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Case #1 Carl Michel et al. v. Moore & Associates, Inc.

Negligent Nondisclosure, November 1, 2007

Introduction

Mike Kirkpatrick was a transaction coordinator and licensed agent for Larry Moore & Associates, Inc. (Moore). In 2000, he inspected a friend's parents home and took notes regarding possible water leaks, cracked interior walls ("Cracks you could slip a coin into. . ."), and damage to the pool. Six months later the property was listed with Fred Sands Real Estate, so Kirkpatrick did not get the listing. A short time later, Kirkpatrick showed the property to Carl and Sydne Michel, who were represented by Lagudis—who was a colleague of Kirkpatrick's and worked for Moore also. During the home tour, Mike did not point out the physical defects he noted several months earlier. The Michels mistakenly thought that Kirkpatrick was the listing agent, when in fact he was working as an associate of Lagudis. The Michels gave Kirkpatrick an offer to purchase the home that was never presented to the sellers. A short time later, the Michels presented another offer to the Fred Sands agent who did present the offer to the sellers. The parties came to agreement and escrow was opened. When selling agent Lagudis completed the Real Estate Transfer Disclosure Statement (TDS), she noted that cracks in the walls had been patched and painted; however, she did not note any of the listed items in Kirkpatrick's previous notes. As transaction coordinator for Lagudis, Mike went over the TDS with the Michel's and did not augment anything from his earlier notes. A month after close of escrow, it rained and cracks emerged in the interior walls. The Michel's also remodeled the backyard and pool and found that they needed a permit to do this. While attempting to obtain a permit, they were required to have a soil engineer inspect the property. The soil engineering report discovering poor topsoil and that the home was tilted 3.5 inches from level. To stabilize the house, the soil engineer recommended caissons down to bedrock and would cost approximately $500,000 to repair. The Michel's heard about Kirkpatrick's notes and asked for a copy of them. Kirkpatrick provided the notes to the Michel's. The Michel's filed suit against Moore for fraudulent concealment for the failure of Lagudis's TDS to disclose defects known to Moore. They also filed a suit for negligent nondisclosure. Fred Sands settled out of court for $50,000. The sellers filed for bankruptcy protection. They went to trial for violation of TDS requirements (civil code) and fraudulent concealment. The jury returned a verdict for Moore on both counts. The jury believed that Moore had conducted a reasonably competent and diligent visual inspection of the property. The appellate court disagreed and reversed the trial court's judgment. The appellate court remanded the matter back to the trial court for trial. The appellate court found that the selling agent (Moore) did have a fiduciary duty to his principal (Michels). They breached this duty by not disclosing Kirkpatrick's notes to the buyers.

Here's What Happened

Mike Kirkpatrick was a real estate agent working for Larry Moore & Associates, Inc., a licensed real estate broker.

Sometime around the beginning of 2000, he inspected a home in Rolling Hills Estates owned by a friend's parents.

Hoping to become the listing agent if the parents decided to sell their house, he took notes of the property's defects, including possible water leaks, cracked interior walls, and damage to the pool.

If he won the listing, he planned to use his notes to identify needed repairs and possible disclosure to potential buyers.

About six months later in June 2000, the house was on the market.

Kirkpatrick, who had not received the sellers' listing, showed the house to appellants Carl and Sydne Michel, who were represented by agent Nicola Lagudis, a colleague of Kirkpatrick also working for Larry Moore & Associates.

During the home tour, Kirkpatrick did not point out any of the defects from his notes.

Carl and Sydne Michel were under the misimpression that Kirkpatrick represented the sellers.

Actually, he was acting as an associate of their agent, Lagudis.

In fact, a Fred Sands office had the sellers' listing.

Based on that misimpression, the Michel’s gave Kirkpatrick a written offer to buy the house.

Several weeks later after receiving no reply to their misdirected offer to Kirkpatrick, the Michel’s revisited the property and submitted a new offer to the Fred Sands agent.

The Michel’s and the sellers shortly thereafter agreed on the terms of sale and entered escrow.

At the end of July, the Michel’s agent Lagudis visually inspected the property and gave the Michel’s her obligatory transfer disclosure statement (TDS).

In accordance with Kirkpatrick's notes some seven months earlier about cracks in the walls, the TDS noted cracks had been patched and painted.

The TDS did not, however, disclose other defects listed in Kirkpatrick's notes.

One of Kirkpatrick's tasks as respondent's “transaction coordinator” was reviewing the sales files of respondent's agents to ensure a sale's paperwork was in order before escrow closed.

Accordingly, Kirkpatrick reviewed Lagudis's TDS to the Michels.

Although mindful of his notes as he reviewed the TDS, he did not tell Lagudis about them, nor did he augment her TDS with anything from those notes.

The Michel’s thus never knew the contents of Kirkpatrick's notes before escrow closed.

Starting with the first winter rains about a month after appellants moved into their new home, cracks emerged in interior walls, which appellants repeatedly patched.

Around that time, the Michel’s started remodeling their backyard and pool.

To do so, they needed a permit, which required a soil engineer to inspect their property.

The engineer discovered poor topsoil and fill had caused significant instability and ground movement on the property.

He found the movement had tilted the house's foundation about 3.5 inches from level, which in his opinion caused the repeated cracks in the walls.

To stabilize the house, he recommended placing caissons under its foundation down to solid bedrock.

Upset by the engineer's report, appellants met with Kirkpatrick in January 2001.

They told him about the soil instability and cracks in the walls, which would likely cost about half a million dollars to fix.

Kirkpatrick replied he had seen during his inspection before the house was put on the market cracks big enough to slip a coin into.

Hearing about his notes for the first time, the Michel's asked for a copy, which Kirkpatrick gave them.

In September 2002, the Michel's sued Larry Moore & Associates.

They alleged causes of action for violation of **Civil Code section 2079** for Moore's failure to competently inspect the property. Larry Moore & Associates, Inc.

They also alleged a cause of action for fraudulent concealment for the failure of Lagudis's TDS to disclose defects known by Larry Moore & Associates, Inc.

And, finally, they alleged a cause of action for negligent nondisclosure in Larry Moore & Associates, Inc.'s not telling the Michel's about problems Larry Moore & Associates, Inc. knew about the property.

The Michel's settled for $50,000 with the listing agent, Fred Sands Palos Verdes Realty and its employees.

The sellers filed for protection under the bankruptcy laws.

The complaint originally pleaded a cause of action for violation of **Civil Code section 1102 et seq.**, but the Michel's amended without objection that cause of action to allege a violation of **section 2079**.

The case went to trial.

Before the Michel's opening statement, Larry Moore & Associates, Inc. moved for a judgment of nonsuit on the Michel's cause of action for negligent nondisclosure.

Larry Moore & Associates, Inc. argued California law required that the Michel's negligence involve an affirmative assertion, but negligence in failing to disclose a fact was not actionable.

The court granted Larry Moore & Associates, Inc.'s motion.

Trial proceeded only on the Michel's causes of action for violation of **Civil Code section 2079** and fraudulent concealment.

The jury returned a verdict for Larry Moore & Associates, Inc. on both causes of action.

Rejecting the claim under **section 2079**, the jury found Larry Moore & Associates, Inc. did not fail to conduct a reasonably competent and diligent visual inspection of the property, and did not fail to disclose to the Michel's any material fact about the property that an investigation would reveal.

Similarly rejecting the claim for fraudulent concealment, the jury found Larry Moore & Associates, Inc. did not conceal or suppress any material fact from appellants.

The court entered judgment for Larry Moore & Associates, Inc.

This appeal followed.

Stated in a nutshell, the Michel's claim Larry Moore & Associates, Inc. is liable for not telling them before they bought their home about Kirkpatrick's walk-through and notes.

The trial court let two causes of action go to the jury: a statutory cause of action for violating **section 2079**, and a common law cause of action for fraudulent concealment.

The court instructed the jury that under **section 2079** “a real estate broker has a duty to the prospective purchaser of a residential real property to conduct a reasonably competent and diligent visual inspection of the property offered for sale and to disclose to a prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal.”

It further instructed for fraudulent concealment that appellants must show respondent intentionally concealed facts with the intent to defraud them.

By its terms, **section 2079** imposes a duty only from the *listing* broker who is *selling* the property to the buyer; it does not impose a duty on the buyer's own broker.

It states in pertinent part, “It is the duty of a real estate broker or salesperson … to a prospective purchaser of residential real property … to inspect and disclose if that broker has a *written contract with the seller* to find or obtain a buyer or is a broker who *acts in cooperation* with that broker to find and obtain a buyer.”

[**§ 2079** obligates seller's broker to conduct reasonable visual inspection for the buyer's protection;

[**§ 2079** obligates *seller's* broker to conduct reasonably competent and diligent visual inspection and disclose to *buyer* facts such an inspection would reveal.)

The appellate court found nothing in the record of a written agreement or evidence of Fred Sands and respondent acting in cooperation to find a buyer.

The court's dismissal of appellants' cause of action for negligent nondisclosure was error because it involved elements different from appellants' **section 2079** and fraudulent concealment causes of action.

In Karoutas v. HomeFed Bank (1991) recognizing negligent nondisclosure where bank did not disclose soil instability to buyer purchasing property after bank foreclosed on the property.

For those latter two causes of action submitted to the jury, Lagudis may very well have been *competent* in her visual inspection of the property in preparing her TDS for the Michel’s AND Kirkpatrick may very well have had no *fraudulent* intent in not telling the Michel’s about his inspection and notes before escrow closed—circumstances justifying the jury's verdict for Larry Moore & Associates, Inc.. on the **section 2079** and fraud causes of action—but that does not mean respondent did not injure appellants by not telling them before they bought their house about Kirkpatrick's notes.

A broker has a fiduciary duty to its client.

Civ. Code, § 2079.24; states: “a broker's fiduciary duty to his client requires the highest good faith and undivided service and loyalty”.)

The fiduciary duty is greater than the negligence standard of due care under **section 2079**.

Civ. Code, § 2079.2 standard of care is of a “reasonably prudent real estate licensee”.)

Thus a broker can be professionally competent under **section 2079** without satisfying the greater duty of a trusted fiduciary.

According to section 2079, the *fiduciary* duty owed by brokers to their own clients is substantially more extensive than the *nonfiduciary* duty codified in **section 2079**.

A fiduciary must tell its principal of all information it possesses that is material to the principal's interests.

A fiduciary's failure to share material information with the principal is constructive fraud, a term of art obviating actual fraudulent intent.

In Assilzadey v. Calfironia Federal Bank (2000) "a real estate agent, as a fiduciary, is … ' "… liable to his principal for constructive fraud even though his conduct is not actually fraudulent.

Constructive fraud is a unique species of fraud applicable only to a fiduciary or confidential relationship."

As a general principle constructive fraud comprises any act, omission or concealment involving a breach of legal or equitable duty, trust or confidence which results in damage to another even though the conduct is not otherwise fraudulent.

Most acts by an agent in breach of his fiduciary duties constitute constructive fraud.

The failure of the fiduciary to disclose a material fact to his principal which might affect the fiduciary's motives or the principal's decision, which is known (or should be known) to the fiduciary, may constitute constructive fraud."

The Michel's negligent nondisclosure/constructive fraud theory relieved them of the burden of needing to prove respondent intended to defraud them, a much easier row to hoe than proving actual intent to defraud for fraudulent concealment.

Section 2079 codifies a negligence standard of care for one particular task that the law imposes on brokers—the obligation (by a seller's agent) to visually inspect the property and disclose the results of that inspection to the buyer.

The Michel's cause of action for negligent nondisclosure rests, in contrast, on respondent's fiduciary duty to disclose material information within its possession.

It was immaterial how the fiduciary obtained the information; it has a duty to disclose the information to its principal.

The *fiduciary* duty owed by brokers to their own clients is substantially more extensive than the *nonfiduciary* duty codified in **section 2079**."

Finally, respondent contends Lagudis's TDS covered all the property defects listed in Kirkpatrick's notes.

Comparing the TDS to Kirkpatrick's notes shows respondent is mistaken because the notes identify defects the TDS did not list.

For example, the notes state "pool needs work—cracks—missing tiles"; the TDS does not mention the pool.

The notes record "sliding doors master bath needs adjusting (hard to slide)," but the TDS does not mention the doors or the master bathroom.

The notes observe that a front planter was cracked, but the TDS says nothing about it.

The notes identify "discoloration under living room doors (leak?)," but the TDS says nothing similar.

The notes state "stucco damage around rear door (water)??" but the TDS only noted cracks in the stucco without referring to the door or mentioning water.

The notes record "damage around living room window"; the TDS does not mention the window.

The notes state “hardwood floors in family room separating,” whereas the TDS says the floors were merely “uneven.”

The notes record “discoloration around toilet (1/2 bath),” but the TDS mentions only the stained floor in the bathroom without connecting it to the toilet.

Respondent's contention that the notes and TDS were redundant does not pass muster.

A jury might reasonably find that if Larry Moore & Associates, Inc. had disclosed the defects from Kirkpatrick's report, the new information, combined with the TDS material, could have alerted the Michel’s to the soil defect that undermined the foundation's stability.

The judgment was reversed by the appellate court and the matter was remanded for further proceedings only on appellants' cause of action for negligent nondisclosure.

In all other respects, the judgment was affirmed. Appellants were to recover costs on appeal.

Cooper, P. J., and Flier, J., concurred.

Moral of the Story

If you are a real estate broker operating in California, it is usually a pretty good idea to have your buyers get a home inspection on every property where you are involved. I don’t know if the home inspection would have discovered the soil instability issues; however, if the inspector did indeed discover the home was 3.5 inches out of level, the buyers may have not gone forward with the transaction or renegotiated the price of the property to reflect this defect. In some cases, the seller is aware of these types of defects and is trying to “pass the home off” on an unsuspecting buyer (i.e. take the money and run).

Case #2 John Warren v. Hildegard Merrill

Agent Fraud, September 21, 2006

Introduction

In July 2001, John Warren the grandson of Earl Warren—former California Governor and Chief Justice of the United States, suffered from several neurological disorders that affected his short-term memory and cognitive abilities. His movie set rental business was not doing well and he was getting a divorce. He wanted to buy a house himself and attended an open house for a condo in Woodland Hills. At the open house he met Hildegard Merrill (Merrill) who was the listing broker for the property. Merrill considered herself the "condo queen" and also performed mortgage lending. Warren had a poor credit rating and low FICO score, as a result of his movie rental business collapsing. Warren had $50,000 he could use as a down payment for the condo; however, Merrill stated that Warren would need at least 20% down payment to obtain a loan. Merrill suggested her daughter, Charmaine as a co-borrower. Warren agreed and also agreed to pay Charmaine $10,000 for her assistance. Warren and Charmaine would be co-owners and co-borrowers. As soon as escrow closed, Charmaine was supposed to sign a quitclaim deed to remove her name from title—in exchange for $10,000. Merrill also agreed to "defer" her commission of $27,000 and loan it to Warren, so he would have the necessary 20% down payment ($77,000). Warren agreed, but the agreement was never put into writing. Warren asked several times for the agreement to transfer title to be into writing. Merrill never did so. Merrill wrote up a purchase agreement for the condo, with Warren and Charmaine as co-borrowers. Warren never filled out a loan application and Merrill never attempted to secure a loan with Warren as a co-borrower with her daughter, Charmaine. Instead, Merrill attempted to secure a loan with Charmaine's name ALONE. Merrill completely misrepresented many facts on Charmaine's loan application, including where Charmaine lived, how much income she had, and that she intended to occupy the condo. In fact, Charmaine was a waitress in Aspen, Colorado and relied on her mother for much of her financial support. Merrill conceded at trial that, "had she been truthful, she wouldn't have gotten the loan." Charmaine was only doing what her mother told her to do, had never met Warren, and never had seen the inside of the property. She did not question her mother's investment decisions, especially since Merril was partially supporting her in Aspen. The $77,000 down payment was paid by Warren through $50,000 into escrow by writing checks to different persons and entities (as directed by Merrill) and repaying Merrill for the $27,000 she loaned him from her commission. Warren was not aware that the seller had agreed to credit the buyers $6,000 in escrow toward closing costs. Merrill had Warren sign an amendment to escrow removing his name from title "as just a formality." The amendment stated that "title would vest solely in Charmaine's name only, and that John Warren was no longer a party to the escrow." It also stated that "all monies on deposit shall accrue to Charmaine." Escrow closed in October 2001 and Warren moved into the condo. Merrill did NOT have Charmaine transfer title to Warren after close of escrow—or anytime thereafter. Warren made loan payments for several months and then developed a substance abuse problem. He checked into the Betty Ford Center for treatment. While there, he defaulted on the condo loan and also the homeowner's association dues of approximately $5,000 in arrearages. Merrill filed an unlawful detainer action to have Warren removed from the condo. She obtained a subsequent writ of possession and evicted him from the unit. She also removed his personal belongings, which included personal papers of his grandfather, former Chief Justice of the United States—Earl Warren. Merrill held a lien sale, where she was the only successful bidder. When Warren left the Betty Ford Center he found himself locked out of his condo and with no place to go. He was forced to sleep in the park and in his car. Merrill described the arrangement at differing times of her testimony as an equity sharing agreement, a lease, a land sale contract, a joint venture, and a partnership. The trial court said Merrill's testimony was, "absolutely unreliable and lacks credibility." The court thought that Merrill's behavior was an incredible breach of fiduciary duty." The court also found that Merrill "had acted outrageously and with at least reckless disregard in perpetrating the fraud on Warren." The court ordered Merrill and Charmaine to convey the property to Warren. Merrill had paid $18,765 for storage of his personal property and other expenses, and $32,000 to the mortgage. The court awarded $50,000 in punitive damages that seemed to cover these expenses. The appellate court affirmed the trail court's judgment.

Here's What Happened

In July 2001, John Warren (plaintiff and respondent), had all sorts of problems.

He suffered from Tourette's syndrome and other related neurological disorders affecting his short-term memory and cognitive abilities.

His movie set rental business was not doing well.

At the time he was also in the process of getting divorced.

He wanted to buy a house for himself.

He attended an open house for a condominium in Woodland Hills near the Warner Center Apartments where he was then living.

At the open house Warren met (defendant and appellant) Hildegard Merrill, doing business as Calabasas Realty, who was the agent for the seller of the condominium.

Merrill told Warren the condominium was a good buy.

She told him the seller was motivated to sell, the condominium had the largest square footage of any of the townhouses in Woodland Hills and would make a good investment.

Merrill is very experienced in the real estate field.

She acquired her real estate license in 1967 and had been a licensed real estate broker since 1981.

She had bought and sold so many condominiums over the years she sometimes referred to herself by her professional nickname of the "condo queen."

In due course Merrill also acquired a mortgage broker's license.

With his permission Merrill ordered a credit report for Warren.

Although his personal credit was fine, a studio set business in which he had been a partner had sustained a $ 1 million judgment for nonpayment of rent when the business collapsed.

As a result, Warren's credit rating was poor and his FICO score was very low.

Merrill told Warren he would have to make at least a 20 percent down payment or he would have to pay a very high mortgage interest rate.

Although Merrill denied it at trial, Warren testified he informed Merrill he only had $ 50,000 to put toward a down payment until his family residence was sold as part of the divorce proceedings.

Merrill told Warren he needed a co-borrower with a good credit rating in order to secure a mortgage at a reasonable rate.

Warren told Merrill he knew of no one who could be a co-borrower with him.

Merrill suggested her own daughter, Charmaine Merrill, for this purpose.

Warren indicated he was interested in pursuing this arrangement and Merrill told Warren she would discuss it with her daughter.

A day or so later Merrill told Warren her daughter Charmaine had agreed to go on title with him and to be the co-borrower on the mortgage provided he pay Charmaine $ 10,000 for her assistance.

Warren testified Merrill explained her plan for the transaction as follows: Charmaine would be the co-owner and co-borrower on the loan.

However, once escrow closed Charmaine would execute a quitclaim deed to him to remove her name from title in exchange for the $ 10,000.

As the loan broker Merrill knew it was important to make a 20 percent down payment in order to secure a reasonable interest rate.

Because Warren did not have the money, Merrill offered to defer her commissions of $ 27,000 and to loan this amount to Warren in order to attain a 20 percent down payment of $ 77,000.

Warren agreed to Merrill's plan.

The parties discussed committing their arrangement to written form but never did.

According to Warren he asked Merrill several times, both before and after escrow closed, to put their agreement to transfer title in writing.

Merrill wrote up a purchase offer for the condominium.

The purchase offer indicated her daughter Charmaine and Warren were the proposed co-purchasers.

Merrill never had Warren fill out a loan application form and Merrill never attempted to secure a loan with Warren as a co-borrower with her daughter Charmaine.

Instead Merrill applied for and secured a loan in Charmaine's name alone.

Through Charmaine's and Merrill's testimony it became apparent Merrill misrepresented the facts when she filled out Charmaine's loan application.

For example, Merrill stated the source of the proposed $ 77,000 down payment was a combination of savings and gifts.

The application stated Charmaine then resided in a condominium at 5800 Kanan Road in Agoura Hills, conducted catering and shuttle businesses out of the residence on Kanan Road, and had been doing so since 2001, earning a monthly income of $ 7,500 from those businesses.

In reality, Charmaine had resided for years in Aspen, Colorado, and had never lived at or conducted a business out of the 5800 Kanan Road residence.

Also, the businesses Charmaine purportedly conducted had shut down sometime in 1990.

Charmaine was instead employed as a waitress in Aspen, Colorado, and periodically conducted her shuttle business there.

She otherwise relied on her mother for support.

Although Merrill indicated on the loan application Charmaine intended the condominium to be her primary residence, the parties' plan all along was for Warren to live in the condominium instead.

As Merrill later conceded in her testimony, she would never have gotten the loan had she been truthful in the loan application.

The trial court was so alarmed by Merrill's testimony and her apparent lack of concern about admitting she had committed a form of fraud on the lender, the court recessed the proceedings to permit Merrill to consult with counsel regarding her **Fifth Amendment** right not to incriminate herself.

After the recess Merrill indicated she wished to proceed.

On the advice of her counsel Merrill believed she had not committed any truly fraudulent act and for this reason stated she had no concerns she might be incriminating herself.

Charmaine was not involved in any part of the transaction other than to sign the documents her mother told her to sign.

She had never met or talked to Warren and by the time of trial had never even seen the interior of the condominium.

Charmaine stated Merrill supported her and she trusted her mother and her mother's judgment implicitly.

Charmaine testified she never questioned or concerned herself with her mother's investment decisions.

As with most of the evidence, how the $ 77,000 down payment was cobbled together was the subject of conflicting evidence.

According to Warren, he paid the entire $ 77,000 down payment: $ 50,000 into escrow by writing checks to different persons and entities as directed by Merrill and by repaying the $ 27,000 Merrill loaned him toward the down payment.

Specifically, Warren testified he and Charmaine each deposited a check for $ 10,000 into escrow.

Then at Merrill's direction, he repaid Charmaine this $ 10,000 by writing two checks of approximately $ 5,000 each: one to pay toward Charmaine's Chase Platinum credit card balance and the other to pay toward Charmaine's MBNA credit card balance.

Warren wrote a check for $ 30,000 to Merrill's boyfriend, again at Merrill's direction.

Merrill then deposited into escrow a check for $ 30,000 written on her and her boyfriend's Paine Webber investment account.

In exchange for her boyfriend's services, Merrill had Warren write her boyfriend another check for $ 2,000.

Merrill deferred her combined sales commission and loan broker commission of $ 27,000 to complete the $ 77,000 down payment.

Warren wrote Merrill a check for $ 27,000 which Merrill held uncashed until Warren repaid her this amount.

He accomplished repayment of the $ 27,000 by writing Merrill checks of between $ 3,000 and $ 4,000 over the course of about six months.

Unbeknownst to Warren, the seller had agreed to credit $ 6,000 in escrow to defray closing costs, which should have reduced the amount Warren repaid Merrill.

Merrill knew the lender would not fund the loan request with different people proposed to hold legal title than had applied for the loan.

Merrill had Warren sign an amendment in escrow to remove his name from title, explaining the document was just a formality required to secure the loan and to close escrow.

The amendment stated title would vest solely in Charmaine Merrill.

The amendment further stated “John Warren is no longer a party to this escrow.

All monies currently on deposit to this date shall accrue to Charmaine Merrill.”

Escrow closed in October 2001 and Warren moved into the condominium.

Merrill did not have Charmaine execute a quitclaim deed to transfer title to Warren after escrow closed or at any time thereafter.

Warren and/or his attorney made the mortgage payments directly to the lender for several months.

However, Warren developed substance abuse problems.

He checked into the Betty Ford Center for treatment.

He had not made arrangements for someone to handle his personal and financial affairs in his absence.

Previously the State of California had provided him with a personal assistant to see to his personal needs and this person had previously been the one to deal with his mail and to pay his bills.

Merrill learned the homeowners' association was about to foreclose on Warren's unit.

A few days before the scheduled foreclosure date Merrill paid the association the approximately $ 5,000 then claimed as arrearages to prevent the foreclosure.

Warren also defaulted on his mortgage payments while in treatment.

Merrill filed an unlawful detainer action to have him removed from the unit.

The unlawful detainer complaint prepared by Merrill alleged Charmaine was the owner of the condominium.

The complaint further alleged Warren occupied the condominium under a land sale contract and this agreement permitted him to occupy the unit so long as he made monthly payments of $ 2,500.

While Warren was still in the Betty Ford Center receiving treatment Merrill secured a judgment against Warren, got a writ of possession and evicted him from the premises.

She removed all his belongings and either placed them in a storage facility or in the garage of her home in Woodland Hills.

According to Warren, his belongings included original artwork, sports memorabilia, the personal papers of his grandfather, the former California Governor and Chief Justice of the United States, Earl Warren, antique furniture, jewelry, medals, and several filing cabinets containing all his business records.

There was some indication in the evidence Merrill held a lien sale of Warren's personal property and was herself the successful bidder at the sale.

When he left the Betty Ford Center in September 2002 Warren discovered he had been locked out of the condominium.

He called Merrill from San Diego and offered to repay her all the money she had advanced to save the condominium from foreclosure.

Warren explained he would request an advance on his inheritance from his brother who was the executor of their parents' estates.

He talked to Merrill many times but she would not permit him to return to the residence.

He did not understand how or why she could remove him from his own residence, or how or why she knew about the homeowners' association arrearages when he was not even aware of the requirement of homeowners' association dues.

In his last conversation with Merrill, Warren explained he was desperate and homeless.

Over a four-month period he had stayed with various friends or slept in his car, but was then sleeping in the park and using public facilities to attend to his personal hygiene.

Merrill told Warren he just “didn't get it.”

Merrill informed Warren he did not owe her any money and directed Warren not to call her any more.

After evicting Warren, Merrill rented the condominium to a series of renters.

At trial, Warren agreed he would have lost the condominium through foreclosure had he been the sole person on the title and trust deed absent extraordinary intervention by his brother who controlled additional funds as the executor of their parents' estates.

In her testimony Merrill acknowledged Warren paid the initial $ 10,000 into escrow.

She also admitted she had held his $ 27,000 check until he repaid her this amount representing her loan to him of her commissions as the sales agent and loan broker.

However, Merrill denied knowing anything about the $ 30,000 check Warren wrote to her boyfriend.

On the other hand, Merrill admitted she recognized the endorsement on the back of Warren's $ 30,000 check as her boyfriend's signature.

Merrill also denied knowing Warren had written her boyfriend a check for $ 2,000.

She stated she had no idea why Warren would do such a thing, but acknowledged her handwriting appeared on the upper portion of the $ 2,000 check.

She also acknowledged the endorsement on the check was her boyfriend's signature.

Merrill denied knowing Warren had written any checks to Charmaine's credit card accounts and further denied knowing whether credit card accounts identified on Warren's checks even belonged to her daughter.

Merrill claimed she paid the $ 30,000 plus out of her Paine Webber account toward the down payment as a gift to her daughter Charmaine.

Merrill explained her arrangement with Warren in varying terms.

She claimed they had an equity sharing agreement.

As she explained it, he was to make lease payments covering the mortgage and all related expenses for a year.

At the end of the year he was to refinance the loan and Merrill would arrange to have Charmaine's name taken off title.

Although she alleged in her unlawful detainer complaint they had a land sale contract, Merrill claimed this was a mistake.

She denied they had agreed to anything more than a lease arrangement which might have evolved into a land sale contract if he had made all "option" payments in a timely fashion and was later able to refinance the loan.

Later in her testimony Merrill described her arrangement with Warren as a sort of "partnership," with Charmaine lending her credit and Warren making all the payments.

However, because Warren defaulted on his payments within the first year, Merrill testified, he had forfeited all monies he had put into the deal.

As Merrill conceded, when she undertook to represent Warren in the real estate transaction she owed him a fiduciary duty which required her to place his interests above her own.

However, Merrill testified she saw no conflict of interest from her simultaneous representation of the seller, Warren and her daughter in the various transactions.

Warren filed suit against Merrill, Charmaine, and others asserting 14 causes of action.

Merrill and Charmaine filed an answer and asserted numerous affirmative defenses.

Trial was to the bench (decided by the judge).

The Court Ruled As Follows

The court ruled as follows: "With respect to the cause of action for quiet title and for a constructive trust, the court finds in favor of the Warren.

As to both Mrs. Hildegard Merrill and Ms. Charmaine Merrill, I wanted to make some comments with respect to my view of the evidence and the element of the procurement by fraud and breach of the fiduciary duty.

One of the problems I've had in evaluating the testimony, particularly of Ms. Hildegard Merrill, is that it's absolutely unreliable and lacks credibility.

She has at various times described the transaction as a land sale contract, as a lease option, as a joint venture, as it may have suited her flexible purposes in the particular context in which the statements were made.

She created for her daughter a loan application that, oh, to say mildly, puffed up the truth.

But beyond that, her manner and demeanor and her attitude toward the statements were: Did she live there? No, but she could have lived there.

It's one admission and avoidance after another.

She also failed to disclose that she was a real party in interest in this matter, and I think that's just an incredible breach of fiduciary duty.

And I entirely disbelieve her testimony that she has no idea how come Mr. Warren paid American Express and the MBNA cards of her daughter.

She just simply doesn't know that.

And she also doesn't know why Mr. Warren would have paid Mr. Lincoln Tate the two checks that were made out to him.

That, to me, is totally beyond credibility based on the testimony that I have heard.

And when I put all those circumstances together, what it appears to me is that she obtained from Mr. Warren the full 20 percent down payment, either by direct reimbursements or by causing him to make the full 20 percent down payment by paying to other people who were close to her and causing Mr. Warren, at her direction, to make those payments.

When all is said and done, the reality of the transaction was that Mrs. Hildegard Merrill made it possible for Mr. Warren to buy the condominium under circumstances where she made $ 10,000 for her daughter and she collected $ 27,000 in commissions for herself.

And the most that can be said for her alleged generosity is basically that she lent him her commission to help him out with the down payment and he repaid it in big, big chunks of $ 3,000- and $ 4,000 as soon as possible in a rather timely manner.

So—and in addition to that, she had him write a check for $ 27,000, which she herself referred to during her testimony in court.

And I think her own testimony lends credibility to Mr. Warren's version of the facts, which is yes, she lent him the $ 27,000.

He was going to pay it, and in fact, he did.

I don't understand the alternative explanation, or at least I'm not persuaded by it, that this was going to be a joint venture, because why would I make my daughter Charmaine jeopardize her credit for a period of 30 years.

According to Ms. Hildegard Merrill's own testimony that the way she structured the transaction was that within a year Mr. Warren was to, ‘clean up his credit and take my daughter out and reimburse her in an uncertain proportion, at least nothing specific enough, for her equity.’

The logical explanation is that at the time, she made $ 10,000 for her daughter, she earned a $ 27,000 commission.

She got to represent both sides, so she could earn the full commission on the real estate.

She was able to close the transaction within the time frame of her agency, whatever that was.

And she was able to get a second commission on the mortgage, on the loan, which is, again, nothing wrong with that, but it hardly represents a fiduciary interest in Mr. Warren's well-being absent a conflict.

I believe that a promise was made to Mr. Warren, and I hold him responsible for knowing what he was signing when he signed the escrow amendment removing his name from title.

I have no problem with that, but I am persuaded by the testimony that clearly a promise was made to him that after the close of escrow he would be on title.

And I do believe that there was no intention to do that at all, and in fact, it wasn't done, and that establishes that part of the agreement was that he would be put on title at the conclusion of—after closing of escrow."

The court subsequently found by clear and convincing evidence Merrill had acted outrageously and with at least reckless disregard in perpetrating the fraud on Warren sufficient to warrant an award of punitive damages (punishment damages used to hurt the defendant's pocketbook—B).

The court entered judgment quieting title in favor of Warren.

The court imposed a constructive trust on the property and ordered Merrill and Charmaine as constructive trustees to convey the property to Warren.

The court awarded Warren noneconomic damages in the amount of $ 15,000 on his causes of action for fraud, breach of fiduciary duty and ejectment.

Regarding the fraud and breach of fiduciary duty causes of action, the court also awarded Warren $ 50,000 in punitive damages against Merrill.

Merrill received credits against these damage awards of $ 18,765 to reimburse her for storage and related expenses and $ 32,000 to reimburse her for mortgage, taxes, homeowners' association dues and other payments she made with regard to the condominium.

Merrill agreed to return all of Warren's personal property and in exchange Warren agreed to dismiss his causes of action for conversion, for return of his personal property, and for an injunction.

The court found in favor of Charmaine and Merrill on Warren's causes of action for intentional infliction of emotional distress and conspiracy.

The court found in favor of Charmaine on all causes of action against her, except, as noted, the causes of action to quiet title and to impose a constructive trust.

Merrill appealed from the judgment.

Charmaine did not appeal from the judgment.

DISCUSSION

Merrill claims the court's judgment is contrary to law and equity and is unsupported by the evidence.

She asserts quieting title in Warren (conveying the property to him), while leaving Charmaine as the borrower on the loan, was erroneous because:

(1) Warren had neither legal nor equitable title because he “withdrew” from escrow;

(2) because Warren “withdrew” from the escrow she owed him no fiduciary duty and therefore there could be no breach and no fraud;

(3) Warren's illegal scheme to defraud the lender made him guilty of unclean hands, which bars relief;

(4) Warren failed to prove the existence of a contract, and if he did, it was an illegal oral contract and thus void;

(5) the lack of a written land sale contract violated the statute of frauds; and

(6) Warren did not prevail on any of his causes of action against Charmaine and thus it is unjust for her to remain on the loan.

Merrill also claims the award of punitive damages was erroneous because Warren suffered no actual damages as he defaulted on the mortgage payments, lived rent free and would have lost the property entirely but for her actions in saving the property from foreclosure by paying all arrearages.

MERRILL BREACHED HER FIDUCIARY DUTY TO WARREN BY PROCURING TITLE TO THE CONDOMINIUM THROUGH FRAUD.

There should be no dispute Merrill owed a fiduciary duty to Warren once she undertook to represent him in the real estate transaction.

Merrill herself acknowledged at trial she held a fiduciary position of trust toward Warren.

Because she owed Warren a fiduciary duty Merrill further acknowledged she was required to place his interests above her own in the real estate transaction.

Nevertheless, she claims there was no evidence of misrepresentation, no evidence of fraud and no evidence of a breach of her fiduciary duties.

She claims this is true because whatever fiduciary duties she owed Warren terminated when he “withdrew” from the escrow.

The appellate court reviewed the court's factual findings with these standards in mind.

The law of California imposes on … the real estate agent … the same obligation of undivided service and loyalty that it imposes on a trustee in favor of his or her beneficiary.

In King v. Wise (1872) and Langford v. Thomas (1926), violation of his or her trust is subject to the same punitory consequences that are provided for a disloyal or recreant trustee.

In Buckley v. Savage (1960), such an agent is charged with the duty of fullest disclosure of all material facts concerning the transaction that might affect the principal's decision.

A real estate agent's failure to disclose he was purchasing the property for himself provided grounds to suspend/revoke his real estate license;

According to the Civil Code section 2322, subdivision (c), the authority of an agent does not extend to violations of his or her fiduciary duties;

According to the Business and Professions Code section 10176, listing grounds to suspend or revoke a real estate license, including making substantial misrepresentations and making "false promises of a character likely to influence, persuade or induce."

A constructive fraud arises on a breach of duty by one in a fiduciary relationship who misleads another to his prejudice.

Actual fraud occurs when a person makes a promise without the intention of performing it.

According to the Civil Code section 1573, to prove a cause of action for actual fraud requires evidence of:

(1) representation;

(2) falsity;

(3) knowledge of falsity;

(4) intent to deceive; and

(5) reliance and resulting damage (causation).

The record in the present case contains substantial evidence satisfying each of the elements of both constructive and actual fraud.

The evidence showed Merrill breached her fiduciary duties toward Warren and committed fraud by deliberately and falsely promising him she would place his name on title to the condominium if he went along with her plan on how to structure the transaction.

From the beginning of the transaction she did not intend to perform her promise of placing his name on title.

Merrill instead intended to procure the condominium for herself but did not disclose her role as a principal in the transaction.

Merrill in fact kept the condominium and in so doing retained Warren's $ 77,000 down payment.

She alternatively claimed he had gifted this money to her daughter Charmaine when he signed the amendment removing his name from title or had forfeited it by defaulting on the homeowners' association dues and mortgage payments.

Specifically, Merrill told Warren he needed a co-borrower in order to finance his purchase of the condominium.

Merrill offered her own daughter for this purpose.

Merrill promised Warren that Charmaine would quitclaim title to him as soon as the loan funded and escrow closed.

However, Merrill's intent not to perform was apparent from the outset as she pursued her plan to use Warren's funds but keep the condominium for herself.

Merrill never had Warren submit a loan application, either as an individual or as a co-borrower with Charmaine.

As an experienced real estate agent, real estate broker and loan broker, Merrill knew a lender would not permit Warren to be on title if he was not also responsible for the loan.

However, Merrill filed a loan application in Charmaine's name alone.

Warren paid the initial $ 10,000 into escrow.

Merrill had him make all subsequent payments representing his $ 77,000 down payment not into escrow, but instead to persons/entities within her control.

If this was a legitimate transaction writing checks to third parties would have been wholly unnecessary.

However for Merrill's purposes it made it appear, at least superficially, she, and not Warren, had contributed the $ 30,000 check into escrow, Charmaine had contributed $ 10,000 into escrow and she had deferred her earned commissions of $ 27,000 as a credit into escrow (while holding Warren responsible for repayment).

Merrill led Warren to believe he had to sign the amendment in escrow removing his name from the title and gifting his contributions to Charmaine in order to secure financing.

Warren obviously trusted Merrill's representation because he signed the amendment.

However, after escrow closed Merrill did not, and never intended to, place Warren's name on title as promised.

Through these deceptive maneuvers Merrill secured for herself an investment property in her daughter's name by lying to her principal and misappropriating his funds.

In these circumstances it seems preposterous to argue, as does Merrill, Warren “withdrew” from escrow and for this reason she owed him no fiduciary duty and thus could not be guilty of fraud.

Instead, it may be more accurate to say Warren was “coerced” into signing the amendment and into “withdrawing” from escrow based on Merrill's representations the loan would not fund and the whole deal would fall apart unless he signed the amendment taking his name off title.

If Warren truly “withdrew” from the escrow then all of the money he had contributed to the down payment should have been returned.

It was not.

In sum, the appellate court agreed with the trial court the evidence in this case was more than sufficient to show an violation of the duties of loyalty and undivided interest by a fiduciary toward her principal, as well as a deliberate plan to defraud him out of his down payment and the property.

THE COURT'S JUDGMENT QUIETING TITLE IN WARREN AND IMPOSING A CONSTRUCTIVE TRUST WERE PROPER REMEDIES IN LIGHT OF MERRILL'S FRAUD AND BREACH OF FIDUCIARY DUTY.

Merrill claims the court's judgment quieting title in Warren is erroneous for any number of reasons.

Many of Merrill's arguments could have merit if this case involved a straightforward real estate transaction and not the acquisition of real property by a fiduciary as the result of committing a fraud on her client.

For example, if this was a standard contract action then the fact Warren defaulted on his payments may indeed have presented a material impediment to his recovery.

But this is not such a case. Indeed, this case did not even allege a contract cause of action.

This was instead an action in equity to redress a fiduciary's actual and constructive fraud.

As found in the previous part, substantial evidence supports the trial court's finding Merrill abused her trust and breached her fiduciary duties to Warren when she procured legal title to the condominium by making a false promise and duping him out of monies he put toward the down payment for the condominium.

Thus, because the factual situation is not as Merrill suggests in her arguments, many of her contentions are either inapplicable or do not withstand scrutiny.

Before the trial even started the court commented on the parties' divergent views of the case.

After opening arguments the court told counsel, “Now one of you is in the Arctic and the other one is in the Antarctic and God knows where the truth lies, but the two of you are operating in very different universes and one has nothing to do with the other.”

What Merrill's arguments overlook are the following principles of law: Once fraud by a fiduciary is shown by the evidence:

(1) a written contract for a real property transaction is not required;

(2) the absence of a written contract does not violate the statute of frauds;

(3) the defrauded person may be found to hold superior title to that held by the defrauder; and

(4) a wide variety of equitable remedies are available and appropriate to remedy the fiduciary's fraud.

In this case the very fraud perpetrated *was* Merrill's oral promise to convey without the intent to perform the promise in order to induce Warren to part with his money.

The appellate court concluded that the trial court did not err in quieting title in favor of Warren and in making Merrill and Charmaine constructive trustees of the property for Warren's benefit.

DISPOSITION

The judgment was affirmed by the appellate court.

Warren was awarded his costs on appeal.

Perluss, P. J., and Zelon, J., concurred.

Moral of the Story
Defrauding a former Supreme Court Justice’s relative is probably not a good idea. I’ll bet a look into the defendant’s past would reveal that she has done this before.

Case # 3 John Strebel v. Brenlar Investments, Inc. et al.

Breach of fiduciary duty, fraud, and non-disclosure of material facts, January 11, 2006

Introduction

In August 1999, John Strebel entered into a contract to buy Jon and Laurie Steel's home for $420,000 in Sonoma County. The house had tax liens and judgments for more than the house was worth. Agent Smith, who was working under Brenlar Investments, was dual agent for both Strebel and the Steels. Smith was aware of the tax liens but concealed them from buyer Strebel. In August 1999, the Steels wrote to Smith to inform him that they had made a compromise offer to the IRS and if this was not accepted, they would not be able to transfer title to Strebel. Agent Smith did not inform Strebel of this. When Strebel did learn of the tax liens on the property, Agent Smith said they would "not be a problem." Meanwhile, buyer Strebel was making preparations to sell his home in San Bruno and in fact sold it in mid-August for $424,950. After assurances from Smith that the Sonoma house was on track to close, Strebel closed escrow on his San Bruno house and moved his personal property into storage. Strebel netted $321,000 in the sale. However, in October 1999 sellers Steele found out that the IRS had rejected their offer in compromise. The Steels told Strebel that they could not sell him their home in Sonoma County because of the outstanding tax liens. Buyer Strebel placed his proceeds from the San Bruno home sale in an interest-bearing bank account and searched unsuccessfully over the next year for a new home. By September 2001, Strebel had still not found a house and was priced out of the market. The jury found that he had made a reasonable effort to find a home and mitigate his situation. Back in June 2000, Strebel had filed suit against Broker Brenlar and Agent Smith for unfair business practices, fraud, negligence, breach of contract, intentional and negligent misrepresentation, and breach of fiduciary duty. In July 2003, the jury found that Brenlar and Smith had intentionally concealed material facts with intent to defraud buyer Strebel. They also found them guilty of negligence. Buyer Strebel was awarded $300,000 in economic damages, which consisted of (1) Lost appreciation between 1999-2003 (46%), and (2) Lost use of the property during that period. The jury also awarded Strebel an additional $50,000 in non-economic damages. This was for the emotional distress that came from not having a house, running around trying to find one, and the withholding of Strebel's $10,000 earnest money deposit. The jury found that Brenlar and Smith had acted with oppression and fraud but not with malice. Buyer Strebel received a total of $305,000 after comparative fault was deducted from the jury award. Upon review, the appellate court thought that Strebel's decision not to reinvest in the market at some point became unreasonable, and ordered the trial court's judgment to be reduced by $102,725 to $202,273. The rest of the judgment was affirmed.

Here's What Happened

On August 5, 1999, Buyer Strebel entered into a contract to buy a house in Sonoma County from Sellers Jon and Laurie Steel for $ 420,000.

Unbeknownst to Buyer Strebel, the Sonoma house was encumbered with tax liens and judgments that exceeded the agreed upon purchase price.

Agent Smith, acting as a dual agent for the buyer and sellers, was aware of the tax liens but concealed that information from Buyer Strebel.

On August 25, 1999, Seller Steels wrote to Agent Smith, explaining that they had made an offer in compromise to the Internal Revenue Service (IRS) to reduce the tax liens, but that if the offer was rejected they would be unable to transfer title to Buyer Strebel.

Agent Smith did not convey this information to Buyer Strebel.

Instead, when Buyer Strebel learned of the tax liens, Agent Smith told him the Seller Steels were working on reducing the liens, which would “not be a problem.”

