveyance. If a co-owner did not sign off on a prior deed, a quitclaim deed could quickly free them from the chain of title. If a name was misspelled on the original deed, it could be corrected using a quitclaim deed. It is also a simple way to transfer property from one family member or co-owner to another.

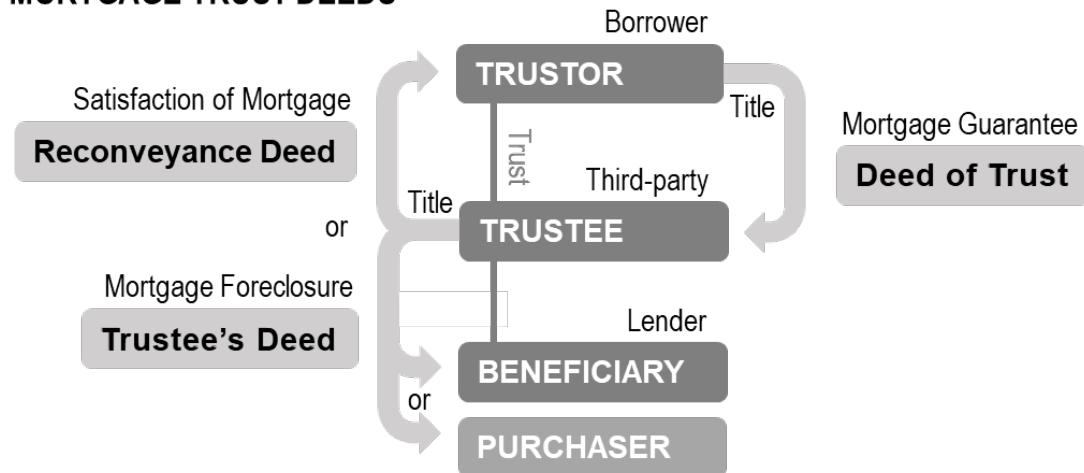
### Deed of Trust

Land trusts are formed when a trustor deeds property to a trustee to the benefit of a beneficiary. Property transferred out of a trust by a trustee will use a **trustee's deed**.

A **deed of trust** or trust deed is used in place of a mortgage in nonjudicial foreclosure states. It serves as an agreement between a borrower (the trustor) and a lender (the beneficiary) to deed the property to a neutral third party (the trustee) until the loan is repaid. The trustee holds the title, and the trustor holds the equitable title.

Once the loan is repaid, the trustee deeds the title back to the borrower utilizing a **deed of reconveyance**. This not only restores the title to the borrower, but it also serves notice that the lien has been withdrawn. It is similar to a satisfaction of mortgage document. If the borrower defaults on the loan, the trustee can sell the property and use the proceeds to pay off the loan balance. The borrower receives any funds remaining from the sale. Properties that are taken out of a trust and are sold at auction are transferred to the buyer under a trustee's deed.

## MORTGAGE TRUST DEEDS



### Transfer by Will

When a person, the **testator**, has a written and executed will at the time of their death, it is said that they died **testate**. The gift of real property using a will is called a **devise**, and the grantee is called a devisee. A will must abide by the state laws of homestead and survivorship.

At death, the will is filed with the court and the estate goes into probate. **Probate** is the formal judicial process to allocate and distribute the decedent's assets. The executor named in the will, or a court-appointed administrator, will complete the process to validate the will and distribute the estate. Before any property can be distributed to the heirs, all of the decedent's debts must be satisfied and removed as well as the payment of any estate or inheritance taxes. This process can take several months or longer before the estate is settled.

The will can transfer only property owned by the testator at the time of death. While alive, the owner retains the right to convey their property – regardless of what is stated in the will. The remaining willed property is deeded to the decedent's specified heirs using an executor's deed. An executor's deed conveys property out of probate according to the property owner's will. An executor's deed is similar to a bargain and sale deed. It includes the covenant that the executor has not taken any actions that would have encumbered the title of the property.

## **Section 4. Transfer by Involuntary Alienation**

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When a grantor is unwilling or unable to convey the property, the transfer is called involuntary alienation. Involuntary transfers occur without the property owner's consent and are usually carried out by the operation of law. Situations that could create an involuntary alienation are mortgage foreclosures, delinquent tax payments, adverse possession or when the owner dies **intestate** (without a valid will).

### **Transfer by Foreclosure**

A **foreclosure** is the legal process by which a lienholder repossesses property that was used as collateral for a loan that is in default. There are two different types of foreclosure:

- **Judicial foreclosure** is a court judgment that permits the real property that was used as security for a mortgage to be sold as repayment of the defaulted debt.
- **Nonjudicial foreclosure** is the process used by a lienholder to obtain ownership of the collateral through a power-of-sale clause or deed of trust as repayment of the defaulted debt without requiring a court judgment.

Because a nonjudicial foreclosure does not involve the court system, it is much quicker than a judicial foreclosure. In both cases, the lender gives the borrower a notice of default and a limited time to cure the default. If the borrower fails to pay the delinquent amount plus any fees and penalties within the time limit, the lender will issue a notice of foreclosure. The notice will include the date the property will be sold at public auction. If the foreclosure sale does not produce enough to pay off the loan balance, the mortgagee can seek a deficiency judgement for the unpaid balance. Any funds remaining after the sale after paying all liens are paid to the borrower.

## Judicial Deeds

In judicial foreclosure states, lienholders use the court system to obtain title to a foreclosed property. The court appoints an official to execute the title transfer under a court order. A court-ordered involuntary alienation of a property is conveyed to a buyer under a judicial deed. The name of the various types of deeds is related to the official executing the deed.

- A **sheriff's deed** conveys foreclosed properties that are sold at a sheriff's sale or auction.
- A **tax deed** conveys properties lost because of the non-payment of taxes.
- A **referee's deed** is used in bankruptcy proceedings and foreclosures.

Judicial deeds are a type of bargain and sale deed. There are no covenants or warranties, but ownership is implied. If another lienholder has a superior lien than the one that foreclosed on the property, they may have a more substantial claim on the title than was granted to the buyer in the judicial deed. This may severely limit the ownership rights of the buyer.

## Trustee's Deed

In non-judicial foreclosure states, mortgages are secured with a deed of trust. If the borrower defaults on the loan, the trustee can sell the property on behalf of the lender (the beneficiary) and use the proceeds to pay off the remaining mortgage amount. The borrower (the trustor) receives any funds remaining from the sale. Properties that are taken out of a trust and sold at auction are transferred to the buyer under a trustee's deed.

## Transfer by Descent

Property passes to the decedent's heirs based on the state's law of descent and distribution. If the property was held in a tenancy by entirety or a joint tenancy with right of survivorship, probate is not needed, and the recorded death certificate transfers ownership to the remaining co-owner(s). If, however, the property owner dies **intestate** or without a will, the property will automatically go into probate. A probate administrator will be appointed by the court to manage the estate's assets and handle the conveyance of the property to the appropriate heirs. Probate proceedings occur in the county where the decedent last resided, and in the county where the physical property is located.

## Administrator's Deed

An **administrator's deed** is used to convey property out of probate to an owner's heirs when they died intestate, or without a will. The administrator's deed is similar to a bargain and sale deed in that it includes the covenant that the fiduciary, or the court-appointed administrator, has not taken any actions that would have encumbered the title of the property being conveyed.

## **Transfer by Escheat**

**Escheat** is a state's common law process to acquire privately owned property if the owner dies intestate, that is without a will or living trust, and there are no legal heirs or claimants. The intention behind escheat is to prevent a property from being abandoned and ownerless. Depending on state law, the property can revert to the state or the county where the property is located. In most states, the title is transferred through a quitclaim deed with the state acting on behalf of the decedent as the grantee.

In most states, the repayment of any liens or mortgages become the responsibility of the state. That is unless the lienholder has foreclosed on the property before the state could take action. Escheat properties are a source of revenue for the state as they are usually sold to the public and again placed on the tax rolls. In other cases, the property can be used to benefit the public perhaps as community centers, public housing, parks, and playgrounds. The escheat process is revocable. If an heir files a claim after the title transfer to the state, the state will either return the property or provide fair market compensation.

## **Transfer by Eminent Domain**

The process used to gain title to privately-owned property for public use through eminent domain is called **condemnation**. Condemnation through eminent domain is different from a building being condemned because of its condition. Condemnation severs an owner's right to the property in exchange for just compensation. Cities, counties, or public service organizations (such as railways, utility companies, and road commissions) have the state-granted power of eminent domain. All property owners must receive fair compensation as protected under the Fifth Amendment to the U.S. Constitution.

The owner's consent is usually granted after negotiating a fair price. The owner may also decide to dedicate the property to the government and perhaps receive a tax deduction. In other cases, the owner will not consent to the transfer, and the government will need to acquire the property through condemnation after paying just compensation.

## **Transfer by Adverse Possession**

**Adverse possession** is the claim to the some or all of the title by an occupant who has notoriously, openly, visibly and continuously occupied the property for a length of time without the permission or eviction of the legal owner. In layman's terms, we call it "squatter's rights." If someone uses another's property for many years without the owner's permission, and the owner does nothing to stop them, they can claim title to that portion of the land under adverse possession.

Not just anyone can make a claim on the title. Five qualifying factors must be met:

- **Open.** The possession must be open or visible and evident to everyone.
- **Hostile.** The possession must be taken without the owner's permission.
- **Continuous.** The possession must also be continuous and uninterrupted for an extended length of time.
- **Adverse.** The possession is against the valid owner's right of possession.
- **Notorious.** The possession must be known by others.

One of the most important factors is that the possession is continuous and uninterrupted for many years. A neighbor who occasionally parks his motorhome over the property line has not taken adverse possession. A neighbor who has parked his motorhome in his neighbor's pole barn for the past ten years without the owner saying anything at all may have a claim. Each state sets the qualifying length of time. Adverse possession can be claimed in only five years in California and Montana if they keep paying the property taxes. It can take 30 years in Louisiana or New Jersey.

Adverse possession can be handed down to a subsequent owner. This is called tacking, and it can be used by the new owner to claim an easement by prescription. The second adverse owner can receive the claim of right (also called color of title) in the form of a deed from the prior adverse owner. This is called privity. Government-owned land is exempt from adverse possession.

Not all adverse possession is intentional. Perhaps your neighbor built a fence ten years ago and it accidentally crossed the property line by several feet. He has listed the property and found a buyer. The survey, however, indicates there is an encroachment. The neighbor may have a claim to the land due to adverse possession. In this case, the property owner could be forced to grant an easement by prescription. He could sell the strip of property to his neighbor or simply quitclaim it to the neighbor as a gift. If the owner is unwilling to deed over the property, the adverse possessor can file for involuntary alienation under common law.

## Transfer by Quiet Title

When there is a question regarding the ownership of real property, a **quiet title** is the legal mechanism that is used to establish ownership. It is a lawsuit which makes it possible to grant a clear title to a single owner when there are several different claims to ownership. In effect, the case "quiets" all other claims. There are several reasons someone may want to use quiet title, they include:

- multiple claims of ownership of a property,
- adverse possession,



## MEMORY HELPER

### **OH CAN**

<b>O</b> – Open	<b>C</b> – Continuous
<b>H</b> – Hostile	<b>A</b> – Adverse
	<b>N</b> – Notorious

*The claim to adverse possession must meet the five qualifying factors which can be remembered as "OH CAN."*

- forged deeds,
- surveying errors, and
- claims by missing heirs.

## Section 5. Quiz

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. True or false. The title is a legal document by which a grantor transfers his or her right of ownership to another party.
  - a. True
  - b. False
2. What kind of title does a buyer who enters into a land contract have?
  - a. Legal title
  - b. Equitable title
  - c. Marketable title
  - d. Grantee title
3. Who is the grantor?
  - a. Buyer
  - b. Seller
  - c. Title Agency
  - d. Attorney
4. Who is the grantee?
  - a. Buyer
  - b. Seller
  - c. Title Agency
  - d. Attorney
5. When does a deed become a legally binding document?
  - a. When it is signed by the grantor.
  - b. When it is acknowledged by a notary public.
  - c. When it is recorded at the county level.
  - d. When it is delivered and accepted by the grantee.
6. What type of deed is the most protective form of property conveyance for a buyer?
  - a. General Warranty Deed
  - b. Limited Warranty Deed
  - c. Special Warranty Deed
  - d. Quitclaim Deed
7. What type of deed is commonly given to lenders in foreclosure and tax sales?
  - a. Warranty Deed
  - b. Quitclaim Deed
  - c. Bargain and Sale Deed
  - d. Executor's Deed

8. What is the purpose of a quitclaim deed?
  - a. To guarantee the property is free of liens.
  - b. To clear up a cloud on the title.
  - c. To relinquish any claim that the grantor has on the real estate.
  - d. Both B and C.
9. What is a quiet title?
  - a. Transferring title without using an attorney.
  - b. Transferring title out of an estate.
  - c. A legal mechanism used to establish ownership.
  - d. A legal mechanism used to identify all owners.
10. Name a method of creating a legal description.
  - a. Rectangular Survey System
  - b. Metes and Bounds
  - c. Lot and Block
  - d. All of the above.

## Quiz Answers

1. True or false. The title is a legal document by which a grantor transfers his or her right of ownership to another party.
  - b. False – The title to a property creates the union of the legal rights of ownership, possession, and custody, which is evidenced by a legal document such as a title deed. The deed is the legal document.
2. What kind of title does a buyer who enters into a land contract have?
  - b. Equitable title – represents the right to use, enjoy and benefit from the real estate while having a financial interest in the property.
3. Who is the grantor?
  - b. Seller – remember that grantors have more.
4. Who is the grantees?
  - a. Buyer – remember that the grantees receives.
5. When does a deed become a legally binding document?
  - d. When it is delivered and accepted by the grantees. – All contracts must be delivered and accepted to become valid.
6. What type of deed is the most protective form of property conveyance?
  - a. General Warranty Deed – it grants six warranties or promises
7. What type of deed is commonly given to lenders in foreclosure and tax sales?
  - c. Bargain and Sale Deed – this deed implies good title and possession of the property and is commonly used in foreclosure and tax sales.
8. What is the purpose of a quitclaim deed?
  - d. Both B and C. – a quitclaim deed is used to clear up a cloud on the title by having the grantor relinquish any claim that they may have on the real estate.
9. What is a quiet title?
  - c. A legal mechanism used to establish ownership. – A quiet title is a lawsuit that makes it possible to grant a clear title to a single owner when there are several different claims.
10. Name a method of creating a legal description.
  - d. All of the above. – The three main methods to create legal descriptions is through the rectangular survey system, metes and bounds, and the lot and block system.

# **Chapter 12 Land Use Controls**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the different types of governmental and private land use controls;
- land use laws that impact real estate development; and
- the four main ways to protect real property.

**OVERVIEW:** Real estate is one of the most valuable items a person can own. It is sensible to look for ways to protect that investment. Land use laws and controls, as well as insurance and the recording of transfer deeds, are primary methods of protecting real estate. This chapter will help you to understand more clearly how each of these protects an owner's investment.

According to the U.S. Department of Agriculture (USDA), over 60 percent of the land within the United States is privately owned. Federal, state, and local governments own 38 percent of the land, and 2 percent have been placed in an Indian tribal land trust. Because so much of the land is privately owned, there must be land use controls to guide property development.

## **Section 1.      Land Use Controls**

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There are two main sources of land use controls: governmental and private. Land use controls, while limiting in nature, serve to protect property value and create a degree of neighborhood uniformity.

### **Governmental Land Use Controls**

In Chapter 9, Section 5, we discussed the governmental power to protect the safety, health, and welfare of the public by restricting property ownership rights through police power. City and county governments have the authority to enact and enforce building codes, environmental laws, and zoning ordinances. City commissions often appoint a planning commission to develop a comprehensive plan or master plan that anticipates the changing needs of a community over the next 20 years or so. It helps to systematically plan for orderly growth through designated land use, anticipated long-term housing needs, transportation expansion, public facility development, and environmental management.

### **Environmental Regulations**

Environmental laws protect natural resources such as land, air, and water and the health of the general population. Several federal agencies create and enforce environmental regulations, such as the US Environmental Protection Agency (EPA), US Department of Agriculture (USDA), Department of Energy (DOE), Fish and Wildlife Service

(USFWS), National Park Service, United States Geological Survey (USGA), Bureau of Land Management (BLM), and the National Oceanic and Atmospheric Administration (NOAA).

## Zoning Ordinances

**Zoning ordinances** are a written regulation and law that defines how property in specific geographic zones can be used. It regulates land size and use, building density and height, property boundary setbacks, building design, style, and appearance. It also protects natural resources. Zoning ordinances are set at the local level and are created in conjunction with their master plan.

There is not a state or national zoning code, but most follow similar classification systems such as agricultural, residential, commercial, and industrial. Land-use areas can be subdivided into more specific uses. A residential zone may have specific areas designated for single-family (attached or detached), manufactured homes, and multi-family (low-rise or high-rise). Properties can have more than one zoning designation which will allow for multiple uses. Properties can also be located within a planned unit development (PUD) that designates specific areas within the development for residential, commercial, and public areas.

It is common for a city's master plan to indicate areas that would benefit from a zoning change. These are often in areas of commercial or residential growth or in areas that are declining and would benefit from a new use. When an area is rezoned, an existing property that no longer conforms to the new zoning designation may be authorized as a **nonconforming use**. The property is referred to as being "grandfathered in" to the new zoning. The current use can legally continue until the present use discontinues or the improvements are destroyed or removed.

**PRACTICAL APPLICATION:** *The city rezoned the six blocks containing Bob's garage from commercial to multi-family. Bob's property was grandfathered into the multi-family zoning. He may continue to use the property for commercial purposes. If he ever decides to redevelop the property, he will need to then abide by the requirements under the multi-family zoning. If Bob decides to sell his property, the new owner will need to check with the local planning and zoning department to see if the current nonconforming use will be allowed after a property transfer.*

Within a designated zoning area, there will be properties that are designated as a non-conforming conditional use. A church located within a residential district is an example of a non-conforming conditional use. Before a property can be used as a nonconforming conditional use, the owner must obtain a conditional-use permit (or special-use permit).

Prior to beginning any development, the property owner is usually required to obtain a zoning permit to ensure that the development is in harmony with the designated zoning requirements and restrictions. If a property owner desires to develop or use a property in a way that violates the current zoning ordinance, they have the right to request a **variance**. A variance does not change the zoning but instead waives the requirements of the zoning ordinance. All variances are subject to the approval of the local zoning board. The zoning examiner will hold a public meeting to determine if the variance should be granted. Other adjacent property owners or individuals that would be impacted by the proposed new use can voice their opinions at this meeting. The property owner must provide reasons why they qualify for a variance. This may include evidence that the current zoning restrictions have created a burden or caused physical hardship to the owner.

### Building Codes

Building codes are designed to protect residents from careless building practices by specifying construction standards, materials, and the quality of workmanship. States can set a statewide building code, and local municipalities can add to it. Municipalities all over the world have adopted the International Building Code to “construct safe, sustainable, affordable and resilient structures.” Building code compliance can be extremely technical and subject to hefty fines and even legal proceedings. This is an area where licensed real estate agents should refer their clients to more qualified authorities.

Before a property owner can begin building or the renovation of an existing building, they must first obtain a building permit. A building permit serves notice to the local building department that regular inspections will be needed to ensure that the construction meets the current building code. Once construction is complete, and it has passed a final inspection, a **certificate of occupancy** (or occupancy permit) is issued. The occupancy permit must be issued before the building can be used for its designated purpose.

### Private Land Use Controls

Private land use controls are expressed through deed restrictions. A **deed restriction** is a use limitation imposed by a current or past owner that is included in the property's deed. Governmental restrictions impact large sections of land that contain many different individually owned parcels. Private land use controls are much narrower in scope.

A private land use restriction can control and maintain certain qualities or conditions of a property, but they cannot, however, violate a governmental land use control. They can impact one single parcel or all the parcels within a designated subdivision or development.

Deed restrictions are binding upon all future owners. There are three types of private land use controls: restrictive covenants, defeasible fee estates, and easements.

### Restrictive Covenants

Private rules that establish standards for all parcels within a subdivision or PUD are called **covenants, conditions, and restrictions (CC&Rs)** or simply **restrictive covenants**. These rules and regulations are attached either directly or by reference to the parent deed. Restrictive covenants impact the use of all the individual units or lots within the development. These are initially set by the developer and eventually enforced by the homeowner's association.

CC&Rs will govern land use, building setbacks, construction size and height, building types, and architectural styles. These restraints are designed to benefit all the property owners within a development, but they cannot violate any governmental laws, including Fair Housing laws. It is, however, legally permissible for a restrictive to be more restrictive than a governmental land control.

**PRACTICAL APPLICATION:** *The CC&Rs in a residential subdivision does not allow a boat to be permanently parked in an owner's driveway. The local zoning regulation has no such restriction. Because the restrictive covenant does not violate the governmental zoning regulation, it is a legally permissible private land control.*

A restrictive covenant for a development can have a time limitation, which will specify how long these land control regulations remain in force. The CC&Rs can be extended or changed based on the terms within the document.

### Defeasible Fee Estates

In Chapter 10, Section 2, we discussed fee simple defeasible estates. When a grantor sets certain conditions, the property is then subject to a private land-use control. The defeasible fee estate restricts the use of the property. If the new property owner fails to observe the conditions established by the grantor, then the property can revert to the grantor.

### Easements

In Chapter 10, Section 4, we discussed easements. An easement provides individuals a legal right-of-way to use or cross a parcel of land owned by another. Indefinite easements are recorded and encumber the legal description of the servient estate and this also creates a private land-use control.

## **Section 2.      Land Use Laws**

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The Environmental Protection Agency (EPA) was created in 1970 to control and regulate environmental use. When Congress passes an environmental law, the EPA enforces it. In addition to federal laws, states can create and enforce their own legislation as long as they meet or exceed federal standards. Real estate agents should be familiar with some of the environmental laws that impact property ownership and use.

### **Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)**

This act was created in 1980 to respond to spills and remediate, restore and redevelop hazardous waste sites. The act sets out procedures to identify potentially responsible parties (PRPs) and hold them responsible for cleaning up any contamination. Cleanup includes the subject property and any contaminated neighboring property. The EPA encourages PRPs to voluntarily undertake site cleanup. If they fail to do so, the EPA has the right to complete the work and then bill the PRPs for the cost. If the PRPs refuse to pay, a court judgment can demand up to three times the actual cost.

Under the Superfund Amendments and Reauthorization Act (SARA), landowners who unknowingly purchased a contaminated property and did not contribute to the contamination are not held liable for the cost of cleanup.

### **Brownfields Revitalization Act**

The EPA's Brownfields Program provides grants and technical assistance to assess, remediate, reduce liability, and sustainably reuse contaminated properties. It also covers properties that are suspected to be contaminated. The Small Business Liability Relief and Brownfields Revitalization Act of 2002 (the Brownfields Law) provides tax incentives for redevelopment. It also shields property owners from any liability or cleanup costs for contamination that they did not contribute to or initially create.

### **The Safe Drinking Water Act (SDWA)**

This act was passed in 1974 to protect public health through the regulation of the public drinking water supplies and the protection of natural sources of water, such as springs, rivers, lakes, and reservoirs. Since this act was enabled, the EPA has set national drinking water standards. There were amendments in 1986 and 1996 that strengthened the standards for water protection.

### **Historic Protection Act of 1966 (NHPA)**

This act created a National Register of Historic Places and a list of National Historic Landmarks for properties of historical significance. Private properties are eligible for inclusion. Properties on this list must submit any renovations or alterations through a Section 106 review to determine if the project will negatively impact the historic nature of the property. Properties on the national register may qualify for funding for historic preservation and qualify for certain tax benefits.

### **Residential Lead-Based Paint Hazard Reduction Act (Title X)**

Congress passed the lead-based paint act in 1992 to protect homeowners from exposure to lead from paint, dust, and soil. Section 1018 requires the disclosure of known information on lead-based paint and lead-based paint hazards before the sale or lease of most housing built before 1978.

### **Interstate Land Sales Full Disclosure Act (ILSA)**

Under the Interstate Land Sales Full Disclosure Act, a seller must file a disclosure statement of record with the Consumer Financial Protection Bureau before marketing vacant lots to out-of-state buyers through telephone or mail. Sellers and developers must also provide a printed disclosure report to all potential buyers before signing a purchase or lease contract. The act was designed to prevent fraudulent marketing schemes when selling uninspected land. The disclosure covers the type of title being transferred, the distance to a nearby community, utility services and charges, soil conditions, and any foreseen construction problems. Subdivisions with fewer than 25 lots, developments where the lots are 20 acres or larger, and improved lots are exempt.

## **Section 3. Personal Land Protections**

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A property owner has provisions at his disposal to protect their property interests. One method is by recording documents that provide proof of ownership or title claims in the public records. Another method is through the purchase of insurance policies to protect the property or the title against future damage from outside sources.

### **Public Records**

Public records include all recorded documents held by a city or county. These records are used to establish property ownership, legalize the priority of liens and mortgages, and provide notice of encumbrances and deed restrictions. Depending on the jurisdiction where the records are held, public records are maintained by a recorder of deeds, county or city clerks, clerks of the court, or county treasurers.

When a document is placed in the public records, it is said to have been recorded. The state requirements for recording can be very exacting – even down to the margins, size, and color of the paper. The legal priority of recorded documents starts with the first document recorded and progresses down the line. A second mortgage is second in line for repayment because it was recorded after the first mortgage. Property taxes, special assessments and delinquent IRS taxes are an exception to this rule. They are always in the first repayment position and they do not need to be recorded.

The order that deeds are recorded creates a **chain of title** of property ownership. As the buyer becomes the seller to a new buyer, a chain of ownership is created. Documents that do not directly relate to the transfer of ownership, such as liens and encumbrances, are not included in the chain of title. The priority or order in which documents are recorded has a significant impact on the chain of title and ownership interests. Gaps in the order of ownership are called a **cloud** on the title.

**PRACTICAL APPLICATION:** *Pat, the property flipper, is buying a property from Stan and then immediately selling it to James, all within the same closing. By the end of the closing, there are two warranty deeds to be recorded, the first deed between Stan and Pat and the second deed between Pat and James. If the title company records the second deed before the first, it will create a break in the chain of title. Technically, James no longer owns the property because Pat cannot convey something she did not own.*

At times, court action is needed to clear up a cloud on the title. If the current possessor can supply sufficient evidence to prove that they are the legal owner, the court can grant a **quiet title**.

A title company, attorney, or lender can complete a property title search as part of the buyer's due diligence. A careful search is made through public records to identify each link in the chain of title going back at least 40 years, depending on the state statutes. A title search should reveal all the liens, mortgages, court judgments, and unpaid property taxes standing against the title. A summary of the research is called an **abstract of title**. It will list the chain of title and the status of all recorded liens and encumbrances.

Liens transfer with the title. Hence, all liens must be paid before the title can be transferred to the buyer, or they would be liable for the repayment. Additionally, any breaks in the chain of ownership must also be resolved.

## Homeowners Insurance

A homeowner's insurance policy insures against the destruction of real estate and personal property by specific perils, such as fire or theft, and it covers liability for injuries or damage to someone else's property. A standard homeowner's insurance policy includes four types of protection:

- **Improvement coverage**, or hazard insurance, covers the cost of the repair or replacement of structures and other improvements caused by physical damage or loss caused by theft, vandalism, fire, lightning, and usually windstorms and hail.
- **Personal property coverage** covers the value or replacement cost of personal property after a covered loss. Personal property includes items such as furniture, electronics, and clothing, but it does not include high-value items such as expensive jewelry, collectibles or artwork.
- **Liability coverage** provides personal liability and medical coverage if someone is injured on the insured premises. Liability protection may help cover an injured party's medical bills and lost wages or the cost to repair the damage the insured caused to someone else's property plus any legal expenses.
- **Loss of use** coverage reimburses the property owner for temporary living expenses if the insured property is rendered uninhabitable due to damage.

Property owners are not required by law to have homeowner's insurance. Most property owners see the wisdom in insuring their property against losses, as it is usually the most valuable possession they own. Property insurance, however, is required to obtain a mortgage, and the lender must be listed in the policy as an additional insured.

Landlords can also require their tenants to purchase renters insurance. It insures, not the structure, but the tenant's personal property found within the rented unit. It also covers temporary living expenses while major repairs are being completed if an insured loss makes the unit uninhabitable. It also covers any liability claims for accidental property damage or bodily injury to a visitor.

### Coverage Values

There are two methods of valuing the coverage of the insured property: the actual cash value (ACV) or the replacement value.

- **Actual Cash Value (ACV)**. The actual cash value is the "as is, depreciated" value of the property as of the date of the claim. The insurance company will only cover the depreciated cost of the damaged item. This policy costs less but pays out less.
- **Replacement Cost**: The replacement cost covers the cost of purchasing a replacement or the restoration of the item to its original new condition – whichever is less. Generally, this policy will insure up to 125 percent of the original building

costs. There is no deduction for depreciation. This policy costs more but pays out more.

**PRACTICAL APPLICATION:** Joe owns a home that cost him \$200,000 to build. Since then, it has depreciated by 10 percent and thus has an actual cash value of \$180,000. Joe opts for the cheaper ACV policy. Six months later, the home burns to the ground. The insurance company sends Joe a check for \$180,000 (less the deductible). Joe decides to rebuild the house. Using today's prices and materials, it will now cost \$250,000 to build. He is \$70,000 short. If he had opted for the replacement cost policy, which insures up to 125 percent of the original building costs, he would have received a check for the full \$250,000 (less any deductible).

### Coverage Exceptions

The coverage provided under an insurance policy differs depending on the policy type and even the insurance company. A standard homeowner's insurance policy does not cover all types of natural disasters. In most states, a standard or broad-form insurance policy *does not cover floods, earthquakes, and sinkholes*. For an additional fee, an addendum (also called an endorsement) can be attached to the policy to cover earthquakes and sinkholes. Flood and mudflow insurance can be purchased as a separate policy through the National Flood Insurance Program (see below).

**PRACTICAL APPLICATION:** Joe insures his home under a broad-form homeowner's insurance policy. A hurricane came through and damaged Joe's house, plus a large Walnut tree fell and damaged the roof. Floodwaters from a failed levee entered the house and caused extensive drywall damage. The insurance policy will cover the damage caused by the fallen tree under the standard wind coverage. However, it will not cover the water damage because the policy does not cover flooding from any source – including hurricanes.

Furthermore, property insurance does not cover the damage caused by neglect or negligence. This includes termite and insect damage, pest invasions, mold, rust, rot, and general wear and tear. It will also not cover mechanical breakdowns or equipment defects. Nuclear hazard damage and war are also not covered.

It is important to note that homeowner's insurance *does not insure the land*. Only the improvements are included in the policy, and thus, the coverage is going to be less than the purchase price. Insurance policies will also include a deductible.

### Federal Flood Insurance Program

Floodwater damage is *not* covered by a standard homeowner's insurance policy. If a property is located in a coastal state subject to frequent hurricanes or near a flood-prone river, it is highly recommended that a property owner obtains flood insurance. Real estate

agents should be aware of identified flood areas and alert their clients to the importance of obtaining flood insurance.

The Army Corps of Engineers have created maps to identify flood-prone areas throughout the United States. If a property is located in a special flood hazard area (SFHAs), flood insurance will be required to qualify for a federally related mortgage. Policies are purchased from the National Flood Insurance Program (NFIP) or a licensed property insurance broker. Coverage does not become effective until 30 days after purchase, and it will not cover any prior damage. In flood-prone areas, flood insurance is subsidized under the National Flood Insurance Act of 1968, which is managed by the Federal Emergency Management Agency (FEMA).

## Title Insurance

**Title insurance** protects the policyholder from losses due to defects in the title. There are two types of title insurance policies: an owner's policy and a lender's policy. An owner's policy will cover the purchase price, and a lender's policy will cover the lender up to the mortgage amount. Unlike homeowner's insurance, title insurance provides protection from past events, not future ones. Title insurance is a contract of indemnity, meaning that while it does not guarantee that there are no problems with the title, it does guarantee that the policyholder will not be liable for any problems. The title insurance company will defend any lawsuit against the title and pay any claims if the title is defective.

**PRACTICAL APPLICATION:** Twenty-five years ago, Joe bought a small farm from old McDonald. During the closing, Mrs. McDonald was attending a chicken council convention and failed to sign the deed. Five years ago, Joe sold the farm. Now old Mrs. McDonald shows up and files a claim for the property, saying her husband sold the farm without her approval. The current owner turns over the claim to their title insurance company, who will not only handle the case with Mrs. McDonald, which includes paying any just compensation, but they will also clear the title at no cost to the buyer.

Standard policies are based on an abstract of title prepared by a title insurance company. It insures the title based on the documents found in public records plus incomplete conveyances, forged documents, and other hidden defects. Title insurance policies do not cover known issues in the chain of title, zoning ordinances, road right-of-ways, special assessments, restrictive covenants, easements, some water rights, and claims caused by bankruptcy. Title insurance issued from the American Land Title Association, called an ALTA policy, provides extended coverage. It protects the property owner from all errors in public records, hidden defects, plus inaccurate surveys, adverse

possession, and some unrecorded liens. Each policy will state the risks they cover and then provide a list of exclusions, exceptions, and conditions.

The premium is paid only once per policy, and it is typically paid at the closing. The policy remains in effect for as long as the buyer and their heirs own the property. A lender's insurance policy remains in effect until the mortgage is paid off. The buyer pays for the lender's policy, and the lender will include it in the mortgage closing costs. In some states, the seller is expected to provide the buyer with an owner's title insurance policy as an assurance that they possess marketable title that is clear of any liens, claims, or encumbrances.

## **Section 5. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What are three forms of governmental land use controls?
  - a. Master plan, EPA, and zoning
  - b. Master plan, police power, and escheat
  - c. Environmental regulations, zoning ordinances and building codes.
  - d. Legal, judicial, and local
2. An existing property that no longer conforms to a new zoning designation may be authorized as a \_\_\_\_\_.
  - a. nonconforming use
  - b. approved use
  - c. illegal use
  - d. misapplied use
3. What are three forms of private land use controls?
  - a. Deed restrictions, nuisance claims, and life estates
  - b. Title conditions, land trusts, and easements
  - c. Restrictive covenants, foreclosure, and taxation
  - d. Easements, deed restrictions, defeasible fee estate
4. What organization controls and regulates environmental use?
  - a. Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)
  - b. The Environmental Protection Agency (EPA)
  - c. Congress
  - d. National Association of Realtors (NAR)
5. True or false. When a document is placed in the public records, it is said to have been deeded.
  - a. True
  - b. False

6. The order that deeds are recorded creates a \_\_\_\_\_ of property ownership.
  - a. cloud
  - b. deed chain
  - c. priority chain
  - d. chain of title
7. True or false. Real estate agents can complete a property title search for their client.
  - a. True
  - b. False
8. What method of homeowner insurance coverage costs more but pays out more?
  - a. Actual Cash Value (ACV)
  - b. Replacement Cost
9. True or false. A standard homeowner's insurance policy covers wind and floodwater damage.
  - a. True
  - b. False
10. True or false. Title insurance protects the policyholder from losses due to defects in the title.
  - a. True
  - b. False

## Quiz Answers

1. What are three forms of governmental land use controls?
  - c. Environmental regulations, zoning ordinances and building codes.
2. An existing property that no longer conforms to a new zoning designation may be authorized as a \_\_\_\_\_.
  - a. nonconforming use
3. What are three forms of private land use controls?
  - d. Easements, Deed Restrictions, Defeasible Fee Estates
4. What organization controls and regulates environmental use?
  - b. The Environmental Protection Agency (EPA) - The Environmental Protection Agency (EPA) was created in 1970 to control and regulate environmental use.
5. True or false. When a document is placed in the public records, it is said to have been deeded.
  - b. False - When a document is placed in the public records, it is said to have been recorded.
6. The order that deeds are recorded creates a \_\_\_\_\_ of property ownership.
  - d. chain of title
7. True or false. Real estate agents can complete a property title search for their client.
  - b. False - A title company, attorney, or lender can complete a property title search as part of the buyer's due diligence.
8. What method of homeowner insurance coverage costs more but pays out more?
  - b. Replacement Cost - The replacement cost covers the cost of purchasing a replacement or the restoration of the item to its original new condition – whichever is less. This policy costs more but pays out more.
9. True or false. A standard homeowner's insurance policy covers wind and floodwater damage.
  - b. False - A homeowner's insurance policy typically insures against the destruction of real estate loss caused by theft, vandalism, fire, lightning, and usually windstorms and hail. Floodwater damage is *not* covered by a standard homeowner's insurance policy.
10. True or false. Title insurance protects the policyholder from losses due to defects in the title.
  - a. True - The title insurance company will defend any lawsuit against the title and pay any claims if the title is defective.

# **Chapter 13 Legal Descriptions**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- how land is measured;
- how to calculate the areas of a parcel of land;
- the three methods used to create legal descriptions; and
- the difference between an easement and an encroachment.

**OVERVIEW:** Before a property can be owned, it must be identified. This chapter will help you to understand how to read and understand a legal description and how to determine the area of a piece of land.

## **Section 1. Units of Land Measurement**

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A **legal description** is a legal method for identifying the boundaries of a property to establish what is owned within a deed or a mortgage. The process of creating a legal description is called a **survey**. The property is measured, the corners are identified, and the area is calculated. The person who completes the survey is called a **surveyor**. The reporting of the legal description is also called the survey.

Standard units of measurement are used in the United States to measure the dimension and area of a parcel. There are two standard units of land measurement:

<b>CUSTOMARY UNITS</b>	<b>US SURVEY METHOD</b>
1 mile = 5,280 feet	1 rod = 16.5 feet
1 acre = 43,560 sq. feet	1 chain = 66 feet or 4 rods
1 sq. mile = 640 acres	1 furlong = 10 chains survey mile = 8 furlongs

It is common to convert units of measurement from one unit to the other. For example, if a parcel of land has 85,000 square feet, it is more helpful to know how many acres the site includes. Divide 85,000 square feet by the 43,560 square feet in an acre. The parcel contains 1.95 acres (only go out two decimal points).

What if the parcel has .59 acres? How many square feet are there? Multiply .59 acres by 43,560 square feet in an acre to learn it has 25,700 square feet (round to the nearest whole number when calculating for square feet.). If a property length is four chains, what is the measurement in feet? The formula is four chains multiplied by 66 feet in a chain or 264 feet.

The lineal feet that run along the primary access road or that contain the property's entrance is called the front feet. Commercial land is often sold based on the price per front foot.

## Section 2. Describing Real Estate

There are three conventional methods to create a legal description: the rectangular or governmental survey system, metes and bounds, and the lot and block or plat method. The method used will depend on where the property is located within the United States.

### Rectangular Survey System

The rectangular survey system is used to identify large parcels of land. It was established by Congress in 1785 to identify land outside the original 13 colonies. It is also known as the Public Land Survey System (PLSS) or the government survey system.

A grid is created using principal meridians that run north-to-south and base lines that run east-to-west. In between each principal meridian are parallel lines called range lines. Lines that run in between the base lines are called township lines. There are six miles between each township and range line. These boxes form townships measuring six square miles each. A township is divided into thirty-six sections of one square mile each. A section contains 640 acres. Sections can be divided into half, quarter, and fractional segments.



#### MEMORY HELPER

To remember the direction of township and range lines, picturing this:



**SAMPLE LEGAL DESCRIPTION:** “The SW quarter of the NW quarter of the NW quarter of Section 36, Township 4 North, Range 5 East of the Third principal median.” (The description can also be abbreviated as SW 1/4, NW 1/4, NW 1/4 of Section 36, T4N, R5E.)

#### How to Use a Rectangular Survey Description.

To determine the location of a property, start at the end of the description and work backward to the beginning. Let us look at our sample legal description again: “*The SW quarter of the NW quarter of the NW quarter of Section 36, Township 4 North, Range 5 East of the Third principal median.*” First, locate the township based on the principal median and base line. “Township 4 North” means that the township will be located four sections above the base line. “Range 5 East” means that the township will be five sections east of the principal meridian. Second, identify the section within the township. In this case, it is section 36. (See Figure 1.)

Figure 1. Identify the Township and the section.

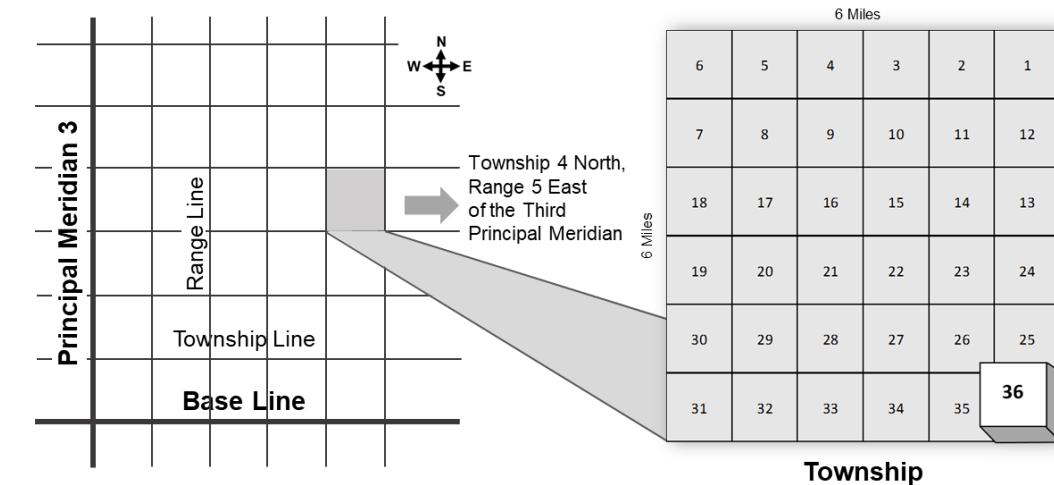
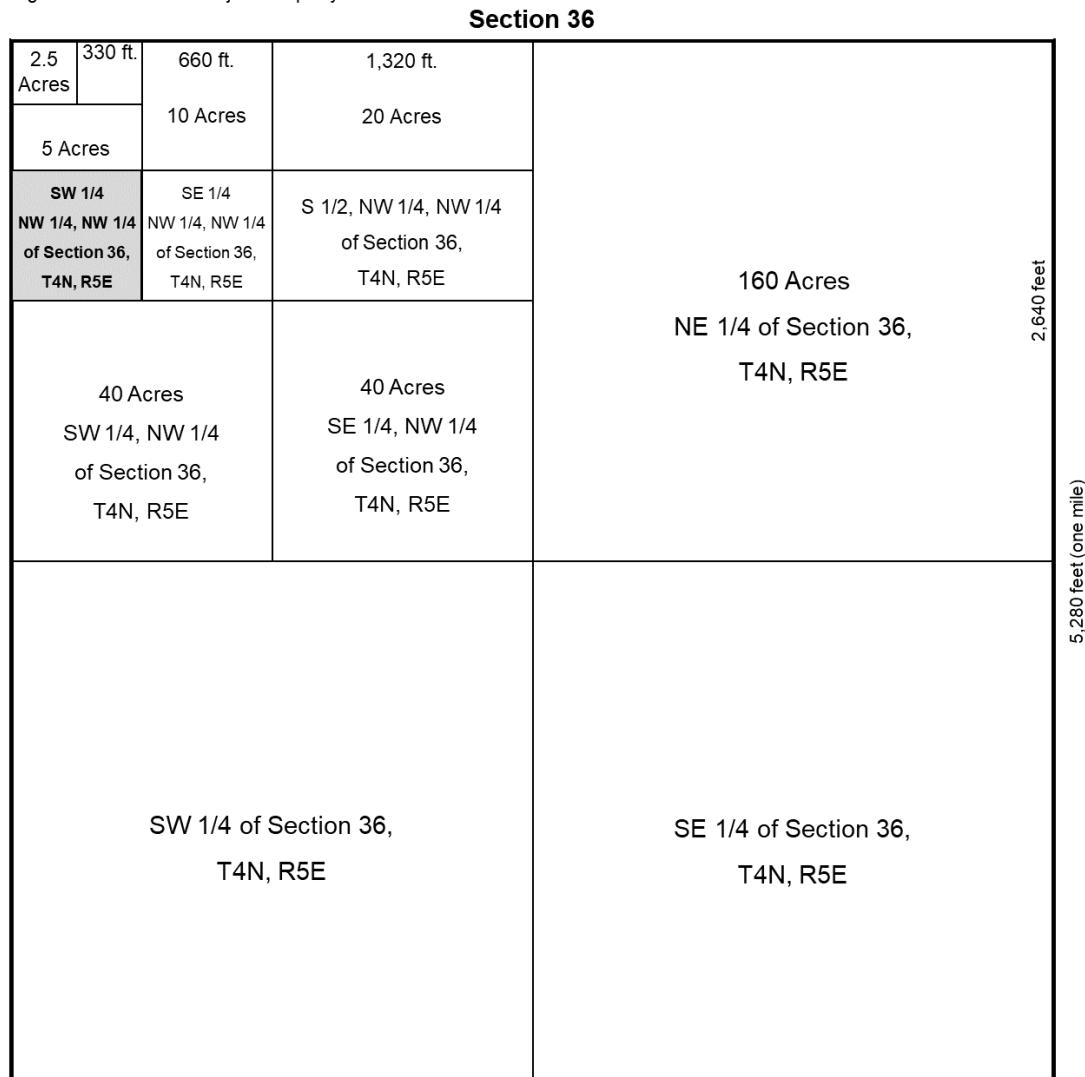


Figure 2. Locate the Subject Property



Third, identify the subject property within the township. To do this, locate the NW quarter within Section 36. Within that quarter, locate the NW quarter. Within that quarter, locate the SW quarter. (See Figure 2.)

Next, identify the size of the property. You can keep a copy of the following section breakdown as a reference, or you can calculate the area using a simple formula. Divide 640 acres by each of the denominators in their correct order. In our example, “SW 1/4, NW 1/4, NW 1/4 of Section 36 =  $4 \times 4 \times 4 = 64$ ;  $640 \div 64 = 10$  acres.

## **Metes and Bounds**

Not all properties form a nice even rectangle. The metes and bounds method is better suited to handle these situations. All descriptions will start from a permanent point of reference, called a **benchmark**. From there, the legal description will identify the distance from the benchmark to the point of beginning (POB). The point of beginning is a permanent marker such as an iron pin or concrete post, referred to as a **monument**, or an established geographical feature such as a river. Only the U.S. Army Corps of Engineers, governmental authorities, or a licensed surveyor can set a monument. The legal description will then progressively identify the dimensions of the property by following compass headings until it reaches back to the start.

**SAMPLE LEGAL DESCRIPTION:** “*Commencing at the intersection of North line of Clayton Road, thence North 208.71 feet, East 108.71 feet, South 208.71 feet, West to the Point of Beginning. Part of SW 1/4, NW 1/4, NW 1/4, Section 36, T4N, R5E 4.5 acres more or less.*”

The rectangular survey system can be used in conjunction with a metes and bounds description to describe a section of land that is smaller than a survey section. Metes and bounds descriptions can become very difficult to read when property dimensions include curves, concave, or convex lines. Newer legal descriptions will frequently refer to GPS degrees, minutes, and seconds. A recorded survey drawing is a useful tool to visualize the property boundaries and identify the site area.

## **Lot and Block**

The simplest legal description is the lot-and-block system, also known as the recorded plat method. This method is used with subdivisions and in densely populated areas. The description will refer to lot and block numbers identified on a recorded plat. The plat could be of a city, town, or a subdivision. The plat will contain a detailed description of the parent parcel, and the smaller individual lots will be identified on the plat by a lot number.

**SAMPLE LEGAL DESCRIPTION:** "Lot 18, Block 24, Section 8, T22N, R7W, RAINBOW SUBDIVISION, according to the plat thereof as recorded in Plat Book 43, Page 209 of the Public Records of \_\_\_\_\_ County, \_\_\_\_\_ State."

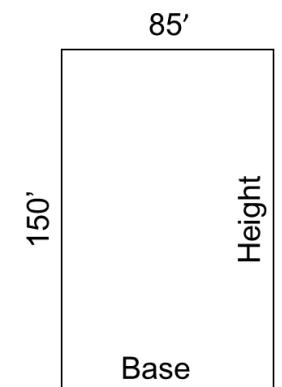
When a parent parcel is divided into less than four units, this is called **partitioning**, and the individual units are called **parcels**. If a parent parcel is divided into more than four units, then the process is called **subdividing**, and the units are called lots.

Condominium developments use a form of the lot and block method to indicate the location of a unit. The difference is that these developments not only extend horizontally along the ground but also vertically into the air. Condominium laws require that plat maps indicate the elevations of each floor and ceiling surface. The base elevation will reference an official **datum** or elevation point set by a local government or the United States Geological Survey (USGS). If a city has not set its datum, the USGS level is used, which is based on the mean sea level at New York Harbor.

### **Section 3. How to Calculate the Area**

Real estate agents need to be able to calculate the area of a parcel. The area of a parcel of land is measured in square feet or acres. Not all legal descriptions will provide a total area. There is no need to worry or feel intimidated; it is quite easy to do once you know the correct formula. Commit to memory that one acre contains 43,560 square feet. It will come in handy when converting land areas from square feet to acres or vice-versa.

**Calculating the area of a square, rectangle or parallelogram.** The majority of lots are going to be rectangular. There are four sides and, thus, four dimensions. As long as there are two pairs with equal dimensions, this formula will work:

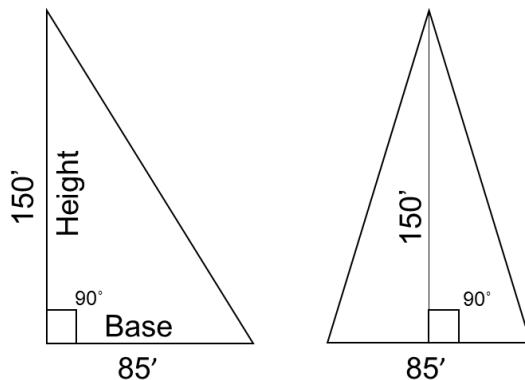


#### **Calculating the Area of a Rectangle**

$$\text{Base} \times \text{Height} = \text{Area}$$
$$85' \times 150' = 12,750 \text{ Sq. Ft.}$$

$$\text{Sq. Ft.} \div \text{Sq. Ft. in Acre} = \text{Acre(s)}$$
$$12,750 \div 43,560 = .29 \text{ Acres}$$

**Calculating the area of a triangle.** To calculate the area of a triangle, you must have the base and height measurements. The base and the height will always intersect at a 90-degree angle (also called a right angle). Here is how to calculate the area:



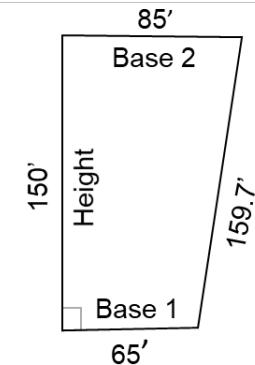
### Calculating the Area of a Triangle

Must know the height and the base and they must intersect at a 90 degree angle.

$$\text{Area} = (\text{Base} \times \text{Height}) \div 2$$

$$(85' \times 150') \div 2 = 6,375 \text{ Sq. Ft.}$$

**Calculating the area of a trapezoid.** A trapezoid is a quadrilateral with at least two sides that run parallel to each other. To calculate the area of a trapezoid, first find the average of the two parallel sides and then multiply by the height. The height must intersect the base at a 90-degree angle.



### Calculating the Area of a Trapezoid

$$\text{Area} = \text{Average Base} \times \text{Height}$$

$$(\text{Base 1} + \text{Base 2}) \div 2 \times \text{Height} = \text{Area}$$

$$(65' + 85') \div 2 = 75' \text{ Average Width}$$

$$75' \times 150' = 11,250 \text{ Sq. Ft.}$$

With these basic formulas, the area of all but the most complicated parcels can be calculated. Properties that do not fit into one of these shapes should be divided into shapes that can be calculated and then find the area of each shape. The sum of all the areas will equal the area of the parcel. These formulas can also be used to calculate the area of a house. That will be discussed in more detail in a future chapter.

## **Section 4.      Special Issues with Boundary Lines**

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An accurate legal description is a critical component of holding equitable title. Legal descriptions should never be altered or combined unless done so by a licensed surveyor or title attorney. Be extra careful when copying a legal description; any errors could result in the transfer of the wrong property and damage the title of an adjacent property. Real estate agents can be held liable for damages because of something as simple as a transposed number or the failure to correctly place a comma in the legal description.

Sometimes there will be a problem with the legal description that impacts the value or even the use of the property. Issues with the boundary lines or legal descriptions are usually identified when a survey is completed or when preparing a title insurance policy. There are a few situations that can impact a legal description.

### **Easement**

An **easement** grants a party the limited use of a parcel of land for a limited and specific purpose. The most common easements are driveways that give access to a neighboring property; a utility easement permitting public utilities to be laid across the property; or a public road right-of-way. An easement can be limited to a specific period of time, or they can last indefinitely. Indefinite easements are added to the legal description and are binding on all future property owners. The property where the easement crosses is called a **servient estate** or servient tenement. The property that benefits from the easement is called a **dominant estate** or dominant tenement.

#### **Common Types of Easements**

**Easement Appurtenant.** This easement grants an adjacent property owner the right to use the servient estate. A driveway easement is an easement appurtenant. This easement is attached to the legal description of the servient estate, and it is indefinite until either the owner of the dominant estate releases the easement or the same owner owns both properties. Another example of an easement appurtenant is a cross easement, such as a wall, fence, well, driveway, or other property improvements that are shared by both property owners. Each own half of the item and has an easement on the other half. Maintenance expenses are shared and typically a written agreement is created.

**Easement in Gross.** This easement represents the interests of a second party in another's land. Commercial easements in gross include utility, railroad, and road right-of-way easements. These may be assigned or conveyed to another third party. Personal

easements in gross are usually not conveyed and are limited to the easement owner, and the easement terminates upon their death.

### The Creation of Easements

Easements are created through a written agreement between two parties that establish the easement's location, usage rights, and a term that the easement is valid. At times, however, one of the parties may not be willing to enter into an easement or are unaware of the need to create an easement. In these cases, there are two methods to create an easement.

**Easement by Necessity.** This easement is created under a court order to grant a **landlocked** property owner access through a neighboring property. A landlocked property is a parcel of land without direct access to a public road, street, or waterway. The law does not allow the ownership of a landlocked property, and hence, it can force an easement by necessity.

**Easement by Prescription.** This is an easement that is used to legalize **adverse possession**. If a property owner has used adjacent land for an extended length of time, but without the property owner's permission, they may be entitled to a prescription easement. The claimant must meet all four qualifications to create a legal claim on the property: (1) The claimant must "reasonably believe" they are entitled to the property. (2) The possession must be "open and notorious" or obvious to all. (3) There must be "hostile" possession, meaning it was taken without the owner's permission. (4) Lastly, it must be "continuous and uninterrupted" for the length of time set by state laws. Adverse possession can be handed down to a subsequent owner. This is called **tacking** and it can be used by the new owner to claim an easement by prescription.

### License

A **license** is not as permanent or binding as an easement. It grants another the privilege to enter or use the land of another. Allowing a neighbor access to their 40 acres to hunt deer every fall is an example of a license. It does not have to be in writing, and it is not attached to the legal description. The owner can revoke it at any time. A license automatically ends with the death of either party or if the owner sells the land.

### Encroachment

When an improvement extends into the property of another, it is called an **encroachment**. Common encroachments are driveways, fences, landscaping items such

as trees or bushes, roof overhangs, and even buildings. There are a couple of ways to handle an encroachment:

- The neighbor can remove the encroachment and repair any damage voluntarily or under a court order;
- The property owner can grant the neighbor an easement that permits their limited use of the encroached area without granting ownership; or
- The property owner can deed the encroached area to the neighbor.

Issues affecting the title of the property should be identified before listing the property. It is important that an agent be aware of these and also determines the impact they will have on the use, value, and market appeal of the property. In other cases, issues affecting the title may become apparent during the sales process. It cannot be overstated the importance of address these issues before closing. The owner will need to obtain the services of a surveyor, title company, or title attorney to clear the title as soon as possible.

## **Section 5. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What is the name of the method for identifying the boundaries of a property?
  - a. Title deed
  - b. Warranty deed
  - c. Legal description
  - d. Surveyor
2. How many square feet are in one acre?
  - a. 5,280
  - b. 35,000
  - c. 43,560
  - d. 64,000
3. What method is used to create legal descriptions for large parcels of land?
  - a. Rectangular survey system
  - b. Metes and bounds system
  - c. Lot and Block system
  - d. All of the above.
4. In a metes and bounds description, what is the permanent point of reference called?
  - a. Point of beginning (POB)
  - b. Benchmark
  - c. Monument
  - d. Commencement

5. What is another name for the lot-and-block system?
  - a. Metes and bounds
  - b. Rectangular survey system
  - c. Subdivision portioning
  - d. Recorded plat method
6. True or false. The formula to calculate the area of a rectangle is base x height.
  - a. True
  - b. False
7. What do you call the property where the easement crosses?
  - a. Servient estate
  - b. Dominant estate
  - c. Easement estate
  - d. Legal estate
8. What is the name of an easement created under a court order to grant access to a landlocked property?
  - a. Easement by prescription
  - b. Easement by necessity
  - c. License
  - d. Encroachment
9. True or false. A license is as permanent as an easement.
  - a. True
  - b. False
10. What are common types of encroachments?
  - a. Driveways, road right of ways, utility easements
  - b. Deed restrictions, adverse possession and licenses
  - c. Driveways, fences, buildings, or landscaping items
  - d. There are no common encroachments. All encroachments are unique.

## Quiz Answers

1. What is the name of the method for identifying the boundaries of a property?
  - c. Legal description - A legal description is a legal method for identifying the boundaries of a property to establish what is owned within a deed or a mortgage.
2. How many square feet are in one acre?
  - c. 43,560
3. What method is used to create legal descriptions for large parcels of land?
  - a. Rectangular survey system - It is also known as the Public Land Survey System (PLSS) or the government survey system.
4. In a metes and bounds description, what is the permanent point of reference called?
  - b. Benchmark - All descriptions will start from a permanent point of reference, called a benchmark.
5. What is another name for the lot-and-block system?
  - d. Recorded plat method - The simplest legal description is the lot-and-block system, also known as the recorded plat method.
6. True or false. The formula to calculate the area of a rectangle is base x height.
  - a. True
7. What do you call the property where the easement crosses?
  - a. Servient estate - The property where the easement crosses is called a servient estate. The property that benefits from the easement is called a dominant estate.
8. What is the name of an easement created under a court order to grant access to a landlocked property?
  - b. Easement by necessity - This easement is created under a court order to grant a landlocked property owner access through a neighboring property. The law does not allow the ownership of a landlocked property, and hence, it can force an easement by necessity.
9. True or false. A license is as permanent as an easement.
  - b. False - A license is not as permanent or binding as an easement. It does not have to be in writing, and it is not attached to the legal description. The owner can revoke it at any time.
10. What are common types of encroachments?
  - c. Driveways, fences, buildings, or landscaping items

# **Chapter 14 Land Development and Impact**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the four primary land uses;
- how to physically inspect a property;
- the issues that impact real estate use and value; and
- legal requirements for disclosure and reporting.

**OVERVIEW:** Real estate can be used in an almost endless variety of ways. This chapter will discuss land use and development as well as internal and external factors that can affect the use and value of a property.

## **Section 1.      Land Uses**

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There are four primary ways to develop and use land. They are classified as residential, commercial, industrial, and agricultural uses.

### **Residential**

Residential properties are used for habitation. A residential property can be built on-site (sometimes called a “stick-built” home), assembled on-site (factory-built or modular housing), or it can be delivered to the site (mobile or manufactured home). Residential properties are divided into classes based on the number of units within each property.

- **Single Family** properties are designed to hold one family and generally will only contain one kitchen. Individual living units within a development are also classified as single-family residential properties, including condominiums and townhouses. It is possible for a single-family dwelling to include a small apartment, but it would be smaller than the main dwelling and it usually lacks the finished quality of the primary residence.
- **Multifamily** properties are classified as residential if they contain four units or less. A duplex has two units, a triplex has three, and a quad-plex has four. Anything over four units is classified as a commercial property.

### **Commercial**

Commercial properties include a wide variety of developmental uses and property types. Sometimes it can be easier to eliminate the other uses, and what is remaining can be classified as commercial. If the property is designed to generate income – due to the operation of a business or directly generated by the property – then it is classified as a commercial property. There are, however, several main classifications of commercial properties.

- **Large multifamily** properties contain five or more units. They include apartment buildings and manufactured housing communities, such as mobile home parks.

They are considered investment properties because they are purchased for their income stream and not for personal housing. The lending market also requires borrowers to obtain commercial financing on apartment buildings that have more than four units.

- **Retail and restaurant** buildings include developmental options such as storefronts, shopping centers, regional malls, theaters, grocery stores, restaurants, and even parking lots.
- **Office** buildings are also classed in the commercial property group, and the size is not a factor. It could be one small office building or a multi-story complex.
- **Hospitality buildings** include motels and hotels, and they are classified as commercial because investors buy them for their income stream. The rooms in a hotel are accessed from internal corridors, whereas guests access a motel directly from the parking lot.
- **Special use** or special purpose properties have been developed for one specific use and would be difficult to convert to another commercial usage. Examples of special purpose properties include golf courses, marinas, amusement parks, churches, self-storage, car washes, hospitals, and nursing homes, to name a few.

## Industrial

Industrial properties are developed with a focus on assembly and storage. These properties can have some office or retail areas, but it will be a small percentage of the whole building. There are several divisions among industrial properties.

- **Heavy manufacturing** buildings contain specialized equipment and have been designed for a particular use or user. Large factories fall into this category.
- **Warehouse** buildings have many different uses, including light assembly, storage, repair, and light manufacturing.

## Agricultural

If the land has a use without needing a structure, then it can be classified as agricultural. This would include farms, ranches, orchards, vineyards, or standing timberland.

## Mixed-Use

Properties that are developed for more than one use are called a mixed-use property. A three-story building with retail on the first floor and apartments on the second and third floor is an example of a mixed-use property. Planned Unit Developments (PUDs) are usually mixed-use because they will contain residential, retail, or office uses.

## Section 2. Building Components

We have identified the different types of improvements and building classifications. Now we are going to break a residential building down into their main components. All functioning structures will have the same components. Real estate agents must be able to identify the superior and inferior characteristics of these components. A seller's agent is going to need to identify problem areas and then decide with their client if they will be only disclosed or resolved. Agents also need to consider the impact on property value and marketability. Agents representing the buyer will also need to identify problem areas that may impact the purchase offer and even the buyer's ability to obtain financing.

### Roof

The cap on any structure is called the roof. Common roofing materials include asphalt shingles, wood shingles and shake, metal roofing, clay, and concrete tiles, and slate. There are also synthetic roofing products that look like shake, slate or clay tiles. Grab a pair of binoculars and look for these issues that can cause roof leaks:

- ✓ curling or thinning shingles,
- ✓ leaking, damaged, or plugged gutters,
- ✓ flashing damage around pipes, vents, or chimneys,
- ✓ damaged or missing soffits, and
- ✓ animal or insect activity.



### Windows

Windows provide residents with a view and a supply of natural light. There are several different types of windows.

- Fixed windows cannot be opened.
- Casement windows are hinged on one side and open outward.
- Awning windows are hinged on the top edge and open outward.
- Sliding windows are mounted on a track and move on a horizontal plane.
- Single-hung windows move on a vertical plane and have one fixed pane.
- Double-hung windows move on a vertical plane with two stacked sliding panes.
- Sliding folding windows or bi-fold windows hinge out and slide on a single track.

When inspecting windows, look for missing or damaged hardware such as locks, handles, and hinges as well as leaking or damaged seals. Windows with any broken panes or evidence of glazing or fogging should be repaired or replaced.

## Foundation

The foundation must be carefully examined as it forms the support structure for the whole house. Problems with a foundation can be identified by cracks or broken cement joints, protruding tree roots, evidence of moisture in the basement or crawl space, misaligned doors and windows, drywall cracks, and uneven floors. If any of these are evident, it is best to have it inspected by a licensed contractor.

## Heating and Cooling Systems

The heating and cooling system will vary depending on where the property is located within the United States. Heating and cooling choices include:

- Forced air heating and cooling systems (HVAC) that blow heated air through ducts. It can be powered with electricity, natural gas, liquid propane, or fuel oil. These can also be connected to a compressor to provide cool air in the summer.
- Gravity air furnaces (octopus furnaces) are used in older homes that have not been updated to an HVAC system. Air is heated in a lower level and distributed through a duct system without a blower. These are fueled the same as with an HVAC system.
- Boilers distribute hot water or steam through pipes and radiators to provide heat. Older systems had large cast iron radiators, and newer installations have radiators that run along the baseboard. It can be powered by oil or natural gas. When water is circulated through tubes or electricity through wiring in the floor, it is called radiant floor heating.
- Heat pumps extract heat from one location and transfer it to another depending on the season. There are an indoor air handler and an outdoor heat pump. In the winter, heat is extracted from the exterior air and transferred inside. During the summer, the process is reversed. Geothermal or ground-source heat pumps get their heat from underground where temperatures are nearly constant.
- Gas-fired direct heating systems, more commonly known as space heaters, are wall-mounted, free-standing, or floor installed units without ductwork. They are best used to heat a single room. It can be powered with electricity, natural gas, propane, and kerosene.
- Wood burning stoves and fireplaces are usually not relied on as the sole source of heat. Sources of combustible material are either split logs or wood pellets. Both require chimneys that draw out the smoke and draw in outside air to create combustion.

Disclosure statements will ask about the age, condition, and past maintenance work of the heating and cooling systems.

## **Electrical Systems**

All homes will have an electrical system consisting of incoming power lines, an electric meter, a service panel, wiring, electrical boxes, outlets, switches, and attached electrical fixtures such as lights, doorbells, and smoke detectors. Other household electrical systems include home theatres, internet connections, telephone lines, intercoms, security, and audio systems. All technical electrical inspections need to be completed by a professional, but here are some items an agent will want to identify:

- Determine the size of the main electrical system. It will either be 100, 200, or 400 amps depending on the size and age of the home.
- If the home is more than 20 years old, ask if the wiring has been updated.
- Look for switches that are warm to the touch, lights that dim or flicker when on, or outlets that are burnt or discolored.
- There should be a smoke detector in each bedroom, outside each sleeping area, and on each level near the stairway or in the living room. New building codes require that they all be wired together and that a carbon monoxide detector is wired into the system.

## **Plumbing Systems**

There are three parts to a residential plumbing system: the water supply, the fixtures and appliances, and the draining system. Agents will need to identify the source of the water supply, such as a private well or a public water system. They will also need to identify the drainage or wastewater system, such as a septic or public sewer. There are several different types of materials used in water supply pipes, including plastic (PVC, CPVC and PEX) and copper. Galvanized steel, lead, and iron pipes are only found in older homes. Leaky plumbing systems can cause all sorts of long-term issues, so keep on the lookout for evidence of leaks, water stains, and mold.

## **Section 3.      Issues that Impact Real Estate**

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Most properties are going to have some unique features, unusual components, or interesting features. Some of these will add value to a home. Others may cause the property to take longer to sell. A few properties will have issues severe enough to discourage most buyers. How a listing agent handles these issues will have a significant impact on their ability to sell the property.

### **Stigmatized Properties**

Property value is not always affected by physical items; it can also be affected by perception. If there are two identical homes in the same subdivision on identical lots, then

it is assumed that the price should be identical as well. What if, five years ago, there was a brutal murder in one of the homes? Which property would sell first? If identical, it will be the one without the stigma. Properties that are shunned by the public because of a tragic event or are near a known nuisance are called **stigmatized properties**. Tragic events include such things as homicide, suicide, perverted behaviors, illegal drug manufacturing, gang-related activity, cult activity, and paranormal sightings. Proximity issues include noise (such as from an airport or highway), smells (such as from a waste processing plant or pig farm), and environmental impacts (such as from a landfill or chemical manufacturer). A stigmatized property can be difficult to sell for market value.

Disclosure of a stigmatized property can put an agent in a precarious position. Remember that an agent must disclose all material facts about a property, but what exactly is a **material fact**? It is anything that, if known, may cause a reasonable buyer to change the purchase price, use, or decision to buy the property. What is material to one buyer may not matter to another. Would knowing that an elderly person died in their sleep ten years ago prevent someone from purchasing the home? Probably not. Would knowing that the home was the site of a recent brutal murder affect someone's decision to purchase? Probably! Accordingly, both federal and state laws were created to protect and help sellers and real estate agents.

- The 1988 Fair Housing Amendment Act states that persons with HIV or AIDS are a protected class, and that disclosure constitutes illegal discrimination.
- Most states consider publicized events, such as murder or suicide, to be a material fact that should be disclosed.
- If a buyer asks their agent about any event that would stigmatize a property, an agent's fiduciary responsibility requires that they answer honestly and with reasonable due diligence.
- Each state has the freedom to create laws regarding disclosure of stigmatized properties and specify what is classified as a material fact.

As a rule of thumb to determine a material fact, if knowing a fact about the property could alter a buyer's perception of the property, then it should be disclosed.

**PRACTICAL APPLICATION:** Two potential buyers are looking at the same home. One is a single man, and the other is a family with two small children. Two doors down from the house is a registered sex offender. The agent became aware of this



#### CHECK THIS OUT

Under the federal legislation known as **Megan's Law**, all states maintain a registration system for persons who have kidnapped or committed sexual crimes against children or is a convicted sexual offender.

State laws may require that an agent disclose the location of sex offenders within a five-mile radius or simply provide a written disclosure with the information on where a buyer may obtain the information.

*information while researching the property. Does this information need to be disclosed? Is it a material fact? To answer, the agent should ask himself if it would affect the purchase decision of the single man? Probably not. How about the family? Absolutely! While each state has set out regulations on this matter, an agent must think about the needs of their buyer. Ask yourself, if you were in their shoes, would you want to know?*

## Environmental Hazards

Properties can be affected by internal and external environmental hazards that can impact an occupant's health and safety. While real estate agents do not have the technical expertise needed to identify and treat an environmental hazard, they should be familiar with the sources of contamination or factors that could pose a health risk to their client. They should also have a basic understanding of state and federal environmental laws and regulatory agencies.

The federal agency that is in charge of regulating the majority of all the environmental hazards is the Environmental Protection Agency (EPA). Concerning environmental hazards that affect residential properties, the Department of Housing and Urban Development (HUD) also becomes involved.

### Sources of Residential Environmental Hazards

There are many different sources of environmental hazards that can affect residential properties. The most common health hazards include the following items.

- **Lead** exposure is toxic to humans and especially young children. Lead paint was used in homes built before 1978. Many older homes also have lead water pipes or used lead solder. It is estimated that lead is present in about 75% of homes built before 1978.
- **Asbestos** is a known cause of cancer. It was used in the past as an insulator, fire-retardant, and strengthener. It can be found in insulation, siding, roofing, and flooring manufactured before 1978. Asbestos is safe as long as the dust and fibers are contained and undisturbed. Instead of removal, the EPA recommends that materials containing asbestos be encapsulated, such as placing vinyl siding over asbestos shingles.
- **Radon** is a colorless, odorless, and tasteless naturally occurring radioactive gas that can increase the risk of lung cancer if persons are exposed to sufficient quantities over time. It seeps up from the ground and can penetrate the foundation of a home.
- **Carbon monoxide** is another colorless, odorless, and tasteless gas that inhibits the blood's ability to transport oxygen. It results from the incomplete combustion and improper ventilation of carbon fuels such as from gas-burning appliances, wood stoves and fireplaces, tobacco smoke, and automobile exhaust.

- **Formaldehyde** is a colorless and pungent cancer-causing gas that is used in the manufacture of some composite wood products, insulation, carpeting, ceiling tiles, wallpaper, and some permanently pressed fabrics. Exposure to formaldehyde can irritate the eyes, skin, and respiratory tract and worsen asthma or allergies. Both the EPA and HUD have enacted regulations that regulate formaldehyde-emission levels.
- **Mold** is a microscopic organism that feeds off of damp organic material. Mold growth on a surface can be identified by discoloration, such as by white, green, gray, brown, or black spots. Sources of indoor moisture that encourages mold growth are leaking roofs, plumbing leaks, damp basements, and crawl spaces, and inadequate ventilation. High exposure to mold can trigger asthma or allergies.
- **Groundwater contamination** can occur in both private and public water sources. Homes with private wells can be affected by surrounding land contamination, contaminated water runoff, and leaking underground storage tanks that have seeped into the water table. Public contamination is caused by the type of pipes used or through contamination from the water processing facility.
- **Underground storage tanks** can be found in older homes that, either presently or in the past, used fuel oil as a heating source. The tanks can be identified by pipes poking out of the ground. Leaking above-ground tanks also can be a source of contamination.

### Sources of Commercial Environmental Hazards

Commercial and industrial properties have the potential to create a much more serious environmental hazard. Buyers are highly encouraged to obtain a professional environmental inspection on all commercial properties prior to closing. Most states do not require sellers of commercial and industrial property to disclose any material facts. Four types of properties can be a source of contamination.

- **Waste disposal sites** or landfills are not always a source of contamination, and neither do they always have a negative impact on residential property values. New landfills are carefully regulated. The holes are lined to prevent leakage into the water supply which is monitored through a series of underground drainage pipes. Once full, the landfill is capped with soil and the site can be reused.
- **Brownfields** are properties that have been used for industrial or commercial purposes in the past with known or suspected environmental hazards that are regulated by the EPA.
- **Properties with underground storage tanks (USTs)** are used to store liquid petroleum, fuel, and other hazardous substances. Gas stations, auto repair shops, airports, and military bases are sites with USTs. The EPA carefully regulates all large commercial USTs and all commercial owners are required to register their tanks. Unregistered tanks pose a significant risk to buyers, and a careful inspection should be made of all commercial sites.
- **Businesses that use hazardous materials** are the most common source of contamination. Businesses that frequently use hazardous materials include gas stations, auto mechanics, heavy and light manufacturing, wood processing

facilities, dry cleaners, chemical distributors, and mineral extractors. The contamination can be the result of accidental or intentional actions, and they usually occur due to improper handling and disposal of hazardous waste.

### Disclosure of Environmental Hazards

Most sellers of commercial and industrial property are *not* required to disclose environmental issues. Sellers of residential property (one to four units), on the other hand, are *required* to disclose material facts about the condition of the property and any known environmental issues. Their real estate agents are also expected to disclose any material defects that they discover. Some states will hold an agent liable if they failed to disclose material facts that they should have known about – even if the seller failed or refused to disclose them. Buyers should be encouraged by their agent to verify all the material facts and not rely on the seller's disclosure as a warranty or guarantee of the condition of the property.

## Section 4. Quiz

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. How many rental units can a residential property have before it is classified as commercial?
  - a. None
  - b. 2
  - c. 4
  - d. 5
2. True or false. A property is commercial if it is designed to generate income.
  - a. True
  - b. False
3. Properties that are developed for more than one use are called a \_\_\_\_\_.
  - a. mixed-use property
  - b. commercial property
  - c. industrial property
  - d. planned unit development.
4. What is the best way for a real estate agent to inspect a roof?
  - a. Physical inspection
  - b. Use a pair of binoculars
  - c. Ask the homeowner's opinion.
  - d. Real estate agents do not inspect roofs.

5. How are foundation problems identified?
  - a. Cracks
  - b. Protruding tree roots
  - c. Misaligned doors and windows
  - d. All of the above.
6. Properties that are shunned by the public because of a tragic event or are near a known nuisance are called \_\_\_\_\_.
  - a. Environmentally impacted
  - b. Below-market sales
  - c. Contaminated properties
  - d. Stigmatized properties
7. True or false. If a buyer asks their agent about an event that would stigmatize a property, the agent has a fiduciary responsibility to answer honestly and with reasonable due diligence.
  - a. True
  - b. False
8. What qualifies as a material fact?
  - a. If knowing it will cost the client money.
  - b. If knowing a fact about the property could alter a buyer's perception of it.
  - c. If a real estate agent could get sued if it was not revealed
  - d. If it does not damage the seller's reputation or financial interests.
9. Lead paint was used in homes before \_\_\_\_\_.
  - a. 1965
  - b. 1972
  - c. 1978
  - d. 1985
10. True or false. Owners of residential real estate are required to disclose all material facts including environmental issues in Massachusetts.
  - a. True
  - b. False

## Quiz Answers

1. How many rental units can a residential property have before it is classified as commercial?
  - c. 4 - Anything over four units is classified as a commercial property.
2. True or false. A property is commercial if it is designed to generate income.
  - a. True – If the property is designed to generate income – due to the operation of a business or directly generated by the property – then it is classified as a commercial property.
3. Properties that are developed for more than one use are called a \_\_\_\_\_.
  - a. mixed-use property - A three-story building with retail on the first floor and apartments on the second and third floor is an example of a mixed-use property.
4. What is the best way for a real estate agent to inspect a roof?
  - b. Use a pair of binoculars - Real estate agents must be able to identify the superior and inferior characteristics of these components. It is still advisable to have the client obtain an inspection from a contractor or licensed home inspector.
5. How are foundation problems identified?
  - d. All of the above. Problems with a foundation can be identified by cracks or broken cement joints, protruding tree roots, evidence of moisture in the basement or crawl space, misaligned doors and windows, drywall cracks, and uneven floors.
6. Properties that are shunned by the public because of a tragic event or are near a known nuisance are called \_\_\_\_\_.
  - d. Stigmatized properties - A stigmatized property can be difficult to sell for market value.
7. True or false. If a buyer asks their agent about an event that would stigmatize a property, the agent has a fiduciary responsibility to answer honestly and with reasonable due diligence.
  - a. True
8. What qualifies as a material fact?
  - b. If knowing a fact about the property could alter a buyer's perception of it. As a rule of thumb to determine a material fact, if knowing a fact about the property could alter a buyer's perception of the property, then it should be disclosed.
9. Lead paint was used in homes before \_\_\_\_\_.
  - c. 1978 - It is estimated that lead is present in about 75% of homes built before 1978.
10. True or false. Owners of residential real estate are required to disclose all material facts including environmental issues in Massachusetts.
  - b. False

# **Chapter 15 Representing the Seller**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the six types of seller contracts,
- how to calculate the building area,
- how to complete a comparative market analysis, and
- what is an earnest money deposit and how to handle them.

**OVERVIEW:** This chapter will explain the responsibilities an agent has towards the seller, including creating a brokerage relationship and the listing, advertising, and selling of the property. You will also learn about advertising laws and how to handle earnest money deposits.

## **Section 1. The Listing Agreement**

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A prospect walks into a brokerage and says they are looking to list their property. The secretary hurries to introduce a broker or sales associate to the prospect. So begins the listing presentation. The agent will explain the services they offer to the seller, including their marketing efforts, the network of associated professionals, and their success rate. The prospect likes what they see and agrees to list their property with the agent. Before the listing can progress any further, the agent needs to create an agency relationship.

The listing agreement is the contract that creates an agency relationship between the broker and the seller. The broker becomes the agent of the seller, and the seller becomes the principal or client of the broker. A listing contract will typically authorize the broker to use the services of their sales associates. It will also provide for broker cooperation between other brokerages in marketing the property.

## **Three Types of Brokerage Relationships**

In Chapter 6, Section 5, we discussed the three types of brokerage relationships that an agent can form with a client. The listing agreement will include a section that creates the brokerage relationship with the client. The client must clearly understand the brokerage relationship and how it will affect the actions of the broker during the sales process. The brokerage relationship sets out the broker's fiduciary responsibilities. The three brokerage relationships are:

- **Single Agency.** A single agency broker represents, as a fiduciary, either a buyer or a seller, but not both, in a real estate transaction. They are an exclusive agent for only one party to a real estate transaction.
- **Transaction Brokerage.** A transaction broker represents the buyer, seller, or both in a real estate transaction, but they do not represent either party as "their" single agent.

- **Dual Agency.** A dual agency broker acts as a fiduciary agent to both the buyer and the seller in a real estate transaction. This is illegal in many states.

## Six Types of Seller Contracts

In Chapter 7, Section 4, we discussed the six types of seller contracts. The seller contract is the same as the listing agreement. The seller contract sets out the responsibilities of both the broker and the seller that will be needed to complete the sale of the client's property. Regardless of the listing agreement chosen by the seller, it needs to be in writing. The six seller contracts are:

- **Exclusive Right to Sell:** The listing broker becomes the sole agent of the seller. The seller guarantees to pay the broker regardless of who finds the buyer.
- **Exclusive Agency:** The listing broker is the sole agent of the seller. The seller agrees to pay the broker unless the seller locates a buyer.
- **Open Listing:** The seller contracts with multiple brokers at the same time and agrees to pay only the broker who locates the buyer.
- **One-Time Show Listing:** The seller agrees to pay the broker a commission if a specifically named buyer completes the purchase within a specific time.
- **Net Listing:** The broker is allowed to keep all proceeds above the seller's list price. Net listings are illegal in most states.

Remember that the listing agreement is between the *broker* and the seller. Sales associates represent their broker, and their broker represents the seller. A licensed sales associate cannot represent sellers directly but they can perform most, if not all, of the listing services on behalf of their broker. This is a fine line. Because the seller is working so closely with the sales associate, they will most likely consider them to be their "exclusive agent" – and that is okay. Letting the client know that their managing broker will be overseeing the sales process can be another "level of service" offered to clients.

## Contract Terms

In addition to creating the brokerage relationship, the listing agreement will set out the contract terms, including the following items:

- **List Price:** The list price is the starting asking price for the property, and the seller often sets this price. The list price is not necessarily the sales price. It is merely a starting point. Later in this chapter, you will learn how to determine a more accurate list price.
- **Advertising:** The seller will need to decide on how much notice they will need before scheduling a showing, the best times for a showing, and if the agent can place a for sale sign on the premises. The seller must also agree, in writing, to include the listing in the multiple listing service (MLS).

- **Buyer's Possession:** The seller will need to decide when, after the closing, the buyer can take possession and move into the property.
- **Compensation.** The contract will state how the seller will compensate the broker and if the broker can share any of the compensation with a cooperating broker. The compensation will be a percentage of the sales price (called the commission), a flat fee, or an hourly rate. Commission payments are the most common form of seller compensation. The seller usually will pay the compensation at the closing out of the proceeds of the sale.
- **Expiration.** All listing contracts must have a term and expiration date. In most states, if a broker fails to specify a definite termination date, the broker could face the suspension or revocation of their license. An automatic extension clause after the base period that continues until terminated by either party is highly discouraged and even illegal in some states. Some courts have decided that an extension clause turns an exclusive agency agreement into an open listing.
- **Broker Protection Clause:** Including a broker protection clause is a common practice. The clause requires the seller to pay the broker's commission if the seller transfers the property to someone initially introduced by the broker, within a specified amount of time after the expiration of the listing agreement. This protects the broker from a seller who encourages a buyer to wait until after the listing expires so they do not have to pay the broker.

## Property Information

A listing agreement allows the seller to provide basic information about the property being sold. This information helps the agent to market the property. The listing agreement will include the following information:

- the names and relationships of the owners,
- the list price or the rental price,
- the property description including the street address, legal description, and property dimensions and area,
- zoning classification and any approved variances,
- the improvements such as construction type, age, square footage, and room count,
- the current property taxes, outstanding special assessments and utility accounts,
- personal property included and real property not included in the sale, and
- if seller financing will be offered to buyers.

Standardized listing contracts are available to agents through the local Association of REALTORS®, the local Multiple Listing Service, other local and state trade associations, or independent publishers that have worked with attorneys to meet legal requirements. These contracts can be intimidating to a seller. Going through the form, line-by-line, with your client will not be considered as an unlawful practice of law.

# Sample Exclusive Right to Sell Listing Agreement

<b>EXCLUSIVE RIGHT TO SELL LISTING AGREEMENT</b>	
This Contract is intended to be a binding Real Estate contract	
 	
<p>1. <b>SPONSORING BROKER.</b> This Exclusive Right to Sell Listing Agreement ("Agreement") is entered into by and between _____ ("Sponsoring Broker") and _____ ("Seller"). 2. In consideration of the following agreements and Sponsoring Broker's efforts to procure a ready, willing and able buyer for the sale or exchange of property and 3. improvements described below (including the undivided interest in the common elements and accumulated reserves, if any) (collectively, "Property"), Seller 4. hereby grants Sponsoring Broker the exclusive right ("Exclusive Right") to sell the Property (or, at Seller's direction, lease, exchange, joint venture or grant an 5. option to purchase) the Property (collectively, "Transfer of Property") pursuant to the terms and conditions set forth below. 6.</p> <p>7. <b>TERM.</b> Sponsoring Broker's Exclusive Right shall extend from the Effective Date, as set forth on page 3 ("Commencement Date") until 11:59 P.M. on 8. _____, 20_____, at which time this Agreement shall automatically terminate ("Termination Date"). From the date of Seller's acceptance of 9. any offer and execution of a contract for the Transfer of Property ("Accepted Offer"), unless the Accepted Offer is expressly subject to the continual marketing of 10. the Property, Sponsoring Broker shall have no further obligation to market, advertise for sale or show the Property. Once all of the contingencies for the Accepted 11. Offer have been satisfied or waived, Sponsoring Broker shall have no further obligation to Seller except to present Seller with any offers or counteroffers 12. pertaining to the Property.</p> <p>13. <b>PRICE.</b> In the event that the Transfer of Property is a sale, Seller directs Sponsoring Broker to market the Property at a price of 14. \$_____ per month ("Marketing Price"). If the Transfer of Property is a lease, Seller directs Sponsoring Broker to market the Property at a 15. price of \$_____ per month ("Rental Price"). The Marketing Price and Rental Price may be changed from time to time at Seller's written direction.</p> <p>16. <b>PROPERTY.</b> 17. Address: _____ Unit Number(s): _____ 18. City: _____ State: _____ Zip Code: _____ 19. Parking Space Number(s): _____ (check all that apply) <input type="checkbox"/> Deeded; <input type="checkbox"/> Limited Common Element; <input type="checkbox"/> Assigned; <input type="checkbox"/> Indoor; <input type="checkbox"/> Outdoor 20. Storage Space Number(s): _____ (check all that apply) <input type="checkbox"/> Deeded; <input type="checkbox"/> Limited Common Element; <input type="checkbox"/> Assigned</p> <p>21. <b>POSSESSION.</b> Seller shall surrender possession of the Property in broom-clean condition and remove all debris and personal property not conveyed to 22. buyer before closing of the transaction set forth in the purchase and sale agreement or lease, unless otherwise agreed to in writing.</p> <p>23. <b>DESIGNATED AGENT.</b> Sponsoring Broker and Seller hereby agree that (a) _____, a sponsored licensee of 24. Sponsoring Broker, is Seller's exclusive designated agent ("Designated Agent") under this Agreement with Sponsoring Broker, and (b) neither Sponsoring 25. Broker nor other sponsored licensees of Sponsoring Broker will be acting as agent for Seller. Seller understands and agrees that Sponsoring Broker and any of 26. Sponsoring Broker's other sponsored licensees may enter into agreements with prospective buyers of the Property as agents of those buyers.</p> <p>27. <b>MINIMUM SERVICES.</b> Pursuant to the _____ Real Estate License Act of _____ as amended, Sponsoring Broker, through the 28. Designated Agent, must provide to Seller, at a minimum, the following services: (a) accept delivery of and present to Seller offers and counteroffers to buy, sell, 29. lease or otherwise transfer any interest in the Property or any portion thereof; (b) assist Seller in developing, communicating, negotiating and presenting offers, 30. counteroffers and notices that relate to the offers and counteroffers until a lease or purchase agreement is fully executed and all contingencies are satisfied or 31. waived; and (c) answer Seller's questions relating to the offers, counteroffers, notices and contingencies.</p> <p>32. <b>SELLER OBLIGATIONS.</b> From and after the Commencement Date of this Agreement, Seller agrees to: 33. (i) cooperate fully with Sponsoring Broker and the Designated Agent; (ii) refer all inquiries to Sponsoring Broker and the Designated Agent; (iii) allow access 34. and entry to the Property at convenient times by Sponsoring Broker, the Designated Agent and cooperating brokers (whether alone or accompanied by 35. Sponsoring Broker or the Designated Agent) for the purpose of showing the Property to prospective buyers or lessees; (iv) if the Property is leased or occupied by 36. a tenant, to comply with paragraph H of the General Provisions of this Agreement; (v) conduct all negotiations through Sponsoring Broker or the Designated 37. Agent; (vi) pay an upfront fee to Sponsoring Broker for professional services in the amount of \$_____; and (vii) pay Sponsoring Broker a 38. commission or compensation pursuant to the terms of Paragraph 9 below.</p> <p>39. <b>COMPENSATION.</b> In the event Sponsoring Broker produces a buyer ready, willing and able to close on the Transfer of Property on the terms provided 40. in this Agreement, then Seller shall pay Sponsoring Broker a commission in the amount of _____ % [percent] of the Purchase Price ("Sale Commission") 41. plus \$_____ ("Additional Commission"). In the event Seller enters into a leasing agreement with a tenant during the term of this Agreement, 42. Seller agrees to pay Sponsoring Broker a rental commission of _____ % [percent] of the monthly rent ("Rental Commission") plus 43. \$_____ ("Additional Rental Commission"). In the event the Property is later purchased by the tenant, or an option to purchase is later granted to 44. and exercised by tenant, then in addition to the Rental Commission and Additional Rental Fee, Seller must pay Sponsoring Broker the Sale Commission and 45. Additional Commission. The Sale Commission, Additional Commission, Rental Commission and Additional Rental Commission are referred to collectively as 46. "Commission." Sponsoring Broker shall be entitled to the Commission pursuant to this Agreement (a) upon the closing of any Transfer of Property prior to the 47. Termination Date, regardless of whether the Transfer of Property resulted from the service and/or effort of the Sponsoring Broker, Designated Agent, Seller or 48. any other persons or entities; or (b) upon the closing of any Transfer of Property within 180 days after the Termination Date to any person to whom the Property 49. was submitted prior to the Termination Date. Notwithstanding the foregoing, if (i) the Property is residential property of four units or less, (ii) the Termination 50. Date has passed, and (iii) Seller has entered into a valid, bona fide, written listing agreement with another licensed real estate broker during the 180 day 51. period, then Sponsoring Broker shall not be entitled to any Commission pursuant to this Agreement on any Transfer of Property. For Property which is not 52. residential property of four units or less, if the Property is listed with another licensed real estate broker during the 180 day period following the Termination 53. Date, Seller shall be liable for the entire Commission, which shall be shared by the Sponsoring Broker and the other licensed real estate broker. The actual 54. allocation of the Commission will be determined pursuant to a separate agreement between Sponsoring Broker and the other licensed real estate broker. 55. Sponsoring Broker may share Sponsoring Broker's compensation or commission with all cooperating brokers regardless of any cooperating broker's agency 56. relationship to Seller, Sponsoring Broker or the buyer.</p> <p>57. In the event this Agreement is cancelled by Seller pursuant to the terms of this Agreement, unless mutually agreed to in writing by Sponsoring Broker and 58. Seller, Seller shall pay to Sponsoring Broker, within 4 business days of written demand by Sponsoring Broker, reimbursement for Sponsoring Broker's 59. performance of professional services in the amount of \$_____, including but not limited to: marketing, advertising, office expenses, Multiple Listing Service 60. (MLS) fees, printing, attorneys' fees and court costs. The amount for Sponsoring Broker's performance of services shall be determined solely by Sponsoring 61. Broker. In cases of the Seller's breach of this Agreement, Seller shall pay to Sponsoring Broker the Commission payable on the Transfer of Property to 62. compensate Sponsoring Broker for Sponsoring Broker's time, expenses and services involved in marketing the Property. Seller expressly agrees to all of the 63. terms of this Agreement with respect to payment of the Commission, including, without limitation, Paragraph M of the General Provisions attached hereto.</p> <p>64. <b>DUAL REPRESENTATION.</b> By checking "Yes" and signing below, Seller acknowledges and agrees that the Designated Agent ("Licensee") may 65. undertake a dual representation (represent both seller and buyer or landlord and tenant) for the sale or lease of property. Seller acknowledges they were 66. informed of the possibility of this type of representation. Before signing this document please read the following:</p>	
Page 1 of 4	
Seller Initials: _____ Seller Initials: _____	
Sponsoring Broker Initials: _____	

67 Representing more than one party to a transaction presents a conflict of interest since both clients may rely upon Licensee's advice and the client's  
 68 respective interests may be adverse to each other. Licensee will undertake this representation only with the written consent of ALL clients in the  
 69 transaction. Any agreement between the clients as to a final contract price and other terms is a result of negotiations between the clients acting in their  
 70 own best interests and on their own behalf. You acknowledge that Licensee has explained the implications of dual representation, including the risks  
 71 involved, and understand that you have been advised to seek independent advice from your advisors or attorneys before signing any documents in this  
 72 transaction.

**WHAT A LICENSEE CAN DO FOR CLIENTS WHEN ACTING AS A DUAL AGENT:**  
 73 1. Treat all clients honestly. 2. Provide information about the property to the buyer or tenant. 3. Disclose all latent material defects in the property that  
 74 are known to the Licensee. 4. Disclose the financial qualification of the buyer or tenant to the seller or landlord. 5. Explain real estate terms. 6. Help the  
 75 buyer or tenant arrange for property inspections. 7. Explain closing costs and procedures. 8. Help the buyer compare financing alternatives. 9. Provide  
 76 information to seller or buyer about comparable properties that have sold so both clients may make educated decisions on what price to accept or offer.

**WHAT A LICENSEE CANNOT DISCLOSE TO CLIENTS WHEN ACTING AS A DUAL AGENT:**  
 77 1. Confidential information that the Licensee may know about a client, without that client's express consent. 2. The price or terms the seller or landlord  
 78 will take other than the listing price without permission of the seller or landlord. 3. The price or terms the buyer or tenant is willing to pay without  
 79 permission of the buyer or tenant. 4. A recommended or suggested price or terms the buyer or tenant should offer. 5. A recommended or suggested price  
 80 or terms the seller or landlord should counter with or accept.

81 If either client is uncomfortable with this disclosure and dual representation, please let Licensee know. You are not required to sign this document  
 82 unless you want to allow Licensee to proceed as a Dual Agent in this transaction. By signing below, you acknowledge that you have read and  
 83 understand this form and voluntarily consent to Licensee acting as a Dual Agent (that is, to represent BOTH the seller or landlord and the buyer or  
 84 tenant) should that become necessary.

85 Seller (check one):  Yes  No Seller Signature: \_\_\_\_\_ Seller Signature: \_\_\_\_\_

**11. ADDITIONAL TERMS AND PROPERTY INFORMATION.** Seller represents that the following information is true and correct as of the date of this  
 86 Agreement and shall keep Sponsoring Broker and Designated Agent informed of all changes to the following information:

87 (a) Property P.I.N. # \_\_\_\_\_ Homeowner's Exemption:  Yes  No  
 88 Real estate taxes for the year 20\_\_\_\_ equal \$\_\_\_\_\_. Senior Citizen's Exemption:  Yes  No  
 89 Senior Freeze Exemption:  Yes  No

90 \_\_\_\_\_ P.I.N. # \_\_\_\_\_  
 91 Real estate taxes for the year 20\_\_\_\_ equal \$\_\_\_\_\_

92 (b) Seller is aware of any circumstances that would affect the transfer of title?  Yes  No  
 93 (example: probate, divorce, liens, his pendents, judgments, etc....)  
 94 If yes, please explain: \_\_\_\_\_

95 (c) Is Property currently leased?  Yes  No  
 96 If yes, lease expiration date is \_\_\_\_\_; rent amount is \$\_\_\_\_\_; security deposit amount (if any) is \$\_\_\_\_\_

97 (d) Utility and Energy. Please enter the Electricity and/or Gas Account Numbers for the Property:  
 98 Electricity Account Number: \_\_\_\_\_ Gas Account Number: \_\_\_\_\_

99 (e) The lot size is approximately \_\_\_\_\_. Approximate square feet of the interior of the Property: \_\_\_\_\_

**(f) If a Condominium or Homeowners Association, Seller shall complete the following information and comply with General Provision C:**

100 Management Contact: \_\_\_\_\_ Phone: \_\_\_\_\_ Email: \_\_\_\_\_

101 Current monthly assessment equals \$\_\_\_\_\_ and includes \_\_\_\_\_.

102 Percentage of interest in common elements is \_\_\_\_%. Waiver of Right of First Refusal necessary?  Yes  No

103 Seller (check one)  is  is not aware of a proposed special assessment. Seller shall keep Sponsoring Broker informed of all Board of  
 104 Directors/Managers actions. Seller shall keep Sponsoring Broker informed of any change to this information.

105 If applicable, the amount of special assessment is \$\_\_\_\_\_ with a remaining balance due of \$\_\_\_\_\_ payable through  
 106 \_\_\_\_\_\_. Special assessments are payable (check all that apply)  Annually;  Semi-Annually;  Quarterly;  Monthly.

107 (g) If this property is new construction, Rider 13, "New Construction Insulation Disclosure", must be completed and attached.

108 (h) If the Property is income or commercial property, Seller shall provide Sponsoring Broker with accurate copies of all leases, income and expense statements,  
 109 a rent roll, existing environmental reports and relevant information necessary to market the property within 14 days after the date of this Agreement.