Three days later Agent Smith again reassured Buyer Strebel that the Seller Steels were "taking care of it and escrow would close; they were moving forward with the transaction."

In the meantime, Buyer Strebel was making preparations to sell his home in San Bruno.

Buyer Strebel entered into a contract to sell the San Bruno property in mid-August for $ 424,950 (must have been a shack to sell for this price--B).

The sale was contingent on the Sonoma escrow closing.

Buyer Strebel immediately told Agent Smith that he had sold the San Bruno home and that escrow was set to close September 3rd.

After receiving assurances from Agent Smith that the Sonoma purchase was on track, Buyer Strebel closed escrow on the sale of his San Bruno house as scheduled and moved his personal property to a storage unit in Sonoma.

Buyer Strebel netted approximately $ 321,000 from the sale of his San Bruno home (now we’re talking—B.).

Unfortunately, the Seller Steels' offer in compromise was rejected by the IRS and on October 4, 1999, the Seller Steels told Buyer Strebel that they could not sell him the Sonoma house because of the outstanding tax liens.

Buyer Strebel placed the proceeds from the sale of the San Bruno house into a bank account bearing 4 percent interest and for over one year searched unsuccessfully for additional properties in Sonoma (at that time there were a lot of good deals, so he probably wasn’t looking very hard—B.).

By September 2001, he was still unable to find a suitable replacement property and began to conclude that he had been priced out of the Sonoma County real estate market (snooze you lose—B.).

On June 27, 2000, Buyer Strebel filed a complaint against Broker Brenlar and Agent Smith alleging unfair business practices, fraud, negligence, and breach of fiduciary duty.

At the liability phase of the trial, which began in July 2003, the jury found that Agent Smith and Broker Brenlar had intentionally concealed material facts with the intent to defraud Buyer Strebel and on a separate verdict from that they were also liable for negligence.

Buyer Strebel was awarded $ 300,000 in economic damages on both claims.

The negligence verdict form alone contained a space for non-economic damages, which the jury found to be an additional $ 50,000.

The jury found that Broker Brenlar and Agent Smith acted with oppression and fraud, but not malice.

The jury returned separate verdicts on three fraud theories: intentional and negligent misrepresentation and concealment.

The jury found in favor of Agent Smith and Broker Brenlar on the claims for intentional and negligent misrepresentation.

The jury also found in Buyer Strebel's favor on a breach of contract claim against the sellers of the Sonoma property.

No appeal has been taken from the judgment entered on that claim.

After the jury returned its verdict on Friday, September 5, 2003, the court ordered the jury to return the following Monday to begin the punitive damages phase of the trial.

At the same time, Buyer Strebel dismissed his punitive damages claim against Agent Smith.

On August 29, in anticipation of the punitive damages phase, Buyer Strebel had attempted to subpoena Broker Brenlar's financial documents.

(NOTE: Punitive damages are generally <u>not</u> based upon the severity of the tort, but on how much money it will take to financial "hurt" the defendant. That is the reason for the buyer's request for the broker's financial records. The broker probably has deeper pockets than Agent Smith and would be a better target for punitive damages. One of the requirements for punitive damages is generally a breach of fiduciary duty—such as intentional misrepresentation. Breach of fiduciary duty also may give Buyer Strebel "benefit of the bargain" damages and opens up recovering lost appreciation if the market goes up—as it did in this case—B.)

At a hearing on the afternoon of September 5, Buyer Brenlar argued that the subpoenas had not been properly served and that an additional document request made only that afternoon was unreasonable.

The court continued the hearing to Monday morning and ultimately determined that Buyer Strebel had not subpoenaed Broker Brenlar's financial documents in a timely manner.

Because Buyer Strebel was unable to present any evidence in support of his claim for punitive damages, the court excused the jury and entered judgment.

Broker Brenlar filed a timely notice of appeal and Buyer Strebel filed a timely notice of cross-appeal.

Defendants' Appeal Regarding Damages

Buyer Strebel's claimed economic damages consisted of several components:

(1) the lost appreciation of his San Bruno house between its sale in 1999 and trial in 2003,

(2) the lost use of the property during that period, and

(3) other components that are not disputed on appeal.

Buyer Strebel's expert witness John D'Andrea testified to Strebel's economic damages, including the value of the loss of appreciation and use of the San Bruno property.

D'Andrea calculated the gross lost appreciation by subtracting the 1999 sale price from his opinion of the then-current fair market value of the house based on a study of comparable sales.

This produced an increase in value of 46 percent, which he considered to be conservative when compared to a 62 percent rate of appreciation between 1999 and 2003 reflected in a general market indicator survey to which he referred.

He then reduced the gross amount by the estimated closing costs on such a sale to reach net lost appreciation, which he calculated to be $ 183,427.

Buyer Strebel presented evidence of his closing costs on the sale of the San Bruno property plus interest to the time of trial ($ 38,985), interest on $ 10,000 lost during a period when the seller of the Sonoma property refused to return Buyer Strebel's deposit in that amount ($ 306), and an offset against his damages for the interest earned on the sale proceeds of the San Bruno home between the time of sale and trial ($ 41,490).

D'Andrea calculated Buyer Strebel's loss of use damages by subtracting the costs associated with living in his house, mortgage interest, taxes and insurance, from the cost of renting a similar house in San Bruno.

This difference was $ 66,046. Adding this amount to $ 183,427 of lost appreciation and including the other undisputed damage elements produced a total of $ 247,273, which was D'Andrea's opinion of economic damages and the amount that Strebel's attorney asked the jury to award.

Strebel's non-economic damages were based on claimed emotional distress arising from "him not having a house and running around looking for a place to live" and from "financial injury ... including the withholding of Buyer Strebel's ten thousand dollar security deposit at the exact time when he was looking for another house to buy and would have needed that to pay towards another purchase offer."

The jury returned verdicts awarding Buyer Strebel $ 300,000 in economic damages on his concealment and negligence claims and an additional $ 50,000 in non-economic damages on his negligence claim.

Judgment was entered in Buyer Strebel’s favor against Broker Brenlar and Agent Smith for $ 305,000.

It appears that the court deducted from $ 350,000 five percent comparative fault that the jury attributed to Buyer Strebel and an additional amount received by Buyer Strebel in settlement of related claims against another party (sellers).

Appreciation Damages

Referring to the claim of constructive fraud by a fiduciary, the court drew from **section 3333** and instructed that damages "must be in an amount that would compensate plaintiff for all harm or loss caused by defendants' wrongful conduct, whether the harm or loss caused by defendants' wrongful conduct could have been anticipated or not."

According to Civil Code section 3343, "One defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received, together with any additional damage arising from the particular transaction, including the following:

(1) Amounts actually and reasonably expended in reliance upon the fraud.

(2) An amount which would compensate the defrauded party for loss of use and enjoyment of the property to the extent that any such loss was proximately caused (legal cause) by the fraud.

(3) Where the defrauded party has been induced by reason of the fraud to sell or otherwise part with the property in question, an amount which will compensate him for profits or other gains which might reasonably have been earned by use of the property had he retained it. ..."

According to section 1709 of the Civil Code, "One who willfully deceives another with intent to induce him to alter his position to his injury or risk, is liable for any damage which he thereby suffers."

And according to Civil Code section 3333, "For the breach of an obligation not arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not."

The jury was instructed that "a person whose property has been damaged by the wrongful act of another is bound to exercise reasonable care and diligence to avoid loss and minimize damages, and may not recover for losses which could have been prevented by reasonable efforts or by expenditures that might reasonably have been made."

The jury here was correctly advised that "the damages awarded must be in an amount that would compensate plaintiff for all harm or loss caused by defendants' wrongful conduct" and that defendants' fraud must be a substantial factor in causing Buyer Strebel's loss.

Buyer Strebel asserted that he was injured because defendants' fraud caused him to sell his San Bruno house sooner than he would otherwise have done, rendering him unable to purchase a replacement home before housing values substantially increased.

Buyer Strebel testified that he intended to sell his home and purchase the new house in Sonoma at the same time, thereby limiting the impact of market fluctuations on the exchange.

However, because of defendants' fraud, Buyer Strebel was unable to make the second transaction before market values rose.

The resultant harm was a decrease in the buying power of the proceeds of his San Bruno house in a rapidly appreciating housing market.

In the words of Buyer Strebel's attorney in closing argument, "All we're asking for here is for him in effect to get enough money to now buy something comparable to the Sonoma property in today's market.

That would be the net effect of what we're asking for, which would in a sense put him back to where he was back in 1999."

In permitting the jury to consider lost appreciation, the trial court properly determined that the jury could reasonably find this element necessary to compensate Buyer Strebel for the injury caused by defendants' concealment.

Under the circumstances shown by the evidence, the jury was entitled to find that recovery of the lost appreciation was reasonable compensation for Buyer Strebel's inability to purchase an acceptable home in Sonoma concurrently with the sale of his San Bruno house.

Here, as discussed below, the jury was instructed on Strebel's duty to mitigate and apparently concluded that he did make reasonable efforts to do so.

The court upheld an award of damages based on the value at the time of trial rather than the time of the sale of property which the seller had been fraudulently induced to sell.

"The fact that values must ordinarily be considered as of the time of the fraudulent transaction does not mean that the court cannot consider circumstances other than value which operate to increase or reduce the injury."

Here, measuring Strebel's damages at the time of the sale would provide no compensation for the most significant portion of the loss he suffered as a result of defendants' fraud.

During the five months that it took to repair the damage, the real estate market declined significantly, reducing the value of plaintiff's house by $ 300,000.

"It has long been the law in this state that a faithless fiduciary must repay to the beneficiary of his fiduciary duties the entire profit that he caused the beneficiary to lose".

More importantly, Buyer Strebel's diminished buying power in the rising real estate market was substantially related to defendants' fraud.

The rising value of the property he intended to purchase with the proceeds from the San Bruno home was not unforeseeable and, indeed, was the very reason Buyer Strebel testified he told defendants he wanted to be sure the Sonoma purchase would close before he sold the San Bruno property.

Defendants requested and the jury was instructed on the concept of an unforeseeable superseding cause with respect to whether the acts of Buyer Strebel's agent for the sale of the San Bruno house extinguished defendants' liability for Buyer Strebel's loss.

No such instruction was requested or given with respect to whether appreciation in the housing market was an unforeseeable superseding cause.

Under the avoidable consequences doctrine as recognized in California, a person injured by another's wrongful conduct will not be compensated for damages that the injured person could have avoided by *reasonable* effort or expenditure.

The reasonableness of the injured party's efforts must be judged in light of the situation existing at the time and not with the benefit of hindsight."

Buyer Strebel does not dispute that "recovery will not be allowed for damages that a party should have foreseen and could have avoided by reasonable effort without undue risks, expense, or humiliation."

As indicated, the jury was instructed that Strebel "may not recover for losses which could have been prevented by reasonable efforts or by expenditures that might reasonably have been made."

Despite defendants' argument to the contrary, the jury apparently concluded that Buyer Strebel did not act unreasonably by investing the proceeds from the sale of the San Bruno property in an interest-bearing money market account, the interest from which was deducted from the calculation of damages.

The jury was entitled to reject defendants' contention that it was unreasonable for Buyer Strebel not to purchase a replacement house in a city in which he no longer wished to live.

Contrary to defendants' assertion, there is nothing inequitable about the recovery of appreciation damages in this case.

The fact that Buyer Strebel received what was the fair market value for his house at the time he sold it did not eliminate financial loss from the premature sale of the property.

Nor did Buyer Strebel attempt to profit from an unreasonable delay in filing suit.

Upholding the jury's verdict in this case does not imply that a defrauded plaintiff may recover appreciation damages over an unlimited period of time.

Buyer Strebel filed his complaint within a year of the fraud and for over a year after the complaint was filed continued to look for a suitable replacement property.

The jury was entitled to conclude that Buyer Strebel made reasonable efforts to avoid the adverse consequences of having sold his former home without being able to purchase a new one as the defendants had led him to believe he could.

The amount by which the value of Buyer Strebel's former home appreciated after the fraudulently induced sale was a reasonable measure of his damage in this case.

At oral argument, defendants' counsel asserted that permitting recovery of lost appreciation in this case would imply that a plaintiff might recover unlimited damages by delaying prosecution of the action for many years.

The appellate court disagreed.

The statute of limitations aside, at some point the failure to reinvest may well become unreasonable (. . .and when will that be!—B).

At that point the chain of causation would be broken and the loss of additional appreciation would be attributable to the plaintiff's decision not to reinvest.

The jury reasonably concluded that this point was not reached in this case. (How did they do that?—B.)

Lost Use damages

D'Andrea calculated Buyer Strebel's damage for the loss of the use of his San Bruno home between the sale and the time of trial by subtracting Buyer Strebel's costs of living in the house (interest on mortgage, taxes and insurance) from the market rent for a similar home.

Broker Brenlar argued that "for the same reasons that appreciation damages should not be allowed, this Court should also strike from the judgment the $ 66,046 in lost 'use' damages."

However, as with the loss of appreciation, the jury was entitled to find that Buyer Strebel suffered this loss when he sold his house in reliance on defendants' fraud.

He is equally entitled under Civil Code section 3333 to recover for his loss of use of the San Bruno home.

The appellate court ordered that the economic damages must be reduced by $52,727.

Disposition

The appellate court stated that the trial court’s judgment shall be reduced by $ 102,727 to $ 202,273 and, as so modified, is affirmed in all other respects.

The parties were ordered to bear their own costs on appeal.

McGuiness, P. J., and Parrilli, J., concurred.

Moral of the Story

The agent really messed up when she did not disclose the tax liens and other encumbrances on the property. Nondisclosure of a material fact in an appreciating market can really be costly, especially to a broker who has vicarious liability for his subagent's actions. Most brokers do have errors and omissions insurance; however, it usually only covers negligent misrepresentation actions and not intentional misrepresentation (i.e. fraud). It is interesting that the buyer spent a couple of years looking for a suitable home and could not find one. Then he asked the "deep pocket" broker to pay for his "lost" appreciation because he wasn't able to bring himself to pull the trigger and buy a home during that time period. The agent was wrong in her fraud, the broker was "roped into it" because of vicarious liability (brokers are responsible for the acts of their subagents who are working under their license), yet the buyer was under a duty to mitigate (minimize) his damages by buying another suitable home. He didn't do it. Yet he was able to recover the appreciation he would have received had he been able to "pull the trigger." This sounds like the trial court, jury, and appellate court are little bit naive on this one. The appellate court is the only opinion that matters, however, and their decisions on this case are now part of the common law.

Case #4 Ingo v. Westminster Investments, Inc. el al.

Home Equity and Sales Contract Act,

December 13, 2007

Introduction

In 2003, seller Schweitzer's home was in foreclosure. Buyer Westminster Investments, through its representative Ms. Cote, agreed in writing to purchase seller Schweitzer's home. Six months later, seller Schweitzer filed this action to void the deed under Home Equity Sales Contract (HESC) provisions. Buyer Westminster did not provide proof that Ms. Cote was bonded (as required under the HESC act). The trial court ruled that because Ms. Cote was not bonded, the contract between seller Schweitzer and buyer Westminster was voidable and seller Schweitzer was entitled to reclaim title to his home from buyer Westminster. Buyer Westminster contended that the bonding requirement applies only to representatives who use undisclosed equity purchasers to purchase homes in foreclosure. Since she disclosed she was acting on behalf of Westminster, the requirements were un-applicable. The trial court ruled that title to the home will be awarded to seller Schweitzer. The appellate court REVERSED the trial court's judgment and said the bonding requirement was vague, ambiguous, and bondability was virtually impossible to obtain. Therefore, the ruling was reversed and title to the home not returned to seller Schweitzer.

Here's What Happened

In 2003, Seller Ingo Schweitzer's home mortgage was in foreclosure.

Buyer Westminster Investments, Inc. (Westminster), through its representative Ms. Cote, agreed in writing to purchase Seller Schweitzer's home and, upon expiration of the statutorily prescribed waiting period Seller Schweitzer conveyed title to the home to Buyer Westminster by grant deed.

Six months later, Seller Schweitzer filed this action to void the deed, arguing the purchase contract was voidable under the HESC because, among other things, Buyer Westminster did not provide proof that Cote was bonded, as required by **section 1695.17**.

The court ruled that because Cote was not bonded (and Buyer Westminster concomitantly failed to provide proof of the bond) the purchase contract was voidable and Seller Schweitzer was entitled to reclaim title to the home from Buyer Westminster.

On appeal, Buyer Westminster asserts the proper interpretation of **section 1695.17** is that the bonding requirement applies only to representatives who use undisclosed equity purchasers to purchase homes in foreclosure, and that because Cote disclosed she was acting on behalf of Buyer Westminster, the requirements of **section 1695.17** are inapplicable.

Buyer Westminster asserts that a contrary interpretation would render **section 1695.17** invalid under the **equal protection clause of the United States Constitution.**

Buyer Westminster also argues the bond requirement is void for vagueness under the **due process clause**, and the attorney fees award to Schweitzer was error.

HESC **section 1695.17** provides that the failure to comply with its provisions "shall at the option of the equity seller render *the equity purchase contract* void."

The appellate court concluded that the bond requirement is void.

The Facts

A home owned by Seller Schweitzer was the subject of mortgage foreclosure proceedings and, by September 9, 2003 (the day before the scheduled trustees sale), Seller Schweitzer was in arrears on 13 monthly payments exceeding $ 16,000.

On September 9, Mr. Webster (an agent working for Buyer Westminster) contacted Seller Schweitzer regarding Buyer Westminster's potential purchase of the home.

That evening, Mr. Webster and Ms. Cote (another agent working for Buyer Westminster) came to Seller Schweitzer's home and Seller Schweitzer signed a contract to sell the home to Buyer Westminster.

Seller Schweitzer knew Buyer Westminster was the buyer and Webster and Cote were acting as agents for Buyer Westminster.

On September 10, Seller Schweitzer signed the grant deed and delivered it to Buyer Westminster, which recorded it.

Also on September 10, Buyer Westminster asked the foreclosure trustee to ascertain the amount required to reinstate the loan.

The trustee postponed the sale and, on September 11, informed Buyer Westminster that nearly $ 23,000 would be required to reinstate the loan.

Buyer Westminster sent the necessary funds to the lender the following day and the loan was reinstated.

The purchase contract allowed Seller Schweitzer to stay in the home until January 2, 2004, at a rental rate of $ 1,300 per month, to be paid by deducting the monthly rents from the purchase contract cash consideration Buyer Westminster owed to Seller Schweitzer.

Buyer Westminster later extended Seller Schweitzer's occupancy to January 31, 2004.

When Seller Schweitzer did not vacate the home, Buyer Westminster commenced unlawful detainer proceedings (i.e. eviction—B.).

Seller Schweitzer responded by filing the present action and tendered restitution of the amounts paid by Buyer Westminster to reinstate the loan.

The Litigation

Seller Schweitzer's complaint alleged the purchase contract was voidable because Westminster did not provide proof of Cote's bonding.

Seller Schweitzer's complaint also alleged the purchase contract was voidable because it did not provide adequate notice of his right to cancel and was unconscionable.

Buyer Westminster disputed those allegations.

Buyer Westminster contended the statutory language, considering the legislative history of the 1990 amendments, showed the bond requirement was intended to apply only when an undisclosed equity purchaser used a “front man” to importune the homeowner into selling his or her home, and did not apply when the agent disclosed the identity of the equity purchaser to the seller.

The trial court ruled the deed could be canceled for noncompliance with the bond requirement of **section 1695.17**.

The court concluded the statutory requirement for a bond applied to all persons acting as representatives for an equity purchaser, regardless of whether the identity of the purchaser was disclosed to the seller, and rejected Buyer Westminster's argument that this interpretation rendered the statute unconstitutional under the **equal protection clause**.

Accordingly, the court declared the deed to the home void and ruled Seller Schweitzer was entitled to title to the home based on Buyer Westminster's violation of **section 1695.17**.

On appeal, Buyer Westminster challenges the judgment as to the court's declaration awarding title to the home to Seller Schweitzer.

The appellate court reversed the judgment.

OVERVIEW

The key disputed issue is whether **section 1695.17** is enforceable, either as applied to this transaction or more generally to any transaction subject to the HESC.

Section 1695.17 provides: "(a) Any representative, as defined in subdivision (b) of Section 1695.15, deemed to be the agent or employee, or both the agent and the employee of the equity purchaser shall be required to provide both of the following:

"(1) Written proof to the equity seller that the representative has a valid current California Real Estate Sales License and that the representative is bonded by an admitted surety insurer in an amount equal to twice the fair market value of the real property which is the subject of the contract.

"(2) A statement in writing, under penalty of perjury, that the representative has a valid current California Real Estate Sales License, is bonded by an admitted surety insurer in an amount equal to at least twice the value of the real property which is the subject of the contract and has complied with paragraph (1). The written statement required by this paragraph shall be provided to all parties to the contract prior to the transfer of any interest in the real property which is the subject of the contract."(b) The failure to comply with subdivision (a) shall at the option of the equity seller render the equity purchase contract void and the equity purchaser shall be liable to the equity seller for all damages proximately caused by the failure to comply."

Section 1695.15 defines a "representative," for the purposes of the licensing and bonding requirements (**§ 1695.17, subd. (a)**), to mean "a person who in any manner solicits, induces, or causes any property owner to transfer title or solicits any member of the property owner's family or household to induce or cause any property owner to transfer title to the residence in foreclosure to the equity purchaser."

The trial court determined **section 1695.17** was applicable to the purchase contract in this matter and rejected Buyer Westminster's challenges to its validity.

When construing a statutory scheme, our primary guiding principle is to ascertain the intent of the Legislature to effectuate the purpose of the law.

THE BOND REQUIREMENT

Buyer Westminster argues we may rely on the legislative history accompanying the 1990 amendments to the HESC, which added the bond requirement, to construe the bond requirement as applicable only when the agent is representing an undisclosed principal.

The appellate court concluded that Buyer Westminster was subject to the bond requirement of **section 1695.17** under the facts of this case.

VAGUENESS

Applicable Principles

A statute is void for vagueness if persons of common intelligence must guess as to its meaning and differ as to its applications.

Evaluation

Westminster asserts the statutory requirement that representatives of home equity purchasers subject to the HESC be "bonded by an admitted surety insurer in an amount equal to twice the fair market value of the real property which is the subject of the contract" is so vague and ambiguous with regard to the nature and conditions of the required bond that persons of common intelligence must necessarily guess at its meaning and differ as to what is required.

The evidence submitted below suggested no surety carrier was willing to issue the bonds, and California Association of Realtors has advised its members that it was "unaware of any insurer currently offering the bond."

However, Westminster proffered a subsequent declaration from Mr. Back (potential bond insurer) in which he explained:

(1) his company had never issued such a bond "as it is not practical given the overly broad and general requirement of the statute," and

(2) his company would be willing to issue such a bond only if the principal on the bond posted "cash collateral equal to the penalty amount of the bond."

The Amount Is Ambiguous

The statute does not specify *the total amount* of the bond required by the statute.

There are two conflicting interpretations as to the amount of the bond.

The first interpretation is that the representative must proffer proof that he or she has a *separate* bond for each transaction in an amount equal to at least twice the fair market value of the home subject to that transaction.

The alternative interpretation is that a representative may conduct multiple transactions under the umbrella of a single "blanket" bond as long as the blanket bond is at least twice the amount of the fair market value of the real property on any individual transaction.

Neither the text of the statute nor the accompanying legislative history provides guidance to determine the legislative intent regarding the amount of the bond, and there are no administrative rulings or regulations addressing this issue.

The trial court below concluded a single blanket bond satisfies the statutory requirement.

The Attorney General, appearing in a capacity on appeal, relies on the interpretative maxims that we should "select the construction that comports most closely with the Legislature's apparent intent, with a view to promoting rather than defeating the statutes' general purpose" while simultaneously "avoiding a construction that would lead to unreasonable, impractical, or arbitrary results" to argue the trial court correctly held a blanket bond is what is required.

However, the basis for this conclusion rests not on statutory language, but instead on the practical recognition that the alternative interpretation would require such a massive outlay of collateral by the representative that it would produce an unreasonable or impractical result.

The appellate court agreed that these economic realities suggest individualized bonds would be unreasonable or impractical.

The Attorney General argues that, because a surety only issues bonds to persons with demonstrable financial strength and good character, the blanket bond is consistent with the statutory goal of preventing "fly-by-night" representatives from acting as representatives.

Whatever merit this argument may have, it introduces (or perhaps merely reveals) yet another ambiguity in the statute at which persons of common intelligence must necessarily guess: what *type* of bond does the statute require?

For example, a representative may be covered by a fidelity bond in the requisite amount, thereby establishing the "bondability" the Attorney General suggests would suffice, but this type of bond would protect the representative's employer for specified malfeasance as to the employer rather than the equity seller.

The appellate court is convinced that persons of common intelligence must necessarily guess what the statute requires as to the amount of the bond, because the resort to its language provides no guidance and considerations extraneous to the statutory language would equally support diametrically opposed interpretations.

(In other words, an ordinary person would have no idea what they are talking about. . .this has been my problem with this law from the beginning. Glad to know I'm finally in the "ordinary intelligence" crowd--B.)

The Conditions and Beneficiaries of the Bond Are Undefined

HESC **section 1695.17** does not:

(1) identify the obligation secured,

(2) does not describe the terms and conditions of the bond, and

(3) is even silent on the identity of the person or persons for whose benefit the bond is provided.

The appellate court asked how claims on the bond would be made and resolved? (No kidding, beats me too—B.)

A person of ordinary intelligence could only guess at what the law required of him or her to satisfy the bond obligation of **section 1695.17**, and this quagmire of vagueness adds to our conclusion that the bond aspect of **section 1695.17** offends due process. (I couldn't have stated it better—B.)

Conclusion

The appellate court was convinced that the amorphous requirement of **section 1695.17, subdivision (a)(1)**, requiring proof the representative is "bonded by an admitted surety insurer in an amount equal to twice the fair market value of the real property which is the subject of the contract," provides no guidance on the amount, the obligee, the beneficiaries, the terms or conditions of the bond, the delivery and acceptance requirements, or the enforcement mechanisms of the required bond.

Instead, persons of ordinary intelligence must necessarily guess at what the statute requires for them to comply with its obligations.

Under these circumstances, the bond requirement of **section 1695.17** is void for vagueness under the **due process clause** and may not be enforced.

The HESC contains 18 sections, prescribing a wide range of rules regulating the conduct of and contractual provisions for home equity sales contracts, and only a portion of one section refers to the bonding requirement.

The appellate court concluded that the clauses containing the bond requirement are grammatically severable from the remaining provisions of the HESC.

The clauses are also functionally severable: the remaining portions of **section 1695.17** impose a licensing requirement on the representative, and the remaining sections added by the 1990 statutory enactment (1) made the equity purchaser liable for all damages caused by the equity purchaser's representative (**§ 1695.15**), and (2) made a contractual provision (purporting to limit liability of the purchaser) a ground for voiding the purchase contract (**§ 1695.16**).

The appellate court was convinced the Legislature would have enacted these regulatory provisions even were the bond requirement removed from the enactment.

DISPOSITION

The appellate court reversed the trial court's judgment.

Nares, Acting P. J., and McIntyre, J., concurred.

Moral of the Story

It appears the appellate court was able to remove an ambiguity in the law. The bonding requirement was always the biggest stumbling block when dealing with properties that have a notice of default recorded against them. In fact, since potential buyers couldn't find a bonding company to provide the required bond, the Legislature was probably using this fact to stop anyone from dealing with distressed home owners. The appellate court's ruling regarding the bonding requirement may make investing in distressed properties a little easier.

Case #5 Alanna Spencer v. Ryan Marshall

November 24, 2008

Home Equity Sales Contracts

Introduction

In 1998, first-time home buyer Spencer bought a two bedroom condo in Hayward, CA. Spencer soon became delinquent on her mortgage payments to her lender, Option One. Option One recorded a notice of default on November 25, 2002. Spencer filed for chapter 13 bankruptcy protection on January 8, 2003. On March 12, 2003 the bankruptcy court confirmed Spencer's chapter 13 bankruptcy plan that intended to revest the property to Spencer upon discharge of the bankruptcy. Spencer still owed $170,000 on the condo and became delinquent again to Option One. Option One filed a motion for request of relief from stay from the bankruptcy court (this would effectively remove the condo from bankruptcy protection—B.) At this point, Spencer was contacted by DirectorLender, a lender specializing in arranging loans for people in bankruptcy. Spencer pursued a loan with DirectLender and a subsequent appraisal showed her property valued at $290,000. When the refinancing could not be completed, DirectLender referred Marshall to her, a licensed real estate broker and president of IRES, a financing company and Innovative Real Estate Strategies. Also, important to note is that Marshall was also president of DirectLending. Spencer had contacted Marshall's office and said she needed $220,000 to pay off her existing creditors through bankruptcy. On August 10, 2004 Marshall provided Spencer with a purchase agreement to buy her condo. The buyer was Marshall "and/or assignee." Marshall also provided Spencer with a one year leaseback agreement for her to lease the condo back at $1,500 per month. Marshall also provided an option agreement where she could repurchase her condo for $260,000 anytime from October 1, 2004 until September 1, 2005--when the option would expire. The rent charged to Spencer was actually higher than her existing mortgage payment to Option One. Marshall provided Spencer with a disclosure addendum outlining all the stipulations that went with the agreement. Spencer reviewed these documents with her bankruptcy attorney. Spencer knew the sale price was below the condo's value and the purchase price was above it, but signed the agreement anyway. Spencer was depressed and terrified about losing her condo and needed an urgent fix, and this seemed to be it. On September 20, 2004 the bankruptcy court issued a request from relief from stay. One September 15, 2004 Spencer had signed a grant deed transferring the property to Lisa Sanderson, who was Marshall's assignee on the purchase agreement. Lisa Sanderson was also co-owner of Innovative with Marshall. Subsequently, Sanderson transferred the property to Innovative, even though she stated on the loan application that she intended to occupy the condo as her second home. Both Marshall and Sanderson knew this last statement to be false. On November 11, 2004 all of Spencer's debts were discharged out of bankruptcy. On May 4, 2005, Spencer wrote to Sanderson asking that her rent be reduced to $1,300 per month and the $200 deferred onto the $260,000 purchase price. Marshall on behalf of innovative agreed. One June 27, 2005 Marshall sent a notice to pay rent or quit because her June rent was past due. Around August 11, 2005 Spencer contacted First Financial Plus to try to arrange a loan to repurchase the condo. First Financial told Spencer that she could not qualify for the loan without a gift of equity from Marshall. Spencer learned that Marshall would not renegotiate the rental agreement and provide her a gift of equity, even though Marshall had said he "would work with her on the financing" when the option came due. Marshall asked Spencer if she would be interested in buying the property for $315,000 and Spencer said she could not pay that much. Marshall listed the property for $369,950. On October 27, 2005 Marshall served Spencer with a 60 day notice to terminate tenancy. Spencer served a notice of recission on December 15, 2005. Spencer sued for quiet title, specific performance, compensatory damages, and punitive damages against Marshall and others. Spencer alleged that Marshall had violated HESCA (Home Equity Sales Act) when taking her condo. On January 4, 2006 Innovative filed an unlawful detainer action against Spencer. After hearing testimony, the trial court issued a statement of decision on August 16, 2007. The court determined that Marshall was liable for violations under HESCA because he structured the deal. The trial court had no doubts that Marshall knew that a notice of default had been recorded against Spencer's condo. The trial court also believed that Marshall had misled Spencer to believe that selling her home was the only way to get out of bankruptcy. Spencer received monetary damages against Marshall and the unlawful detainer action against Spencer was dismissed as well. The trial court awarded Spencer a total of $252,700 against Marshall. Marshall appealed. The appellate court said that it was unlawful to take unconscionable advantage of a property owner in foreclosure. It also said that the act was designed to protect distressed homeowners from "archetypal foreclosure vultures" who prey upon them. Marshall was not protected by the bankruptcy code. The appellate court affirmed the trial court's judgment.

Here's What Happened

In 1998, Spencer, a first time homebuyer, bought a two-bedroom condominium in Hayward.

Spencer became delinquent on her mortgage payments to her lender, Option One Mortgage Corporation (Option One), and Option One recorded a notice of default and election to sell under deed of trust on November 25, 2002.

Spencer contacted bankruptcy attorney David A. Boone, and filed a chapter 13 petition on January 8, 2003.

The confirmed plan filed on January 8, 2003, in the bankruptcy court stated the following: "The debtor(s) elect to have property of the estate revest in the debtor(s) upon plan confirmation. Once the property reverts, the debtor(s) may sell or refinance real or personal property without further order of the court, upon approval of the Chapter 13 Trustee."

On March 12, 2003, the bankruptcy court issued an order confirming Spencer's chapter 13 plan, finding that it complied with the provisions of chapter 13, title 11, of the United States Code.

Spencer still owed $ 170,000 on her home and she fell behind in her post-bankruptcy payments to Option One.

At some point, Option One filed a motion in the bankruptcy court requesting relief from the automatic stay to enforce its interest in the property.

Spencer received a mail solicitation from DirectLender, a mortgage company, which stated "payoff your bankruptcy early."

DirectLender made money arranging home loans for people in bankruptcy.

Marshall had been president of DirectLender.

Spencer sought to refinance her property with the assistance of DirectLender; an appraisal completed as part of the process valued the property at $ 290,000.

When the refinancing could not be completed, DirectLender, according to Spencer, referred her to Marshall, a licensed real estate broker and the owner and president of IRES, a financing company; he was also the co-owner of Innovative Real Estate Strategies, LLC (Innovative).

According to Marshall, Innovative and IRES are two separate companies.

Spencer contacted Marshall's office and told Marshall's staff that she needed $ 220,000 to pay her creditors through bankruptcy.

On August 10, 2004, Marshall provided Spencer with a standard California Association of Realtors residential purchase agreement for the sale of her home for $ 220,000 to Marshall "and or Assignee."

Marshall also presented to Spencer for signature a one-year leaseback agreement for $ 1,500 per month and an option agreement that stated Spencer could repurchase her condominium for $ 260,000 anytime from October 1, 2004, until September 1, 2005, at which time the option would expire.

The rent charged to Spencer was actually higher than the Option One monthly mortgage payment on which Spencer had defaulted.

This amount of $ 1,500 covered all of Marshall's costs plus an extra $ 200 for a monthly management fee for Lisa Sanderson.

Attached to the contract for the sale of Spencer's home was a "Controlled Business Arrangement Disclosure Statement" and an "Addendum to Purchase Agreement."

The former document stated that "Innovative Real Estate Strategies/Sisu Management Inc./IRES Co., Ryan Marshall Division" was assisting Spencer "in the purchase, sale, and or creative strategy for her property." ("Creative Strategy" usually equals "Lawsuit"—B.)

The addendum contained the following provision, among others: "Seller is aware and understands that the present fair market value of the property may be higher than the purchase price set forth herein.

Seller hereby expressly waives any and all claim to any potential or actual income. Profits, or other sums in excess of the purchase priced [*sic*] agreed upon, which may be realized by buyer or others [*sic*] result of any transaction of the property. Seller acknowledges that the purchase price stated in the purchase agreement is fair and equitable and is in the best interest of the seller, and it is the sellers [*sic*] decision to sell was not made in reliance on any representations of buyer which is not expressly contained in this disclosure or purchase agreement." (If you can't spell, it always looks bad in court—B.)

The addendum also provided the following: "The 'Tenant' will rely solely upon the advice of his or her own counsel before entering into such agreement. … The tenant shall not rely on any other information but that received by the professional of his/her choice. …"

Spencer reviewed these documents with her bankruptcy counsel, Boone.

Spencer knew that the sale price was less than the appraisal and that the repurchase price was higher than the sale price.

Spencer did not request any changes or modifications to any of the agreements.

The bankruptcy court was about to lift its stay on Option One's foreclosure proceedings, and Spencer testified that she was "depressed" and "terrified."

She stated that she believed the situation was "urgent" and that "someone would come and padlock the front door and that would be it."

On August 30, 2004, the bankruptcy court issued an order, effective on and after September 20, 2004, granting Option One's motion for relief from the automatic stay to enforce its interest in the property. (Thus removing the property from Bankruptcy Court protection—B.)

The court stated that this "order shall be effective on and after September 20, 2004."

On September 10, 2004, Martha G. Bronitsky, the bankruptcy trustee in Spencer's bankruptcy case, sent a letter to California Sunset Escrow regarding Spencer.

Bronitsky stated that she understood that an escrow had been opened and that through this transaction it would satisfy the debts to Spencer's named secured creditors.

This letter constituted her approval of the sale pursuant to Spencer's Chapter 13 plan.

Bronitsky testified that her only concern was whether the sale would generate enough money to pay off the liens on the property and pay the unsecured creditors their 13 cents on the dollar.

She was not concerned with the question of Spencer's receiving a fair price. (A bankruptcy court trustee is concerned with obtaining as much money as possible for to the estate—i.e. creditors—B.)

On September 15, 2004, escrow closed and Spencer signed a grant deed transferring her property to Lisa Sanderson.

Sanderson was Marshall's assignee under the purchase agreement and, according to Marshall, the co-owner of Innovative.

Subsequently, Sanderson transferred title to Innovative, although Sanderson indicated on the loan application that she intended to occupy the property as her second home.

Both Sanderson and Marshall admitted at trial that they knew this statement regarding Sanderson's intent to live on the property was false, but listing it as being personally occupied permitted IRES to sell the loan at a higher price. (Isn't that called "FRAUD?"—B.)

On November 5, 2004, Bronitsky filed a notice of plan completion with the bankruptcy court, recommending discharge of Spencer's debts because the chapter 13 plan had been completed pursuant to bankruptcy law and all required disbursements had been made.

On November 11, 2004, the bankruptcy court issued an order finding that Spencer had fulfilled her requirements under the chapter 13 plan, and discharging her debts in bankruptcy.

Spencer continued to reside at the Hayward property pursuant to the lease agreement.

On May 4, 2005, Spencer wrote a letter to Sanderson, asking that her monthly rent be reduced to $ 1,300, with the accumulated $ 200 monthly balance to be added to the $ 260,000 repurchase price under the option agreement.

Marshall, on behalf of Innovative, agreed to this request.

On June 27, 2005, Marshall sent a letter to Spencer enclosing a notice to pay rent or quit, notifying her that rent for the month of June was past due.

At some point before August 11, 2005, Spencer contacted First Financial Plus to try to arrange a loan to repurchase the property.

According to Spencer, First Financial Plus advised her that she could not qualify for a loan without a "gift of equity" from Marshall.

When Spencer learned that Marshall would not renegotiate the option agreement to provide her with a gift of equity, Spencer wrote a letter to Marshall dated August 11, 2005, stating: "For me the deception is that when I entered into this agreement almost one year ago, I was told that you would work with me on the financing."

Spencer did not repurchase the Hayward residence by September 1, 2005, the date when the option agreement expired.

Marshall wrote to Spencer and asked her if she would be willing to repurchase her property for $ 315,000.

Spencer said that she could not pay that much; Marshall listed the property for sale for $ 369,950.

On October 27, 2005, Marshall served Spencer with a 60-day notice to terminate the tenancy. Spencer served a notice of rescission.

On December 15, 2005, Spencer filed her complaint to quiet title and for compensatory and punitive damages against Marshall and others.

She alleged that Marshall violated HESCA when taking title to her condominium.

On February 3, 2005, she filed a first amended complaint against IRES, Sanderson, Marshall, and two other companies to quiet title and for specific performance, compensatory damages, and punitive damages.

In her first cause of action against Sanderson, Spencer sought rescission of the purchase agreement and to quiet title to the property.

She alleged that the form and content of the purchase agreement did not conform with the requirements of HESCA.

In her third and fifth causes of action against Marshall and Sanderson, she requested actual and punitive damages, alleging that they transferred and encumbered the property in violation of HESCA.

Prior to trial, Spencer dismissed her complaint against SISU Management Inc., and Mortgage Electronic Registration Systems, Inc.

Spencer's second cause of action requested specific performance of her repurchase option under the option agreement.

Her fourth cause of action sought alternative money damages in the amount of $ 50,000 pursuant to an alleged promise by Marshall to pay her that amount in return for her cooperating with the attempted sale of the property.

After the first phase of the trial, Spencer dismissed these causes of action.

On January 4, 2006, Innovative filed a complaint in unlawful detainer against Spencer.

On March 6, 2006, the trial court consolidated the unlawful detainer action with Spencer's action.

On November 14, 2006, the court ordered a bench trial of the HESCA claims to be heard first.

At the court trial, Bronitsky, Marshall, and Spencer testified.

After hearing their testimony and arguments, the trial court issued its statement of decision on August 16, 2007.

The court rejected the argument that HESCA did not apply.

The trial court noted that Marshall and Sanderson could not both be equity purchasers.

It determined that Marshall, not Sanderson, was liable for the violations of HESCA because he was the person who structured the terms of the transaction and had the primary dealings with Spencer regarding the property.

The court concluded: “In sum, the evidence presented at trial shows that Marshall, through his contacts at DirectLender, was looking to find people in financial distress, in particular, homeowners in bankruptcy like Spencer.

Despite Marshall's reluctance at trial to admit that at the time he entered into the transaction with Spencer he knew that a notice of default had been recorded against the property, the court has no doubt that Marshall was fully aware that he was buying Spencer's residence on the eve of foreclosure and that he used this circumstance to his own advantage to get a price well below market value.

Moreover, even though Marshall knew that Spencer had come to him because she had been unable to qualify for a $ 220,000 loan, he misled her into believing that by selling the property to him and getting out of bankruptcy, she could then afford, with his help in obtaining financing, to buy back her home. At least as to their dealings with Spencer, defendants were in every respect the ‘archetypal predators’ that HESCA seeks to regulate.” (TOO TRUE—B.)

The trial court set forth three possible remedies and Spencer chose monetary damages against Marshall.

Subsequently, Innovative dismissed its unlawful detainer complaint against Spencer.

Other options that Spencer rejected were rescission of the purchase agreement and restoration of title to the property to Spencer, subject to an equitable mortgage to Innovative for the sum of $ 202,827.

The trial court filed its amended judgment on September 20, 2007.

The court entered judgment in favor of Spencer on counts 1, 3, and 5 of her first amended complaint.

It awarded her monetary damages against Marshall in the amount of $ 280,000, representing the sum of actual damages of $ 70,000 and exemplary damages of $ 210,000. Pursuant to a stipulation of the parties, the award was reduced by $ 27,300 for unpaid rent, for a net recovery of $ 252,700.

Despite finding no liability for the purposes of a damages award against Sanderson and IRES, the court concluded that they were necessary parties to the action given the alternative remedies available and therefore it found Spencer to be the prevailing party against all of defendants for the purpose of awarding attorney fees.

Marshall filed a timely notice of appeal.

On appeal, Marshall contends that Spencer's sale of the property to Sanderson as his assignee was outside the scope of HESCA. HESCA applies only to an equity purchaser and this sale, according to Marshall, falls under the exceptions to an equity purchaser.

The purpose underlying the Legislature's enactment of HESCA is:
“(a) The Legislature finds and declares that homeowners whose residences are in foreclosure have been subjected to fraud, deception, and unfair dealing by home equity purchasers. … During the time period between the commencement of foreclosure proceedings and the scheduled foreclosure sale date, homeowners in financial distress, especially the poor, elderly, and financially unsophisticated, are vulnerable to the importunities of equity purchasers who induce homeowners to sell their homes for a small fraction of their fair market values through the use of schemes which often involve oral and written misrepresentations, deceit, intimidation, and other unreasonable commercial practices.

“(b) The Legislature declares that it is the express policy of the state to preserve and guard the precious asset of home equity, and the social as well as the economic value of homeownership.

“(c) The Legislature further finds that equity purchasers have a significant impact upon the economy and well-being of this state and its local communities, and therefore the provisions of this chapter are necessary to promote the public welfare.

“(d) The intent and purposes of this chapter are the following:

“(1) To provide each homeowner with information necessary to make an informed and intelligent decision regarding the sale of his or her home to an equity purchaser; to require that the sales agreement be expressed in writing; to safeguard the public against deceit and financial hardship; to insure, foster, and encourage fair dealing in the sale and purchase of homes in foreclosure; to prohibit representations that tend to mislead; to prohibit or restrict unfair contract terms; to afford homeowners a reasonable and meaningful opportunity to rescind sales to equity purchasers; and to preserve and protect home equities for the homeowners of this state.

“(2) This chapter shall be liberally construed to effectuate this intent and to achieve these purposes.” In Segura v. McBride (1992), the appellate court explained that HESCA seeks to regulate transactions between an equity purchaser and an equity seller resulting in the sale of residential real property in foreclosure.

The Act sets forth a number of requirements aimed at protecting the homeowner:

“The contract must include:

the total consideration given, terms of payment and terms of any rental agreement;

a conspicuous statement of the right to cancel within five business days or until 8 a.m. on the day scheduled for foreclosure, with an attached notice of cancellation; and

a conspicuous notice that until the right to cancel has ended, the equity purchaser cannot ask the seller to sign a deed or any other document.

The equity purchaser must provide, and complete, the contract in conformity with these terms.

During the ‘cooling off’ period, the equity purchaser cannot take title to the property by written instrument or recordation thereof; transfer or encumber any interest in the property; or pay the seller any consideration.

Moreover, the purchaser cannot make untrue or misleading statements about the value of the property, any foreclosure proceeds, or the terms of sale.

Additionally, when the seller grants the residence by an instrument purporting to be an absolute conveyance but reserves or is given an option to repurchase, the equity purchaser cannot grant any interest in the property to another without the written consent of the seller.

Finally, it is unlawful to take unconscionable advantage of the property owner in foreclosure.

The Act is intended to have broad application. “While the archetype prompting the Legislature to regulate the field of equity purchases may well have been the business person who seeks out and preys upon distressed homeowners, the resulting legislation embraced a broader class of persons in order to systematically protect homeowners from the unfair loss of the precious asset of home equity. Thus, the Act regulates not only the archetypal predator, but *all* equity purchasers, as defined.”

An equity seller is “any seller of a residence in foreclosure.”

An “equity purchaser means any person who acquires title to any residence in foreclosure.

Here, it is undisputed that Spencer's home was in foreclosure and Marshall does not challenge the lower court's findings that the sale did not comply with HESCA.

Marshall, however, maintains that the Act did not apply to the purchase of Spencer's property, and asserts that the exceptions set forth in **section 1695.1, subdivision (a)(4)** and **(5)** applied to the sale.

The appellate court considered whether either of these exceptions applied.

A purchaser is exempt from the requirements of HESCA when the person acquires title: “At any sale of property authorized by statute.”

Marshall contends that the sale was authorized by the bankruptcy statutes.

In particular, Marshall sites **section 363 of the Bankruptcy Code**, which states, “The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate … .”

Marshall concedes that Spencer's sale of the property did not proceed after notice to the creditors and a hearing as required by **section 363(b)(1) of the Bankruptcy Code.**

However, he emphasizes that Bronitsky testified at trial that the Oakland Bankruptcy Court has a local procedure, which permits debtors to sell their property upon approval of the trustee without a noticed hearing or further court order.

Marshall further notes that Spencer's chapter 13 plan confirmed this when it stated as follows: “The debtor(s) elect to have property of the estate revest in the debtor(s) upon plan confirmation.

Once the property revests, the debtor(s) may sell or refinance real or personal property without further order of the court, upon approval of the Chapter 13 Trustee.”

Marshall argues that Spencer's sale of the property to Sanderson as Marshall's assignee, as approved by Bronitsky, was authorized by the Bankruptcy Code.

The appellate court disagreed.

The Bankruptcy Code permits the seller to sell the property with the approval of the trustee, but it does not mandate a sale.

Our task in construing a statute is to ascertain the legislative intent to permit us to effectuate the purpose of law.

The statutory language ordinarily is the most reliable indicator of legislative intent.

The appellate court concluded that the clear language of **section 1695.1, subdivision (a)(4)**, does not apply to the present sale.

HESCA excludes from its coverage a purchaser acquiring title: “*At* any sale of property authorized by statute.”

Marshall argues that his interpretation is consistent with the policy underlying HESCA and that fairness is not a primary concern because that would not explain the other exceptions to an equity purchaser, such as property acquired from a family member or purchased for one's own personal residence.

Further, he emphasizes that Spencer was protected by the automatic bankruptcy stay against any potential foreclosure by her creditors and that she had all the information necessary to make an informed and intelligent decision regarding her sale of the property.

Additionally, Marshall points out that Spencer reviewed the agreement with her bankruptcy attorney.

Marshall claims that he was not an archetypal foreclosure vulture and that his primary business was as the president of IRES, a loan-making finance company. He states that he purchased properties from homeowners in bankruptcy on only two or three other occasions. (Didn't take him long to get hauled into court did it?—B.)

Marshall may complain that some of the other exceptions to the definition of an equity purchaser under the Act are too broad and not based on principles of fairness, but it is clear that HESCA was enacted to protect owners of residence in foreclosures from fraud, deception, and unfair dealings by home equity purchasers.

The intent of HESCA is "to provide each homeowner with information necessary to make an informed and intelligent decision regarding the sale of his or her home to an equity purchaser; to require that the sales agreement be expressed in writing; to safeguard the public against deceit and financial hardship; to insure, foster, and encourage fair dealing in the sale and purchase of homes in foreclosure; to prohibit representations that tend to mislead; to prohibit or restrict unfair contract terms; to afford homeowners a reasonable and meaningful opportunity to rescind sales to equity purchasers; and to preserve and protect home equities for the homeowners of this state."

The bankruptcy process does not provide any of the safeguards present in HESCA.

As trustee Bronitsky testified, her approval of the sale of the property was based only on the fact that the sale price would pay off Spencer's bankruptcy debts; Bronitsky was not concerned with whether Spencer would be receiving a fair price.

To interpret the HESCA in the manner urged by Marshall would deprive all persons filing for bankruptcy of the protections of HESCA.

Further, Marshall's rendition of the facts is contrary to the findings of the lower court. The lower court's findings were that Spencer was precisely the type of seller that was the focus of the Act.

At the time DirectLender referred Spencer to Marshall, Option One was contacting her regularly to bring her mortgage payments current.

Moreover, her attempt to refinance the property had failed and the bankruptcy court was about to lift its stay on the lender's foreclosure proceedings.

Spencer testified that she believed the situation was "urgent" when she saw Marshall and that she "was terrified."

She stated that she "envisioned that someone would come and padlock the front door and that would be it."

The court found Spencer's version of what happened more credible than Marshall's rendition.

Spencer stated that she saw Marshall's offer as the only way she could remain in her home and testified that Marshall misled her into believing that, by selling the property to him and getting out of bankruptcy, she could afford, with his help in obtaining financing, to buy back her home within a year.

The court concluded that Spencer was especially vulnerable to Marshall's predatory tactics.

We conclude that the record amply supported the lower court's findings that Spencer was vulnerable and susceptible to Marshall's promises that he could help her.

The Legislature set forth narrow exclusions to the Act and we do not agree with Marshall that public policy supports excluding from the protection of HESCA those foreclosures where the seller is in chapter 13 bankruptcy.

Marshall's interpretation contradicts this requirement as it would essentially exclude from coverage all sales involving people filing for bankruptcy.

Accordingly, we conclude that Sanderson, as Marshall's assignee, was an equity purchaser under HESCA and therefore the safeguards of this Act applied to the purchase of Spencer's home.

Accordingly, Sanderson, as Marshall's assignee, was an equity purchaser and the sale of Spencer's home was subject to the requirements of HESCA.

DISPOSITION

The appellate court affirmed the trial court's judgment. Marshall was ordered to pay the costs of appeal.

Haerle, Acting P. J., and Richman, J., concurred.

Moral of the Story

Its not a good idea to mess around with distressed homeowners. The courts do not like "archetypal foreclosure vultures."

Case #6 Larry Calemine et al. v. Walter Samuelson,

February 17, 2009

Nondisclosure of a material fact

Introduction

In February 1993, Samuelson and his wife became the initial owners of a three-story condominium located on Jared Court in Woodland Hills, CA. The lower level was a three car garage and a bonus room. Samuelson lived in the condo until 2003, when he sold it to the Calemines. Between 1983 and 1999, Samuelson personally noticed water intrusion and flooding in the lower level of the condo. In 1986, Samuelson and the HOA had brought a lawsuit against the developer alleging construction defects. In 1992, the HOA hired Westar to repair and waterproof the affected areas of Jared Court. Even though Samuelson's bonus room did not have any further water intrusion problems, the rest of the Jared Court condos did. So the HOA filed suit against Westar in 1996. Samuelson had served as president of the HOA from March 1993 until June 1994, and as treasurer of the HOA board from June 1999 until April 2001. In September 1997, consultant Jacobs prepared a report on the Westar lawsuit and said it would cost $724,516 to repair all the Jared Court condos. In 1997, a supplemental report added $296,380.72 to the original estimate. The Westar lawsuit settled in 1998 for $410,000 to the Jared Court HOA, after attorney fees. The HOA solicited bids from several contractors, ranging from $119,800 to $305,000 per unit. CHI ultimately won the bid ($119,800 per unit) and Samuelson was the "point man" in connection with work performed by CHI on the Jared Court condos. CHI's proposal cautioned that this was only a fix and would need more repairs later. CHI completed its work in 1998, after which time Samuelson did not notice any more water intrusion into his condo. In the fall of 2001, Samuelson began negotiation with Calemine to sell his Jared Court condo to him. In November 2001, Sameulson signed a Real Estate Transfer Disclosure Statement (TDS) where he stated that he was aware of "flooding, drainage, or grading problems" and added the notation, "heavy rains below ground walls and slab." According to Samuelson, water had come up in the cracks in the garage five or six times during the twenty years he had owned the condo. The listing agent on the TDS further stated, "water damage noted in the garage. Buyer is urged to get a physical inspection from a licensed contractor." Negotiations began between the Calemines and Samuelson in April 2002 and they closed in July 2002. In May 2002, the Calemines retained Preferred Home Inspection Services, Inc. to inspect the condo. The inspector noted evidence of above ground leakage in the garage, as well as several other items were noted. In June 2002, Carpenter Termite Control prepared a report that noted excessive moisture in the garage. According to the Calemines, Samuelson explained in person what repairs had been made to the condo and said the water intrusion problem had been solved. Based on this information the Calemines thought the water intrusion problem was a minor one and moved forward and closed escrow in July 2002. In January 2005, the condo's garage flooded. At that time the Calemines first learned of the developer lawsuit and Westar lawsuit. Samuelson had not disclosed the existence of the lawsuits because he believed that he was only obligated to disclose pending actions. Samuelson had never mentioned the lawsuits during the two or three conversations he had with the Calemines. The garage flooding reoccurred in March 2005 and again in January and April of 2006. The Calemines filed suit against Samuelson, the HOA, and others alleging causes of action for nuisance, breach of contract, negligence, and misrepresentation/concealment. The negligence cause of action against Samuelson alleged his breach of duty to make full and complete disclosures of past actions. Samuelson also failed to disclose that he was a member of the HOA board at the time of the lawsuits and subsequent repairs. Samuelson answered in January 2006 denying the allegations, and said that he was not under a duty in the TDS to disclose more than he did. He asked the trial court for summary judgment (the Calemines did not have a triable issue of fact) and received it. The trial court entered a judgment in favor of Samuelson. The Calemines appealed the trial court's judgment in August 2006. The appellate court said that the intent of the TDS was to make disclosures specific and clear. The court also said the requiring the seller to make disclosures in good faith, which is “honesty in fact in the conduct of the transaction.” The appellate court said that Samuelson had said “no” on the TDS where it asked him if he was “aware of any lawsuits by or against the seller threatening to or affecting this real property, including any lawsuits alleging a defect or deficiency in this real property or common areas.” Samuelson did not disclose the existence of the two lawsuits on the TDS or during the two or three conversations he had with the Calemines. The appellate court believed that this information on the two lawsuits would affect the desirability and value of the property. Therefore, the appellate court reversed the trial court’s judgment and remanded it back to the trial court for further proceedings.

Here’s What Happened

In February 1983, Samuelson and his wife became the initial owners of a three-story condominium, unit 5, located on Victory Boulevard in Woodland Hills (condominium), in building 2 of a development known as Jared Court.

The lower level of the condominium was comprised of a three-car garage and a carpeted and windowless “bonus room” that Samuelson used as a sewing room and office.

Samuelson resided in the condominium until July 2002 when he sold it to appellants.

Between 1983 and 1999, Samuelson personally observed intermittent incidents of water intrusion and flooding in the lower level of the condominium.

In 1986, the Jared Court Homeowners Association (HOA) and individual unit owners, including Samuelson, brought a lawsuit against the developer alleging design and construction defects in the units and common areas (developer lawsuit).

In 1992, the HOA hired Westar Flooring (Westar) to repair and waterproof the affected areas of Jared Court.

After the Westar work in 1992, the bonus room area did not suffer any further water intrusion problems.

Samuelson was aware, however, that Westar's repairs were not effective throughout Jared Court, and he knew that the HOA filed a lawsuit against Westar in 1996 (Westar lawsuit).

Samuelson served as president of the HOA board from March 1993 to June 1994 and as treasurer of the HOA board from June 1994 to April 2001.

A September 1997 report prepared by a consultant retained by the HOA in connection with the Westar lawsuit, Robert Jacobs & Associates (Jacobs), estimated the cost of the waterproofing repairs at $ 724,516 and characterized the repair process as lengthy and extensive.

A supplemental report prepared by Jacobs in November 1997 added $ 296,380.72 to the original estimate following testing of individual units.

The Westar lawsuit settled in 1998.

Minutes from the March 24, 1998 annual meeting of the HOA indicated that the HOA received $ 410,000 from the settlement after payment of attorney fees.

The HOA board solicited and considered bids from several contractors to perform repairs and waterproofing.

It received bids from Construction Headquarters Inc. (CHI) to undertake repairs to the Jared Court common area and individual units, including the condominium, ranging from $ 119,800 to $ 305,000.

CHI's lowest and ultimately accepted proposal was addressed to Samuelson in care of the HOA, and Samuelson served as the “point man” in connection with the work CHI ultimately performed.

The final $ 119,800 CHI proposal cautioned: “It must be clearly understood that this is only one phase of our due diligence in attempting to mitigate the water intrusion problem being encountered at this time. This proposal will only solve a portion of the problem. The remaining work is necessary to mitigate fully.”

Once the repairs were completed, CHI wrote to Samuelson in care of the HOA that the “next proposed phase of work will apparently involve clean up, patching, painting and ‘band-aid’ covering up of existing subterranean garage and storage room walls.”

CHI also wrote to confirm several discussions with HOA board members in which it indicated “we can take no responsibility nor give any guarantees whatsoever, that the water penetration issues, through the retaining walls, will be controlled or corrected, due to the existing hydrostatic pressures, capillary action from ground water intrusion or any other issues relating to dampness, as we are not addressing these issues in the garage/storage contract.”

CHI completed its work in November 1998.

After that time, Samuelson did not observe any further flooding or water intrusion into the garage area of the condominium, though occasionally damp spots would appear on the garage floor during periods of heavy rain.

The Sale of the Condominium to Appellants.

During the fall of 2001, Samuelson and appellants (Calemine) began negotiations for the sale of the condominium. In connection with the transaction, in November 2001 Samuelson signed a real estate transfer disclosure statement (transfer disclosure) in which he stated he was aware of “flooding, drainage or grading problems” and added the notation “heavy rains below ground, walls & slab.”

According to Samuelson, water came up through the cracks in the garage slab approximately five to six times during the almost 20 years he lived in the condominium.

The section of the transfer disclosure to be completed by the listing agent further stated: “Water damage noted in garage. Buyer is urged to get a physical inspection from a licensed contractor.”

Samuelson signed the relevant disclosure documents in November 2001 and declared that he began negotiating with appellants at that time.

Appellants, on the other hand, contend that negotiations began in April 2002; escrow did not close until July 2002.

In May 2002, appellants retained Preferred Home Inspection Service, Inc., to inspect the condominium.

According to the inspection report, the inspector observed: “Evidence of below grade leakage is evident at garage south and west walls. (Moisture bubbling & efflorescence at below grade foundation walls & staining along hairline floor cracks in garage.) Moisture staining was also noted at base boards at lower level room. Status of leakage cannot be visually ascertained. Further investigate to determine if repairs have been made or will be made. Below grade leakage occurrence typically would be an H.O.A. repair. See seller for status/information."

In June 2002, Carpenter Termite Control Company prepared a report after its own inspection, which noted with respect to the garage area that "excessive moisture has damaged drywall and plaster at rear and left side of garage. Source of excessive moisture appears to have been from soil abuting [*sic*] retaining wall. Other Contractors have installed additional concrete and drainage in the past. No moisture was evidence [*sic*] at time of inspection."

After receiving this report, appellants contacted Samuelson for an explanation.

According to appellants, Samuelson was standing in the lower level of the condominium when he stated: "'We've had some water intrusion near the bottom of this wall and up through the slab and the homeowners association came in. They dug out around the patio areas, waterproofed the wall, put in French drains. Then inside the garage—on the outside they dug down the wall, exposed the wall, waterproofed the wall put French drains in. Put the dirt back in. Rebuilt the patios. On the inside of the unit they waterproofed the walls and put these drywall'—you know, drywall in those areas. 'Haven't had a problem since. Problem solved.'"

Samuelson recalled stating that there had been some water damage and we weren't having it anymore, it had been fixed."

On the basis of Samuelson's explanation, appellants believed the water intrusion problem was a minor issue.

Appellants moved into the condominium in July 2002 when escrow closed.

In January 2005, the condominium garage flooded.

At that time, appellants first learned of the developer lawsuit and the Westar lawsuit.

Appellants discovered that the HOA had filed the developer lawsuit, received a recovery and made repairs.

They further learned that the Westar lawsuit resulted from the repairs being ineffective, that the Westar lawsuit had settled and that additional repairs had been made both inside and outside of the condominium.

Samuelson had not disclosed the litigation in the transfer disclosure because he believed he was obligated only to disclose pending actions. Nor did Samuelson ever mention the lawsuits during the course of two or three conversations he had with appellants during the transaction.

The flooding recurred in March 2005 and January and April 2006.

As a result of appellants' complaint to the HOA about their lack of knowledge of the water intrusion litigation and repairs, the HOA prepared a letter outlining the history of its repair efforts that was designed to be provided to prospective purchasers at Jared Court.

The Pleadings and Summary Judgment Motion

Appellants filed their complaint in August 2005 against Samuelson, the HOA and others, alleging causes of action for nuisance, breach of contract, negligence and misrepresentation/concealment.

In connection with the negligence cause of action brought against Samuelson, appellants alleged that he breached his duty to make full and complete disclosures of past actions.

In support of the misrepresentation claim, appellants alleged that Samuelson “made representations to plaintiffs that Unit #5 was free of defects and was fit for habitation” and that he failed to disclose he was a member of the HOA board at the time of the second lawsuit and failed to describe the repairs made as a result thereof.

They further alleged that Samuelson knew his representations were false when made and knew appellants were unaware of the truth, that they acted in justifiable reliance on his representations, and that they suffered damage as a proximate (legal—B.) result of the misleading statements and concealed information.

Samuelson answered in January 2006, generally denying the allegations and asserting several affirmative defenses.

In April 2006, Samuelson moved for summary judgment and alternatively for summary adjudication.

He asserted that the undisputed evidence showed appellants were aware of all material facts relating to the water intrusion, Samuelson did not make any representations that were knowingly false and appellants did not justifiably rely on any of Samuelson's representations.

In support of the motion, Samuelson submitted his own declaration, copies of documents associated with appellants' purchase of the condominium and copies of pleadings from actions filed by the HOA.

Appellants opposed the motion.

They asserted that triable issues of fact existed as to whether the information Samuelson provided to them in the transfer disclosure was incomplete, misleading and/or inaccurate.

In support of their opposition, they submitted Larry Calemine's (Calemine) declaration, deposition excerpts, copies of documents associated with their condominium purchase and copies of HOA documents.

On reply, Samuelson asserted that the transfer disclosure imposed no duty on him to disclose the specific facts which appellants claimed were omitted or concealed, including the scope of prior repairs, the decision to implement limited repairs, the existence of nonpending lawsuits and the settlement of a lawsuit.

He also offered excerpts of Calemine's deposition.

Following a July 17, 2006 hearing, the trial court granted the motion, finding “that there was sufficient disclosure of defects by moving defendant Walter Samuelson. There is no triable issue of material fact regarding a misrepresentation or failure to disclose as to water intrusion.”

Judgment was entered in August 2006 and this appeal followed.

DISCUSSION

Appellants contend that the evidence presented below raised a triable issue of fact as to whether Samuelson's disclosures concerning the condominium's water intrusion were adequate.

While the evidence was undisputed that Samuelson sufficiently disclosed the existence of the water intrusion itself, a triable issue of fact remained as to whether disclosure of the prior lawsuits would have been material to appellants and thus should have been disclosed.

In Shapiro v. Sutherland (1998), a real estate seller has both a common law and statutory duty of disclosure. The court outlined the common law duty, explaining: "In the context of a real estate transaction, 'it is now settled in California that where the seller knows of facts materially affecting the value or desirability of the property … and also knows that such facts are not known to, or within the reach of the diligent attention and observation of the buyer, the seller is under a duty to disclose them to the buyer.

In Pagano v. Krohn (1997), "undisclosed facts are material if they would have a significant and measurable effect on market value." A seller's duty of disclosure is limited to material facts; once the essential facts are disclosed a seller is not under a duty to provide details that would merely serve to elaborate on the disclosed facts.

In Lingsch v. Savage (1963), "where a seller fails to disclose a material fact, he may be subject to liability "for mere nondisclosure since his conduct in the transaction *amounts to a representation of the nonexistence of the facts which he has failed to disclose.*

In Shapiro*, g*enerally, whether the undisclosed matter was of sufficient materiality to have affected the value or desirability of the property is a question of fact.

With respect to a seller's statutory obligations, effective January 1, 1987, the Legislature enacted division 2, part 4, title 4, chapter 2, article 1.5 of the Civil Code which specifies the information a residential property seller must disclose when transferring the property.

In enacting this article, the Legislature made clear it did not intend to alter a seller's common law duty of disclosure.

The purpose of the enactment was instead to make the required disclosures specific and clear.

In its statement of legislative intent the Legislature declared it "did not intend to affect the existing obligations of the parties to a real estate contract, or their agents, to disclose any fact materially affecting the value and desirability of the property, including, but not limited to, the physical conditions of the property and previously received reports of physical inspections noted on the disclosure form set forth in **Section 1102.6** or **1102.6a**, and that nothing in this article shall be construed to change the duty of a real estate broker or salesperson.

The Legislature specified the precise disclosure form which must be used. (**Civ. Code, § 1102.6**.) Among the items which must be disclosed, the legislatively mandated form requires a seller to answer whether he or she is "aware of any significant defects/malfunctions" in the slabs and sidewalks, and whether he or she is aware of "flooding, drainage or grading problems" and "any lawsuits by or against the Seller threatening to or affecting this real property, including any lawsuits alleging a defect or deficiency in this real property or 'common areas' (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others)." (**Civ. Code, § 1102.6**.)

In addition to mandating the use of the disclosure form, the Legislature also required the seller to make each disclosure in "good faith," defined as "honesty in fact in the conduct of the transaction." (**Civ. Code, § 1102.7**.)

A Triable Issue of Fact Existed with Respect to the Adequacy of Samuelson's Disclosures.

In the third cause of action for negligence, appellants alleged that Samuelson breached his duty to "make full and complete disclosures of past actions to new owners such as Plaintiffs and not refuse or conceal past activity."

The fourth cause of action for misrepresentation/ concealment more specifically alleged: "On or about June, 2002, defendant Walter Samuelson made representations to plaintiffs that Unit #5 was free of defects and was fit for habitation."

"Defendants did not disclose that Samuelson had been a member of the Board at the time of Lawsuit #2 (the Westar lawsuit) nor what had been done with the funds nor repairs made subsequent thereto."

"At the time, June 2002, when Samuelson "made representations, he knew them to be false, inaccurate and made solely for the intention of facilitating the sale of his property to the Plaintiffs who were unaware of the true nature of the conditions and did not have access to the information."

In opposition to summary judgment, appellants identified the undisclosed "past actions" as falling into two general categories:

facts relating to the water intrusion problem and the condition of the condominium itself, and

facts relating to the developer lawsuit and the Westar lawsuit.

The trial court correctly determined the undisputed evidence established that Samuelson's disclosures concerning the existence of water intrusion were adequate.

On the transfer disclosure—the form mandated by **Civil Code section 1102.6**—Samuelson indicated that the slabs and sidewalks suffered from "defects/ malfunctions" in the form of "underground water."

Moreover, he represented that he was aware of "flooding, drainage or grading problems" which he described as "heavy rains below ground, walls & slab."

Orally, Samuelson confirmed the existence of past water intrusion and generally outlined the repairs that had been made to resolve the problem.

Appellants offered no evidence to show that Samuelson had any reason to doubt the accuracy of his representation that the repairs had resolved the problem in the condominium's lower level, as the evidence was undisputed that the bonus room area and garage had not suffered from water intrusion for several years prior to appellants' purchase.

Appellants suggest that a triable issue of fact existed as to whether Samuelson should have disclosed more detail concerning the repairs, including that the HOA utilized a low bid which may not have been designed to "mitigate fully" the water intrusion problem. (Good point—B.)

In the context of disclosures associated with the water intrusion problem itself, the trial court properly ruled there was no triable issue of fact.

In several respects, the facts here are akin to those in **Pagano v. Krohn,**. There, after several units in a condominium development suffered water intrusion, the homeowners association brought suit against the developer. In response to a questionnaire to all unit owners asking them to describe any moisture intrusion problems in their units, the seller reported no problems inside her unit but complained of efflorescence on the concrete in her garage and algae or moss on the garage's exterior wall. These problems disappeared and did not recur once certain sprinklers were adjusted so as not to spray on the affected areas. During escrow, the seller disclosed both the fact that several of the units within the condominium association had suffered water damage and the existence of the lawsuit against the developer. After escrow closed, the buyers discovered dry rot and dampness in an area from which carpet and baseboard had been removed and brought suit against the seller and others alleging a failure to disclose the water damage to the garage. The appellate court affirmed summary judgment in favor of the seller, reasoning that the buyers were informed of "the essential facts concerning water intrusion at Blackhorse—i.e., that there was a water intrusion problem in the development which affected some of the units and resulted in litigation against the developer." The court rejected the buyers' argument that the seller's agent should have disclosed additional facts relating to the water intrusion problem—including her receipt of homeowners association documents chronicling the problem, her knowledge of problems in other units and her awareness of the specific allegations in the developer lawsuit—reasoning that "disclosure of these additional facts would have served only as elaboration on the basic disclosed fact that there was a water intrusion problem in the development affecting some of the units and resulting in a lawsuit against the developer." It further rejected the argument that the seller should have disclosed the past occurrence of efflorescence or algae she observed more than one year before the sale, particularly given that it was unclear whether the condition related to the water intrusion problem generally and the problem had been remedied long before the sale. (All the above was from the case Pagano v.Krohn).

Here, likewise, appellants were apprised of the water intrusion problem in the condominium and were urged to obtain a physical inspection, notwithstanding Samuelson's oral representations concerning the repair.

Further information concerning the type and scope of repairs made fell within the category of "elaboration" which the **Pagano** court determined is not part of a seller's duty of disclosure.

Moreover, the evidence established that Samuelson's representations were made in good faith, as the condominium had not suffered from water intrusion after the repairs were made.

Accordingly, the trial court properly concluded the undisputed evidence established that Samuelson neither misrepresented nor failed to disclose facts relating to water intrusion within the condominium.

But the same cannot be said with respect to Samuelson's failure to disclose the existence of the two previous lawsuits relating to water intrusion repairs.

The transfer disclosure mandated by **Civil Code section 1102.6** requires a seller to state whether he or she is aware of "any lawsuits by or against the Seller threatening to or affecting this real property, including any lawsuits alleging a defect or deficiency in this real property or 'common areas' (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others)."

Samuelson declared that he responded "no" to the foregoing inquiry because he believed the form required disclosure of only then pending lawsuits. (Duh!—B.)

In Kovich v. Paseo Del Mar Homeowner's Association (1996), it is apparent that Samuelson owed a common law "duty to disclose information materially affecting the value or the desirability of the property."

The evidence presented in connection with the summary judgment motion established a triable issue of fact as to whether the existence of the developer lawsuit and the Westar lawsuit was the type of information which should have been disclosed.

According to Samuelson's own declaration, the HOA and Samuelson as a unit owner filed the developer action after the lower level of the condominium suffered intermittent incidents of water intrusion and flooding for more than 15 years.

Thereafter, Westar performed repair work.

Although the condominium's bonus room did not suffer further water intrusion after the Westar work, Samuelson knew that the Westar repairs in the common areas were not effective and resulted in the Westar lawsuit.

At the time of the Westar settlement, Samuelson was treasurer of the HOA board.

According to Samuelson's deposition, in that capacity he solicited bids from CHI and acted as the "point man" in connection with the repairs performed by CHI.

In connection with those repairs, CHI informed the HOA its "proposal will only solve a portion of the problem" and that "remaining work is necessary to mitigate fully."

<u>Samuelson did not disclose the existence or outcome of the lawsuits in either the transfer disclosure statement or in the two or three conversations he had with appellants before escrow closed.</u>

In Shapiro v. Sutherland, in a real estate transaction, "whether the matter which was not disclosed was of sufficient materiality to have affected the value or desirability of the property is … a question of fact … ."

Here, the evidence revealed a triable issue of fact, as the existence of the two lawsuits was the <u>very type of material information that a potential buyer could find seriously affected both the desirability and value of the property.</u>

Litigation between seller and earlier potential buyer should have been disclosed as it "materially affected the desirability of the property".

Moreover, Samuelson's disclosing the repairs made by the HOA in the absence of providing information about the context in which those repairs were made could be characterized as a partial disclosure, likewise creating a triable issue as to whether the balance of information concerning the litigation should have been disclosed.

Where one does speak he must speak the whole truth to the end that he does not conceal any facts which materially qualify those stated.

Here, notwithstanding Samuelson's admitted knowledge of the developer lawsuit and the Westar lawsuit, he failed to disclose the existence of either action to appellants.

Disclosure of the litigation would have enabled appellants to examine the details of those actions and evaluate their purchase in light of information including that the water intrusion had existed since the condominium was built, repairs throughout Jared Court were twice ineffective and the CHI repairs were made on a budget governed by the amount of the Westar lawsuit settlement.

Without Samuelson's disclosure of the existence of the lawsuits, these matters were not within appellants' diligent attention.

The materiality of the existence of the lawsuits was also shown by Calemine's declaration, in which he stated that appellants would not have purchased the condominium had they known about the prior lawsuits.

Disposition

The appellate court reversed the trial court's decision and remanded it back for trial.

Boren, P. J., and Ashmann-Gerst, J., concurred.

Moral of the Story
Sometimes being a little too litigious yourself can come back to haunt you. Samuelson (it appeared) may have spearheaded the litigation against the developer and Westar, and then had it come back to haunt him when he sold his own condo. Past lawsuits are always a material fact—especially with condos—and the trial court should have figured that out. Again, the appellate court to the rescue. . .this time for a seller with a faulty memory. The TDS should be called the "memory enhancement" disclosure form.

By the way, the TDS protects agents too.

Case #7 California Golf, LLC v. Perry Cooper, et al.
Buyer at Trustee's Sale Stops Cashier's Check,
June 9, 2008

Introduction

In 2004, lender California Golf (Golf) bought a loan from Hanil Bank. Golf elected to sell the property at a trustee's sale on January 14, 2005. There were two active bidders: lender California Golf and buyer Perry Cooper. Bidding opened at $400,000 and Golf made a full credit bid of $957,642.31. Buyer Cooper bid one dollar over this amount and won the bid. Immediately thereafter, Buyer Cooper presented 13 cashier's check to the trustee totaling $960,000. All of the cashier's checks had been issued by Wells Fargo Bank. Buyer Cooper was named as payee on each. Buyer Cooper endorsed in blank each check and gave them to the foreclosure trustee. The trustee deposited the checks into his account for the lender Golf's benefit. Two hours after the trustee's sale, Sami Ostayen (Cooper's partner) left a voicemail message with Golf explaining that his partner had made a mistake in bidding $957,000 for the property. Ostayen mentioned, however, that they would "still be willing the buy the property for $400,000." Later on that day, buyer Cooper went to Wells Fargo and signed 13 affidavits as to "lost, destroyed, or stolen cashier's check or official check" forms. In the affidavits, Cooper acknowledged that he had been duly sworn and stated that he had "lost or never had possession of the described checks. . ." and his "loss of possession was not the result of transfer by Cooper or lawful seizure." The trial court said they believe that these statements are untrue. Wells Fargo, relying on Cooper's affidavits, stopped payment and refused to honor the checks. Wells Fargo placed the $960,000 with the court clerk and interpleaded (let the court decide—B.) to the court to decide what to do with the money. Buyer Cooper took the position that lender California Golf had gotten the checks as a result of fraudulent misrepresentation regarding the condition of the subject property and the amount owed on the promissory note. Buyer Cooper had been guilty of this kind of dispute before. Ostayan had asked the court in 1997 to relieve him of a foreclosure purchase because he was misled by the foreclosing lender. In any event, the accepted remedy is only the costs to lender Golf of re-noticing the trustee's sale. The trial court concluded that Golf was not entitled to any further remedy. Golf pleaded causes of action against Cooper for fraud and wrongful failure to conclude a trustee's sale. Buyer Cooper was awarded the $960,000 in interpleaded funds. In addition, judgment was entered in favor of Golf for $14,415.16 which represented ½ the fees and costs incurred by Wells Fargo and the costs of re-noticing the sale. The appellate court disagreed with the trial court and ordered Cooper to restore those funds to the custody of the court. The appellate court also had the intention to refer the matter to the district attorney for criminal investigation. In addition, judgment was entered in favor of Golf for $14,415.16 which represented ½ the fees and costs incurred by Wells Fargo and the costs of re-noticing the sale. The appellate court disagreed with the trial court and ordered Cooper to restore those funds to the custody of the court. The appellate court also had the intention to refer the matter to the district attorney for criminal investigation

Here's What Happened

Lender California Golf pleaded fraud and breach of warranty.
Buyer Cooper contends that under **Civil Code section 2924h**, governing non-judicial foreclosure sales, the trustee's sale was effectively "cancelled" by the bank's "stop payment" and California Golf's *only* remedy was to notice a new sale.
The trial court agreed and held the only remedy against Buyer Cooper was to re-notice the sale and recover from them the costs of the new notice of sale.
In the appellate court's view, this was error.
The appellate court therefore reversed the trial court's judgment.

The Facts
In 2004, Lender California Golf obtained a beneficial interest in the property at issue (i.e. bought the loan—B.).

Its predecessor in interest was Hanil Bank. Hanil Bank transferred its beneficial interest to Lender California Golf.

Subsequently, Lender California Golf chose to pursue *non-judicial* foreclosure proceedings under the deed of trust.

A foreclosure sale was duly noticed, and held on January 14, 2005.

There were two active bidders at the sale, Lender California Golf (the foreclosing beneficiary) and respondent Buyer Perry Cooper.

Bidding opened at $ 400,000, and quickly reached $ 600,000. At this point, Lender California Golf made a full credit bid, in the amount of $ 957,642.31.

Buyer Perry Cooper bid one dollar in excess of this amount.

There were no further bids, and Buyer Perry Cooper was the winning bidder.

Immediately thereafter, Buyer Perry Cooper presented 13 cashier's checks to the trustee, totaling $ 960,000.

All of these checks had been issued by Wells Fargo Bank, National Association (Wells Fargo), and Buyer Perry Cooper was the named payee on each of them.

Buyer Cooper endorsed the checks in blank and gave them to the foreclosure trustee as payment for the foreclosed real property.

The trustee deposited the checks into its checking account for Lender California Golf's benefit.

Approximately two hours after the completion of the trustee's sale, Sami Ostayan (Buyer Cooper's partner) left a voicemail message for Joseph Park, an officer of Lender California Golf, indicating that his partner, Perry Cooper, had made a mistake in bidding $ 957,000 for the property.

Ostayan, however, stated that he and his partners were still willing to purchase the property, but only for the sum of $ 400,000.

The following is a transcript of Ostayan's voicemail message: "Hi Joseph, It's Sam Ostayan again. Joseph, I just spoke to Perry Cooper. We may have a small problem here. You may like it or not. I did tell him not to … our impression is, like, we were going to buy it for $ 400 thousand. He told me he bought it for $ 900-something you know? So … and I promised him half the deal, but not at that price. So, give me a call, let me know if you're gonna take the property back and instruct the trustee to give us our checks back. We have no problem with it, you know? Give me a call as soon as you can Joseph. [Telephone number.] We will still go ahead with the deal if you agree to take the $ 400, but not the $ 900 thousand and change that he paid at the sale. When he told me he bought it, I was under the impression he bought it for the $ 400 thousand. So call me as soon as you can Joseph. Like we have two options. Give us the money back, keep the property and [unintelligible word] … or give us the property only for $ 400 thousand and we can work the logistics with it, alright? Take care, bye."

Later on that same day, January 14, 2005, Buyer Perry Cooper went to Wells Fargo and signed, *under penalty of perjury*, thirteen "Affidavit As To Lost, Destroyed or Stolen Cashier's or Official Check" forms.

In these affidavits, Buyer Perry Cooper acknowledged that he had been duly sworn and stated that he had "lost or never had possession of the described check" and that his "loss of possession was not the result of transfer by (Perry Cooper) or a lawful seizure."

These statements were untrue.

As already indicated, Buyer Perry Cooper had in fact endorsed and delivered those checks to the trustee earlier that day in payment of his successful bid.

Wells Fargo, relying on these affidavits, stopped payment on, and refused to honor, the checks.

The originals of the thirteen endorsed cashier's checks have been in the custody of either the trustee (until August of 2005) or Lender California Golf (from and after August 2005).

Under **California Uniform Commercial Code section 3312, subdivision (b)(1)**, the claim of someone filing a declaration of loss becomes enforceable "at the later of (i) the time the claim is asserted, or (ii) the 90th day following the date of the check, in the case of a cashier's check."

Of the 13 cashier's checks at issue in this case, only one, for $ 100,000, was dated more than 90 days prior to the filing of the declarations of loss; the others were dated only weeks before.

In other words, Buyer Cooper's claim to the funds was immediately enforceable with respect to only $ 100,000; his claim to the remaining $ 860,000 would not be effective until some time in March 2005.

Until the claim is enforceable "it has no legal effect and the obligated bank may pay the check … . Payment to a person entitled to enforce the check discharges all liability of the obligated bank with respect to the check."

In light of the affidavits of loss submitted by Buyer Cooper, Wells Fargo interpleaded (have the court determine what to do with it—B.) the $ 960,000 by depositing that amount with the clerk.

Wells Fargo took the position that, if Lender California Golf was entitled to any damages beyond the $ 960,000, those damages were caused by Buyer Perry Cooper, not Wells Fargo.

Included as exhibits to Wells Fargo's cross-complaint were 12 affidavits signed by Buyer Cooper, one for each of 12 of the 13 checks used to pay for the purchase of the land.
In each of the affidavits Buyer Cooper stated that he had *lost* the cashier's or official check listed in such affidavit.
The funds represented by the checks referenced in those 12 affidavits total $ 660,000.
According to Lender California Golf's appellate brief, late in the trial court proceedings in this case, Wells Fargo produced the thirteenth affidavit of loss signed by Perry Cooper, which was for a $ 300,000 cashier's check issued by Wells Fargo.

They also took the position that Lender California Golf had come into possession of the cashier's checks by means of fraudulent misrepresentations regarding the condition of the subject property and the amount of money owed on the promissory note secured by the trust deed, and asserted that, on that basis, Buyer Cooper had “submitted a stop payment order to Wells Fargo.”
The appellate court said that this was not the first time they have had before them a dispute where one of the respondents (Buyer Cooper’s partner was Ostayan) sought to avoid performance of a successful foreclosure bid.
Respondent Ostayan was a plaintiff in another case in which he sought to be relieved of his purchase of property at a 1997 non-judicial foreclosure sale by claiming to have been misled into purchasing the property.
(i.e. this probably wasn’t an “accident”—B.)
According to the **Civil Code section 2924h**:

(a) Each and every bid made by a bidder at a trustee's sale under a
ower of sale contained in a deed of trust or mortgage shall be deemed to be an irrevocable offer by that bidder to purchase the property being sold by the trustee under the power of sale for the amount of the bid.

(b) At the trustee's sale the trustee shall have the right
to require every bidder to show evidence of the bidder's ability to deposit with the trustee the full amount of his or her final bid in cash, a cashier's check drawn on a state or national bank, a check drawn by a state or federal credit union, or a check drawn by a state or federal savings and loan association, savings association, or savings bank specified in Section 5102 of the Financial Code and authorized to do business in this state, or a cash equivalent which has been designated in the notice of sale as acceptable to the trustee prior to, and as a condition to, the recognizing of the bid, and to conditionally accept and hold these amounts for the duration of the sale, and
to require the last and highest bidder to deposit, if not deposited previously, the full amount of the bidder's final bid in cash, a cashier's check drawn on a state or national bank, … immediately prior to the completion of the sale, the completion of the sale being so announced by the fall of the hammer or in another customary manner.

(c) In the event the trustee accepts a check drawn by a credit union or a savings and loan association pursuant to this subdivision or a cash equivalent designated in the notice of sale, the trustee may withhold the issuance of the trustee's deed to the successful bidder submitting the check drawn by a state or federal credit union or savings and loan association or the cash equivalent until funds become available to the payee or endorsee as a matter of right.

However, the sale is subject to an automatic rescission for a failure of consideration in the event the funds are not “available for withdrawal” as defined in Section 12413.1 of the Insurance Code.

(d) If the trustee has not required the last and highest bidder to deposit the cash, a cashier's check drawn on a state or national bank, a check drawn by a state or federal credit union, or a check drawn by a state or federal savings and loan association, savings association, or savings bank specified in Section 5102 of the Financial Code and authorized to do business in this state, or a cash equivalent which has been designated in the notice of sale as acceptable to the trustee in the manner set forth in paragraph (2) of subdivision (b), the trustee shall complete the sale.

If the last and highest bidder then fails to deliver to the trustee, when demanded, the amount of his or her final bid in cash, a cashier's check drawn on a state or national bank, a check drawn by a state or federal credit union, or a check drawn by a state or federal savings and loan association, savings association, or savings bank specified in Section 5102 of the Financial Code and authorized to do business in this state, or a cash equivalent which has been designated in the notice of sale as acceptable to the trustee, <u>that bidder shall be liable to the trustee for all damages which the trustee may sustain by the refusal to deliver to the trustee the amount of the final bid, including any court costs and reasonable attorneys' fees.</u>

(e) If the last and highest bidder willfully fails to deliver to the trustee the amount of his or her final bid in cash, a cashier's check drawn on a state or national bank, … or if the last and highest bidder cancels a cashiers check drawn on a state or national bank, … <u>that bidder shall be guilty of a misdemeanor punishable by a fine of not more than two thousand five hundred dollars ($ 2,500).</u>

In the event the last and highest bidder cancels an instrument submitted to the trustee as a cash equivalent, the trustee shall provide a new notice of sale in the manner set forth in Section 2924f and shall be entitled to recover the costs of the new notice of sale as provided in Section 2924c.

(f) In the event that this section conflicts with any other statute, then this section shall prevail.

(g) It shall be unlawful for any person, acting alone or in concert with others,

to offer to accept or accept from another, any consideration of any type not to bid, or

to fix or restrain bidding in any manner, at a sale of property conducted pursuant to a power of sale in a deed of trust or mortgage. However, it shall not be unlawful for any person, including a trustee, to state that a property subject to a recorded notice of default or subject to a sale conducted pursuant to this chapter is being sold in an 'as-is' condition.

In addition to any other remedies, any person committing any act declared unlawful by this subdivision or any act which would operate as a fraud or deceit upon any beneficiary, trustor, or junior lienor shall, upon conviction, be fined not more than ten thousand dollars ($ 10,000) or imprisoned in the county jail for not more than one year, or be punished by both that fine and imprisonment."
Moreover, independent of their analysis of the term "cash equivalent," respondents argued that **subdivision (c) of section 2924h** required that the sale be deemed rescinded because the funds submitted by them were not available for withdrawal.
<u>While it is true that the funds were not available for withdrawal, such circumstance was due to Buyer Cooper's own fraudulent inducement of Wells Fargo's stop payment action on the same day that the foreclosure sale was held.</u>
Buyer Cooper cannot now be heard to rely on such fund unavailability as a basis for a rescission of the sale.
The trial court concluded that the cashier's checks were "cash equivalents" as that term was used in **section 2924h**.
As **section 2924h** provides that the remedy for the cancellation of a cash equivalent is the cost of re-noticing a new sale, the trial court concluded Lender California Golf was entitled to no further remedy.
On that basis, the court granted summary adjudication (entered judgment) in favor of the Buyer Cooper on Lender California Golf's complaint.

Lender California Golf pled causes of action against Buyer Cooper for fraud (alleging that they had conspired to present affidavits to Wells Fargo in which Buyer Cooper falsely asserted that he had lost the cashier's checks), and for wrongful failure to conclude the trustee's sale.

Lender California Golf's cause of action against Buyer Cooper was for wrongful failure to conclude the trustee's sale, and the proper disposition of the interpleaded funds.

By this time, Lender California Golf had re-noticed the foreclosure sale, and had sold the property at auction for $ 600,000.

Buyer Cooper filed a motion for summary judgment (asked the court to make a ruling in their favor—B.) on Lender California Golf's remaining cause of action and for distribution of the interpleaded funds to themselves.

Buyer Cooper was awarded the interpleaded funds, and a judgment was entered in their favor against Lender California Golf in the amount of $ 14,415.16 (representing one-half of the fees and costs awarded to Wells Fargo, less California Golf's costs of re-noticing the foreclosure sale).

Lender California Golf filed a timely appeal.

Under **California Uniform Commercial Code section 3312**, after a bank waits until the claim of the individual filing the declaration of loss becomes enforceable, the bank is obligated to pay the amount of the check to the claimant, if the check has not otherwise been paid to a person entitled to enforce the check.