110 (i) For residential properties located within the \_\_\_\_\_, local ordinances require that all properties must have smoke and carbon monoxide detectors  
 111 present and in working condition. Seller shall comply with these ordinances. In addition, Seller shall provide Sponsoring Broker with the following, if  
 112 applicable, within 72 hours after the written acceptance of this Agreement: (a) Residential Real Property Disclosure Report; (b) Heat Disclosure; (c)  
 113 Lead Paint Disclosure; (d) Radon Disclosure; and (e) Zoning Certificate.

**12. PROMOTING AND ADVERTISING PROPERTY PER THE REAL ESTATE LICENSE ACT OF AMENDED.** Sponsoring  
 121 Broker is hereby authorized to promote and advertise the Property as Sponsoring Broker deems appropriate, including but not limited to (i) displaying signs on  
 122 the Property, (ii) placing the Property in any multiple listing service in which Sponsoring Broker participates at the time a contract is executed, (iii) promoting  
 123 the Property on Sponsoring Broker's internet website, social media sites, and on the internet websites of other brokers, and/or through any other advertising  
 124 medium which Sponsoring Broker may subscribe to or otherwise use, and (iv) releasing information as to the amount of the selling price, type of financing, and  
 125 number of days to sell this Property to any multiple listing service in which Sponsoring Broker participates at the time a contract is executed. Consistent with  
 126 the foregoing, any internet website on which the Property is promoted may (a) allow third parties to write comments or reviews about the Property, or display a  
 127 hyperlink to such comments or reviews, or (b) include an automated estimate of the fair market value of the Property, or display a hyperlink to such an  
 128 estimate. The foregoing notwithstanding, by checking one or both of the boxes at the end of this Paragraph 13, and writing its initials below, Seller requests  
 129 that on any internet website on which the Property is promoted, one or both of these features be disabled or discontinued. Sponsoring Broker in turn will disable

130 Seller Initials: \_\_\_\_\_ Seller Initials: \_\_\_\_\_ Sponsoring Broker Initials: \_\_\_\_\_

27 or discontinue such designated features on its website, and will communicate to each multiple listing service in which it participates, and to each broker or other  
28 third party on whose internet website the Property is promoted or advertised, that the Seller has elected to have one or both of these features disabled or  
29 discontinued. However, notwithstanding any such Seller request, a broker's internet website may (1) communicate the broker's professional judgment  
30 concerning the Property, and (2) notify its customers and visitors to its website that a feature has been disabled or discontinued "at the request of Seller".

- 31 Disable/Discontinue Website Features (*check any that apply and initial*):  
32      Disable/Discontinu Comments/Reviews regarding Property;  
33      Disable/Discontinu Automated Estimate of Market Value of Property.

34     Seller Initials: \_\_\_\_\_ Seller Initials: \_\_\_\_\_

35     **13. FIXTURES AND PERSONAL PROPERTY.** In conjunction with any Accepted Offer, Seller agrees to transfer by a bill of sale, all heating, electrical, and  
36 plumbing systems that are owned by Seller and serve the Property together with the following to the buyer (*check or enumerate applicable items*).  
37

- |   |  |  |   |  |
|---|--|--|---|--|
| <input type="checkbox"/> Refrigerator     | <input type="checkbox"/> Sump Pump   | <input type="checkbox"/> Central air conditioner   | <input type="checkbox"/> Fireplace screen       | <input type="checkbox"/> Built-in or attached    |
| <input type="checkbox"/> Oven/Range       | <input type="checkbox"/> Smoke and carbon monoxide                               | <input type="checkbox"/> Window air conditioner    | <input type="checkbox"/> shelves or cabinets    | <input type="checkbox"/> detectors               |
| <input type="checkbox"/> Microwave        | <input type="checkbox"/> detectors   | <input type="checkbox"/> Electronic air filter     | <input type="checkbox"/> Fireplace gas log      | <input type="checkbox"/> Ceiling fan             |
| <input type="checkbox"/> Dishwasher       | <input type="checkbox"/> Intercom system   | <input type="checkbox"/> Central humidifier        | <input type="checkbox"/> Firewood               | <input type="checkbox"/> Radiator covers         |
| <input type="checkbox"/> Garbage disposal | <input type="checkbox"/> Security system (rented or owned) ( <i>strike one</i> ) | <input type="checkbox"/> Lighting fixtures         | <input type="checkbox"/> Attached gas grill     | <input type="checkbox"/> All planted vegetation  |
| <input type="checkbox"/> Trash compactor  | <input type="checkbox"/> Satellite Dish  | <input type="checkbox"/> Electronic garage door(s) | <input type="checkbox"/> Existing storms        | <input type="checkbox"/> Outdoor play set/swings |
| <input type="checkbox"/> Washer           | <input type="checkbox"/> Attached TV(s)  | <input type="checkbox"/> with remote unit(s)       | <input type="checkbox"/> Tacked down carpeting  | <input type="checkbox"/> Home                    |
| <input type="checkbox"/> Dryer            | <input type="checkbox"/> TV Antenna  | <input type="checkbox"/> Other Equipment           | <input type="checkbox"/> warranty (as attached) | <input type="checkbox"/> Multimedia equipment    |
| <input type="checkbox"/> Water Softener   | <input type="checkbox"/> Stereo speakers/surround sound                          |  |   |  |

47 Seller also transfers the following: \_\_\_\_\_.

48 The following items are excluded: \_\_\_\_\_.

49     **14. MULTIPLE LISTING SERVICE (MLS).** MLS rules require Sponsoring Broker to input Property into the MLS within 72 hours of the execution of this  
50 Agreement. If Seller does not want the Property inputted into the MLS within 72 hours, Seller must set forth the date to have the Property inputted into the  
51 MLS by adding a date and initialing below. If Seller would like the listing to be exempt from the MLS during the entire listing period provided for in this  
52 Agreement, Seller must complete and sign the form provided by MRED, "Seller's Listing Exemption Addendum." Unless noted otherwise below, Sponsoring  
53 Broker will publish the MLS listing of the Property within 72 hours of the full execution of this Agreement in accordance to MLS guidelines.

54 Seller authorizes Sponsoring Broker not to submit Property into the MLS until \_\_\_\_\_ (Date)

55 Initial if date is entered above: Seller Initials: \_\_\_\_\_ Seller Initials: \_\_\_\_\_

56 **THE GENERAL PROVISIONS ON THE FOLLOWING PAGE ARE HEREBY INCORPORATED HEREIN AND MADE A PART OF THIS  
57 AGREEMENT.**

58 **SELLER'S INFORMATION:**

59 Seller's Signature: \_\_\_\_\_

60 Seller's Signature: \_\_\_\_\_

61 Date: \_\_\_\_\_

62 All Legal Title Holders or Legal Agent for Seller:  
63 \_\_\_\_\_  
64 \_\_\_\_\_

65 Seller's Name (print): \_\_\_\_\_

66 Seller's Name (print): \_\_\_\_\_

67 Address: \_\_\_\_\_

68 City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_

69 Phone #: \_\_\_\_\_

70 Phone #: \_\_\_\_\_

71 Phone #: \_\_\_\_\_

72 Phone #: \_\_\_\_\_

73 Fax #: \_\_\_\_\_

74 Email Address 1: \_\_\_\_\_

75 Email Address 2: \_\_\_\_\_

SPONSORING BROKER'S INFORMATION:

Sponsoring Broker's Signature: \_\_\_\_\_

Date: \_\_\_\_\_ ("Effective Date")

Sponsoring Broker (print): \_\_\_\_\_

Address: \_\_\_\_\_

City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_

Office Phone: \_\_\_\_\_

Office Fax: \_\_\_\_\_

Office MLS ID: \_\_\_\_\_

Designated Agent Name (print): \_\_\_\_\_

Designated Agent MLS ID: \_\_\_\_\_

Office Phone: \_\_\_\_\_

Agent Direct Line: \_\_\_\_\_

Agent Cell Phone: \_\_\_\_\_

Agent Fax Number: \_\_\_\_\_

Agent Email Address: \_\_\_\_\_

Seller Initials: \_\_\_\_\_ Seller Initials: \_\_\_\_\_

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Sponsoring Broker Initials: \_\_\_\_\_

76 GENERAL PROVISIONS:  
 77 A. **Fair Housing Act.** IT IS ILLEGAL FOR EITHER THE SELLER OR THE SPONSORING BROKER TO REFUSE TO DISPLAY, LIST, LEASE OR SELL, OR  
 78 REFUSE TO NEGOTIATE FOR THE LEASE OR SALE OF, OR OTHERWISE MAKE UNAVAILABLE OR DENY, REAL ESTATE TO ANY PERSON BECAUSE OF ONE'S  
 79 MEMBERSHIP IN A PROTECTED CLASS, E.G.: RACE, COLOR, RELIGION, NATIONAL ORIGIN, SEX, ANCESTRY, AGE, MARITAL STATUS, PHYSICAL OR  
 80 MENTAL HANDICAP, FAMILIAL STATUS, OR ANY OTHER CLASS : SELLER AND  
 81 SPONSORING BROKER ACKNOWLEDGE THAT THEY SHALL ALSO BE BOUND BY THE PROVISIONS OF STATE AND LOCAL (CITY AND/OR COUNTY) HUMAN  
 82 RIGHTS OR FAIR HOUSING ORDINANCES IF ANY AND AGREE TO COMPLY WITH SAME.  
 83 B. **Obligations of Seller.** Seller shall comply with the Real Estate Settlement Procedures Act of 1974, as amended, if applicable, and furnish all information required for  
 84 compliance with the Act, and, if applicable, Seller agrees to comply with the Residential Real Property Disclosure Act, as amended.  
 85 C. **Condominium Property Act.** If the property is a condominium, then no later than 15 days from the date of this Agreement, Seller shall furnish to Sponsoring Broker a  
 86 complete set of condominium documents, including the declaration, bylaws, and if available, a survey. If the Property is a cooperative, then, no later than 15 days from the date hereof  
 87 Seller shall furnish to Sponsoring Broker a complete set of cooperative documents, including the proprietary lease or trust agreement, bylaws, and if available, a survey. If the Property  
 88 is a townhouse or condominium and dependent upon the condominium association's governing documents, either upon execution of this Agreement or upon Seller's acceptance of an offer  
 89 by buyer, Seller shall promptly notify the appropriate representative of the condominium association or any affiliated organization of the contemplated transaction. Seller shall furnish  
 90 to the buyer a statement from an authorized officer or agent of the condominium association certifying payment of assessments for condominium common expenses, and if applicable,  
 91 proof of waiver or termination of any right of refusal or general option contained in the declaration of condominium together with any other documents required by the declaration of  
 92 condominium or its bylaws as a precondition to the transfer of ownership. At closing, Seller shall deliver to the buyer all appropriate documents properly endorsed and a survey or plat of  
 93 the condominium unit showing the location of all improvements of the unit and further showing any parking spaces or garages that will be conveyed. Seller shall comply with all of the  
 94 conditions and stipulations of the Illinois Condominium Property Act as amended, as may be applicable.  
 95 D. **Title.** At least 5 days prior to closing, Seller shall furnish an owner's title insurance policy in the amount of the purchase price showing good and merchantable title, and  
 96 execute and deliver, or cause to be executed and delivered to the buyer a proper instrument of conveyance.  
 97 E. **Survey.** If the Property is not a condominium or a cooperative, then prior to closing, Seller shall furnish to the buyer at least 5 days prior to closing a survey by a licensed land  
 98 surveyor dated not more than 6 months prior to date of closing (as defined in the Seller's Real Estate Sale Contract) showing the present location of all improvements on the Property. If  
 99 the buyer or buyer's mortgagee desires a more recent or extensive survey, then the survey shall be obtained at the expense of either the buyer or seller, as agreed to by buyer and Seller.  
 100 F. **Lock Box.** Seller hereby authorizes Sponsoring Broker and its agent to place an electronic or combination lock box on the Property in accordance with the terms and conditions of  
 101 this Agreement for the purpose of keeping a key to the Property for access by cooperating real estate agents. Seller shall hold Sponsoring Broker, its agents, and any Multiple Listing  
 102 Service of which Sponsoring Broker is a participant harmless from any and all liability, claims, judgments, obligations, or demands against Sponsoring Broker and/or agent as a result of  
 103 Seller's authorization to use a "Lock Box," including, but not limited to, any and all liabilities and costs, including reasonable attorneys' fees incurred by Sponsoring Broker and/or agents  
 104 as a result of this authorization, except for any criminal or gross negligence on the part of the Sponsoring Broker and/or agents.  
 105 G. **Seller's Personal Property.** Seller has been advised by Sponsoring Broker of the importance of safeguarding or removing valuables now located within the Property and the  
 106 need to obtain personal property insurance through Seller's insurance company.  
 107 H. **Leased Property.** If the Property is leased or occupied by a tenant, Seller acknowledges and agrees to the following: (i) Seller has notified and advised the tenant/occupant of this  
 108 Agreement, including, without limitation, the terms and provisions of Paragraph F of these General Provisions; (ii) Seller will comply with all of the provisions of the Chicago Residential  
 109 Landlord and Tenant Ordinance and any other laws, regulations, and ordinances relating to the provision of notice to, and obtaining permission from, any tenant or occupant of the  
 110 Property for the Sponsoring Broker, its agent, cooperating real estate agents, and prospective buyers or lessees to enter the Property during reasonable times during the term of the  
 111 Agreement; (iii) it is Seller's responsibility to keep the Sponsoring Broker informed of any times that Seller's tenant or occupant has not agreed to provide access to the Property; and (iv)  
 112 Seller has advised all of the tenants and occupants of the Property of the importance of safeguarding or removing valuables now located within the Property and the need to obtain  
 113 personal property insurance during the term of this Agreement.  
 114 I. **Indemnity.** Seller hereby indemnifies and holds Sponsoring Broker and Sponsoring Broker's agents harmless, from any and all claims, disputes, litigation, judgments, costs and  
 115 legal fees from the defense of Sponsoring Broker and Sponsoring Broker's agents, including reasonable attorneys' fees and costs, arising from any misrepresentation by the Seller or  
 116 other incorrect information supplied by the Seller to Sponsoring Broker or any third party.  
 117 J. **Authority.** Seller warrants that Seller has the authority to execute this Agreement and to deal with and on behalf of the Property as provided in this Agreement.  
 118 K. **Sponsoring Broker's Duty.** Sponsoring Broker's sole duty is to use Sponsoring Broker's best efforts to effect a Transfer of Property, and Sponsoring Broker is not charged with  
 119 the custody of the Property, its management, maintenance, upkeep or repair.  
 120 L. **Disbursement of Earnest Money.** If a dispute arises between Seller and the buyer as to whether a default had occurred and Sponsoring Broker acts as Escrowee of earnest  
 121 money, Sponsoring Broker shall hold the earnest money and pay it out as agreed in writing by Seller and the buyer or as directed by a court of competent jurisdiction. In the event of a  
 122 dispute Seller agrees that Sponsoring Broker may deposit the funds with the Clerk of the Circuit Court by the filing of an action in the nature of an Interpleader. Seller agrees that  
 123 Sponsoring Broker may be reimbursed from the earnest money for all costs, including reasonable attorneys' fees and court costs, related to the filing of the Interpleader and hereby  
 124 agrees to indemnify and hold Sponsoring Broker harmless from any and all claims and demands, including the payment of reasonable attorneys' fees, costs and expenses arising out of  
 125 the default, claims and demands. If Seller defaults, earnest money, at the option of the buyer, and upon written direction by Seller and the buyer or as directed by a Court of competent  
 126 jurisdiction, shall be refunded to the buyer and Seller shall not be released from any of its obligations under this Agreement. Notwithstanding anything in this Agreement to the  
 127 contrary, disbursement of earnest money shall be in accordance with the Real Estate License Act of 2000, as amended.  
 128 M. **Commission.** No amendment or alteration with respect to the amount of commission or time of payment of commission shall be valid or binding unless made in writing and  
 129 signed by the parties hereto. Sponsoring Broker's commission is to be paid at time of execution and delivery of deed, option, lease, joint venture agreement, or installment agreement  
 130 for deed, whichever occurs first, and Sponsoring Broker is authorized to deduct the commission and expenses from the earnest money deposit at time. SPONSORING BROKER IS  
 131 AUTHORIZED TO ACCEPT AN EARNEST MONEY DEPOSIT FROM THE BUYER. IF THE BUYER DEFAULTS AND EARNEST MONEY IS RELEASED TO THE  
 132 SELLER, THE EARNEST MONEY SHALL BE APPLIED FIRST TO PAYMENT OF SPONSORING BROKER'S COMMISSION AND ANY EXPENSES INCURRED, AND  
 133 THE BALANCE SHALL BE PAID TO SELLER, EXCEPT AS OTHERWISE STATED BELOW IN PARAGRAPH "N" OF THE GENERAL PROVISIONS OF THIS  
 134 AGREEMENT.  
 135 N. **Dispute Resolution.** The parties agree that any dispute, controversy or claim arising out of or relating to this Agreement, or any breach of this Agreement by either party, shall  
 136 be resolved by arbitration in accordance with the Code of Ethics and Arbitration Manual of the National Association of REALTORS, as amended from time to time, through the facility of  
 137 the Association of REALTORS. The parties agree to be bound by any award rendered by any professional standards arbitration hearing panel of the Association of  
 138 REALTORS and further agree that judgment upon any award rendered by a professional standards arbitration hearing panel of the Association of REALTORS may be entered  
 139 in any court having jurisdiction. The parties agree to execute any arbitration agreements, consents and documents as may be required by the Association of REALTORS to  
 140 facilitate any arbitration.  
 141 O. **Representation of Multiple Sellers.** Seller understands and agrees that Sponsoring Broker may from time to time represent or assist other sellers who may be interested in  
 142 selling property to the buyers with whom Sponsoring Broker has a buyer agency contract or with whom Sponsoring Broker is working as a customer. The Seller consents to Sponsoring  
 143 Broker's representation of other sellers before, during and after the expiration of this Agreement and expressly waives any claims, including, but not limited to, breach of fiduciary duty  
 144 or breach of contract, based solely upon Sponsoring Broker's representation or assistance of other sellers who may be interested in selling property to the buyers with whom Sponsoring  
 145 Broker has a buyer agency contract or with whom Sponsoring Broker is working as a customer.  
 146 P. **Notice.** All notices required by this Agreement shall be in writing and shall be served upon the Parties at the addresses provided in this Agreement. The mailing of notice by  
 147 registered or certified mail, return receipt requested, shall be sufficient service. Notices may also be served by personal delivery or commercial delivery service or by the use of a  
 148 facsimile machine. In addition, facsimile signatures or digital signatures shall be sufficient for purposes of executing this Agreement and shall be deemed originals. E-mail notices  
 149 shall be deemed valid and received by the addressee when delivered by e-mail and opened by the recipient. Each Party shall retain a copy of proof of facsimile transmission and email  
 150 notice and provide such proof, if requested.  
 151 Q. **Miscellaneous.**  
 152 (1) Where applicable, the singular form shall include the plural, and the masculine form shall include the feminine and neuter, and vice versa.  
 153 (2) This Agreement shall be binding upon and inure to the benefit of the heirs, executors, administrators, successors, and assigns of the parties to this Agreement.  
 154 (3) Any reference in this Agreement to "day" or "days" shall mean business days, not calendar days. Business Days are defined at Monday through Friday, excluding  
 155 Federal holidays. Business Hours are defined as 8:00 A.M. to 6:00 P.M. Chicago Time.

Seller Initials: \_\_\_\_\_ Seller Initials: \_\_\_\_\_

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Sponsoring Broker Initials: \_\_\_\_\_

## **Section 2. Seller Disclosures**

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The real estate market has dramatically changed over the past couple of decades. The mantra of *caveat emptor* or “buyer beware” has changed to one of full disclosure. **Real estate disclosures** inform buyers about elements that affect the real property that may not be readily identifiable. It will disclose health or safety hazards, limitations to property rights, or other conditions that could impact property value or restrict an owner’s enjoyment and use of the property.

Each state decides the minimum number of disclosures required by law. The agent may need to help the seller complete the form and understand the questions. The seller should complete, date, and sign all the disclosures when they sign the listing agreement. All the required disclosures must be presented to the buyer before or immediately after the seller accepts the purchase contract.

Honest disclosure minimizes lawsuits and facilitates a quicker and smoother sale. Encourage the client to disclose *everything* that could affect a buyer’s decision to purchase the property. There will be less price renegotiation after the buyer’s home inspection if the buyer knows in advance about any potential problems.

There are several common disclosure forms. A disclosure form is *not a warranty* of any kind. The buyer is responsible for verifying the accuracy of the disclosure.

- **Seller’s Property Disclosure Statement.** This is a standard disclosure form that allows the seller to identify all known material defects as well as the condition of the structural and mechanical features. The seller can also disclose any recent repairs, upgrades, improvements, or inspections. There is also space for the seller to list all the appliances, fixtures, and other personal property included in the sale.

Each state has its standardized form, but it will contain information similar to this sample disclosure statement from Michigan.

## Sample Seller's Disclosure Statement

### Seller's Disclosure Statement

Property Address: \_\_\_\_\_ MICHIGAN  
 Street \_\_\_\_\_ City, Village or Township \_\_\_\_\_

**Purpose of Statement:** This statement is a disclosure of the condition of the property in compliance with the Seller Disclosure Act. This statement is a disclosure of the condition and information concerning the property, known by the Seller. Unless otherwise advised, the Seller does not possess any expertise in construction, architecture, engineering or any other specific area related to the construction or condition of the improvements on the property or the land. Also, unless otherwise advised, the Seller has not conducted any inspection of generally inaccessible areas such as the foundation or roof. **This statement is not a warranty of any kind by the Seller or by any Agent representing the Seller in this transaction, and is not a substitution for any inspections or warranties the Buyer may wish to obtain.**

**Seller's Disclosure:** The Seller discloses the following information with the knowledge that even though this is not a warranty, the Seller specifically makes the following representations based on the Seller's knowledge at the signing of this document. Upon receiving this statement from the Seller, the Seller's Agent is required to provide a copy to the Buyer or the Agent of the Buyer. The Seller authorizes its Agent(s) to provide a copy of this statement to any prospective Buyer in connection with any actual or anticipated sale of property. The following are representations made solely by the Seller and are not the representations of the Seller's Agent(s), if any. **THIS INFORMATION IS A DISCLOSURE ONLY AND IS NOT INTENDED TO BE A PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.**

**Instructions to the Seller.** (1) Answer ALL questions. (2) Report known conditions affecting the property. (3) Attach additional pages with your signature if additional space is required. (4) Complete this form yourself. (5) If some items do not apply to your property, check NOT AVAILABLE. If you do not know the facts, check UNKNOWN. FAILURE TO PROVIDE A PURCHASER WITH A SIGNED DISCLOSURE STATEMENT WILL ENABLE A PURCHASER TO TERMINATE AN OTHERWISE BINDING PURCHASE AGREEMENT.

**Appliances/Systems/Services:** The items below are in working order. (The items listed below are included in the sale of the property only if the purchase agreement so provides.)

	Yes	No	Unknown	Not Available		Yes	No	Unknown	Not Available
Range/oven	_____	_____	_____	_____	Lawn sprinkler system	_____	_____	_____	_____
Dishwasher	_____	_____	_____	_____	Water heater	_____	_____	_____	_____
Refrigerator	_____	_____	_____	_____	Plumbing system	_____	_____	_____	_____
Hood/fan	_____	_____	_____	_____	Water softener/conditioner	_____	_____	_____	_____
Disposal	_____	_____	_____	_____	Well & pump	_____	_____	_____	_____
TV antenna, TV rotor controls	_____	_____	_____	_____	Septic tank & drainfield	_____	_____	_____	_____
Electric system	_____	_____	_____	_____	Sump pump	_____	_____	_____	_____
Garage door opener & remote	_____	_____	_____	_____	City water system	_____	_____	_____	_____
Alarm System	_____	_____	_____	_____	City sewer system	_____	_____	_____	_____
Intercom	_____	_____	_____	_____	Central air conditioning	_____	_____	_____	_____
Central vacuum	_____	_____	_____	_____	Central heating system	_____	_____	_____	_____
Attic fan	_____	_____	_____	_____	Wall furnace	_____	_____	_____	_____
Pool heater, wall liner & equipment	_____	_____	_____	_____	Humidifier	_____	_____	_____	_____
Microwave	_____	_____	_____	_____	Electronic air filter	_____	_____	_____	_____
Trash compactor	_____	_____	_____	_____	Solar heating system	_____	_____	_____	_____
Ceiling fan	_____	_____	_____	_____	Fireplace & chimney	_____	_____	_____	_____
Sauna/hot tub	_____	_____	_____	_____	Wood burning system	_____	_____	_____	_____
Washer	_____	_____	_____	_____	Dryer	_____	_____	_____	_____

Explanations (attach additional sheets if necessary):

UNLESS OTHERWISE AGREED, ALL HOUSEHOLD APPLIANCES ARE SOLD IN WORKING ORDER EXCEPT AS NOTED WITHOUT WARRANTY BEYOND DATE OF CLOSING.

**Property conditions, improvements & additional information:**

1. **Basement/Crawlspace:** Has there been evidence of water? yes \_\_\_\_\_ no \_\_\_\_\_  
If yes, please explain: \_\_\_\_\_
2. **Insulation:** Describe, if known: \_\_\_\_\_ Urea Formaldehyde Foam Insulation (UFFI) is installed? unknown \_\_\_\_\_ yes \_\_\_\_\_ no \_\_\_\_\_  
3. **Roof: Leaks?** Approximate age if known: \_\_\_\_\_  
4. **Well:** Type of well (depth/diameter, age and repair history, if known): \_\_\_\_\_  
Has the water been tested? yes \_\_\_\_\_ no \_\_\_\_\_  
If yes, date of last report/results: \_\_\_\_\_

BUYER'S INITIALS \_\_\_\_\_  
SELLER'S INITIALS \_\_\_\_\_

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FORM H JUN/06

## Seller's Disclosure Statement

Property Address:	Street	City, Village or Township
5. <b>Septic tanks/drain fields:</b> Condition, if known: _____ 6. <b>Heating system:</b> Type/approximate age: _____ 7. <b>Plumbing system:</b> Type: copper _____ galvanized _____ other _____ Any known problems? _____ 8. <b>Electrical system:</b> Any known problems? 9. <b>History of Infestation,</b> if any: (termites, carpenter ants, etc.) 10. <b>Environmental problems:</b> Are you aware of any substances, materials or products that may be an environmental hazard such as, but not limited to, asbestos, radon gas, formaldehyde, lead-based paint, fuel or chemical storage tanks and contaminated soil on property. Unknown _____      yes _____      no _____		
If yes, please explain: _____		
11. <b>Flood Insurance:</b> Do you have flood insurance on the property?      unknown _____      yes _____      no _____ 12. <b>Mineral Rights:</b> Do you own the mineral rights?      unknown _____      yes _____      no _____		
<b>Other Items:</b> Are you aware of any of the following: 1. Features of property shared in common with the adjoining landowners, such as walls, fences, roads and driveways, or other features whose use or responsibility for maintenance may have an effect on the property?      unknown _____      yes _____      no _____ 2. Any encroachments, easements, zoning violations or nonconforming uses?      unknown _____      yes _____      no _____ 3. Any "common areas" (facilities like pools, tennis courts, walkways, or other areas co-owned with others) or a homeowners' association that has any authority over the property?      unknown _____      yes _____      no _____ 4. Structural modifications, alterations, or repairs made without necessary permits or licensed contractors?      unknown _____      yes _____      no _____ 5. Settling, flooding, drainage, structural, or grading problems?      unknown _____      yes _____      no _____ 6. Major damage to the property from fire, wind, floods, or landslides?      unknown _____      yes _____      no _____ 7. Any underground storage tanks?      unknown _____      yes _____      no _____ 8. Farm or farm operation in the vicinity; or proximity to a landfill, airport, shooting range, etc.?      unknown _____      yes _____      no _____ 9. Any outstanding utility assessments or fees, including any natural gas main extension surcharge?      unknown _____      yes _____      no _____ 10. Any outstanding municipal assessments or fees?      unknown _____      yes _____      no _____ 11. Any pending litigation that could affect the property or the Seller's right to convey the property?      unknown _____      yes _____      no _____		
If the answer to any of these questions is yes, please explain. Attach additional sheets, if necessary: _____		
The Seller has lived in the residence on the property from _____ (date) to _____ (date). The Seller has owned the property since _____ (date). The Seller has indicated above the conditions of all the items based on information known to the Seller. If any changes occur in the structural/mechanical/appliance systems of this property from the date of this form to the date of closing, Seller will immediately disclose the changes to Buyer. In no event shall the parties hold the Broker liable for any representations not directly made by the Broker or Broker's Agent.		
Seller certifies that the information in this statement is true and correct to the best of Seller's knowledge as of the date of Seller's signature.		
<b>BUYER SHOULD OBTAIN PROFESSIONAL ADVICE AND INSPECTIONS OF THE PROPERTY TO MORE FULLY DETERMINE THE CONDITION OF THE PROPERTY. THESE INSPECTIONS SHOULD TAKE INDOOR AIR AND WATER QUALITY INTO ACCOUNT, AS WELL AS ANY EVIDENCE OF UNUSUALLY HIGH LEVELS OF POTENTIAL ALLERGENS INCLUDING, BUT NOT LIMITED TO, HOUSEHOLD MOLD, MILDEW AND BACTERIA.</b>		
<b>BUYERS ARE ADVISED THAT CERTAIN INFORMATION COMPILED PURSUANT TO THE SEX OFFENDERS REGISTRATION ACT, 1994 PA 295, MCL 28.721 TO 28.732 IS AVAILABLE TO THE PUBLIC BUYERS SEEKING SUCH INFORMATION SHOULD CONTACT THE APPROPRIATE LOCAL LAW ENFORCEMENT AGENCY OR SHERIFF'S DEPARTMENT DIRECTLY.</b>		
<b>BUYER IS ADVISED THAT THE STATE EQUALIZED VALUE OF THE PROPERTY, PRINCIPAL RESIDENCE EXEMPTION INFORMATION, AND OTHER REAL PROPERTY TAX INFORMATION IS AVAILABLE FROM THE APPROPRIATE LOCAL ASSESSOR'S OFFICE. BUYER SHOULD NOT ASSUME THAT BUYER'S FUTURE TAX BILLS ON THE PROPERTY WILL BE THE SAME AS THE SELLER'S PRESENT TAX BILLS. UNDER MICHIGAN LAW, REAL PROPERTY TAX OBLIGATIONS CAN CHANGE SIGNIFICANTLY WHEN PROPERTY IS TRANSFERRED.</b>		
Seller _____	Date: _____	
Seller _____	Date: _____	
Buyer has read and acknowledges receipt of this statement.		
Buyer _____	Date: _____	Time _____
Buyer _____	Date: _____	Time _____
<b>Disclaimer:</b> This form is provided as a service of Michigan Realtors®. Please review both the form and details of the particular transaction to ensure that each section is appropriate for the transaction. Michigan Realtors® is not responsible for use or misuse of form for misrepresentation or for warranties made in connection with the form.		

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FORM H JUN/06

- **Lead-Based Paint and Hazard Disclosure.** If a residential house was built before 1978, Federal law requires that all prospective buyers receive a copy of the lead-based disclosure form and an EPA-approved *Protect Your Family from Lead in Your Home* pamphlet.

## Sample Lead-Based Paint Disclosure

### **Disclosure of Information on Lead-Based Paint and/or Lead-Based Paint Hazards**

#### **Lead Warning Statement**

*Every purchaser of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women. The seller of any interest in residential real property is required to provide the buyer with any information on lead-based paint hazards from risk assessments or inspections in the seller's possession and notify the buyer of any known lead-based paint hazards. A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.*

#### **Seller's Disclosure**

- (a) Presence of lead-based paint and/or lead-based paint hazards (check (i) or (ii) below):
- (i) \_\_\_\_\_ Known lead-based paint and/or lead-based paint hazards are present in the housing (explain).
- 
- (ii) \_\_\_\_\_ Seller has no knowledge of lead-based paint and/or lead-based paint hazards in the housing.
- (b) Records and reports available to the seller (check (i) or (ii) below):
- (i) \_\_\_\_\_ Seller has provided the purchaser with all available records and reports pertaining to lead-based paint and/or lead-based paint hazards in the housing (list documents below).
- 
- (ii) \_\_\_\_\_ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

#### **Purchaser's Acknowledgment (initial)**

- (c) \_\_\_\_\_ Purchaser has received copies of all information listed above.
- (d) \_\_\_\_\_ Purchaser has received the pamphlet *Protect Your Family from Lead in Your Home*.
- (e) Purchaser has (check (i) or (ii) below):
- (i) \_\_\_\_\_ received a 10-day opportunity (or mutually agreed upon period) to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards; or
- (ii) \_\_\_\_\_ waived the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

#### **Agent's Acknowledgment (initial)**

- (f) \_\_\_\_\_ Agent has informed the seller of the seller's obligations under 42 U.S.C. 4852d and is aware of his/her responsibility to ensure compliance.

#### **Certification of Accuracy**

The following parties have reviewed the information above and certify, to the best of their knowledge, that the information they have provided is true and accurate.

Seller	Date	Seller	Date
Purchaser	Date	Purchaser	Date
Agent	Date	Agent	Date

- **Other Less Common Disclosure Forms.** The state may require that all residential housing built before 1975 include an asbestos hazard disclosure. Some states are also requiring radon disclosure. There are other disclosure forms for wells, septic systems, flood plains, methamphetamine production, mold, environmental hazards, wetlands, erosion, and protected species.

Licensed agents need to know about the state-required disclosure forms. The managing broker will instruct their team on what forms the state requires and what additional forms they will use in their brokerage.

## Section 3. The Property Inspection

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Before an agent can determine the listing price of the property, they are going to need to inspect it and identify features that may impact, either positively or negatively, the market value of the property. The physical inspection is going to serve three primary purposes:

- it helps to evaluate the property in order to set a list price,
- it helps to gather information and photographs for marketing, and
- it helps to verify the information contained in the seller's disclosure form, and
- it fulfills the agent's ethical and fiduciary duties to disclose any identified physical or material problems.

As an agent gains experience, they will start to be able to identify standard features in similarly-classed homes. They will identify features that impact the market value of the property. Negative features include visibly worn carpet, an inefficient kitchen design, and too few bathrooms. Positive features include upgraded kitchen appliances, custom tile work, or a large outside entertainment area.

Pay particular attention to health or safety issues such as leaks, poor drainage, electrical problems, rotting deck boards, and infestation. Encourage the seller to have these items repaired or replaced as soon as possible. If the seller is proactive and repairs items in advance, it can facilitate a quicker sale. If the listing agent identifies problems with the property that are not revealed on the seller's property disclosure form, they should encourage the seller to revise the form. If they refuse, the agent has a good faith obligation to provide disclosure to possible buyers.

### Calculating the Land Area

The seller will provide the property size. While that is helpful as a starting point, *do not rely on this information*. An agent is responsible for verifying all marketing information. Check to see if there is a survey or a plat map for the property. That information can be

found in the city or county public records. In the absence of a property drawing, public records will also have an accurate legal description. An agent can use it to calculate the land area. Another source of property information is a past real estate appraisal. This will contain a treasure trove of property information. The formulas for calculating land area were covered in Chapter 13, Section 3.

## Calculating the Building Area

The seller will also provide the square footage of the house. Do not rely on this information either. If an agent assumes the information is correct and the buyer finds out that the area was overstated, the agent is liable – not the seller. Remember, it is the agent's responsibility to verify all marketing information. If the house is relatively new, try to get a copy of the floor plans. Ask the seller if they have a copy of a past property appraisal. If so, the appraiser will have measured the house and included a basic sketch. That information can be relied on and used in marketing. Do not, however, rely on tax records. They are often inaccurate.

Real estate agents have a poor habit of calculating the area for each room of the house and then adding them all together to determine the square footage of a house. While this will provide a “livable area,” it is inaccurate. Measuring only the interior “airspace” works for condominiums, but it does not take into consideration the interior walls in a house. According to the American National Standards Institute, Inc. (ANSI), “calculation of square footage is made by using exterior dimensions.” It is the same method used by appraisers and architects.

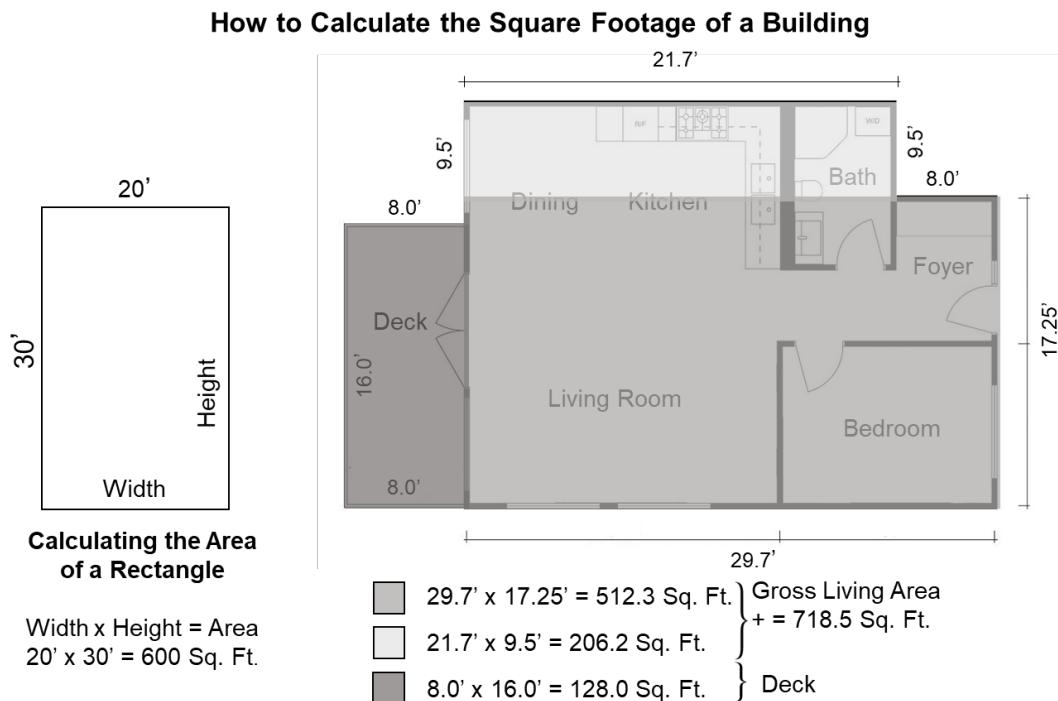
A 100-foot-long tape measure or a laser measuring tool will make measuring the house easier. Start at one corner of the house and work systematically around the foundation. Round off the measurements to the nearest inch. As you measure, draw a sketch and record each measurement. The measurements will need to be converted into decimals. Calculate to only one or two decimal points. For example, 24 feet 3 inches would be converted to 24.25 feet. Remember to measure decks, porches, and verandas. While these are not living areas and are not included in the square footage of the home, they are still valuable features that interest buyers.

### MATH

Convert inches to decimals using this handy chart.

1" = .10 ft.	7" = .60 ft.
2" = .20 ft.	8" = .70 ft.
3" = .25 ft.	9" = .75 ft.
4" = .30 ft.	10" = .80 ft.
5" = .40 ft.	11" = .90 ft.
6" = .50 ft.	12" = 1.00 ft.

Now divide the building into rectangles and calculate the area for each. The sum of all the areas will give you the total square footage for the building. Use the same process for the second or third floor. Calculate all the non-livable areas separately.

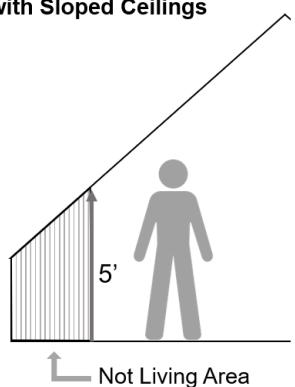


## Living and Non-Living Areas

Not all areas of a home are considered living areas. Even areas of a home that are used as bedrooms may not be technically living areas.

- Finished Basements:** A finished basement is not considered in the above-grade area unless three sides are exposed. It can only be considered as below-grade living area if it is finished similar to the upper levels, and all basement bedrooms have ingress/egress windows. Unfinished basement areas should be stated separately from the gross living area.
- Garage:** Garages are measured separately and are not included in the square footage of the residence. The size of the garage is specified, not by the area, but by the number of cars it can hold. A 2.5 car garage holds two cars plus has a storage area or workshop.
- Sloped Ceilings:** For an area with a sloped ceiling to be included in the living area of the home, the ceiling must have a height of at least 5 feet, and at least one-half of the area of the room must have a vertical ceiling height of at least 7 feet.

**Calculating Living Area with Sloped Ceilings**



- **Bay Windows:** If a protrusion, such as a bay window or a chimney, extends past the foundation, but it does not have a floor, it should not be included in the living area.
- **Enclosed Porches and Breezeways:** In order for it to be included in the living area, it must be heated and finished similar to the rest of the house. Unfinished or unheated areas should be mentioned in the comments section.

## Room Counts

There are some standard guidelines when counting rooms and especially when counting bedrooms and baths.

- **Walk-through Bedroom.** If the bedroom can only be accessed by passing through another bedroom, it does not qualify as a bedroom. The area should, however, be included in the gross living area.
- **Small Bedrooms.** A bedroom should have a minimum of 70 square feet, and one wall must measure at least seven feet wide.
- **Windowless Bedrooms.** There must be two ways out of a bedroom – such as a door and a window. If there is only one method of ingress or egress, it is included in the gross living area, but should not be counted as a bedroom.
- **Below Grade Bedrooms.** If the bedroom has ingress/egress windows and is finished similar to the above grade area, then it may be included in the total bedroom count.
- **Bathrooms.** A full bath includes a sink, a toilet, and either a tub or a shower. Half baths or powder rooms feature only a sink and a toilet.
- **Split level and Bi-Levels.** Lower levels of a bi-level or split level should not be included in the above-grade square footage, but they can be listed in the below-grade area.
- **Four-Season Porch.** It must be finished as the other rooms in the house, have glass windows, and a permanent heat source.

## Section 4. The Comparative Market Analysis

The seller may know how much they want to make from the sale. They may even think they know the best price to sell the house. Their agent, however, can do much to assist their seller in setting a fair asking price. The presentation made to the seller to assist in setting a listing and sales price is called a Comparative Market Analysis (CMA).

A **Comparative Market Analysis (CMA)** is an analysis of actively listed and sold properties that are similar to the subject property. The goal is to establish a list price for the property. A CMA is *not an appraisal*, and it is a license violation to give a client the impression that it is. Only appraisals can be used in court or by lenders to establish market value. A CMA is a reference for the buyer or a seller, nothing more. There are four steps to create a CMA:

1. **Locate comparable listings and recent sales.** The best source for this information is the local MLS. Ideally, sold properties should have closed within three to six months. Keep the listings and sales separate. Try to locate three of each. Expired listings can be used sparingly. Focus on comparables that have these features in common:
  - **Location.** The market area radius should be as small as realistically possible - within 3 miles, if possible. If a lack of comparables forces an expanded market area, locational adjustments may be needed if the comparable is in a superior or inferior location.
  - **Site size.** If the subject is on a lot, then all of the comparables should be on similar sized lots. If it is a rural acreage property, then all of the comparables should be similarly sized rural properties.
  - **Bedrooms to bath ratio.** The ratio of bedrooms to baths is an important value consideration. A three-bedroom house should have two or two-and-a-half baths, and a four-bedroom house should have a minimum of three full baths. The comparables should have the same ratio as the listing.
  - **Square footage.** The above-grade square footage of each of the comparables should be within 20 percent of the subject property. The closer they are in size, the more accurate the CMA will be.
  - **Basements and garages.** If the listing has an unfinished basement or a three-car garage, then the comparables should too.
2. **Apply monetary or percentage adjustments to the comparables.** The adjustments for superior or inferior characteristics are always made to the comparables. The subject property is not adjusted. The adjustments can be a flat amount (minus \$5,000 for each excess garage stall) or a monetary amount based on a percentage adjustment (plus 10% because the subject's kitchen is superior). There are no hard and fast rules on adjustment amounts. They should, however, be based on how a typical buyer values that item. There are some valuable resources to help:
  - **Ask your broker.** They are an expert in the market, and they know what is acceptable in the market area.
  - **Ask an appraiser.** A reliable residential appraiser should be part of an agent's network. They have studied the market in great depth and know the market value of individual features. Make a note of the market adjustments from any appraisals and read their comments to learn more.
  - **Build a database.** As an agent becomes familiar with the market, they will start to understand why one house sold for more or less than another. Keep track of this information for future reference.
3. **Determine the adjusted sales price of the comparables.** Take the price of the comparable and add or subtract each of the adjustments, so it closely resembles the size, quality, and features of the subject property, creating an adjusted listing or sales price for each of the comparables.
4. **Determine the list price, possible sales price, and marketing period.** This is done by reconciling the adjusted price of the comparable listings and sales. The three active listings usually are averaged to create a recommended list price for the

subject property. The three adjusted sold properties are averaged to create a likely sales price. The average number of days on the market for the sold properties will indicate the marketing period.

A listing or selling price should not be set in stone, because in actuality, real property has a range of value. The CMA is an example of that range. After adjusting each of the comparables, each price will not equal the same value. The comparables should be within 5 to 10 percent of each other, with the listings being at the higher end of the range and the sales at the bottom. The target sales price will be somewhere in between. The seller should not list the property for more than the highest adjusted listing comparable and they should not sell it for less than the lowest adjusted sold comparable. Anything in between that range is acceptable and hopefully, the real estate appraiser will agree.

In the end, the seller gets to make the final decision on the list price. It is part of an agent's fiduciary responsibility to obey or follow the direction of their client. If they want a ridiculously high list price, that is their right, and you must do your best to market and sell the property for that price. After a time, they may go back and reconsider the CMA and lower the price, but as their agent, you cannot force or badger them to do so.

## **Section 5. Marketing the Listing**

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Marketing a listing is used to locate a ready and willing buyer. Advertising is not only targeted directly at prospective buyers but also to buyer brokers and their sales associates. The ways to advertise a listing are nearly endless.

### **Internet Advertising**

The internet is one of the most effective advertising mediums. Almost all brokerages will have their own website with a database of in-house listings. The local **Multiple Listing Service (MLS)** is an internet-based membership-accessed database of all the active local listings and property sales supplied from other brokerages. The National Association of REALTORS® has adopted the Internet Data Exchange (IDX) policy, which allows all MLS members equal rights to display all listings (except opted-out listings) on their websites. The MLS also syndicates their records to publicly maintained listing databases such as Realtor.com, Redfin, Trulia, and Zillow. There can, however, be a lengthy delay between when data is entered into a local MLS and when it is posted on a syndicated site. These sites have disclaimers to indicate that the information has no warranties or representations.

Social media, including Facebook, Twitter, LinkedIn, Instagram, and others, are popular methods of keeping in contact with prospects. Agents are welcome to use these sources, but they should be careful to uphold their fiduciary responsibility of client confidentiality at all times. The actions of agents should also reflect well on the real estate profession.

Email marketing is frequently used to market listings and brokerage services. There are advertising laws that impact email advertising which will be discussed below. Email and text messaging are also an effective method of communication between parties in a real estate transaction. As a licensed real estate professional, all agents need to follow texting etiquette and make sure their messages are clear, concise, and never misleading.

## **Conventional Advertising**

While the internet is a very cost-effective advertising medium, agents should not dismiss the effectiveness of more conventional forms of advertising. These “hard print” channels include classified ads, newspaper display ads, flyers, open houses, bulk mailings, and property signage. Be aware that before the start of any advertising campaign, the agent must have written permission from the property owner. This permission is granted in the listing agreement.

## **Advance Fee**

Conventional methods of advertising can be quite expensive, causing some brokers to collect an advance fee from their seller. The agreement for the advance fee can be made part of the listing agreement. The agent holds the fee in a trust or escrow account, and the funds may never comingle with personal or other client escrow accounts. The funds are restricted and may only be used to benefit the seller directly or advertising of the seller’s property. The seller must receive regular statements that itemize the use of the advance fee money.

The advance fee is credited towards the commission paid at closing, or the agent will refund any unused funds to the client at the end of either the advance fee agreement or the listing contract. Each state has specific rules that govern the handling of advance fees. It would be ill-advised to accept an advance fee without understanding the laws and penalties or without the approval of the managing broker.

## **Section 6.      Earnest Money Deposits**

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Upon the seller's acceptance of the purchase agreement, the buyer will usually give the seller's agent an **earnest money deposit (EMD)** as evidence of their commitment to complete the transaction. The EMD is applied towards the buyer's down payment. There are no strict rules on how large the deposit should be. As a general rule of thumb, however, a seller can expect a deposit of around one to three percent of the purchase price. The EMD serves three purposes:

- It deters the buyer from defaulting on the purchase contract and losing the EMD;
- If the buyer does default, it compensates the seller for taking the property off the market; and
- If the buyer defaults, it should cover any transactional expenses incurred by the seller.