If the bank pays the check to the claimant under those circumstances, and the check is *then* presented to the bank for payment "by a person having rights of a holder in due course, the claimant is obliged to:
refund the payment to the obligated bank if the check is paid, or
pay the amount of the check to the person having rights of a holder in due course if the check is dishonored."

On appeal, Lender California Golf argues that the trial court erred when it granted a summary judgment for the wrongful failure to conclude a trustee's sale.

Lender California Golf contends that the undisputed record in this case demonstrates that each of those causes of action has merit.

The appellate court agreed.

Buyer Cooper said that they contend that **section 2924h** limits the remedy available to Lender California Golf for a "cancelled" sale to the costs of publishing a new notice of sale.

The appellate court concluded that a cashier's check is not a "cash equivalent" within the meaning of **section 2924h**.

Therefore, the provisions relating to the remedy of obtaining the costs of re-noticing the sale are simply not applicable.

Second, the appellate court concluded that, although the statutory scheme governing non-judicial foreclosures has, in certain circumstances, been held to constitute the exclusive civil remedy for wrongdoing in the context of a non-judicial foreclosure, that exclusivity cannot be applied to immunize the fraudulent and apparently felonious conduct of respondents in this case.

Finally, the appellate court concluded that while the misdemeanor penalty provided by **section 2924h** may be applicable, that criminal remedy is also not exclusive.

A Cashier's Check Is Not a "Cash Equivalent"
The appellate court was concerned with the interpretation of a single sentence in **section 2924h, subdivision (d)**, which states: "In the event the last and highest bidder cancels an instrument submitted to the trustee as a *cash equivalent*, the trustee shall provide a new notice of sale in the manner set forth in **Section 2924f** and shall be entitled to recover the costs of the new notice of sale as provided in **Section 2924c**."

In accepting the argument of Buyer Cooper, the trial court necessarily ruled that the cashier's checks were "cash equivalents" for purposes of **section 2924h**.

Here, the plain language of the statute convinces us that the trial court erred in its interpretation of **section 2924h**.

"At the trustee's sale the trustee shall have the right … to require every bidder to show evidence of the bidder's ability to deposit with the trustee the full amount of his or her final bid in
(1) cash,
(2) a cashier's check drawn on a state or national bank,
(3) a check drawn by a state or federal credit union, or
(4) a check drawn by a state or federal savings and loan association, savings association, or savings bank specified in Section 5102 of the Financial Code and authorized to do business in this state, or
(5) a cash equivalent which has been designated in the notice of sale as acceptable to the trustee prior to, and as a condition to, the recognizing of the bid, and to conditionally accept and hold these amounts for the duration of the sale."

According to the trial court and Buyer Cooper, the term "cash equivalent" is a generic term that includes both the various methods of payment that precede the term "cash equivalent" and the additional methods of payment that a notice of sale states would be acceptable to the trustee.

The Legislature plainly used the words "cash equivalent" as a term of art in **section 2924h** to refer to something different from "cash," "cashier's check," or "check drawn by a bank." (It looks like the Legislature is producing "art" these days, I've heard some people call it something entirely different—B.)

The term "cash equivalent" was clearly meant to designate *other* forms of payment which the trustee had found acceptable prior to the sale.

Repeating the entire list confirms that a cashier's check is not a cash equivalent.

Subdivision (c) provides that a trustee may withhold the issuance of a trustee's deed to a successful bidder, "until funds become available to the payee or endorsee as a matter of right."

That provision, however, only applies when the successful bidder has submitted, as a form of payment, "a check drawn by a credit union or a savings and loan association … or a cash equivalent designated in the notice of sale."

By not including cashier's checks, the Legislature was clearly intentionally omitting them from this provision.
The omission makes sense, as an implicit recognition of the fact that when cashier's checks are submitted as payment, the funds are immediately available to the trustee as a matter of right.

The appellate court concluded that “cash equivalent” is a term of art that does not include cashier's checks, the disputed language of **section 2924h, subdivision (d)** providing for the recovery of the costs of re-noticing the sale if “the last and highest bidder cancels an instrument submitted to the trustee as a cash equivalent” simply does not encompass the “stop payment” of cashier's checks submitted to the trustee as payment.

Therefore, the trial court erred in holding that Lender California Golf can recover only the costs of re-noticing the sale.

Also missing from Buyer Perry’s analysis is the fact that the remedy of recovering the costs of re-noticing the sale is provided by **section 2924h** to the *trustee*, not the foreclosing beneficiary (lender). The statute is silent as to any remedies for the foreclosing beneficiary.

The Civil Remedies Provided by Section 2924h Are Not Exclusive
[Civil Code sections 2924 through 2924k provide a comprehensive framework for the regulation of a non-judicial foreclosure sale pursuant to a power of sale contained in a deed of trust.
This comprehensive statutory scheme has three purposes:

to provide the creditor/beneficiary with a quick, inexpensive and efficient remedy against a defaulting debtor/trustor;

to protect the debtor/trustor from wrongful loss of the property; and

to ensure that a properly conducted sale is final between the parties and conclusive as to a bona fide purchaser.

The court concluded that “ ‘the antideficiency laws were not intended to immunize wrongdoers from the consequences of their fraudulent acts’ ” and that, if the court applies a proper measure of damages, “ ‘fraud suits do not frustrate the antideficiency policies because there should be no double recovery for the beneficiary.’ ”
The first two goals of the non-judicial foreclosure statutes: (1) to provide the creditor/beneficiary with a quick, inexpensive and efficient remedy against a defaulting debtor/trustor and
to protect the debtor/trustor from a wrongful loss of the property, are not impacted by the decision that we reach.

This case most certainly, however, involves the third policy interest: to ensure that a properly conducted sale is final between the parties and conclusive as to a bona fide purchaser.

This policy consideration is advanced by the fact that, under the statutory scheme, a bid at a foreclosure sale constitutes an “an irrevocable offer” to purchase the property for the amount of the bid.

It is similarly advanced by the fact that, under the statutory scheme, once the bid is accepted, the sale is complete.

It is further advanced by the fact that, under the statutory scheme, bidders are required to pay their bids in cash, cashier's checks, or bank checks.

Certain “cash equivalents,” such as personal checks, can only be accepted if the trustee so designates in the notice of sale.

The statutory scheme envisions payment by means of cash, cashier's checks, or bank checks in an apparent attempt to guarantee that the acceptance of the highest bid will, in fact, result in funds in that amount actually being transferred.

Similarly, the Commercial Code is concerned with guaranteeing the validity and collectability of cashier's checks.

Purchasers of cashier's checks have no right to stop payment on them.

If a bank wrongfully refuses to pay a cashier's check, the holder is entitled to compensation which may include consequential damages.

A purchaser of a cashier's check can file a declaration of loss, but only under penalty of perjury.

Even when such a declaration is made, it has no effect until 90 days after the date of the check, and the bank may pay on the check in the interim, with no risk of liability.

Cashier's checks are a preferred form of payment in non-judicial foreclosure sales precisely because they are readily negotiable and come with a bank's guarantee of payment.

For this reason, they advance the goal of achieving finality of properly conducted foreclosure sales.

There would be no point in preferring cashier's checks as payment at non-judicial foreclosure sales if cashier's checks could be cancelled as freely as could, say, personal checks.

Cashier's checks are preferred because they are as good as cash; cashier's checks are as good as cash because of provisions such as **Commercial Code section 3312**.

Allowing Lender California Golf to proceed with a cause of action against Buyer Cooper for violating **section 3312** is not contrary to the policies underlying the non-judicial foreclosure statutes; instead, it supports those policies.

Buyer Cooper asserts that they "stopped payment" on the cashier's checks due to alleged fraudulent misrepresentations which had induced them to bid too much for the property.

If Buyer Cooper was the victim of fraud in the sale, his remedy was to properly pursue the judicial remedies for fraud, not to engage in "self-help" by intentionally and fraudulently filing affidavits of loss in order to frustrate a trustee's sale which had already been completed.

The Criminal Remedies Are Not Exclusive

Buyer Cooper suggest that, in addition to requiring the sale to be re-noticed at their expense, **section 2924h** also provides for a *criminal* remedy, which, together with the costs of renoticing the sale, is exclusive. **Subdivision (d) of section 2924h** provides that "that bidder shall be guilty of a misdemeanor punishable by a fine of not more than two thousand five hundred dollars ($ 2,500)." While it appears that this language would apply to Buyer Perry's conduct in obtaining a "stop payment" on the cashier's checks, the
appellate court said, "While the cancellation of such items might not otherwise be subject to criminal prosecution, the cancellation of a cashier's check by the means of a false declaration under penalty of

<u>perjury appears to involve the commission of the felony of perjury, punishable with two, three, or four years imprisonment.</u>

While the statute speaks of the “cancellation of a cashier's check,” the appellate court recognized that it is not strictly possible to stop payment on a cashier's check.

A bank may *voluntarily* agree with the purchaser not to pay a cashier's check, although the Commercial Code imposes penalties on a bank wrongfully refusing to pay a cashier's check in order to discourage the practice.

In this case, we assume the term “cancels a cashier's check” includes the inducement of the bank to not pay a cashier's check, whether by voluntary agreement or declaration of loss.

A criminal prosecution for perjury must be commenced “within four years after discovery of the commission of the offense, or within four years after the completion of the offense, whichever is later.”

The false affidavits were completed by Buyer Perry Cooper on January 14, 2005. Thus, as of the date that this opinion is filed, the statute has not yet run on any possible prosecution against Buyer Perry Cooper for perjury, and the remaining respondents for conspiracy to commit perjury.

Based on the undisputed record before us, the appellate court was both surprised and puzzled by the trial court's seeming indifference to this apparent criminal conduct.

<u>It was the appellate court’s intention to refer this case to the District Attorney of Los Angeles County for further investigation.</u>

The trial court granted summary adjudication to Buyer Cooper with respect to Lender California Golf's complaint. Summary judgment was awarded Buyer Cooper with respect to Lender California Golf's cause of action for wrongful failure to complete the trustee's sale, crediting it only with the cost of re-noticing the sale.

Each of these rulings was based on the determination that Lender California Golf's sole remedy against the respondents was the cost of re-noticing the foreclosure sale.

Since the appellate court has determined that Lender California Golf's remedy is not so limited, this ruling was in error.

The appellate court ordered the trial court to vacate their orders.

<u>Moreover, the trial court's order releasing the interpleaded funds to the respondents was clear error as respondents had demonstrated no entitlement thereto.</u>

The appellate court directed the trial court to issue an order requiring the immediate restoration of those funds to the custody of the court, to be held and disbursed after a *final* determination of the extent of the parties' respective entitlement thereto.

<u>The judgment from which Lender California Golf has appealed is reversed and the cause is remanded with directions requiring that the trial court:</u>

“(1) vacate its orders sustaining the demurrer and granting summary judgment and adjudication with respect to California Golf's complaint and cross-complaint and issue new orders overruling the demurrer and denying the motions for summary judgment and adjudication,
vacate its order apportioning the attorney's fees ordered paid to Wells Fargo,
issue an order requiring the respondents, and each of them, to forthwith return the interpleaded funds to the custody of the court; and
to conduct such further proceedings as may be appropriate and not inconsistent with the views expressed herein.
California Golf shall recover its costs on appeal.”

In light of Lender California Golf's subsequent sale of the property, the parties may be able to agree on the amount at issue in this matter. If so, the trial court may accept the parties' written stipulation (or agreement orally recited in open court) as to the exact amount to be restored to court custody. Alternatively, if the parties cannot agree as to the amount remaining at issue, the court may determine that amount on appropriate motion.

The clerk of this court is directed to forward a copy of this opinion to the District Attorney of Los Angeles County for such investigation and action as he may deem appropriate.

Klein, P. J., and Kitching, J., concurred.

Moral of the Story

Amazingly the buyers of a foreclosed property bid too much, provided cashiers checks for the full amount that was bid, and then were able to change their minds—stop the cashiers checks—get their money back by lying to the bank—and then escape prosecution. And they initially got away with it too. Thanks to the California Appellate Court system, justice is once again served. The appellate court justices usually get it right, so giving up your rights to the courts (i.e. signing arbitration clauses) is probably not a good idea when you lose your ability to appeal.

PREDICTION: If the money doesn’t show up on time, I’ll bet the District Attorney will dangle a little jail time in front of these guy’s noses. . .just to move things along, of course.

Case #8 Thap-Nhut Van Nguyen et al. v. Larry Hung Tran et al.

Arbitration,

December 7, 2007

Introduction

In August 2003, Buyers Nguyen purchased real property from sellers Yeh. Several years later, buyers Nguyen sued seller Yeh, and both cooperating brokers (representing buyers) and listing brokers (representing sellers) for allegedly failing to disclose that the guest house was not built with the necessary permits. Buyers filed suit for breach of contract against sellers, breach of implied covenant of good faith and fair dealing and fraud against sellers and both brokers, and breach of fiduciary duty against cooperating brokers. The cooperating brokers petitioned for arbitration of the dispute based on the arbitration clause that he been initialed by the buyer and seller in the purchase agreement (both brokers were not parties to the contract and did not sign it). Both the sellers and listing brokers opposed the arbitration petition and contended that the cooperating brokers were not parties to the contract and could not compel arbitration. The listing brokers also argued that the cooperating brokers had no authority to bind them to an arbitration provision they had not signed to consent to. The trial court denied the cooperating brokers' petition to compel arbitration. The trial court said that the cooperating brokers failed to establish they were entitled to enforce an arbitration provision in an agreement between buyers and sellers. The trial court also ruled that listing brokers are not a party to the agreement. The cooperating brokers appealed. The appellate court stated there was no factual or legal basis for them to impose an obligation to arbitrate under these circumstances. So, the cooperating brokers were not able to compel arbitration of the dispute.

Here's What Happened

In August 2003, Buyers Nguyen purchased real property from Chi Shu Yeh and Horng Tao Yeh (sellers).

Several years later, buyers sued sellers and both the cooperating and listing brokers for allegedly failing to disclose that the guesthouse on the property was not built with the necessary permits.

Buyers asserted causes of action for breach of contract against sellers, breach of the implied covenant of good faith and fair dealing and fraud against sellers and both brokers, and a cause of action for breach of fiduciary duty against cooperating brokers.

Cooperating brokers petitioned for arbitration based on a clause in the purchase agreement between the buyers and sellers.

That clause provides "(B) Arbitration of Disputes: (1) Buyer and Seller agree that any dispute or claim in Law or equity arising between them out of this agreement or any resulting transaction, which is not settled through mediation, shall be decided by neutral, binding arbitration, including and subject to paragraph 17B(2) and (3) below. (3) Brokers: Buyer and Seller agree to mediate and arbitrate disputes or claims involving either or both Brokers … provided either or both Brokers shall have agreed to such mediation or arbitration prior to, or within a reasonable time after, the dispute or claim is presented to Brokers. Any election by either or both Brokers to participate in mediation or arbitration shall not result in Brokers being deemed parties to the agreement."

The next paragraph notified the parties that by initialing it, they agreed to arbitrate disputes involving matters included in the “Arbitration of Disputes” provision and to give up their rights to a trial, discovery, and appeal.

It further advised that if they refused to arbitrate after agreeing, they could be compelled to do so.

Buyers and sellers both initialed in the spaces provided.

No line was provided for the brokers to initial or consent to the provision, and they did not do so.

Buyers and listing brokers opposed the petition to compel arbitration, contending cooperating brokers were not parties to the purchase agreement and third parties were involved.

<u>Listing brokers further argued cooperating brokers had no authority to bind them to an arbitration provision they had not signed.</u>

The trial court denied the petition, stating cooperating brokers failed to establish they were “entitled to enforce the arbitration provision in the … agreement between buyers and sellers.

Listing brokers also oppose the motion and do not agree to voluntarily participate in arbitration.

They are not parties to the agreement.

Moving party has not shown that listing brokers are agents of any party.

Standard of Review

Enforcement of Arbitration Agreement by Nonsignatories

Cooperating brokers contend the trial court erred in denying the petition to compel arbitration. The appellate court agreed in part and disagreed in part.

“Public policy favors arbitration as an expedient and economical method of resolving disputes, thus relieving crowded civil courts.

However, arbitration assumes that the parties have elected to use it as an alternative to the judicial process. <u>Arbitration is consensual in nature</u>.

The fundamental assumption of arbitration is that it may be invoked as an alternative to the settlement of disputes by means other than the judicial process solely because all parties have chosen to arbitrate them.

According to Westra v. Marcus & Millichap Real Estate Investment Brokerage Company, subject to limited exceptions, only parties to an arbitration contract may enforce it or be required to arbitrate.

We focus our attention, therefore, on whether cooperating brokers are entitled to enforce the arbitration provision as agents for a signatory.

In Westra, a real estate broker sued for fraud by the purchasers of real property petitioned to compel arbitration based on a clause in the purchase agreement signed by the buyers and the seller but not the broker.

The provision read, “ Buyer, Seller and Agent agree that such controversy arising with respect to the subject matter of the purchase agreement shall be settled by final, binding arbitration … .”

Although the purchase agreement contained spaces for the buyers and seller to initial to indicate consent to arbitration, there was no place for the broker to do the same and he did not do so.

Westra reversed the denial of the broker's petition to compel arbitration.

Because the broker had a preexisting relationship as the agent for both parties to the agreement, *Westra* concluded the arbitration provision was “binding on the broker as well as the buyers, and the broker as an agent is entitled to enforce the arbitration agreement, to which the buyers and seller had agreed.”

Here the purchase agreement lists cooperating brokers as the agents of buyers, who signed the purchase agreement.

As such, <u>cooperating brokers could have been compelled to arbitrate the claims against them although they did not sign the agreement and were not parties to it.</u>

The trial court in this case distinguished *Westra*, stating “there is no language in the instant arbitration agreement that an agent agrees to arbitrate disputes … .”

This appears to be a reference to the language of the arbitration clause in *Westra* providing that the “ ‘Buyer, Seller and Agent agree’ ” to arbitrate the controversy.

But *Westra* based its decision on agency principles, not the specific language of the arbitration clause.

Another distinction made by the trial court was that the arbitration agreement here contained no language “that buyer and seller agree to allow an agent to invoke the arbitration provisions if buyer and seller are not arbitrating their disputes.”

On the contrary, the arbitration provision expressly states: “Buyer and Seller agree to mediate and arbitrate disputes or claims *involving either or both Brokers … provided either or both Brokers shall have agreed to such mediation or arbitration* prior to, or within a reasonable time after, the dispute or claim is presented to Brokers.”

Under a plain reading of this clause, buyers and sellers agreed to let either or both cooperating brokers and listing brokers decide whether to arbitrate the claims against them.

Cooperating brokers demanded it and no claim has been made the demand was untimely.

<u>The appellate court arrived at a different conclusion with respect to listing brokers. Unlike cooperating brokers, they did not agree to arbitration or mediation.</u>

The record contains no arbitration agreement between sellers and listing brokers, buyers and listing brokers, or listing brokers and cooperating brokers.

The arbitration provision in the purchase agreement is a contract between buyers and sellers, not one by listing brokers or cooperating brokers.

And although sellers and buyers agreed to arbitrate disputes between them and the brokers, if either or both brokers agreed, listing brokers never consented to arbitrate anything.

Thus, there is no evidence of an agreement to arbitrate by listing brokers.

Cooperating brokers are correct that listing brokers were sellers' agents, as listing brokers acknowledged during oral argument.

According to Miller and Starr, “The relationship between a real estate broker and the client is that of principal and agent, with the broker being a special agent with limited powers.”

But cooperating brokers have not identified any authority to support the proposition that one nonsignatory party has the right to invoke an arbitration clause against another nonsignatory party based on an agreement signed only by the principals.

We have found no case in which a nonsignatory was able to compel arbitration against another nonsignatory.

It is true the claims of buyers and the defenses of the agents all relate to the same basic issue.

The core allegation of the complaint centers on alleged failure to disclose an un-permitted guesthouse on the property; the purchase agreement refers both to required disclosures and to the permitting of structures; and listing brokers' affirmative defense blames buyers and others for buyers' damages.

Therefore, it might be more efficient if the entire dispute, not just the claims against cooperating brokers, were arbitrated.

Based on this record and our review of the cases and their analyses, we see no basis to create another exception to the general rule that an arbitration provision cannot be enforced to compel a nonsignatory to arbitrate.

Cooperating brokers and listing brokers were free to enter into a written arbitration agreement if they so desired.

They did not and there is no factual or legal basis for us to impose an obligation to arbitrate under these circumstances.

Although listing brokers cited the statute in their opposition to the petition to compel arbitration, the court did not discuss it in its ruling and the issue was not raised on appeal.

We thus have no occasion to consider it and offer no opinion on whether it applies.

DISPOSITION

The order denying the petition to compel arbitration was reversed by the appellate court with respect to plaintiffs' claims against defendants Larry Hung Tran and TransCiti Mortgage & Realty.

In all other respects, the order is affirmed.

Defendants High Ten Partners, Inc., and Gary Lee shall recover their costs on appeal.

Fybel, J., and Ikola, J., concurred.

Moral of the Story

It appears that since the listing broker did not sign the agreement, or initial the arbitration clause in the agreement, he or she may not compel or be compelled to decide a matter by arbitration. Arbitration itself can be a double-edged sword. It is generally faster and cheaper than litigation; however, the arbitrator may not get it right and there is generally no appeal. In addition, arbitration CAN cost more than litigation.

Case #9 Robert Feduniak et al. v. California Coastal Commission

California Coastal Commission Orders Homeowner to Remove Private Golf Course,

March 27, 2007

Introduction

In the early 1980's, the Bonnano's, Griggs, and Miller were co-owners of a 1.67 acre parcel on 17 mile drive in the Asilomar Dunes area of Pebble Beach in Monterey. In July 1983, the owners received a development permit from the building department to demolish the existing house on the property and build a larger one. The Coastal Commission (Commission) limited the size of the new house to 14% of the parcel size, to prevent adverse impact to the environmentally sensitive habitat area. The Commission also required the owners to record an open space easement for the rest of the parcel, thereby precluding building on it. The owners agreed to the Commission's stipulations. In October 1983, the owners received a permit from the Commission. In 1986, the Bonnanos now solely owned the property and submitted a modified landscape plan to the Pebble Beach Company (who had discretion over the CC&Rs in the overall development) including a 3 hole chip and put golf course on the property. In addition, in 1986 the Del Monte Foundations, Inc. (Foundation) was designated by the Coastal Commission to maintain the open space in the Del Monte Forest. The Bonnanos did not submit these modifications to the building department or the Coastal Commission. The Pebble Beach Company approved the plan. In 1985, the new house was built and the golf course installed. In 1986, Bonnano's architect applied to the building department for a permit to build a caretaker's home on the property. In their application they represented that there were no easements on the property. The building department issued a permit and there was no appeal. By 1996, the building department had been given authority by the Commission to issue permits in the coastal areas of Monterey county. Thereafter, the Commission only heard appeals of existing uses and not new permits. In 2000, the Feduniaks purchased the property from the Bonnanos for $13 million. In the Real Estate Transfer Disclosure Statement (TDS), the Bonnanos had answered "yes" to the question asking them about any encroachments, easements, or similar matters on the property. Yet, the Bonnanos only disclosed a fence encroachment. The Feduniaks received a preliminary title report and it did NOT reveal the recorded easement on the property. During their due diligence, the Feduniaks did not consult with the Commission or building department regarding any possible violations. They believed the TDS. The Feduniaks stated that they would not have bought the property if the golf course had not been on it. In August 2001, the Del Monte Forest Foundation, Inc. wrote to the Feduniaks to arrange an inspection review to ensure compliance with the open space easement. The Feduniaks had never heard of the easement. In July 2002, the Foundation wrote to the Feduniaks informing them that their current landscaping did not comply with the open space easement. The Foundation acknowledged that the golf course was installed by the former owners and the Feduniaks did not know about the easement. However, he attached a copy of the Bonnano's plan as a starting point to bring the landscaping into compliance. In September 2002, the Commission learned from the Foundation about this problem. The Commission's staff visited the property and the permits on it. In December 2002, the Commission notified the Feduniaks that their golf course violated the easement. The Commission requested that the Feduniaks submit a removal and restoration plan. The Feduniaks refused, and in February 2003 the Commission gave notice of intent to issue a cease-and-desist order and restoration orders. In July 2003, the Commission approved the cease-and-desist order after an administrative hearing. The Feduniaks asked for a writ of administrative mandate. In the hearing, a former Commission member stated that he knew about the golf course, was unaware of its permit requirements, and had no idea the golf course was not permitted. Testimony from The Pebble Beach Company and the Commission said the same thing. In March 2003, the Feduniaks asked the Foundation about the possibility of making a payment in lieu of removing the golf course as a form or alternative mitigation. The Foundation submitted the proposal to the Commission and they declined the proposal for offsite mitigation. The trial court concluded that the Commission should be estopped (stopped—B.) from enforcing its orders against the Feduniaks. The trial court also found that the Commission should have known about the violations to the easement and permit restrictions because the golf course was easily visible, had been there for 18 years, the Commission did not inspect the site until 2002, and there would be more harm to the Feduniaks to remove the golf course than harm to the public keeping it. Also, the trial court held that the Feduniaks had no knowledge of the easement or permit restrictions. The Feduniaks had relied on the Commission's inaction to buy the property. The trial court also found that it was reasonable for the Feduniaks to rely on the Bonannon's TDS and conduct no further investigation. It would cost $100,000 to remove the golf course. The trial court also mentioned that the Feduniaks may have causes of action against the title company and the seller. The Commission appealed the trial court's decision. The appellate court stated that the Commission does not owe a duty of care to future property owners to regularly monitor property for easement violations so as to prevent them from buying property that is in violation of applicable restrictions. The appellate court said that the Feduniaks should have contacted the Commission before buying the property (how would the Commission be a help when didn't know about the violations in the first place—B?) The appellate court reversed the trial court's judgment and the estoppel order was removed so the golf course could be removed and replanted with natural vegetation. The Feduniaks petitioned the Califronia Supreme Court, but they denied to hear the case.

Here's What Happened

In 2002, the California Coastal Commission (Commission) issued cease-and-desist and restoration orders, directing plaintiffs Robert and Maureen Feduniak (the Feduniaks) to remove the three-hole pitch-and-putt golf course that surrounded their house on the Monterey County coast and restore the grounds to the dune vegetation native to the area.

The Feduniaks challenged the orders by filing a petition for a writ of administrative mandate. (**Code of Civ. Proc., § 1094.5**.)

They claimed that the Commission's orders were invalid; and even if valid, the Commission was estopped from enforcing them.

The trial court agreed with the second claim and granted the writ, estopping the Commission from enforcing its orders for as long as the Feduniaks owned the property.

The Commission appeals from the judgment and claims the court erred in applying estoppel.

The appellate court agreed and reversed the trial court's judgment.

Discussion

In the early 1980's, Bert and Bonnie Bonanno, James and Gail Griggs, and John and Marcia Miller were co-owners of a 1.67-acre parcel on the 17 Mile Drive in the Asilomar Dunes area of Pebble Beach in Monterey County.

In May of 1983, the owners applied to the Commission for a development permit to demolish the existing house and build a larger one.

In July 1983, the Commission granted the permit with conditions.

The Commission determined that the parcel is located within the Asilomar Dune complex, much of which is considered an "environmentally sensitive habitat area" (ESHA) because of the unique, indigenous flora that had evolved over time and provided stability for the dune environment.

A survey of the parcel at the time revealed that "the site has been severely altered through previous home construction"; its "vegetation is mainly iceplant and other exotics with a few randomly occurring native plants"; and "the native plants on-site as well as in the general area, are for the most part threatened by the spread of the aggressive iceplant." (I once saw Gary Player bounce one off an ice plant at Pebble Beach and land eight feet from the hole. So, ice plant *does* have its uses—B.)

Consequently, the "site requires restoration rather than preservation."

In accordance with the general policy for new development, which required native landscaping and botanic easements to protect the undeveloped dune areas, the Commission limited the size of the proposed new home to 14 percent of the parcel "to prevent adverse impacts to the habitat."

It further required the owners to dedicate and record an open space "easement for the protection of the scenic and natural habitat values on the site" that would extend over the remaining 86 percent of the parcel and include provisions "to prohibit development; to prevent disturbance of native groundcover and wildlife; to provide for maintenance and restoration needs in accordance with the approved landscape plan; and to specify conditions under which non-native species may be planted or removed, trespass prevented, and entry for scientific research secured."

An open-space easement is an instrument whereby the owner relinquishes to the public the right to construct improvements upon the land, effectively preserving for public use or enjoyment the natural or scenic character of the open-space land.

In addition, the Commission required the owners to submit for review and approval a landscape and maintenance plan prepared by a professional botanist.

"The plan shall show the removal of all ice plant and other exotics on the site *and revegetation of the lot with dune vegetation native to the Asilomar dunes*."

The permit further provided, "<u>Unless waived by the Executive Director, a separate coastal permit shall be required for any additions to the permitted development."</u>

The Commission found that "implementation of a native revegetation program will restore the site"; and, with the dedicated easement and restored landscape, "the proposed development can be found consistent both with previous Commission action in this area and with **Section 30240(b)** of the Coastal Act, as an adjacent environmentally sensitive habitat area will be protected."

Development in areas adjacent to environmentally sensitive habitat areas and parks and recreation areas shall be sited and designed to prevent impacts which would significantly degrade those areas, and shall be compatible with the continuance of those habitat and recreation areas."

The owners of the property agreed to all of the conditions, at least on paper, and initially complied with them.

They recorded an irrevocable offer to dedicate an open space easement, which incorporated by reference the specific provisions of the permit, in which they agreed "to restrict development on and use of the Property so as to preserve the open-space and scenic values present on the property and so as to prevent the adverse direct and cumulative effect on coastal resources and public access to the coast which could occur if the Property were not restricted … .”

The owners also submitted a landscape plan providing for the removal of nonnative plants and restoration of the entire site to native dune plants and grasses.

On October 28, 1983, the Commission issued the permit.

A title report dated October 14, 1983, reveals the existence of the irrevocable offer to dedicate an open space easement.

In 1986, the Del Monte Forest Foundation, Inc. (the Foundation), which was designated by the Commission to hold and maintain the open space in the Del Monte Forest area of Monterey County, formally accepted the owners' offer of an easement, and its acceptance was recorded.

After receiving the permit, the Bonannos, who by this time had become the sole owners of the property, modified the original landscape plan to include a three-hole pitch-and-putt golf course.

They submitted the new plan to the Pebble Beach Company for its approval.

However, they did not submit it to the Commission or seek a supplemental permit for additional development, as required by their permit.

The Pebble Beach Company approved the golf course.

By 1985, the new house was built, the golf course was installed, and the property became known as Fan Shell Greens.

As part of the deeds and covenants, conditions, and restrictions to all properties in Pebble Beach, all construction and development required the approval of the Pebble Beach Company.

In 1996, the Bonannos' architect, Eric Miller, applied to the Monterey County Planning and Building Inspection Department (Planning Department) for a permit to build a caretaker's house on the property.

In the Bonannos' application, Miller represented that there were no easements on the property.

The Planning Department approved the application, finding, among other things, that the property complied with “all rules and regulations pertaining to the use of the property, that no violations exist on the property and that all zoning abatement costs, if any, have been paid.”

No one appealed from the Planning Department's decision to issue the permit.

By 1996, Monterey County had adopted a local coastal plan, and the Commission had certified it, thereby making the Planning Department the permitting agency for development in coastal areas within the county.)

Thereafter, the Commission's role in the permit process for coastal development was to hear appeals from decisions by the county to grant or deny permits.

Where the local government grants a coastal development permit, the action may be appealed to the Commission by the applicant, any aggrieved person, or two members of the Commission.

Early in 2000, the Feduniaks learned that Fan Shell Greens was for sale.

Mr. Feduniak testified below that he and his wife had seen the property with its prominent golf course numerous times in the 1980's and had always liked its unique landscaping.

Consequently, they made an offer, and the Bonannos accepted it.

In their real estate transfer disclosure statement, the Bonannos answered "Yes" concerning whether there were "encroachments, easements or similar matters that may affect the Feduniaks' interest in the subject property."

However, they disclosed only a "fence encroachment" and did not also disclose the easement and permit restrictions.

<u>The Feduniaks obtained a preliminary title report from Old Republic Title Company, but neither it nor the final report revealed the restrictions, although they were recorded.</u>

The Feduniaks did not consult with the Commission or check its files concerning the property or otherwise rely on any representations or information from the Commission in deciding to purchase the property.

Based on the Bonannos' disclosure statement and the title report, they bought the property for $ 13 million.

<u>Mr. Feduniak testified below that they would not have bought the property if the golf course had not been there.</u>

In August 2001, Steven Staub, a forester for the Foundation, wrote to the Feduniaks to arrange an inspection review of the property to ensure its compliance with the terms of the open space easement, which he attached to his letter.

The Feduniaks were bewildered because they had no knowledge of the easement.

Moreover, Mr. Feduniak testified that it seemed to them "inconceivable" that there was a problem that had gone unnoticed for such a long time.

Staub and his colleagues inspected the property and met with the Feduniaks a few times.

In July 2002, Staub wrote again and informed the Feduniaks that the current landscaping on the property did not comply with the open space easement.

He acknowledged that the golf course was installed by the former owners and that the Feduniaks may not have known about the easement when they bought the property.

Nevertheless, he attached a copy of the original landscape plan that the Bonannos had submitted to the Commission, which had been approved, and offered it as a reference and starting point for bringing the property into compliance.

He also offered the assistance of experienced habitat consultants in helping them restore the easement area to native dune vegetation and create functional and aesthetically pleasing native landscaping.

In September 2002, the Commission staff learned from Staub about the compliance problem on the property.

Staff reviewed the permit and visited the parcel.

In December, the Commission notified the Feduniaks that the golf course violated the easement.

Consequently, the Commission requested that the Feduniaks submit a removal and restoration plan.

The Feduniaks declined, and in February 2003, the Commission gave notice of its intent to issue cease-and-desist and restoration orders, and thereafter a formal proceeding was commenced.

In July 2003, after an administrative hearing, the Commission approved the issuance of cease-and-desist and restoration orders.

It found that the golf course constituted an "unpermitted development" that was inconsistent with the permit condition, which required that the entire area around the proposed house "be restored with native dune vegetation and preserved with a dedicated easement for the protection of scenic and natural habitat values."

Thereafter, the Feduniaks sought the instant writ of administrative mandate.

At the hearing on the petition, David Armanasco, a longtime resident of Pebble Beach and former member of the Commission, testified that he had seen the golf course for many years.

He was unaware of the permit requirements, open space easement, and the contents of the administrative file.

Therefore, he had no idea the course violated them.

He also was not aware of any statements or representations by the Commission to the Feduniaks that the golf course complied with those conditions.

Armanasco further said that although he and other commissioners took field trips with staff along the coast, the purpose of the trips was not to investigate new permit violations or generally monitor compliance with previous permits but to gather information about matters that were pending or had been resolved.

Cheryl Burrell and Jeff Marko, who worked for the Pebble Beach Company, each testified that on different occasions they met with some commissioners at various places along the 17 Mile Drive from where the three-hole golf course was plainly visible.

However, both testified that none of the visits concerned the golf course, and there was no discussion of its compliance with applicable restrictions.

Nancy Cave, the Northern California supervisor of enforcement for the Commission, testified about how permit conditions were enforced.

She explained that the enforcement program had long suffered from an enormous backlog of cases caused by inadequate funding and staff.

Moreover, the Commission issued approximately 1,000 permits every year, making it humanly impossible to continually visit each parcel to monitor compliance with permit conditions.

Consequently, the Commission focused resources where problems were likely to arise: parcels (1) for which the permit conditions were initially challenged or resisted; and (2) about which they receive complaints of possible violations.

Cave opined that the Bonannos' original permit would not have been audited for compliance because they had accepted the proposed conditions without challenge or resistance.

As a result, the permit application along with the proposed conditions appeared on the Commission's consent calendar, and it was approved without dispute or debate.

Cave further noted that after the permit was approved, the Bonannos appeared to comply with the conditions.

They recorded their offer to dedicate an open space easement, submitted proof of recordation, and filed an appropriate landscape plan, which was approved.

Accordingly, the file on its face showed compliance, and nothing would have triggered the attention of enforcement staff.

However, when the enforcement staff first learned of a possible permit violation from Staub of the Foundation, the Commission immediately commenced an investigation, visited the site, notified the Feduniaks in writing about the problem, advised them how to resolve the violation, and notified them that the failure to resolve the violation could result in an enforcement action.

Cave was unaware whether members of the Commission had ever seen the golf course.

However, she opined that when a Commission member visits a site for a particular purpose, staff may or may not check with the enforcement unit concerning other pieces of property.

She explained, “If we know they are going out in the field, we might ask them to look at a site that was already an identified enforcement case and take pictures.

But typically they are focused on the reason that they're going out on the site visit and nothing else.”

Moreover, it is not routine for a Commission planner to review all permits in the area before making a visit to a particular site.

Cave further opined that one cannot determine whether there are permit violations by simply looking at a piece of property.

Rather, one must review the record and the permit history.

In this instance, simply seeing the golf course would not have led her to assume there was a permit violation because the house might have been built before the Commission was created.

In March 2003, the Feduniaks asked the Foundation about the possibility of making a payment in lieu of removing the golf course as a form of alternative mitigation that could be used to correct the environmental degradation elsewhere on the coast. (This is a common way to set aside another equal-sized property in the area--B.)

The Foundation made some proposals and cost estimates and then submitted the idea of such a settlement to the Commission for its evaluation and approval.

However, the Commission declined the proposal for offsite mitigation. (suspicious—B.)

Concerning the estimates, the Foundation estimated the cost of removing the golf course and installing native plantings to be between $ 50,000 and $ 100,000.

The Foundation estimated the cost of proposed offsite mitigation in the Pescadero Canyon area to be between $ 125,000 and $ 300,000.

Mitigation in the Indian Village/Lemos House Foundation/Gingerbread House areas would cost between $ 100,000 and $ 250,000.

Thus, the Foundation observed, “Any of these alternatives is thus likely to cost as much or more than replacing the existing golf course landscaping with native vegetation around the Feduniak residence.”

The Trial Court's Decision

In its statement of decision, the trial court first rejected the Feduniaks' challenge to the Commission's orders, which was based on a claim that the underlying 1983 easement and permit restrictions were invalid because the property had been improperly designated as an ESHA or adjacent ESHA.

The court found that the Commission's orders were supported by substantial evidence and that the Bonannos' failure to challenge the restrictions when they were imposed in effect barred the Feduniaks from doing so now.

Nevertheless, the court concluded that under the unique facts of this case, the Commission should be estopped from enforcing its orders against the Feduniaks.

The court found that the Commission should have known that the golf course violated the easement and permit restrictions because (1) the golf course was easily visible, (2) it had been there for 18 years, and (3) the Commission did not inspect the site for compliance until 2002.

The court further found that the Feduniaks had no actual knowledge of the recorded easement or permit restrictions when they bought the property, and the Commission's "acquiescence as to the existence of the landscaping for such a long period of time contributed to the Feduniaks' lack of knowledge of the recorded easement and permit conditions," and, therefore, the Feduniaks "had no reason to believe their property was not in compliance with the law." Moreover, the Feduniaks relied on the Commission's inaction to buy the property.

The court declined to impute knowledge of the easement and permit restrictions to the Feduniaks.

It found that it was reasonable for the Feduniaks to rely on the Bonannos' disclosure statement and the title report and conduct no further investigation.

The court further opined that even if the Feduniaks had had knowledge of the easement and restrictions, "there is no reason they would have known that the landscaping purportedly violated the easement—in that the landscaping is primarily lawn, which is surrounded by native vegetation, and it has been in place for a very long time."

Last, the court concluded that the injury to the Feduniaks without estoppel exceeded any injury to the public with it.

As support, the court noted that the Feduniaks "purchased the property because of the golf course"; it was in a degraded condition when they bought it; the golf course had existed for 18 years without objection; it did not cause any "ongoing resource damage"; and removing it would cost over $ 100,000. (So why the problem now?—B.)

The court also opined that the Feduniaks had "persuasively argued that the property has never been in an Environmentally Sensitive Habitat Area [ESHA], nor adjacent to one."

The court rejected the Feduniaks' argument that estoppel should be permanent because they would lose future value if the orders were enforceable.

The court found the argument subjective and speculative.

"The next buyer may not care about the present landscaping, and the Feduniaks may still have remedies against the title company and/or sellers for monetary damages."

Rather, the court estopped the Commission from enforcing its orders for as long as the Feduniaks owned the property.

“Generally speaking, four elements must be present in order to apply the doctrine of equitable estoppel:

the party to be estopped must be apprised of the facts;

he must intend that his conduct shall be acted upon, or must so act that the party asserting the estoppel had a right to believe it was so intended;

the other party must be ignorant of the true state of facts; and

he must rely upon the conduct to his injury.”

On appeal, the Feduniaks specifically argue that the Commission “had a duty and power to inspect and enforce conditions imposed by it on permits.”

Certainly, the Commission has a general mandate to implement the Coastal Act to preserve and protect the California coast and thus has broad administrative responsibility to regulate coastal development by enforcing applicable laws and regulations and imposing conditions on development permits, including open space easements.

However, we have found no authority suggesting that the Commission has a statutory duty to inspect all properties for compliance with conditions after a permit has been issued, let alone a duty to do so on an ongoing basis for as long as the permit is applicable.

Likewise, we have found no authority indicating that the Commission owes a duty of care to future property buyers to regularly monitor property for easement violations so as to prevent them from buying property that is in violation of applicable restrictions. (It looks like you are on your own--B.)

Neither the trial court nor the Feduniaks provide any such authority.

Concerning the enforcement of easements and permit conditions, we note that Nancy Cave, an enforcement supervisor for the Commission, testified that the Commission issues approximately 1,000 permits per year, and the relatively small size of the enforcement staff and budgetary constraints make it impossible to monitor compliance on every property subject to permit conditions.

Rather, as a practical matter, investigative and enforcement resources are focused where problems are most likely to arise or exist: properties where the conditions were challenged or resisted and properties about which they receive complaints.

Cave testified that the Bonannos' property did not fall within these categories and would not have triggered investigative action because the Bonannos had agreed to all of the permit conditions and appeared to have complied with them.

Cave further explained that when Commission staff visit a particular site, they do not ordinarily expand the scope of their purpose to include a review of the permits and conditions related to adjoining areas and a check for compliance unless those properties are the subject of a pending action.

Moreover, she opined generally that one cannot determine that a property is in violation of a permit condition by simply looking at it.

One must view the property in light of the record and the permit history.

In this instance, simply seeing the golf course on the property would not have led her to assume that there was a permit violation because the house might have been built before the Commission was created.

The Feduniaks argue that the court implicitly rejected Cave's testimony and therefore we must disregard it.

The appellate court disagreed.

Cave's position qualified her to testify about the history of enforcement, the personnel and budget available for enforcement, and the Commission's enforcement.

Moreover, her qualifications were not challenged.

Under the circumstances, we can conceive of no rational basis for the court to reject Cave's testimony and do not feel compelled to disregard it.

In finding that the Commission should have discovered the violation, the trial court implicitly expected Commission members and staff to be fully aware at all times of the permit history of every piece of property within the Commission's jurisdiction and thus able to tell at a glance whether a particular property is in compliance with permit conditions.

However, given Cave's testimony, we consider such an expectation to be unrealistic.

Indeed, we believe common sense renders such an expectation unrealistic.

Rather, given the practical considerations involved in inspecting property and enforcing easement and permit conditions and given the budgetary limitations on, and inherently discretionary nature of, allocating administrative resources for those purposes, as outlined by Cave, we find it unreasonable for the trial court to conclude that the mere sight of the golf course should have put the Commission on notice of a violation or at least triggered a duty to investigate.

Here, the Commission did not know about the violation before 2002.

It had no statutory (legislative—B.) duty to inspect the Bonannos' property for compliance after the golf course was installed and before the Feduniaks bought the property.

And even if Commission members or staff saw the golf course at some point during that time, the circumstances do not support a finding that the Commission was negligent in failing to investigate the property sooner than it did.

The Feduniaks argue that the 1996 permit issued by the county for the Bonannos' caretaker house, in which the county found that that the property "is in compliance with all rules and regulations pertaining to the use of the property, and that no violations exist," should have put the Commission on notice of inquiry concerning the easement violation.

However, the trial court did not rely on the 1996 permit to impute knowledge to the Commission.

As noted, upon certification of its local coastal program, the county replaced the Commission as the permitting agency for coastal development.

The Commission's function thereafter was to review decisions by the county that were appealed. (In other words, at this point one hand didn't know what the other one was doing—B.)

Thus, the county's finding cannot be deemed a representation, albeit erroneous, by the *Commission* to the Feduniaks that the golf course complied with all applicable easements or restrictions on the property.

Although their preliminary title report noted the existence of the Bonannos' 1996 permit for the caretaker house, the title report did not include the county's finding.

In short, the appellate court concluded that the Commission's regulatory inaction for so many years in the face of a prominently located golf course does <u>not</u>, by itself, support the trial court's finding that the Commission had constructive knowledge of the violation.