If a buyer refuses to complete the purchase without a justifiable reason, there is a provision placed in some purchase agreements that allow the seller to seek liquidated damages from the buyer. **Liquidated damages** are a sum that represents the intangible losses to a party in a breached contract. The earnest money deposit is usually considered sufficient compensation, and the seller's acceptance of the EMD as liquidated damages prevents them from suing the buyer for further damages. The purchase agreement will explain how earnest money deposits are to be handled and dispersed. This must be in harmony with state laws.

## **Trust and Escrow Accounts**

Earnest money deposits are held in an **escrow account**, which is a trust account that holds client funds. Escrow accounts keep transactional funds from **commingling** with brokerage operating funds. It is illegal to place transactional funds into the operational brokerage account. All trust funds can be kept in the same account as long as the broker keeps accurate individual accounting records. While a brokerage is allowed to manage their escrow account, it is common to use a third-party's escrow account such as an attorney or title company. Each state will have specific escrow laws that all real estate professionals will need to follow carefully.

## **Section 7.      Seller Due Diligence**

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Once the seller accepts the purchase agreement and both parties have a copy of the signed contract, the **performance of contract** phase begins. Performance of contract is when both the buyer and the seller fulfill their commitments made in the purchase

agreement. The success in getting the transaction to close relies much on the efforts of their agents to help their clients complete their due diligence. For residential transactions, most due diligence periods are between 7 to 30 days, but that is negotiable. There are a couple of items that are on the seller's due diligence checklist.

### Title Contingency

The seller has stated in the property disclosure statement the type of title that they will be passing to the buyer. The title contingency gives the seller sufficient time to provide proof of title, in the form of a **title commitment**. This is a preliminary report of title or a commitment to issue a title policy. A title company issues the title commitment, and it is frequently the same company that will handle the closing. It is common for a seller to provide and pay for a title insurance policy as evidence of a clear title. The premium is paid once at the closing. Title insurance was discussed in detail in Chapter 12, Section 3.

### Lienholder Approval

If the property is under foreclosure and will be sold for less than the mortgage amount, it is called a **short sale**. All short sales must have written approval from the current lienholder(s) and the owner must also agree to the sale. Approval must come from not only the primary mortgage holder, but any second mortgages, home improvement loans, or other lienholders.

Short sales take significantly longer to close. A short sale can take anywhere from two to six months or more to close. The buyer should be made aware that there will be a delay in the closing. If the lienholder(s) does not approve the sale, they can suggest changes in the contract terms or purchase price. The seller and the buyer are not obligated to accept these changes, and the purchase contract can be rescinded if an amended agreement cannot be achieved.

## **Section 8. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. Before you can start marketing your client's property, what needs to be completed *first*?
  - a. Create a marketing package.
  - b. Help the seller to fill out the required disclosures.
  - c. Establish your legal agency relationship.
  - d. Inspect the property.

2. A seller must complete a lead paint disclosure if the house was built before \_\_\_\_.
  - a. 1955
  - b. 1968
  - c. 1978
  - d. 1980
3. True or false. The listing agent should complete a physical inspection to verify the seller's property disclosure form.
  - a. True
  - b. False
4. True or false. A basement can only be considered as below-grade living area if it is finished similar to the upper levels.
  - a. True
  - b. False
5. What should a listing agent do if they identify a problem with the property, but the seller did not reveal it on the property disclosure form?
  - a. Encourage the seller to revise the form.
  - b. Provide disclosure to possible buyers.
  - c. Encourage your seller to have it corrected by a professional.
  - d. All of the above.
6. What is a Comparative Market Analysis?
  - a. An appraisal.
  - b. An evaluation of recently listed or sold homes.
  - c. A method of establishing a list price.
  - d. Both B and C.
7. True or false. When completing a Comparative Market Analysis (or CMA), the agent will adjust the subject property.
  - a. True
  - b. False
8. True or false. An agent must have written permission from the seller to advertise the property.
  - a. True
  - b. False
9. True or false. A broker can deposit transactional funds into the brokerage operating account if it is eventually placed into the escrow account.
  - a. True
  - b. False
10. All short sales must have written approval from the \_\_\_\_\_.
  - a. The homeowner.
  - b. The bank/lender.
  - c. The neighbors
  - d. The homeowner and all lienholders.



## Quiz Answers

1. Before you can start marketing your client's property, what needs to be completed *first*?
  - c. Establish your legal agency relationship. – Before you can take an active interest in marketing your seller's property, you must establish your legal agency relationship.
2. A seller needs to complete a lead paint disclosure if the house was built before \_\_\_\_\_.
  - c. 1978 – Homes built before 1978 may have lead paint.
3. True or false. The listing agent should complete a physical inspection to verify the seller's property disclosure form.
  - a. True – It is the responsibility of the agent to verify all seller provided information as is reasonably feasible.
4. True or false. A basement can only be considered as below-grade living area if it is finished similar to the upper levels.
  - a. True – In addition, all basement bedrooms must have ingress/egress windows.
5. What should a listing agent do if they identify a problem with the property, but the seller did not reveal it on the property disclosure form?
  - d. All of the above. – Agents have a fiduciary responsibility to disclose any physical or material problems or issues that have been identified.
6. What is a Comparative Market Analysis?
  - d. Both B and C. – A CMA is an evaluation of recently listed or sold homes that are used to establish a list price.
7. True or false. When completing a Comparative Market Analysis (or CMA), the agent will adjust the subject property.
  - b. False – Adjustments are always made to the comparables *not* the subject property.
8. True or false. An agent must have written permission from the seller to advertise the property.
  - a. True - The agent must have written permission from the property owner. This permission is granted in the listing agreement.
9. True or false. A broker can deposit transactional funds into the brokerage operating account if it is eventually placed into the escrow account.
  - b. False - It is illegal to place transactional funds into the operational brokerage account
10. All short sales must have written approval from the \_\_\_\_\_.
  - d. The homeowner and all lienholders. The seller must accept the offer and the bank/lender also must approve the offer since they will likely be accepting less than the amount they are owed.

# Chapter 16 Representing the Buyer

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the aspects and terms in a buyer agency agreement,
- how to locate properties for the buyer,
- how to prepare the purchase offer,
- the buyer due diligence checklist, and
- situations that could make a buyer lose their earnest money deposit.

**OVERVIEW:** Buyers are especially in need of representation. Buying a home is often the most expensive purchase an individual will ever make. It is vital as their buyer broker to know how to protect their client's interests and how to help them successfully reach the closing. This chapter will prepare a sales associate for this role.

It is common for new sales associates to focus on working with sellers and listing properties, but they should not forget the other half of the transaction – the buyer. Many real estate agents prefer to work only with buyers as they find it easier than being a listing agent. To provide the skills to represent both types of clients, let us examine the role of a buyer's broker.

## Section 1. The Buyer Agency Agreement

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The **buyer agency agreement**, also called a buyer-broker agreement, is the contract that creates an agency relationship between the broker and the buyer. The broker becomes the agent of the buyer, and the buyer becomes the principal or client of the broker. Similar to a listing agreement, a buyer-broker contract can authorize the use of the services of their sales associates.

In Chapter 7, Section 5, we discussed the three different types of buyer agency agreements. The three agency agreements are:

- **Exclusive Right to Represent:** The buyer agrees to pay compensation to the broker *regardless of who finds the property for the buyer* if the agent is not receiving compensation from another source, such as the seller's agent.
- **Non-Exclusive Right to Represent:** The buyer will pay compensation to the broker *only if the broker supplied knowledge of the property*, and the agent is not receiving compensation from another source.
- **Non-Exclusive/Not for Compensation:** The buyer contracts with multiple brokers at the same time. This agreement does not obligate the buyer to pay the broker any compensation. Compensation must come from another source.

Back in the day, buyers were usually represented by the seller's agents. The buyer would locate a property and then work directly with the listing agent. Few buyers

understood that the listing agent had a fiduciary responsibility to the seller – not the buyer. This caused a ton of ethical and legal problems and caused the birth of a new generation of buyer representation. Even now, if an agent works with a buyer *without* a buyer agency representation agreement, they are, in fact, a subagent of the seller. So, do it right and get the brokerage relationship in writing. Educate the buyer about buyer-broker representation and how it protects them.

Just like seller contracts, the buyer agreement is made between the buyer and a broker – not the sales associate. **All states require that buyer-broker relationships be in writing to be enforceable in court.** Local real estate associations have standardized buyer representation forms. State law will define the roles and responsibilities of a buyer's broker.

## **Brokerage Relationship**

The buyer agency agreement will, first of all, create a brokerage relationship with the client. We have gone over this a couple of times, so by now, you should be able to list the three different types of brokerage agreements: the transactional, dual agency, and single agency brokerage relationships. A review of the fiduciary duties for each role can be found in Chapter 6, Section 5.

## **Compensation**

In almost all cases, the buyer's broker will receive their commission from the seller's agent. In effect, the seller's agent is paying the buyer's broker for doing half the work by finding the buyer. All three of the buyer agency agreements allow the buyer's agent to accept compensation from a third party, such as the seller's agent. The compensation can be based on a percentage of the purchase price, a flat fee, or both depending on the terms in the buyer-broker agreement. All sales associates will receive compensation from their employing broker.

Regardless of the source of the compensation, once a buyer agency agreement is signed, the agent now has a fiduciary responsibility towards their client, and they must represent their client's interests (a lower purchase price) above their interests (a higher commission). Remember that *the source of an agent's compensation does not determine agency.*

## **Expiration and Termination**

A buyer broker will have a fixed period in which to locate a property for their client. Every buyer agency agreement must have an expiration date. A broker cannot transfer the

buyer agency contract to another broker without the buyer's written consent. If the broker is unable or unwilling to fulfill the terms of the contract, the client may be entitled to sue for damages caused by the breach of contract. A buyer can breach the contract if they refuse to cooperate with their broker's efforts to fulfill the contract, or they refuse to proceed with an accepted purchase contract. If a transaction fails to close, through no fault of the buyer, the buyer-broker agreement remains in effect until the termination date.

**EXCLUSIVE BUYER - BROKER AGREEMENT**  
**This Contract is Intended to be a Binding Real Estate Contract**



Rev. 01/2012

- 1    1. **BROKER.** This Exclusive Buyer-Broker Agreement ("Agreement") is entered into by and between \_\_\_\_\_ ("Broker") and \_\_\_\_\_ ("Buyer").  
2  
3    Broker agrees to appoint a sales associate affiliated with Broker to act as the Buyer's designated agent ("Buyer's Designated Agent") for the purpose of assisting Buyer in identifying and negotiating the acquisition of residential real estate ("Property") and Buyer agrees to grant  
4    Buyer's Designated Agent the exclusive right ("Exclusive Right") to represent Buyer in such acquisition per the terms and conditions set forth  
5    in this Agreement. The terms "acquire" or "acquisition" shall mean the purchase (title transfer or Articles of Agreement for deed), lease,  
6    exchange, or contract for the option to purchase Property by Buyer or anyone acting on Buyer's behalf.  
7
- 8    2. **TERM.** Broker's Exclusive Right shall extend from the Effective Date, as set forth on page 3 ("Commencement Date"), until 11:59  
9    P.M. on \_\_\_\_\_, 20\_\_\_\_\_, at which time this Agreement shall automatically terminate ("Termination Date").  
10  
11    3. **COMPENSATION.** Broker shall seek to be paid a commission from the listing broker under a cooperative brokerage arrangement  
12    or from the seller if there is no listing broker. In the event that the seller or listing broker does not pay Broker a commission, then  
13    Buyer shall pay Broker at the time of closing, compensation equal to \_\_\_\_\_ % [percent] of the purchase price of the Property  
14    which Buyer acquires during the Term of this Agreement ("Acquisition Commission"), whether or not the Property has been  
15    identified by Broker to Buyer. If Buyer leases Property or enters into a lease/purchase contract during this Agreement, and the landlord  
16    does not agree to pay Broker a leasing commission, then Buyer shall pay to Broker for the duration of the lease, including all renewals and  
17    extensions, a commission of \_\_\_\_\_ % [percent] of the yearly lease amount OR a \$\_\_\_\_\_ flat fee commission (strike one) ("Rental  
18    Commission"). The Rental Commission and the Acquisition Commission are together referred to as "Compensation". Furthermore, if  
19    Buyer acquires (or enters into an agreement to acquire) Property that was identified to Buyer by Broker during the Term of this Agreement  
20    within \_\_\_\_\_ days / months (strike one) following the Termination Date ("Compensation Deadline"), then Buyer shall pay Broker at  
21    closing or upon the commencement of any lease, as the case may be, the Compensation set forth above. If Buyer enters into an agreement to  
22    acquire Property and the closing does not occur because of any fault on the part of Buyer, then Broker shall still be entitled to the  
23    Compensation set forth above. In no event shall Broker be obligated to advance funds to Buyer to facilitate the closing of any acquisition.  
24    (strike the following sentence if NOT applicable) Buyer shall pay Broker's Designated Agent a non-refundable retainer fee of  
25    \$\_\_\_\_\_ which shall be due and payable to, and shall be considered earned by, Broker upon signing this Agreement. Buyer's  
26    obligations under this Paragraph 3 shall survive the termination of this Agreement.  
27  
28    4. **MINIMUM SERVICES.** Pursuant to the Real Estate License Act of 2000, as amended, Broker must provide, at a minimum, the  
29    following services: (a) accept delivery of and present to the Buyer offers and counteroffers to sell or lease any Property that Buyer seeks to  
30    acquire; (b) assist the Buyer in developing, communicating, negotiating and presenting offers, counteroffers and notices that relate to the  
31    offers and counteroffers until a lease or agreement for the acquisition of the Property is signed and all contingencies have been satisfied or  
32    waived; and (c) answer the Buyer's questions relating to the offers, counteroffers, notices and contingencies.  
33  
34    5. **BUYER'S DESIGNATED AGENT.** Broker and Buyer agree that (a) \_\_\_\_\_, a sponsored licensee of Broker, is Broker's Designated Agent under this Agreement with Broker, and (b) neither Broker nor other sponsored  
35    licensees of Broker will be acting as agent for Buyer. Buyer understands and agrees that Broker and any of Broker's other sponsored  
36    licensees may enter into agreements with other prospective purchasers and sellers of Property as agents of those purchasers and sellers.  
37  
38    6. **BUYER'S DESIGNATED AGENTS DUTIES.** Buyer's Designated Agent shall: (a) use best efforts to identify Properties  
39    available for acquisition that meet the Buyer's specifications relating to location, purchase price, features and amenities; (b) arrange, to the  
40    extent available, inspections of Properties identified by Buyer as potentially appropriate for acquisition; (c) negotiate a contract acceptable to  
41    Buyer for the acquisition of Property; (d) safeguard and protect any confidential or proprietary information that Buyer discloses to Buyer's  
42    Designated Agent; (e) disclose to Buyer any information known to Buyer's Designated Agent that would materially affect Buyer's decision to  
43    acquire the Property; and (f) assist Buyer, once a contract for acquisition is signed, in securing financing or other commitments or services as  
44    may be necessary to close the transaction.  
45  
46    7. **LIMITATIONS ON BUYER'S DESIGNATED AGENT'S DUTIES.** Buyer acknowledges and agrees that Broker's Designated  
47    Agent: (a) may enter into exclusive brokerage relationships with other buyers of Property and may show the same or similar Properties in  
48    which Buyer is interested to other prospective buyers that Buyer's Designated Agent represents; (b) is not an expert with regard to matters  
49    which could have been revealed through a survey, title search or inspection of the Property; the condition of Property or items within the  
50    Property; building products and construction techniques; the necessity or cost of any repairs to the Property; hazardous or toxic materials;  
51    termites and other wood destroying organisms; the tax and legal consequences of any acquisition; the availability and cost of utilities and  
52    community amenities; appraised or future value of the Property (or matters relating to financing for which Buyer is hereby advised to seek  
53    independent expert advice); and conditions off the Property which may affect the Property; (c) is not responsible for the accuracy of room  
54    dimensions, lot size, square feet, variances, zoning or use restrictions which may or may not be reflected in the Multiple Listing Service  
55    ("MLS") or other sources; (d) shall owe no duties to Buyer nor have any authority on behalf of buyer other than what is set forth in the  
56    Agreement; (e) may make disclosures as required by law; (f) may show Buyer Property which is listed in the MLS by Broker or Broker's  
57    Designated Agent; and (g) is NOT OBLIGATED TO SHOW PROPERTIES THAT ARE FOR SALE BUT NOT IN THE MLS IN WHICH  
58    BROKER OR BUYER'S DESIGNATED AGENT PARTICIPATE, UNLESS REQUESTED TO DO SO BY BUYER IN WRITING, AND THE  
59    PROPERTY IS AVAILABLE FOR SHOWING BY BUYER'S DESIGNATED AGENT.  
60  
61    8. **BUYER'S DUTIES.** Buyer must (a) work EXCLUSIVELY with Buyer's Designated Agent to identify and acquire Property during  
62    the Term of this Agreement; (b) comply with reasonable requests of Buyer's Designated Agent to supply relevant financial information that  
63    may be necessary to permit Buyer's Designated Agent to fulfill its obligations under this Agreement; (c) be available upon reasonable notice

Buyer Initials: \_\_\_\_\_ Buyer Initials: \_\_\_\_\_

Broker Initials: \_\_\_\_\_ Broker Initials: \_\_\_\_\_

1 of 3

59 and at reasonable hours to inspect Properties that are potentially appropriate for acquisition by Buyer; (d) identify to Buyer's Designated  
60 Agent those specific Properties not in the MLS that Buyer would want to inspect; (e) otherwise cooperate with Buyer's Designated Agent in  
61 its efforts to fulfill its obligations under this Agreement; and (f) pay Broker, or cause seller's listing broker or seller to pay Broker, the  
62 Compensation set forth in Paragraph 3 of this Agreement.

63 **9. DISCLAIMER.** Buyer acknowledges and agrees that Broker and Buyer's Designated Agent are being retained solely as real estate  
64 professionals and NOT as attorney, tax advisor, surveyor, structural engineer, home inspector, environmental consultant, architect,  
65 contractor, or other professional service advisor. Buyer understands and agrees that such other professional service providers are available to  
66 render advice or services to Buyer, if desired, at Buyer's expense.

67 **10. INDEMNIFICATION OF BROKER.** Buyer hereby indemnifies and holds Broker and Buyer's Designated Agent harmless from  
68 and against any and all claims, disputes, litigation, judgments, costs, and legal fees arising from (i) misrepresentations by Buyer or other  
69 incorrect or incomplete information supplied by Buyer; (ii) earnest money handled by anyone other than Broker; and (iii) injuries to persons  
70 on the Property and/or loss or damage to the Property or any portions of the Property.

71 **11. ARBITRATION.** Any controversy or claim arising out of or relating to this Agreement, or the breach of this Agreement, shall be  
72 settled by arbitration in accordance with the rules of the Association of REALTORS, and judgment upon the award rendered by the  
73 arbitrator may be entered in any court having jurisdiction.

74 **12. LIMITATION ON BROKER'S LIABILITY.** Neither Broker nor Buyer's Designated Agent shall, under any circumstances, have  
75 any liability pursuant to this Agreement which is greater than the amount of the Compensation paid to Broker by Buyer or seller's listing  
76 broker or seller, as the case may be (and excluding any commission amount retained by the listing broker, if any).

77 **13. REAL ESTATE SETTLEMENT PROCEDURES ACT COMPLIANCE.** Buyer shall comply with the Real Estate Settlement  
78 Procedures Act of 1974, as amended ("Act"), if applicable, and furnish all information required for compliance with the Act.

79 **14. DUAL REPRESENTATION.** By checking "yes" and writing its initials below, Buyer acknowledges and agrees that Buyer's  
80 Designated Agent ("Licensee") may undertake a dual representation (represent both seller and buyer or landlord and tenant, as the case may  
81 be) in connection with any acquisition of Property. Buyer acknowledges and agrees that Buyer has read the following prior to executing this  
82 Agreement:

83 Representing more than one party to a transaction presents a conflict of interest since both parties may rely upon the Licensee's  
84 advice and the parties' respective interests may be adverse to each other. The Licensee will undertake the representation of more  
85 than one party to a transaction only with the written consent of ALL parties to the transaction. Any parties who consent to dual  
86 representation expressly agree that any agreement between the parties as to any terms of the contract, including the final contract  
87 price, results from each party negotiating on its own behalf and in its own best interest. Buyer acknowledges and agrees that (a)  
88 Broker has explained the implications of dual representation, including the risks involved, and (b) Buyer has been advised to seek  
89 independent counsel from its advisors and/or attorneys prior to executing this Agreement or any documents in connection with this  
90 Agreement.

91 **WHAT A LICENSEE CAN DO FOR CLIENTS WHEN UNDERTAKING DUAL REPRESENTATION:**

92 1. Treat all clients honestly. 2. Provide information about the property to the purchaser or tenant. 3. Disclose all latent material  
93 defects in the property that are known to the Licensee. 4. Disclose the financial qualification of Buyer to the seller or landlord.  
94 5. Explain real estate terms. 6. Help the Buyer arrange for property inspections. 7. Explain closing costs and procedures. 8. Help the  
95 Buyer compare financing alternatives. 9. Provide information to seller or Buyer about comparable properties that have sold so both  
96 clients may make educated decisions on what price to accept or offer.

97 **WHAT A LICENSEE CANNOT DO FOR CLIENTS WHEN UNDERTAKING DUAL REPRESENTATION:**

98 1. Disclose confidential information that the Licensee may know about either client without that client's express consent. 2.  
99 Disclose the price the seller or landlord will take other than the listing price without the express consent of the seller or landlord.  
.00 3. Disclose the price the purchaser or tenant is willing to pay without the express consent of the purchaser or tenant. 4.  
.01 Recommend or suggest a price the Buyer should offer. 5. Recommend or suggest a price the seller or landlord should counter with  
.02 or accept.

.03 Buyer acknowledges having read these provisions regarding the issue of dual representation. Buyer is not required to accept this Paragraph  
.04 unless Buyer wants to allow the Licensee to proceed as a dual agent ("Dual Agent") in this transaction. By checking "yes", initialing  
.05 below, and signing this Agreement, Buyer acknowledges that it has read and understands this Paragraph 14 and voluntarily consents to the  
.06 Licensee acting as a Dual Agent (that is, to represent **BOTH** the seller and purchaser or landlord and tenant, as the case may be) should it  
.07 become necessary. (*check one*) Yes \_\_\_\_\_ No \_\_\_\_\_ (Buyer initials) \_\_\_\_\_ (Buyer initials).

.08 **15. NONDISCRIMINATION. BROKER, ITS AGENTS AND EMPLOYEES AND BUYER'S DESIGNATED AGENT SHALL  
09 NOT ACT IN ANY WAY TO INDUCE OR DISCOURSE BUYER FROM ACQUIRING A PARTICULAR PROPERTY BASED ON  
10 THE RACE, COLOR, RELIGION, NATIONAL ORIGIN, SEX, ANCESTRY, AGE, MARITAL STATUS, PHYSICAL OR MENTAL  
11 HANDICAP OR FAMILIAL STATUS (OR ANY OTHER CLASS PROTECTED BY ARTICLE \_\_\_\_ OF THE \_\_\_\_ HUMAN  
12 RIGHTS ACT) OF THE SELLER AND/OR BUYER. THE PARTIES TO THIS AGREEMENT AGREE TO COMPLY WITH ALL  
13 APPLICABLE FEDERAL, STATE AND LOCAL FAIR HOUSING LAWS.**

Buyer Initials: \_\_\_\_\_ Buyer Initials: \_\_\_\_\_

Broker Initials: \_\_\_\_\_ Broker Initials: \_\_\_\_\_

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- 114      **16. MISCELLANEOUS PROVISIONS.**
- 115      A. **Amendments.** No amendment or alteration of this Agreement shall be valid or binding unless made in writing and signed by  
116      the Broker, Buyer's Designated Agent and Buyer.
- 117      B. **Gender Neutral.** Where applicable in this Agreement, the singular form of any word shall include the plural and the  
118      masculine form shall include the feminine and neuter, and vice versa.
- 119      C. **Successors and Assigns.** This Agreement shall be binding upon and inure to the benefit of the heirs, executors, administrators,  
120      successors and assigns of the parties.
- 121      D. **Days.** Any reference in this Agreement to "day" or "days" shall mean business days, not calendar days, including Monday,  
122      Tuesday, Wednesday, Thursday, and Friday, and excluding all official federal and state holidays.

123      **BUYER INFORMATION:**

124      Buyer's Signature: \_\_\_\_\_  
125      Buyer's Signature: \_\_\_\_\_  
126      Date: \_\_\_\_\_

127      Buyer's Name (print): \_\_\_\_\_  
128      Address: \_\_\_\_\_  
129      City: \_\_\_\_\_  
130      Office Phone: \_\_\_\_\_  
131      Home Phone: \_\_\_\_\_  
132      Cell Phone: \_\_\_\_\_  
133      Fax: \_\_\_\_\_

134      Buyer's Name (print): \_\_\_\_\_  
135      Address: \_\_\_\_\_  
136      City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
137      Office Phone: \_\_\_\_\_  
138      Home Phone: \_\_\_\_\_  
139      Cell Phone: \_\_\_\_\_  
140      Fax: \_\_\_\_\_  
141      Email Address: \_\_\_\_\_

123      **BROKER INFORMATION:**

124      Managing Broker's Signature: \_\_\_\_\_  
125      Date: \_\_\_\_\_ ("Effective Date")

127      Brokerage Company Name (print): \_\_\_\_\_  
128      Office Address: \_\_\_\_\_  
129      City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
130      Office Phone: \_\_\_\_\_  
131      Office MLS Identification Number: \_\_\_\_\_  
132      Office Fax Number: \_\_\_\_\_  
133      Email Address: \_\_\_\_\_

134      Designated Agent Name (print): \_\_\_\_\_  
135      Designated Agent MLS Identification Number: \_\_\_\_\_  
136      Office Address: \_\_\_\_\_  
137      City: \_\_\_\_\_ State: \_\_\_\_\_ Zip: \_\_\_\_\_  
138      Agent Direct Line: \_\_\_\_\_  
139      Agent Cell Phone: \_\_\_\_\_  
140      Agent Fax Number: \_\_\_\_\_  
141      Agent Email Address: \_\_\_\_\_

Buyer Initials: \_\_\_\_\_ Buyer Initials: \_\_\_\_\_

Broker Initials: \_\_\_\_\_ Broker Initials: \_\_\_\_\_

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## Section 2. Locating Properties

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The buyer's agent's primary objective is to locate a property that matches their client's criteria. Once they have established a list of their client's needs and wants, they can now start the search. There are several reliable sources of residential property listings:

- **Multiple Listing Service (MLS).** The MLS has the largest concentration of listings in one place. The interface that sorts and tracks the database will offer detailed sorting parameters. If an agent cannot find what their buyer is looking within the active listings, they can expand the search to expired listings. There is always a chance that the seller may be still looking for a buyer. Agents can also sign up to receive daily emails of all the new listings.
- **Pocket Listings.** A pocket listing is a non-MLS listed property that may or may not be under contract with another agent. It is not in the MLS because the seller has not yet signed a listing agreement, or they want to sell the property privately. Marketing is done through word of mouth among agents. To get easy access to pocket listings, buyer brokers can send out their search criteria to other agents.
- **FSBOs.** A FSBO is an acronym for a “for sale by owner” listing. These sellers will use classified ads, non-brokerage “For Sale” signs, and websites that market properties without agent representation. Check out websites such as Craigslist, ForSalebyOwner.com, Fizber, and FSBO.com. These sellers do not want to pay a commission, and they do not want representation. One option is to have the property owner sign a One-Time Show Listing. This listing agreement creates a transaction brokerage relationship between the seller and the named buyer. If the buyer completes the purchase, then the seller has agreed to pay the buyer broker a commission. The commission is general the amount the agent would receive if they were splitting the commission with the listing agent. If the buyer turns down the property, the working relationship with the property owner ceases. If the agent brings them a new buyer, then they would need to create another agreement. Another option is to have the buyer pay the compensation based on the terms in the buyer's agency agreement. Because the seller is not paying commission, the purchase price should be considerably lower making a buyer's payment of commission reasonable.
- **Foreclosures.** Foreclosure properties are usually offered at below market value. They are the riskiest of all residential real estate investments. These properties are purchased at a foreclosure auction. The property is sold to the highest bidder. Most real estate agents will not represent clients in a foreclosure auction because of the added liability and high investment risk. Here are just a few of the risks that come with an auction foreclosure purchase:
  - Payment in full is required either immediately following the auction or within a few days. There is rarely time to obtain bank financing.
  - Property is sold “As Is” without any warranty. These properties are usually suffering from extensive deferred maintenance and owner damage. There also is no guarantee that the property is vacant.
  - There is a limited amount of inspection time. Some properties are auctioned based on an exterior inspection only.

- The buyer is responsible for *all liens and debts prior to the defaulted debt*. It is the buyer's responsibility to identify any liens that will remain attached to the title, including government tax liens, mortgages, mechanics liens, unpaid property taxes and homeowner association dues.
- Property is transferred on either a sheriff's deed or trustee's deed with no title warranties or guarantees.
- Most states grant a **statutory redemption** period that gives a mortgagor or borrower/owner the right to regain ownership of a foreclosure property within a specified time period. A buyer cannot take possession of the property until after the redemption period, but they must pay the mortgage, property taxes, and homeowner's insurance during the redemption period. The wait varies from state to state and can last up to two years.
- **Short Sales.** Short sales are pre-foreclosure properties that the lender is permitting to be sold for less than the mortgage balance. The lender is willing to accept less than what is owed to avoid the lengthy and costly foreclosure process. These properties are usually discounted to encourage a quick sale. If the property does not sell before the foreclosure date, it can still be put up for auction. All sales must be pre-approved by the mortgage holder and they must also receive consent from all other lienholders. Short sales can take up to six months to close. These properties are nearly always listed in the MLS system.
- **Real Estate Owned (REO).** Foreclosed properties that are owned by the lender are called real estate owned (REO) properties. If a lender has foreclosed on a property, they will be the primary bidder at the foreclosure auction. They want to gain the title to the property so they can recoup their investment. Once the statutory redemption period has passed, they usually list the property with a local broker. These properties are sold with a warranty deed, and all past liens have been cleared. These properties may or may not have a discounted list price. These properties can be found within the MLS.

## **Section 3. Preparing the Purchase Offer**

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All agents hope that their buyer will select a property and submit an offer. The first step in preparing the purchase offer is to determine the purchase price.

### **Determining the Purchase Price**

The listing will have a stated price. Most buyers are reluctant to pay the full price because they want to feel like they are getting a deal. The purchase price, however, can be altered by market activity. In a seller's market where there are fewer properties than interested buyers, it is not uncommon to have a bidding war where a group of buyers will offer *more* than the list price in hopes of "winning" the property. It is the role of the buyer's agent to know what is going on in the market in order to recommend a purchase price that gives their client the best chance of acquiring the property and reflects the actual market value.

One of the best ways to determine a purchase price is to complete a Comparative Market Analysis (CMA). This was discussed in the preceding chapter. Preparing a CMA for a buyer is a little easier. The buyer is only interested in knowing the purchase price, so a buyer's CMA will use only sold properties.

Another consideration is the buyer's approved loan amount. In most markets, sellers will require that buyers obtain mortgage pre-approval before an offer is submitted. The highest offering price should not exceed the mortgage amount plus the buyer's down payment less closing costs.

## The Purchase Agreement

Once the agent and their buyer have agreed on a purchase price, the next step is to prepare the purchase agreement or the offer. The **purchase agreement** or **real estate purchase contract** is a voluntary but conditional indication of a buyer's willingness to purchase real property under a set of specific terms and conditions which, upon the seller's acceptance, creates a binding contract. The purchase agreement is going to be covered in detail in Chapter 17. It should be noted that purchase agreements are not confidential. The seller has the right to instruct their agent to reveal details about other offers hoping to receive a superior offer from another buyer. The real estate purchase agreement is state specific and is approved by the National Association of Realtors.

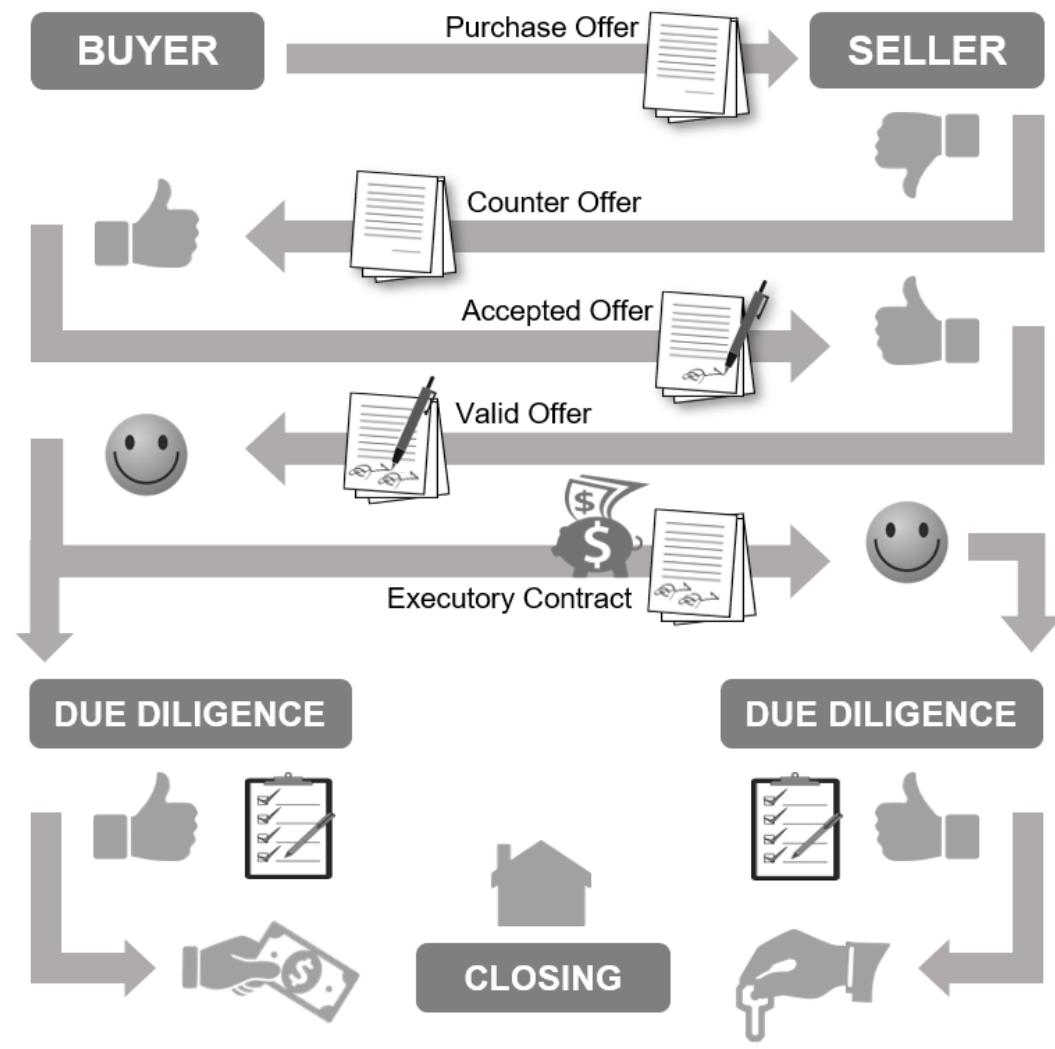
## Seller Disclosures

The purchase agreement will have a section that the buyer will acknowledge that they have received the *Seller's Disclosure Statement*. There will be a time allowance, usually 72 hours, that the buyer can terminate the purchase agreement with written notice if there are items on the disclosure that are unacceptable to the buyer. This means that prior to signing the purchase agreement, the buyer should have received a copy of the seller's disclosure form.

## Negotiation

In a perfect world, buyers would be willing to pay the full purchase price, and sellers would accept every initial purchase offer – and real estate agents would be out of a job. Instead, getting buyers and sellers to accept mutually agreeable terms usually requires several rounds of skillful negotiation under the guidance of their respective agents. The purchase process will go something like this:

## THE PURCHASE PROCESS



A purchase agreement is not a legal contract until both the seller and the buyer sign the contract. The buyer can withdraw the offer any time before the seller signs the offer. As the buyer's agent helps their client to complete the purchase process, remember that they *cannot act outside of the scope of their license*. That means that a sales associate or their broker cannot give any legal advice whatsoever. They should, however, always recommend that their clients consult with an attorney.

## **Section 4.      Earnest Money Deposits**

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It is expected that a buyer will provide an earnest money deposit (EMD) as evidence of their good faith and intent to complete the purchase. The earnest money deposit is applied to the purchase price and is credited towards the buyer's down payment. The amount of the deposit will depend on what is common in the market area. There is no set requirement. It is between one and five percent of the purchase price.

The purchase contract will state when the earnest money deposit is to be paid. It is customary to deliver the earnest money to the seller's agent within two days after receiving notice of the seller's acceptance. If the buyer's payment is late, they are in default of the contract, and the seller is within their legal right to rescind the contract. To prevent this from happening, the buyer will often give their agent a check for the earnest money deposit at the time of the initial offer. The check can be postdated, deposited in an escrow account, or submitted to the seller with the offer. If the offer is not accepted, the deposit is returned.

The listing agent will deposit the funds in either their brokerage's trust account or with the third-party handling the closing, such as the seller's attorney or title company. A receipt of the deposit needs to be kept in the transactional file. Neither the buyer or the seller will have access to the EMD until closing or when the contract is rescinded.

### **Refundable and Non-Refundable Deposits**

The purchase agreement will set the terms for any refunds of the earnest money deposit if the transaction does not close. Agents for the buyer have a fiduciary responsibility to protect their client's deposit. They should help their client to understand the actions that could result in a loss of the deposit.

The terms in the contract can be enforced in a court of law. If there are problems, the seller and the buyer – with the help of their agents – can usually come to a reasonable settlement. The seller will most likely require compensation for any out-of-pocket costs incurred as a direct result of the contract, and the remainder will be returned to the buyer. If an agreement cannot be reached, legal arbitration may be required.

## CAN THE EARNEST MONEY DEPOSIT BE RETURNED?

*What if the buyer...*

	YES	NO	MAYBE
cannot get mortgage approval?	✓		
finds significant problems with the property?	✓		
finds a better property?*		✓	
decides they don't want the property?*		✓	
receives an appraisal that is less than the purchase price?	✓		
finds out there are problems with the title?	✓		
cannot meet the property sale contingency on time?			✓
finds out the seller has not completed the agreed repairs before the closing?*	✓		
agrees to remove contract contingencies and then finds a problem?		✓	
refuses to close due to the poor condition of a home purchased "As Is"?*		✓	
fails to meet contract deadlines?*			✓

*What if the seller...*

backs out of the contract?*	✓		
accepts a higher offer from another buyer?*	✓		
fails to meet contract deadlines?*	✓		

\* The innocent party may have the right to sue for specific performance and force the sale to close.

## Section 5. Buyer Due Diligence

Once the seller accepts the purchase agreement and both parties have a copy of the signed contract, the **performance of contract** phase begins. The buyer must now fulfill their commitments stated in the purchase agreement. The purchase contract will have a performance of contract deadline.

### Buyer's Due Diligence Checklist

It is up to the buyer to assess any actual or potential risks involved in a property purchase. This is called **due diligence**. The due diligence period will allow the buyer time to satisfy whatever contingencies they placed in the purchase contract. There are four typical items on a buyer's due diligence checklist.

#### Mortgage Contingency

If the buyer needs to obtain a mortgage to complete the purchase, then they should have been pre-approved before submitting the purchase contract. If that did not happen, then fulfilling the finance contingency will be of primary concern. Helping the client to understand mortgage financing is an important part of an agent's fiduciary responsibility. Chapter 18 contains more information about financing.

## Inspection Contingency

The property inspection is an important contingency in the purchase agreement. A buyer has the legal right to back out of a contract if they identify unsatisfactory problems with the property before closing. It is highly recommended that the buyer has the property inspected by a licensed general contractor or home inspector. Home inspectors should carry an errors and omissions insurance policy and be members of either The American Society of Home Inspectors (ASHI), the National Association of Home Inspectors (NAHI), or the International Association of Certified Home Inspectors (NACHI).

The home inspector will conduct a careful visual examination of the property's structure, systems, and site conditions and prepare a report identifying any problems. The report may indicate the need to have certain areas inspected by a specialist if mold, foundation issues, or insect infestation have been identified.

Nearly every home has some maintenance issues. Many of these will be minor such as a leaking pipe or a faulty electrical outlet. Others may be more costly and significant such as an inadequate heating system or a deteriorated roof. A buyer has several options. They can

- accept the defect and proceed forward with the closing;
- ask the seller to make the repairs;
- request a reduction in the purchase price; or
- rescind the contract.

The seller is not obligated to make any repairs or accept a lower purchase price – but the buyer is not obligated to complete the purchase either. This is where the agent can help to negotiate an acceptable compromise.

## Property Sale Contingency

When a buyer is in the process of selling their home, they will find it nearly impossible to resist the urge to shop for a new property. As it usually happens, they will find the "perfect" property before their house has sold. Most homeowners, however, are unable to qualify for two mortgages on non-income generating properties at the same time. The property sale contingency allows the buyer the time to complete the sale of their home before being obligated to close on the second property. The buyer's agent cannot do much to help this process along. If the sale deadline is approaching, based on the wishes of their client, they may need to negotiate an extension with the seller's agent or request the voiding of the contract and a return of the client's earnest money deposit.

## Appraisal Contingency

Mortgage approval is going to be contingent on a satisfactory appraisal. The buyer's lender will order the appraisal. If the appraisal comes in lower than the purchase price, there are a couple of options.

- The lender may ask the appraiser to review the appraisal and verify the value.
- The lender may order a new appraisal.
- The buyer can request from the seller a reduction in the purchase price.
- The buyer can increase their down payment to cover the difference, or
- The buyer can rescind the contract, receive their EMD, and walk away.

## Other Due Diligence Items

In addition to the contingencies in the purchase agreement, the buyer will want to add these items to their due diligence checklist:

- **Homeowner Insurance.** A new homeowner insurance policy must begin on the day of closing to ensure coverage is maintained. The seller is obligated to maintain coverage up until the day of closing. While it is highly recommended that every property purchase includes a title insurance policy, unless it is required by the lender or the state, the property can be transferred without one.
- **Flood Insurance.** If the property is located in a special flood hazard area, then an additional flood insurance policy is highly recommended and may be required by the lender.
- **Title Insurance.** If the seller is not providing a title insurance policy at closing, the buyer will need to decide if they want broad title protection. The policy should be ordered in advance and will be paid for at closing.
- **Homeowners Association Covenants & Restrictions.** If the property is a condominium, townhouse, or located in a development with a CC&R, the buyer will need to review the requirements, laws, and dues carefully.

## Section 6. Quiz

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What should an agent do before they submit an offer on a For Sale by Owner?
  - a. Have the property owner sign a One-Time Show Listing.
  - b. Have the property owner sign an Exclusive Right to Sell Listing
  - c. Have the property owner sign an Open Listing
  - d. Have your client sign an agreement guaranteeing payment of commission.

2. Choose an answer that best describes a short sale:
  - a. Short sales are usually listed below market value.
  - b. Short sales must be approved by the mortgage holder.
  - c. Short sales take much longer to close.
  - d. All of the above.
3. Choose an answer that best describes a foreclosure sale:
  - a. Foreclosure properties can be purchased directly from the lender.
  - b. The winning bidder will receive a Quit Claim Deed.
  - c. The property is sold in "As Is" condition.
  - d. All of the above.
4. Choose an answer that best describes a real estate owned (REO) property:
  - a. REOs are directly owned by the bank or lender.
  - b. REOs are listed with real estate agents and found in the MLS.
  - c. Purchased REOs come with a warranty deed.
  - d. All of the above.
5. True or false. Each real estate brokerage firm creates their own purchase agreement.
  - a. True
  - b. False
6. When should the buyer receive a copy of the *Seller's Disclosure Statement*?
  - a. Before signing the purchase agreement.
  - b. After signing the purchase agreement.
  - c. Before paying the earnest money deposit.
  - d. Before closing.
7. What does it mean that an agent cannot act outside of the scope of their license?
  - a. The agent cannot help the buyer fill out the purchase agreement.
  - b. The agent cannot provide any advice.
  - c. The agent cannot provide any legal advice at all.
  - d. All of the above.
8. True or false. Every property purchase must include homeowner's insurance.
  - a. True
  - b. False
9. True or false. The seller does not have to return the earnest money deposit if the buyer decides they do not want the property.
  - a. True
  - b. False
10. True or false. A buyer under a signed purchase agreement can sue the seller for specific performance if they accept a higher offer from another buyer.
  - a. True
  - b. False

## Quiz Answers

1. What should an agent do before they submit an offer on a For Sale by Owner?
  - a. Have the property owner sign a One-Time Show Listing. - This listing agreement creates a transaction brokerage relationship between the seller and your specifically named buyer.
2. Choose an answer that best describes a short sale:
  - d. All of the above. – A short sale is a property that is sold for less than the amount owed on the property and must be lender approved, and the process takes significantly longer to close than a conventional listing.
3. Choose an answer that best describes a foreclosure sale:
  - c. The property is sold in “As Is” condition. – Foreclosure properties are auctioned by an auctioneer and the winning bidder will receive a sheriff’s deed or trustee deed and the property is sold in “As Is” condition without any guarantees or warranties.
4. Choose an answer that best describes a real estate owned (REO) property:
  - d. All of the above. – REOs are owned by the bank or lender and they hire a real estate agent to list the property and the sale includes the transfer of title via a warranty deed.
5. True or false. Each real estate brokerage firm creates their own purchase agreement.
  - b. False – the real estate purchase agreement is state specific and is approved by the National Association of Realtors. However, some brokerages can create and utilize their own purchase agreement.
6. When should the buyer receive a copy of the *Seller's Disclosure Statement*?
  - a. Before signing the purchase agreement. The purchase agreement requires that the buyer acknowledge that the *Seller's Disclosure Statement* has been provided.
7. What does it mean that an agent cannot act outside of the scope of their license?
  - c. The agent cannot provide any legal advice at all. – The agent cannot provide legal advice but should always recommend that their clients review the contract with their attorney prior to signing.
8. True or false. Every property purchase must include homeowner’s insurance.
  - b. False – Unless it is required by the lender or the state, the property can be transferred without homeowner’s insurance.
9. True or false. The seller does not have to return the earnest money deposit if the buyer decides they do not want the property.
  - a. True – The seller has the right to sue for specific performance and force the sale to close or they may require compensation for out-of-pocket costs and then return the remainder to the buyer.
10. True or false. A buyer under a signed purchase agreement can sue the seller for specific performance if they accept a higher offer from another buyer.
  - a. True

# **Chapter 17 Purchase Agreements**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the contents of a purchase agreement,
- the difference between an amendment and an addendum,
- common sale contingencies, and
- when a purchase agreement is accepted and becomes a contract.

**OVERVIEW:** The purchase agreement is at the heart of the real estate market. It is the legal contract that facilitates the transfer of real property between a seller and a buyer. An agent must understand all of the functions of the purchase agreement.

## **Section 1. The Offer**

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While there may be some preliminary negotiation between the agents of the seller and the buyer, an accepted purchase price needs to be written into a purchase agreement. The purchase agreement (also called the sales contract, offer to purchase, or contract of purchase and sale) will contain the complete agreement between the buyer and seller.

When initially presented to the seller, it is only a purchase *offer*. Once it is signed by both parties, it becomes a purchase *contract*. The signed and accepted **purchase agreement or buy and sell agreement** is a legal contract that establishes the rights and obligations of both parties. The real estate purchase contract is state-specific, and agents should use the one approved by their state or the National Association of Realtors (NAR).

### **Letter of Intent**

Initial offers submitted on a commercial property may be presented as a letter of intent or binder instead of a complete sales contract. Commercial contracts are complex and should be drawn up by an attorney. To reduce costs and expedite the negotiation process, a buyer submits a **letter of intent** that clearly states the essential terms of the offer. If the seller accepts the letter of intent, their attorney will prepare the formal and complete sales contract.

### **Presentation of the Offer**

The purchase agreement should be presented to the seller's agent by the buyer's agent. The seller's agent has an ethical and fiduciary responsibility to present *all* offers to their client as "objectively and quickly as possible" – especially if you are working as the seller's single agent. A buyer's offer can be withdrawn at any time before it is accepted.

## Priority of Multiple Offers

Each agent has an ethical and fiduciary responsibility to present *all* offers to their client as “objectively and quickly as possible.” A delay on the part of the agent could result in another offer being legally accepted.

There will be times when a seller receives multiple offers at the same time. The purchase price is not always the primary consideration. The seller will also want to weigh the terms of the offer as well.

**PRACTICAL APPLICATION:** *The seller receives two offers during the same 24-hour period. Offer #1 is for ten percent less than the purchase price. The buyer is pre-approved for financing and agrees to close within 15 days. Offer #2 is for the list price, but the buyer has included a sales contingency that can delay the closing up to four months. The seller has accepted a job in another state and wants to close on the sale as quickly as possible. The seller decides that the first offer is the best one and accepts it.*

When a seller receives multiple counter offers, their broker can offer suggestions and advice. In the end, it is the seller that must choose the course of action. They have several choices.

- They can accept the best offer;
- They can inform all potential purchasers that they are considering multiple offers in an attempt to start a bidding war;
- They can counter one offer while holding onto the other offers; or
- They can counter one offer and reject all others.

## Section 2. The Counteroffer

---

If the seller does not accept the initial offer, they may change the terms of the offer and submit a **counteroffer**. A counteroffer voids the original offer. The buyer may accept, reject, or change the counteroffer. Like an offer, a counteroffer can be withdrawn at any time before it is accepted. As each change is submitted, the prior offer ceases to exist. Negotiation can continue back-and-forth until either both parties reach an agreement or one party withdraws their offer and ends the negotiation.

### Acceptance

Acceptance occurs when the receiving party signs and dates the contract, *and the submitting party has been notified*. Real estate agents have a heavy responsibility to present all offers as quickly as possible. If an agent does not promptly notify the other party of the acceptance, their client could lose their offer or counteroffer to another party.

**PRACTICAL APPLICATION:** The seller receives a purchase offer from Buyer A on Monday, and he submits a counteroffer on the same day. On Tuesday morning, Buyer A accepts the counteroffer and gives it to his agent, who agrees to deliver it to the seller's agent by the end of the day. Early that afternoon, the seller receives a higher-priced offer from Buyer B and accepts it on the spot. The seller's agent quickly calls Buyer B's agent to notify them that the offer has been accepted. There are now two active offers on the same property. Which purchase offer has become an accepted and legally binding contract since both have been signed?

The contract between the seller and Buyer B has been legally accepted because the submitting party, Buyer B, via his agent, has been notified of the acceptance. Even though Buyer A signed the counteroffer before the seller signed Buyer B's offer, the seller was not notified about the acceptance. A contract is not legally accepted until the submitting party has been notified of the acceptance.

The purchase offer becomes a legal contract when the submitting party then signs and dates the form. A copy of the signed contract is provided to each party. An attorney can be consulted either before or after the acceptance of the contract.

### **Section 3.        Contents of a Purchase Agreement**

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Both the pre-designed purchase contract form and contracts prepared by an attorney will contain similar clauses and provisions. A purchase agreement must include the following items:

- the name of the seller(s) and buyer(s),
- description of the property including the street address, legal description or tax ID number,
- the purchase price,
- buyer's statement of obligation to purchase the property,
- buyer's statement about how they intend to pay for the property, the amount of the earnest money deposit, and the anticipated mortgage finance terms,
- seller's statement of evidence of title, deed of transfer and any covenants, conditions, and reservations,
- seller's statement of any outstanding special assessments and the party responsible for payment,
- identification of the closing or settlement agent,
- closing or settlement instructions,
- the closing date,
- the date of the buyer's possession of the property,

- the method of prorating real estate taxes, rents, prepaid utilities, and other expenses,
- the effect on the contract should the property be damaged or destroyed before the closing date,
- provisions in case of default including liquidated damages and specific performance,
- a list of contingencies or conditions of the sale,
- a list of personal property included in the sale,
- a list of fixtures or other real property that is not included in the sale,
- transfer of any applicable warranties on mechanical systems, appliances, or other improvements and fixtures,
- a list of any leased equipment that must either be transferred to the buyer or returned to the lessor,
- statement of the buyer's right to a final inspection immediately before the closing or settlement,
- list of documents provided by each party and where and when delivery will occur,
- dated signatures from both seller(s) and buyer(s) and, in some states, their spouses, and
- the real estate agency disclosure statement (required in most states).

## Contract Contingencies

Each purchase agreement will contain buyer and seller **contingencies** that must be satisfied before the purchase contract can be fully enforceable. A contingency creates a voidable contract because if any of the contingencies are not satisfied, the contract can be voided.

Each itemized contingency must indicate which party is responsible for satisfying the contingency and the actions involved, who is responsible for paying for any costs to satisfy the contingency, and the time frame to complete the contingency. There are a few common contingencies.

### Buyer Contingencies

- **Mortgage contingency.** If the buyer is unable to obtain a sufficient mortgage, a mortgage contingency releases the buyer from the contract and guarantees a refund of the earnest money deposit (EMD).
- **Inspection contingency.** This contingency allows the buyer to complete certain inspections of the property such as inspections for termites, lead-based paint, septic systems, radon, mechanical systems, electrical systems as well as general structural and building condition inspections. If the inspections are unsatisfactory,

and the parties cannot agree on a remedy, the buyer can be released from the contract and receive their earnest money deposit.

- **Property sale contingency.** This contingency provides the buyer time (often 30 to 90 days) to sell another property owned by the buyer before closing on the seller's property. It helps to ensure that there are sufficient funds available to complete the purchase. It also allows the buyer to be released from the contract and receive their EMD if the buyer is unable to sell their property by the specified time.
- **Appraisal contingency.** If the property appraisal is lower than the purchase price, the contract can be terminated and the earnest money refunded to the buyer.

### Seller Contingencies and Clauses

- **Title contingency.** If the seller is unable to demonstrate that they possess title to the property, the buyer is released from the contract with a full refund of the EMD. The contingency may also stipulate that a title report is to be provided by an authorized title company before the closing or that the seller will provide title insurance.
- **Lienholder approval contingency.** If the property is in the process of foreclosure and the lender has permitted a short sale, this contingency will require the approval of the seller's lienholder. If the seller's lienholder does not approve the contract terms or the sales price, they may request modifications or additional conditions to the contract upon the consent of the buyer and seller or either party may terminate the contract.
- **Escape Clause.** A seller who accepts a property sale contingency may include an escape or kick-out clause allowing the seller to continue to market the property. If the seller receives an acceptable offer from another buyer, the first buyer is given a specified number of days to waive the property sale contingency (usually three days) and proceed with the closing or cancel the contract. In most cases, the EMD will be returned to the buyer.

The next couple of pages contain a sample purchase agreement from Michigan. These forms are state-specific. Since they will all have approximately the same information and layout, this provides a good idea of what to expect.

## Buy and Sell Agreement



Offer Date: \_\_\_\_\_, 20\_\_\_\_\_

Selling Office: \_\_\_\_\_ ("Selling Broker")

Selling REALTOR®: \_\_\_\_\_

Selling REALTOR®'s Email Address: \_\_\_\_\_

Selling REALTOR®'s Phone: \_\_\_\_\_ Facsimile: \_\_\_\_\_

Listing Office: \_\_\_\_\_ ("Listing Broker")

Listing REALTOR®: \_\_\_\_\_

Listing REALTOR®'s Email Address: \_\_\_\_\_

Listing REALTOR®'s Phone: \_\_\_\_\_ Facsimile: \_\_\_\_\_

1. **PROPERTY DESCRIPTION:** Buyer agrees to buy from Seller the property located at \_\_\_\_\_, \_\_\_\_\_ County, Michigan, and legally described as: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

The property includes all buildings; all fixtures; all gas, oil, and mineral rights owned by Seller; built-in appliances; lighting fixtures; plumbing fixtures; water softener (unless rented); heating fixtures; electrical fixtures; radio and television antennas and any mechanical controls; shades; awnings; shutters; window blinds; curtain and drapery rods; attached floor coverings; attached fireplace doors and screens; garage door openers and controls; screens, storm windows and doors; landscaping, fences, and mailboxes, if any; and \_\_\_\_\_

but does not include: \_\_\_\_\_

2. **PURCHASE PRICE:** The purchase price for the property is \$\_\_\_\_\_

3. **METHOD OF PAYMENT:** All payments must be in the form of cash, certified check, cashiers check, or money order. The purchase will be completed by the following method:

- CASH:** Buyer will pay the purchase price in cash upon Seller's delivery of a warranty deed conveying marketable title.
- NEW MORTGAGE:** This Agreement is contingent on Buyer's ability to obtain a \_\_\_\_\_ mortgage loan in the amount of \$\_\_\_\_\_. Buyer will provide evidence of mortgage application and appraisal order from Buyer's lender within \_\_\_\_\_ days of the date of this Agreement. If Buyer fails to deliver to Seller evidence of the loan approval before \_\_\_\_\_, 20\_\_\_\_\_, Seller may cancel this Agreement. The sale will be completed upon Seller's delivery of a warranty deed conveying marketable title.
- LAND CONTRACT:** Buyer will purchase the property on land contract with a \_\_\_\_\_ down payment and monthly installments of principal and interest in the amount of \$\_\_\_\_\_ or more, including annual interest of \_\_\_\_\_ percent. Buyer will pay the entire balance, which may require a lump-sum payment, within \_\_\_\_\_ years after closing.
- MORTGAGE ASSUMPTION or LAND CONTRACT ASSIGNMENT:** If the holder of the mortgage or land contract agrees, Buyer will assume and pay Seller's existing mortgage or land contract according to its terms. Buyer will pay the difference between the purchase price and the existing balance of approximately \$\_\_\_\_\_ upon Seller's delivery of a warranty deed or a land contract assignment. Buyer will reimburse Seller at closing for any funds held in escrow.

4. **TITLE INSURANCE:** Seller shall provide to Buyer, at Seller's expense, an owner's policy of title insurance with standard exceptions in the amount of the purchase price. Seller will apply for a commitment for title insurance within \_\_\_\_\_ days after the Buyer has waived all other contingencies contained in this Agreement. Any special exception will be subject to Buyer's approval, provided that this contingency shall be deemed waived unless Buyer notifies Seller in writing within \_\_\_\_\_ days of receipt of the commitment. Seller will have 30 days after receiving written notice to remedy any claimed defect.

5. **PROPERTY INSURANCE:** Seller shall be responsible for fire and extended coverage insurance on the property until sale is closed.
6. **CLOSING COSTS:** Seller shall pay all state and county transfer taxes and costs required to convey clear title. Buyer shall pay the cost of recording the deed and/or security interests and all mortgage closing costs and fees required in connection with the Buyer's loan and the issuance of the lender's title insurance policy.
7. **REAL ESTATE TAXES:** Seller will pay all prior years' real estate taxes. The current year's real estate taxes will be paid as follows:
- NO PRORATION:** Seller will pay the taxes which are due before the date of closing. Buyer will pay taxes which are due on or after the date of closing. "Due" means the date on which a tax becomes payable.
  - PRORATION:** With current year taxes treated as though they are paid in  arrears  advance, based on a  calendar year  fiscal year.
  - OTHER:** \_\_\_\_\_
8. **SPECIAL ASSESSMENTS:** All special assessments for municipal improvements which have become a lien on the property shall be paid by the Seller, provided, however, that in the event a special assessment is payable in installments, current and future installments shall be  allocated between Seller and Buyer using the same method for the proration of real estate taxes in paragraph 7 above; or  paid in full by Seller at closing.
9. **MISCELLANEOUS PRORATED ITEMS:** Rent, association fees, insurance (if assigned) and fuel, as well as interest on any existing land contract, mortgage or other lien assumed or to be paid by the Buyer, will be prorated to the date of closing.
- Additional items: \_\_\_\_\_
- 
10. **CLOSING DATE:** Sale to be closed on or before \_\_\_\_\_, 20 \_\_\_\_\_.  
 11. **OCCUPANCY:** Seller will give occupancy as follows:
- Immediately after closing
  - \_\_\_\_\_ days after closing by 12:00 noon. From the date of closing to the date of vacating, Seller will pay Buyer \$\_\_\_\_\_ per day as an occupancy charge. At closing, Seller will pay \$\_\_\_\_\_ to Listing Broker to be held in escrow. After Seller shall vacate the property, Listing Broker will use these funds to pay the accrued occupancy charge to Buyer and refund the balance, if any, to Seller. Seller is liable to Buyer for damage to the property occurring after closing and before vacating, to the extent not covered by the Buyer's homeowners policy, as well as for any deductible portions of a covered claim.
- If tenants occupy the property, then:
- Seller will cause the tenants to vacate the property before closing.
  - Buyer will take the property subject to the rights of the tenants.
12. **SELLER'S DISCLOSURE:**
- Buyer acknowledges that a Seller's Disclosure Statement has been provided to Buyer.
  - Seller shall provide Buyer with a Seller's Disclosure Statement with Seller's acceptance of this offer. Pursuant to the Seller Disclosure Act, MCL 565.951, *et seq.*, Buyer will have 72 hours after hand-delivery of the disclosure statement (or 120 hours after delivery by registered mail) to terminate this Agreement by delivery of a written notice to Seller or Seller's agent.
13. **RELEASE:** Buyer and Seller acknowledge that neither Listing Broker nor Selling Broker, nor their respective agents, have made any representations concerning the condition of the property covered by this Agreement or the marketability of title, and Buyer and Seller release the Listing Broker and Selling Broker and their respective agents, with respect to all claims arising out of or related to this Agreement, any addendums or counteroffers; all claims arising from any purported representations as to the physical and environmental condition of the property covered by this Agreement or the marketability of title; and all claims arising from any special assessments and/or utility bills which have been or may in the

future be charged against the property covered by this Agreement and, in addition, agree to indemnify and hold harmless the Listing Broker and Selling Broker and their respective agents from any and all claims related to those matters.

14. **LEAD-BASED PAINT DISCLOSURE/INSPECTION (For residential housing built prior to 1978 only):** Buyer acknowledges that prior to signing this Agreement, Buyer has received a copy of the *Lead-based Paint Sellers Disclosure Form* completed by the Seller on \_\_\_\_/\_\_\_\_/\_\_\_\_, the terms of which shall be part of this Agreement. Buyer also agrees (check one below):

- Buyer shall have \_\_\_\_\_ days after the date of this Agreement to conduct an inspection of the property for the presence of lead-based paint and/or lead-based paint hazards. (Federal regulations require a 10-day period or other mutually agreed upon period of time.) If Buyer is not satisfied with the results of this inspection, upon notice from Buyer to Seller within this period, this Agreement shall terminate and any deposit shall be refunded to Buyer.
- Buyer hereby waives his/her opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

15. **LAND DIVISION ACT (For unplatted land only):** Seller and Buyer agree that the following statements shall be included in the deed at the time of delivery:

- (a) The grantor grants to the grantees the right to make \_\_\_\_\_ (insert "zero" or a specific number, as appropriate) division(s) under section 108 of the Land Division Act, MCL 560.108.
- (b) This property may be located within the vicinity of farm land or a farm operation. Generally accepted agricultural and management practices which may generate noise, dust, odors and other associated conditions may be used and are protected by the Michigan right to farm act.

**CAUTION:** If the space contained in subparagraph (a) above is left blank, the deed will NOT grant Buyer the right to any divisions.

16. **PROPERTY INSPECTIONS:** Buyer has personally inspected the property and accepts it in AS IS present condition and agrees that there are no additional written or oral understandings except as otherwise provided in this Agreement.

- This offer is contingent upon satisfactory inspections of the property, at Buyer's choice and at Buyer's expense, no later than \_\_\_\_ business days of the date of this Agreement. These inspections may include, but may not be limited to, structural and/or mechanical inspections, survey and site investigation, soil borings, as well as inspections for radon, pests, mold and/or asbestos. Buyer agrees to return the property to its prior condition after any inspections or tests. If Buyer is not satisfied with the results of any inspection, upon written notice from Buyer to Seller within this period, this Agreement shall terminate and any deposit shall be refunded to Buyer. In the event the Buyer neither removes the contingencies nor terminates this Agreement in the time provided, the Buyer shall be deemed to have waived this contingency. Any request by Buyer to modify this Agreement based on the results of an inspection shall terminate this Agreement unless: (a) the request is agreed to by Seller in writing, or (b) the Buyer removes the inspection contingency in writing within the time for inspections.
- Buyer acknowledges that Selling Broker/REALTOR® has recommended that Buyer obtain an inspection of the property by an inspector and/or a licensed contractor. Buyer does not desire to obtain an inspection of the property.

17. **EARNEST MONEY DEPOSIT:** Buyer deposits \$\_\_\_\_\_ to be held by \_\_\_\_\_ ("Escrowee") evidencing Buyer's good faith, which deposit shall be applied to the purchase price at closing.

If this offer is not accepted or title is not marketable, or insurable or if the terms of purchase are contingent upon ability to obtain a new mortgage or any other contingencies as specified, which cannot be met, this deposit shall be refunded to Buyer. In the event the Buyer and Seller both claim the earnest money deposit, the earnest money deposit shall remain in Escrowee's trust account until a court action has determined to whom the deposit must be paid, or until the Buyer and Seller have agreed in writing to the disposition of the deposit. (This paragraph may be subject to the arbitration provisions in paragraph 22 below.)

18. **DEFAULT:** If Buyer defaults, Seller may enforce this Agreement, or may cancel the Agreement, keep the deposit, and pursue legal remedies. If Seller defaults, Buyer may enforce this Agreement or may demand a refund of the deposit and pursue legal remedies. (This paragraph may be subject to the arbitration provisions in paragraph 22 below).

19. **LIMITATION:** Buyer and Seller agree that any and all claims or lawsuits which they may have against the Listing Broker and its agents and/or Selling Broker and its agents relating to their services must be filed no more than six (6) months after the date of closing of the transaction described in this Agreement. Buyer and Seller waive any statute of limitations to the contrary.

20. **ENTIRE AGREEMENT:** Buyer and Seller agree that this is the entire agreement between the parties and that there are no other written or oral understandings. Buyer and Seller further agree that this Agreement supersedes any and all prior agreements, understandings or representations made by the parties or their agents.
  21. **WALK-THROUGH:** Buyer has the right to walk through the property within forty-eight (48) hours prior to closing.
  22. **ARBITRATION:** Any dispute over the disposition of any earnest money deposits or claim arising out of or related to the physical condition of any property covered by this Agreement, included without limitation, claims of fraud, misrepresentation, warranty and negligence, shall be settled in accordance with the rules, then in effect, adopted by the endorsed provider of arbitration services for the Michigan Association of REALTORS®. This is a voluntary agreement between the Buyer and Seller. Failure to agree to arbitrate does not affect the validity of the Agreement. A judgment of any circuit court shall be rendered on the award or determination made pursuant to this Agreement. This Agreement is specifically made subject to and incorporates the provisions of the Michigan Uniform Arbitration Act, MCL 691.1681, *et seq.* This Agreement is enforceable only as to parties and brokers/agents who have agreed to arbitrate as acknowledged by their initials below. The terms of this paragraph shall survive the closing.

**INITIAL IF YOU AGREE TO ARBITRATE:**

Seller \_\_\_\_\_ Buyer \_\_\_\_\_ Listing Broker \_\_\_\_\_ Selling Broker \_\_\_\_\_

23. **ELECTRONIC COMMUNICATION:** As an alternative to physical delivery, the parties agree that this Agreement, any amendment or modification of this Agreement and/or any written notice or communication in connection with this Agreement may be delivered to the Seller in care of the Listing REALTOR® and the Buyer in care of the Selling REALTOR® via electronic mail or by facsimile via the contact information set forth above. Any such communication shall be deemed delivered at the time it is sent or transmitted. Seller represents and warrants that an electronic email address has been provided to Listing REALTOR® from which Seller may receive electronic mail. Buyer represents and warrants that an electronic email address has been provided to Selling REALTOR® from which Buyer may receive electronic mail. The parties agree that the electronic signatures and initials shall be deemed to be valid and binding upon the parties as if the original signatures or initials were present in the documents in the handwriting of each party.

24. **COUNTERPARTS:** This Agreement may be signed in any number of counterparts with the same effect as if the signature of each counterpart were upon the same instrument.
  25. **HEIRS, SUCCESSORS AND ASSIGNS:** This Agreement binds Seller, Seller's personal representatives and heirs, and anyone succeeding to Seller's interest in the property. Buyer shall not assign this Agreement without Seller's prior written permission.

## **26. OTHER CONDITIONS:**

27. THIS OFFER WILL EXPIRE ON \_\_\_\_\_, 20\_\_\_\_ at \_\_\_\_\_ A.M./P.M., or upon Seller's receipt of revocation from Buyer, whichever is earlier.

28. RECEIPT IS ACKNOWLEDGED BY BUYER of a copy of this Agreement.

Buyer Signature

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**Buyer Signature**

Print Name

Print Name

**BUYER'S ADDRESS**

Deposit in the form of  Personal Check  Other \_\_\_\_\_ received by \_\_\_\_\_  
Selling Broker/REALTOR®

Form A ©1995 Michigan Realtors®, Revised 8/13

Date \_\_\_\_\_, 20\_\_\_\_

**SELLER'S ACCEPTANCE**

29. THE ABOVE OFFER is hereby accepted \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
and/or see addendum attached hereto.

30. SELLER ALSO AGREES to pay the Listing Broker/REALTOR® named above a commission as stated in the Listing Agreement for the property.

31. RECEIPT IS ACKNOWLEDGED by Seller of a copy of this Agreement.

Seller Signature

Seller Signature

Print Name

Print Name

SELLER'S ADDRESS: \_\_\_\_\_  
\_\_\_\_\_

Date \_\_\_\_\_, 20\_\_\_\_

**BUYER'S RECEIPT OF ACCEPTANCE**

32. RECEIPT IS HEREBY ACKNOWLEDGED BY BUYER of the Seller's acceptance of Buyer's offer. In the event the acceptance was subject to changes from Buyer's offer, the Buyer agrees to accept said changes, as set forth in paragraph 29 above.

Date \_\_\_\_\_, 20\_\_\_\_

**BUYER'S RECEIPT OF ACCEPTANCE**

32. RECEIPT IS HEREBY ACKNOWLEDGED BY BUYER of the Seller's acceptance of Buyer's offer. In the event the acceptance was subject to changes from Buyer's offer, the Buyer agrees to accept said changes, as set forth in paragraph 29 above.

Buyer Signature

Buyer Signature

Print Name

Print Name

**Disclaimer:** This form is provided as a service of Michigan Realtors®. Please review both the form and details of the particular transaction to ensure that each section is appropriate for the transaction. Michigan Realtors® is not responsible for use or misuse of the form, for misrepresentation, or for warranties made in connection with the form.

## **Amendments and Addendums**

An **amendment** is a change or modification of a contract. Amendments are frequently used to change words, provisions, or clauses in pre-printed form contracts. An amendment is signed or initialed by all parties before, at the time of, or after the contract is signed.

*PRACTICAL APPLICATION: The seller and buyer have a signed purchase agreement that sets a closing date “within 30 days of contract acceptance.” The buyer is having trouble securing suitable financing and requests that the seller extends the closing date an additional 30 days. The seller’s agent draws up an amendment that changes the closing clause to read “within 60 days of contract acceptance” and has both the buyer and seller sign and date the amendment.*

An **addendum** adds additional terms, clauses, or provisions to an existing contract. It is not amending the contract but an addition to the contract. An addendum will refer to the contract it is impacting, but it does not change anything in the original contract. Like an amendment, an addendum is signed or initialed by all parties referenced in the original contract. Addendums in residential purchase agreements can include items such as a:

- Short Sale Addendum (which is a lengthier lienholder approval contingency),
- Septic Inspection Addendum,
- Condominium Association Addendum,
- Tenants and Parties in Possession, and other
- property disclosure addendums.

Even though the buyer should have received copies of all of the seller’s property disclosure forms before submitting their purchase offer, the disclosure forms should be added as addendums to the purchase agreement. When the buyer signs and dates the disclosure forms, they are officially acknowledging the receipt of the disclosures.

## **Section 4. Option Contract**

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In some cases, a buyer may wish to purchase the property in the future. This is often the case when a tenant would like to purchase the property in the future. Options can also be used on commercial property when a future condition, such as building permit approval or a zoning change, is obtained.

An **option contract** is between the property owner, called the optionor, and the future buyer or tenant called the **optionee**. The option contract grants the optionee the right to purchase the property at a fixed price by a certain date. An option is a unilateral contract. The buyer is not obligated to purchase the property, but the seller is obligated to the terms of the contract if the buyer decides to accept the option. An option contract restricts the right of the property owner from selling the property to another during the option period

without first receiving written authorization from the optionee that they waive their right to purchase.

Option contracts are not popular with sellers because of the loss of some of their bundle of rights during the length of the contract. Some option contracts are short, lasting less than 90 days, but others can last for several years in the case of commercial properties and developmental parcels. As compensation for the temporary loss of the owner's property rights, the buyer will pay an option fee. This is the consideration that legalizes the contract. If the buyer does not exercise their purchase option, the seller keeps the option fee.

If the optionee exercises their option, then a purchase agreement is created between the buyer and the seller at the purchase price stated in the option contract. The purchase agreement now creates a bi-lateral contract. It is strongly recommended that all parties seek the counsel of an attorney specializing in real estate before entering into an option agreement.

## Lease Options

A **lease option**, or lease with an option to buy, is a type of option contract between the owner/landlord and the tenant/future buyer. The lease option grants the tenant the right to purchase the property at the end of the lease agreement. Tenants who want to purchase a home but lack the down payment or mortgage approval will frequently seek leases with options to buy. Within an amount of time stated in the contract, the tenant has the *option* to purchase the property, but they are *not obligated* to buy it.

A lease with an option to buy involves two separate but related contracts: the lease agreement and the option contract. Lease option contracts can require an upfront option fee, which, according to the contract, may or may not be applied to the down payment. Frequently lease options include a fixed monthly payment that goes towards the down payment on the purchase. The option payment is in addition to the rent. The rent *is not applied* to the purchase price. Some lease option contracts state that if the tenant does not decide to exercise the option, all the option payments are forfeited.

Lease options sound like a great idea on the surface, but they are fraught with problems and can create legal nightmares. It is critical to become familiar with the state regulations that govern lease options and to involve the assistance of an attorney in these matters. An agent's fiduciary duties and ethical responsibilities will also make it necessary

to ensure that all parties to a lease option fully understand *all* of the terms, conditions, and risks involved.

## **Section 5. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. True or false. Before submitting an offer on a residential property, agents should submit a letter of intent to the seller's agent.
  - a. True
  - b. False
2. How is a purchase offer submitted on a listed property?
  - a. The buyer delivers the offer to the seller.
  - b. The buyer's agent delivers the offer to the seller.
  - c. The buyer's agent delivers the offer to the listing agent.
  - d. The buyer's agent delivers the offer to the seller's attorney.
3. What is the best purchase offer?
  - a. The offer with the highest price.
  - b. The offer with the quickest closing date.
  - c. The offer with the fewest contingencies.
  - d. The offer that best meets the seller's needs.
4. True or false. A seller can go back and accept the first offer if he does not like the counteroffer.
  - a. True
  - b. False
5. When is a purchase agreement legally accepted?
  - a. When the receiving party verbally agrees to the offer.
  - b. When the receiving party signs and dates the contract
  - c. When the seller is notified.
  - d. When the receiving party signs and dates the contract and the submitting party has been notified.
6. True or false. The property address, city, and state are all that is needed to identify the property in a purchase agreement.
  - a. True
  - b. False
7. What are common buyer contingencies?
  - a. Mortgage, inspection, property sale, and appraisal
  - b. Mortgage, personal property, inspection and liquidation
  - c. Financing, appraisal, move-in date and property sale.
  - d. Both B and C.
8. What is an escape clause?

- a. It allows the seller to continue to market the property during the due diligence period if the buyer has a property sale contingency.
  - b. If the seller finds another buyer, the first buyer must waive their property sale contingency and close or cancel the contract.
  - c. It allows the seller to cancel the contract with valid reason.
  - d. Both A and B.
9. True or false. An addendum modifies the original contract.
- a. True
  - b. False
10. True or false. In a lease with option to buy, all rent money goes towards the down payment.
- a. True
  - b. False

## Quiz Answers

1. True or false. Before submitting an offer on a residential property, agents should submit a letter of intent to the seller's agent.
  - b. False – Because commercial contracts are complex and drawn up by an attorney, a buyer submits a letter of intent to expedite the negotiation process.
2. How is a purchase offer submitted on a listed property?
  - c. The buyer's agent delivers the offer to the listing agent.
3. What is the best purchase offer?
  - d. The offer that best meets the seller's needs. The purchase price is not always the primary consideration. The seller will also want to weigh the terms of the offer as well.
4. True or false. A seller can go back and accept the first offer if he does not like the counteroffer.
  - b. False - A counteroffer voids the original offer.
5. When is a purchase agreement legally accepted?
  - d. When the receiving party signs and dates the contract and the submitting party has been notified. If an agent does not promptly notify the other party of the acceptance, their client could lose their offer to another party.
6. True or false. The property address, city, and state are all that is needed to identify the property in a purchase agreement.
  - b. False – the property description should also include the legal description or the property tax ID number.
7. What are common buyer contingencies?
  - a. Mortgage, inspection, property sale, and appraisal
8. What is an escape clause?
  - d. Both A and B. - An escape clause allows the seller to continue marketing the property if there is a property sale contingency. If the seller receives an acceptable offer from another buyer, the first buyer must either waive the contingency and proceed with the closing or cancel the contract.
9. True or false. An addendum modifies the original contract.
  - b. False - An addendum does not modify the contract, instead it adds additional terms, clauses, and provisions to an existing contract.
10. True or false. In a lease with option to buy, all rent money goes towards the down payment.
  - b. False – Only the lease option payment and possibly the upfront fee goes towards the down payment. The rent does not apply to the purchase price.

# **Chapter 18 Financing**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the primary sources of mortgage funding,
- the different types of real estate loans,
- the difference between a promissory note and a mortgage, and
- the three mortgage qualifications.

**OVERVIEW:** This chapter will help you to acquire a basic understanding of financing, including the different aspects of a mortgage. You will also learn where lenders obtain their funds and what happens to a mortgage after it is written.

## **Section 1. Types of Mortgages**

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A borrower has a wide variety of financing choices – from the conventional to the non-traditional. Within each broad category are slightly different loan packages. There is no way to cover them all, but here are the broad categories.

- **Conventional Loans** have a fixed-term that is not guaranteed or insured by a federal institution such as FHA or VA. They have stricter loan requirements and are usually sold to the secondary mortgage market. Those that are held inhouse by the lender are called **portfolio loans**.
- **Federal Housing Authority Loans (FHA)** is a government-insured mortgage with less stringent loan requirements, a smaller down payment, and a higher APR than a conventional loan. Borrowers who make a down payment of less than 20 percent must pay an upfront premium of 1.75% of the loan amount in addition to a monthly mortgage insurance premium based on the original loan amount. This mortgage is insured against a lender's loss if the foreclosure value is insufficient to cover the loan balance.
- **Veteran's Administration Loans (VA)** is a government-guaranteed mortgage available to armed service personnel, veterans, and their spouses, widows, widowers, and dependents. VA loans offer 100 percent financing, no private mortgage insurance, and competitive interest rates. The government guarantees that the lender will be protected against loss if the borrower defaults on the loan.
- **USDA Rural Development Loans** are, in fact, a payment assistance program offered by the United States Department of Agriculture Rural Development to low and very-low-income borrowers to obtain housing in rural areas. They also offer a guaranteed loan program for low and moderate-income households that requires only a 10 percent down payment.
- **Construction Loans** are used to fund the construction of an improvement. The lender releases the borrowed funds over time as the construction progresses. During the construction period, the borrower makes interest-only payments. Once the construction is complete, the loan is converted into a conventional mortgage.
- **Bridge Loans**, or interim financing, gap financing, or swing loans are short-term loans that allow a borrower to purchase another home before selling their current

residence. It rolls the two mortgages together into one payment and has a term of up to one year. They are more expensive than conventional financing.

- **Reverse Mortgages**, or a Home Equity Conversion Mortgage, converts home equity into monthly payments that are paid to the property owner. They are available to property owners who are 62 years or older. The loan balance increases as payments are made to the owner, but no repayments are required until the homeowner moves, sells, or dies.
- **Home Equity Loan**, also called a second mortgage, use the equity in a property (up to 85 percent) to obtain additional financing secondary to any other mortgages. The closing costs and introductory adjustable interest rates are low.
- **Home Equity Line of Credit (HELOC)** is a line of credit rather than a loan. The equity in the property is used as collateral. The borrower has access to funds like a credit card. Interest is only charged on the borrowed amount.
- **Commercial Loans** are a type of conventional financing for commercial, industrial, or developmental properties. They require a higher down payment and carry a higher interest rate. Most loans are amortized over 30 years but require a balloon payment after five, ten or fifteen years.
- **Seller Financing**. When a buyer makes regular periodic payments, plus interest, to the seller, this is called seller financing or a **land contract**. With seller financing, no lender is involved in the transaction. The land contract (which is like a mortgage) is recorded against the title and the buyer and seller create a promissory note that contains the terms of the loan. The agreement between the buyer and the seller to establish the terms of the seller financing is called a land contract. Most seller-financed loans will have a balloon payment after typically three to five years.

## **Section 2.      The Parts of a Mortgage**

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A property loan consists of two documents: the promissory note and the mortgage. While the term “mortgage” is used broadly to represent any lender-based loan on real property, it technically only refers to one half of the lending process.

### **Promissory Note**

The **promissory note** or financing instrument is a legally enforceable unilateral contract with an unconditional and unsecured promise made by a borrower, the payor, to pay the lender, the payee, a specified sum based on the terms contained in the contract. The promissory note will contain the amount of the debt, the method of payment, the term of repayment, and the rate of interest.

For the first several years, the majority of the loan payment will go towards the interest, and very little will be applied to the principal. The longer the borrower makes payments, the more principal is paid back every month. As the principal amount borrowed is paid back, the owner’s equity increases.

The promissory note will also contain a **nondisturbance clause** that ensures the rental agreement will continue under any circumstances. In the event of a foreclosure, the lender agrees not to terminate any leases on the property as long as the lessee continues to pay the rent.

The payor signs the promissory note, but the payee does not. A promissory note is a negotiable instrument meaning that the payee can negotiate or assign the note to another party. A loan that is sold to another lender is an example of this. Selling loans is how lenders recoup borrowed funds.

## Mortgage

Contrary to how we use the word in colloquial English, a mortgage is not a loan. A **mortgage** is a legal contract that conveys the property's equitable title (also called the security interest) from the property owner or buyer, the mortgagor, to the lender, the mortgagee, as *security for the promissory note*. When the property owner pledges property as collateral to secure a loan without transferring title to the lender, it is called **hypothecation**. When the loan is repaid in full, the mortgagee issues a **satisfaction of mortgage** or mortgage satisfaction document, which is recorded to return the title back to the property owner. Mortgages are recorded to establish lien priority.

In a **lien theory state**, if the borrower defaults on the loan, the mortgage gives the lender the right to foreclose on the collateral to satisfy the outstanding loan balance through a court foreclosure proceeding.

In a **title theory state**, the lender will take a **deed of trust** instead of a mortgage. The owner will give up the legal title of the mortgaged real estate but retain equitable title. A deed of trust functions in the same way as a mortgage, except the lender can bypass the court system during the foreclosure process. Deeds of trust were discussed back in Chapter 11, Section 3.

## Interest

The interest rate is the cost of borrowing money. It is a measure of national economic stability and the risk to the lender based on the borrower's qualifying factors. The United States Federal Reserve sets a base rate for risk-free U.S. Treasury securities. Lenders add a margin to the base rate to represent their risk tolerance and profit margin. The interest rate is expressed as an annual rate.



### CONFUSING WORD PAIRS

**MORTGAGOR:** the borrower

**MORTGAGEE:** the lender

*Remember that ORs have more (they own the house) and EEs receives the mortgage payment.*

There are four ways interest can be charged to a borrower. The type of mortgage is named after these four interest payments:

- **Fixed-Rate Mortgage** is a constant and stable interest rate for the full term of the loan. A fixed interest rate enables mortgage payments to remain constant.
- **Adjustable-Rate Mortgage (ARM)** includes a variable interest rate during the term of the loan. Periodically the interest rate is adjusted up or down to reflect current rates. When the interest rate changes, which usually happens annually, the payments change as well. Most mortgages will have a periodic rate cap that limits the increase per adjustment period. There should also be an aggregate cap that limits the total increase over the life of the loan.
- **Straight, Term Loan or Interest-Only Mortgage** requires the borrower to make only interest payments at the beginning of the mortgage. After a set term, payments begin to cover the principal, or the loan will require a balloon payment of all of the principal. The interest rate can be fixed or adjustable. During the interest-only payments, the mortgage balance does not decrease. If the payment amount is less than the incurred interest, the loan balance will increase during this time.
- **Hybrid ARM** combines features of both a fixed-rate and an adjustable-rate mortgage. The interest rate is fixed for the first three, five, or seven years and then it changes to an adjustable rate.

### MATH: Mortgage Calculations

Loan Balance: \$200,000

Interest Rate: 5%

Annual Interest: \$10,000

Solve for...

$$\text{Interest (Annual)} = \text{Loan Balance} \times \text{Interest Rate} = \$200,000 \times .05 = \$10,000$$

$$\begin{aligned}\text{Interest (Monthly)} &= \text{Annual Interest} \div 12 \text{ months} = \$10,000 \div 12 = \$833.33 \\ \text{or} &= \text{Interest Rate} \div 12 \text{ mo.} \times \text{Loan Balance} = (.05 \div 12) \times \$200,000 = \$833.20\end{aligned}$$

$$\text{Loan Amount} = \text{Annual Interest} \div \text{Interest Rate} = \$10,000 \div .05 = \$200,000$$

$$\text{Interest Rate} = \text{Annual Interest} \div \text{Loan Balance} = \$10,000 \div \$200,000 = .05 \text{ or } 5\%$$

The **annual percentage rate (APR)** reflects the *total annual cost of financing*, including the interest rate *plus* loan fees and mortgage points that are wrapped into the cost of the loan. Like the interest rate, the APR is expressed as a percentage. The Federal Truth in Lending Act requires that lenders disclose the APR. The consistency in reporting can be a reliable standard to compare loan costs. Knowing the APR gives a more accurate picture of the actual cost of the loan.



CHECK THIS OUT

The **Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)** created an extensive list of mortgage disclosure rules and consumer lending protections.

## Principal

**Principal**, as it relates to a mortgage, is the portion of the mortgage payment that applies to the repayment of the amount borrowed. There are two ways to repay the principal:

- **Amortization** is the gradual periodic repayment for the term of the mortgage. The loan ends when all of the borrowed amount plus the interest have been paid in full.
- **Balloon Payment** is a final lump sum payment of a partially amortized loan. It represents the loan balance after a series of payments have been made over a stated term.

## Mortgage Term

The time it takes to repay the loan is called the **mortgage term**. A typical residential mortgage will take either 15 or 30 years to repay. The longer the mortgage, the more interest the borrower pays, and the higher the total cost of the loan. Help clients understand that a lower payment does not always mean a cheaper loan.

**PRACTICAL APPLICATION:** A borrower gets a \$200,000 mortgage at an interest rate of 5 percent. If the borrower agrees to a 15-year term, he will have a monthly payment of \$1,582. If the borrower opts for a 30-year mortgage, then his payment will be only \$1,074. That is over \$500 less per month. If the borrower can afford both payments, which one is the better choice? Consider not just the monthly payment, but the total cost of the loan. The interest payments for the 15-year loan amount to \$84,686, whereas the 30-year loan will cost \$186,512 to borrow \$200,000!

## Mortgage Points

**Mortgage points**, also known as discount points, are prepaid interest fees paid to a lender at closing in exchange for a reduced interest rate. Buying points can lower the



### MATH: Calculating Mortgage Points

	Mortgage without Points	Mortgage with 1 Point
Mortgage Amount	\$200,000	\$200,000
Interest Rate	5.00%	4.75%
Term	30 Years	30 Years
<b>Monthly Payment</b>	<b>\$1,074</b>	<b>\$1,043</b>
Value	Cost	
1 Point	- 0.25%	1% of Mortgage
Formula		Calculation
Interest Reduction	Interest Rate - (# Points x 0.25)	5.00 - (1 x 0.25) = 4.75%
Cost of Point	Mortgage Amount x (# Points x 0.01)	\$200,000 x (1 x .01) = \$2,000
Annual Savings	(Mtg Pmt w/o Pts - Mtg Pmt w Pts) x 12	(\$1,074 - \$1,043) x 12 = \$364.18
Years to Recoup Cost	Cost of Point ÷ Annual Savings	\$2,000 ÷ \$364.18 = 5.5 Years

monthly mortgage payment. One point will lower the interest rate by .25 percent, and it will cost the borrower 1 percent of the mortgage amount.

## Mortgage Assumption

A mortgage assumption occurs when the buyer assumes the seller's mortgage. The buyer must meet conventional mortgage requirements to qualify. There are no loan closing costs except perhaps a transfer fee. Most mortgages no longer contain this clause and can initiate the acceleration clause (or due-on-sale clause) if a mortgage assumption happens without the lender's approval.

## Acceleration Clause

A mortgage will usually contain an **acceleration clause** that allows the lender to require the borrower to pay some or all of the remaining balance if the terms of the lending contract are breached. This is also known as a due-on-sale clause.

## Prepayment Penalties

Lenders make long-term income off the interest payments for the full length of the loan. If a borrower pays off the mortgage early, the lender will collect less than the anticipated interest. To prevent this, some mortgages contain a prepayment clause which will require a borrower to pay a **prepayment penalty** against the unpaid portion of interest. Since January 10, 2014, penalties are calculated using the percent of principal method.

Any loans that are insured or guaranteed by the federal government or that will be sold to the secondary mortgage market cannot contain a prepayment penalty. In addition, the Dodd-Frank Act requires that prepayment penalties on fixed-rate mortgages issued after January 2014 can only be charged during the first three years of the loan and for no more than 2 percent of the principal balance.

## Section 3. Qualifying for a Mortgage

Residential mortgages are qualified based on the borrower's credit scores, employment history, income, debt-to-income ratios, loan-to-value ratios, and the value of the real property being used as collateral. Qualifying for a mortgage is based on the "three C's" of underwriting: credit, capacity, and collateral and it is determined by an **underwriter**.

### Credit

To measure individual loan risk, lenders will examine a borrower's **credit score**, which measures a consumer's historical use of credit and their payment history. There are three major credit reporting companies: Equifax, Experian, and TransUnion. Their reports will include a list of outstanding loans, open credit accounts, payment history, closed accounts, and recent credit inquiries. Based on this information, a credit, or FICO, score is created that will range from a low of 300 to a high of 850. The higher the credit score the more reliable the borrower and the lower the investment risk to the lender.



#### CHECK THIS OUT

The **Equal Credit Opportunity Act (ECOA)** passed in 1974 and implemented through Regulation B makes it illegal for lenders and creditors to discriminate against people based upon race, color, religion, national origin, sex, marital status, age, or receiving public assistance. The Act also gives the consumer the right to know the specific reason why credit was denied or why the terms are less favorable than advertised.

### Capacity

The lender must also ensure that the borrower has the present capacity, or ability, to repay the loan. As a means to calculate the **debt-to-income ratio (DTI)** it is also called the housing expense ratio, lenders include the principal loan amount, loan interest, property taxes, homeowner's insurance, and private mortgage insurance (if required) in the total monthly mortgage payment. Lenders refer to this as **PITI**. The general rule of thumb is that the monthly PITI payment cannot exceed 28 (conventional) to 31 percent (FHA) of a borrower's gross (pre-tax) monthly income (called the front-end ratio) and the PITI plus HOA dues, condo fees, credit card payments, and any other loan payments cannot exceed 36 (conventional) to 43 percent (FHA) of the gross monthly income (called the back-end ratio) depending on the lender and choice of mortgage.



#### MEMORY HELPER

##### **PITI**

- P** – Principal
- I** – Interest
- T** – Taxes
- I** – Insurance



#### MATH: Calculate the Maximum Affordable Payment

Gross monthly pre-tax income: \$5,000

Front-end Ratio: 28%     $\$5,000 \times .28 = \$1,400 = \text{PITI}$

Back-end Ratio: 36%     $\$5,000 \times .36 = \$1,800 = \text{PITI} + \text{Other Dues & Debts}$

## Collateral

Most mortgages require the borrower to have an equity position of at least 20 percent of the market value or the appraised value – whichever is less. The more personal funds a borrower has invested into the property, the less likely they are to default on the loan.

Lenders will require a property valuation to establish the value of the collateral. If the loan is to be held in the lender's portfolio, they can opt for a **broker's price opinion (BPO)**, which is similar to a CMA that uses standardized forms. In all other cases, a lender will hire a real estate appraiser to complete an appraisal.

If a borrower contributes less than 20 percent, the lender will require the borrower to purchase **private mortgage insurance (PMI)** that protects the lender against a loss in the



### MATH: Calculate the Cost of Private Mortgage Insurance (PMI)

Mortgage Amount: \$150,000

Annual Rate for Private Mortgage Insurance (PMI): 1%

Monthly PMI Rate:  $1\% \div 12 \text{ Months} = .00083$

Monthly PMI Payment =  $\$150,000 \times .00083 = \$124.50$

event of a foreclosure. PMI typically costs the borrower annually between .55 to 2.25 percent of the original loan amount. The payment is made monthly at the same time as the mortgage payment.

Another part of the mortgage is the **loan-to-value ratio (LTV)**, which expresses the lienholder's debt interest in the real estate. The LTV is calculated by dividing the mortgage balance into the market value or appraised value (whichever is lowest). An LTV of 80 percent also means that the property owner has a 20 percent ownership interest in the real estate. The ownership interest is called **equity**. The LTV plus the equity must equal 100 percent of the property value.

## Section 4. The Secondary Mortgage Market

Where do lenders get the money to keep writing loans? It comes from the secondary mortgage market. The primary mortgage market is where loans are created between the lender and the borrower. The **secondary mortgage market** is where mortgage loans are sold to long-term investors.

### MATH: Calculate the Loan-to-Value Ratio (LTV)

Property Value: \$250,000  
Down Payment: \$50,000  
Mortgage Amount: \$200,000

$$\begin{aligned}\text{Owner's Equity} &= \text{Down Payment} (\$50,000) \div \text{Property Value} (\$250,000) = 0.2 \text{ or } 20\% \\ \text{Loan-to-Value} &= \text{Mortgage Amount} (\$200,000) \div \text{Property Value} (\$250,000) = 0.80 \text{ or } 80\%\end{aligned}$$

With non-portfolio loans, a lender makes their money from loan fees and paid mortgage points - not from the interest. Long-term investors purchase these mortgages in the secondary mortgage market because the periodic payments generate a reliable income stream.

Purchasers include institutional investors, private firms, and governmental agencies. There are three government-sponsored agencies under the Federal Housing Finance Agency that are the principal purchasers in the secondary mortgage market:

- Federal National Mortgage Association (Fannie Mae)
- Federal Home Loan Mortgage Corporation (Freddie Mac)
- Government National Mortgage Association (Ginnie Mae)

Mortgages are purchased in bulk and are pooled into similar loan types, which are sold in the secondary mortgage market as mortgage-backed securities, also known as mortgage-backed bonds. The securities are then sold in the open market to investors. The mortgages are held in the secondary mortgage market and the investors receive a share of the income generated by the pool of mortgages.

## **Section 5. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. The agreement that a buyer makes with a seller to make regular periodic payments plus interest is called:
  - a. Balloon Payment
  - b. Due on Sale Clause
  - c. Seller Financing
  - d. Adjustable Rate Mortgage
  
2. What are the two documents that make a loan legal?
  - a. Promissory note and mortgage
  - b. Promissory note and deed of trust
  - c. Mortgage and deed of trust
  - d. Either A or B.
  
3. What are the names of the three different ways interest rates can be charged?
  - a. Land contract, adjustable rate mortgage, and annual percentage rate
  - b. Annual percentage rate, hybrid ARM, and adjustable rate mortgage
  - c. Fixed rate mortgage, adjustable rate mortgage, and straight.
  - d. Fixed rate mortgage, land contract, and adjustable rate mortgage
  
4. What is the difference between the interest rate and the annual percentage rate?
  - a. The annual percentage rate reflects the total cost of financing including the interest rate, loan origination costs, mortgage points and other lender fees.
  - b. The interest rate is variable, and the annual percentage rate is fixed.
  - c. The interest rate is always higher than the annual percentage rate.
  - d. The annual percentage rate is variable, and the interest rate is fixed.
  
5. The gradual repayment of a loan in equal, or nearly equal, installments is called a \_\_\_\_\_.
  - a. mortgage term
  - b. interest rate
  - c. loan origination
  - d. amortization
  
6. What is a negative feature of an FHA loan?
  - a. The annual percentage rate is higher than conventional financing.
  - b. The borrower must pay a monthly mortgage insurance payment.
  - c. The borrower must pay an upfront mortgage insurance premium of 1.75 percent of the loan amount.
  - d. All of the above.
  