The trial court found that:

the Commission acquiesced in the existence of the golf course for many years;

its acquiescence contributed to the Feduniaks' lack of knowledge about the easement; and

because they lacked such knowledge, they had no reason to believe their property was not in compliance with the law.

The record does not support these findings, and the findings themselves do not support a finding of intent.

Perhaps what the trial court meant to say was that because the Feduniaks had seen the golf course remain unchanged for so many years, they inferred and believed that the Commission had acquiesced in it (i.e. grandfathered in, as they say—B.)

Although that inference is not illogical, without any information about the property, the Commission's regulatory procedures, and the actions it had previously taken, it is purely speculative to infer that the Commission's inaction signaled regulatory acceptance.

The Commission's apparent inaction could just as well reflect, and according to Cave did reflect, bureaucratic, budgetary, or personnel limitations on enforcement of easements and permit restrictions. ("Bureaucratic limitations" is a nice way of saying that the Coastal Commission was not getting the job done—B.)

In any event, even if the Feduniaks initially believed that local agencies had accepted the golf course, they did not act on that belief except to seek out appropriate information before buying the property (GOOD LUCK FINDING ANY INFORMATION ON THE GOLF COURSE, WHEN THE COASTAL COMMISSION COULDN'T FIGURE IT OUT THEMSELVES—B.); nor did the Commission's inaction "contribute" to their lack of knowledge about the open space easement.

Rather, the Feduniaks obtained a disclosure statement from the Bonannos and a preliminary title report.

<u>Thus, they were unaware of the easement because the Bonannos failed to disclose it and the title company failed to find it, and the Feduniaks relied on those failures, rather than their perception of the Commission's inaction, in buying the property.</u> (So the Feduniaks may have a cause of action against the sellers of the property and the title insurance company—B.)

Last, the court's finding that the Feduniaks had no reason to suspect that the golf course violated some restrictions may be true.

Moreover, we observe that if it were reasonable for the Feduniaks to think that the restrictions would never be enforced because they had not been enforced for many years, then more generally, one could argue against the enforcement of a law that had not been enforced for many years and seek estoppel on that ground.

However, courts have never accepted such reasoning.

On the contrary, the mere failure to enforce the law, without more, will not estop the government from subsequently enforcing it.

In sum, the record does not support a finding that the Feduniaks reasonably could have believed that the Commission intended its regulatory inaction to be relied and acted upon.

Here, the Commission had no contact with the Feduniaks.

It took no affirmative action toward them and made no statements to them that could have induced action.

Indeed, the Feduniaks did not even consult with the Commission before buying the property. (Even if they had consulted with the Commission, it wasn't aware of the violations because of "budgetary constraints" so they wouldn't have been any help anyway. Maybe a fortune teller or palm reader may have worked—B.)

Simply put, the public has a vital interest in the protection and preservation of the California coast. It follows that when the Commission acts and issues orders in accordance with the Coastal Act, those actions and orders embody the policies of the Coastal Act and constitute rules adopted for the public benefit.

Here, the Commission found that the parcel is located in or adjacent to the Asilomar Dune complex, much of which is considered an ESHA because of its unique and indigenous flora, which also help stabilize the dune complex.

The Commission found that in 1983, when the Bonannos sought a development permit, restoration and future preservation were necessary because the site had already become "severely altered through previous home construction," and the spread of aggressive ice plant was threatening "native plants on-site as well as in the general area." Indeed, the trial court specifically found that the parcel was in a "degraded" state before the easement and restrictions were imposed.

Although individuals may disagree over whether a pitch-and-putt golf course is more aesthetically pleasing than the natural geography and native vegetation of the California coast, the people of the state, acting through the Legislature, have unequivocally voiced a strong preference for the natural state of the coast and deemed it to be a valuable asset that must be protected, preserved, restored, and maintained, especially in ESHA's and areas adjacent to them.

On the other hand, it noted that (1) the property was in a "degraded" condition before the golf course was installed; (2) after installation, no one objected to it for over 18 years; and (3) it was not causing any "ongoing resource damage." (No kidding—B.)

The court further opined that the Feduniaks "persuasively argue that the property has never been in an Environmentally Sensitive Habitat Area [ESHA], nor adjacent to one."

The appellate court disagreed with the court's analysis.

The court devalued the strong public interest in the natural state of the coast and its native vegetation and in restoring it, where, as here, it had already become degraded by 1983.

The court seems to have found that the golf course was an improvement that solved the previous degradation.

However, the court ignored the fact that the golf course violated the applicable restrictions.

Moreover, as a violation, the golf course itself represented ongoing developmental damage to the coast that continued to frustrate the public interest in having the parcel restored to its natural state.

The un-permitted development of a golf course on the property represented “continuing resource damage.”

The Feduniaks argue that they were “innocent purchasers” of the property and should not be bound by the fact that the Bonannos did not challenge, and instead accepted, the easement and permit restrictions.

However, the Feduniaks were “innocent” buyers only because the title company had failed to discover the restrictions before the purchase. (Key point—B.)

In any event, once the period to challenge the restrictions had expired and they were recorded, they became immune from collateral attack by the original property owner *and successor owners*.

Indeed, the court recognized that the Feduniaks could not challenge those determinations because the Bonannos had failed to challenge them.

For this reason, the appellate court rejected the Feduniaks' claim that the Commission's findings, and in particular the ESHA-related findings, are not supported by substantial evidence.

The only injuries to the Feduniaks identified by the trial court—and the only injuries claimed below were the cost of removing the golf course and the frustration of an expectation of beneficial enjoyment.

However, the Feduniaks may have legal remedies against the Bonannos and the title company concerning the failure to disclose and find the recorded restrictions that could mitigate the cost of complying with the Commission's orders. (Finally, getting to the point--B.)

In any event, the cost burden cannot reasonably be considered injury or injustice because the Feduniaks offered the Commission an equivalent amount of money to pay for mitigation of damage elsewhere on the coast in lieu of removing the golf course.

In other words, since the Feduniaks were willing to fund a restoration project of equivalent cost elsewhere in order to keep their golf course, the real injury is that they would no longer be able to own, see, and use a private golf course uniquely situated on the California coast.

In this regard, we note that Mr. Feduniak testified that alternative remedies against the Bonannos and the title company for damages would not compensate for the loss of the golf course. (Good point—B.)

He explained, “Our interest in this property was very, very predominately driven by our attraction to the unique and attractive and mature landscaping.

And I don't see how any of the remedies that I believe have been referred to would enable us to continue to live in the property with that type of landscaping that has matured over a period of some two decades.”

The trial court found that the injustice in depriving the Feduniaks the enjoyment of their golf course outweighed “any possible injury to the public should the landscaping remain.”

We are mindful of the very real impact that losing the future enjoyment of their private golf course and its landscaping will have on the Feduniaks and do not underestimate their personal loss. Nevertheless, their individual loss of enjoyment cannot outweigh the public's strong interest in:
eliminating an ongoing un-permitted development, which violates applicable restrictions and has done so now for over 20 years;
finally restoring the area to its natural state and native vegetation; and

protecting the Commission's ability to enforce existing and future easement and permit conditions. (Probably the underlying issue in this case—the Feduniak's disregard for the Coastal Commission's authority. They're upset because the owners are not jumping when they say jump—B.)

Conclusion

The evidence does not support a finding that the Commission knew or should have known that the golf course violated the easement and permit restrictions before the Feduniaks purchased Fan Shell Greens.

It does not support a finding that the Commission intended for the Feduniaks to rely on its failure to enforce the restrictions over the years or that the Feduniaks reasonably could have believed that the Commission so intended its regulatory inaction.

Under the circumstances, therefore, the appellate court concluded that the trial court erred in estopping (stopping) the Commission from enforcing its cease-and-desist and restoration orders.

Alternative Mitigation

The Feduniaks claim that the Commission's refusal to accept their offer to fund alternative mitigation elsewhere in lieu of removing the golf course was arbitrary and unreasonable. (Sounds pretty good to me—B.)

They argue that their property is not in an ESHA or adjacent to one, and thus it was unreasonable as a matter of law for the Commission to insist on enforcing the easement instead of accepting their offer to fund restoration projects in properly designated ESHA's.

Under the circumstances, the appellate court rejected this claim.

The claim reiterates one conclusory statement in the Feduniaks' pleading below: "The Coastal Commission's refusal to accept the Petitioner's offer of off-site mitigation to consider the Foundation's mitigation proposals was unreasonable."

The Bonannos submitted a landscape plan that conformed to the permit conditions, which was approved.

Thereafter, they modified the plan to add the installation of a golf course, comprising extensive areas of regular lawns, manicured putting greens, and sculpted sand traps, none of which reasonably can be considered "dune vegetation native to the Asilomar dunes."

The Bonannos did not obtain, or even seek, a separate coastal permit for that addition to their initial landscape plan.

Disposition

The appellate court reversed the trial court's judgment. The Commission is entitled to its costs on appeal.

Premo, J., and Elia, J., concurred.

Respondents' petitioned for review by the Supreme Court was denied June 20, 2007. Baxter, J., Chin, J., and Corrigan, J., were of the opinion that the petition should be granted.

Moral of the Story

The buyers purchased a property that had a three hole golf course in their backyard (pretty cool!). The sellers did not disclose possible code violations and the title insurance company did not pick up the open space easement in their preliminary title report. For some reason, the Coastal Commission became upset about the golf course being there (going on its third decade of being in existence), and decided to go after the buyers. A very acceptable method of mitigating this type of problem is to purchase another property of the same size and dedicate it to public enjoyment. However, the Coastal Commission would not allow this to happen, even though the buyers were willing to do so. When the trial court ruled against the Coastal Commission, they used public funds to file an appeal and finally had their cease and desist order and restoration order not vacated by the trial court. My best guess is that someone, somewhere had a dispute with the buyers over an unrelated matter and is using or instigating this litigation through the Coastal Commission. <u>This has politics written all over it</u>—especially since this golf course has been in existence for over 18 years and is fairly well-known throughout California as a “golfer’s dream home.” They had plenty of time to object to it and didn’t. Why now? Good question. . . .

I almost forgot the moral of the story. Make sure to check out the Coastal Commission and local building department when doing due diligence on properties along the California Coast. It appears that neither of them knows what the other is doing. So you better contact both and try to see what is really going on—because they obviously don’t know themselves.

Case #10 Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC, et al.

Realtor representing lessee's duty to inform lessor of lessee's deteriorating financial condition, April 30, 2008

Introduction

MF Downton Sunnyvale LLC (Sunnyvale) owned a property in Sunnyvale, CA. Mozart Development Company (Mozart) was Sunnyvale's agent for leasing and managing the property. Mozart in early 1999 listed the property with Commercial Property Services (CPS) to lease the property. The building had not yet been completed, but the commission agreement provided for ½ of the commission to be payable upon full execution of the lease and the second half upon rent commencement. In early 2001, Mozart entered into a written lease with Handspring, Inc. The leases set delivery of the building in August or September 2002. Handspring was required to provide letters of credit for $23 million. Blickman Turkus (BTC) through agent Tom Snider represented Handspring in the lease transaction. Mozart alleged that from October 2001 until July 2002 Snider and BTC were advised by Handspring that it was having financial difficulties and it was considering possible exit strategies from the leased buildings. Mozart said he did not learn of these difficulties until mid-August 2002, when another agent contacted him to negotiate the termination of the lease. Mozart alleged that the delay in its learning about Handspring's financial problems caused him to sustain damage. Mozart and Handspring eventually negotiated a termination of the lease. On January 28, 2003 BTC filed a complaint against Handspring and Mozart alleging that they were the procuring agent for the lease and were due a commission. BTC had received the first half of the commission ($850,873.22), but had not received the second half of the commission. The BTC complaint was for breach of commission agreement by Mozart, breach of the covenant of good faith and fair dealing, breach by Mozart and Handspring of an implied promise to complete the lease transaction, and tortuous interference by Handspring with BTC's economically advantageous relationship. The trial court entered summary judgment where both parties did not receive anything. The gist of Mozart's claim is that for a ten month period BTC wrongfully failed to disclose information about Handspring's precarious financial condition, and this knowledge would have enabled Mozart to avoid some injury. The appellate court questioned whether BTC was under a duty to disclose those facts to Mozart. As a result of BTC's conduct, Mozart lost rent in a vacant building—while he tried to rent up the building. Mozart said he lost over $100 million. The appellate court said that since BTC was representing Handspring, it had a duty to be truthful and honest and disclose material facts to Mozart. Since the disclosure of Handspring's financial condition was a confidential fact, BTC could not disclose it to Mozart. The appellate court believed that ruling in Mozart's favor would change forever the rules of conducting business and require each party's agent to disclose everything about the transaction. For these reasons, the trial court and appellate courts agreed that BTC not Mozart had a case. On January 19, 2006, Mozart filed suit for $496,000 in attorney fees. This amount was reduced to $398,000 on March 8, 2006. The trial court denied Mozart's motion for attorney fees. The appellate court affirmed the trial court's judgement.

Here's What Happened

MF Downtown Sunnyvale, LLC, (Sunnyvale) is a limited liability company owning certain real property in Sunnyvale, CA.

At issue in this action are two buildings, known as buildings 2 and 3, situated on the property.

Mozart Development Company (Mozart) was the agent for MF Downtown Sunnyvale, LLC, for purposes of leasing and managing the property.

Mozart alleges that in early 1999, it entered into a written commission agreement with Commercial Property Services (CPS) by which it engaged CPS and two affiliated individuals to act as its listing broker and agent in securing a lease of the premises for a specified commission.

The buildings had "not yet been constructed or completed," but awaited execution of a lease so that they could be completed or improved to the tenant's specifications.

Under the agreement, the first half of the commission would be "due and payable upon full lease execution of the lease and the second half … upon rent commencement." (Very common with large tenants—B.)

In early 2001, Mozart entered into written leases with Handspring, Inc., for buildings 2 and 3.

The leases contemplated delivery of the premises in August and September, 2002, with both parties working in the interim to prepare the buildings for occupancy in accordance with Handspring's needs.

Their respective rights and obligations in connection with these efforts were set forth in "work letters" attached to the leases.

Under the work letters, Handspring was required to secure its performance by providing letters of credit in the aggregate amount of some $ 23 million.

Blickman Turkus, LP, doing business as BT Commercial Real Estate (BTC), through its agent Tom Snider, represented Handspring in the lease transaction.

BTC later contended that it was the "procuring agent" entitled to a commission under the commission agreement between Mozart and CPS.

Mozart acknowledged this assertion, and while denying it, also adopted it hypothetically as a basis for recovery against BTC should it be sustained by the court. (i.e. playing both ends against the middle—B.)

Mozart alleged that from October 2001 through "at least" July 2002, Snider and BTC were "advised by Handspring that it was having financial difficulties," that "its projected growth was not as fast as it had originally thought," and that it was "considering possible exit strategies" from the leased buildings, including a negotiated termination of the leases and reducing Handspring's financial risk.

Mozart alleged that it did not learn of these matters until mid-August, 2002, when another agent contacted it to negotiate a termination of the leases.

Mozart alleged that as a result of the delay in its learning of these matters, it sustained damage.

Mozart and Handspring eventually negotiated a termination of the leases.

This action was commenced on January 28, 2003, not by Mozart, but by BTC, which filed a complaint against Mozart and Handspring in which it alleged that as the procuring agent in the lease transaction, it was a third party beneficiary of Mozart's commission agreement with BTC and thus entitled to the commission there specified.

It alleged that Mozart had paid the first half of the commission as called for in the agreement, but had refused to pay the second half.

As eventually amended, the complaint asserted claims for breach of the commission agreement by Mozart, breach of the covenant of good faith and fair dealing, breach by both Mozart and Handspring of an “implied promise to complete the lease transactions,” and tortious interference by Handspring with BTC's economically advantageous relationship with Mozart.

Mozart successfully attacked BTC's complaint by motions for summary adjudication and judgment on the pleadings.

The court entered a judgment by which neither party took anything.

<u>The gist of Mozart's claim is that for a period of some 10 months, BTC wrongfully failed to disclose information—Handspring's precarious financial condition—knowledge of which would have enabled Mozart to avoid some of the injury it allegedly suffered when Handspring finally approached it to negotiate a termination of the leases.</u>

A central issue, as the parties seem to recognize, is whether it appears from the facts alleged in the cross-complaint that BTC was, during those 10 months, under any duty to disclose those facts to Mozart.

It goes without saying that no one can be liable in tort for causing injury to another unless he, or someone whose conduct is attributed to him, was legally obligated to act differently.

Liability cannot arise from silence unless the law commands the defendant to speak.

A duty to speak may arise in four ways:

it may be directly imposed by statute or other prescriptive law;

it may be voluntarily assumed by contractual undertaking;

it may arise as an incident of a relationship between the defendant and the plaintiff; and

it may arise as a result of other conduct by the defendant that makes it wrongful for him to remain silent.

Here, Mozart points to no statute obligating BTC to warn it of Handspring's weakened financial condition.

BTC was under a continuing obligation of an arguably contractual nature to inform its “client” of matters relevant to a transaction.

But with one qualification discussed below, there is no hint that Mozart was, or ever viewed itself as, BTC's “client.”

Indeed, there is no contractual relationship between Mozart and BTC.
Mozart contends that BTC owed such a duty:
as the agent for Handspring;
hypothetically, as an agent for Mozart itself; or
by virtue of statements by BTC that obligated it to speak when they ceased to be correct.

Mozart's first cause of action asserts “concealment” against Snider and BTC in that they:
breached a duty of full and fair disclosure they owed to Mozart as the real estate agents for Handspring; and made representations at the time of Mozart's entry into the lease agreement that obligated them to speak when they learned that Handspring might be unable to perform that agreement.

Snider contacted at least one other real estate broker advising that *there was a strong possibility Handspring would have both Buildings 2 and 3 available for sublease*."

It is also alleged that at least as late as May 2002, Handspring was still communicating with an architect and forwarding at least some of those communications to BTC.

The amount of the commission already paid to BTC by the listing broker in the transaction, Commercial Property Services, in the approximate amount of $ 850,873.22.

Additionally, Handspring never commenced the payment of rent for Buildings 2 and 3 and terminated its Leases with Mozart.

Despite diligent efforts by Mozart to lease said buildings they have been unable to lease a majority of the space.

As a result, they have been damaged due to the conduct of BTC and/or Snider in the amount of the *loss of the rent they could have obtained* and *other payments to be made by Handspring* pursuant to said Leases in the excess of $ 100 million."

The appellate court said that it was difficult to see how the alleged concealment could have caused Mozart to lose rent payments by Handspring under the lease.

If Handspring had been otherwise able to perform its obligations under the lease, no conduct attributed to BTC by Mozart could have reduced that capability.

Instead of holding Handspring to those obligations, however, Mozart renegotiated their relationship, apparently receiving very considerable sums of money in the process.

But even if that had not occurred, nothing supports the notion that earlier knowledge of Handspring's finances could have somehow preserved the original lease arrangement.

BTC offered evidence that the renegotiated transaction permitted Mozart to draw both letters of credit as well as a letter of credit on a third building, plus receive cash, notes, and stock, for a total value well in excess of $ 50 million, plus improvements paid for by Handspring.

Mozart objected to this evidence as irrelevant, but did not dispute its accuracy.

As noted, Mozart's first cause of action appears to predicate a duty to disclose on two distinct theories.

At all times, *as a real estate agent representing Handspring*, Snider owed a duty to be truthful and honest and disclose material facts to Mozart.

According to Earp v. Nobmann (1981, every real estate licensee has a "fundamental duty … to deal honestly and fairly with **all** parties in the transaction, not just his or her own principal.

It is enough to conclude that *Earp* provides no authority for holding that a buyer's (or lessee's) agent has any duty of disclosure, as such, toward a seller (or lessor).

There is a judicially developed rule that "where the seller knows of facts materially affecting the value or desirability of the property which are known or accessible only to him and also knows that such facts are not known to, or within the reach of the diligent attention and observation of the buyer, the seller is under a duty to disclose them to the buyer."

"Failure of the seller to fulfill such duty of disclosure constitutes actual fraud."

It then noted that a similar duty rests upon the seller's agent: "Where such agent or broker possesses, along with the seller, the requisite knowledge according to the foregoing decisions, whether he acquires it from, or independently of, his principal, he is under the same duty of disclosure.

He is a party connected with the fraud and if no disclosure is made at all to the buyer by the other parties to the transaction, such agent or broker becomes jointly and severally liable with the seller for the full amount of the damages."

According to Cooper v. Jevne (1976), "where a real estate broker or agent, *representing the seller*, knows facts materially affecting *the value or the desirability of property offered for sale* and these facts are known or accessible only to him and his principal, and the broker or agent also knows that these facts are not known to or within the reach of the diligent attention and observation of the buyer, the broker or agent is under a duty to disclose these facts to the buyer.".)

In Easton v. Strassburger (1984), "obligates the agent for a *residential seller* to disclose "reasonably discoverable defects" to the buyer, and to "conduct a reasonable investigation" to that end. The agent has an affirmative duty to conduct a reasonably competent and diligent inspection" and to disclose facts affecting value to buyer.

This holding was ultimately codified in **Civil Code section 2079, subdivision (a)**, which declares that a broker who is engaged by a seller, or who acts in cooperation with a broker engaged by a seller, has a duty "to a prospective purchaser of residential real property … to conduct a reasonably competent and diligent visual inspection of the property offered for sale and to disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal … ."

Here the duty imposed by these authorities never came into existence because:

Mozart was a seller (lessor), not a buyer;

BTC represented a buyer, not a seller;

the transaction involved commercial, not residential, property; and

the matter allegedly concealed went not to the value of the property, or even the desirability of the transaction, but to facts learned by the broker after the transaction had been consummated, at least to the extent of executing an agreement binding on the parties.

Nor did the appellate court see any reason to extend the duty described above to the situation before us. (i.e. commercial leases—B.)

As the *Easton* court observed, the primary purposes of burdening a seller's broker with disclosure duties running to the buyer are "to protect the buyer from the unethical broker and seller and to insure that the buyer is provided sufficient accurate information to make an informed decision whether to purchase."

The duty is justified not only by the broker's likely superior knowledge of facts affecting the value of the property, but by the risk that the residential purchaser will suppose the broker to be adequately representing his interests.

Thus the court observed that "in residential sales transactions the seller's broker is most frequently the best situated to obtain and provide the most reliable information on the property *and is ordinarily counted on to do so*."

The real estate broker's relationship to the buyer is such that the buyer usually expects the broker to protect his interests.

In the typical residential real estate transaction … , the buyer, in particular, may be intentionally or inadvertently led … to believe the broker will represent his interest even where he is aware the broker has a listing agreement with the seller. (This is really old agency theory, probably true twenty years ago. Times have changed, though—B.)

Since the broker's commission is generally paid as a percentage of the sales price, the broker's interest is more closely identified with that of the seller than of the buyer. (This reasoning is really not very applicable in today's world. Agents generally understand fiduciary duties to their principal and the duty and honest and fair dealing to the other principal on the other side of the deal—B.)

Where the buyer is unappreciative of the potentially divided loyalty of the broker, he may be lulled into relying on the broker to his significant detriment. (Again, probably true twenty years ago, but generally not the case today—B.)

Misplaced reliance by the buyer can extend beyond the issue of price to questions regarding quality of title, condition of the premises, and pro-ration of closing costs, property taxes, recording fees, and other expenses.

Indeed the *Easton* court expressed doubt that any such duty should be imposed in commercial transactions, writing, "Unlike the residential home buyer who is often unrepresented by a broker, or is effectively unrepresented because of the problems of dual agency, a purchaser of commercial real estate is likely to be <u>more experienced and sophisticated</u> in his dealings in real estate and is usually represented by an agent who *represents only the buyer's interests*.

Here there is no allegation that Mozart was ever led to believe, or did believe, or rationally could have believed, that BTC was representing its interests.

On the contrary, recognition that each party in the transaction was represented by its own agent—Mozart by CPS, Handspring by BTC. (It looks like they got it—B.)

Thus Mozart affirmatively alleged that Snider and BTC *represented Handspring*, not Mozart, in the lease transaction, i.e., Snider was BTC's "authorized agent *representing Handspring* in the transaction," and that he made statements to Mozart "on Handspring's behalf, and as a representative of BTC."

Mozart further alleged that it shared the understanding with CPS that the latter would "continue to *act on Mozart's behalf*, with respect to any leases to be executed, until such time as the duties and obligations of Mozart and any tenant were fulfilled," that BTC similarly understood that it would "continue to *represent its client* until such time as the building(s) is/are finished, tenant improvements complete, and rent is to commence," that Mozart expected and intended CPS, and any cooperating broker or procuring agent, to "continue to *represent their respective clients* after the Leases were executed, until such time as rent commenced," and that CPS and BTC understood as between themselves "that they would continue to represent their respective clients until rent commenced … ."

If anything both stood to lose from a termination of the lease agreement—Mozart would lose its expectation of rents and other payments called for by that agreement, while BTC would lose the second half of its commission, or at least a clear claim to that sum.

The record suggests no basis for any expectation by Mozart that BTC would disclose matters regarding Handspring other than as its "respective client," Handspring, might direct.

The only factor in common with *Easton* is BTC's presumably superior knowledge of its client's financial condition.

But so far as this record indicates, BTC only had that knowledge by virtue of its confidential relationship with Handspring.

Mozart alleges that beginning in late 2001 and continuing to mid-2002, "Snider and BTC were advised by Handspring" of various matters, including "that Handspring was having financial difficulties and that its projected growth was not as fast as Handspring had originally thought."

If the possession of superior knowledge so gained were enough to trigger a duty to disclose, every agent of any kind could be required to disclose information obtained in confidence from his principal so long as it appeared potentially germane to the interests of another party to a proposed transaction. (BINGO!!!!—B.)

This would of course make it impossible for any principal to conduct negotiations through an intermediary without disclosing every fact that might improve the bargaining position of the other party. (No kidding!!!—B.)

Nothing known to us would justify such a revolution in the law governing business transactions. (Whew!!! That was a close one!!!—B.)

In sum, none of the cases cited by Mozart, and no other authority known to us, supports the imposition of a duty on a lessee's agent in a commercial real estate transaction to disclose to the lessor information, acquired after execution of a lease, concerning the lessee's finances.

Mozart has offered no reason to impose such a duty.

The appellate court, therefore declined to do so.

"Prior to Handspring's entering into the Leases for Buildings 2 and 3, Snider, on Handspring's behalf, and as a representative of BTC, had made affirmative representations to Cross-complainants regarding Handspring's ability to pay the rent into the future.

At all times, as a result, he not only had a duty to disclose all material facts known to him as a real estate agent, but also a duty to correct any information which, if previously true, had become false or had changed.

These duties continued as long as Snider and BTC continued to act as agent and broker in the transaction, including following execution of the Leases."

This allegation, and the cross-complaint as a whole, fail to identify any statement that was rendered false or inaccurate, then or later, by any failure of disclosure.

Snider made unspecified statements on an identified *topic*—"Handspring's ability to pay rent in the future."

Concealment is a species of fraud, and "fraud must be pleaded with specificity."

To plead tort liability based on false or incomplete statements, the pleader must set forth at least the *substance* of those statements.

Mozart can hardly claim not to know what statements were made to it.

We can conceive of no excuse for its failure to plead them "with specificity."

Mozart alleged, "After February 18, 1999, and prior to February 14, 2001, authorized agent, Thomas Snider, <u>represented to John Mozart, either directly or through representations to Mozart's real estate agents … that Handspring was fully qualified as a tenant, financially stable, creditworthy, and otherwise willing and financially able to meet its obligations under the Leases …</u> ."

Mozart writes that they "knew their assurance that Handspring was a ready, willing and able tenant had changed."

"BTC and Snider had a duty to *correct their representation* that Handspring was ready, willing and able to enter into the Leases when they discovered that information was no longer true."

We may suppose that in a transaction of this magnitude some kind of financial data were provided to the lessor. (Guessing?—B.)

But we must also suppose that Mozart was satisfied with those data, and indeed finds no fault with them now, since it has apparently never suggested that its *entry into the leases* was procured by fraud.

Its apparent inability to attribute an affirmative representation to BTC is reflected in such constructions as its reference to the concealment of information that "contradicted the *basic notion* that Handspring was a ready, willing and able tenant."

And like much of Mozart's presentation below and here, this statement seeks to blur the distinction between two critically different points of time: the point when the leases were executed, at which time all parties apparently believed Handspring was ready, willing, and able to perform; and the time beginning eight months later, when that supposition became clouded by doubt.

The question is not what "basic notion" might have been shared by the participants at an earlier time, but whether Mozart has alleged facts sufficient to impose a duty of disclosure on BTC at the later time.

The question then becomes whether, supposing BTC had affirmatively assured Mozart of Handspring's financial ability to perform its obligations, BTC would thereby become obligated to notify Mozart when, following execution of the lease, Handspring betrayed doubts about its ability to perform.

<u>The appellate court did not believe that any existing authority would impose a duty on BTC to, in Mozart's words, "correct" this information under the circumstances alleged by Mozart.</u>

<u>More essentially, the harm for which Mozart seeks compensation is *not* its *entry into* the lease with Handspring, but its failure to *withdraw* from that agreement some time after executing it.</u>

As we have said, this assumes the undemonstrated and highly doubtful proposition that Mozart *could* have withdrawn from that agreement in any manner other than the one it ultimately chose: a mutual agreement with the other contracting party.

While an agent's duty of disclosure *ordinarily* ends upon termination of the agency relationship, this is by no means automatic; the agent may remain under such a duty "when it is foreseeable to the agent that the principal will continue to rely on the agent for information and the agent does not inform the principal that no further information will be provided."

"For example, if an agent arranges a transaction on behalf of a principal that is ongoing at the time their agency relationship ends, it may be foreseeable to the agent that the former principal will continue to rely on the agent to provide information relevant to the ongoing transaction."

Here Mozart has alleged precisely such a situation, and if it has neglected to allege <u>foreseeable continued reliance</u> by it, the defect could presumably be cured by amendment.

Disclosure of Handspring's confidential information to Mozart, without Handspring's consent, would unquestionably have constituted a breach of BTC's fiduciary duties to Handspring.

“An agent has a duty not to use or communicate confidential information of the principal for the agent's own purposes or those of a third party.”

The Restatement (Agency) describes a hypothetical situation in which a sales agent might be obligated to disclose to his employer that a new product relevant to the employer's business was being developed by a corporation in which the agent owned an interest. The comment states in part, “It is, of course, possible that an agent may assume an adverse position in which the agent may not legally discharge the duties of disclosure that the agent owes to the principal because the agent owes a duty to another person not to disclose a fact that is required be disclosed to the principal.

In the described hypothetical situation, for example, the agent's duties to his corporation may prohibit his disclosure of new product developments to its customer, his employer. Unless it is possible for his corporation to shield him from access to facts that he will have a duty to disclose to his employer, the agent's position is not tenable, and consequently he must withdraw as his employer's agent.”

The appellate court agreed with the trial court that the second cause of action fails to state facts sufficient to constitute a cause of action.

Around January 19, 2006, after the trial court granted summary adjudication against BTC on the remaining causes of action of its complaint, Mozart filed a cost bill claiming some $ 496,000 in attorney fees “pursuant to separate motion to be filed.” (Here’s where the commercial real estate brokerage business gets expensive—B.)

On February 6, BTC filed a motion to tax costs, challenging the fee claim on the grounds that:

in view of its failure to secure any relief under its cross-complaint, Mozart was not a prevailing party entitled to a fee award; and

Mozart had no contractual or statutory right to fees from BTC, because BTC was not a party to the underlying contract and would not itself have been entitled to fees had it prevailed on its complaint.

On March 8, 2006, Mozart brought a motion seeking some $ 398,000 in fees it claimed to have incurred in defeating BTC's complaint.

The motion rested on the following points:

BTC's complaint was founded upon the commission agreement between Mozart and its broker, CPS.

The agreement contained a clause providing for recovery of attorney fees by the prevailing party in “any litigation between the parties hereto to enforce any provision of this Agreement.”

Although BTC was not a party to the agreement, it claimed to be a third party beneficiary entitled to enforce its terms, and it prayed in its complaint for attorney fees under the quoted clause.

BTC would thus have been entitled to fees had it prevailed upon its complaint.

Since Mozart prevailed instead, it was entitled to fees pursuant to **Civil Code section 1717** and **Code of Civil Procedure section 1021**.

The trial court denied the motion for fees and granted the motion to tax them from the cost bill.

A request for an award of attorney fees is largely entrusted to the discretion of the trial court, whose ruling “will not be overturned in the absence of a manifest abuse of discretion, a prejudicial error of law, or necessary findings not supported by substantial evidence.”

The appellate court concluded that BTC could not have recovered its fees had it prevailed on its claims. Therefore Mozart had no reciprocal right to fees.

The appellate court affirmed the trial courts judgment.

The order denying attorney fees was also affirmed.

The cross-appeal was dismissed.

Respondents and cross-appellants shall recover their costs on appeal.

Premo, J., and Elia, J., concurred.

Moral of the Story

If the trial court and appellate court had ruled that BTC was responsible to disclose this type of information about a tenant, this would have completely changed the way we do real estate business in California. Principals could not afford to have an agent who had to disclose items that will affect a tenant’s negotiating position. This would have been a real “can of worms.” Fortunately, the courts got this one right at both levels.

Case #11 Yu Fang Tan et al v. Arnel Management Co.

Owner and Property Manager liable for not providing secure premises for tenants,

April 29, 2008

Introduction

Arne Management Company was the property management company that managed Pheasant Ridge Apartments, a 620 unit apartment complex situation on 20.59 acres in Rowland Heights, CA. The entrance to the complex is from Colima Road. There are two parking lots outside the fenced and gated area within the complex, and two remote-controlled security gates at the back of the property. Most of the parking spaces are within the security gates. In July 2002, the Tans moved into Pheasant Ridge Apartments and received one assigned parking space. Tenants could have paid an additional charge to rent a garage, but the Tans chose not to do so. The Tans learned when they leased the property that they could park their second car in unassigned parking spaces throughout the complex or in one of the outside lots. Tan arrived home around 11:30pm on December 28, 2002, he drove around the complex and could not find an available parking space (unknown to Tan at the time, the property management company had rented out unassigned parking spaces to nontenants who did not live in Pheasant Ridge). Tan's wife had parked the family car in their assigned parking space in the complex. So Tan parked his car in the leasing office space outside the gate. As Tan parked the car, an unidentified man approached him and asked for help. When Tan opened his window, the man pointed a gun at him and told him to get out of the car because the man wanted it. Tan responded, "Okay, let me park my car first." But the car rolled forward and the man shot Tan in the neck. The incident rendered Tan a quadripalegic. Tan filed suit against Arnel Property management Company for negligence, loss of consortium, and fraud. The fraud charge was summary adjucated (judged that there was not a triable issue of fact), but the other two causes of action went forward. Before trial, the trial court granted Tan's motion to present evidence of prior acts of a similar nature that would show that the assault on Tan was foreseeable and hence impose a duty of care on Arnel Management Company. At the hearing, the Tan's expert was UCLA Sociology professor, Jack Katz. Katz had looked at police reports, complaints, property management reports, and Pheasant Ridge security service records. He found ten incidents he viewed as "particularly significant warning signs" of which three involved "prior violent incidents." All of the incidents involve sudden attack without warning, late at night, by a stranger on someone who was on the un-gated portion of the premises. One example was an assault on a security guard two years before the attack on Tan, and the second was about a year before. The assailants committed the robbery by blocking the tenant's car, smashing him in the head, and deamanding his valuables. The third violent attack took place 9 months before at 3:55am, the assailants suddenly and violently attacked the tenant in the face, causing profuse bleeding. The Tans also presented over 80 examples of thefts from garages or cars occurring at the property. The Tans said that the apartment complex should have a fence and gate around the two un-fenced and un-gated parking lots. Professor Katz presented evidence that when gates are installed, the rate of violent crime goes down. He stated that, "offenders who violently attack strangers are in the first instance concerned with their escapes." The trial court said the Tans had not presented evidence that would "demonstrate a high degree of forseeability of the crime committed against plaintiffs based upon similar incidents of violent crime at Pheasant Ridge." The trial court granted Arnel Management Company's motion for judgment on the pleadings and ruled in favor of Arnel Management Company. The Tans appealed. The appellate court ruled that the three prior incidents cited are sufficiently similar to make the assault on Tan foreseeable and to place a duty of care on Arnel Property Management. The appellate court reversed the trial court's judgment.

Here's What Happened

Defendant Arnel Management Company manages the Pheasant Ridge Apartments.

Pheasant Ridge is a 620-unit, multi building apartment complex, with over 1,000 residents, situated on 20.59 acres in Rowland Heights, California.

Entrance to the complex is gained from Colima Road.

The entrance road bisects the property.

The beginning of the entrance road has a grassy median and is bordered on both sides by tennis courts.

A little farther up the road lie two open parking lots.

One is a visitor lot, located on one side of the entrance road, and the other is the parking lot for the leasing office, located on the other side of the road.

Just before the two parking lots, in the middle of the entrance road, sits a "guard shack."

Continuing past the two parking lots to the back of the property, the entrance road fans out into a circle by which vehicles can turn left or right through two security gates.

The apartments are located beyond the security gates.

The gates are remote control operated.

Most of the property's parking spaces lie behind these gates by the apartments.

Plaintiffs moved into Pheasant Ridge in July 2002 and received one assigned parking space.

Tenants could pay an additional fee for a garage, but plaintiffs chose not to rent one.

At the time they leased the apartment, plaintiffs learned that if they had a second car, they could park it in unassigned parking spaces located throughout the complex, or in one of the two lots for visitors and the leasing office, as long as the car was removed from the leasing office lot before 7:00 a.m.

At around 11:30 p.m. on December 28, 2002, Tan arrived home.

He drove around the property looking for an open parking space because his wife had parked the family's other car in their assigned space.

Unable to locate an available space, Tan parked in the leasing office parking lot outside the gated area.

As Tan was parking his car, an unidentified man approached him and asked for help.

When Tan opened his window, the man pointed a gun at Tan and told him to get out of the car because the man wanted it.

Tan responded, "Okay. Let me park my car first."

But, the car rolled a little, at which point, the assailant shot Tan in the neck.

The incident rendered Tan a quadriplegic.

In their ensuing complaint against defendants, plaintiffs alleged three causes of action: negligence, loss of consortium, and fraud.

The trial court granted summary adjudication of the fraud cause of action, but denied summary adjudication of plaintiffs' negligence and loss of consortium causes of actions.

Before trial, the court granted defendants' motion for an hearing to ascertain plaintiffs' evidence of prior similar criminal activity.

Defendants wanted to investigate whether the prior incidents raised by plaintiffs were sufficiently similar to make the assault on Tan foreseeable and hence to impose a duty of care on defendants.

At the hearing, plaintiffs' expert, UCLA (University of California at Los Angeles) Sociology Professor Jack Katz, looked at police reports, complaints to the police, property management reports, and records of Pheasant Ridge's security service, and PACWEST Security Services.

After excluding from his analysis those prior incidents involving attacks by acquaintances, Professor Katz found 10 incidents he viewed as being “particularly significant warning signs,” of which three involved “prior violent incidents.”

All of the incidents involved a sudden attack without warning, late at night, by a stranger on someone who was on the un-gated portion of the premises.

PACWEST Security Services was hired by defendant Arnel Management Company to perform nightly patrols throughout Pheasant Ridge.

Defendants cross-complained against PACWEST Security Services, who were dismissed earlier in the action after the court granted summary judgment in their favor.

The first example of a violent incident occurred just under two years before Tan's attack and involved an assault with a deadly weapon.

A guard, who was patrolling on his bicycle around 1:30 a.m., saw someone standing by the maintenance garage.

The guard approached the subject and asked him what he was doing.

The subject replied he was waiting for a friend.

When the guard asked for identification, the subject retrieved an unknown object from his pocket and swung it at the guard.

The guard raised his arm in self-protection and received a one-and-one-half-inch slash on his forearm.

The second example occurred about a year before plaintiff's attack and before the existing gates at the back of the entrance road were installed.

The assailants carjacked a car in Santa Monica with what the victim perceived to be a gun.

Finding Pheasant Ridge “a good place to rob somebody” because there was no gate to impede their escape, as they told police later, the assailants came onto the property and robbed a tenant at his parking spot.

The assailants committed the robbery by blocking the tenant's car, smashing him on the head, and demanding his valuables.

They took the tenant's cell phone and other property.

The third violent incident occurred at 3:55 a.m., nine months before the attack on plaintiff.

The incident was “also a violent attack, apparently, by strangers in late nighttime in a parking lot,” and may have actually been in the leasing office lot.

The assailant suddenly and viciously attacked the tenant in the face causing profuse bleeding.

Although the victim did not mention a weapon, the police classified the attack under **Penal Code section 245**, an assault with a deadly weapon or force likely to produce great bodily injury.

Professor Katz explained that these three prior incidents all involved “strangers coming in late night, suddenly becoming violent against people they don't know in un-gated parking areas.”

Professor Katz opined that these three incidents “show that the probability is foreseeable here that people on this property will be attacked at some point by a stranger in open parking areas late at night.”

Plaintiffs also presented nearly 80 examples of thefts from garages or cars or thefts of cars occurring on the Pheasant Ridge property.

The trial court excluded the evidence of these thefts because they did not involve robberies or violent attacks on people.

The trial court asked plaintiffs to “articulate your theory of what additional security measures the defendants were under a duty to have in place in order to prevent the harm” to Tan.

Accordingly, plaintiffs' counsel stated that the first thing plaintiffs wanted was for defendants to install gates on the entrance roadway before the leasing office and visitor parking lots, rather than at the back of the entrance road.

The gates plaintiffs contemplated were “more substantial” than swing-arms; something more akin to the gates defendants had already installed.

Counsel explained, “anything that could effectively deter escape is going to help reduce … the probability of a carjacking occurring.”

In particular, counsel declared that plaintiffs were not asking that defendant undertake a measure that would require ongoing surveillance or monitoring, or necessitate the expenditure of significant funds.

Professor Katz cited research showing that when gates were installed in crime areas, the rate of violent crime went down.

The research showed that “offenders who violently attack strangers are in the first instance concerned with their escapes. And, when you put gates in, you—while they can circumvent the gate to get in, they could climb a fence or get around it, they can't anticipate an easy escape. … They will shy from a crime target that has a gate in favor of one that's un-gated. It will shift their focus of attention. Also, gates deter strangers who must explain their presence on the property.”

Professor Katz testified that Pheasant Ridge should have ensured that the two objectives (of giving the impression that:

escape would be impeded and that,

one's presence on the property would have to be explained) were achieved by having a gate.

Professor Katz explained that the effect of gates before the visitor and leasing parking lots would be to block access to all parking spaces and to make escape problematic.

He did not eschew a swing-arm that rises and falls as cars enter because criminals could “anticipate on escape that they might have to break it and call attention.”

But, Professor Katz testified, the preferable gate would be “something that is continuous barrier such that if you are on the other side of it, you either have a reason to be there or you don't.”

Professor Katz also discussed fencing, either four or six feet, depending on the sight lines of the property.

However, he explained, because the vast majority of the property is already surrounded by fencing, only a “very small area” of the property would require an extension of the existing barrier, with the result that the extension would be “very minor.”

Professor Katz specifically stated he was not recommending that defendants hire security guards or monitor the property.

At the close of the hearing, the trial court ruled that plaintiffs “failed to demonstrate that enclosing the entire complex, moving the gates, and installing some system or a guard that would let invited guests enter the complex at night, as they propose, would be any less burdensome than providing full-time security guards at night.”

Therefore, the court observed, in order to impose a duty on defendants, plaintiffs would have to “demonstrate a high degree of foreseeability of the crime committed against plaintiffs based upon prior similar incidents of violent crime at Pheasant Ridge.”

The three incidents that Professor Katz characterized as “prior violent incidents,” the court ruled, “neither singularly nor collectively, make the armed attempted carjacking and attempted murder of Mr. Tan by gunfire foreseeable.”

The court stated, “Notably, plaintiffs presented no evidence of a prior attempted carjacking, or an attempted murder, or a completed carjacking or murder, or of anyone being shot, or shot at, or reports of gunfire, at Pheasant Ridge.”

Therefore, the court held, defendants had no duty to take plaintiffs' proposed additional measures to enhance the security in their common areas, including the leasing office parking lot where the crime occurred.

The court granted defendants' ensuing motion for judgment on the pleadings and plaintiffs' timely appeal followed.

The duty of landlords to prevent third party criminal acts on their premises

To succeed in a negligence action, the plaintiff must show that:

- the defendant owed the plaintiff a legal duty,
- the defendant breached the duty, and
- the breach proximately or legally caused,
- the plaintiff's damages or injuries.

Our Supreme Court has clearly articulated “the scope of a landowner's duty to provide protection from foreseeable third party criminal acts … . It is determined in part by balancing the foreseeability of the harm against the burden of the duty to be imposed.

“In cases where the burden of preventing future harm is great, a high degree of foreseeability may be required. On the other hand, in cases where there are strong policy reasons for preventing the harm, or the harm can be prevented by simple means, a lesser degree of foreseeability may be required.”