7. What are some positive features of a VA loan?
  - a. 100% Financing
  - b. No private mortgage insurance
  - c. Competitive interest rates
  - d. All of the above

8. What are the three C's of underwriting?
  - a. Credit, compensation, and collateral
  - b. Credit, capacity, and collateral
  - c. Credit score, co-signing, and capital
  - d. Capital, credit and collection
9. What does PITI stand for?
  - a. Promissory, interest, taxation, and inflation
  - b. Payment, internet, taxes, and insurance
  - c. Principal, interest, taxes and insurance
  - d. Payment, investment, title, and inflation
10. How do lenders get money to make loans?
  - a. They sell the loans to the secondary mortgage market.
  - b. They save the interest payments from borrowers.
  - c. They get funding from the Federal Reserve.
  - d. They use money in savings accounts.

## Quiz Answers

1. The agreement that a buyer makes with a seller to make regular periodic payments plus interest is called:
  - c. Seller Financing – The regular period payments plus interest made to a seller. It is also called a land contract.
2. What are the two documents that make a loan legal?
  - d. Either A or B. – A loan is made up of the promissory note and a mortgage or a deed of trust.
3. What are the names of the three different ways interest rates can be charged?
  - c. Fixed rate mortgage, adjustable rate mortgage, and straight – the fixed rate mortgage offers a stable interest rate; the adjustable rate mortgage offers a variable interest rate; and straight requires interest- only payments are made at the beginning of the mortgage.
4. What is the difference between the interest rate and the annual percentage rate?
  - a. The annual percentage rate reflects the total cost of financing including the interest rate, loan origination costs, mortgage points and other lender fees.
5. The gradual repayment of a loan in equal, or nearly equal, installments is called \_\_\_\_\_.
  - d. amortization
6. What is a negative feature of an FHA loan?
  - d. All of the above. The APR is higher than conventional financing and the borrower must pay mortgage insurance including an upfront mortgage premium.
7. What are some positive features of a VA loan?
  - d. All of the above. VA loans offer the borrower 100% financing, no private mortgage insurance, and competitive interest rates.
8. What are the three C's of underwriting?
  - b. Credit, capacity, and collateral
9. What does PITI stand for?
  - c. Principal, interest, taxes and insurance
10. How do lenders get money to make loans?
  - a. They sell the loans to the secondary mortgage market. Once a lender has a mortgage, they turn around and sell it to the secondary mortgage market where mortgage loans are sold to long-term investors.

# **Chapter 19 The Closing**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the duties of both the buyer and the seller during the closing,
- the documents used in a closing,
- the costs associated with a closing, and
- how commissions are paid.

**OVERVIEW:** This chapter is designed to help you understand what is involved in the closing process and the documents that are needed to complete it.

## **Section 1. Overview of the Closing Process**

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The transfer of title in exchange for payment is called the **closing**. A closing involves three groups: the seller, the buyer, and the closing agent. The **closing agent** facilitates the transaction, and they could be an agent from the title company, an attorney, lender, or the buyer or seller's broker.

There are two ways to close a real estate transaction:

- **Face-to-Face Closing.** These closings require the physical presence of each party or their representatives. It can be held at the office of a title or escrow company, lender, attorney, brokerage, or even at the county recorder. After the seller and the buyer have signed their side of the paperwork, the seller will officially deliver the deed to the buyer, and that concludes the closing. The appropriate documents are then taken by the escrow agent to the appropriate office and recorded in the correct order.
- **Escrow Closing.** An **escrow agent**, as a neutral third party, handles the closing. The parties may not ever see each other. The escrow agent could be an attorney, title company, or a title company agent that coordinates the closing. The escrow agent holds all transactional funds in an escrow account. Before the closing date, they will collect all the signed documents. Once everything is in order, the documents are recorded by the escrow agent, and then the proceeds are dispersed.

Closing on the real property will have two parts. First, the buyer and the seller acknowledge that all the conditions and contingencies of the purchase agreement have been satisfied. Next, there is the consummation of the contracts where the deed transfer takes place. If the buyer is getting a mortgage, there will be two closings. The first closes on the real property, and the second closes on the buyer's mortgage.

## **Section 2.      Closing Parties and Costs**

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Both the seller and the buyer will have responsibilities during the closing process. Let us examine the checklists for each party to the transaction.

### **Seller's Closing Checklist**

After the due diligence period, but before the closing, the seller will need to complete several critical items. The seller's agent should be mindful of the deadlines supplied by the closing agent.

At least one week before closing:

- ✓ Complete all required repairs,
- ✓ Fulfill all other seller-specific terms in the sales agreement,
- ✓ Request a loan payoff statement, as of the closing date, from all lienholders that are using the property as collateral,
- ✓ Provide current statements or invoices for prorated items,
- ✓ Provide the name, phone number, and account numbers for all utility services,

At least 24-hours before closing:

- ✓ Provide an **Affidavit of Title**, if required. This is a sworn statement specifying that the seller possesses title to the property and that no new defects in the title or additional liens have occurred since the date of the title examination.
- ✓ Review the settlement statement,

The seller may or may not need to attend the closing. Some documents may be able to be pre-signed with the closing agent or power of attorney can be given to their representative. Sale proceeds can be wired directly to their bank account.

Another item of consideration is the seller's tax consequences. Seller's should be encouraged to consult a Certified Public Accountant to help them assess any taxes that will be owed and how they could reduce them. The closing agent should supply the required Internal Revenue Service (IRS) tax forms. The seller's broker should confirm who is responsible for overseeing this area of the closing.

**Capital gains tax** is calculated based on the sales price less the cost basis and any closing costs. The **cost basis** is the original purchase price plus the original closing costs and any long-term improvements less any accumulated depreciation. All closing costs from the sale, such as broker's commission, recording fees, attorney costs, and other closing expenses are deducted from the sale proceeds. Depending on the taxpayer's filing status,

they may be eligible for additional deductions. A seller who files a joint tax return with their spouse will not be liable for capital gain taxes if the capital gains are less than \$500,000. If the property was owner-occupied within at least two out of the last years, then a single taxpayer can deduct \$250,000 and a married couple filing jointly can exclude \$500,000. Remember a real estate agent cannot exceed the boundaries of their license by giving financial advice.

### Buyer's Closing Checklist

After the due diligence period but prior to closing, the buyer will need to complete the following items:

At least one week before closing:

- ✓ Retain an attorney, if necessary,
- ✓ Review the seller's deed,
- ✓ Purchase homeowner insurance,
- ✓ Schedule the transfer of utilities, phone and garbage services,
- ✓ Fulfill all other buyer-specific terms in the sales agreement,
- ✓ File for a change of address,

At least 24-hours before closing:

- ✓ Complete a final property inspection to make sure that:
  - the property is in the same or better condition than the original inspection,
  - the seller has not removed any items that are included in the purchase agreement,
  - the seller has removed all items that are not included in the purchase agreement,
  - all trash and debris have been cleared off the property, and
  - the agreed repairs have been completed to the buyer's satisfaction.
- ✓ Review the Loan Estimate Statement,
- ✓ Review the Closing Disclosure Statement,
- ✓ Review the settlement statement,
- ✓ Make arrangements to cover the closing costs with a wire transfer, cashier's check, or certified check.

### MATH: Calculate Capital Gains

#### Calculate Net Sales Price

Sold Price	\$ 335,000
Closing Costs (1%)	- \$ 3,350
Commission (8%)	- \$ 26,800
<b>Net Sales Price</b>	<b>\$ 304,850</b>

#### Calculate Adjusted Basis

Basis (Purchase Price)	\$ 225,000
Acquisition Costs (2%)	+ \$ 4,500
Capital Improvements	+ \$ 25,000
Claimed Depreciation	- \$ 15,000
<b>Adjusted Basis</b>	<b>\$ 239,500</b>

#### Calculate Capital Gains

Net Sales Price	\$ 304,850
Cost of Acquisition	- \$ 239,500
<b>Capital Gain</b>	<b>\$ 65,350</b>

If the final inspection reveals any problems or concerns with compliance with the terms of the purchase agreement, the seller's agent should be contacted immediately. The time to open any new negotiations, however, has passed. Always work through the seller's agent and not directly with the seller.

**PRACTICAL APPLICATION:** As per an addendum to the purchase agreement, the seller agreed to repair a portion of the water-damaged ceiling. At the pre-closing inspection, the buyer noticed that the work had not been completed. After a discussion with the seller's agent, it is agreed to withhold \$2,500 from the closing until the work is completed.

## Other Parties to the Closing

### Real Estate Broker

In addition to standard fiduciary duties to their client, the state may also require licensed agents to handle certain activities pertaining to closings. This would certainly include helping their client complete the items on the closing checklist. Unless directed by their client, agents should be present at the closing.

### Title Agent

The **title agent** will review the title commitment or abstract. To ensure that no additional liens have been filed since the initial title search, a final title search will be completed shortly before the closing. This is called a bring down.

### Attorney

Some states do not require an attorney at closing. Regardless of the state requirement, an agent should never discourage a client from using an attorney at any time during the transaction. An attorney should provide an opinion of title by reviewing the abstract of title and providing a statement of the quality of the seller's title.

### Lender

The seller's lender(s) will provide a payoff statement based on the closing date. The payoff statement will show the loan balance, any unpaid interest, credits for prepaid tax and insurance reserves, any prepayment penalties, and the fee for issuing either the certificate of satisfaction or the release deed.

The buyer's lender will have the mortgage documents ready for the closing. The buyer will be given adequate time to review these documents before the closing. The buyer's lender will work with the closing agent to ensure that funds are available to complete the closing.

## Closing Costs

The closing costs are divided between the buyer and the seller. If the buyer requests that the seller covers some or all of their closing costs, it should have been clearly stated in the purchase agreement.

### DISPERSMENT OF CLOSING COSTS

	SELLER	BUYER
Lien Payoffs	✓	
Deed Preparation Fees	✓	
Filing Fees/Recording Expenses	✓	
Prorations of Property Taxes & Special Assessments	✓	& ✓
Prorations of Pre-Paid Expenses	✓	& ✓
Property Transfer Taxes	✓	or ✓
Broker Commission	✓	& ✓
Individual Attorney Fees	✓	& ✓
Owners Title Insurance Policy	✓	or ✓
Survey Fees (if required)	✓	or ✓
Home Inspection Fees	✓	or ✓
Homeowner Property Insurance		✓
Mortgage-related Closing Costs		
Appraisal Fees	✓	or ✓
Credit Report Fees		✓
Loan Fees		✓
Pre-Paid Mortgage Points		✓
Lender's Title Insurance Policy		✓
Mortgage Recording Tax		✓
Private Mortgage Insurance (if required)		✓
Property Taxes and Insurance Reserves (if required)		✓

### Prorating

Some ownership expenses have been prepaid by the seller, such as utilities, property taxes, and special assessments. Other ownership expenses that cover items in arrears may have a future due date. **Proration** divides a whole amount into daily or monthly portions that are then billed to the seller or buyer based on the date of ownership. Costs that are payable are a debit (-). Costs that are received are a credit (+).

**PRACTICAL APPLICATION:** Two months before closing, the seller spent \$600 to fill the propane tank. Based on past historical usage, it is determined that the tank will last six months. Thus, each month amounts to \$100 of propane usage ( $\$600 \div \text{six months}$ ). On the closing statement, the buyer will pay \$400 in prorated propane costs.

*The annual property taxes for the property total \$6,500. They are paid in arrears on December 31. The closing is scheduled for April 1<sup>st</sup>. Taxes are charged on a per diem rate of \$17.81 (\$6,500 ÷ 365). There are 90 days between January 1<sup>st</sup> and April 1<sup>st</sup> and thus \$17.81 x 90 = \$1,602.74. The seller will pay the buyer this amount at the closing.*

## Section 3.      Closing Documents

There are standard documents used at a real estate closing. Each state may include other documents in addition to these federally required forms:

- **Closing Disclosure Form (CDF).** This disclosure, which is also known as the settlement form, itemizes all the closing costs that the buyer and the seller are responsible for paying. It also itemizes the costs of the buyer's mortgage, including the interest rate, APR, prepayment penalties, and the total cost of the loan. It must be provided three days before closing on a loan. Prior to October 2015, it was referred to as the HUD-1 Settlement Statement and the Truth-in-Lending Disclosure Statement. This statement is required under Regulation Z.
- **Owner's Title Insurance Policy.** If a title insurance policy is required by state law, the lender, or has been requested by the buyer, it will be signed by the title insurance company and paid out of the closing costs.
- **Property Deed.** This is the document that transfers the title from the seller to the buyer. The seller signs it in the presence of a notary public. Some states require that the buyer sign the deed too. The deed must be recorded to protect the buyer's ownership rights.
- **IRS Forms.** This includes the Real Estate Transfer Report (IRS Form 5217), Combined Real Estate Transfer Tax Return (IRS Form TP 584), Proceeds from Real Estate Transactions (IRS Form 1099-S), and if applicable, the Foreign Investment in Property Tax Act (FIRPTA) certificate.
- **Property Disclosure Forms.** Receipt of the seller disclosure forms that were provided to the buyer before the closing will need to be acknowledged again.
- **Other Closing Documents.** Depending on the state requirements and the property being transferred, these following forms may be necessary:
  - Certificate of Occupancy
  - Homestead Exemption
  - Bill of Sale for personal property
  - Estoppel certificate on rental properties
  - Flood Insurance Policy
  - Land Contract
  - Lease
  - Lien Waivers
  - Trust Documents
  - Proration of property taxes, homeowner association dues, or utilities



### CHECK THIS OUT

Under the Truth in Lending Act, **Regulation Z** requires lenders to advise borrowers in writing of all costs that are associated with credit portion of a financial transaction.

- **Mortgage Closing Documents.** If the buyer is getting a mortgage to complete the purchase, these documents will be part of the closing.
  - **Loan Estimate Form.** This is a summary of the borrower supplied information as well as quoted loan terms such as the interest rate, monthly payment, and the total mortgage costs. The borrower signs it. It replaces the Truth in Lending statement and the Good Faith Estimate.
  - **Promissory Note.** This is signed by the buyer.
  - **Mortgage or Deed of Trust.** The borrower signs this document, and when recorded, it encumbers the property with a lien.
  - **Lender's Title Insurance Policy.** Similar to an owner's title insurance policy, it protects the lender against liens, debts, and title claims. The policy is paid for by the borrower and signed by the title company.
  - **Other Closing Documents.** Depending on the type of mortgage transaction, lender policy, or state requirements, the borrower may have to sign additional disclosures, riders, and affidavits.

## **Section 4. Commission Payments**

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Real estate agents that attend the closing will not be paid at the closing. The seller's compensation is paid out of the sales proceeds. The closing agent holds the payment in escrow. The closing agent will prepare a check or direct deposit made out to the brokerage firm. Once the brokerage receives the payment, the seller's managing broker will disperse the compensation to their agents and the buyer's managing broker. The buyer's managing broker will then disperse their compensation to their associates. If an attending agent is given a check at closing, it should be in the name of the brokerage firm – not the attending agent. The check should be promptly given to the managing broker, who will disperse the commission accordingly.

## **Section 5. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. At closing, which of the following closing costs is the seller typically responsible for?
  - a. Transfer Taxes
  - b. Broker Commission
  - c. The seller's prorated property taxes
  - d. All of the above
2. True or false. A seller who has lived in their home for 2 out of the past 5 years and files a joint tax return with their spouse will not be liable for capital gain taxes if the capital gains are less than \$500,000.
  - a. True
  - b. False
3. Why does a pre-closing inspection need to happen 24-hours prior to closing?
  - a. To make sure that the seller has not removed any items included in the purchase agreement.
  - b. To confirm that the condition of the property is the same or better than the original inspection.
  - c. To make sure that all the specified repairs have been completed.
  - d. All of the above
4. At closing, which of the following closing costs is the buyer responsible for?
  - a. Inspections
  - b. Survey Fees
  - c. Homeowner Insurance
  - d. All of the above
5. Who orchestrates the closing?
  - a. The buyer's agent
  - b. The seller's agent
  - c. The loan officer
  - d. The closing agent
6. Who records the deed?
  - a. Buyer's agent
  - b. Seller's agent
  - c. Closing agent
  - d. Lender
7. True or false. There is always only one closing in a real estate transaction.
  - a. True
  - b. False
8. How many days before the closing must the Closing Disclosure Form be delivered to the buyer?
  - a. 1 Banking Day

- b. 2 Banking Days
- c. 3 Banking Days
- d. 7 Banking Days

9. True or false. The seller must attend the closing.

- a. True
- b. False

10. True or false. The agent will receive their commission check at closing.

- a. True
- b. False

## Quiz Answers

1. At closing, which of the following closing costs is the seller responsible for?
  - d. All of the above. The seller is typically responsible for transfer taxes, commission, the owner's title policy, deed preparation fees, lien payoffs, and recording expenses.
2. True or false. A seller who files a joint tax return with their spouse will not be liable for capital gain taxes if the capital gains are less than \$500,000.
  - a. True. If the property was owner-occupied within at least two (2) out of the last (5) years, then a single taxpayer can deduct \$250,000 and a married couple filing jointly can exclude \$500,000.
3. Why does a pre-closing inspection need to happen 24-hours prior to closing?
  - d. All of the above. The buyer wants to confirm the condition of the property, that all repairs have been completed, that any items in the purchase agreement have not been removed if they shouldn't have been.
4. At closing, which of the following closing costs is the buyer responsible for?
  - d. All of the above. The buyer is responsible for inspections, survey fees, homeowner property insurance, and any mortgage-related closing costs.
5. Who orchestrates the closing?
  - d. The closing agent – the closing agent can be an escrow agent, attorney, or a title agent.
6. Who records the deed?
  - c. Closing agent. The closing agent records the deed. The closing agent can be a title agent or an attorney.
7. True or false. There is always only one closing in a real estate transaction.
  - b. False – if the buyer is getting a mortgage then there will be two closings, one for the real estate purchase and the other to close on the mortgage.
8. How many days before the closing must the Closing Disclosure Form be delivered to the buyer?
  - c. 3 Days - This form must be provided to consumers three business days before closing on a loan.
9. True or false. The seller must attend the closing.
  - b. False - The seller may or may not need to attend the closing. Some documents may be able to be pre-signed with the closing agent or power of attorney can be given to their representative. Sale proceeds can be wired directly to their bank account.
10. True or false. The agent will receive their commission check at closing.
  - b. False - an agent's compensation always is paid through the brokerage, never directly from the buyer or the seller.

# Chapter 20 Real Estate Appraisal

**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the definition of market value,
- the characteristics of value,
- the importance of determining the highest and best use, and
- the three processes involved in appraising real estate.

**OVERVIEW:** Real estate appraisal is a vital component of a sales transaction. This chapter will provide an overview of appraisal methodology and how it is different from a Comparative Market Analysis.

## Section 1. Introduction to Real Estate Appraisal

An **appraisal** is the process of developing an opinion of value on a piece of real property. The property being appraised is called the **subject property**. The person who is licensed to complete an appraisal is called the **appraiser**. The results of an appraisal are presented to the client in an appraisal report.

A real estate appraiser is a neutral and unbiased third party to a real estate transaction. They do not represent the seller or the buyer, and they do not work for the lender. They are simply hired to determine the value of a property. While brokers and agents are paid commissions, an appraiser is paid a flat fee that has no relationship to the property value. It is illegal for appraisers to accept a commission or base their fee on an appraised value.

### The Definition of Market Value

There are many different types of values an appraiser can determine, including insurance value, salvage value, or assessment value, but the most common objective is to determine the market value. The **market value** is the highest estimated price that a buyer would pay and a seller would accept in an open and competitive market. A more detailed definition of market value is set by *The Appraisal of Real Estate, 13<sup>th</sup> Ed.* as:

*The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under duress.*



### CONFUSING WORD PAIRS

**MARKET VALUE:** the opinion of a property's worth

**MARKET PRICE:** the asking, offer, or sales price of a property.

There is a marked difference between market value and market price. The market price is the asking price, purchase offer, or the sales price of a property, and it is *not always the market value*.

**PRACTICAL APPLICATION:** *The seller is moving to care for their infirm parents. They need to sell their home as quickly as possible. They list the home for \$185,000, and they receive an offer within the week. When appraised, the property is valued at \$205,000. The market price was \$185,000. The market value is \$205,000.*

## Comparative Market Analysis vs. Appraisal

All real estate appraisals must be completed by a licensed real estate appraiser. *Real estate agents, brokers, and sales associates are not allowed to appraise real property.* While an appraiser can prepare a CMA, a real estate agent *cannot* complete an appraisal. So, what are the differences?

- **Quality of Reporting.** Appraisers have received considerably more training and experience in property valuation and thus have the skills and experience to provide a more in-depth market analysis. All adjustments, conclusions, and opinions of value must have market-based justification.
- **Impartiality.** Appraisers are unbiased and neutral. They do not represent any party in the transaction – unlike real estate agents who have the fiduciary responsibility to represent the interests of their clients.
- **Use.** Only appraisals can be used by lenders to qualify a mortgage and as evidence in a court case. A CMA can only be used by a seller or buyer to establish a transaction price.

## Section 2. Licensing Requirements

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Licensing and certification happen at the state level. The Appraiser Qualifications Board (AQB) of the Appraisal Foundation has set minimum levels of education and experience to obtain an appraiser's license. There are three levels of licensing that allows for independent real estate appraisal

- A **Licensed Residential Real Property Appraiser** is licensed to appraise non-complex one-to-four family units and residential land with a transaction value of less than \$1,000,000 and complex residential properties less than \$250,000. They need a minimum of 150 hours of core curriculum education and obtain 1,000 hours of qualifying experience under the supervision of a licensed appraiser in no less than six months.
- A **Certified Residential Real Property Appraiser** is licensed to appraise one-to-four residential units without regard to the value or complexity. They need a minimum of 200 hours of core curriculum education, 1,500 hours of qualifying experience in no less than 12 months in addition to successfully completing at least 30 semester hours of college-level education or holding an associate degree or higher.

- A **Certified General Real Property Appraiser** is licensed to appraise all types of real property. They need a minimum of 300 hours of core curriculum education, 3,000 hours of qualifying experience in no fewer than 18 months, and 1,500 of the hours must come from commercial appraisal work under the supervision of a Certified General Real Property Appraiser. Applicants must hold a Bachelor's degree or higher.

## **Regulation of Real Estate Appraisal**

The Appraisal Foundation sets Congressionally authorized qualifications and professional standards for real estate appraisers. It consists of two independent boards: the Appraiser Qualifications Board (AQB) and the Appraisal Standards Board (ASB). The ASB prepares the *Uniform Standards of Professional Appraisal Practice (USPAP)* that all real estate appraisers must follow. USPAP establishes a code of conduct and ethical requirements, along with appraisal performance standards.

## **Section 3. Appraisal Value Concepts**

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The appraisal of real estate is based on the underlying principles of value. The forces behind these principles establish property value. The following list highlights some of the main principles of value:

- **Anticipation** states that value is created by the expectation that a specific event will occur. For example, the news that the area's largest factory will be closing can impact property values before the event occurs.
- **Conformity** states that a property will achieve maximum value when the surrounding properties have a similar style, condition, function, and use. For example, a 5,000 square foot mansion will have less value if it is surrounded by a manufactured housing park.
- **Contribution** states that a property feature is only worth what it contributes in value to the whole. For example, it costs \$20,000 to install a heated pool in Montana, but it only contributes \$5,000 to the market value. Thus, the pool is only worth \$5,000.
- **Progression** states that a property of lesser value is enhanced by its proximity to properties of higher value. For example, an older home in a neighborhood with larger newly constructed homes will have a higher value than if it was located in a neighborhood with similar older homes.
- **Regression** states that a property of greater value is negatively affected by its proximity to lower value properties. For example, a newer home in a neighborhood with older homes will have a lower value than if it was located in a neighborhood with similar newly constructed homes. Regression is the opposite of progression.
- **Increasing and Decreasing Returns:** the point that the added value of a feature, addition, repair, etc. is more (increasing returns) or less (decreasing or diminishing returns) than the actual cost of the item.

- **Substitution** states that an informed buyer will not pay more for a property than the price of an equally desirable substitute. For example, a buyer will not pay \$320,000 for a townhome if they can buy the identical model next door for \$285,000.
- **Supply and Demand** is the amount of a product available to buyers and the demand for that product which forms a relationship determining the price of that product. A buyer's or seller's market is based on the principle of supply and demand. For example, low interest rates create a buyer frenzy that drives up list prices because of the increase in demand.

## Highest and Best Use

The most fundamental principle of real estate appraisal is the principle of highest and best use. **Highest and Best Use** is the use of a property that is (1) physically possible, (2) legally permissible, (3) economically feasible, and (4) most profitable. Every property that is appraised must be run through each of the four tests of highest and best use – and they must be done in order. A proposed 24-unit apartment building may be physically possible, but if it is not zoned for multi-family use (not legally permissible), then it does not matter if it is economically feasible or the most profitable use of the site. An existing use of a property *may not be its highest and best use*.

**PRACTICAL APPLICATION:** *A two-story older home on a high-traffic road was recently rezoned as office/service. If sold as a residence, it would only fetch \$175,000. If it was converted into office use, then under the new zoning, it could easily sell for \$210,000. Hence, the highest and best use is as an office building, not the current use as a residence.*

## Section 4. The Appraisal Process

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A real property appraisal is a study of physical, economic, social, and political influences that impact property values along with an analysis of specific property data. An appraiser can use three different approaches to determine the value of a property. Each approach measures the value of the property through a different set of qualifications. The three approaches are the sales comparison approach, the cost approach and the income approach.

### The Sales Comparison Approach

The **Sales Comparison Approach** makes a direct comparison between the subject property and other similar recent sales. This approach is based on the principle of substitution. The sales comparison approach is considered the most reliable and accurate approach when appraising residential properties.

The appraiser will select at least three sold properties that are comparable to the subject property in location, site size, square footage, bedroom and bathroom count, age, condition, and marketable features such as basements, garages, and pools. The appraiser will then make adjustments to the comparables based on market-based values. As a

Uniform Residential Appraisal Report										File #
There are comparable properties currently offered for sale in the subject neighborhood ranging in price from \$ to \$ .										
There are comparable sales in the subject neighborhood within the past twelve months ranging in sale price from \$ to \$ .										
FEATURE	SUBJECT	COMPARABLE SALE # 1			COMPARABLE SALE # 2			COMPARABLE SALE # 3		
Address										
Proximity to Subject										
Sale Price		\$		\$		\$		\$		
Sale Price/Gross Liv. Area		\$ sq. ft.	\$ sq. ft.	\$ sq. ft.	\$ sq. ft.	\$ sq. ft.	\$ sq. ft.	\$ sq. ft.		
Data Source(s)										
Verification Source(s)										
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	+(-) \$ Adjustment	DESCRIPTION	+(-) \$ Adjustment	DESCRIPTION	+(-) \$ Adjustment	DESCRIPTION	+(-) \$ Adjustment	
Sale or Financing Concessions										
Date of Sale/Time										
Location										
Leasehold/Fee Simple										
Site										
View										
Design (Style)										
Quality of Construction										
Actual Age										
Condition										
Above Grade	Total	Bdrms.	Baths	Total	Bdrms.	Baths	Total	Bdrms.	Baths	
Room Count										
Gross Living Area	sq. ft.		sq. ft.			sq. ft.			sq. ft.	
S A L E S										
Basement & Finished Rooms Below Grade										
Functional Utility										
Heating/Cooling										
C O M P A R I S O N										
Energy Efficient Items										
Garage/Carport										
Porch/Patio/Deck										
Net Adjustment (Total)	<input type="checkbox"/>	<input type="checkbox"/>	\$	<input type="checkbox"/>	<input type="checkbox"/>	\$	<input type="checkbox"/>	<input type="checkbox"/>	\$	
A P P O F Comparables	Net Adj.	%		Net Adj.	%		Net Adj.	%		
	Gross Adj.	%	\$	Gross Adj.	%	\$	Gross Adj.	%	\$	

measure of the similarity of the comparables, the total net adjustment should be less than 15 percent and the gross adjustments below 25 percent for each comparable. The adjusted sales prices are then used to determine a value for the subject property based on this approach to value.

## The Cost Approach

The **cost approach** values the subject property by estimating the cost to construct all the improvements less any depreciation or obsolescence plus the value for the site. This approach is also based on the principle of substitution. A buyer would not be willing to pay more for a property than the cost to buy vacant land and construct the same improvements. This approach to value is the most accurate on recently constructed

properties or special-purpose buildings that have a unique use or purpose. It can receive additional weight if there is a lack of comparable sales data.

The appraiser will first determine the value of the site, as if it was vacant, by analyzing similar vacant sites that have been recently sold. Next, the appraiser will utilize local contractor estimates, market data, and cost estimating manuals to determine the construction costs and value of the site improvements. The appraiser then factors in the **depreciation**, which is a loss of value from any cause. The causes of depreciation are:

- physical deterioration which is known as wear and tear and can be curable or incurable,
- functional obsolescence which is a loss of value due to inadequacies or super adequacies (i.e., one bath to three bedrooms or a \$35,000 kitchen in an 800 square foot house), and
- external obsolescence which measures the financial impact of external factors that impact the subject property (i.e., a residential property surrounded by commercial buildings).

Depreciation only applies to improvements, not the land. The appraiser totals all of the individual components to determine the market value according to the cost approach.

COST APPROACH TO VALUE (not required by Fannie Mae)								
Provide adequate information for the lender/client to replicate the below cost figures and calculations.								
Support for the opinion of site value (summary of comparable land sales or other methods for estimating site value)								
COST APPROACH	ESTIMATED <input type="checkbox"/> REPRODUCTION OR <input type="checkbox"/> REPLACEMENT COST NEW			OPINION OF SITE VALUE ..... = \$				
	Source of cost data	Dwelling	Sq. Ft. @ \$ .....	= \$				
	Quality rating from cost service	Effective date of cost data		Sq. Ft. @ \$ .....	= \$			
	Comments on Cost Approach (gross living area calculations, depreciation, etc.)			Garage/Carport	Sq. Ft. @ \$ .....	= \$		
				Total Estimate of Cost-New	.....	= \$		
				Less	Physical	Functional	External	
				Depreciation				= \$( )
				Depreciated Cost of Improvements	.....	= \$		
				"As-is" Value of Site Improvements	.....	= \$		
	Estimated Remaining Economic Life (HUD and VA only)	Years	Indicated Value By Cost Approach .....			= \$		

## The Income Approach

The **Income Approach** converts an income stream into a market value. It determines the present value of a future income stream. It is only used in a residential appraisal if it is a rental property or if it could support a higher market value if it were rented. There are two methodologies used in residential appraisals:

- **Gross Rent Multiplier (GRM).** The GRM is the ratio between a property's market value and the annual gross income. This method has several limitations: It does not factor in any expenses which can vary significantly between investments, and

it does not accurately reflect the motivation of investors in the marketplace who are more interested in cash flow rather than gross income. The formulas are:

$$\text{Market Value} \div \text{Annual Gross Income} = \text{Gross Rent Multiplier}$$

$$\text{Annual Gross Income} \times \text{Gross Rent Multiplier} = \text{Market Value}$$



#### MATH: Calculate the Gross Rent Multiplier

<b>Market Value</b>	<b>\$295,000</b>
Monthly Rental Income	Unit 1      \$1,200
	Unit 2      +      \$1,200
Gross Monthly Income	<u>\$2,400</u>
	x      12
<b>Annual Gross Income</b>	<b>\$28,800</b>

#### Solve for the Gross Rent Multiplier (GRM)

$$\begin{array}{rcl} \text{Market Value} & \div & \text{Annual Gross Income} = \text{Gross Rent Multiplier} \\ \$295,000 & \div & \$28,800 = 10.24 \end{array}$$

#### Solve for the Market Value

$$\begin{array}{rcl} \text{Annual Gross Income} \times \text{Gross Rent Multiplier} & = & \text{Market Value} \\ \$28,800 \times 10.24 & = & \$295,000 \end{array}$$

- **Capitalization Rate (cap rate).** The cap rate is the ratio between a property's market value and the net operating income. It is the rate of return an income property will produce. The capitalization rate is used for income-producing commercial investments. A profit and loss statement (P&L) is used to determine the net operating income (NOI). The property's actual vacancy rate is compared to the market rate to measure accuracy. The P&L does not include any mortgage expenses. Even though it is a typical owner expense, it is not required for the operation of the property and it varies greatly between investors. The next step is to convert the income stream into a market value. As long as the P&L is accurate, this is a very effective approach in setting the market value and comparing investments of similar risk and utility. As a capitalization rate decreases, the market value increases. The formulas are:

$$\text{Net Operating Income} \div \text{Market Value} = \text{Capitalization Rate}$$

$$\text{Net Operating Income} \div \text{Capitalization Rate} = \text{Market Value}$$

INCOME APPROACH TO VALUE (not required by Fannie Mae)			
Estimated Monthly Market Rent \$	X Gross Rent Multiplier	= \$	Indicated Value by Income Approach
Summary of Income Approach (including support for market rent and GRM)			

 MATH: Calculate the Capitalization Rate

Market Value	\$295,000
Monthly Rental Income	
Unit 1	\$1,200
Unit 2	+ \$1,200
Gross Monthly Income	\$2,400
	x 12
<b>Annual Gross Income</b>	<b>\$28,800</b>
Less Vacancy Rate	10%
<b>Adjusted Gross Income</b>	<b>\$25,920</b>
<hr/>	
<b>Expenses</b>	
Property Taxes	\$1,300
Property Insurance	\$800
Property Management	\$1,800
Utilities	\$1,300
Repairs & Maintenance	\$2,600
	<hr/>
Total Expenses	\$7,800
<b>Net Operating Income</b>	<b>\$18,120</b>

**Solve for the Capitalization Rate**

$$\text{Net Operating Income} \div \text{Market Value} = \text{Capitalization Rate}$$
$$\$18,120 \div \$295,000 = 0.061 \text{ or } 6.1\%$$

**Solve for the Market Value**

$$\text{Net Operating Income} \div \text{Capitalization Rate} = \text{Market Value}$$
$$\$18,120 \div 0.061 = \$295,000$$

## Reconciliation

The final step in completing the appraisal report is to reconcile each of the three valuation methods into one single market value. If done correctly, the applicable approaches should be within five percent plus or minus of each other. Large variances between the approaches can indicate an error in the data or, most likely, the highest and best use.

**PRACTICAL APPLICATION:** A duplex is under a purchase agreement for \$325,000. The three approaches in the appraisal report are as follows: Sales Comparison Approach = \$320,000, Cost Approach = \$350,000 and the Income Approach = \$295,000. What is the estimated market value?

A direct average of all three is \$322,000, but is this the most accurate conclusion? If the duplex was constructed only a few years ago, the cost approach might contribute more to the value leading to a market value of \$329,000. If the property

*market is saturated with duplexes and the typical buyer is an investor, perhaps a value of \$315,000 would be more accurate. It is up to the appraiser to apply his knowledge of the market and the most typical purchaser to determine an accurate market value.*

## Reporting

An appraisal report must be in writing. Most residential appraisals will be completed using the *Uniform Residential Appraisal Report (URAR)*. This form has been approved to be used in all transactions and activities that require a written appraisal report. If additional information needs to be included, it can be attached as an addendum, or the appraiser can prepare a narrative report. Narrative reports are usually reserved for commercial appraisals. As the name implies, it involves a more narrated explanation of the subject property and the approaches to value.

## Understanding the Appraisal Report

A market value appraisal report will conclude with a single “Estimated Market Value,” however, it is more accurate to look at the whole appraisal as creating a range of value. A range of value is a more accurate indicator of the market value of the subject property.

**PRACTICAL APPLICATION:** *If a buyer receives 100 offers on a property, some of the offers will come in very high and others very low. If we removed the top and bottom 10 percent, the remaining 80 percent of the offers should be within 10 percent of each other, forming the market value range of the property. It represents the actions of a group of informed buyers in an open and competitive market, which is the definition of market value. The appraisal report is measuring the actions of typical buyers through the different approaches to value.*

Real estate agents will want to help their clients to understand the true nature of an appraisal report. An appraisal report that comes in higher or lower than the purchase price is most likely based on the actions of a *typical* buyer and may indicate that the actual seller or the buyer may have an *atypical* motivation. It could also be that the appraiser put more emphasis on an approach to value that more accurately reflects the marketplace or that, at the time of the appraisal, there was a lack of comparable sales in which to substantiate the market price.

The appraisal of real estate is not an exact science. It is an opinion of value based on the education, experience, and competence of the appraiser and the reliability of quantifiable market data. That being said, the role of a real estate appraiser is invaluable to a buy-sell transaction because it educates buyers and sellers, helps to prevent market bubbles, and controls unscrupulous lenders.

## **Section 5. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. Choose the best definition of market value.
  - a. The price a buyer is willing to pay.
  - b. The price a seller is willing to accept.
  - c. The highest estimated price that a buyer would pay and a seller would accept in an open and competitive market.
  - d. The highest sales price that is determined by a real estate appraisal.
  
2. What class of appraisal licensing can appraise any residential property without regard to value or complexity?
  - a. Licensed Residential Appraiser
  - b. Certified Residential Appraiser
  - c. Certified General Appraiser
  - d. Both B and C.
  
3. True or false. A Comparative Market Analysis can be used to get a mortgage.
  - a. True
  - b. False
  
4. True or false. A real estate appraisal can be used as evidence in a court case.
  - a. True
  - b. False
  
5. What are the three approaches to value in a real estate appraisal?
  - a. Sales Comparison Approach, Construction Approach, Income Approach
  - b. Market Approach, Construction Approach, Rent Multiplier Approach
  - c. Sales Comparison Approach, Cost Approach, Income Approach
  - d. Sales Comparison Approach, Cost Approach, Rent Multiplier Approach
  
6. True or false. An appraiser will adjust the subject property to equal the comparables.
  - a. True
  - b. False
  
7. True or false. A house with five bathrooms and three bedrooms is an example of functional obsolescence.
  - a. True
  - b. False
  
8. True or false. The Gross Rent Multiplier is more accurate than a market-derived Capitalization Rate.
  - a. True
  - b. False
  
9. What is the formula for the capitalization rate?
  - a. Net Operating Income ÷ Market Value = Capitalization Rate
  - b. Gross Potential Income ÷ Market Value = Capitalization Rate

- c. Net Operating Income x Market Value = Capitalization Rate
- d. Market Value ÷ Net Operating Income = Capitalization Rate

10. True or false. A real estate appraisal establishes an estimated market value and also a market value range.

- a. True
- b. False

## Quiz Answers

1. Choose the best definition of market value.
  - c. The highest estimated price that a buyer would pay, and a seller would accept in an open and competitive market.
2. What class of appraisal licensing can appraise any residential property without regard to value or complexity?
  - d. Both B and C. - both Certified Residential Appraisers and Certified General Appraisers can appraise any residential property without regard to value or complexity.
3. True or false. A Comparative Market Analysis can be used to get a mortgage.
  - b. False – Only a real estate appraisal can be used to get a mortgage
4. True or false. A real estate appraisal can be used as evidence in a court case.
  - a. True – A real estate appraisal can be used as evidence in a court case but a comparative market analysis cannot.
5. What are the three approaches to value in a real estate appraisal?
  - c. Sales Comparison Approach, Cost Approach, Income Approach
6. True or false. An appraiser will adjust the subject property to equal the comparables.
  - b. False – the appraiser will adjust the *comparables* to equal the subject property
7. True or false. A house with five bathrooms and three bedrooms is an example of functional obsolescence.
  - a. True – Functional obsolescence measures the loss of value due to property related inadequacies or super adequacies.
8. True or false. The Gross Rent Multiplier is more accurate than a market-derived Capitalization Rate.
  - b. False – the gross rent multiplier does not factor in the expenses which varies greatly between investments and it does not accurately reflect the motivation of investors in the marketplace.
9. What is the formula for the capitalization rate?
  - a. Net Operating Income ÷ Market Value = Capitalization Rate
10. True or false. A real estate appraisal establishes an estimated market value and also a market value range.
  - a. True – the market value range is created by each of the adjusted comparable sales and each of the approaches to value.

# **Chapter 21 Real Estate Investing**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the advantages and disadvantages of real estate investing,
- investment options,
- how leverage affects real estate investment, and
- the difference between the capitalization rate and the return on investment.

**OVERVIEW:** Real property is not always purchased to be owner-occupied. Real estate is also a very lucrative source of income and wealth. Real estate professionals will be working closely with investors. It will be helpful to understand what motivates investors and how they measure a successful investment.

## **Section 1. Overview of Investing**

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There are two broad types of buyers: homeowners and investors. Up to this point, we have focused on homeowners; however, investors make up a large percentage of property buyers. An investor willing gives up a current asset, money, in exchange for future benefits, an income stream or realized gains. The investor anticipates that the money earned will exceed the money spent.

### **Investing Advantages**

Investing in real estate carries some measurable advantages over other non-tangible forms of investing, such as stocks and bonds. Let us consider some of these:

- **Cash Flow.** A primary motivation for investing in an income-producing property is to generate cash flow or spendable income.
- **Price Appreciation.** Over the long-term, almost all real estate appreciates. The investor gains the value appreciation at the sale or when leveraged. Price appreciation occurs through inflation and the increase of intrinsic value.
- **Above-Average Rates of Return.** Historically, investing in real estate generates a rate of return or yield, which is higher than other risk-similar investments.
- **Direct control.** Real estate offers an investor a greater degree of control over the asset than other options, including stocks, bonds, securities, or even REITs.
- **Tax Benefits.** Different tax incentives can make investing in real estate appealing. Standard income tax deductions include depreciation (or cost recovery), certain expenses, and cash flow losses. There are also options to defer capital gains and reduce or even eliminate estate taxes. Some properties can qualify for tax credits to encourage the revitalization of old buildings or the creation of low-income housing.

## **Investing Disadvantages**

Anything that requires an investment of time, energy, and money will carry a degree of risk. Real estate investment has a varying degree of risk that is unique to itself.

- **Risk.** Investing in an income-producing investment property does not guarantee a profit. The possibility of financial loss occurring as the result of owning a real estate investment is called **risk**. Real estate is subject to economic forces, acts of nature, and tenant default. These factors create risk.
- **Liquidity.** Unlike stocks and bonds, real estate investments cannot be quickly converted into cash. In order to facilitate a quick sale, an investor may need to lower the price substantially (reducing their investment gain).
- **Leverage.** The purchase of real property involves a considerable sum of money and usually requires financing to obtain. An investor must need to leverage the real estate in exchange for borrowing money. While an owner may hold the deed to the property, the lender will usually hold the majority interest.
- **Management.** An investment property requires a varying degree of management. Some properties, such as residential rentals can be very labor-intensive. A practical solution is to hire a property manager. This will, however, reduce the net income.

## **Section 3. Types of Investment Property**

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It is safe to say that if a property is not completely owner-occupied, then it is an investment property. The choices of investment properties are nearly endless. Each investor will have their investment criteria and personal motivation. There are two broad categories of investment property:

- **Unimproved Land.** Developers and investors purchase undeveloped land with the expectation that future development will provide a profit margin that exceeds the time and costs of the development. Because future growth, demand, and regional expansion can be unpredictable, investing in developmental land can carry a higher risk making it difficult to obtain lender financing.
- **Improved Land.** Investors often choose improved land as a way to satisfy market supply and demand. When there is demand for a property, there is reduced investment risk and a greater potential for return. Improved investment properties include office buildings, retail stores, recreational properties, residential rentals, apartment buildings, manufacturing, warehouses, mobile home parks, mixed-use, and transitional properties.

## **Section 4. Investment Options**

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There are various structures or options for investors to own real estate investments.

### **Direct Ownership**

One of the most common investment ownership options is through direct ownership. The investor and any partners have direct title ownership and decision-making capacities. The investors shoulder the burden of risk management, debt repayment, and cash flow management but they also receive all the net profits. The forms of direct ownership were discussed in detail in Chapter 10, Section 5.

### **Real Estate Investment Trust (REIT)**

An investor that would like the ease of a mutual fund investment plus the benefits of a real estate investment can direct their funds into a **real estate investment trust (REIT)**. The trust can invest direct property ownership, real estate mortgages, or a combination of both. For a fund to qualify as a REIT, at least 75 percent of the trust's income must come from real estate investment. Investors purchase stock in the trust, and then at least 90 percent of the taxable income is regularly distributed to shareholders.

### **Real Estate Mortgage Investment Conduit (REMIC)**

A **real estate mortgage investment conduit (REMIC)** is used to pool mortgage loans and issue mortgage-backed securities (MBS). Commercial and residential mortgages are pooled together based on risk and maturity. They are held in a trust and securities or bonds are issued to investors. The securities are then traded in the secondary mortgage market. Fannie Mae and Freddie Mac are two prominent issuers of REMICs. While REITs are a stock investment, REMICs invest in bonds.

### **Real Estate Syndicates**

A business venture whereby investors pool their resources to develop or own a real property investment is called a **syndicate**. Investors that lack sufficient capital to have direct property ownership can experience the benefits of contributing to a syndicate. It allows them to invest in properties and projects that are much larger than what they could afford or manage on their own. Members of a syndicate realize a pro-rated share of the net profit from management operations. The sale of the property will create an even greater return on the investment.

Syndicate members can hold property in joint tenancy or as tenants in common. They will function as either a limited partner or a passive member. The syndicate is usually

structured as a Limited Liability Company or a Limited Partnership with a sponsor (the manager and operator) participating as the General Partner or Manager.

Syndication is a real estate securities investment. A **real estate security** is the investment in real estate without having to buy land or buildings. Syndicates are subject to federal and state securities acts and “blue-sky laws” and are often not covered by a real estate license.

## Section 5. Investment Considerations

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When making an investment decision, an investor will consider a number of factors. Each factor will contribute to the success of the investment.

### Cash Flow

Cash flow measures the net operating income after removing all the expenses from the gross income. There are three variables that an investor can control: the rent and other sources of income, operating expenses, and debt repayment. If the income generated from the rents is not enough to cover all the expenses, a negative cash flow will result. One of the easiest ways to increase the cash flow is to keep operating expenses low. An investor, however, must be careful not to reduce operating expenses to the point that it impacts building condition, market value, or tenant desirability. The formula is:

$$\text{Gross Income} - \text{Operating and Capital Expenses} - \text{Debt Repayment} = \text{Cash Flow}$$

### Return on Investment (ROI)

The owner's **return on investment** is a profitability ratio that measures the profit made on an investment as a percentage of the cost of the investment. The return on an investment can be calculated for the property as a whole by using the capitalization rate and the return on the owner's actual investment costs by using the cash-on-cash return.

### Capitalization Rate

The **capitalization rate (cap rate)** measures the ratio between the market value (or purchase price) and the net operating income. It is a reliable way of comparing the returns on different types of properties. The capitalization rate does have limitations. It only measures the return on a cash investment. It does *not include* any debt payments. While it is useful to compare apples to oranges when making a purchase, it is not a particularly useful gauge after the investment has been made. The formula for the cap rate is:

$$\text{Net Operating Income} \div \text{Purchase Price (market value)} = \text{Capitalization Rate.}$$

## Cash on Cash Return

The owner's **cash-on-cash return (CoC)** or cash yield measures the actual return on the owner's out-of-pocket costs (down payment plus acquisition costs and loan fees). It is a more accurate gauge than the capitalization rate because it factors in the effect of the debt payments on the cash flow. The formula for the cash-on-cash return is:

$$\text{Pre-tax cash flow} \div \text{Owner's Initial Investment Costs} = \text{Cash-On-Cash Return}$$

## Leverage

The use of borrowed money to financing an investment is called **leverage**. The investor leverages a portion of their equity, by obtaining a mortgage, in exchange for cash. The use of leverage is a delicate balance between risk and return. Risk is directly proportionate to leverage. If the property cannot generate sufficient income to cover the expenses, the investor runs the risk of losing the investment to foreclosure.

On the surface, it would appear that leverage should be avoided wherever possible. However, this is not the case. As a rule, an investor can maximize their return by using other people's money to purchase an investment.

**PRACTICAL APPLICATION:** An investor is considering the purchase of a tri-plex. The purchase price is \$225,000. She has the resources to pay cash, but she also has qualified for a mortgage if she puts 30% down. Which purchase option will generate a more profitable return on her investment?

PROFIT & LOSS STATEMENT		PURCHASE PRICE	FINANCING TERMS
Annual Gross Income	\$29,160	<b>\$225,000</b>	Interest Rate 5.0%
Total Expenses	<b>-\$11,437</b>		Amortization 30 yrs
Net Operating Income	\$17,723		Down Payment 30%
CASH PURCHASE		MORTGAGE PURCHASE	
Owner Investment	\$225,000	Net Operating Income	\$17,723
<b>Return on Investment</b>	<b>7.9%</b>	Annual Debt Service	<b>-\$10,146</b>
		<b>Annual Cash Flow</b>	<b>\$7,577</b>
		Owner Investment	\$67,500
		<b>Return on Investment</b>	<b>11.2%</b>

Even though the cash flow to the owner is reduced by the annual debt service, the return on the investment increases by 3.3%. Because the investor only contributed \$67,500 to the purchase, she has \$157,000 left to invest in another property.