A “*high degree* of foreseeability is required in order to find that the scope of a landlord's duty of care includes the hiring of security guards … because the monetary costs of security guards is not insignificant” and “the obligation … is not well defined.”

The burden of hiring security guards is “so high in fact, that the requisite foreseeability to trigger the burden could rarely, if ever, be proven without prior similar incidents.

Once the burden and foreseeability have been independently assessed, they can be compared in determining the scope of the duty the court imposes on a given defendant.

The more certain the likelihood of harm, the higher the burden a court will impose on a landlord to prevent it; the less foreseeable the harm, the lower the burden a court will place on a landlord.

With these rules in mind, we turn to the evidence presented in the instant case.

The trial court erred in finding defendants owed no duty

Referring to the first step of the analysis, i.e., the specific security measures that plaintiffs proposed defendants should have taken, the record shows that plaintiffs requested minimal changes: Professor Katz recommended:

moving the existing security gates from the back of the access road, *or*

installing “very similar” gates before the visitor and leasing office parking lots.

An additional gate could be “any gate …—that would *not necessarily* impede climbing over it. It wouldn't have spikes or—or be unusually high. It would just define a property boundary … .” “*very similar to the gates they have* … .”

Indeed, Professor Katz did not reject swing-arm gates.

Any gate could remain open during the day to allow business in the leasing office.

Plaintiffs clearly stated they were *not* asking for the hiring of a guard or for any form of ongoing surveillance or monitoring.

Furthermore, because an existing fence extends around almost the entire perimeter of the property, only a “very minor” extension over a “very small area” would be necessary to close the fencing gap, Professor Katz testified, and could be achieved by merely mounding dirt.

Plaintiffs also argued that defendants should not have rented parking spaces out to nontenants because that practice had the effect of reducing nonassigned spaces for tenants, forcing tenants to park in the unprotected leasing office lot.

However, the evidence shows that Tan was offered the opportunity to rent a garage and turned it down, with the result he may not raise this issue.

The second issue requires the court to analyze how financially and socially onerous the proposed measures would be to the landlord.

The measures “could range from minimally burdensome to significantly burdensome under the facts of the case.”

The evidence presented at the hearing was that the cost to defendants to install the two security gates barricading the two roads at the back of the property was about $ 13,050.

And, plaintiffs suggested using the same gates for the front of the property.

Although plaintiffs presented no evidence about the cost of extending the fence, notably Professor Katz testified that would necessitate only a “minor extension,” because the property is already almost completely surrounded by walls, *and could even involve merely mounding dirt*.

As plaintiffs observed, their proposed security measures involved a one-time expenditure and did not require ongoing surveillance of any kind, or the expenditure of significant funds.

Most of what plaintiffs requested was a burden that defendants had already undertaken when they installed the security gates at the back of the property and so should not be very burdensome, either financially or socially, for defendants' 620-unit apartment complex.

<u>Turning then to the heart of this case, the third element of foreseeability, plaintiffs demonstrated three prior incidents of sudden, unprovoked, increasingly violent assaults on people in *ungated parking* areas on the Pheasant Ridge premises by a stranger in the middle of the night, causing great bodily injury.</u>

Professor Katz opined, based on the three incidents, that “the probability is foreseeable here” of plaintiff's attack because in his experience, “you don't get more than this.”

The appellate court concluded that plaintiffs presented substantial evidence of prior similar incidents or other indications of a reasonably foreseeable risk of violent criminal assaults on the property so as to impose on defendants a duty to provide the comparatively minimal security measures plaintiffs described.

In light of the minimum security measures proposed by plaintiffs here, they have presented substantial evidence of prior, sudden, vicious assaults by a stranger at Pheasant Ridge.

It is of no moment that the assaults were not committed with guns where they nonetheless inflected great bodily injury.

Plaintiffs demonstrated a reasonably foreseeable risk of violent criminal assaults on the property.

Professor Katz very conservatively cited evidence of attacks in common areas of the Pheasant Ridge property only.

Although the court required a high degree of foreseeability, it had already explained that the security measures sought, namely, (1) the hiring of security guards and (2) the eviction of gang member tenants, “could not be considered a minimal burden.”

Because plaintiffs have only asked for relatively minimal security measures—ones already taken by defendants in another portion of the property—the degree of foreseeability required here is not especially high.

As a matter of law, therefore, the three prior incidents cited are sufficiently similar to make the assault on Tan foreseeable and to place a duty of care on defendants.

Accordingly, the trial court erred in ruling that defendants had no duty of care in this case.

The appellate court reversed the trial court's judgment. Defendants to bear the burden of costs on appeal.

Croskey, Acting P. J., and Kitching, J., concurred.

Moral of the Story

Here is where the liability comes in as a property manager. I wonder if the trial court and appellate court understand that the property manager doesn't own the property and cannot make decisions for capital expenditures without the owner's permission?

Case #12 Kelly McClain v. Octagon Plaza, LLC

Dispute over tenant's share of CAMs, January 31, 2008

Introduction

On February 28, 2003 Kelly McClain of "A+ Teaching Supplies" agreed to lease a commercial space within a shopping center owned and managed by Ted and Wanda Charanian in Valencia, CA. The lease was for five year terms. The lease agreement was on an American Industrial Real Estate Association form and said "net." The lease described the size of the unit as approximately 2,624 square feet. McClain was paying $2,804 per month as base rent. In addition, she was required to pay her pro-rata share (proportion) of the common area operating expenses related to the ownership and operation of the shopping center. On June 17, 2005 McClain filed suit against the Charanians for negligent and intentional misrepresentation, breach of the covenant of good faith and fair dealing, declaratory relief, violation of the lease agreement, and an accounting. McClain alleged that the Charanians intentionally or negligently had mistaken the size of her unit. She also alleged that the Charanians had improperly obtained her credit report in 2005. Following a bench trial, the trial court determined that the Charanians had not violated the lease agreement by obtaining her credit report and that McClain had no right to an accounting under the lease. Judgment was entered in the Charanian's favor on August 15, 2006. McClain appealed. The appellate court found, upon reviewing the facts on the case, that the Charanians had applied for earthquake insurance disclosing the correct size of the shopping center as 12,800 square feet, rather than 11,835 as described in McClain's lease agreement. Upon measuring her unit, she found it to be 2,438 square feet, instead of 2,624 square feet as represented by the Charanians. Her base rent should have been $3,535.10 per month, and not $3804.00 per month, as recited in the lease. Because of the inaccurate amounts, McClain was induced to pay over $90,000 more in rent over the life of the lease. The appellate court stated that using the word "approximation" cannot insulate a lessor from potential liability for misrepresentation about size. The appellate court ruled to have the Charanians produce records to substantiate the actual numbers for the operation of the shopping center. The appellate court said that McClain cannot demand explanation for how any of the money was spent. Therefore, the appellate court reversed the trial court's judgment with respect to McClain's claims for misrepresentation, an accounting, and declaratory relief. The matter was remanded back to the trial court for further proceedings.

Here's What Happened

McClain operates a business known as "A+ Teaching Supplies."

Ted and Wanda Charanian, who are married, are the principals of Octagon, which owns and manages a shopping center in Valencia.

On February 28, 2003, McClain agreed to lease commercial space within the shopping center for a term of five years two months, with an option to extend the lease for two additional five-year terms.

The lease executed by the parties is a standard form agreement prepared by the American Industrial Real Estate Association, and is entitled, "Standard Industrial/Commercial Multi-Tenant Lease—Net."

The tenant on the lease is identified as "Kelly McClain dba A+ Teaching Supplies."

Paragraph 1.2(a) of the lease describes the size of the unit leased by McClain as “approximately 2,624 square feet,” and attached to the lease is a diagram of the shopping center that represents the size of the unit as 2,624 square feet.

Paragraph 2.1 states: “… Unless otherwise provided herein, any statement of size set forth in this Lease, or that may have been used in calculating Rent, is an approximation which the Parties agree is reasonable and any payments based thereon are not subject to revision whether or not the actual size is more or less.”

Paragraph 2.4 further provides: “Lessee acknowledges that: (a) it has been advised by Lessor … to satisfy itself with respect to the condition of the Premises, and their suitability for Lessee's intended use, and (b) Lessee had made such investigation as its deems necessary with reference to such matters and assumes all responsibility therefor as the same relate to its occupancy of the Premises.”

With qualifications not relevant here, paragraph 1.5 of the lease obliges McClain to pay $ 3,804 per month as “Base Rent.”

In addition, paragraphs 1.6 and 4.1 require McClain to pay as additional rent 23 percent of the “Common Area Operating Expenses” (common expenses), which are defined in paragraph 4.2 as costs incurred by Octagon for enumerated purposes “relating to the ownership and operation” of the shopping center.

Paragraph 4.2 provides that McClain's share of the common expenses is due no later than 10 days after Octagon provides her with “a reasonably detailed statement of actual expenses.”

Paragraph 4.2 also permits Octagon, at its option, to estimate the common expenses for the upcoming calendar year and to require McClain to pay a prorated share of the estimate with her monthly base rent during the year.

Under this option, Octagon is obliged to provide McClain with a “reasonably detailed statement” showing her share of the actual annual common expenses within 60 days after the end of the calendar year.

If McClain underpays her share of the common expenses, she must pay the balance owing no later than 10 days after receiving the statement; if McClain overpays her share, she is to receive a credit against her share of the common expenses for the forthcoming year.

After a dispute arose concerning McClain's share of the common expenses, she filed an action in small claims court, which was eventually transferred to superior court.

The action was resolved by a settlement in November 2004.

On June 17, 2005, McClain initiated the underlying action against Octagon.

McClain filed a complaint (FAC), which contained claims for negligent or intentional misrepresentation, breach of the covenant of good faith and fair dealing, declaratory relief, violation of the CCRAA, and an accounting.

Regarding the first three claims, the FAC alleged that the Charanians induced her to agree to pay excessive rent by intentionally or negligently misstating the size of her unit prior to the execution of the lease.

The FAC further alleged that Octagon violated the CCRAA by improperly obtaining her credit report in March 2005.

Finally, it sought an accounting and declaratory relief with respect to the statement that she received in February 2005 regarding her share of the common expenses for the 2004 calendar year.

Following a bench trial, the trial court determined that the Charanians had not violated the CCRAA in obtaining McClain's credit report, and that McClain had no right to an accounting under the lease.

Judgment in Octagon's favor was entered on August 15, 2006.

McClain contends that the trial court erred.

"To meet this burden, a plaintiff must submit a proposed amended complaint or, on appeal, enumerate the facts and demonstrate how those facts establish a cause of action."

Misrepresentation

McClain contends that the FAC adequately alleges a claim for fraud in the inducement, that is, misrepresentation involving a contract in which "the promisor knows what he or she is signing but consent is induced by fraud."

The appellate court agreed.

Generally, the elements of fraud, which give rise to the tort action for deceit, are:

- misrepresentation (false representation, concealment, or nondisclosure);
- knowledge of falsity (or 'scienter');
- intent to defraud, i.e., to induce reliance;
- justifiable reliance; and
- resulting damage.

"The tort of negligent misrepresentation does not require scienter or intent to defraud.

It encompasses 'the assertion, as a fact, of that which is not true, by one who has no reasonable ground for believing it to be true', and 'the positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true."

Under California law, a defrauded party to a contract may elect to rescind the contract and seek restitution, or stand on the contract and recover damages arising from the fraud.

Here, the FAC seeks damages rather than rescission of the lease.

Regarding the fraud claim, the FAC alleges the following facts: In January 2003, when McClain investigated leasing space in the shopping center, Octagon informed her that the unit in which she was interested comprised exactly 2,624 square feet.

Because the base rent in the shopping center was $ 1.45 per square foot per month, McClain's total base rent would be $ 3,804 per month.

Moreover, because the unit occupied 23 percent of the shopping center, McClain would be responsible for this share of the common expenses.

Prior to entering into the lease, McClain attempted to confirm the size of the unit.

The Charanians, who purported to be offended by her inquiries, responded that measuring the area would be unreasonably costly due to the unit's unusual angles.

They insisted that they had intimate knowledge of every detail of the shopping center, and that McClain could rely on their representations regarding the sizes of the unit and the shopping center.

Due to the Charanians' pretense that they were offended by her request to confirm the size of the unit and their repeated assurances that McClain could rely on their honesty and accuracy, McClain was induced to accept their representations, and she placed reasonable reliance upon the representations in executing the lease.

The Charanians knew, or had reason to know, that the representations were materially inaccurate.

<u>In early 2005, McClain obtained a copy of Octagon's application for earthquake insurance, which disclosed that the correct size of the shopping center was 12,800 square feet, rather than the 11,835 square feet the Charanians had used in calculating McClain's share of the common expenses.</u>

<u>Upon investigation, she also discovered that her unit occupied approximately 2,438 square feet, rather than the 2,624 square feet represented.</u>

Had she known the correct sizes, she would not have agreed to the base rent and share of the common expenses stated in the lease.

Under the agreed-upon rental rate of $ 1.45 per square foot, the base rent for the unit should have been $ 3,535.10 per month, rather than $ 3,804, as recited in the lease; moreover, McClain should have been allocated 19 percent of the common expenses, rather than the 23 percent share that she accepted under the lease.

As a result of Octagon's misrepresentations, she was induced to enter into a lease that obliged her to pay excess rent of more than $ 90,000 over the term of the lease.

These allegations, considered in isolation, are sufficient to establish the elements of a claim for intentional or negligent misrepresentation.

The focus of our inquiry is paragraph 2.1, which asserts that “any statement of size” in the lease or used to calculate rent “is an approximation which the Parties agree is reasonable and any payments based thereon are not subject to revision whether or not the actual size is more or less.”

In our view, this provision does not insulate Octagon from liability for fraud or establish that McClain's reliance on the Charanians' alleged misrepresentations was unjustifiable as a matter of law.

Here, the Charanians' alleged precontractual figures for the unit's size and McClain's share of the common expenses—respectively, 2,624 square feet and 23 percent—were repeated (with qualifying language) in the lease.

Here, McClain alleges that the Charanians exaggerated the size of her unit by 186 square feet, or 7.6 percent of its actual size, and increased her share of the common expenses by 4 percent through a calculation that understated the size of the shopping center by 965 square feet, or 8.1 percent of its actual size.

As alleged in the complaint, they operated to increase the rental payments incurred by McClain's retail business by more than $ 90,000 over the term of the lease.

During oral argument, Octagon's counsel suggested that the term “approximation” in paragraph 2.1 gave any prospective lessee notice that no firm or actionable representations about size were made in the lease.

However, the question is not whether the term puts a prospective lessee on notice that the stated size may not be precisely accurate.

It does.

The question is whether it necessarily renders any deviation from the stated size immaterial.

It does not.

Where, as here, the deviations cannot be said to be immaterial as a matter of law, <u>the use of the term “approximation” cannot insulate a lessor from potential liability for misrepresentations about size.</u>

If, as McClain asserts, the Charanians assured her that the square footage represented was accurate and dissuaded her from taking her own measurements, any agreement that the measurement set forth in the lease was reasonable reflects nothing more than a belief induced by such misrepresentations.

Breach of the Implied Covenant of Good Faith and Fair Dealing

We reach the contrary conclusion regarding McClain's related claim for breach of the implied covenant.

Generally, every contract, including commercial leases, “imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”

Regarding this claim, the FAC alleges that Octagon breached the implied covenant “by negotiating with McClain for the rental of the Premises on a per-square foot basis and then intentionally, or negligently, overstating the true size of the Premises.

The net result of the foregoing was that Octagon pulled a ‘bait & switch’ on McClain in that Octagon negotiated a per-square foot price for the Premises and then inserted only its fraudulently derived amount for the base rent as the purported final agreement between the parties in the Lease.

The net result was that Octagon intentionally deprived McClain of the benefit of her bargain by surreptitiously charging her a rental rate which was far in excess of the mutually negotiated price.”

The FAC also alleges that Octagon breached the implied covenant “by negotiating the common expenses charges with her on a per-square foot basis, which Octagon held out as a reflection of the ratio which the Premises held to the size of the Shopping Center as a whole.

Octagon falsely represented the ratio to be 23 percent.

Octagon induced McClain to enter into the Lease which provided that her proportional share of the annual common expenses were 23 percent, when it knew or had reason to know that the true ratio was substantially less.”

Accounting

McClain contends that the trial court erred in denying her request for a declaration that under the lease she is entitled to an accounting of her share of the common expenses.

She argues that the express provisions of the lease, together with the implied covenant, oblige Octagon to permit her to examine its records to verify her share of the common expenses.

Regarding this claim, the record establishes that in February 2005, Octagon sent McClain a letter stating her share of the actual common expenses for the 2004 calendar year and her share of these expenses for the 2005 calendar year.

When she requested "a reasonably detailed statement" regarding these expenses pursuant to the lease, Octagon provided a more elaborate description of the common expenses for the 2004 calendar year.

McClain's husband responded to the statement in a letter dated April 7, 2005.

Asserting that a landlord owed a fiduciary duty to a tenant, the letter questioned certain expenditures, disputed the need for others, and sought documentation beyond that verifying the actual expenses incurred.

In addition, the letter requested permission for an auditor to examine Octagon's records and obtain answers to the questions raised in the letter.

Octagon did not agree to the request.

The trial court determined that neither the express language of the lease nor the implied covenant of good faith and fair dealing accorded McClain the right to such an audit.

For the reasons explained below, we conclude that McClain is not entitled to dispute the need for expenses or to audit Octagon's records.

Rather, she is entitled only to disclosure of the documents supporting the Charanians' "reasonably detailed statement" of her share of the common expenses, for the limited purpose of verifying that the listed expenses were incurred and that the listed amounts are accurate.

Octagon may fulfill this obligation in any reasonable manner it elects, as by providing copies of the relevant documents or permitting McClain to examine the originals.

On appeal, McClain argues only that the implied covenant supports her request for an accounting, and does not suggest that the lease imposes fiduciary duties upon Octagon regarding the common expenses.

That right can be derived not from a fiduciary duty, but simply from the implied covenant of good faith and fair dealing inherent in every contract, because without an accounting, there may be no way ' "by which such [a] party [entitled to a share in profits] could determine whether there were any profits … ."

The lease obliges the parties to share the common expenses of the shopping mall, as enumerated in the lease, but accords Octagon exclusive management and control over those expenses while requiring it to provide McClain with a reasonably detailed statement of the expenses.

Because McClain's share of the common expenses under the lease is determined by the *actual expenses* incurred by Octagon, she is entitled to verify that such expenses were, in fact, incurred and that the listed amounts are accurate.

Accordingly, if requested, Octagon must provide McClain with the documents it used in preparing the “reasonably detailed statement”; to hold otherwise would necessarily “‘frustrate McClain's rights to the benefits of the contract.’

Octagon may discharge this obligation in any reasonable manner it selects, including providing McClain with copies of the pertinent documents or giving her an opportunity to view the original documents.

In so concluding, we do not suggest that McClain's limited right to the documents underlying the “reasonably detailed statement” accords her greater control over the shopping center and its management than authorized by the express terms of the lease.

We hold only that Octagon may not prevent her from examining the records supporting its statements regarding actual common expenses incurred.

McClain's requested audit, as described in the letter dated April 7, 2007, far exceeds the access to Octagon's documents authorized by the principles we have articulated.

Under our holding, McClain is entitled to have Octagon produce the records to confirm the figures in the statement it provided her regarding her share of the common expenses; she is not entitled to demand explanations of Octagon's decisions to incur common expenses or to challenge these decisions.

The appellate court reversed the trail court’s judgment with respect to McClain's claims for misrepresentation, an accounting, and declaratory relief. The matter is remanded for further proceedings in accordance with this opinion.

The judgment was otherwise affirmed in all other respects.

The parties were to bear their own costs on appeal.

Willhite, Acting P. J., and Suzukawa, J., concurred.

Moral of the Story

Unfortunately, it’s all too common for shopping center owners to mess with tenants’ CAM charges. I have seen everything from changing actual square footage estimates to including the owner’s car insurance in the expenses. Unfortunately, there generally is not much a tenant can do to protect themselves. Some ideas are to count the 2’ x 4’ ceiling tiles to get a pretty good idea of size, monitoring the CAM charges on an ongoing basis and asking the owner for a periodic accounting. You may not get much, but at least the owner knows you are watching him. Another problem that tenants have is when shopping center sale prices go up over time. The shopping center’s property taxes go up every time the shopping center is sold. Of course, so does a tenant’s CAM charges to pay the higher property taxes. Tenants then have their CAM charges go up and they attempt to have their base rent reduced to counter these higher costs. Unfortunately, the new shopping center owner paid so much for the property that he cannot cover his debt service if he reduces the rent. The tenant ends up moving to another location where he can get lower rent, the shopping center owner gets a vacancy, and may either have to sell the center at a discount or lose it to foreclosure. Interesting stuff.

Case #13 Redevelopment Agency of the City of San Diego v. Ahmad Mesdaq

Challenge to right of Eminent Domain, August 31, 2007

Introduction

In 2001, Mesdaq purchased a 5,000 square foot commercial property in San Diego for $1.3 million. In 2003, after improving the property, Mesdaq opened Gran Havana, a coffee shop and cigar store. On April 27, 2004 the Redevelopment Agency of the City of San Diego (Agency) adopted a resolution to take Mesdaq's property through the power of eminent domain. The Agency planned to have a 40,000 square foot hotel erected on his and other adjoining properties. The Agency deposited $3,091,000 as probable compensation for the property and requested possession. Mesdaq objected and after a hearing, the trial court granted possession to the agency. At Mesdaq's request, the trial court delayed the Agency from taking his property so he could continue operating his business. The trial court held three separate trials on the matter: (1) Agency's gross abuse of power; (2) precondemnation damages; and (3) just compensation. The trial court determined that the Agency had not engaged in gross abuse of discretion. However, the trial court did find that the Agency had acted unreasonably during precondemnation proceedings, and the jury could include damages for that conduct. In the jury trial, Mesdaq was awarded:

1. $4,250000 for loss of fair market value
2. $3,361,208 for loss of business goodwill
3. $96,100 for lost furniture and equipment
4. $77,823.83 in precondemnation damages
5. $1,230,714.41 in attorney fees and costs

The Agency appealed. The appellate court agreed with the Agency in their contention that the date of value of the property is the date of their deposit, and not the date of the trial. The appellate court reversed the trial court's judgment and remanded it back to the trial court for further proceedings. The appellate court had problems with the valuation of the property, amount of goodwill, and attorney fees and costs.

Here's What Happened

The Agency contends that the compensation award must be reversed because it is based on:

an erroneous valuation date;

speculative expert testimony as to lost business goodwill; and

an improper award of damages based on the Agency's issuance of an environmental remediation notice under the Polanco Redevelopment Act (Polanco Act)).

In addition, the Agency contends that the trial court erred in awarding Mesdaq $1,230,714.41 in litigation expenses.

As discussed in greater detail below, the appellate court agreed with the Agency's contentions.

With respect to the first issue, our Supreme Court's recent opinion compels the conclusion that the trial court erroneously set the date of valuation as the date of trial, rather than the earlier date of deposit, for purposes of the jury trial on compensation.

On the second issue, the appellate court agreed with the Agency that the trial court abused its discretion in permitting expert testimony that relied upon a goodwill valuation methodology that did not value Mesdaq's actual business but instead valued a hypothetical business operating at Mesdaq's facility.

Third, the appellate court concluded that the trial court's ruling allowing the jury to assess $77,823.83 of pre-condemnation damages based on the Agency's issuance of a Polanco Act notice was erroneous.

As a result of these determinations, the jury's compensation award must be vacated and relitigated.

The appellate court reversed, as well the award of attorney fees to Mesdaq, which was based, in substantial part, on the now vacated award.

FACTS

In 2001, Mesdaq purchased a 5,000-square-foot commercial property at 502 J Street in the Gaslamp District of San Diego for $1.3 million.

In 2003, after improving the property, Mesdaq opened the Gran Havana—a coffee shop and cigar store.

On April 27, 2004, the Agency adopted a “resolution of necessity,” which resolved that the public interest and necessity required that Mesdaq's property be acquired through an exercise of the power of eminent domain, so that a planned 40,000-square-foot hotel could be erected on his and the adjoining properties.

Three days later, the Agency filed a complaint in eminent domain with respect to Mesdaq's property.

In concert with its complaint, the Agency deposited $3,091,000 as probable compensation for the property and requested an order for possession.

After a hearing, the trial court denied Mesdaq's initial objections to the Agency's right to take his property and granted possession to the Agency.

At Mesdaq's request, however, the court delayed actual transfer of title to allow Mesdaq to continue operating his business.

The court then held three separate trials with respect to the proposed taking:

a court trial regarding whether the Agency engaged in a “gross abuse of discretion” in adopting its resolution of necessity and whether the taking was for a public use;

a court trial regarding Mesdaq's request for pre-condemnation damages; and finally a jury trial to determine "just compensation" for the taking of the property.

At the conclusion of the first two proceedings, the trial court determined that the Agency had not engaged in a gross abuse of discretion; that the property was taken for a public use; and that the Agency had acted unreasonably by issuing a Polanco Act notice during pre-condemnation proceedings, and the jury could include damages for that conduct in calculating its compensation award.

In the jury trial, Mesdaq was awarded:

loss of the fair market value of the property of $4,250,000;

loss of business goodwill of $3,361,208;

loss of furniture and equipment worth $96,100; and

precondemnation damages of $77,823.83. The trial court subsequently awarded Mesdaq attorney fees and costs in the amount of $1,230,714.41. (Seems a bit high—B.)

The Trial Court Erred by Ruling That the Date of Valuation of the Property Was the Date of Trial

The Agency contends that the trial court improperly disregarded the statutory requirement that when probable compensation is deposited, the date of valuation for purposes of determining any compensation award is the date of the deposit, not the date of trial. (Big factor in a rising market—B.)

The appellate court agreed with the Agency under the authority of our Supreme Court's recent decision (**Mt. San Jacinto, supra, 40 Cal.4th 648**) and consequently reversed the jury's award of compensation to Mesdaq.

Applicable Statutory and Constitutional Principles

The starting point for any analysis of eminent domain law is the California Constitution, which states in **article I, section 19**: "Private property may be taken or damaged for public use only when just compensation, ascertained by a jury unless waived, has first been paid to, or into court for, the owner. The Legislature may provide for possession by the condemnor following commencement of eminent domain proceedings upon deposit in court and prompt release to the owner of money determined by the court to be the probable amount of just compensation."

The federal constitution also contains a provision regarding eminent domain, stating that private property shall not "be taken for public use, without just compensation."

The Eminent Domain Law delineates two different types of proceedings for the governmental taking of property.

The first is a standard condemnation proceeding in which the public agency does not take possession and title to condemned property until after a jury has awarded just compensation; thus, the "taking" and the "compensation" are contemporaneous and occur at the conclusion of court proceedings.

Until then, the property owner bears the risk of loss to the property.

The second procedure, a quick-take proceeding, allows a public agency to take possession of a condemned property and the property owner to obtain the probable compensation for that property well in advance of the termination of court proceedings.

A public entity may accomplish an early taking of property by making a deposit of the “probable amount of compensation” at any time prior to entry of judgment.

The amount of the deposit must be based on an appraisal of an expert qualified to express an opinion as to the value of the property and must be supported by a written statement of, or summary of the basis for, the appraisal.

After a deposit of probable compensation has been made, the court may order that possession of the property be transferred to the condemner, after considering any opposition from the owner of the property and making certain findings regarding the public entity's legal right to take the property and the relative hardships that would befall the parties were title not transferred until after legal proceedings are completed.

Once the deposit is made, the property owner can apply to withdraw “all or any portion of the amount deposited,” and the court “shall order the amount requested in the application, or such portion of that amount as the applicant is entitled to receive, to be paid to the applicant.”

The statement must contain “detail sufficient to indicate clearly the basis for the appraisal,” including:
The date of valuation, highest and best use, and applicable zoning of the property.
The principal transactions, reproduction or replacement cost analysis, or capitalization analysis, supporting the appraisal.

If the appraisal includes compensation for damages to the remainder, the compensation for the property and for damages to the remainder separately stated, and the calculations and a narrative explanation supporting the compensation, including any offsetting benefits.”

While the valuation date in standard condemnation proceedings “is either the date of commencement of proceedings, or of commencement of trial, a different rule applies in quick-take situations.

There, the land is to be valued as of the date of the deposit of estimated value which permits an order for early possession.

These valuation provisions “give effect to the fact that, except for defenses to the exercise of eminent domain, a landowner in California is permanently deprived of all of his rights in property sought by a public agency when the agency exercises its option to deposit estimated value and obtain early possession for the intended public use.”

At any time after a deposit has been made, the trial court shall, upon motion of any party with an interest in the property, “determine or re-determine whether the amount deposited is the probable amount of compensation that will be awarded in the proceeding.”

In ruling on the motion, the “court may order the plaintiff to increase the deposit or may deny the plaintiff possession of the property until the amount deposited has been increased to the amount specified in the order”; or if possession has already transferred “order the amount deposited to be increased to the amount determined to be the probable amount of compensation,” and if the plaintiff does not comply, dismiss the action and award litigation costs and damages to the defendant.

A motion seeking re-determination “shall be supported with detail sufficient to indicate clearly the basis for the motion, including, but not limited to, the following information:

A public entity, however, is not required to make a motion to *increase* the deposit, but "may at any time increase the amount deposited without making a motion under this section."

Procedural Background

The Agency employed the quick-take procedures under the Eminent Domain Law in the instant case.

On April 30, 2004, the Agency filed, along with its complaint in eminent domain and application for an order of possession, a "Request for Deposit."

The Agency included with its filing a "notice of deposit and summary of the basis for the appraisal" and attached the appraisal reports of two certified real estate appraisers valuing Mesdaq's property at over $3 million.

Mesdaq objected to the application for possession, contending that his objections to the Agency's right to take his property must be heard before any transfer of possession, and informing the court that he has "an active, thriving business, and his revenues increase every month."

Mesdaq also objected that the Agency was not entitled to possession because the deposit was not sufficient in that it included a deduction for "environmental remediation" and did not include compensation for lost goodwill.

At a hearing on these contentions, the trial court implicitly found that the amount of the deposit was sufficient and postponed its decision on the Agency's request for an order of possession.

At the subsequent hearing, the trial court granted Mesdaq's request to delay decision on the Agency's request for possession until December 28, 2004, to enable it to first rule on Mesdaq's objections to the taking.

The court then issued an order that: "AGENCY shall make a deposit of probable compensation with the County Treasury in the amount of $3,091,000," at which time, pursuant to **section 1255.410**, it would be empowered to take exclusive possession of the property.

As noted earlier, the trial court delayed the Agency's actual physical possession of the property until December 28, 2004.

The transfer of physical possession was further delayed in subsequent rulings.

Immediately prior to trial, the court determined that the date of trial, not the statutorily determined date of deposit, would be the date of valuation.

The court reasoned rising property values and delays in concluding the proceedings necessitated a later valuation date to enforce the constitutional mandate of just compensation

The parties and the trial court recognized that the court's ruling on the date of valuation was a "critical issue" for purposes of determining the compensation award.

The Trial Court Erred in Disregarding Section 1255.010 in Setting the Date of Valuation

In Mt. San Jacinto, the trial court subsequently ruled that given increasing property values, the statutory date of valuation should not control and that the date of valuation would be the date of trial, resulting in a significant increase in the amount of compensation awarded. The Court of Appeal reversed, and our Supreme Court affirmed the appellate court's ruling. (Key point—B.)

In a quick-take proceeding, the constitutional requirement that an owner receive “just compensation” does not support a court's decision to disregard the statutory mandate because, under the state Constitution itself, “just compensation” is made available to the owner at the time of the deposit.

Consequently, in the words of our Supreme Court, “no credible reason exists to invalidate the statutory date of valuation … when a deposit was made before trial and the owner had access to the money at that time.”

As noted earlier, the trial court, in fact, found that the Agency's deposit was adequate, at first tentatively at a hearing addressing that issue and then definitively in a subsequent written order that the “AGENCY shall make a deposit of probable compensation with the County Treasury in the amount of $3,091,000.”

Mesdaq's second argument is that *Mt. San Jacinto* does not apply because the case “does not speak at all to the effect of … **section 1263.130**.”

Mesdaq contends **section 1263.130** controls here because it separately sets the date of valuation as the date of trial if the “issue of compensation is not brought to trial within one year after the commencement of the proceeding” and any delay was not the fault of the defendant. (**§ 1263.130**.)

This argument fails because **section 1263.130** is explicitly “subject to **Section 1263.110**”—the provision that sets the date of valuation as the date of deposit in a quick-take procedure.

Thus, as the Law Review Commission comment to the statute makes clear, **section 1263.130** establishes the date of valuation only “where that date is not established by an earlier deposit (**Section 1263.110**).” (Cal. Law Revision Com. com., 19A West's Ann. Code Civ. Proc. (1982 ed.) foll. **§ 1263.130**, p. 18.)

The appellate court stated that the trial court erred in disregarding the statutory requirement under **section 1263.110** that the date of valuation is the date of deposit and the award of just compensation, which is based on the erroneous valuation date,

The appellate court said that it must be reversed.

The Trial Court Erred in Permitting Speculative Testimony Regarding the Value of Lost Goodwill

The Agency contends that the trial court also erred by allowing an expert witness to testify to his conclusion that Mesdaq lost over $3.3 million in foregone business goodwill by virtue of condemnation.

The Agency contends the expert's calculations, and thus his testimony, did not represent the goodwill actually lost based on the taking of Mesdaq's business, but rather represented speculative goodwill lost for a hypothetical alternative business. (Obviously, the justices have never had their livelihood—i.e. a business—condemned and then had themselves thrown out on the street. Of course, Mesdaq could move his business a short distance away with probably minimal lost interruption. However, that loss is difficult to measure, especially goodwill—B.)

Mesdaq's Expert Testimony Regarding Lost Business Goodwill

Mesdaq presented an expert, Nevin Sanli, to testify regarding the business goodwill lost as a result of the taking of Mesdaq's business.

Prior to Sanli's testimony, the trial court granted the Agency's motion precluding any testimony as to lost goodwill that was based not on Mesdaq's actual operations but rather on hypothetical uses of the property.

Immediately prior to and throughout Sanli's testimony there were objections and subsequent discussions between counsel and the court regarding the implications of the court's ruling.

During these discussions, Sanli and Mesdaq's counsel assured the court that Sanli's testimony solely concerned the facilities and operations that currently existed, and consequently the court permitted Sanli to testify. The court emphasized, however, that "hypothetical restaurant evidence is not coming in."

At trial, Sanli testified that Mesdaq lost over $3.3 million in business goodwill as a result of the taking of the Gran Havana—a business Sanli characterized as an "eating and drinking establishment" (as opposed to "a restaurant") that sold "cigars and … non-restaurant items," as well as hot and cold beverages and pre-made food items, such as pastries, sandwiches and salads.

Sanli explained that in reaching his opinion, he attempted to determine the "fair market value" of the business, which he defined as the "highest price on the date of valuation," in light of "all uses of the facility" to which it is "reasonably adaptable"—in essence, the value of a business at Mesdaq's location that engaged in the "highest and best use" of Mesdaq's existing facilities. (This is really stretching—B.)

This familiar terminology that Sanli utilized in his testimony traditionally refers to the measure of constitutionally required "just compensation" for property taken, not the statutorily required value of lost business goodwill.

Sanli relied on the discounted cash flow methodology, projecting Mesdaq's future profits and then discounting those profits to a present value. To project future profits (essentially, projected gross sales minus projected expenses), Sanli first reviewed the existing financial statements for the almost three years the Gran Havana had been in operation, noting that 2003 (annualized) sales were $676,000; 2004 sales were $947,000; and 2005 (annualized) sales were $1,154,000.

Sanli then projected future sales by creating "representative" income statements for years 2005 and 2006. Instead of simply relying on 2005's actual annualized sales of just over $1 million for purposes of valuation, he projected 2005 sales to be $3.1 million. (Not very bright on his part—B.)

Sanli acknowledged that "my projections" were the reason sales jumped from $1 million to $3 million in 2005, "not something Mesdaq did."

Because the Gran Havana was not open for the full year in either 2003 or 2005, Sanli annualized sales for those years based on the partial data that existed. (Not a good idea either. He probably should have broken sales down monthly and then worked the numbers—B.)

Sanli arrived at the 2005 figure by breaking down the potential sales into approximately $1.3 million in projected non-restaurant sales and approximately $1.7 million in projected restaurant sales.

While the non-restaurant sales were tied to Mesdaq's historical sales, Sanli explained the restaurant sales projections were not, but rather were a product of the number of seats that Mesdaq had available multiplied by the median sales per seat in a comparably sized California restaurant: $9,000 in food sales and $2,140 in beverage sales.

As noted, the discounted cash flow methodology relies on the discounted value of future profits, not sales.

Sanli thus further calculated projected future *profits* by subtracting projected future expenses from his sales projections.

Sanli's calculation of future expenses is not challenged on appeal nor is his discount rate, and thus we discuss only his projected sales calculations here, which are contested.

Utilizing a projected growth rate, Sanli next determined that 2006 sales (restaurant and non-restaurant) would grow to $3.25 million, with sales plateauing at that figure for the foreseeable future.

Sanli freely acknowledged the 2005 and 2006 calculations were not grounded in historical data but were based on "what the business would have done with a better use … of its resources," and were obtained by "maximizing sales" at the Gran Havana. (i.e. dream on—B.)

After the Agency objected to Sanli's testimony as to the projected sales, the court held a bench conference at which Sanli explained that he was not valuing the Gran Havana as a hypothetical restaurant, but rather was valuing "the existing operation expanding into selling more food items"; "they have all the equipment they need to do the projections I'm mentioning." Sanli explained, "I took the amount of seats he has available and the number of tables he has available, and I multiplied that by sales you do at a seat" based on "industry statistics on eating and drinking establishments."

At the conclusion of Sanli's testimony, the court denied the Agency's motion to strike the testimony, and later denied the Agency's request for a new trial on the ground that the testimony was based on speculative calculations. (No kidding—B.)

The court recognized that the admission of Sanli's testimony was a "close call" but determined that it was too late to strike the testimony.

The court stated: "I welcome the Court of Appeal to scrutinize this and sort it out rather than have me mess with it again."

Applicable Legal Principles

By statute, the owner of a business on a condemned property is entitled, after establishing certain preconditions, to be compensated for the "loss of goodwill" that results from a taking.

The statute defines "goodwill" as "the benefits that accrue to a business as a result of its location, reputation for dependability, skill or quality, and any other circumstances resulting in probable retention of old or acquisition of new patronage."

The owner is only entitled to an award of goodwill if he or she proves:

The loss is caused by the taking of the property.

The loss cannot reasonably be prevented by a relocation of the business or by taking steps and adopting procedures that a reasonably prudent person would take and adopt in preserving the goodwill.

Compensation for the loss will not be included in payments for moving expenses otherwise mandated by law.

Compensation for the loss will not be duplicated in the compensation otherwise awarded to the owner."

The statute does not provide any guidance as to how the value of lost goodwill should be calculated.

Consequently, the courts have recognized that "there is no single method by which to measure goodwill and that each case must be determined on its own facts and circumstances."

"Nevertheless, the evidence presented to a jury regarding lost goodwill must be such as legitimately establishes value and generally represents the present value of the anticipated profits of the business."

"Goodwill may be measured by the capitalized value of the net income or profits of a business or some similar method of calculating present value of anticipated profits"

In other words, while there are no explicit statutory requirements regarding an expert's use of a particular methodology for valuing lost goodwill, the expert's methodology must provide a fair estimate of *actual* value and cannot be based on "hypothetical" or speculative uses of a condemned business.

The appellate court agreed with the Agency that the trial court abused its discretion in allowing Sanli's testimony regarding the value of goodwill lost by virtue of the taking of the Gran Havana to be presented to the jury.

Under **section 1263.510**, the lost goodwill for which a business owner must be compensated is defined as the intangible "benefits that accrue to a business" as a result of that business's particular characteristics that would enable the business to retain existing customers and acquire new ones.

Under this definition, a legal methodology for valuing lost goodwill in the instant case would include any valid measurement of the future anticipated profits at the Gran Havana.

In addition, "goodwill may be measured by the capitalized value of the net income or profits of a business or by some similar method of calculating the present value of anticipated profits";

Mesdaq's expert, however, did not calculate the value of anticipated profits at the Gran Havana, but rather valued anticipated profits of a different business—a hypothetical business that *could* have existed on the Gran Havana's site had the business owner better utilized the facility, or in Sanli's words, "what Mesdaq's business would have done with a better use … of its resources … ."

Sanli's valuation of an idealized version of what Mesdaq's business should have been turned the principles of **section 1263.510**—a desire to compensate a business owner for the unique attributes of a condemned business—on its head by valuing not the particular characteristics of Mesdaq's business, but those of a better, maximized business.

As Sanli explained, his calculations of "representative" restaurant income for 2005 and 2006 (the basis for the future income stream that would then be discounted to determine present value of anticipated profits) were related to Mesdaq's *actual business* operation only by virtue of the classification of the business as a "restaurant" and by reference to the number of available seats.

Sanli did not determine whether Mesdaq was actually filling all of his seats or how much *Gran Havana* earned per seat, but simply multiplied the per-seat sales of a hypothetical median California restaurant ($9,000 + per seat) by the number of seats Mesdaq had "available."

“Goodwill must, of course, be measured by a method which excludes the value of tangible assets or the normal return on those assets”.

Compounding this methodological error was the fact that, as the trial court ruled and Sanli acknowledged, Mesdaq's business was not actually a “restaurant,” and did not have a liquor license, and thus calculating anticipated profits by reference to sales at restaurants generally, including those with liquor licenses, introduced further speculation into the calculations.

Further calling into question whether Sanli's projections, which provided exponential growth for both cigar sales and restaurant sales at Gran Havana, were realistic was the fact that, as Sanli acknowledged, California law restricts the degree to which smoking and eating activities can be combined within the same facility. (True—B.)

As the goodwill statute does not contemplate compensation for hypothetical or potential as opposed to *actual* goodwill lost, the trial court should not have permitted Sanli to testify to a goodwill value determined by creating a future income stream not tied to Mesdaq's actual business operations.

The 2005 and 2006 restaurant sales used to determine the future income streams to be discounted were based not on expected growth in Mesdaq's historical earnings, but represented anticipated profits from an “imaginative” better use of Mesdaq's existing facility.

The trial court should exclude “imaginative claims” of experts in eminent domain proceedings because “a condemnation trial is a sober inquiry into values, designed to strike a just balance between the economic interests of the public and those of the landowner”.)

Consequently, Sanli was permitted to use (and did use) a growth rate to calculate the Gran Havana's anticipated revenues as those revenues increased in future years.

The error in Sanli's calculations was not the use of a growth rate, but rather Sanli's application of that growth rate to the revenues of a *hypothetical* business rather than the revenues of the *actual* business being valued.

In sum, Sanli approached the valuation of Mesdaq's business “as a laboratory exercise rather than as an empirical measure of what actually existed.”

Thus, since not based upon a quantified and verified comparison “of patronage-related benefits accruing to the business, the expert's testimony about the value of loss of goodwill did not meet the statutory requirements for admissibility as an expert opinion”. (I'll bet Sanli was pretty convincing in court—B.)

Consequently, the jury's award of lost goodwill, which adopted Sanli's erroneous calculation of value, must be reversed.

We Reverse the Trial Court's Award of Litigation Expenses Without Regard to the Agency's Contentions on Appeal

The Agency argues the trial court abused its discretion in awarding $1,230,714.14 in attorney fees to Mesdaq under **section 1250.410, subdivision (b)**, which authorizes a trial court to award “litigation expenses” to the defendant in an eminent domain proceeding if it determines that the final pretrial “offer of the plaintiff was unreasonable and that the demand of the defendant was reasonable viewed in the light of the evidence admitted and the compensation awarded in the proceeding.”

As the factors that the trial court was required to rely on, and did rely on, under **section 1250.410** in making its determination were derived from a jury award that we now reverse, we accordingly reverse the trial court's award of litigation expenses, regardless of the merits of the Agency's contention on appeal.

We do so without prejudice to any subsequent ruling by the trial court on litigation expenses after further proceedings on remand.

MESDAQ'S APPEAL

On appeal, Mesdaq challenges the trial court's ruling that the Agency had the legal authority to take his property.
Specifically, Mesdaq argues the court erred by:
failing to apply the appropriate standard of review in evaluating whether the Agency's action in taking his property constituted a "gross abuse" of the Agency's discretion;
concluding that the Agency's action did not constitute a gross abuse of discretion; and
limiting the evidence that he was permitted to introduce in challenging the Agency's actions.

During the litigation, Mesdaq entered into a stipulation that, in the event the Agency was successful in taking his property, Mesdaq's mortgage lender, First National Bank (FNB), would receive payment of the balance of its loan out of the proceeds of the compensation award.

On August 4, 2005, seven months after the trial court rejected Mesdaq's challenges to the Agency's right to take his property, FNB filed an application for withdrawal of $1,194,555.60 of the Agency's probable compensation deposit, a sum which "represented the outstanding principal balance, interest balance, attorney's fees and costs due and owing by Mesdaq to FNB."

The application noted the stipulation between Mesdaq and FNB, and that Mesdaq had defaulted on a recent loan payment.

Mesdaq filed a response to FNB's request, stating that there was "no legal basis" for the request and that it violated the deed of trust on the property and the stipulation, which "both provide that FNB is not entitled to withdraw funds unless the case is settled or goes to judgment.

Nevertheless, Mesdaq asserted in his pleading that he was "not objecting to the withdrawal of the outstanding mortgage amount plus interest" to pay off his loan.

Mesdaq did object to $19,590.76 of FNB's request—the portion designated to pay FNB's attorney fees.

In light of Mesdaq's consent to the bulk of FNB's request, the trial court subsequently authorized FNB to remove $1,174,964.90 from the Agency's deposit—the amount of FNB's request minus the amount objected to by Mesdaq. FNB subsequently withdrew the authorized sum.

Mesdaq appended the deed of trust to his filing, which states that if "any award is made or settlement entered into in any condemnation proceedings affecting" the property, FNB is entitled to apply the "award or settlement" to its indebtedness.

By Consenting to the Withdrawal of the Funds Deposited for His Property to Pay Off His Indebtedness, Mesdaq Forfeited Any Further Right to Object to the Taking

By statute, “if any portion of the money deposited pursuant to” an eminent domain action “is withdrawn, the receipt of any such money shall constitute a waiver by operation of law of all claims and defenses in favor of the persons receiving such payment except a claim for greater compensation.”

As it is undisputed that a challenge to an agency's right to take property is not “a claim for greater compensation,” it necessarily follows that Mesdaq has waived the claims raised in his appeal.

DISPOSITION

The appellate court reversed the trial court’s judgment, and the case was remanded to the superior court for further proceedings consistent with this opinion. The parties are to bear their own costs on appeal.

Nares, Acting P. J., and McDonald, J., concurred.

Moral of the Story

The issues of eminent domain and resulting condemnation actions have been a point of contention nationally. What really is for the “public good?” In a rising market, it’s really difficult to determine what a property is really worth. The faster the Agency can take the property, the more money they will save in the process. And the more money the new redeveloped property will be worth after completion.

Subprime Loans

Subprime and Pick-A-Payment Option ARM loans are responsible for bankrupting many lenders in the United States, wiping out hedge funds, costing thousands of jobs, and causing millions of foreclosures. They are also responsible for massive volatility in the stock market and real estate markets at home and around the world. Losses are estimated in the billions of dollars (that's billion with a "b").

The real estate boom was fueled by historically low interest rates. The Federal Reserve (Fed) started lowering interest rates after the "Dot Com" downturn in 2001. The separation between the interests of Wall Street and the U.S. consumer may have been at odds and Wall Street won the battle. Remember, always follow the money. It is interesting to note that when the private Federal Reserve Bank was established in 1913 (along the lines of the German Central Bank), concerns that Wall Street would be more influential than the U.S. public's well being became apparent at that time. Now close to a century later, this same concern has manifested itself in the actions of the Fed's former chairman, Alan Greenspan. Greenspan seemed to cater to the wishes of Wall Street over the U.S. public's well being.

As short term interest rates decreased from 2001 to 2004, due to reductions in the Federal Funds Rate (the rate banks charge each other for short term loans), traditionally bond yields have followed. This did not occur during this period. Bond traders who traded in ten (10) year treasury bonds (which are considered the benchmark for real estate interest rates) did not follow the Fed's lead. They kept long-term fixed rate loans at the same level during the Fed's unprecedented sixteen (16) increases in the Federal Funds Rate from 2001 to 2004.

As the Federal Funds Rate increased over this period, interest paid by banks on cash deposits increased (certificates of deposit or CD's and money market accounts). In fact, the yield for long-term deposits is usually higher than short-term deposits. In this instance however, the yield curve for long-term and short-term deposits became inverted and short-term interest rates were higher than long-term interest rates. In the past this has indicated that a recession was looming. For this reason, lenders thought that interest rates would decrease in the future and they did not want to lock-in a long-term interest rate that was likely to go down in the future.

With long-term interest rates remaining at fairly low levels, lenders were in a quandary regarding how to increase their yields on real estate loans. Instituting fixed rate loans when rates were projected to stay low, had no upside for lenders. About this time hedge funds got into the business of lending. Looking for better returns than they were getting in the stock market, they looked at Collateralized Debt Obligations. In the past these were called Mortgage-Backed Securities and were debt instruments that were collateralized by loans. If there was a default, the lender could look to the loan and its underlying collateral (the house) to recoup their investment upon default. Normal default risk showed a less than 1% default rate on most real estate loans, so hedge funds saw a way to obtain above average returns.

What the hedge fund managers did not understand was that lenders are conservative by nature. Hedge funds by definition are for risky investments that provide above-average returns. In fact, U.S. investors who are allowed to invest in hedge funds must be high net worth individuals or investment funds who understand the risks and can handle the losses that may occur. This is not the case in other countries around the world.

Real estate lenders have learned over the years that real estate markets are cyclical (go up and down) over time. They have also learned that loan-to-value is a lender's first line of defense against loan default. Hedge funds set underwriting guidelines that allowed borrowers to finance their home with 100% financing (usually a first loan coupled with a second loan) and stated income (make up whatever income you need to qualify for the loan), with low FICO scores—and qualifying the borrower on the initial teaser rate that is much lower than the fully-indexed payment that would show up about two years after the loan was made. Borrowers thought they could refinance the loan at the end of two years and get another loan. Lenders thought they would obtain another refinance with up to three points of yield spread or rebate money on top of their normal loan fees when the loan adjusted two or so years later. The hedge fund underwriters thought they could move borrowers from low interest fixed rate loans to adjustable loans, thereby placing the market risk in rising interest rates on the borrower and not the lender. To entice borrowers to go into an adjustable rate loan instead of a fixed rate, they offered negative amortization payments as a means for borrowers to borrower more money than they could really afford. This artificially drove housing prices up.

A negative amortization payment is so low that the borrower is not only not reducing any of the principal balance of the loan that is due, but he is not paying all of the interest that is due. The interest that is not paid is called "deferred interest" and must be paid sometime in the future. As the borrower continues to make the negative amortization payment (lowest) of the four that are available in an option ARM (also called a pick-a-payment loan), he continues to accrue deferred interest. At a point in time (usually around two years) the loan must be recast and the borrower's loan payment (usually) converts to an interest only payment. This may increase his payment from $300 to as high as $1,000 or more per month. Most homeowners cannot afford this increase and end up losing their homes to foreclosure.

In addition, the adjustable nature of the ARM (adjustable rate mortgage) may increase the homeowner's payment also. Most ARMs are tied to an index that measures the cost of money. There are many indexes that vary somewhat in how fast they move up and down, however, they all measure the cost of money in relation to its supply and demand. When the Federal Reserve decreases the Federal Funds Rate, they usually impact the cost of money and have an affect on these indices. A decrease in the indices will generally cause a reduction in adjustable rate loan interest payments and correspondingly decrease loan payments made by lenders.

There was so much demand for high-risk and high return subprime loans that lenders originating these loans could not keep up with the demand from hedge funds on Wall Street. And that's what caused this mess.

The one thing that I have learned over the years is that MARKET TIMING is the most critical thing that affects the success or failure of a real estate investment. And yes, your home is an investment. Most people think of their home as their home—and it is. However, it is also an investment. It is probably the biggest investment you will make in your lifetime and you need to make sure to buy as near to the bottom of the market as possible, and sell as close to the top as possible (not the other way around).

The largest road to wealth in the US is by home ownership. In fact, around 97% of the millionaires and multi-millionaires I have met over the years did it with real estate—not the stock market. The reason is leverage. With real estate you can utilize leverage to provide incredible returns on your investment (if you do it when the market is going up).

For example, you purchase a home for $100,000 (okay, in some markets that will only buy you a dog house) and pay all cash to purchase the property. If the property goes up to $200,000 in value within two years, you have a $100,000 increase in value (called appreciation, because I always appreciate it!) and that's a 100% return on your investment ($100,000 invested and $100,000 return = 100% return on investment in two years (not bad). However, if you had placed $20,000 as down payment and financed the remaining $80,000, you would have had a $100,000 increase in value for a $20,000 investment—and that's a 500% return on your money. That's called leverage (and I like that even better). With 100% financing your return would be infinite--$100,000 increase with no investment!!!

Leverage works when the market is going up. This is called a seller's market because the sellers are in an advantageous position because there are more buyers coming into the market than the number of sellers who wish to sell their properties. Leverage doesn't work when the market is going down. This is called a buyers market because (you guessed it) there are more sellers wishing to sell their properties than buyers who are willing to purchase. Real estate markets are generally cyclical—they go up and they go down, shifting from sellers markets to buyers markets.

Many buyers in a seller's market think they are on a "roller coaster to the moon." They think the market will never go down. However, over time real estate markets will generally go up, overheat, then go down. Each high and each low will usually be at a higher price than the last cycle. Real estate has traditionally been a very good inflation hedge. Real estate prices tend to track inflation over time.

Time usually heals, and over the years this has generally been true. You only lose if you sell in a down market. However, make sure you can handle the loan payments. If you have to rent the property out because of unforeseen circumstances, you can do so without a huge negative cash flow.

I like to buy when everyone else is selling and sell when everyone else is buying. This is exactly opposite of the crowds. So when the news media is in the doldrums, that's when I break out the checkbook and go shopping. You either find the deals or you make the deals—and there are lot's of properties to choose from. Inside information is not as critical in a buyer's market (property values going down) because quality properties tend to stay on the market long enough to find them. In a seller's market (property values going up), properties are sold long before they are posted on the multiple listing service (MLS) and good deals are few and far between. It's tough to get a good deal when there are multiple offers on a property—thereby driving prices up and creating a sense of urgency that is not in a buyer's favor.

Tracking the market for single-family homes has become much easier with the advent of the internet. There are several websites devoted to tracking single-family home sales—and most of them are free. They derive income from selling advertising space and selling sales leads to real estate agents and loan officers.

I usually track a market that I am interested in investing in for two to ten years back in time to see where it has been is trending. Based upon where the market is trending, I usually try to invest somewhere near the bottom of the next market "up cycle." This is not always easy to predict. You must look at prevailing wages in the market, median home prices, and affordability of houses in an attempt to determine how far the buyer's market will go down. The louder the news media cries, the more interested I become in buying. As long as you are looking at a long-term hold, if your timing is a little off it won't hurt you. If you are looking to purchase a home to live in, remember, you need a home to live in—so if you're even more off on your timing, as long as you can handle the loan payments you will be able to wait out the market. Historically, time has always healed downturns in the real estate market. If you can wait out the market, you have a good chance of making your money back (and then some) over time.

When I investigate a single-family home market, I look at the intrinsic value of the overall market. What are the properties REALLY worth? In other words, what are the properties worth in relation to the existing local market? I use single-family sales comparables (properties that have recently sold) of similar properties to come up with a value. Then I look at what the property is really worth in relation to the overall real estate market in the local area, state, national, and international levels. Then I look at what it is really worth in relation to other investment vehicles--and I'm not talking about Winnabagos--I'm talking about certificates of deposit, money market, stocks, bonds, gold, etc. If I need a home, then it's pretty clear what my investment vehicle is going to be: a single-family home. However, if I'm looking at investment property, I try to determine whether I can get a better return on my money by putting it in the bank. The answer in recent years has many times been—yes.

In addition to intrinsic value, you should ask yourself why the single-family real estate market may go up in the future? Is the overall area a desirable place to live? How about weather, population increases, and job growth. I always look for a Wal-Mart and a Lowes. If they are in the market, they expect growth. This might be a good place to purchase a home. You also need to look at job sources. What is the predominant industry and is there a risk of it deteriorating in the future? Lumber in the Pacific Northwest and tourism in Hawaii are two industries that could possibly be at risk.

Another risk to market timing is whether investors have been artificially inflating the prices of properties. Speculators can drive prices up (kind of like a pyramid marketing scheme) with no sound basis for the price increases, except finding another investor (called a sucker) to pay more for the property. This occurred in the market around Phoenix, Arizona when investors from Southern California and other places descended upon the area and drove prices above what the local prevailing wages could afford. When the investors left the market, so did home values. In the long run, the market will adjust to a level that is affordable to the local home buyers.

In addition to speculators, lenders themselves are partly to blame for artificially inflating markets on a national basis. Large Wall Street investment firms (hedge funds, pension funds, etc.) purchase pools of mortgages called collateralized debt obligations. These are securities that are collateralized by mortgage loans in pools of $100 million or more. These Wall Street investment firms (many were hedge funds) set the mortgage underwriting default risk guidelines for these loans. Unfortunately, these guys got a little aggressive (nice word for greedy) and reduced the underwriting criteria for subprime loans. Subprime borrowers have less than exemplary credit scores and generally pay a higher interest rate than stronger "A Paper" borrowers. The demand for these loans (because of their higher interest rates and resulting higher returns) increased to an extent that lenders were making 100% loan-to-value loans to borrowers who could not really afford them. I call them "NINJA" loans: No Income, No Job, No Assets, NO PROBLEM. This led to a high foreclosure rate for subprime loans.

In addition, lenders in the "A Paper" market decided to go to 100% financing, but with a little twist: since the fixed rate lending market had pretty low interest rates and there was no sign of an up-tick in interest rates in the near (or far) future, they really did not want borrowers to purchase or refinance with fixed rate loans—this placed the market risk (interest rates going up) on the lender and not the borrower. Lenders went to "Option ARM" loans. This allowed borrowers to "pick their payment." There were generally four payment options (highest to lowest): 15 year amortized, 30 year amortized, interest-only, and negative amortization.

The highest payment is the 15 year amortized payment. The next highest payment is the 30 year amortized payment, then the interest only payment, and the lowest is the negative amortization payment. Amortization is the systematic liquidation of a debt obligation on an installment basis over a period of time. For example, with a 30 year amortized loan, you will pay the loan off on a monthly basis over thirty years. Therefore, 30 years x 12 months/year = 360 payments. Each of these payments are part principal and part interest. The principal pays off the loan. With each payment, the interest portion goes down and the principal portion goes up. However, its not a linear function you math wizards.

Option ARM loans gave lenders several initial advantages. They were adjustable rate loans, so when the cost of money goes up so does your interest rate. This passes the interest rate risk on real estate loans onto the borrower and not the lender. As interest rates go up, your loan interest rate goes up also. In a fixed rate loan, the interest rate is fixed and does not go up or down. With this type of loan, the lender loses interest (opportunity cost) when interest rates increase and you have a fixed rate loan. Generally, in times when interest rates are low (i.e. 5%-6% interest), it is in your best interest to obtain a fixed rate loan. Getting an ARM is not really a very intelligent move for a borrower in this type of market.

The Option ARM enticed borrowers to obtain ARMs and transfer this risk to themselves, instead of the lenders. The lenders also wanted the deferred interest from negative amortization loans. Lenders could "take" this interest on their books, even though they had not received it. It also changed simple interest loans to compound interest by the very nature of the loan. Now you are paying interest on interest and principal, instead of only on principal. In a negative amortization loan you did not pay any principal reduction, and in fact you did not pay all the interest that was due. So this interest that you didn't pay (called "deferred" interest) added to the loan balance and the loan went up and not down (how much were you drinking when you signed that one?) This works well in an appreciating market that is going up; however, it is disastrous in a declining market. In a depreciating market, the loan is going up and the property value is going down. When they cross the homeowner will become "upside down" and the loan is now worth more than the value of the home.

Lenders enticed borrowers to accept ARMS with deferred interest. Lenders were then able to borrower against this deferred interest using it as collateral. Talk about a house of cards!!! On top of all this, the lenders paid mortgage brokers three (3) yield spread points on the back end of the loan to make these types of loans. What this means is that if you obtained a $400,000 loan, the mortgage broker who originated your loan was paid $12,000 by the lender (on top of what you paid them in origination fees) to make your loan. With this kind of enticement its no wonder the only loan mortgage brokers were selling from approximately 2001 through 2006 was Option ARMs.

The hedge funds that started this whole thing issued some really exotic debt instruments with all sorts of catchy acronyms such as "SIV" for "Structured Investment Vehicle" and "CDO" for "Collateralized Debt Obligation." These derivatives were well named; however, buyers of these debt instruments could not correctly assess their risk. The CDOs were sold all over the world.

I was in Australia and the top story was an Australian hedge fund losing several million Australian Dollars that had been invested in US subprime mortgages. The editors of the newspaper were so enraged that they told their readers how much money the hedge fund partners had spent on their own homes and the addresses of where they could be found! It is obviously a little more "wild and wooley" in Sydney than in the US.

The bottom line is that the "shadow bankers" who thought up this scheme were making loans to people who couldn't qualify to get a cell phone, yet they could buy a house. The investors in the CDOs were gobbling them up because they offered above average returns on investment. However, the shadow bankers were not really bankers and it showed. They may have been slick with their adjustable rate loans, compound interest, and CDOs; however, they did not learn that loan-to-value ratio is a lender's first line of defense.

Loan-to-value ratio takes the loan and divides it into the sale price or appraised value, whichever is lower. Lender traditionally have been reluctant to make loans above an 80% LTV.

If lenders do loan above the 80% LTV, they usually required private mortgage insurance (called PMI). So, if there is a foreclosure the lender will generally get most of his money back. The borrower and PMI company will be the ones who will take the loss. This concept has worked well for many years. Throughout the 1990's market, lenders adhered to this policy and weathered the downturn in 1997 fairly well.

During that period also, lenders sold some of their loans to Fannie Mae and Freddie Mac who bundled them up, packaged them, and sold them to investors as mortgage-backed securities. The shadow bankers tried to emulate Fannie Mae and Freddie Mac; however, they missed one key area: default risk underwriting guidelines that adequately measure the borrower's risk of default.

To make matters worse, the large banks who loan their own funds (portfolio lenders) were forced to compete with the shadow bankers who were selling their CDOs all over the world. Several of the larger banks and many smaller ones copied the shadow bankers and have felt the sting of these bad loans. Banks were given the choice of either making these high risk loans or going out of the lending business from 2001 until 2006. I remember one very large bank that would not make these types of risky loans. At the time, the financial publications really took pot shots at the CEO for lagging behind the rest of the banks and his stock price suffered because of it. Then, when the market changed from a seller's market to a buyer's market and foreclosures caused many mortgage bankers and banks to go out of business, he is now lauded as a cautious visionary who steered his bank around troubled waters. His stock prices have been very respectable, while his competitors may get listed as penny stocks in the very near future. He definitely got the last laugh.

Enough about what caused it. The main point is that this artificial inflation of prices through favorable financing caused the real estate boom that started in 1997 to extend much longer than it should have. The artificial inflation seen from 2001 through 2005 was caused by financing—especially in lower to middle socio-economic markets where a large number of these risky loans were made. The shadow bankers who started this thing got in early and got out before the market turned downward. They made a lot of money—everyone else was left holding the bag.

Slow and steady price appreciation caused by population growth and economic growth is REAL appreciation and will generally go up and down slowly. This is the type of market that I like to invest in. It is slow and fairly easy to track and you can line up your personal factors to decide if the time is right to purchase real estate.

As a potential home seller or home buyer, you have to look at the market timing and decide if selling or buying a home is the right time in light of your present job situation, marriage, and children. Is buying a home a good idea when looking at your present corporate position? Your willingness to move is one of the key determining factors for corporate promotion; however, the time you are promoted my not coincide with real estate market timing. Relocation packages tend to soften the hurt felt when selling in a buyer's market or buying in a seller's market. In fact, you may end up selling in a buyer's market AND buying in a seller's market (the worst of both worlds).

If your wife and family are firmly entrenched in their present neighborhood and schools, you may have a hard time uprooting them and moving across the country for a new corporate promotion. Remember guys: "A Happy Wife Is A Happy Life!!!" You may be tossed out of the "Corporate Promotability Career Path" and into the "Corporate Holding Career Path" (also called the "Your Days Are Numbered" career path—and that's coming from an old corporate executive like myself).

The one good thing from all of this is that you can time the market around real estate instead of your career. You might actually make more money timing the market that you actually net in your corporate job. Corporate America probably really hates me by now, but I always tell it like it is. . .and this *is* how it is.

You always need to have a place to live. No matter where the market trends, time (usually) always heals. Over time your home will probably go up in value. Of course, inflation may also have something to do with this increase. Over time, real estate values will generally track inflation.

In addition, there will generally be an increase in demand in desirable markets throughout the US. According to supply and demand, as demand goes up and supply stays the same (the San Francisco Bay Area is a good example) prices will generally rise. There is no new land for development, so the housing supply will remain constant and will not increase.

Conversely, when demand goes up and supply goes up, the prices of homes in areas where there are a lot of new homes being built will initially rise because of builder price increases between building phases. Builders will many times increase prices of new homes between building phases. Buyers many times know this and try to get in "early" in a subdivision to get a "good deal."

Another thing that occurs when demand goes up and supply goes up is speculators enter the market and artificially drive prices up. This is best related to the pyramid marketing scheme we mentioned earlier where the buyer is looking for someone else to buy the home after he initially bought it from the builder. That buyer, in turn, looks for another buyer to buy it from him at a higher price than he paid for it, and the scenario goes on. . .until there are no more buyers willing to purchase the home and the last buyer loses. The price is so high that the local homebuyer market (without the speculator's artificially driving prices up) cannot and will not pay the price the last buyer paid for the property. The unfortunate situation is that the last buyer is many times a local homeowner who is looking to purchase a home for his family. He experiences a big downturn in the market as demand plummets and supply increases dramatically.

However, he only loses if he sells. If he can hold on to the property for a long period of time, the home will probably go up in value.

To cause you more problems, if you bought the home with a no down payment Option ARM and made the minimum (negative amortization) payment, within two to three years from buying the home your loan payment will most likely recast (adjustment from the negative amortization to a more normal payment amount). This increase can be several hundreds of dollars per month.

In addition, your loan may adjust because of a movement in the index underlying an adjustable rate loan. This index measures the cost of money and may increase or decrease over time.

If the index increases, you may experience a “double whammy” increase in payments caused by an increase in your payment resulting from the recast and another increase in the payment from the interest rate index adjusting upward.

Suddenly, many homeowners are not able to afford the loan payments on their own homes. Unfortunately, the new payment may be 50% or more of the homeowner’s gross income. When you look at their net income after taxes, almost all of their pay will now go to cover the new loan payment.

Many homeowners look to sell their homes and become renters (riding the market down and hopefully buying again at the bottom); however, they may not be able to sell their home because the value of the home has decreased to well below their existing loan amount.

At this point, they stop making their scheduled loan payments and look to either refinance their loan(s) with another option ARM (kind of like putting a band aid on a band aid) or, if they do not have enough equity to qualify for a loan refinance because of a too high loan-to-value ratio, they will be forced to either modify their loan, complete a short sale of their property or let it go into foreclosure.

Their options are generally as follows:

1. Do nothing. Make the payments no matter how difficult it is. Stick it out until the market comes back around. You need a home and as long as you can afford the payments who cares about how much the home may have declined in value.
2. Obtain a loan modification from the lender with terms that are acceptable to the borrower and lender. You must prove financial hardship and it must be a win-win for both parties, or it won’t work. Most loan modifications will reduce the interest rate, while only a few will reduce the principal balance of the loan.
3. Refinance the loan. May be a problem if the property is upside down (which is generally the case in highly depreciating markets where a lot of new homes were built).
4. Sell the home <u>with</u> equity. If the property still has equity, a normal sale is possible with no damage to the homeowner’s credit rating.
5. Sell the home <u>without</u> equity. If the loan is greater than the value of the home (this is called “upside down”) then the seller’s lender(s) may voluntarily forgive the debt. This is called a “Short Sale.” The homeowner may have one, two, (even) three loans on the property.
6. Foreclosure. This will be by either judicial or non-judicial foreclosure. Non-judicial foreclosure is generally used in states that use deeds of trust as their primary security device for real estate loans (i.e. California). Most judicial foreclosures occur in states where a mortgage is used as the predominant loan security device. Foreclosure is generally accomplished through a trustee’s sale in states that use a deed of trust.
7. Bankruptcy. Chapter 7 (liquidation) and Chapter 13 (restructuring) filings are many times used to stop the foreclosure of a home. However, when you come out of foreclosure (or if the bankruptcy trustee decides to move you out earlier than you planned) then you generally go right back to the place where you were (in the foreclosure process) prior to filing for bankruptcy. Your lender(s) may also ask the federal bankruptcy court for a “Request For Relief From Stay” that will effectively remove your home from bankruptcy protection and allow the lender(s) to foreclose.

As mentioned earlier, the Phoenix market appreciated when investors from Southern California came over to Arizona and purchased (speculative) homes in the hopes of easy profits. There were literally “bus loads” of investors coming in from California buying Phoenix Area homes and driving home prices up. These speculators drove home prices up, and subsequent loan payment levels were now well above what local residents could comfortably afford.

However, when a hot market cools (changes from a seller’s market to a buyer’s market) these highly volatile markets have the highest deprecation rates (reduction in value) of all the markets in the US. Their foreclosure rates are usually among the highest in the nation when market trends move from a seller's market to a buyer's market.

For this reason, market timing is the most critical ingredient to success in buying or selling real estate. More fortunes are made--and lost-- because of market timing. You must know when to move and when not to. I always like to do everything exactly opposite of the crowds. When everyone is selling—I'm buying. I'm looking for great deals in light of the intrinsic value of properties, or I'm making my own great deals on over-priced properties.

Conversely, when everyone is buying—I'm selling. I'm looking to get the most return from the property and then move the money into a "down" market if possible. I'm always buying when everyone else is selling and selling when everyone else is buying. Just listen to the news media and do exactly opposite of what they suggest.

Most real estate agents will agree that FINANCING DRIVES DEALS. Almost all real estate purchases use financing to leverage a transaction. For this reason, the loan is usually the determining factor in whether a transaction is completed and the broker receives a commission.

To fully understand the lending process, you must understand WHY loans are originated. Borrowers may be a first-time home purchaser, refinancing their existing home, or an ultra-sophisticated commercial investor. Each has similar lending requirements; however, all have different reasons for wanting a loan.

A first time home purchaser wants a home for his family. Obtaining a loan is the only way he is going to purchase his family's first home.

A refinancing home owner usually wants to reduce the interest rate on her existing loan. She pays off her existing loan and obtains a new loan at a lower interest rate.

An ultra-sophisticated commercial investor is usually looking for a return on her investment. She is not interested in a home or a roof over her head, she wants to purchase an asset that will return a specific amount over a holding period.

The first-time home purchaser and refinancing home owner are the most prevalent types of borrowers in the marketplace and will be discussed at length in this section. Investors are discussed later.

Nuts & Bolts

Why is someone willing to loan money to a borrower? What type of guarantee does a lender have that he will be paid back by the borrower, including interest?

A lender requires *collateral* for a loan. This is something a borrower places with a lender as a guarantee for repayment of a loan. Since it is very difficult for a new home buyer to place (for example) $160,000 cash as collateral for a $160,000 loan, lenders have allowed borrowers to place the home itself as security for a loan (collateral).

Placing a home as security for repayment of a loan is called hypothecation and comes in two forms: mortgage and deed of trust (also called trust deed).

Both mortgages and deeds of trust hypothecate a piece of real property as security for a loan. However, deeds of trust are used almost exclusively in California. If a borrower does not repay the loan (with interest), then the lender will foreclose the property and sell it to repay the debt.

An appraisal is generally required by a lender when a property is purchased, and this appraisal is important because it assures the lender that the property is actually worth the loan amount. Otherwise, a lender will lose the difference between the value of the home and the loan amount.

A borrower is usually required to pay a part of the purchase price known as the *down payment*.

For example,

$200,000 purchase price of home (sales price)
$40,000 down payment (20% of purchase price)
$160,000 loan

If the down payment is substantial (20% of more of the purchase price or appraised value, whichever is lower), then the lender may feel somewhat secure that the borrower will make every attempt to make the loan interest payments and not lose their initial $40,000 down payment. In other words, the borrower has enough money at stake so he will not walk away from the debt obligation.

As the down payment decreases to less than 20%, the lender will become very nervous and worried that the borrower does not have enough money at stake to prevent him from walking away from the obligation. The borrower may stop making interest payments and allow the lender to foreclose the loan.

Private Mortgage Insurance (PMI) companies have stepped in to help lenders with this problem. PMI insures a lender for the amount of the loan over 80%. For example:

$200,000	Purchase/sale price
$10,000	Down payment (5%)
$190,000	Loan

This is a 95% loan-to-value (LTV) loan. A lender is usually comfortable with a 80% LTV loan. The PMI company insures the 15% down payment (as well as the entire loan amount) the borrower did not make toward the purchase price.

Therefore,

	(80% LTV)	$160,000	Lender assumes the risk of borrower default, unless PMI covers this also.
	(15%LTV)	$ 30,000	PMI company assumes the risk of borrower default.
	(95%LTV)	$190,000	Total loan made toward purchase of property.
Plus	(5% down)	$ 10,000	Down payment
TOTAL		$200,000	Purchase/Sale price of property

A promissory note is secured by a deed of trust.

Promissory Note = Evidence of the loan

secured by

Deed of Trust = Collateral for the lender

A first deed of trust has been recorded first and usually has priority over other subsequently recorded deeds of trust and liens. However, there are three exceptions: mechanic’s liens, taxes, and subordinated loans.

A deed of trust is comprised of
Trustor (Borrower/Buyer)
Trustee (3rd party who holds legal title to the property
Beneficiary (Lender)

The deed of trust is "in favor of" either:

a. lender if a new loan is instituted**,** or
b. seller if the seller extends credit and carries a loan on the property

A formal assumption of an existing deed of trust makes a buyer personally liable for repayment of a loan. The buyer becomes the trustor and the seller (former trustor) is removed from liability for repayment of the loan.

In the past, some FHA loans instituted prior to 1986 (and some up to 1989) have allowed buyers to take over a loan *Subject To* (also called a simple assumption). Subject To allows a buyer to purchase a property without loan qualification and the seller remains primarily liable for repayment of the loan for five years after the property is sold!!!

Subject To assumptions were initially designed to help distressed homeowners sell their properties quickly with minimal costs (usually only $25). However, investors saw a way to make a quick profit and many times did not disclose to a seller that she was personally liable for repayment of the loan for five years after the sale. Many homeowners sold their properties and did not know they were still liable for the loan on their old property!

Today, FHA loans instituted after 1989 are not assumable under a Subject To assumption. They may be assumable as a formal assumption, which releases a seller from liability. However, some investors may try to assume them "Subject To" anyway. HUD must enforce the due-on-sale clause, not the lender.

Loan Payments

Loan payments are the monthly principal and interest (P & I) payment. Property taxes, homeowner's insurance, private mortgage insurance (PMI), and homeowner association dues, are NOT included in the amount. A good financial calculator like the Calculated Industries Qualifier Plus IIx can be used to perform amortization calculations.

If a second deed of trust has been recorded second, it is in second position to a recorded first deed of trust. If a foreclosure occurs, the holder of the first (1^{st}) trust deed is generally paid first and the holder of the second (2^{nd}) trust deed is paid second.

Foreclosure

If a trustor (borrower) stops making payments on a loan (evidenced by a promissory note), the beneficiary (lender) must institute a foreclosure proceeding against the trustor. This procedure can be either judicial or non-judicial. Judicial foreclosure allows a deficiency judgment and a redemption period for the borrower. However, most foreclosures in California are by non-judicial *trustee's sale*. A trustee's sale has no deficiency judgment and no redemption period.

Trustee's Sale

Trustee's sale example:

$150,000	Original sales price of the property
$100,000	Loan secured by a 1st deed of trust on the property
$ 30,000	Loan secured by a 2nd deed of trust on the property
$ 20,000	Cash down (by buyer)

If the property value DECREASES to $100,000 and the trustor stops making loan payments, then the beneficiary (lender) on the 1st TD will institute a foreclosure action and direct the trustee to initiate a trustee's sale. The trustee records a Notice of Default and (approximately) three (3) months and twentyk-one (21) days later a trustee's sale occurs on the property.

If no other bids (that are more than the loan amount) are received at the trustee's sale, the beneficiary receives the property and places it in his portfolio of "Real Estate Owned" properties called REO's. The lender then attempts to sell the property and recoup as much of the original $100,000 loan as possible.

The beneficiary (lender) of the 2nd TD will lose all of her money loaned to the trustor (buyer). The 2nd TD beneficiary may assume the 1st TD and take over the property, thereby attempting to recoup the $30,000 2nd TD loan in the future, when the property increases in value. The trustor (buyer) will lose his $20,000 cash down payment in either case.

If a lender agrees to accept less than the loan amount prior to a trustee's sale, it is called a short sale and will affect a seller's credit similar to a foreclosure. In a declining market, short sales are usually very common.

Maximum Interest

Fixed rate loans have interest rates that remain fixed during the life of a loan.

Amortization

Amortization is the systematic liquidation of a financial obligation over a period of time. Long-term thirty (30) year and fifteen (15) year installment loans are usually amortized over these periods.

Adjustable Rate Loan

Loans that adjust their interest rates to a predetermined index are called adjustable rate loans (ARM's) or variable rate loans. ARM's allow a lender to minimize interest rate risk because, as market interest rates increase, so do the interest rates. Of course, decreases in interest rates cause a reduction in interest paid to a lender and are an inherent risk to lenders.

An example is a $100,000 loan with a 4% interest rate in the first 6 months of the loan. This is called a *teaser rate.* This low rate does not last long and "teases" the borrower with its low initial rate.

After 6 months the loan "kicks in" to a *fully indexed note rate* of 2% over the Cost of Funds, Cost of Savings Index, London Interbank Offered Rate (LIBOR), or various treasury indexes. This increase in loan interest payment is called *rate shock.*

A borrower may also experience *negative amortization*. The interest portion of the loan payment is so small that it does NOT cover the interest due to the lender. Consequently, the principal balance of the loan INCREASES during the life of the loan (no kidding).

Maximum Movement

Maximum movement is the maximum interest rate increase or decrease over a given period of time. Maximum rate increase is also called a *rate cap* or *rate ceiling*. A maximum rate decrease is called a *rate floor*.

An example is a 7% fully-indexed note rate. Maximum movement is 2% per year, with a *lifetime cap* of 13%. This adjustable rate loan can increase 6% from its initial fully-indexed rate.

Balloon Payment

When a final loan payment is significantly larger than previous installment payments, this is called a *balloon payment*.

Many adjustable rate loans (as well as some fixed rate loans) have a balloon payment due some time in the future. An example is a $100,000 loan at a 7% fully-indexed note rate, amortized over 25 years, due in 10 years. The loan is due in 10 years and this is the balloon payment date.

Interest only loans by definition have a balloon payment at the end of the loan period. Many second (2^{nd}) trust deeds have interest only payments with a balloon payment due at the end of the loan period, usually no more than five (5) years from the origination date.

Buydown

A seller or real estate builder/developer may subsidize a buyer's loan payments with a *buydown* program.

A common buydown program is a “2-1 buydown.” It results in 2% of the buyer's interest rate payment being paid by the seller or developer in the first year of the loan.

Example: $100,000 loan @ 8.5% market note rate, 30 year amortization schedule, principal and interest payment is $768.91/month.

Year One: The seller/developer pays 2% of the buyer's interest payment.
8.5% - 2% seller/developer buy down = 6.5% paid by the buyer = $632.07.

The seller/developer pays the difference between $768.91 and $632.07 = $136.84/month. Therefore, 136.84/month x 12 months =$1,642.08 total paid by seller/developer for year one.

Year Two: The seller/developer pays 1% of the buyer's interest payment.
8.5% - 1% seller/developer buy down = 7.5% paid by the buyer = $699.21 (not taking into account principal reduction in years one and two).

The seller/developer pays the difference between $768.91 and $699.21 = $69.70/month. Therefore, $69.70 x 12 months = $836.40 total paid by seller/developer for year two.

Seller/developer's total contribution is:
$1,642.08 + 836.40 = $2,478.48

A total of $2,478.48 will be placed in an escrow account. Each month the appropriate amount will be taken from the escrow account and added to the buyer’s payments. This allows the buyer to qualify for a more expensive home and subsequent loan, since the lender may allow the borrower to qualify at the buydown rate of 6.5%. It depends upon the lender and their qualifying criteria at the time of the loan application. It is assumed that the homebuyer's income will increase over the first three years of the loan.

Buyer To Pay Loan Fees/Points Not To Exceed. . .

Conventional loans generally allow a buyer to pay all or part of the loan fees and points charged in making a loan. Government loans, specifically FHA insured and VA guaranteed loans stipulate *certain loan fees that CANNOT be paid by the buyer.* These fees are called non-allowable closing costs and may total more than $950 or more!!!

Fees the buyer CANNOT pay:

FHA	**VA**
Document Preparation Fees	Document Preparation Fees
Administration Fees	Administration Fees
Tax Service Fees	Tax Service Fees
County Transfer Tax	County Transfer Tax
Wire Transfer Fee	Wire Transfer Fee
Notary Fee	Notary Fee
Flood Certification	Escrow Fee
	City Transfer Tax
	Termite Report
	Termite Clearance
	Termite Work
	Sales Commission

Loan fees typically encompass *loan origination, document processing, administration fees, wire transfer fees, notary fees,* and *recording fees* (for grant deeds and trust deeds), as well as several other stipulated fees.

Loan Origination

A loan origination fee is usually approximately one percent (1%) of the loan amount (varies considerably). This is the commission or fee paid to a loan originator, who is usually a mortgage banker, mortgage broker, or institutional lender.

A Mortgage Banker is an entity that provides his own funds in making real estate loans. Mortgage Bankers sell originated loans on the Secondary Mortgage Market through entities such as Fannie Mae, Freddie Mac, and Ginnie Mae. They are licensed by the Department of Corporations.

A Mortgage Broker is an entity that sells originated loans to mortgage bankers and institutional lenders, that sell them on the Secondary Mortgage Market. Mortgage Brokers do NOT lend their own funds. Mortgage loan brokers are licensed by the California Department of Real Estate.

Institutional lenders are commercial banks, savings banks, and insurance companies who lend their own funds and may or may not sell them on the Secondary Mortgage Market.

Document Preparation and Administration Fees

Document preparation and administration fees are commonly called "garbage fees" because they are thrown in by a lender to increase his yield on a loan. They usually range from $300 to $500 or more.

Processing Fee

A Loan Processing Fee is another garbage fee that is thrown in to increase a lender's yield on a loan. This fee is usually justified by the processing entity to cover costs of processing the loan. Many times a loan officer originating a loan pays for the actual processing from the one percent (1%) loan origination fee. Some lenders charge a “brokerage fee” that doesn’t cover anything. It merely increases the lender’s yield.

Wire Transfer Fees, Notary Fees, and Recording Fees

Wire transfer fees are incurred when a lender wires funds into escrow after all loan documents have been signed and all loan conditions have been satisfied by a buyer. Most lenders wire funds into escrow.

Notary fees are charged by a notary public ("notary") when a buyer and seller sign escrow instructions and all the supporting documents in the escrow closing process. A notary verifies the acknowledgment (signature) of the buyer and seller and requires a photographic identification of each party to the transaction. Costs range from $10 to $50. Most notaries require a thumb print also.

Another Tip To Make Life Simpler

When the buyer and/or seller are scheduled to sign escrow instructions and other documents, remind them to bring their driver's license or photo ID card with them when they come into the escrow office. The escrow officer will not be able to notarize the documents, and thereby close the escrow without a photo ID.

Discount Points

Discount points are also called "points" and are calculated as one percent (1%) of the loan amount. If a borrower would like to decrease the interest rate on a loan, she can pay the lender a certain amount of money at the time of loan origination and decrease (discount) the loan interest rate.

Generally, a borrower will pay one percent (1%) of the loan amount (one discount point) for every one-eighth percent (1/8%) decrease in the loan (note) rate. Amounts vary however, depending upon many variables and risks perceived by the lender.

For example:
8% fixed rate loan, at par (0 points).
Borrower would like a 7.5% fixed rate loan.
Therefore, 1/8% interest rate decrease = 1 point
4/8% = 1/2% rate decrease (8%-7.5%) = 4 points
$100,000 loan x 4 points = $4,000 paid by the borrower to receive a 7.5% fixed rate loan (1/2% loan rate reduction).

Not taking the time-value of money into consideration or tax implications, a borrower's break-even is usually between four and five years. If the borrower plans to keep a property more than four or five years and interest rates are fairly high, he may want to consider paying some amount of discount points and reducing the loan interest rate in his favor. With low interest rates, discount points are not as commonly used as a financing strategy.

Contingency

A contingency is a contract provision that requires a happening of a certain event before a "contract" is binding upon both parties.

Generally, obtaining an earnest money deposit, down payment, and other closing costs are NOT contingencies unless specified in the purchase agreement. Common contingencies include:

- Financing;
- Physical Inspection;
- Appraisal; and
- Tenant estoppel certificates (commercial leased investments only).

A *financing contingency* is best defined as a requirement for a buyer to obtain a loan commitment from a lender before the purchase agreement becomes a binding contract.

A *physical inspection contingency* is best defined as a requirement that a buyer physically inspect and approve a property before the purchase agreement becomes a binding agreement.

An *appraisal contingency* stipulates that a property must appraise for at least the purchase price or the buyer my elect not to remove the contingency and not go forward with the contract.

Tenant Estoppel Certificates are used with leased investments to verify lease terms and amounts represented by a seller. The tenants must sign, under penalty of perjury, that the lease amounts represented by the seller are indeed true and correct.

FHA Financing

The Federal Housing Administration (FHA) is part of the Department of Housing and Urban Development (HUD). FHA insures loans made by approved lenders and does not originate loans.

Since conventional loans may require a twenty percent (20%) or more down payment, not considering private mortgage insurance, FHA has instituted low down payment loan programs with both fixed rate and adjustable rate programs.

FHA loan programs have significantly affected single family loan programs throughout California. Places like the San Francisco Bay Area and parts of Southern California have not been able to use these programs because the prices of homes exceed maximum FHA loan amounts.

FHA is designed to protect the borrower. When a property is appraised by an FHA approved appraiser, it is inspected by him also. The inspection assures the buyer that he is purchasing a home within HUD's minimum construction standards. An appraiser may require a broken window to be repaired, missing window screens to be replaced, and missing closet doors to be installed before FHA will insure the loan. These repairs must be completed prior to loan funding and close of escrow.

Conventional loans usually do not require appraiser-related repairs and do not have a non-allowable closing cost provision. Therefore, for FHA loans to be competitive in today’s lending environment it may be necessary for an FHA buyer to pay a higher purchase price than a conventional buyer—resulting in the same net to a seller.

VA Financing

The Veterans Administration guarantees loans made to qualified veterans. A VA-approved appraiser performs an inspection to determine the condition of a property. The VA issues a Certificate of Reasonable Value (CRV) determining a maximum value for a property. If the maximum value is LESS than the contract price stipulated in the purchase agreement, then the veteran may elect to cancel the purchase agreement and NOT go through with the transaction. VA allows a no down payment type loan for qualified veterans. This allows the veteran to purchase a property with no down payment and no closing costs. The VA does, however, usually charge a funding fee that can normally be financed. A veteran typically will increase the purchase price to cover the many costs he will incur, similar to FHA programs.

All Cash Offers

Buyers using all cash to purchase a property do not require a financing contingency or appraisal contingency because they will not be obtaining a loan on the property. These types of buyers usually require only a physical inspection contingency to complete a transaction.

A seller may require some sort of verification that a buyer does indeed have the funds available. This verification can be provided by a bank officer or bank statements.

Loan Application and Tentative Qualification Letters

A seller may ask a buyer to show some evidence that she has started the loan process. A lender may be required to send a tentative qualification letter to a seller within a certain specified time period (usually 15 days, but this varies). The lender letter usually states, " Based upon unconfirmed information we believe we may be able to make the loan." This letter merely informs the seller that the buyer has started the loan process. The letter is not a loan commitment and explains this very specifically.

If the buyer's lender does not provide a tentative qualification letter, or if the letter does not tentatively qualify the buyer, then the seller may be able to cancel the transaction and terminate the contract and escrow.

Prequalification

Prequalification is generally a term used to describe a buyer who has met with a lender (prior to finding a property to purchase) and the lender has made a preliminary analysis of the buyer's situation; as well as a determination regarding whether a loan can be made and at what price level.

Many buyer's agents require their buyers to be prequalified before they will spend time showing them properties. Buyers must be ready, willing, and (most importantly) able to purchase a parcel of real property.

Remember, loans drive deals. If a buyer is not able to purchase a property, a considerable amount of time will have been wasted with an unqualified prospect.

Generally, if a prospect is not willing to take the time to meet with a lender prior to looking at properties, then the agent should not take the time to work with the prospect.

Seller Financing

Seller financing occurs when a seller provides the financing for a transaction. A buyer may be required to complete a loan application (1003 FNMA/FHLMC Uniform Residential Loan Application), provide a very recent credit report, and supply any other pertinent documentation required in the purchase agreement.

Required seller financing terms may include:

- Request for Notice of Default;
- Request for Notice of Delinquency (must be negotiated in the contract);
- Acceleration Clause;
- Late Charge;
- Title Insurance;
- Tax Service;
- Fire Insurance;
- Written Consent for Assignment; and
- Social Security or Tax Payer ID Numbers.