## Equity Buildup

Equity is the owner's financial interest in the property. At the time of purchase, the owner's equity is equal to the down payment. As the owner makes payments on the

principal portion of the mortgage, their equity increases. The accumulated equity can be converted into cash through the sale or refinancing of the property. Equity can be lost if the market value decreases.

## Section 6. The Sale of Investment Property

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A property's income stream creates a steady cash flow, like a trickle from a dam. The sale of the property opens the dam and releases a much larger one-time cash deluge.

### Capital Gains

Capital gain is the profit from the sale of a property. Capital gains are taxable as income. Thus, the Internal Revenue Service defines **capital gain** as the difference between the adjusted basis and the amount the seller gets when they sell an asset. The basis is the investor's initial cost of the real estate. An adjusted basis factors in the cost of all capital improvements made to the property that increases the market value since the purchase. Any claimed depreciation is then subtracted from the basis. The difference between the net sales price and the adjusted basis is the capital gain. The capital gain is taxed based on state and federal tax rates.

**PRACTICAL APPLICATION:** An investor has owned a tri-plex for the past ten years. She initially paid \$225,000 and 2% closing costs. Since the purchase, she has invested \$25,000 in renovations and claimed \$15,000 in depreciation. She has just closed on the sale of the property. The sales price is \$335,000. She paid a sales commission of 8 percent and closing costs of 1 percent. What is the investor's capital gain?

### CAPITAL GAIN ANALYSIS

Sold Price	\$335,000	Basis (Purchase Price)	\$225,000
Closing Costs (1%)	- \$3,350	Acquisition Costs (2%)	+ \$4,500
Commission (8%)	- \$26,800	Capital Improvements	+ \$25,000
<b>Net Sales Price</b>	<b>\$304,850</b>	Claimed Depreciation	- \$15,000
		<b>Adjusted Basis</b>	<b>\$239,500</b>
Capital Gain Calculation			
Net Sales Price	\$304,850		
Adjusted Basis	- \$239,500		
<b>CAPITAL GAIN</b>	<b>\$65,350</b>		

### 1031 Exchange

An investor can defer the payment of capital gains by immediately reinvesting the proceeds from a sale into another investment property by utilizing a 1031 Exchange. This is a tax reduction arrangement set up by the Internal Revenue Service (IRS). It allows

investors to sell a property and “exchange” them for another “like-kind” investment while deferring all the capital gain and depreciation recapture taxes.

A “like-kind” exchange can be any type of investment property exchanged for another type of investment property or any business property exchanged for another business property within the United States or U.S territory. It does not, however, include personal property, owner-occupied property, or properties that are primarily held for resale. A \$1,200,000 strip mall can be exchanged for three \$240,000 duplexes and a \$500,000 warehouse if the investor pays the additional \$20,000 difference.

If the investor decides to reinvest some of the sale proceeds and keep the remaining cash from the sale, the investor will owe capital gains tax on the unspent net profit called the boot. When an investor reinvests all of the sale proceeds, the taxes are deferred but not eliminated. Capital gains taxes accrue from each transaction until a property is sold without utilizing a 1031 exchange. There are a few requirements and strict Federal guidelines that must be followed to complete a valid exchange. It is essential that the investor work with a tax professional at the very beginning of the transaction.

## **Section 7. Quiz**

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. What is an advantage of real estate investing?
  - a. Cash flow
  - b. Price appreciation
  - c. Above-average rates of return
  - d. All of the above
  
2. What is a disadvantage of real estate investing?
  - a. Risk
  - b. Liquidity
  - c. Leverage
  - d. All of the above
  
3. What is a real estate syndicate?
  - a. A real estate securities investment
  - b. A conduit to pool mortgage loans and issue mortgage-backed securities
  - c. A business venture whereby investors pool their resources to purchase or develop real estate.
  - d. Both A and C.

4. True or false. Selling real estate securities is not usually covered by a real estate license.
  - a. True
  - b. False
5. What is the formula to calculate the capitalization rate?
  - a. Market value ÷ net operating income = capitalization rate
  - b. Net operating income ÷ market value = capitalization rate
  - c. Market value ÷ Pre-tax net income = capitalization rate
  - d. Market value ÷ gross income = capitalization rate
6. What best measures the actual return on the owner's out-of-pocket costs?
  - a. Gross Rent Multiplier
  - b. Capitalization Rate
  - c. Cash-on-Cash Return
  - d. Profit and Loss Statement
7. True or false. An investor can maximize their return by leveraging properties.
  - a. True
  - b. False
8. What are capital gains?
  - a. Increase in equity
  - b. The profit from the sale of a property
  - c. Improvements that increase property value
  - d. A measurement of inheritance tax
9. What is a 1031 Exchange?
  - a. A tax deferral arrangement set up by the IRS
  - b. A method to defer the payment of capital gains tax.
  - c. A method to defer depreciation recapture taxes.
  - d. All of the above.
10. If an investor decides not to reinvest all of the sales proceeds in a 1031 exchange, what is the unspent net profit called?
  - a. The boot
  - b. The shoe
  - c. The remainder
  - d. The tax

## Quiz Answers

1. What is an advantage of real estate investing?
  - d. All of the above – Cash flow generates spendable income, price appreciation increases property value over time, historically, real estate generates above-average rates of return.
2. What is a disadvantage of real estate investing?
  - d. All of the above - risk has a potential of financial loss, real estate cannot be quickly converted into cash, and the purchase of real property usually requires financing to obtain.
3. What is a real estate syndicate?
  - d. Both A and C. A syndicate is a business venture whereby investors pool their resources to develop or own a real property investment. Syndication is a real estate securities investment.
4. True or false. Selling real estate securities is not usually covered by a real estate license.
  - a. True - Syndicates are subject to federal and state securities acts and “blue-sky laws” and are often not covered by a real estate license.
5. What is the formula to calculate the capitalization rate?
  - b. Net operating income ÷ market value = capitalization rate
6. What best measures the actual return on the owner's out-of-pocket costs?
  - c. Cash-on-Cash Return - is a more accurate gauge than the capitalization rate because it factors in the effect of the debt payments on the cash flow.
7. True or false. An investor can maximize their return by leveraging properties.
  - a. True - As a rule, an investor can maximize their return by using other people's money to purchase an investment.
8. What are capital gains?
  - b. The profit from the sale of a property.
9. What is a 1031 Exchange?
  - d. All of the above. A 1031 exchange is a tax deferral arrangement set up by the IRS that defers the payment of capital gains and depreciation recapture taxes
10. If an investor decides not to reinvest all of the sales proceeds in a 1031 exchange, what is the unspent net profit called?
  - a. The boot - If the investor decides to reinvest some of the sale proceeds and keep the remaining cash from the sale, the investor will owe capital gains tax on the unspent net profit called the boot.

# **Chapter 22 Property Management**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to explain

- the duties and responsibilities of a property manager,
- the different kinds of leases,
- the rights and responsibilities of both the landlord and the tenant, and
- the eviction process.

**OVERVIEW:** A real estate sales license allows for the practice of property management. This chapter will go over the duties and responsibilities of a property manager, landlord, and tenant. It will also discuss common lease types, lease terminology, and the eviction process.

## **Section 1. Overview of Property Management**

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A rental property can be classified as residential (one-to-four units) or as commercial (five units or more). Both classes are officially labeled as an investment property or income-producing property. Trusts, condominiums, and cooperative homeowner associations, though not income properties, also benefit from property management.

A property owner who desires to reduce their management responsibilities and yet preserve and enhance their capital investment may decide to hire a property manager. A mortgage lender may also require professional property management as a form of income stream protection.

The **property manager** is an agent of the owner, and they have a fiduciary responsibility to maintain the investment and generate income. A property manager can be an individual or a property management company. Individual property managers can work independently or with a business. A property manager is allowed to manage multiple income properties for multiple clients at the same time. Building managers can work underneath a property manager to supervise the daily operations of a building. Some states require on-site building managers for large residential complexes.

## **Section 2. Responsibilities of the Property Manager**

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**Property management** covers the day-to-day activities of the management, maintenance, and leasing of income-producing properties. A property manager must possess the skill sets used in many different professions such as an advertising specialist, bookkeeper, building inspector, handyman, market analyst, negotiator, and salesperson.

## Duties of the Property Manager

Property managers are usually required by the state to have a real estate salesperson license or a separate property management license. Some states allow property managers who are directly employed by the owner to be unlicensed. The daily management of a rental property includes the following duties:

- **The development of a management plan** is a forward-looking plan to implement the owner's long-term goals. Factors that contribute to the plan's development include an analysis of the strengths and weaknesses of the subject property, market data, and budget development.
- **Leasing** is the process of locating and approving tenants, and it includes advertising, unit showings, tenant screening, preparing and executing leases, and determining market rents. Effective leasing includes analyzing market rents, occupancy rates, unit absorption, and competition.
  - All advertising must comply with federal and state laws, including nondiscrimination laws. Advertising mediums include the internet, social media, classified ads, radio, signage, and direct mail.
  - Market rent can be determined through an analysis of comparable rental properties. Residential rates are quoted per unit, and commercial properties are quoted as an annual price per square foot.
  - Vacancy rates are a good indicator of rental rates and management skills and are measured based on the market rate. A property's high vacancy rate indicates the rent is too high or the property is undesirable. Low vacancy rates indicate low rent, high demand, or excellent property management.
  - Tenant screening includes determining the ability of the tenant to pay the rent, their credit rating, and other factors. It is common to contact the tenant's previous landlords to learn about past performance. Financial qualifications must be applied equally to all applicants. Fair housing laws are strictly enforced in this area.
- **Rent collection** is one of the primary duties and includes assessing and collecting late fees and other rental add-ons such as parking fees, pet deposits, utilities, and common area charges.
  - State laws have strict requirements on the handling and protection of security deposits. These are to be held by the property manager in a trust or escrow account.
- **Maintenance and repairs** are necessary to maintain the utility and value of a property and include preventative and corrective maintenance, and property inspections. The property manager will either hire staff or contract with professionals to complete any maintenance and repairs.



### CHECK THIS OUT

The **Equal Credit Opportunity Act (ECOA)** requires property managers to use the same method of tenant screening for every applicant. If a credit report is pulled on one applicant, it must be pulled on all applicants. Financial screening must also be consistent.

- Preventative **maintenance** identifies and corrects issues before an item fails through scheduled maintenance. The annual servicing of an HVAC unit is an example of preventative maintenance.
- Corrective maintenance **repairs** an item that is broken, leaking, or has failed. These items require immediate attention and could cause damage to the building or create a physical hazard if not corrected. Repairing a broken water pipe is an example of corrective maintenance.
- **Accounting** tracks income deposits and expense payments. Accounting includes preparing periodic financial statements. It can also include the implementation of an annual operating budget and controlling expenses.
- **Communication** includes managing tenant complaints, scheduling maintenance personnel, and providing the owner with regular progress updates. At least once a year, the property manager should meet with the client to review and update the management plan.

A property manager's responsibilities *do not include* acting as the owner's selling agent. A separate brokerage agreement must be created.

## **Management Agreement**

A **management agreement** creates a general agency relationship between the property owner and the property manager and defines the duties and responsibilities of each party. The management agreement should be in writing. The contract should contain the following items:

- **Property description.** Such as the property address, tax identification number, or legal description.
- **Term.** The contract should identify the length of the contract, including commencement and termination dates.
- **Compensation.** The management fee or other forms of compensation should be clearly stated, as well as the frequency of payment.
- **Owner's expectations and responsibilities.** The owner should state their long-term goals, such as maximizing net income, increasing capital value, securing long-term tenants. The agreement should also define the owner's financial and managerial responsibilities, including the payment of taxes, insurance, and management fees.
- **Property manager's authority and responsibilities.** All of the manager's duties, limitations, and restrictions should be clearly defined. This would include subjects such as rental rate determinations, cost limitations, repair order authorizations, and the management of staff and independent contractors.
- **Management expense allocation.** The responsibility for the costs associated with the operation of the property manager's business, such as office rent, employees, utilities, and other expenses, should be determined.

- **Reporting.** The agreement should define the frequency, type, and detail of the manager's periodic financial and managerial reports. Be aware that the state may have established reporting regulations.
- **Liability insurance.** The report should indicate who is responsible for obtaining, maintaining, and paying for the policy. It should also require that the property manager be included as an additional insured.
- **Equal opportunity statement.** Residential property management agreements should explicitly state the manager's commitment to equal opportunity housing.
- **Termination clause.** This section should identify the provisions for termination, when notice of termination must be provided, any fees for early termination, and the obligations of both parties.

## Fiduciary Responsibilities

Under the management agreement, the property manager typically functions as a general agent. They will have the authority to make more decisions on behalf of the owner than a seller's agent. Their primary responsibility is to ensure the property produces the highest return while meeting the owner's expectations and adhering to federal and state laws.

Property managers must provide their clients with all the fiduciary responsibilities, including obedience, loyalty, disclosure, confidentiality, accounting and reasonable care.

## Management Fees

In exchange for these services, a property management company charges a maintenance fee. Typically, this fee is a percentage of the gross income, and the rate averages between six to eight percent. The management fee can also be fixed or a combination of both. In addition to the base fee, a property manager may also charge other fees such as leasing and renewal fees or supervision fees.

### MATH: Calculate Property Management Fees

Each unit in a 10-unit apartment building rents for \$900. Two units are vacant. The owner agrees to pay the property manager an 8% fee based on gross rents. What is the property manager's fee for this month?

10 Units x \$900 per unit.....	\$ 9,000
Less 2 vacant units.....	<u>-\$ 1,800</u>
<b>Gross Rent.....</b>	<b>\$ 7,200</b>

Property Management Rate.....	x 0.08
<b>Property Management Fee.....</b>	<b>\$ 576</b>



### MEMORY HELPER

#### OLD CAR

<b>O</b> - Obedience	<b>C</b> - Confidentiality
<b>L</b> - Loyalty	<b>A</b> - Accounting
<b>D</b> - Disclosure	<b>R</b> - Reasonable Care

The fees are negotiated between the agent and the principal. Management fees are subject to antitrust laws, just like real estate commissions. They cannot be standardized in the marketplace as it creates illegal price-fixing.

## Cash Flow Statement

The cash flow statement is one of the most valuable financial reporting tools. It measures the sources and amounts of income and expenses. It provides an accurate picture of the financial status of a property.

### Income

Sources of gross income include rents, late fees, vending machines, laundry facilities, storage charges, common area charges, utility reimbursements, parking spot rentals, and other similar charges. The property management agreement will need to define the sources of income upon which the management fee will be based. The fee should be calculated off on the actual income and not the projected income. It will factor in current unit vacancies and delinquent payments.

### Expenses

Real estate has both fixed and variable operating expenses. Fixed expenses have predictable amounts, such as property taxes and insurance. Variable expenses fluctuate from year to year and include items such as utilities, repairs, and property management fees. The expense section *does not include* any debt payments.

### Net Operating Income

The operating expenses are subtracted from the income to calculate the net operating income (NOI). The NOI does *not include* any mortgage or other debt payments.

### Cash Flow

The cash flow calculation subtracts any debt payments and capital reserves from the NOI. **Capital reserves** are the funds that are aside for the replacement of long-life building items such as the roof and HVAC systems. The cash flow is the actual pre-tax income to the owner that has been generated by the property.

Following is a sample cash flow statement. A cash flow report can be prepared monthly, quarterly, semi-annually, or annually. The **profit and loss statement** is similar in form but stops at the line for the net operating income.

## SAMPLE ANNUAL CASH FLOW

<b>INCOME</b>		
Rental Income		
Unit 1		10,800
Unit 2		10,800
Unit 3		10,800
	<b>Total Rental Income</b>	32,400
	Less Vacancy and Credit Loss	10% (3,240)
Other Income		
Laundry, vending, parking, etc.		-
	<b>Total Gross Income</b>	29,160
<b>EXPENSES</b>		
Fixed Expenses		
Property Insurance		1,458
Property Taxes		1,458
Variable Expenses		
Property Management Fees	7%	2,041
Utilities		3,240
Repairs and Maintenance		3,240
Homeowner or Condo Dues		-
Legal Fees		-
	<b>Total Expenses</b>	11,437
	<b>NET OPERATING INCOME</b>	17,723
Less Annual Debt Service		10,140
Less Capital Reserves		648
	<b>ANNUAL CASH FLOW</b>	6,935

### Section 3. Introduction to Leases

The legally binding contract that grants the tenant the right to use a property owned by another for a time in exchange for compensation is called a **lease agreement**. The property owner is called the **landlord** or **lessor**. The tenant is called the **lessee**.

#### Types of Tenancy

A signed lease creates a **leasehold estate**. In Chapter 10, Section 3, we discussed the four types of tenancy that can be created under a leasehold estate.



#### CONFUSING WORD PAIRS

**LESSOR:** the property owner

**LESSEE:** the tenant

*Remember that ORs have more (they own the property) and EEs receives the unit.*

- **Fixed-term Tenancy.** The lease has a fixed termination date. It is also called a tenancy for years.

- **Periodic Tenancy.** It is known as a month-to-month lease.
- **Tenancy at Will.** There is an indefinite term and can be terminated without notice.
- **Tenancy at Sufferance.** A tenant remains past the lease expiration or eviction date.

## Types of Leases

The type of lease payment classifies the lease type. Each category includes different payment requirements for each party. Residential leases are either gross or single net leases. Commercial leases will incorporate one of these main types.

### TYPES OF LEASES

LEASE TYPE	LESSEE (TENANT)	LESSOR (LANDLORD)
GROSS	Rent	Utilities Taxes and Insurance Repairs and Maintenance Capital Improvements
SINGLE NET (N)	Rent Utilities	Taxes and Insurance Repairs and Maintenance Capital Improvements
DOUBLE NET (NN)	Rent Utilities Taxes and Insurance	Repairs and Maintenance Capital Improvements
TRIPLE NET (NNN)	Rent Utilities Taxes and Insurance Repairs and Maintenance	Capital Improvements
ABSOLUTE NET	Rent Utilities Taxes and Insurance Repairs and Maintenance Capital Improvements	
PERCENTGE	Base Rent Percentage of Gross Sales (Possibly Some Utilities)	Taxes and Insurance Repairs and Maintenance (Some Utilities)

A lease can be fixed or variable. A variable or graduated lease allows for rent increases at specified terms during the lease, such as each year. An index lease will use the consumer price index or some other indicator to increase or decrease the rent periodically.

When a commercial company wishes to free up capital, they may sell the property and then lease it back. This is called a **sale-and-leaseback**. These leases are usually an absolute net lease and have terms that can last up to 30 years.

## Lease Agreement Requirements

A lease agreement governs the relationship and actions between a landlord and a tenant. A lease agreement is a legally binding contract and is subject to the same requirements that were discussed in Chapter 7, Section 3. Under a state's statute of frauds, lease agreements for one year or more must be in writing to be enforceable. Oral leases are enforceable if they are for one year or less.

Leases can be prepared by the property owner, a property manager, or an attorney. If it is a commercial lease or complex in nature, drafting a lease may constitute the practice of law. In these cases, the property manager or their client should obtain legal counsel. While there are preprinted lease forms, there is no such thing as a standard lease. A lease should contain, at a minimum, the following provisions:

- **Identification.** The lease should identify the lessor, lessee, any property managing agent, and the leased premises.
- **Lease term.** There should be a specific starting and ending date and the total period of the lease.
- **Rent and security deposit.** In order to create a legally binding contract, compensation must be stated. It should also state when, where, and to whom the rent payment should be made and the amount of the security deposit. A security deposit is used to cover the costs if the tenant defaults on the rent or damages the unit. State laws govern the amount, use, and return of security deposits.
- **Insurance.** While homeowner's insurance, including liability protection, must be kept on the building at all times, it is also common to require tenants to obtain renters insurance. The owner's policy does not insure the tenant's personal property. Commercial leases may require the tenant to obtain liability protection.
- **Restrictions.** Rules and regulations concerning the property use, number of occupants, subletting, assignment of leases, pets, and tenant improvements should be clearly stated. An assignment of lease clause transfers the leasehold interest to another. A sublease clause allows another party to rent the property, the original lessee, however, remains responsible to the lessor for the rent and any damage.
- **Responsibilities.** Landlord and tenant responsibilities should be clearly defined, including period inspection, advance notice, maintenance, and repairs. The lease should specify whom to contact in the event of a repair, accident, or complaint.
- **Destruction of premises.** The lease should define the actions of both parties in the event that the leased premises are destroyed or rendered uninhabitable.
- **Remedies.** Information about termination, evictions, breach of contract, and dispute resolution should also be included.
- **Option.** A lease may grant the lessee several options, but this is not required. The lessee may have a **renewal option**. Some leases allow the lessee a **purchase option**.

at a predetermined price and within a specified term. The lessee may also have a right of first refusal that allows the lessee the first opportunity to purchase the property if the lessor decides to sell.

- **Disclosures.** Some states require disclosures of rent control rules, flood zones, smoke alarm locations, nearby sex offenders, and the handling of the security deposit. Federal law requires landlords to include a lead disclosure form on all properties constructed before 1978.

## Section 4. Landlord and Tenant Rights

The state determines the rights and responsibilities of landlords and tenants. The differences from state-to-state will be minor. The rights of one party create a responsibility on the other to guarantee those rights. For example, the tenant has the right to privacy, which means the landlord has the responsibility to provide notice before entering.

### Landlord Rights

- **Right to protect their investment.** A landlord has the right to access the property to inspect, maintain, and repair the property. They also have the right to set minimum renting qualifications and screen applicants in harmony with the Fair Housing Act.
- **Right to payment.** The landlord has the right to collect rent and a security deposit in exchange for the tenant's use of the property.
- **Right to evict.** If a tenant breaches the lease agreement, a landlord has the right to follow the state procedure to evict the tenant.
- **Right to restrict use.** The landlord has the right to restrict residential properties from commercial uses and commercial tenants to a specific use. If a lease does not restrict the use, local ordinances will govern the use.



### WARNING!

The **Fair Housing Act** states that it's unlawful to discriminate against any person based on their race, color, national origin, religion, disability, sex, familial status, creed, marital status, sexual orientation, gender identity, military, HIV/AIDs, or Hepatitis C status.

### Tenant Rights

- **Right or covenant of quiet enjoyment.** The tenant has the right to occupy the premises without interference from the owner or anyone else. This means that the landlord, or their agent, must provide the tenant a minimum of 24-hours' notice before entering the property, except in emergencies. A lease agreement runs with the land, and if the lessor transfers the title, the new owner is bound to the lease agreement until it expires (even in a foreclosure) unless there is a sale clause in the lease or as provided by state law.
- **Right to safety.** The tenant has the right to live in a property that is safe and secure. This requires that landlords maintain the property in accordance with local building codes and standards. Each unit is guaranteed to have access to suitable plumbing, heating, and electricity under the **warranty of habitability**. A tenant may be able to

withhold rent if the property is not in a habitable condition. If the property was constructed before 1978, federal law requires lead disclosure.

- **Right to a service or companion animal.** Fair Housing laws permit a tenant to have a service or companion animal, even if the landlord has a no pet policy. The tenant, however, is responsible for paying for any damages. The landlord cannot demand pet rent or charge a pet security deposit. They cannot limit the type of animal, breed, or size unless the animal aggressively threatened someone or the landlord or one of their family members is living on-site, and they are allergic to the animal.
- **Right to make improvements.** A tenant is usually allowed to make improvements at their own expense with the landlord's permission. This includes accessibility modifications for a tenant with a disability. The landlord may require the tenant to restore the unit to the original leased condition, less wear and tear. Attached residential improvements become the property of the landlord. A tenant can remove commercial trade fixtures after the lease expires, provided that they restore the premises to its leased condition.
- **Right of control.** Commercial tenants in a property with single-occupancy are also granted the right of control. They are given more control over the use of the property. This right is not usually granted in a residential lease.

## **Section 5. Breaches and Eviction**

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If any party violates a lease provision, it is called a breach. The court system allows the innocent party to certain remedies as governed by state law. For example, a landlord can pursue an eviction. Both the landlord and their property manager *must* follow state eviction requirements. The state will require notice of the intent to evict plus a period of time to allow the tenant to either fix the problem, contest the eviction, or move out. Most states require anywhere from between three to ten-days' notice. If the landlord, or their agent, take action outside of the state-approved procedure (such as shutting off utilities or changing the locks), the tenant can sue the landlord and will usually win.

If the tenant continues to breach the lease, the landlord can file an unlawful detainer lawsuit. The court will serve the tenant with a summons and a complaint for eviction. The landlord cannot take any action until the court date. If the judge rules in favor of the landlord, the court will issue a judgment for possession along with a deadline for the tenant to move-out. The landlord now has to wait until that date. If the tenant remains in possession, then the sheriff, not the landlord, can enforce the judgment and forcibly remove the tenant and their possessions. Some states will allow a landlord the right to seize the tenant's property for nonpayment of rent, called the right to distrain. It will require a court order that grants permission to change the locks.

A tenant who abandons the lease, without the permission of the landlord, is still bound to the terms in the lease. That includes paying the rent and for any damage to the premises. A lease is terminated if any of the following conditions are met:

- All parties have fulfilled the terms of the lease,
- both parties agree to cancel the lease,
- under **constructive eviction** whereby the leased premises have become unusable due to the conscious landlord neglect,
- the tenant abandons and the landlord re-rents the premises (subject to state law),
- the owner of a life estate leased the property,
- the property is leased as a tenancy at will, and either party dies, or
- by operation of law such as an eminent domain action, bankruptcy, and some foreclosures.

## Section 6. Quiz

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*Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.*

1. True or false. A property manager is a representative of the property owner.
  - a. True
  - b. False
2. Which statement is true?
  - a. A property manager cannot collect the rent for a property owner.
  - b. A property manager cannot charge a percentage of the gross rent.
  - c. A property manager cannot turn off the electricity to force an eviction.
  - d. Both B and C.
3. True or false. The landlord and their agent have the right to enter the rental property.
  - a. True
  - b. False
4. What is the minimum notice a landlord, or their agent, must give a tenant before entering the rental property?
  - a. 12 Hours
  - b. 24 Hours
  - c. 3 Days
  - d. 7 Days
5. True or false. While a licensed real estate agent cannot discriminate, the property owner has the right to limit the types of tenants allowed to rent a property they are not occupying.
  - a. True
  - b. False
6. In what circumstances can a landlord withhold all or a portion of the security deposit?
  - a. Unpaid rent

- b. Unit damage
  - c. Move-out inspection fee
  - d. Both A and B.
7. Of the bundle of rights granted to tenants, which one is usually only granted to commercial tenants?
- a. Possession
  - b. Enjoyment
  - c. Privacy
  - d. Control
8. A month-to-month lease is an example of what type of tenancy?
- a. Fixed term
  - b. Periodic
  - c. Tenancy at will
  - d. Tenancy at sufferance
9. What is the first step in the eviction process?
- a. Obtain a court judgment.
  - b. Serve the tenant a court summons.
  - c. Give the tenant notice of the intent to evict.
  - d. Contact the sheriff and schedule an eviction.
10. If the tenant is still in possession of the rental property after the deadline in the judgment for possession has passed, what is the landlord's next step?
- a. Serve the tenant another court summons.
  - b. Bring the judgment to the police station.
  - c. Call the sheriff and schedule an eviction.
  - d. Change the locks and turn off the utilities.

## Quiz Answers

1. True or false. A property manager is a representative of the property owner.
  - a. True – is an agent of the owner, and they have a fiduciary responsibility to maintain the investment and generate income.
2. Which statement is true?
  - c. A property manager cannot turn off the electricity to force an eviction. – Neither the landlord nor the property manager can turn off any of the utilities to force an eviction.
3. True or false. The landlord and their agent have the right to enter the rental property.
  - a. True - the landlord has the right to access the property to inspect, maintain, and repair the property.
4. What is the minimum notice a landlord, or their agent, must give a tenant before entering the rental property?
  - b. 24 Hours - the landlord, their property manager, or their real estate agent does not have the right to enter the rental property without first providing at least 24-hour's notice to the tenant.
5. True or false. While a licensed real estate agent cannot discriminate, the property owner has the right to limit the types of tenants allowed to rent a property they are not occupying.
  - b. False – while landlords also have the right to screen potential tenants and to set minimum renting qualifications, based on the Fair Housing laws, they cannot discriminate.
6. In what circumstances can a landlord withhold all or a portion of the security deposit?
  - d. Both A and B. - the security deposit is used to cover any delinquent rent payments or unit damage upon move-out. Any remaining portion of the security deposit must be returned to the tenant.
7. Of the bundle of rights granted to tenants, which one is usually only granted to commercial tenants?
  - d. Control - in a residential lease, the landlord maintains control, but this right is given to commercial tenants in a property with single-occupancy.
8. A month-to-month lease is an example of what type of tenancy?
  - b. Periodic - a month-to-month lease is an example of a periodic tenancy.
9. What is the first step in the eviction process?
  - c. Give the tenant notice of the intent to evict and a period to either allow the tenant to fix the problem, contest the eviction, or move out.
10. If the tenant is still in possession of the rental property after the deadline in the judgment for possession has passed, what is the landlord's next step?
  - b. Bring the judgment to the police station. - If the tenant is still in possession of the property, then the judgment will need to be delivered to the police station and a sheriff will come and forcibly remove the tenant.

# **Chapter 23 Real Estate Math**

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**LEARNING GOAL:** By the end of this chapter, you will understand and be able to

- calculate property and building areas,
- use property valuation formulas,
- explain the calculations used in loan financing,
- calculate closing costs
- explain the return on investment

**OVERVIEW:** The real estate field is all about buying and selling real property. This process involves values, calculations, and profit and loss analysis. All of this will require a basic understanding of real estate math. This chapter will summarize all the formulas that were discussed in previous chapters.

## **Section 1. Property and Building Area Calculations**

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### **Measurements and Conversions**

Real estate is measured using inches, feet, miles, acres or square miles. In some areas they will use the US Survey Method that include rods, chains, furlongs and survey miles.

#### **Formulas for Measurement Conversion**

$$\text{Inches} \div 12 = \text{feet} (120'' \div 12 = 10')$$

$$\text{Feet} \times 12 = \text{inches} (10' \times 12 = 120'')$$

$$\text{Feet} \div 3 = \text{yards} (12' \div 3 = 4 \text{ yards})$$

$$\text{Yards} \times 3 = \text{feet} (4 \text{ yards} \times 3 = 12')$$

$$\text{Miles} \times 5,280 = \text{feet} (1.5 \text{ miles} \times 5,280 = 7,920')$$

$$\text{Feet} \div 5,280 = \text{miles} (7,920' \div 5,280 = 1.5 \text{ miles})$$

$$\text{Rods} \times 16.5 = \text{feet} (4 \text{ rods} \times 16.5 = 66')$$

$$\text{Feet} \div 16.5 = \text{rods} (66' \div 16.5 = 4 \text{ rods})$$

### **UNITS OF MEASUREMENT**

#### **BUILDING UNITS**

$$12 \text{ inches} = 1 \text{ foot}$$

$$36 \text{ inches} = 3 \text{ feet} = 1 \text{ yard}$$

#### **LAND UNITS**

$$1 \text{ mile} = 5,280 \text{ feet}$$

$$1 \text{ acre} = 43,560 \text{ square feet}$$

$$1 \text{ sq. mile} = 640 \text{ acres}$$

#### **US SURVEY METHOD**

$$1 \text{ rod} = 16.5 \text{ feet}$$

$$1 \text{ chain} = 66 \text{ feet or } 4 \text{ rods}$$

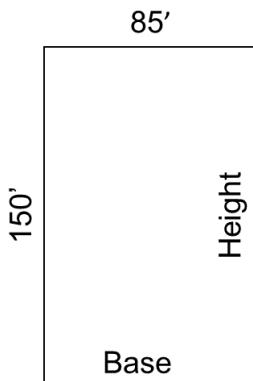
$$1 \text{ furlong} = 10 \text{ chains}$$

$$\text{survey mile} = 8 \text{ furlongs}$$

### **Area Calculation**

The two-dimensional surface of an object is the **area**. Area is expressed as square units or as acres. Multiplying the width by the height gives you the area or the square unit. The same unit of measurement must be used for each dimension. Inches multiplied by inches become square inches (abbreviated as sq. in or in<sup>2</sup> or "²). Feet multiplied by feet become square feet (abbreviated as sq. ft., SF, or ft<sup>2</sup> or '²). Buildings are measured by the square foot. Land is measured by square feet or acres.

**Calculating the area of a rectangle.** There are four sides and, thus, four dimensions. As long as there are two pairs with equal dimensions, this formula will work:



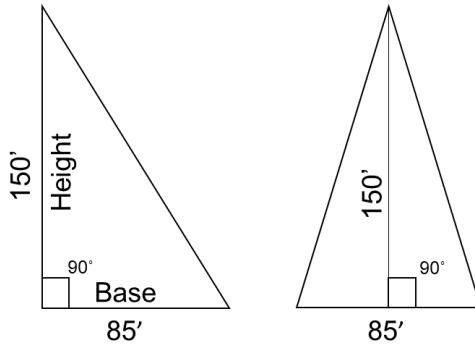
### Calculating the Area of a Rectangle

$$\text{Base} \times \text{Height} = \text{Area}$$
$$85' \times 150' = 12,750 \text{ Sq. Ft.}$$

$$\text{Sq. Ft.} \div \text{Sq. Ft. in Acre} = \text{Acre(s)}$$
$$12,750 \div 43,560 = .29 \text{ Acres}$$

**PRACTICAL APPLICATION:** A parcel has 210 feet of road frontage and is 500 feet deep. How many acres does the property contain?  $210' \times 500' = 105,000$  square feet (sq. ft.)  $\div 43,560 = 2.41$  acres.

**Calculating the area of a triangle.** To calculate the area of a triangle, you must have the base and height measurements. The base and the height will always intersect at a 90-degree angle (also called a right angle). Here is how to calculate the area:



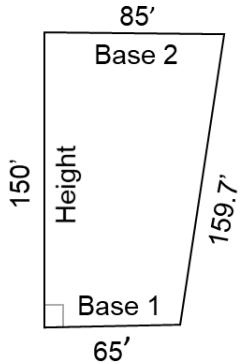
### Calculating the Area of a Triangle

Must know the height and the base and they must intersect at a 90 degree angle.

$$(\text{Base} \times \text{Height}) \div 2 = \text{Area}$$
$$(85' \times 150') \div 2 = 6,375 \text{ Sq. Ft.}$$

**PRACTICAL APPLICATION:** A triangular parcel has 210 feet of road frontage and is 500 feet deep. How many acres does the property contain?  $(210' \times 500') \div 2 = 52,500$  sq. ft.  $\div 43,560 = 1.2$  acres.

**Calculating the area of a trapezoid.** A trapezoid is a quadrilateral with at least two sides that run parallel to each other. To calculate the area of a trapezoid, first find the average of the two parallel sides and then multiply by the height. The height must intersect the base at a 90-degree angle.

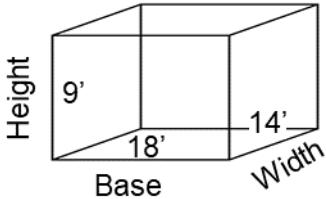


### Calculating the Area of a Trapezoid

Average Base x Height = Area  
 $(\text{Base 1} + \text{Base 2}) \div 2 \times \text{Height} = \text{Area}$   
 $(65' + 85') \div 2 = 75'$  Average Width  
 $75' \times 150' = 11,250$  Sq. Ft.

## Volume Calculations

The space inside a three-dimensional object is called **volume**. Volume is expressed as cubic units, for example cubic feet are represented as CF or ft.<sup>3</sup> or '<sup>3</sup>. The length is multiplied by the width which is multiplied by the height.



### Calculating the Volume of a Cube

Base x Height x Width = Cubic Area  
 $18' \times 9' \times 14' = 2,268$  CF

## Cost per Unit Calculations

When converting areas to a cost or value per unit, divide the cost/value by the unit of measurement. This can be used to calculate the cost per square foot or the property's value per acre.

**Sales Price ÷ Unit of Measurement = Price per Unit of Measurement**

**PRACTICAL APPLICATION:** A 40-acre parcel sold for \$224,000. What is the value per acre?  $\$224,000 \div 40$  acres = \$5,600 per acre. A 2,400 square foot house will cost \$85 per square foot to construct. What is the total construction cost?  $2,400$  SF x \$85 per SF = \$204,000. Commercial sites are being sold for \$12,000 per front foot. The listed property has 110 front feet. How much is the property worth?  $110' \times \$12,000 = \$1,320,000$ .

## Determining Acreage Using the Rectangular Survey System

The survey book will have a breakdown of the size of each section, or you can calculate the area using a simple formula. Divide 640 acres by each of the denominators in their correct order.

SW 1/4, NW 1/4, NW 1/4 of Section 36 =  $640 \div 4 \div 4 \div 4 = 10$  acres

N 1/2, of the SW 1/4, of the N 1/2 =  $640 \div 2 \div 4 \div 2 = 40$  acres

## Section 2. Income Valuation

There are several formulas and calculations that are used to convert income into value or to determine profitability.

### Net Operating Income (NOI)

The net operating income (NOI) is the result of subtracting the expenses from the income. The NOI does *not include* any mortgage or other debt payments.

$$\text{Income} - \text{Expenses} = \text{Net Operating Income}$$

### Calculating the Net Operating Income

#### INCOME

Rental Income		
Unit 1	10,800	
Unit 2	10,800	
Unit 3	10,800	
Total Rental Income	32,400	
Less Vacancy and Credit Loss	10%	(3,240)
Other Income		
Laundry, vending, parking, etc.		-
<b>Total Gross Income</b>		<b>29,160</b>

#### EXPENSES

Fixed Expenses		
Property Insurance	1,458	
Property Taxes	1,458	
Variable Expenses		
Property Management Fees	7%	2,041
Utilities		3,240
Repairs and Maintenance		3,240
Homeowner or Condo Dues		-
Legal Fees		-
<b>Total Expenses</b>		<b>11,437</b>
<b>NET OPERATING INCOME</b>		<b>17,723</b>

### Capitalization Rate

The cap rate is the ratio between a property's market value and the net operating income. As a capitalization rate decreases, the market value increases. The formulas are:

$$\text{Net Operating Income} \div \text{Market Value} = \text{Capitalization Rate}$$

$$\text{Net Operating Income} \div \text{Capitalization Rate} = \text{Market Value}$$

**PRACTICAL APPLICATION:** A small rental property was purchased for \$85,000 with a net operating income of \$6,800. What is the capitalization rate?  $\$6,800 \div \$85,000 = 0.08$  or 8%.

An apartment building has a net operating income of \$72,000 and the market cap rate is 11%. What is the market value of the property?  $\$72,000 \div 0.11 = \$654,500$ .

## Equity

Equity is the owner's share of the property value. If a property was purchased for cash, then 100 percent of the property value is the owner's equity. If the buyer obtains financing then the owner's equity is equal to the down payment. If the owner refinances, the owner's equity is the difference between the market value and the amount financed. Equity can be expressed as a dollar amount or as a percentage.

$$\text{Market Value} - \text{Loan Balance} = \text{Owner's Equity}$$

$$\text{Purchase Price} \times \text{Percentage of Down Payment} = \text{Owner's Equity}$$

$$\text{Owner's Equity} \div \text{Market Value} = \text{Percentage of Owner's Equity}$$

**PRACTICAL APPLICATION:** The buyer is putting 20% down on a \$150,000 purchase. How much equity will they have?  $\$150,000 \times .20 = \$30,000$ . Five years later the owner refinances the property. The property is now worth \$185,000 and he is borrowing \$115,000. What is the percentage of the owner's equity?  $\$185,000 - \$115,000 = \$70,000$  value of owner's equity  $\div \$185,000 = 0.3783$  or 38% percentage of owner's equity.

## Section 3. Financing Calculations

Following are the formulas and calculations that are used in loan financing.

### Down Payments

If a buyer pays a portion of the purchase price and then finances the remainder, the portion the buyer has paid is called the down payment. Down payments are expressed as a percentage.

$$\text{Purchase Price} \times \text{Percentage of Down Payment} = \text{Down Payment Amount}$$

**PRACTICAL APPLICATION:** The lender requires a 20% down payment to qualify for a mortgage. If the purchase price is \$275,000, what is the down payment?  $\$275,000 \times .20 = \$55,000$ .

### Loan-to-Value

The loan-to-value (LTV) represents the ratio between the mortgage amount and the property value. It is calculated by dividing the mortgage balance into the market value or

appraised value (whichever is lowest). An LTV of 80 percent also means that the property owner has 20 percent equity in the real estate. The LTV plus the equity must equal 100 percent of the property value.

$$\text{Mortgage Amount} \div \text{Lowest Property Value} = \text{Loan-to-Value (LTV)}$$

$$\text{Lowest Property Value} \times (1 - \text{Down Payment Percentage}) = \text{Mortgage Amount}$$

**PRACTICAL APPLICATION:** A lender approves a mortgage for \$157,500 on a property valued at \$225,000. What is the LTV?  $\$157,500 \div \$225,000 = 0.70$  or 70%.

A buyer is purchasing a duplex for \$345,000. The appraisal came in at \$355,000. They are putting 20% down. What is the loan amount?  $\$345,000 \times .80 (1 - .20) = \$276,000$  mortgage amount.

## Interest

Interest is the cost of borrowing money. It is expressed as a percentage. It can be calculated annually or per payment. To determine the amount of interest, the loan balance and interest rate must be known. The loan amount will be based off the purchase price or an appraised value, whichever is less.

$$\text{Loan Balance} \times \text{Interest Rate} = \text{Annual Interest Payment}$$

$$\text{Loan Balance} \times \text{Interest Rate} \div 12 = \text{Monthly Interest Payment}$$

**PRACTICAL APPLICATION:** A house was purchased for \$325,000 and the buyer was approved for an 80% loan at 5% for 30 years with monthly payments. The property appraised for \$320,000. How much interest will be paid in the first monthly payment?  $\$320,000 \times .80 \times .05 = \$256,000$  loan balance  $\times .05 = \$12,800$  (annual interest)  $\div 12 = \$1,066.67$  (first payment interest).

Interest can compound or increase value over time. Interest (or appreciation) is added to the principal balance and future interest is calculated off the new balance. The periodic rate of appreciation is calculated and then added to the property value which then increases at the periodic rate of appreciation. Use this formula to calculate compounding interest:

$$\text{Principal Balance} \times (1 + \text{Interest Rate}) = \text{New Principal Balance}$$

$$\text{New Principal Balance} \times (1 + \text{Interest Rate}) = \text{New Principal Balance}$$

**PRACTICAL APPLICATION:** The annual market rate of appreciation is 3%. A property is valued at \$285,000. What will be the market value in three years?  $\$285,000 \times 1.03 = \$293,550$  (year 1)  $\times 1.03 = \$302,357$  (year 2)  $\times 1.03 = \$311,428$  (market value at the end of year 3).

## Amortizing Loan Payments

Once the loan balance, monthly payment and the interest rate is known, it can be determined how much of the payment applies to the principal and how much goes towards the interest. The order of the formulas must be maintained.

1. **Loan Balance x Interest Rate ÷ 12 months = Monthly Interest Payment**
2. **Monthly Payment – Monthly Interest Payment = Monthly Principal Payment**

To calculate the next month's principal payment,

3. **Loan Balance – Monthly Principal Payment = New Loan Balance**
4. **New Loan Balance x Interest Rate ÷ 12 months = New Monthly Interest Payment**
5. **Monthly Payment – New Monthly Interest Payment = New Monthly Principal Payment**

**PRACTICAL APPLICATION:** There is a 15-year mortgage loan for \$165,000 at a 4.50% interest rate. The monthly payment is \$1,262.24. What is the loan balance after three months?

Step 1.  $\$165,000 \times .045 \div 12 = \$618.75$  monthly interest payment  
Step 2.  $\$1,262.24 - \$618.75 = \$643.49$  monthly principal payment  
Step 3.  $\$165,000 - \$643.49 = \$164,356.51$  new loan balance after 1 month  
Step 4.  $\$164,356.51 \times 0.045 \div 12 = \$616.34$  new interest payment  
Step 5.  $\$1,262.24 - \$616.34 = \$645.90$  new principal payment  
Step 6.  $\$164,356.51 - \$645.90 = \$163,710.61$  new loan balance after month 2  
Step 7.  $\$163,710.61 \times .045 \div 12 \text{ months} = \$613.91$  new interest payment  
Step 8.  $\$1,262.24 - \$613.91 = \$648.33$  new principal payment  
Step 9.  $\$163,710.61 - \$648.33 = \$163,062.28$  loan balance after month 3.

## Discount Points

Discount points (also called mortgage points) are prepaid interest fees paid to a lender at closing in exchange for a reduced interest rate. Buying points can lower the monthly mortgage payment. One point will lower the interest rate by .25 percent, and it will cost the borrower 1 percent of the loan amount.

**Loan Amount x Points as a Percentage = Cost of Points**

**Cost of Points ÷ Points as a Percentage = Loan Amount**

**Cost of Points ÷ Loan Amount = Points as a Percentage**

**Starting Interest Rate – (Number of Points x .25) = New Interest Rate**

**PRACTICAL APPLICATION:** The lender charges 2 points on a \$375,000 loan at 4.75% interest. What is the total amount paid for the points at closing? \$375,000

$x .02 = \$7,500$ . What will be the new interest rate?  $2 \text{ Points} \times .25\% = 0.50\%$  reduction in interest rate. Starting interest rate of  $4.75\% - 0.50\% = 4.25\%$  new interest rate.

## Debt-to-Income Ratios

To qualify for a mortgage, lenders require that the PITI (principal, interest, taxes and insurance) and other debts amount to equal or less than a set percentage of the borrower's gross income. First calculate the PITI and then the debt-to-income ratio (also called the housing expense ratio).

Front-End Ratio (28% Conventional, 31% FHA)

**Mortgage Payment (Principal + Interest) + Property Taxes + Property Insurance + Private Mortgage Insurance (if required) = PITI**

**PITI ÷ Gross Monthly Income = Front-End Debt-to-Income Ratio**

Back-End Ratio (36% Conventional, 43% FHA, and 41% VA)

**PITI + All Dues & Debts ÷ Gross Monthly Income = Back-End Debt-to-Income Ratio**

To calculate the maximum affordable Payment:

**Gross Monthly Income x Front-End = PITI**

**Gross Monthly Income x Back-End Ratio = PITI + Other Dues & Debts**

## Prepayment Penalties

A prepayment penalty is a fee charged to some borrowers who pay off their mortgage early. The fee protects the lender from the loss of anticipated interest payments. There are three basic methods for calculating prepayment penalties. Since 2014, the only allowed penalty method is the percent of principal method.

### Percentage of Interest Method

**Loan Balance x Interest Rate ÷ 12 months x # Penalty Months x Penalty Ratio = Prepayment Penalty**

**PRACTICAL APPLICATION:** A mortgage at 5 percent interest that has a loan balance of \$200,000 has a percentage of interest prepayment penalty of 80 percent of six-months interest. How much is the prepayment penalty?  $\$200,000 \times .05 \div 12 \times 6 \times .80 = \$4,000$

### Interest Rate Differential Method

**Loan Interest Rate – Market Interest Rate x Loan Balance = Prepayment Penalty**

**PRACTICAL APPLICATION:** The owner decides to refinance to get a better rate. The original loan had an interest rate of 6 percent. Currently new loans are available at 5.25% The loan balance is \$200,000. What is the prepayment penalty?.06 – .0525 = 0.0075 x \$200,000 = \$1,500.

### Percent of Principal Method:

**Loan Balance x Penalty Percentage = Prepayment Penalty**

**PRACTICAL APPLICATION:** An investor obtains a mortgage for \$200,000 from a credit union that keeps investor loans in-house. There is a 2 percent prepayment penalty within the first three years. Two years into the loan, the investor decides to refinance with a major lender on better terms. The loan balance is \$194,215.36. What is the prepayment penalty?  $\$194,215.36 \times .02 = \$3,884.31$ .

## Section 4. Settlement and Closing Costs

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### Net to Seller

Use this formula to calculate the minimum sales price based off what the seller wants to net from the sale.

**Net to Seller + Closing Costs ÷ (100% - Broker Commission) = Minimum Sales Price**

**PRACTICAL APPLICATION:** A seller wants to net a minimum of \$250,000 from the sale of their home. The closing costs are estimated at \$3,500 and the broker is charging a 6% commission. What must the home sell for?  $\$250,000 + \$3,500 \div .94 (1.0 - .06) = \$269,680$ .

If the seller will need to pay off their mortgage, use this formula to calculate the net to seller.

**Minimum Sales Price = Net to Seller + Loan Balance + Closing Costs ÷ (100% - Broker Commission)**

**PRACTICAL APPLICATION:** A seller wants to net a minimum of \$25,000 from the sale of their home. They owe \$200,000 and closing costs are estimated at \$3,500 and the broker is charging a 6% commission. What must the home sell for?  $\$25,000 + \$200,000 + \$3,500 \div .94 (1.0 - .06) = \$243,085$ .

### Seller's Percentage of Profit or Loss

To calculate the seller's percentage of profit from a sale, use these formulas:

**Sales Price – Purchase Cost – Capital Improvements = Seller's Profit**

**Seller's Profit ÷ Sales Price = Percentage of Profit**

**PRACTICAL APPLICATION:** The seller originally purchased a property for \$125,000 and later sold it for \$142,000. What was the percentage of profit?  $\$142,000 - \$125,000 = \$17,000$  seller's profit  $\div \$125,000 = 13.6\%$ .

## Prorated Items

Proration divides a whole amount into daily or monthly portions that are then billed to the seller or buyer based on the date of ownership. The cost of an item can be divided by days or months. Days in a year can be calculated based on 365 or 360 (used with mortgages).

$$\text{Monthly Amount} \div \text{Days in Month} = \text{Daily Amount}$$

$$\text{Annual Amount} \div \text{Days in a Year} = \text{Daily Amount}$$

**PRACTICAL APPLICATION:** The buyer is assuming the seller's mortgage on March 20. The seller has already paid the March mortgage payment. The mortgage balance is \$83,000 and the interest rate is 5%. Calculate the prorated interest payment due from the buyer at closing.  $\$83,000 \times .05 = \$4,150$  (annual interest)  $\div 360 = \$11.53$  (daily interest).  $\text{March 20} - \text{March 31} = 12 \text{ days} \times \$11.53 = \$138.36$ .

## Property Tax Calculations

Property taxes are calculated off the assessed value *not the sales price*. In most states, the tax rate is calculated off a mill levy. A mill equals \$1 for every \$1000 units of value. A tax rate shown as 15 mills is equal to \$0.015 ( $15 \div \$1,000$ ).

$$\text{Mill Rate: Assessed Value} \div \text{Unit of Value} \times \text{Mill Rate} = \text{Property Taxes}$$

**PRACTICAL APPLICATION:** A property is assessed for \$250,000. The local mill rate is 45. How much are the annual property taxes?  $\$250,000 \div 1000 \times 45 = \$11,250$

## Transfer Taxes

Some states charge real estate transfer taxes based on a percentage of the sales price. Others have a transfer tax rate of a price per unit of value, such as \$1.10 per \$1,000 of the sales price.

$$\text{Sales Price} \div \text{Unit of Value} \times \text{Tax Rate} = \text{Transfer Taxes}$$

**PRACTICAL APPLICATION:** A property was sold in Massachusetts for \$345,000 and their transfer tax rate is \$2.28 per \$500. Calculate the transfer tax.  $\$345,000 \div 500 \times \$2.28 = \$1,572.20$ .

## Commission and Commission Splits

A real estate agent's commission is almost always based on a percentage of the sales price. Commissions can be split between the seller's and buyer's brokers and their sales associates.

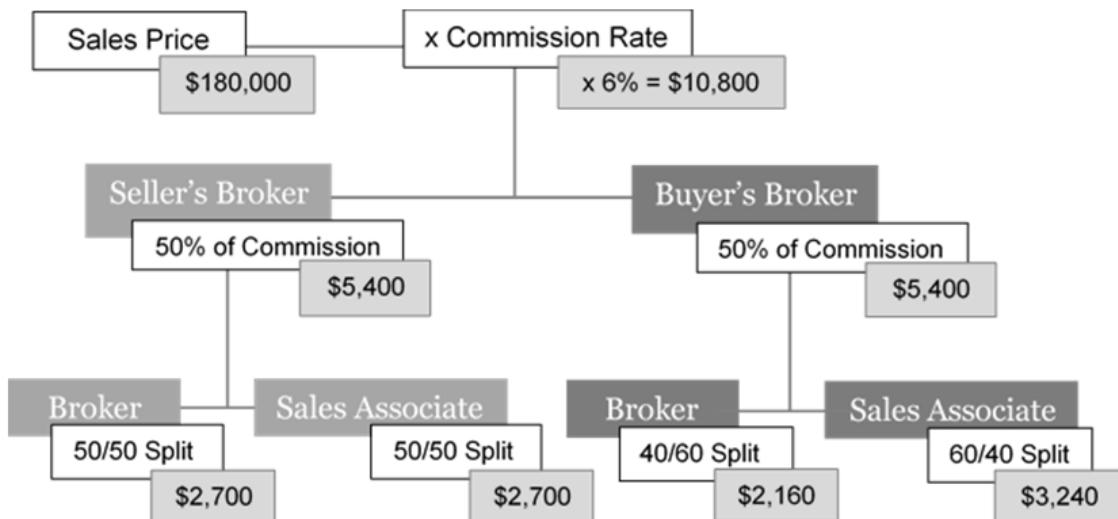
$$\text{Sales Price} \times \text{Full Commission Rate} = \text{Full Commission}$$

$$\text{Full Commission} \times \% \text{ of Full Commission to Broker} = \text{Broker's Full Share of Commission}$$

$$\text{Broker's Full Share of Commission} \times \text{Sales Associate's \% of Broker's Share} = \text{Sales Associate's Share of Commission}$$

$$\text{Broker's Full Share of Commission} - \text{Sales Associate's Share of Commission} = \text{Broker's Share of Commission}$$

## How to Split Commission Payments



**PRACTICAL APPLICATION:** The sales associate is entitled to a 40/60 split with her broker. She just closed on a \$600,000 sale and her brokerage will split the 8 percent commission payment with the buyer's broker. How much did the sales associate earn?  $\$600,000 \times .08 \text{ (full commission)} \times .5 \text{ (broker's full share)} \times .40 \text{ (sales associate's share)} = \$9,600$ .

## Section 5. Investment Valuation

### Rate of Return

The rate of return includes calculating for the capitalization rate, cash-on-cash return, and return on investment. The formula is the same. It is what is included in the income and investment values that create the different results. The basic formula is:

**Income ÷ Investment = Rate of Return**

**PRACTICAL APPLICATION:** An investor is annually receiving \$10,000 from a real estate investment that cost \$125,000 to purchase. What is the investor's rate of return?  $\$10,000 \div \$125,000 = .08$  or 8%.

### Capitalization Rate

**Net Income ÷ Market Value = Capitalization Rate**

### Return on Investment (ROI)

**Gain on Investment – Cost of Investment ÷ Cost of Investment = Return on Investment**

### Cash-on-Cash Return (CoC)

**Net Income – Capital Reserves – Debt Payments = Pre-Tax Net Income**

**Down Payment + Capital Improvements + Closing Costs = Cash Invested**

**Pre-Tax Net Income ÷ Cash Invested = Cash-on-Cash**

**PRACTICAL APPLICATION:** An investor pays \$275,000 for a duplex and puts 20% down (\$68,750). He paid \$3,000 in closing costs and invested \$15,000 in capital repairs. The net operating income is \$22,000 and he pays \$14,172 annually in mortgage costs. What is the investors CoC return?  $\$22,000 - \$14,172 = \$7,828$  pre-tax net income.  $\$68,750 + \$3,000 + \$15,000 = \$86,750$  cash invested.  $\$7,828 \div \$86,750 = .09$  or 9%.

### Appreciation and Depreciation

Appreciation and depreciation are expressed as a percentage. To calculate the value of the appreciation or depreciation use this formula:

**Value x Rate = Amount**

**PRACTICAL APPLICATION:** There is an old barn on the property that has been assessed with 60% depreciation. Thirty years ago, it cost \$28,000 to build. Today it would cost \$85,000. What is the amount of depreciation?  $\$85,000 \times .60 = \$51,000$ . The value of the land, however, has appreciated significantly. The appraiser estimated that the property has increased in value by 30% since the last appraisal which valued the land at \$450,000. What is the current market value of the land?  $\$450,000 \times (1 + .30) = \$585,000$

Depreciation is also used in accounting and applying tax deductions. Straight line depreciation decreases the value by an equal amount each year of its useful or economic life. The formula for straight-line depreciation is:

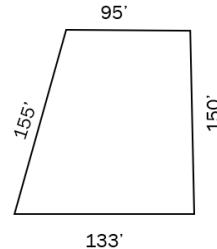
**Initial Cost ÷ Economic Life = Annual Depreciation Amount**

**PRACTICAL APPLICATION:** An investor purchases an apartment complex for \$600,000. The remaining economic or useful life is 22 years. What is the annual depreciation amount?  $\$600,000 \div 22 = \$27,273$ .

## Section 6. Quiz

Print out this ten-question quiz and then select the most appropriate answer from the choices given. The answers are provided on the next page.

1. A lot is 125 feet by 250 feet. How many acres does the lot contain?
  - a. 31,250
  - b. 0.5
  - c. 0.72
  - d. 2
2. How many square feet are contained in this lot?
  - a. 14,250 sq. ft.
  - b. 17,100 sq. ft.
  - c. 17,670 sq. ft.
  - d. 19,950 sq. ft.
3. A 38,532 square foot parcel sold for \$52,000. What is the price per square foot?
  - a. \$0.74
  - b. \$1.19
  - c. \$1.35
  - d. \$1.43
4. An investor is considering an apartment building that has a net operating income of \$28,000 and it is listed for \$350,000. The market-based capitalization rate for this type of property is 9.5 percent. Is the property a good value?
  - a. Yes
  - b. No
5. The value of a property is \$75,000 today. What was the original cost if the property has lost 25% of its value over the past 5 years?
  - a. \$18,750
  - b. \$56,250
  - c. \$100,000
  - d. \$131,250
6. A buyer is approved for an 80% loan on a house valued at \$125,000, how much additional cash is required as a down payment if the buyer has already paid \$6,000 in earnest money?
  - a. \$17,500
  - b. \$19,000
  - c. \$25,000
  - d. \$28,800
7. A closing on a rental house is scheduled for April 10<sup>th</sup>. The tenant pays \$1,200 in rent on the first. At closing, what is the amount of rent due the buyer?
  - a. \$400
  - b. \$800
  - c. \$812.90
  - d. \$1,200



What

8. An owner agrees to list his property as long as she receives at least \$28,000 after paying off a \$98,000 loan and paying a 6% broker's commission. Closing costs are estimated at \$3,000. What is the minimum sales price?
- \$132,255
  - \$135,255
  - \$136,740
  - \$137,234
9. The listing broker will be splitting her 7% commission with the selling broker. The selling broker's sales associate receives a 60% share. The property sold for \$275,000. How much did the sales associate receive?
- \$3,850
  - \$5,775
  - \$9,625
  - \$11,550
10. A property purchase for \$320,000 is appreciating 3% annually and will be held by the investor for four years. Assuming no other changes in value, how much will the property be worth at the end of the holding period?
- \$329,600
  - \$349,672
  - \$358,400
  - \$360,163

## Quiz Answers

1. A lot is 125 feet by 250 feet. How many acres does the lot contain?  
c.  $0.72 (125 \times 250 = 31,250 \div 43,560 \text{ sq. ft per acre} = 0.72 \text{ acres})$
2. How many square feet are contained in this lot?  
b.  $17,100 \text{ sq. ft. } (95 + 133) \div 2 \times 150 = 17,100 \text{ sq. ft.}$
3. A 38,532 square foot parcel sold for \$52,000. What is the price per square foot?  
c.  $\$1.35 (\$52,000 \div 38,532 = \$1.35 \text{ per square foot})$
4. An investor is considering an apartment building that has a net operating income of \$28,000 and it is listed for \$350,000. The market-based capitalization rate for this type of property is 9.5 percent. Is the property a good value?  
b. No (Subject property:  $\$28,000 \div \$350,000 = .08$  Cap Rate. Market rate:  $\$28,000 \div .095 = \$294,736$ ) The market rate is considerably lower than the list price.
5. The value of a property is \$75,000 today. What was the original cost if the property has lost 25% of its value over the past 5 years?  
c.  $\$100,000 (\$75,000 \div .75 = \$100,000)$
6. A buyer is approved for an 80% loan on a house valued at \$125,000, how much additional cash is required as a down payment if the buyer has already paid \$6,000 in earnest money?  
b.  $\$19,000 ((1 - .80) \times \$125,000 = \$25,000 - \$6,000 = \$19,000)$
7. A closing on a rental house is scheduled for April 10<sup>th</sup>. The tenant pays \$1,200 in rent on the first. At closing, what is the amount of rent due the buyer?  
b.  $\$800 (\$1,200 \div 30 \text{ days in April} = \$40 \text{ per day} \times 20 \text{ days} = \$800)$
8. An owner agrees to list his property as long as she receives at least \$28,000 after paying off a \$98,000 loan and paying a 6% broker's commission. Closing costs are estimated at \$3,000. What is the minimum sales price?  
d.  $\$137,234 (\$28,000 + \$98,000 + \$3000 = \$129,000 \text{ seller's gross income after commission. } 100\% \text{ Sales price} - 6\% \text{ commission} = 94\% \text{ seller's percentage after commission. Thus, } \$129,000 \div .94 = \$137,234 \text{ is the minimum sales price.}$
9. The listing broker will be splitting her 7% commission with the selling broker. The selling broker's sales associate receives a 60% share. The property sold for \$275,000. How much did the sales associate receive?  
b.  $\$5,775 (\$275,000 \times .07 = \$19,250 \text{ full commission} \div 2 = \$9,625 \text{ selling brokerage share} \times .60 = \$5,775 \text{ selling broker's sales associate's share.})$
10. A property purchase for \$320,000 is appreciating 3% annually and will be held by the investor for four years. Assuming no other changes in value, how much will the property be worth at the end of the holding period?  
d.  $\$360,163 (\$320,000 \times 1.03 [\text{year 1}] \times 1.03 [\text{year 2}] \times 1.03 [\text{year 3}] \times 1.03 [\text{year 4}] = \$360,163)$

## Chapter 24 Glossary of Terms

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**Abstract of Title:** a summary of the successive conveyances and other facts on a title to real property.

**Acceleration Clause:** a clause that allows the lender to require the borrower to pay some or all of the remaining balance if the terms of the lending contract are breached.

**Acceptance:** (1) a final and unqualified expression of consent to the terms of an offer; (2) the formal taking possession of a deed to property upon delivery.

**Accession:** the conversion of a trade fixture into real property.

**Accretion:** the increase of land over time through natural forces.

**Acknowledgment:** a formal declaration made under oath or in the presence of a notary public.

**Act of Conveyance:** the transfer of ownership or interest in real property from one person to another by a document such as a deed, lease, or mortgage. (Also called the granting clause.)

**Addendum:** the addition of terms, clauses, or provisions to an existing contract.

**Adjustable Rate Mortgage (ARM):** a loan agreement in which the interest rate is periodically adjusted up or down to reflect the current market rates (also called a variable rate mortgage).

**Administrator's Deed:** a deed that is used to transfer real property from the estate of a deceased person to an heir in the absence of a will. (See also Executor's Deed.)

**Administrative Law:** rules and regulations created by an administrative agency that regulates procedures, operations, and conduct.

**Adverse Possession:** the claim to the title of a private property by an occupant

who has notoriously, openly, and visibly occupied the property continuously for a length of time in opposition to the rights of its legal owner who has not challenged the claimant's possession.

**Affidavit of Title:** a sworn statement specifying that the seller possesses title and states the status of potential legal issues involving the property.

**Agency:** the relationship and accountability that is formed when an agent is working on behalf of that client in all matters pertaining to a specific real estate transaction.

**Agent:** a real estate licensee (including brokers and sales associates) acting in an agency relationship as defined by state law or regulation.

**Air Rights:** the ownership rights that apply to the space above the land.

**Amendment:** a change or modification of a contract.

**Amortization:** the gradual repayment of a loan in equal, or nearly equal, installments which include portions of interest and principal.

**Annual Percentage Rate (APR):** the total cost of financing on an annual basis and includes the interest rate plus the cost of loan origination costs, mortgage points, and any other lender fees.

**Annexation:** the act of converting personal property into a fixture.

**Anticipation:** the concept that value is created by the expectation that a specific event will occur.

**Appurtenance:** a tangible or intangible item that is part of the real property and is transferred with the property.

**Appraisal:** the act or process of developing an opinion of value or the opinion of the value (see Real Estate Appraisal).

**Appraiser:** a licensed individual who is qualified by education, training, and experience to estimate the value of real and personal property.

**Area:** the two-dimensional surface of an object.

**Asbestos:** a durable and fireproof silicate-mineral fiber that becomes brittle and toxic with age.

**Avulsion:** a sudden loss of land through natural forces.

**Balloon Payment:** one large payment at the end of a set term of a mortgage that pays off the balance of the loan.

**Benchmark:** the permanent point of reference in a legal description.

**Bid-rigging:** when buyers work together to control auction prices that restrict and open and fair market.

**Bilateral Contract:** an agreement in which two parties promise to fulfill certain obligations to complete a transaction.

**Blockbusting:** the illegal practice of scaring homeowners into selling their homes because a protected class of people is moving into the neighborhood under the assumption that it will lower home values.

**Breach of Contract:** an act of breaking the terms set out in a contract.

**Bridge Loan:** a short-term loan that allows a borrower to finance a transaction pending the receipt of other funds.

**Broker:** a person or business entity who has taken education beyond the agent level and is licensed as a broker to perform services of real estate for others for compensation.

**Broker Associate:** a person who is qualified to be issued a license as a broker but who operates as a sales associate in the employ of another. (Also called an associate broker.)

**Broker's Price Opinion (BPO):** a report prepared by a real estate broker of the value of a property based on a comparison of the subject property to similar properties on the market. (Similar to a Comparative Market Analysis.)

**Brokerage:** a real estate business.

**Brownfield:** properties with known or suspected environmental hazards that are regulated by the EPA.

**Buyer Agency Agreement:** the contract that creates an agency relationship between the broker and the buyer. (Also called a buyer-broker agreement.)

**Buy and Sell Agreement:** a voluntary but conditional indication of a buyer's willingness to enter into an agreement under specific terms to purchase real property from a seller, which upon the seller's acceptance creates a binding contract. (Also known as a Real Estate Purchase Contract or Purchase Contract.)

**Capacity to Contract:** the capacity to enter into a legal agreement and the competence to perform the terms of the contract.

**Capital Gains:** the profit made on the sale of real property or another capital asset.

**Capitalization Rate:** the return an investor strives to get on their investment without considering debt repayment in comparison to other investment choices of similar risk.

**Carbon Monoxide:** a colorless, odorless, and tasteless gas that inhibits the blood's ability to transport oxygen.

**Caveat Emptor:** "let the buyer beware;" a principle in commerce: without a warranty, the buyer takes the risk.

**Certificate of Occupancy:** a certificate issued by a local authority indicating a building meets building-code requirements. (Also called an occupancy permit.)

**Chain of Title:** the chronological order of conveyance of a property given in an abstract of title from the earliest owner to the current one.

**Chattel:** identifiable tangible objects that are considered by the general public as being "personal;" all tangible property that is not classified as real estate. (Also called personal property.)

**Client:** the persons or entities with whom a real estate agent and their firm have an agency or legally recognized non-agency relationship.

**Closing:** the transfer of title in exchange for payment.

**Closing Agent:** a neutral third-party such as a title agent or attorney that orchestrates a real estate closing (also called an escrow agent).

**Closing Disclosure Form (CDF):** a form that itemizes all the closing costs that the buyer and the seller are responsible for paying (also known as the settlement form).

**Cloud:** an objection on public record or a potential defect in the title that may hinder or prevent its conveyance.

**Commingling:** the illegal act of mixing a business funds with transactional funds.

**Commission:** Compensation paid for the services of a broker that is based on a percentage of the sales price.

**Common Law:** a law that has been developed on the basis of preceding rulings by judges.

**Community Property:** real estate or personal property that was acquired by either spouse during the marriage.

**Comparative Market Analysis (CMA):** an evaluation of recently listed or sold properties that are similar to the subject property in order to establish a listing or selling price for a property.

**Compensation:** anything of value or valuable consideration, directly or

indirectly paid, promised, or expected to be paid or received.

**Condemnation:** the legal process by which a governmental body exercises its right of eminent domain to acquire private property for public use.

**Condominium:** the absolute ownership of a unit based on a legal description of the airspace the unit contains plus an undivided interest in the common elements.

**Conformity:** a particular home will achieve maximum value when the surrounding properties have a similar style, condition, and function.

**Consideration:** something with a monetary value that is voluntarily exchanged for an act, interest, promise, right, goods, or services.

**Contingency:** an event or condition in a contract that, if not met, can make the contract null and void.

**Contract:** a legally enforceable agreement between two or more people.

**Contract Assignment:** when one party to a contract gives the obligations and benefits of the contract to another party.

**Contribution:** the concept that a property feature is only worth what it contributes in value to the whole.

**Conventional Loan:** a loan with a fixed-term and a fixed-rate which is not guaranteed or insured by the Federal Housing Administration, the Farmers Home Administration, or the Department of Veterans Affairs.

**Conversion:** the illegal act of using the property, money, or goods of another without permission.

**Cooperative:** an ownership arrangement whereby the buyer owns shares in the corporation that owns the building and has the right to live in a specific unit.

**Corporation:** a legal business entity that is separate and distinct from its owners

or shareholders who share in the profits and losses.

**Cost Approach:** an appraisal valuation approach that values the subject property by estimating the cost to construct all the improvements less any depreciation or obsolescence plus the value for the site.

**Cost Basis:** the original market value of real property plus purchasing expenses, long-term improvements, and less any accumulated depreciation which is used in computing capital gains.

**Counteroffer:** a return offer made by a party that has rejected a prior offer.

**Covenant:** an enforceable deed restriction that creates a non-possessory interest in real property that restricts or controls some aspect of the use of the real property.

**Covenants, Conditions, and Restrictions (CC&Rs):** a set of rules establishing the individual and collective rights and obligations of the property owners within a particular community or subdivision.

**Credit Score:** the measurement and analysis of a consumer's historical use of credit and payment history.

**Customer:** a party to a real estate transaction who receives information, services, or benefits but has no contractual relationship with an agent or the agent's firm.

**Customer Allocation:** when businesses agree to segment their clients between competing businesses to reduce competition.

**Datum:** an official elevation point.

**Debt-to-Income Ratio (DTI):** the ratio of all personal debt to the gross personal income. (Also called the Housing Expense Ratio.)

**Deed:** the legal document used to transfer the title from one party to another.

**Deed of Reconveyance:** a deed used by a trustee to deed the title back to borrower.

**Deed of Trust:** an agreement between three parties, including a trustor, beneficiary, and a trustee to establish a trust. (Also called a trust deed.)

**Deed Restriction:** a limitation or covenant written in a deed to restrict the control, occupancy, or use of a property. (Also known as a restrictive covenant.)

**Deed:** a legal document by which an owner (grantor) transfers his or her right of ownership to another party (the grantee).

**Delivery:** final, unconditional, and absolute transfer of the deed to a grantee in such a manner that it cannot be recalled by the grantor.

**Depreciation:** a loss in property value from any cause; the difference between the cost of an improvement and the market value of the improvement on the same date.

**Designated Agency:** a brokerage relationship created when agents from the same brokerage are designated by a managing broker to represent both the buyer and the seller. (Also known as a dual-licensed dual agency.)

**Designated Sales Associate:** an agent assigned by a managing broker to represent either the buyer or seller when both parties are clients of the same brokerage.

**Devise:** the gift of real property using a will.

**Discount Points:** prepaid interest fees paid to a lender at closing in exchange for a reduced interest rate. (Also known as mortgage points or simply points.)

**Dominant Estate:** the property that benefits from an easement.

**Dual Agent:** a broker who represents both the prospective buyer and the prospective seller as a fiduciary in a real

estate transaction. (Not allowed in some states.)

**Dual-Licensed Dual Agency:** a brokerage relationship created when agents from the same brokerage are designated by a managing broker to represent both the buyer and the seller. (Also called a designated agency.)

**Due Diligence:** an investor's duty to gather necessary information on the actual or potential risks involved in a property purchase.

**Due-on-Sale Clause:** a clause that allows the lender to call the loan due and require immediate payment on the remaining balance if the borrower transfers ownership of the mortgaged property.

**Earnest Money Deposit (EMD):** a monetary deposit made to a seller as a show of a buyer's good faith in a real estate transaction.

**Easement:** the permission, privilege, or right granted to a party to use another's real property for a specific and limited purpose.

**Easement Appurtenant:** an easement that grants an adjacent property the right to use the servient estate.

**Easement by Necessity:** an easement created under a court order.

**Easement by Prescription:** an easement used to legalize adverse possession.

**Easement in Gross:** an easement that represents the interests of a second party in another's land.

**Emblements:** Annual crops that are considered as personal property.

**Eminent Domain:** the right of the government to take private property for public use upon payment of just compensation.

**Encroachment:** the situation when a fixture or improvement crosses property lines, whether it is intentional or accidental.

**Encumbrance:** a claim, liability, or regulation that affects the clear title, diminishes the market value, or prevents the transfer of title of real property.

**Equitable Title:** the right to obtain full ownership or an interest in real property.

**Erosion:** the gradual wearing away of the land through natural forces.

**Escheat:** the right of the government to take private property if the owner dies intestate and without any heirs.

**Escrow Account:** a trust account that holds a buyer's earnest money deposit.

**Escrow Agent:** a neutral third-party such as a title agent or attorney that orchestrates a real estate closing (also called a closing agent).

**Estate at Sufferance:** a leasehold estate created when a tenant remains in possession of the property without the landlord's consent.

**Estate at Will:** a lease similar to an estate from period to period but without a written agreement or stated term.

**Estate in Land:** the degree, quantity, nature, or extent of a person's possessory interest in real property.

**Estate from Period to Period:** a lease for an indefinite term. (Also known as a periodic tenancy or month-to-month lease.)

**Estate for Years:** a lease with a fixed term. (Also called a fixed-term tenancy.)

**Ethical Behavior:** the application of moral principals in a given situation, including honesty, fairness, equality, dignity, diversity, while conforming to society's moral standards.

**Ethics:** moral principles that govern a person's behavior or the conducting of an activity.

**Eviction:** the legal removal of an occupant or tenant from a property.

**Exaggeration:** a statement that represents something as better as or worse than it really is. (Also called puffing.)

**Exclusive Agency:** a seller agreement that agrees to pay the agent a commission as long as the seller does not find the buyer.

**Exclusive Right to Represent:** a buyer-broker agreement that promises to pay the agent regardless of who found the property unless the commission is paid by another party.

**Exclusive Right to Sell:** a seller agreement that promises to pay the agent regardless of who sells the property.

**Executed Contract:** a contract that has been fulfilled by both parties according to the contract's terms and conditions.

**Executory Contract:** a contract under execution where one or more parties have not yet performed their duties as set forth in the contract.

**Express Agreement:** an agreement that is created when both parties formally express their intention to create a brokerage relationship either orally or in a written contract.

**Federal Housing Authority Loans (FHA):** a government-insured mortgage.

**Fee Simple Defeasible Estate:** ownership that could be void or revoked at a future date or for a particular reason.

**Fee Simple Estate:** the highest form of indefinite absolute real estate ownership, which grants the owner the full bundle of rights, which are only limited by law or private restriction. (Also called a fee simple absolute estate.)

**Fee Simple Subject to a Condition Subsequent:** fee simple land ownership that is subject to a condition of ownership in a deed.

**Fiduciary Duties:** the duties and responsibilities of a real estate agent or broker to a buyer or seller during a transaction as mandated by law.

**Fiduciary:** a real estate agent who becomes a single agent of a seller or buyer through the execution of a written agreement and is bound by fiduciary duties.

**Finder's Fee:** a fee paid to a person who makes a deal possible by bringing together two parties in a transaction. Also known as a referral fee or a bird dog fee.

**Fixed-Rate Mortgage:** a loan agreement under which the interest rate and the amount of each payment remain constant throughout the term of the loan.

**Fixed Term Tenancy:** a tenancy that automatically, and without notice of termination, expired at the end of the period stated in the lease agreement (also called a tenancy for years.)

**Fixture:** an item of personal property that is permanently attached to the real estate.

**For Sale by Owner (FSBO):** a property listing that the owner is selling themselves without the representation of a licensed real estate agent.

**Foreclosure:** the legal process by which a lender repossesses the collateral (or property) in an attempt to collect the balance owed on the promissory note after the borrower has defaulted on the loan.

**Formaldehyde:** a colorless and pungent cancer-causing gas.

**Fractional Timeshare:** a form of fee simple ownership whereby multiple owners hold an equal interest in the whole property.

**Franchise:** an authorization granted by a company to an individual or group to use its trademark, business systems, and processes.

**Fraud:** the intentional act or course of deception, concealment, omission, or perversion of the truth causes another party to suffer a loss.

**Freehold Estate:** the exclusive right to enjoy the possession and the use of a real property for an indefinite period of time.

**Future Interest:** a future right to possess real property that may be dependent upon the occurrence of a specific condition or event.

**General Agent:** an agent who is authorized by the principal to perform any and all acts associated with the ongoing operation of a job or business.

**Good Faith:** a sincere belief or motive without any malice or the desire to defraud others.

**Grantee:** the buyer or receiver of the title.

**Granting Clause:** the transfer of ownership or interest in real property from one person to another by a document such as a deed, lease, or mortgage. (Also called the act of conveyance.)

**Grantor:** the owner or seller of the title.

**Gross Rent Multiplier (GRM):** (1) the factor by which gross rent is multiplied in order to obtain an estimate of value; (2) the ratio between the sale price and potential gross income or effective gross income.

**Group Boycott:** when two or more businesses join together and refuse to deal with a type of customer, service provider, or competing business.

**Habendum Clause:** a clause in a deed that describes the limits of the estate being granted.

**Highest and Best Use:** the use of a property that is physically possible, legally permissible, economically feasible, and most profitable.

**Holdover Tenancy:** a tenancy created when the tenant remains in possession after the lease expires and the landlord continues to accept rental payments.

**Home Equity Line of Credit (HELOC):** a line of credit based on the equity in a property used as collateral.

**Home Equity Loan:** the use of equity in a property to obtain additional financing secondary to any other mortgages. (Also called a second mortgage.)

**Homestead:** a right and life estate that protects the family residence from all unsecured creditors.

**Housing Expense Ratio:** the ratio of all personal debt to the gross personal income. (Also called the Debt-to-Income Ratio.)

**Hybrid ARM:** a type of adjustable-rate mortgage in which the initial interest rate remains fixed for a certain period of time, whereby it then becomes adjustable.

**Hypothecation:** the act of a property owner pledging property as collateral to secure a loan without transferring title to the lender.

**Implied agreement:** an agreement created unintentional or accidentally by the behavior and actions of one or both parties.

**Impossibility of Performance:** when both parties cannot legally or practically fulfill their duties as required under a contract and hence, they are released from their contractual obligations.

**Income Approach:** an appraisal valuation approach that converts an income stream into a market value.

**Increasing and Decreasing Returns:** the point that the added value of a feature, addition, repair, etc. is more (increasing returns) or less (decreasing or diminishing returns) than the actual cost of the item.

**Independent Contractor:** an individual who provides services to a company, but is not an employee.

**Intangible property:** personal property that is not physical in nature but represents something of value.

**Interest:** a percentage of the principal amount the borrower repays to the seller over a certain period of time.

**Interest-Only Mortgage:** a mortgage that requires the borrower to make only interest payments at the beginning of the mortgage. (Also known as a Straight Mortgage.)

**Interest Rate:** the cost of borrowing money.

**Intestate:** the state of a person who dies without a valid will.

**Joint Tenancy:** the joint ownership between two or more people, which creates the same undivided interest at the same time and with the same deed.

**Judicial Foreclosure:** the process a lender or third-party uses to obtain ownership of the collateral used to secure a loan through a civil lawsuit as a result of a borrower defaulting on a debt.

**Land Contract:** the seller agrees to transfer the possession and use of real property but retains the title until the purchase price plus interest is paid to the seller in fixed and regular installments (also known as seller financing).

**Landlocked:** a parcel of land without direct access to a public road, street, or waterway.

**Lead:** a heavy metal that is toxic to humans.

**Legal Description:** a geographical description of the land that identifies the precise location, boundaries, and permanent easements that are used in legal documents.

**Legal Title:** the right of legal ownership of real property.

**Lease Agreement:** a contract between a lessor and lessee that allows the lessee rights to use a property owned or managed by the lessor for a period of time.

**Lease Option:** a type of contract whereby the tenant has the option to purchase the property at the end of the lease agreement (also known as a Lease with Option to Buy).

**Leased Fee Estate:** the owner's legal interest in real property after granting the rights of use and occupancy under a lease to a tenant.

**Leasehold Estate:** the exclusive right to enjoy the possession and the use of a real property for a limited period of time.

**Leasehold Interest:** the tenant's legal interest in real property. (Also called a leasehold estate.)

**Leasing:** the process of locating, approving, and granting property to a tenant under a lease agreement.

**Lender:** an entity that advances cash to a borrower for a stated period in exchange for the payment of interest.

**Lessee:** the tenant or renter of the leased property.

**Lessor:** the owner, titleholder, or landlord of the leased property.

**Letter of Intent:** an initial offer submitted on a commercial property.

**Leverage:** the use of borrowed money to finance an investment.

**License:** a privilege granted by the state to operate as a real estate broker, broker associate, or sales associate.

**Lien:** a creditor's conditional right of ownership against a debtor's asset or property that bars its sale or transfer without paying off the creditor.

**Lien Theory State:** a U.S. state that treats a mortgage solely as a security

interest in real property, with title to the property being retained by the borrower.

**Life Estate:** a limited freehold estate for the duration of the life of a designated person.

**Life Estate Pur Autre Vie:** a life estate based on the life of someone other than the life tenant.

**Limited Liability Company:** a corporate structure that creates a barrier of separation between the members of the company and the company's debts and liabilities.

**Liquidated Damages:** the sum that represents the intangible losses to a party in a breached contract.

**Lis Pendens:** a recorded claim, dispute, interest, filed lawsuit, or legal proceeding relating to land that affects the property title.

**Listing Agreement:** an agreement between a property owner and a real estate agent that authorizes the agent to sell or lease the property in return for a commission or other compensation.

**Littoral Rights:** the ownership rights to use adjacent lakes, seas, and oceans.

**Loan Officer:** an official representative of a lending institution that is authorized to act on behalf of the lender within specified limits.

**Loan-to-Value (LTV) Ratio:** the ratio of the mortgage balance to the estimated market value.

**Manufactured Home:** a residence that is pre-constructed in a factory and is supported by a fixed steel chassis and detachable wheels.

**Market Allocation:** when businesses agree to divide their market area and work only in their assigned territory to reduce competition.

**Management Agreement:** a contract that creates a general agency relationship between the property owner and the property manager.

**Managing Broker:** a licensed real estate broker that supervises sales or broker associates. (Also known as a supervising broker.)

**Market Allocation:** when businesses that agree to divide their market area and work only in their assigned territory to reduce competition.

**Market Value:** The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under due duress.

**Material Fact:** anything that, if known, may affect the decision of a reasonable person in a transaction.

**Misrepresentation:** a nonintentional statement or action that is not factual and creates a false impression or conclusion.

**Modular Home:** a residence that is constructed in a factory and assembled on-site on a permanent foundation and conforms to all local, state, and regional building codes.

**Mold:** a microscopic organism that feeds off of damp organic material.

**Monument:** a permanent marker such as an iron pin or concrete post that marks the point of beginning in a legal description.

**Mortgage:** a legal agreement that conveys the conditional right of ownership of a property from the property owner (the mortgagor) to a lender (the mortgagee) as security for a loan.

**Mortgage Assumption:** the action of a buyer assuming the seller's mortgage.

**Mortgage Broker:** a financing professional who seeks to obtain

optimum rates and terms on behalf of a borrower but is not a party to the mortgage transaction.

**Mortgage Points:** prepaid interest fees paid to a lender at closing in exchange for a reduced interest rate. (Also known as discount points or simply points.)

**Mortgage Term:** a fixed period of a loan.

**Multilateral Contract:** a contract with more than two parties and each have exchanged promises of performance.

**Multiple Listing Service (MLS):** a database service used by licensed real estate professionals to provide joint access to member property listings.

**Mutual Recognition:** a transactional agreement between two states that provides for the recognition of each other's real estate license education.

**National Association of Realtors (NAR):** a national organization of real estate agents, created to promote the real estate profession and foster professional behavior in its members.

**Net Listing:** a seller agreement that allows the broker an open commission rate. (This is illegal in most states.)

**Nonconforming Use:** the authorization for the continued use of an existing property that no longer conforms to a new zoning designation.

**Non-Exclusive/Not for Compensation:** a buyer agreement that allows buyers to work with multiple brokers and does not obligate the buyer to pay any compensation to the broker.

**Non-Exclusive Listing:** a listing contract whereby the seller contract with multiple brokers at the same time and agrees to pay commission only to the broker who locates a buyer. (Also called an open listing.)

**Non-Exclusive Right to Represent:** a buyer agreement that pays compensation only if the broker supplied knowledge of the property to the client.

**Nondisturbance Clause:** a clause in a mortgage that ensures the rental agreement will continue under any circumstances.

**Nonjudicial Foreclosure:** the process a lender uses to obtain ownership of the collateral used to secure a loan through a power of sale clause or deed of trust as a result of a borrower defaulting on their debt.

**Nonpossessory Interest:** the right to use but not legally possess the land owned by another.

**Novation:** the action of substituting a new contract in place of the original contract.

**Nuisance:** an activity, conduct, or situation that causes annoyance, inconvenience, or interferes with the use, enjoyment, health, or safety of the public.

**Occupancy Permit:** a certificate issued by a local authority indicating a building meets building-code requirements. (Also called a certificate of occupancy.)

**Offer:** a voluntary but conditional indication of a buyer's willingness to enter into an agreement under specific terms to purchase real property from a seller, which upon the seller's acceptance creates a binding contract. (Same as Real Estate Purchase Contract and Purchase Agreement.)

**Omission:** the action of excluding or leaving out someone or something.

**One-Time Show Listing:** a seller listing agreement that is limited to a specific buyer.

**Open Listing:** a listing contract whereby the seller contract with multiple brokers at the same time and agrees to pay commission only to the broker who locates a buyer. (Also called a non-exclusive listing.)

**Option Contract:** a contract that gives the buyer the right to purchase a property for an agreed-upon price within

a specific time frame (also called an Option Agreement.)

**Optionee:** the buyer in an option contract.

**Parcel:** an individual unit of land.

**Partial Performance:** when one party does not fully perform the duties required by a contract, which can result in contract termination.

**Partitioning:** the division of a parent parcel of land into less than four units.

**Partnership:** a legal form of business operation between two or more individuals who share the debts and obligations of the business.

**Performance of Contract:** the execution of a contract whereby both parties fully performed the duties required under it.

**Periodic Tenancy:** a tenancy that automatically continues until terminated by the tenant or landlord.

**Personal Property:** identifiable tangible objects that are considered by the general public as being "personal;" all tangible property that is not classified as real estate. (Also called chattel.)

**PITI:** an acronym for mortgage expenses including principal, interest, taxes and insurance.

**Planned Unit Development (PUD):** a condominium-style ownership of a subdivision or mixed-use development.

**Pocket Listing:** any listing that is known or held by a listing agent or salesperson that is not in the Multiple Listing Service.

**Points:** prepaid interest fees paid to a lender at closing in exchange for a reduced interest rate. (Also known as discount points or mortgage points.)

**Police Power:** the state's power to make, adopt and enforce laws for the protection and the preservation of the public's general welfare.

**Prepayment Penalty:** a clause in a mortgage which requires a borrower to

pay a fee against the unpaid portion of interest.

**Price-fixing:** when competing businesses come together and agree to set rates and prices to restrict competition.

**Principal:** (1) the amount of a mortgage that is applied to the purchase price. (2) the persons or entities with whom a real estate licensee has entered into a Single Agent Relationship.

**Private Mortgage Insurance (PMI):** insurance that protects a lender against a loss in the event of a loan repayment deficiency when the loan-to-value exceeds 80 percent of the home's value.

**Probate:** the formal judicial process to allocate and distribute the decedent's assets.

**Procuring Cause:** the interaction between a buyer or seller and a real estate agent that results in a real estate transaction that merits financial consideration to the real estate agent.

**Profit à Prendre:** an easement that includes the right to remove natural resources or something of value from the property.

**Progression:** the concept that a property of lesser value is enhanced by its proximity to properties of higher value.

**Promissory Note:** an unconditional, written, signed, and unsecured promise by one party to another to pay a specified sum based on established terms.

**Property Management:** the process of managing, maintaining, and handling all the day-to-day activities surrounding a rental property.

**Property Manager:** an individual or a company that oversees the daily responsibilities of an income property.

**Proration:** the division of a whole amount into daily or monthly portions.

**Prospect:** a purchaser, seller, tenant, or landlord who has not entered into a

representation relationship with an agent or the agent's firm.

**Puffing:** the exaggeration of a material fact or property benefit.

**Purchase Agreement:** a voluntary but conditional indication of a buyer's willingness to enter into an agreement under specific terms to purchase real property from a seller, which upon the seller's acceptance creates a binding contract. (Also known as a Real Estate Purchase Contract or buyer and sell agreement.)

**Purchase Option:** a lease option that allow the lessee to purchase the property at a predetermined price within a specified term.

**Quiet Title:** the legal mechanism used to establish and grant a clear title and ownership of real property.

**Radon:** a colorless, odorless, and tasteless naturally occurring radioactive gas.

**Real Estate:** an identified parcel or tract of land, including any improvements permanently attached to it. (Also called realty.)

**Real Estate Disclosures:** a document provided by a home seller that outlines known issues with a property and other historical details.

**Real Estate Investment Trust (REIT):** a publicly held company that owns income generating real estate investments or related assets.

**Real Estate Owned (REO):** a foreclosed home that is owned by a bank or lender.

**Real Estate Mortgage Investment Conduit (REMIC):** a publicly held entity that holds a fixed pool of mortgages and issues mortgage-backed securities.

**Real Estate Purchase Contract:** a voluntary but conditional indication of a buyer's willingness to enter into an agreement under specific terms to purchase real property from a seller,

which upon the seller's acceptance creates a binding contract. (Also called a buy and sell agreement and a Purchase Agreement.)

**Real Estate Security:** the investment in real estate without having to buy land or buildings.

**Real Estate Services:** real estate activities involving compensation for performing the activities for another.

**Real Estate Settlement Procedures Act (RESPA):** a federal statute enacted by the U.S Department of Housing and Urban Development (HUD) to govern the real estate settlement process.

**Real Property:** the land, the improvements, plus the interests, benefits, and rights inherent in the ownership of real estate.

**Realtor:** (1) a person who acts as an agent for the sale and purchase of buildings and land; a real estate agent; (2) a real estate agent who is a member of the National Association of REALTORS®.

**Redlining:** the act of refusing a mortgage or insurance policy because of where the applicant lives rather than their creditworthiness.

**Referee's Deed:** a deed used in bankruptcy proceedings and foreclosures.

**Regression:** the concept that a property of greater value is negatively affected by its proximity to lower value properties.

**Regulation Z:** Federal Reserve Board regulations that implement the Truth in Lending Act of 1968.

**Renewal Option:** an option in a lease agreement allowing the tenant to extend their tenancy under the terms of the initial lease agreement.

**Return on Investment (ROI):** a profitability ratio that measures the profit made on an investment as a

percentage of the cost of the investment.

**Reverse Mortgage:** a loan that converts home equity into monthly payments that are paid to the property owner.

**Riparian Rights:** the ownership rights to use a river or stream.

**Risk:** the possibility of financial loss.

**Sale-and-Leaseback:** a commercial property owner who sells the property to an investor and then enters into a long-term lease for the property.

**Sales Associate:** anyone who holds a real estate license and values, auctions, sells, exchanges, buys, or rents for compensation under the direction, control, or management of a broker or owner/developer. (Also called a real estate agent salesperson.)

**Sales Comparison Approach:** an appraisal valuation approach that makes a direct comparison between the subject property and other similar recent sales.

**Satisfaction of Mortgage:** a legal document indicating a mortgage loan has been paid in full and, when recorded, removes the lien from the property.

**Secondary Mortgage Market:** the financial market in which existing mortgage loans are bought by other lenders, collection agencies, and investors.

**Seller Financing:** the seller agrees to transfer the possession and use of real property but retains the title until the purchase price plus interest is paid to the seller in fixed and regular installments (also known as a land contract).

**Servient Estate:** the property containing an easement.

**Severance:** The act of converting real property to personal property.

**Sheriff's Deed:** a deed given by a court to affect the sale of the property to satisfy a judgment.

**Short Sale:** real estate that is sold for less than the amount owed on the property, with the approval of the lienholder.

**Single Agent:** an agent who provides a buyer or seller with exclusive representation that establishes fiduciary duties.

**Single-License Dual Agency:** created when a broker represents both the buyer and seller in a transaction.

**Sole Proprietorship:** the simplest business entity that legally has no distinction between the assets and liabilities of a business and those of its owner.

**Special Agent:** an agent who has limited and/or temporary authority granted to them by a principal.

**Specific Performance:** when a party completely fulfills all of the duties required of them under a contract.

**Statute of Limitations:** the amount of time established under contract law that an injured party can file for legal action.

**Statutory Laws:** written laws passed by legislature and governments of a country and those laws which have been accepted by society.

**Statutory Life Estate:** a legal life estate created by a state's common law when certain events occur.

**Statutory Redemption:** a mortgagor or borrower's right to regain ownership of a property that has been foreclosed upon within a certain period of time.

**Steering:** the illegal practice of channeling buyers or renters into areas that are primarily composed of people of their own race or ethnicity.

**Stigmatized Property:** a property that is shunned for the historical occurrence of

a tragedy or an event which weakens its market appeal.

**Straight Mortgage:** a mortgage that requires the borrower to make only interest payments at the beginning of the mortgage. (Also known as a Interest-Only Mortgage.)

**Sub-agency:** a client representation relationship between a listing agent and another real estate agent whereby a licensed salesperson is the agent of the agent.

**Subdividing:** the division of a parent parcel of land into more than four units.

**Subject Property:** the property being appraised or valued.

**Subsurface Rights:** the ownership rights that apply to the natural resources below the surface of the land.

**Supply and Demand:** the concept that the amount of a product available to buyers and the demand for that product forms a relationship determining the price of that product.

**Surface Rights:** the ownership rights that apply to the surface of the land.

**Survey:** (1) the process of creating a legal description; (2) the reporting of the legal description.

**Surveyor:** the person who completes a survey.

**Substitution:** the concept that an informed buyer will not pay more for a property than the price of an equally desirable substitute.

**Syndicate:** a business venture whereby investors pool their resources to develop or own a real property investment.

**Tacking:** the act of passing adverse possession to a new owner.

**Tangible Property:** an item of personal property that has physical substance and can be touched.

**Tax Deed:** a deed that conveys properties lost because of the non-payment of taxes.

**Tenancy by the Entirety:** equal and undivided co-ownership by married couples.

**Tenancy in Common:** equal or unequal undivided ownership interests of two or more individuals.

**Tenancy in Severalty:** absolute and sole ownership by one entity, such as an individual or corporation.

**Testate:** the state of a person who has a written and executed will at the time of their death.

**Testator:** the person who has written and executed a last will and testament.

**Title:** the right of ownership to real property.

**Title Agent:** a neutral third-party that researches the title status of real property to ensure that the seller is the legal owner of the property and that there are no legal defects in the title that would prevent the transfer to a buyer.

**Title Commitment:** (1) a preliminary report of title or (2) a commitment to issue a title policy.

**Title Insurance:** an insurance policy that covers the owner against loss because of liens, encumbrances, or defects in the title to the property.

**Title Theory State:** a U.S. state in which mortgages are treated as passing legal title to the lender, with the borrower having equitable title.

**Transaction Broker:** an agent who provides a limited form of representation to a buyer, a seller, or both in a real estate transaction, but does not represent either in a fiduciary capacity or as a single agent.

**Trade Fixtures:** Commercial fixtures that are considered as personal property and transfer with the going concern.

**Trust Account:** a savings account that holds funds for a specific purpose on behalf of a beneficiary.

**Underwriter:** an individual working for a lender who determines whether or not a borrower's loan is approved by evaluating the entire loan application, including the appraisal.

**Unilateral Contract:** a contract whereby only one party is accountable for the fulfillment.

**Universal Agent:** an agent who is authorized by the principal to perform all acts which are not limited to real estate transactions.

**USDA Rural Development Loans:** a payment assistance program offered to

low and very low-income borrowers to obtain housing in rural areas.

**Variance:** an official dispensation from a rule or regulation.

**Veteran's Administration (VA) Loan:** a federally-backed mortgage loan available to veterans of the United States Armed Forces.

**Voluntary Alienation:** when title to real property is transferred voluntarily.

**Warranty of Habitability:** an implied warranty required by law that obligates the landlord to ensure that a residential property is habitable and safe.

**Zoning Ordinance:** a written regulation and law that defines how property in specific geographic zones can be used.