Loan Assumptions

When a buyer assumes or takes over an existing conventional or government loan it is called a *loan assumption*. A seller usually has a specified period of time to give a buyer copies of:

- existing promissory notes (evidence of the debt obligation);
- trust deeds (that secure the note(s) with the property);
- loan balances;
- interest rates (for adjustable rate loans); and
- existing principal and interest (p+i) payments.

Any difference between estimated and actual loan balances can be paid by a buyer or seller with cash, seller-carry financing, or other equitable means (boats, cars, airplanes, etc.)

If there are existing impound accounts, they can be either assigned to a buyer or debited/credited to a buyer or seller as appropriate.

An *Impound Account* occurs when a lender collects property taxes and homeowner’s insurance payments each month and pays property tax bills and homeowner’s insurance as they become due.

Since property taxes are due in two installments (1st installment due Nov. 1st and delinquent December 10th; the 2nd installment is due Feb. 1st and delinquent April 10th) the lender usually pays them before they become delinquent.

Homeowner’s insurance is generally paid once each year. A lender collects a monthly amount that is calculated to pay the total insurance amount at the beginning of each year.

Many times FHA-approved lenders collect up to fourteen (14) months insurance up-front at close of escrow in addition to the collected monthly impound amounts. They may also collect up to six (6) months property taxes in addition to the collected monthly impound amounts. For these reasons, the impound account may contain much more money in it than what is required to pay the taxes and insurance.

A homeowner can write a letter at the end of the year requesting that the additional funds in the impound account be returned to her. The lender is required by law to return excess amounts in the impound account anyway, without requiring a letter from the borrower. The lender or servicing company collecting the impound funds usually receives interest on the funds.

For example, a lender or servicing company collecting property taxes and homeowner's insurance, in addition to a loan payment of principal and interest, may realize the following scenario:

$750/month	principal and interest
$ 50/month	property taxes (approximately 1 to 1.15% of the property sale price).
$ 30/month	homeowner's insurance (usually fire and homeowner's liability)
$830/month	total collected (PITI)

Another Tip To Make Life Simpler. . .

If a loan is having property taxes and homeowner's insurance impounded each month and a borrower would like to make additional principal payments to reduce the loan amount, the borrower should write a SEPARATE CHECK and mark on the check, "PRINCIPAL ONLY." This will prevent the lender from placing the extra funds into the impound account.

Secondary Mortgage Market

Many years ago, lenders made a loan and then held it until it was paid off by a borrower. For example:

1. Lender Smith has $1,000,000 cash in his local bank.
2. He takes the money out of the bank and makes five loans, each loan totally $200,000.
3. Lender Smith collects initial loan origination fees (and other loan fees), as well as interest throughout the duration of the loans; until they are paid off (sold or refinanced) and the loans retired. This gave cash rich areas an advantage over cash poor areas.

To equally distribute loans throughout the nation, the United States Federal Government instituted the Federal National Mortgage Association (FNMA), also called "Fannie Mae." Today this organization is a private entity that performs a vital function for the U.S. economy. Other similar entities are the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) which is also private. The Government National Mortgage Association (GNMA or Ginnie Mae) is a government agency that takes pools of mortgages originated by FNMA and FHLMC and passes them through as mortgage-backed securities. This gives institutional investors on Wall Street the ability to invest in securities that are collateralized (backed) by existing mortgage loans.

FNMA and FHLMC have instituted a **Secondary Mortgage Market** that purchases bundles of similar mortgage loans and sells them to investors. Since Investor Green (for example) did not originate the five loans, he would like to know how risky these borrowers are, and the probability of their defaulting on the loans.

Fortunately, Lender Smith has received **Underwriting Guidelines** specifying exactly what information Investor Green requires to make a decision to purchase the loans.

Investor Green has $1,000,000 in cash to invest and would like to make as high a return on his money as possible, he requires a return at least equal to the interest rate and default risks of each loan.

Where do loans come from? Let's take a look.

Loan Origination

A person who meets with a borrower and starts the loan process is called a *Loan Officer* or *Loan Originator*. A person who processes all of the resulting paperwork and prepares the loan package for review is called a *Loan Processor***.** The person who reviews the loan package and makes a final lending decision is called a *Loan Underwriter***.**

A Loan Officer and Loan Processor document whether a borrower meets Investor Green's lending requirements. These requirements are called *Underwriting Guidelines*.

Underwriting guidelines are set by investors, such as Investor Green, to insure the loans they purchase on the Secondary Mortgage Market fit their prescribed lending requirements. In other words, they are not higher risk borrowers than their interest rate reflects and their default risk is within specified investment parameters.

Since it requires (theoretically) $1,000,000 to be able to sell loans in the Secondary Mortgage Market, only a small number of large loan originating companies were able to participate. In response to this problem, small lenders have been allowed to participate in the Secondary Mortgage Market through a *Loan Correspondent* program.

For example, Lender Smith has $1,000,000 in cash he uses to make mortgage loans. Lender Smith is located in Dallas, Texas. The lending market in San Francisco shows a strong demand for loans. Therefore, Lender Smith approves Broker Jones to institute loans in San Francisco on his behalf. Broker Jones SELLS these loans to Lender Smith. Broker Jones is called a *Mortgage Broker* and Lender Smith is called a *Mortgage Banker*.

Borrower Allen comes to Broker Jones for a mortgage loan for the purchase of a $200,000 single-family home in San Francisco (if he could find one for this price!). Broker Jones originates Borrower Allen's loan, processes all the documentation required by the underwriter, and sells the loan to Lender Smith.

If all documents are in order and fit underwriting guidelines, Lender Smith purchases and funds the loan. He then pays Broker Jones a predetermined fee called a *commission*.

An advantage of a mortgage banker is their direct funding in the secondary market. They are not required to "sell" their loans. A disadvantage is their limited number of underwriters and private mortgage companies. Since loan underwriting is very subjective, a choice of several underwriters may be a better course for problem borrowers. Also, mortgage bankers many times have a very limited number of private mortgage insurance companies available to them.

An advantage for mortgage brokers is that larger mortgage brokers are usually approved with forty or more lenders (like Lender Smith) who are called *Mortgage Wholesalers*. Mortgage brokers are able to "shop" a loan package until an underwriter is willing to loan the funds needed to complete the transaction. Mortgage brokers can also shop private mortgage insurance companies. A disadvantage of mortgage brokers is that they do not lend their own funds and can go in and out of business rather frequently. This is why mortgage brokers are regulated by the California Department of Real Estate and all mortgage loan brokers must have a real estate license to originate loans in California.

Mortgage bankers and brokers hire individuals to originate loans. They are called *loan officers*. After a loan application has been completed and the necessary loan documentation has been requested from a borrower, the loan is turned over to the loan processor.

A loan processor is not normally licensed by the California Department of Real Estate. This person handles follow-up on all documentation required by the underwriting guidelines (which come from Investor Green).

It is usually thirty (30) to sixty (60) days, depending upon the loan type, from the time the loan officer initially meets with the borrower to when the loan is normally funded. A Loan Processor has control over all of the loan documents used during the loan process and is responsible for compiling required documents into a designated format called a *Loan Package*.

Loan processing is a key element in the loan process. All the required forms must be in the correct sequence for the underwriter to review.

After the loan package has been completed, it is then submitted to an underwriter. This will be an in-house underwriter if it is a mortgage banker. It may be several different underwriters if it is a mortgage broker.

An underwriter examines the loan package and compares it to underwriting guidelines for a particular type of loan. An underwriter also looks at *compensating factors* which include borrower credit rating (FICO scores) and job stability. FICO scores rate a borrower's attitude toward debt. The underwriter makes a determination with the following possible outcomes: acceptance, acceptance with conditions, need more information, or denial.

When a loan underwriter accepts a loan, *loan documents* (called "loan docs") are drawn up by the lender.

Whether a new loan is a purchase or a refinance, loan processing requirements are the same (except a purchase requires a purchase agreement, Real Estate Transfer Disclosure for FHA insured loans, and pest report). The loan officer meets with potential borrowers and completes a Form 1003 Uniform Residential Loan Application.

A loan originator will ask prospective borrowers for the following documents:

- Purpose of loan letter (if a refinance).
- Approval to obtain a credit report and collect the fee for the report.
- Signed Rental History Verification form (if presently renting) to be sent to the landlord.
- Signed Verification of Employment form, sent to present employer(s) to verify employment and length of employment.
- Current pay stubs.
- W-2's for the last two years.
- Federal income tax returns for the last two years.
- Signed Verification of Deposit form for each existing bank account. This will be sent to each bank or financial institution.
- Current bank statements.
- Rental agreements for rental properties and existing home if it will become a rental (existing home, not the home being purchased).
- Purchase agreement for purchases.
- Pest report for purchases.
- Divorce documents (decree), if applicable.

After a loan officer obtains the above information, she may "shop" wholesalers for the best program to fit a borrower's needs. This involves scanning rate sheets and qualifying criteria from several different lenders.

Loan Documents

Loan documents are drawn by a lender after approval by a loan underwriter. Loan documents are then sent to the escrow holder. The escrow holder may be an escrow company, title company, attorney, real estate broker, or bank. Generally, escrow companies handle the escrow in Southern California (Fresno, south to the Mexico border) and title companies handle escrow in Northern California (north of Fresno). An escrow holder prepares the loan documents for signature by the borrower(s). Brokers can handle escrows for their clients and their own transactions; however, this is usually similar to a dermatologist performing brain surgery. . .probably not a good idea even if it is legal.

A borrower signs the loan documents and the escrow holder sends these documents back to the lender. A lender's *Loan Funder* reviews the documents for completeness and, if everything looks okay, sends the loan funds to the escrow holder. The funds are generally sent via wire or check.

If a loan is in conjunction with a purchase, the escrow holder disperses funds per the escrow instructions that were signed by the buyer and seller. These funds are not dispersed until an executed grant deed has been recorded by the county recorder in the county where the real property is located.

If a loan is a refinance of an existing property, the escrow holder disperses the funds per the agreement with the lender.

This is an overview of the lending process that is important to real estate transactions. Remember, loans drive deals and lenders drive loans. That is why it is imperative for an agent to refer their clients to a very professional loan officer.

Another important area is to understand the difference between your home and an investment property. You always need a home. So worrying about its value going up or down is pretty silly. As long as you can continue to make the required debt service payments (principal, interest, property taxes, and insurance, called PITI) who cares what your home is worth? Since real estate has traditionally been the best inflation hedge, it will usually track inflation and (at the worst) still go up in value over time.

So, is your home a good investment vehicle? I think it is marginal at best. You keep a lot of equity in your home that is not providing a return to you. You can't move that equity from one hot market to another to protect your capital. It will be a victim of the rising and falling real estate market around it. You're stuck with your home in the market you live in. Appreciation is great, but how do you "liberate" all that equity you have amassed in your home? That's right you sell it. But then where do you go? Or better yet, you do a cash-out refinance and "pull" the equity out of the home (like its "free money" and you don't have to pay it back). Then the market goes down, you have an upside down property with a higher debt service than you had before, you spent all the "free money" so its gone, and you can't handle the higher debt service!

For the above reasons, I have found that the best way to capture equity in a market is with rental properties. You have the advantage of being able to buy at the bottom of the market and sell at the top of the market. Not only can you use leverage to purchase these properties, you also get the appreciation in value, and the depreciation over the life of the investment. You can defer any capital gains taxes with a 1031 exchange and let your heirs deal with the problem of what to do with all that money (ha! ha!).

For many years I have heard astute real estate investors say, "The key to success in real estate is location, location, and location." And they are very correct in saying it because a property's location is very difficult to change. Price, terms, and condition can be changed, however, location is usually fixed. Unless the property is a mobile home or you're featured on Mega Mover, you're probably not going to be able to move it once you buy it.

I usually try to purchase the smallest useable property in the best possible location. You will continually be faced with decisions between location, size, and age of a property. There are trade-offs for all three.

If I don't really know an area I am interested in investing in, I will many times search the internet using websites such as www.realtor.com and other MLS accessible websites. I look at the highest priced homes that do not have huge acreage, but standard size lots for the local area (i.e. small in urban areas and large in rural areas). I then take note of the zip codes where these higher-end properties are located. These areas are a good place to start looking for an investment property, and then work your way downward in terms of desirability and corresponding price levels.

It is also a good idea to use the internet to check school ratings in the areas you are considering. I many times find that the schools with the highest ratings are located in the zip codes that correlate to the most expensive homes in the area. Each state has different ways to measure (or not measure) school effectiveness. Some states have tests that measure each school's ability to teach to their standardized test that is given each year. California uses a test called the SCORE report. As a result, each school strives to teach to the test and, thereby increase their school's "score" and resulting standing in the community. The higher the school's test scores the "better" the school. Even though this score may only measure a school's ability to teach to the test, it can be used as a general indicator of the school's perception in the community. Perception is many times reality when looking at home values, and especially resale home values. If the local residents consider a school or school district to be the "best," then it is. It doesn't matter whether it actually is or not. It's as simple as that. Just ask a few residents where the best schools are (especially moms with children in school) and you will quickly have your answers.

For example, Park City, Utah became known worldwide during the Salt Lake City Winter Olympics and has became an international destination location for skiing and snowboarding enthusiasts from all over the world. Park City has three of the top-rated ski resorts in the US, a highly-acclaimed international film festival, an awesome downtown area with world-class dining & night life, and some of the best schools in Utah. Entry level single-family homes start at around $600,000 and go up to well over $10 million. Higher-end custom home lots start at around $3 million and you may have a famous film star, singer, or athlete as your next door neighbor. Therefore, a Park City address has good intrinsic value and is a good location to consider investing.

Homes are better insulated in Park City than in warmer climates (prices too). For example, the local building codes that are enforced by the Summit County building department require 2"x 6" exterior walls with commensurate R21 insulation and thicker exterior sheathing than homes in less rigorous climates. Many of the homes in Park City also have heated driveways that melt the snow in the winter. This is accomplished by running hot water pipes throughout the concrete in the driveway when it is poured. The hot water pipes are hooked up to a thermostat and the whole set up is fairly expensive to operate; however, it precludes the necessity of tedious snow removal during the cold winter months. Very convenient, if you can afford it, and many Park City residents *can* afford it.

Many places have their resident deer or elk herds that locals tout as "their own". They make an appearance and "wow" the tourists. Not in Park City—instead of paltry old deer or elk--they have Moose. One homeowner told me she hadn't seen any moose for months. As soon as her relatives (who live in warmer, less exotic climates) showed up, so did the moose. It was a photo op for her visitors and she didn't bother to tell them she hadn't seen a moose in ages. It was funny because after that, every time rookie visitors showed up from the flat lands--so would the moose. It was almost like they were on the payroll. (Safety Tip of the Day: Be sure to watch moose from a safe distance because they can be <u>very</u> dangerous! Several sled dogs have been killed by moose during the Iditarod sled dog race in Alaska.)

Of course, Oatman, Arizona has its photogenic burros wandering around its streets looking for a hand out of carrots. This is great for tourism. And Kenai, Alaska has it brown bears that have fisherman running around trying to avoid being their next meal, while admiring them at the same time. They both probably beat Park City's moose—but what the heck, a moose is still a pretty cool animal (and dangerous too!).

The Park City market is very international in composition because of the three top ski resorts that are located on the mountains above the town. It is really a quaint little old town that hosts the Sundance Film Festival each winter. It's really an excuse for celebrities to hang out in a really cool place and do some skiing or snowboarding. Many celebrities end up purchasing or building vacation homes in the area. Having a celebrity as a neighbor has its pros and cons. It is good because it drives values up having a celebrity next door. It is bad because of the paparazzi and looky-lous who show up at all times of the day and night trying to get a glimpse of your neighbor. For this reason, some celebrities purchase homes under assumed names to maintain their privacy.

Park City has solid intrinsic value because of its proximity to Salt Lake City and its international airport, great climate for skiing, clean air, small-town feel, cultural activities (film festival and year-round performing arts), world-class dining (with world class prices), excellent schools (probably the best in Utah), and a "Park City" address that has grown to an Aspen or Vail prestige level. Recreational activities abound and help keep the international visitors coming back year after year.

There is a factory outlet mall located between Salt Lake City and Park City. I was in the Nike store and asked the clerk how many languages he had heard spoken this week. He told me he had heard nine different languages spoken just during that week. All the languages were from the European Union (EU) countries. The tourists were obviously taking advantage of the Euro's strength against the US dollar.

In fact, many foreign investors have come into the US and purchased real estate using the Euro's strength against the US dollar. These investors are playing the exchange rate and parking wealth in the US. They believe that the US is a safe place to park wealth. Probably not a bad idea. They got burned on the collateralized debt obligations, so why not try some tangible assets for a change?

In my trips to the EU countries, I have talked with several of the locals each time I have traveled there. It appears to me (only my humble opinion) that the strong EU countries are propping up the weaker ones. I wonder how long this will last. Foreign investors probably do too.

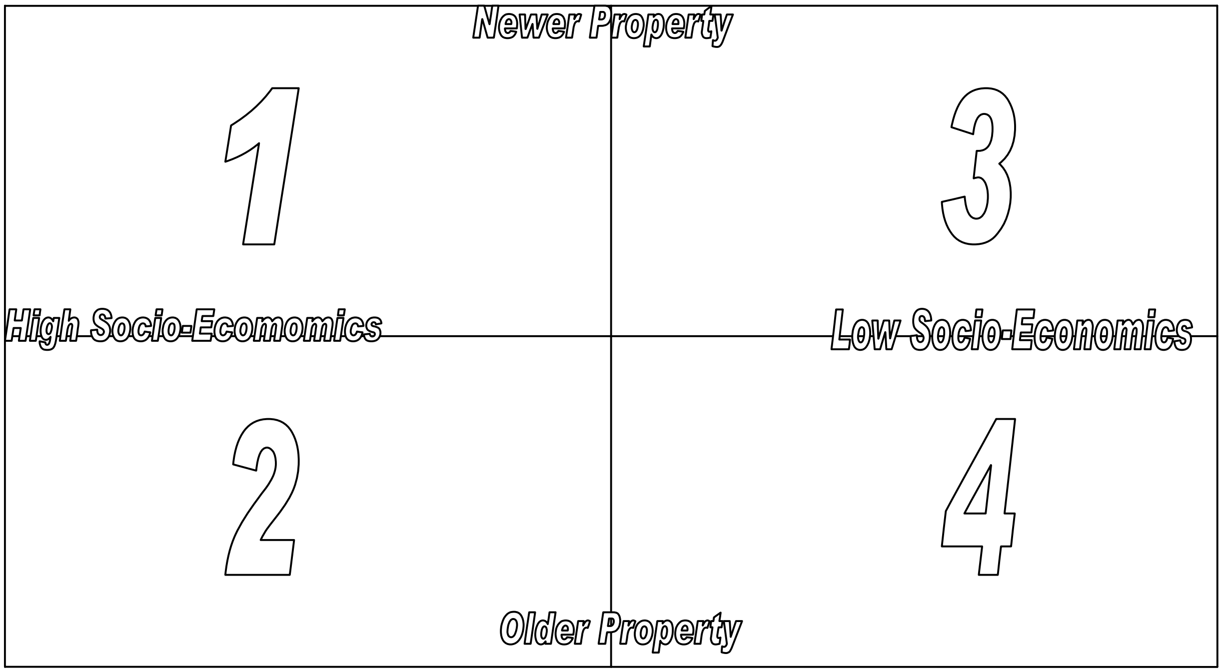
The EU Vat tax (around 19.25%) must be a big drag on their economy. I was told that a lot of black market operations take place that don't pay the VAT tax. Large purchases, that cannot be black marketed as easily must be where most of the taxes are paid.

A favorable Euro vs. US dollar exchange rate is good for our exports. Tourism and foreign real estate investment have benefited from this situation. People are always looking for good deals and a trip to Park City appears to be a good deal for EU tourists.

Back to Park City's great location and intrinsic value. There is a Wal-Mart and Home Depot in Park City. Another of my requirements is a major airport within thirty minutes. Salt Lake International Airport is about thirty minutes west on I-80. Traffic is usually minimal (unless there's a snow storm, then everyone seems to think they're driving a rocket-powered Snowcat) and it's a straight shot to the airport. I-80 is kept open in the winter because it is a major trucking route between the east coast and west coasts of the US.

Two variables that have a huge impact on success is neighborhood socio-economics and age. Please take a look at the following diagram and then we'll take a look at how they divide up into four quadrants:

Figure #1: Four Quadrants of Success



As you can see there are four possible scenarios (quadrants) that you may select for your investment:
Quadrant #1 Higher Socio-Economic Neighborhood/Newer Property
Quadrant #2 Higher Socio-Economic Neighborhood/Older Property
Quadrant #3 Lower Socio-Economic Neighborhood/New Property
Quadrant #4 Lower Socio-Economic Neighborhood/Older Property

Let's talk about each quadrant and how it relates to value.

Newer Property/Higher Socio-Economic Neighborhood

In this investment scenario you are purchasing a newer home in an upscale and usually very expensive neighborhood. This type of property is typically the most expensive of all four quadrants, yet it has the highest potential appreciation (increase in value) as well. The home is fairly new in age (probably five years old or less) and will most likely require less maintenance than other older properties.

In a seller's market, this type of property usually sells for whatever the market will bear (and the market will usually bear a lot). I have seen these types of properties receive multiple offers, all of them over list price.

In a buyer's market, as the market turns downward, these properties tend to experience a lesser percentage loss in value than other quadrants. In other words, they really hold their value well. For this reason, they continue to be in demand during a buyer's market and generally retain their value better than properties in other quadrants. Unfortunately, many home owners tend to hang onto these types of quality properties during a buyer's market, waiting for a seller's market to sell at a much higher price. Occasionally a seller will sell a quality property during a buyer's market and this is when a real plum will come on the market--and give you enough time to find it and buy it.

These types of properties generally have very minimal styling problems (called functional obsolescence for you Mensa candidates). They have large master bedrooms, large walk-in closets, large bathrooms with separate tub and shower, three car or larger garages, large kitchens with island, nook, and large pantry, 9 foot + ceilings, separate formal living room, formal dining room, and family room.

You also find newer schools in these types of neighborhoods. The schools are wired for computer networks and the internet. They also may have newer facilities and more and better school materials and supplies because the socio-economics of the neighborhood. Parent involvement in the local schools (especially at the elementary level) and significant donations to the PTA and directly to the teachers results in a high-quality learning environment.

In these types of neighborhoods the social structure is generally new and undeveloped. There is not an entrenched social structure that may be in evidence in an older neighborhood—where everyone already knows everyone—and you are an "outsider." Since everyone is new, you are on the same social footing as your neighbors..

Older Property/Higher Socio-Economic Neighborhood

In this investment scenario you are purchasing an older property in a higher socio-economic neighborhood. These older properties tend to hold their value well. They generally require more maintenance than newer homes in a higher socio-economic neighborhood and should cost a little less because of it; however, this may not be the case. Many of these homes, because of their established nature and low probability of deteriorating over time, may actually cost *more* than newer properties in a higher socio-economic area. Even though older homes may have some styling issues, be smaller in size than newer homes, and experience on-going maintenance issues, they may actually sell for a considerably *higher* cost per square foot than the newer homes.

These neighborhoods are well established and will probably not see a lot of change in the future. For this reason, they may have an entrenched social structure of neighbors who have known each other for a long time. Being the "new neighbor" may make it difficult to become accepted in the neighborhood social structure.

These neighborhoods typify many areas within the inner circle of concentric growth patterns that have maintained their values. Many owners are older and stay in their homes for many years. They probably started as homeowners with children and have moved to empty nesters.

Homes in these areas are usually good rehabilitation candidates because of the higher socio-economic neighborhood and resulting contribution to value that results from a rehab. Home Depot and Lowes love these type of properties and may locate a store near them because of the amount of business that results from remodeling the homes. Although, really high-end homes may hire professionals to design and install their rehab.

Sometimes you may be better off tearing the home completely down, rather than rehabilitating it. When a homeowner tears down all the walls except for one and rebuilds the home, this is called a "California Remodel." The reason homeowners do a California Remodel is because they are not required to obtain building permits for the work being done.

Newer Property/Lower Socio-Economic Neighborhood

The houses in this area are generally less expensive than newer properties in a higher socio-economic area. However, since the homes are new they will tend to have less maintenance issues. They usually have a slower appreciation rate in a seller's market and faster depreciation rate in a buyer's market than that experienced by newer homes in higher socio-economic areas.

One investment risk for this type of property is the change from owner-occupied to non owner-occupied use over time. Since the properties are usually cheaper than those located in higher socio-economic areas, investors will be able to cover their loan payments and thus derive some cash flow.

In other words, the area may change from owner-occupants to renters. Most of the time, owner-occupants will take care of their properties better than tenants. Tenants don't generally have the pride of ownership that owner-occupants have and may be destructive to the property. A good indication that an area has changed to renters is a large number of cars parked around the property during the evening time and oil spots in the driveway. The number of cars indicates several tenants occupying the home (each possibly renting a room). The oil spots indicate cars that may be in disrepair and may indicate rentals in the area. Also, the front landscaping may not be as well maintained as in higher socio-economic areas. This may be a result of a tenant's do-it-yourself gardening versus an owner's pride of ownership TLC or the use of a professional gardener to keep the yard mowed and maintained.

Older Property/Lower Socio-Economic Neighborhood

An older property in a lower socio-economic neighborhood will experience the slowest appreciation rate in a seller's market and fastest depreciation rate in a buyer's market. In other words, it will go up the slowest rate and down the fastest rate—the worst of both worlds. You have an old property that needs a lot of maintenance and it will not increase in value as fast as properties located in the other three quadrants.

Tenants in older properties and lower socio-economic neighborhoods can be more destructive than tenants in other areas. Oil on the driveway is an indication of tenants (with old cars) living in this type of neighborhood.

In addition to the four quadrants to success, there are several common growth patterns that will help you determine where the path of progress is and when and where to invest in that area.

The Concentric Growth Pattern and the Nodal Growth Pattern are seen throughout the United States and are covered in many real estate textbooks. However, even though the authors usually explain the patterns, they usually don't explain how to possibly profit by them.

I was adjunct associate professor of real estate and marketing at Golden Gate University in San Francisco and taught many undergraduate and graduate-level real estate courses at that fine institution. Literally, all of the textbooks we used in the curriculum were written by my esteemed colleagues who taught real estate all over the country. These guys really do know what they're talking about when it comes to real estate theory. However, they lack experience in the "knock down drag out" world of real estate investment and development.

With over twenty years experience as a real estate broker, investor, and developer I've been able to take the theories taught at the university and apply them to actual situations and real-world opportunities. The difference is that instead of theorizing about where the path of progress is located and when it will develop, I put my money where my mouth is (usually my *foot* where my mouth is) and actually invest hard earned dollars much like being "all in" in a Texas Hold'em poker game (except I don't have the cool sunglasses).

The only difference is that I invest (gamble) only enough to make a significant return for my efforts WITHOUT causing my wife and kids to go hungry (and lose a lifestyle they have become accustomed to) if the investment goes south and loses all of its value.

My litmus test (determining factor) is if I can lose all the money I am investing in the venture and it doesn't change my lifestyle, then the risk of loss (or gain) is in a tolerable range in light of my overall investment objectives. Stock market investors use a similar strategy when they invest in stocks and buy either calls or puts to limit the amount of gains or losses. They don't lose too much and don't gain too much (if that's possible). The range is acceptable whichever direction the market goes.

I use the same principles in real estate investment by not risking too much of my total net worth (total assets minus total liabilities) in any one real estate investment. Of course, when you're getting started in real estate investment *any* property will probably stretch your net worth. However, as you become more experienced and, hopefully more affluent, you can start risking larger portions of your hard-earned money without changing your lifestyle.

Many real estate developers leverage themselves a little too much by over-paying for land at the top-of-the-market. When the market turns from a seller's market to a buyer's market, many developers find themselves with a big problem: how to obtain loans to develop the off-site improvements and build-out the lots. The lender's loan-to-value ratio starts going up as the values of the lots drop.

When a market changes from a seller's market to a buyer's market, many lenders start asking developers for more money (out of their own pocket) before they will extend off-site improvement loans and construction loans. If the developer has deep-enough pockets, he can start building out-of-pocket without having to deal with nervous bankers whose knees start shaking when they hear the words "buyer's market" in the media. As long as the bankers are aware that you have the financial ability to write a check and wipe them out, you will usually be in a strong position to deal with them. If they think they have you, then they probably do.

Recently, a family member had a construction loan that came due on a custom home that he was building. He told the lender that he would like to extend the loan. However, after three months time and no action, the family member informed the lender that if he wasn't going to extend the loan to please let him know exactly how much had been drawn against the construction loan and he would immediately cut him a check for that amount. The lender decided to extend the loan.

There's an old bankers saying, "When you need money you can't get it and when you don't need money you can get all you want." Real estate loans are used for risk management by deep-pocketed developers. Instead of risking all of your money (all your eggs in one basket), why not only risk part of it and borrower the rest from the bank. Sounds like a good idea to me. Let's head back to the two predominant growth patterns: Concentric Growth patterns and Nodal Growth patterns.

A Concentric Growth Pattern is probably the most common growth pattern seen in urban cities. It occurs when the path of progress moves outward in a concentric ring from the Central Business District (CBD).

As the path of progress moves outward from the center, newer more desirable properties will usually be built in the outlying areas. As a result, older properties at or near the Central Business District may become less desirable than these newer properties.

The newer areas located within the outside concentric growth rings may range between New Homes located in Higher Socio-Economic Neighborhoods to New Homes located in Lower Socio-Economic Neighborhoods. Many homeowners elect to sell their homes at or near the CBD and move to the outlying areas. This has given rise to suburban growth and the term "suburbs."

Properties located in the CBD remain in or near the center of the growth pattern and range from older properties in higher socio-economic neighborhoods (those that have maintained their value) to older properties in lower socio-economic neighborhoods (those that have NOT maintained their value). Many times the CBD is comprised of office buildings and retail, as well as some high-density residential condos or apartments.

The other predominant type of growth pattern is the Nodal Growth pattern. A Nodal Growth Pattern has nodes of growth that develop outward from the CBD.

Villages take shape outside the CBD. However, physical geography has an impact on the overall growth that develops. Natural and man-made barriers may have a large impact on where growth develops in an area. Natural barriers may include bays, rivers, mountains, freeways, and major roads.

New Orleans

The French Quarter in New Orleans is located along the banks of the Mississippi River. The homes located in the French Quarter exhibit French influences that have been in existence for many years. Many properties, especially on Bourbon Street and Royal Street, sell for well into seven figures. If you go ten blocks (literally) away from the river, you can find the same size property for $1/10^{th}$ the price. Remember: location, location, and location.

The French Quarter in New Orleans is an international destination location and has been there for a long time because of its location above sea level and good ole Andy Jackson (with a little help from the pirate Jean Laffite). The river is the natural barrier and the areas around and outside of the French Quarter have not maintained their values because they do not have the unique flavor or great location on high ground near the river. Oh by the way, they don't have Mardi Gras, either. Beads anyone?

San Francisco

San Francisco has a system of streets that run in different directions in a seemingly haphazard manner. San Francisco has the ocean on one side and the bay on the other. Growth in the city of San Francisco has occurred in very distinct areas called districts.

The cities that have developed around San Francisco Bay have followed a nodal growth pattern. These cities are generally linked to the City of San Francisco by a system of bridges. However, each outlying city has its own different socio-economics and distinct cultural flavor. Of course, the city of San Francisco has cultural amenities that make it a world-class travel destination.

Rome

Another interesting city is Rome. Rome has the Vatican and has many ruins scattered around the city that give it historical grandeur. The word "travel" came from the word "travail" because it was dangerous to move around in ancient times.

And getting around Rome is still a bit hazardous. As one astute resident pointed out to me, "Traffic lights in Rome are for decoration purposes only." I was trying to cross the street near where Mussolini met his doom during World War II. The traffic light was green in my direction as I tried to use the crosswalk. As I entered the crosswalk, the driver of a car slammed on his brakes and narrowly missed hitting me. I then (cautiously) continued on. At this point a guy on a Vespa motor scooter darted out and almost hit me. I instinctively took a swing at him with my backpack, but missed and spun around in the wrong direction. Finding my bearings, I continued across the street and was almost hit by another driver, who slammed on his brakes, narrowly missing me. This started getting old. I finally made it across the street to where my wife and kids were patiently waiting for me. My kids yelled, "Hey dad you looked like 'Frogger' out there." I didn't think they were funny.

I'm glad I didn't hit the guy on the Vespa, because I discovered that two police officers were watching the whole thing. I could just see my wife trying to bail me out of a Rome jail—even if it was for knocking over a (well deserving) Italian guy on a scooter. The cops thought I was just another crazy tourist who didn't know how to cross the streets of Rome. I still don't.

Monte Carlo

Monte Carlo is bordered on the south by the Mediterranean Sea and on the north by almost vertical mountains. There are three roads that run parallel to the Mediterranean Sea. There is a lower road near the sea, a second road half-way up the mountain, and a third road near the top of the mountain. The third and highest road was a Roman road from ancient times. (Princess Grace's car accident occurred between the middle and high roads in a very steep area near her house in the country.)

The city developed in a small area between the sea and the base of the mountains. Land is at a premium with large office buildings dominating the cityscape. The Ferrari dealership is located in a hole in the mountain just back from the main part of town. Anywhere else but Monte Carlo, the location would be a laugher. But in Monte Carlo it's a great location—because they *have* a location. It reminded me of the "Bat Cave" in the 1960's television series "Batman." However, remember: location, location, and location.

Now that we've taken a look at the two predominant types of growth patterns, lets take a look at how to make money investing in or behind the path of progress. In a concentric growth pattern, opportunities will occur for rehabilitation of existing properties left behind the path of progress. In addition, opportunities will exist to purchase land in the path of progress and wait for the growth to arrive.

Rehabilitation

Rehabilitation of existing properties in urban areas is a great way to make money from existing properties. Many cities are only too happy to have these areas rehabilitated and thereby, increase the value of the "downtown" area. This has led some cities to use the power of eminent domain to condemn blighted properties in or around the CBD and change the land use to a higher and better use. Many cities have been tearing down old homes and building marinas and other higher-end uses, which include expensive commercial and high density residential properties. Of course, the many homeowners who are uprooted and have to find another home to live in do not appreciate the "public good" that comes from this type of revitalization. They think the increased tax base to the city does not equate to public good. There will continue to be a difference of opinion between consumer advocacy groups and developers.

The good part of rehabbing older properties in a changing urban area is that you can collect rents before, during, and after the rehabilitation project. Hopefully you can raise rents after completion of the rehab. Everyone needs a place to live, so no matter how beat up the property is, you can usually find a tenant at some price (even if it is pretty low). Make sure there are no rent control issues involved. If there is rent control, I usually don't invest. Period. It's hard enough to make money without government restrictions to hinder your potential revenue increases.

Purchase Land In The Path Of Progress: Speculate and/or Develop

The other way to make money is to purchase land in the path of progress. The key is to purchase the land far enough out in front of the path of progress so you get a good deal, yet close enough to be able to develop or sell for a profit within a reasonable period of time. However, the land will generally <u>not</u> be producing income during the holding period so you will need to be able to carry it until the path of progress arrives at your property (i.e. no cash flow).

Once the news media declares "it's a sellers market" you're dead in the water. Everybody (and their dog) will be out trying to buy land in the path of progress (if they can find it) in the hopes of big profits.

I buy when everyone else is selling and sell when everyone else is buying. When I buy I either find a good deal or I make one. The time to buy is before the stampede hits--not after it starts. However, be careful and don't start the stampede yourself. Market timing is critical with both rehabilitation projects and purchasing land in the path of progress.

The Story of Dan

My friend Dan went to Park City, Utah in the dead of winter and picked up some infill lots where he wanted to build some custom homes. Infill lots are vacant parcels that are among developed properties. There were several feet of snow on the ground and properties had been sitting on the market for a long time. Either you look for a deal or you make one.

In this case, Dan found some deals. He thought the area was about to explode because of the many Park City recreational amenities abounding in the area and the international nature of the real estate market. The euro was very strong against the U.S. dollar, so many European investors were looking to pick up good quality properties in the area. Dan came in and negotiated aggressively for four custom home lots that he wanted to purchase.

The first lot was so cheap he knew something had to be wrong with it. The seller signed escrow instructions just before Dan did and happened to be leaving the escrow office when he arrived. Instead of saying "hello" he avoided acknowledging Dan and scurried out of the office. This should have been a hint that the seller was hiding something. It was the dead of winter and Dan went ahead and purchased the lot anyway. He figured that even if it was wetlands, it would still be a good deal.

In the spring when the snow melted, he found that in fact he had purchased a lot that was comprised of 99% wetlands (he still doesn't know where the 1% that is *not* wetlands is located). Dan was able to mitigate the situation with the U.S. Army Corp of Engineers (who own all the streams and rivers in Utah) and build a nice custom single-family home on the lot. A geo-technical report (which costs about $1,500) was needed to properly set the foundation.

The second lot was a "great deal" also. When Dan started to build on this lot, the neighbor on one side had a dispute over the lot line. Looking at the survey (which Dan obtained after buying the lot), there were at least three different metal stakes (rebar) showing the particular property corner in dispute. The surveyor did not really have a clue where the property corners were (nor did anyone else). The lots were surveyed in the 1960's before Global Positioning Satellite (GPS) technology was available. Instead of a lengthy and expensive court battle, Dan negotiated with the neighbor and they decided that "Stake Number Two" was the correct one (kind of like Let's Make A Deal). The house was built and everyone is happy—including the resident moose who occasionally dine in Dan's front yard.

The third lot was located in the same general area. The house was located across a ditch and up a hillside from the road. Dan was concerned because the front portion of the lot looked like a possible creek during the spring runoff. He still went ahead and purchased the lot (blind faith once again) in the dead of winter, hoping he could build on part of it in the spring. It was so cheap, he thought "What the heck, let's take a gamble." The Army Corp of Engineers verified that a stream flowed through the property during the spring thaw.

Dan was able to mitigate this situation with a large culvert under the driveway. The Army Corps initially said the driveway could only be ten feet wide, however, Dan countered that if he arrived home drunk some night (with six feet of snow on the ground) there was no way he was going to make that turn. They agreed and decided to increase the width of the driveway to accommodate Dan's inebriated driving ability. This completely eliminated the possibility of him having a drunk driving accident in his own front yard (try to explain that one to your insurance agent).

The geo-technical report showed the front part of the lot was deep with silt. Dan had to excavate downward and remove the silt where the driveway came across to the road. It is expensive to excavate, however, he placed loose rock down to bedrock and was able to construct the driveway.

When Dan finally got around to having the lot surveyed (nothing like knowing what you've bought), the neighbor on one side had a dispute with the lot line. The foot print of the custom home he was about to build encroached onto what the neighbor said was his property. Dan had to go back to the building department and get approval for a different set of plans (and lost six weeks in the process) with a smaller foot print. Because of set back requirements, he would have been a couple of feet too close to the disputed property line with the first home plan.

He went ahead and built the house and found out later that the owner with the lot line dispute wanted to purchase the lot himself. He wanted to build a custom home on the lot himself; however, Dan showed up with his snowshoes and "scooped him" on the deal. Sometimes, you snooze—you lose.

It is usually best to have the property surveyed as a contingency to the contract. I usually do this. However, when buying lots in the dead of winter, surveyors will not survey the property until spring. You either take your risks or wait until spring when everyone is out looking to buy lots and prices go up.

On this occasion, Dan was buying these lots so cheap (in his estimation) that he wasn't concerned with the exact property corners at the time of purchase. Dan also didn't want to alert anyone else (competitors) to what he was doing. He even used a couple of different real estate agents who did not specialize in lot sales to help him negotiate the lots. They would not have contacts with local developers and could not alert them to what Dan was doing.

The fourth lot is a beautiful piece of land. It's over 2/3 of an acre and has a nice view. Dan drove up to the lot and it looked pretty good. There was at least six feet of snow covering the lot, yet he made the deal anyway, and bought it.

In the spring he had the lot surveyed and found that he had bought the wrong lot! He had bought the lot next door! No kidding. This lot was pretty good too, so no problem. He had it surveyed (with the usual surveyor uncertainty), but this time he met with both property owners on each side and made sure everyone was in agreement where the property lines are located. He has plenty of room for set back issues, so he's really not too worried on this one. It's a big lot with lots of room to build. He's most concerned with the driveway's 10% maximum grade requirement. He doesn't want to have to get a variance from the county to build the driveway. A variance allows you to build something that is not within the county's allowable guidelines.

If Dan hadn't been concerned with alerting his competitors to what he was doing, he would have extended the escrows, closed escrow in the spring, and had all four of the lots surveyed prior to closing escrow. However, by buying these lots in the dead of winter (without the possibility of a survey) and so far under their intrinsic value, he accepted the risks and bought the properties anyway. He figured the worst case scenario was that they were worth more than he was paying—survey or not. Park City epitomizes (you guessed it) location, location, and location.

In addition to rehabbing older properties behind the path of progress and purchasing in front of the path of progress, it's a good idea to know where a good location is in relation to general orientation of the area.

Cul-De-Sac Location

A cul-de-sac is another name for a "dead end" street. Cul-de-sac sounds a lot better than dead end street, so there you have it. Parents like cul-de-sac locations because of safety considerations for their children. Less traffic equates to a safer environment for children who play in the front yard.

Property owners who own a home located in a cul-de-sac also enjoy an easier time backing out of their driveway because of the reduced amount of traffic and slower speeds of cars because of the dead end nature of the street.

Homeowners who purchase lots near the back of the cul-de-sac tend to have larger lots than those located in the neck area near the entry. Many builders charge a "lot premium" for larger lots located in a more desirable location; however, homeowners should be aware that they will generally not get their lot premium back when they sell the property in the future. The lot will sell faster than other smaller and less desirable lots. However, it will not be for a considerably higher sale price.

Feng Shui

There have been many books written about Feng Shui (pronounced "Fung Shway). In my opinion, most of the positives and negatives revolve around good sound judgment. For example, according to Feng Shui you should not purchase a home on the end of a street. This is sound advice. If a speeding car (probably being chased by the cops) proceeds down the street and cannot make the turn, it is most likely going into your house. I have seen some builders build their large square footage (and most profitable) models in the back of the cul-de-sac. The resulting lot premiums increase profitability on the most desirable lots in the subdivision.

Greenbelt Location

A greenbelt adjacent to a home can be good and bad. It is desirable because of the aesthetics of looking at a greenbelt, instead of another home when lounging in your backyard. It gives a home a "woodsy" look and builders many times charge a lot premium for lots located in a greenbelt.

However, it also may be a problem because snakes or other undesirable reptiles may not have discovered that a new home has been built in their neighborhood. This may result in unwanted visits from the old-time "neighbors."

Field mice and other rodents will have direct access to the home through the greenbelt. A good "mouser" can take care of this problem. . .as long as he doesn't drag his "prizes" into the house.

When a new home is built in an area with a greenbelt, the local wild animal population may show up during the first couple of years after construction has ended. One homeowner had a disturbance in his backyard and went to investigate. He found his Brittany Spaniel cowering in a corner of the yard with a large mountain lion sizing him up for dinner.

Another homeowner found a large rattlesnake slithering around his backyard. He was glad his small children didn't find the reptile before he did. I had a crazy turkey running around in circles in the street in front of my home. The turkey was obviously confused by all the homes blocking his path of retreat. He was over four feet tall and had a mean look in his eyes. I had a fleeting thought of putting him on the dinner table, but a big old tom like him was probably so tough you couldn't chew the gravy. I decided to "shoo" him out of the neighborhood and see if some easier to chew turkey was on sale at the local supermarket.

There is an old adage in real estate investment: "Location, location, and location." Price, terms, and condition can be altered; however, location is the one variable in a real estate investment that cannot be changed.

The location of a property in relation to growth patterns and age of the property have a profound affect on present and future property values. The astute real estate investor will consider rehabilitation projects of existing well-place properties, as well as purchasing land in the path of progress and either speculate or develop.

What is your property really worth? In other words, what is its "intrinsic value." Intrinsic value is what a property is really worth in light of the market around it, the surrounding area, the county, state, nation, and world. Looking at everything else in the world, what is its REAL value?

This is the analysis I use every time I purchase a property. Whether it is an investment property or a home for my family, I always look at the property's intrinsic value. If I believe that a property's intrinsic value is more than the sales comparables show (properties that have recently sold that are similar to the subject property), I will buy it.

Capitola

I was looking for a second home in a small little beach resort town south of San Francisco called Capitola. The home was 1,100 square feet, 65 years old, and had a small yard. It was walking distance to Capitola Village, with its nice shops and wonderful beach. The asking price was $1.2 million. I asked my wife what she thought it was really worth, she said about $200,000. She is a licensed real estate broker and has extensive experience investing and building properties with me in the US.

Looking at the cost to build the home she would be correct. However, we had to consider the location of the property. Remember: location, location, and location.

Being a high-end resort location, the value of the land is the factor that drives prices up. Building costs are affected by local contractors and availability of building materials. Contractors are fairly expensive in the area, but not outrageous. Materials are easy to find at a materials supply store catering to contractors such as Lowe's. I like areas where Lowe's stores are located. They tend to keep local competitors' prices in line because of their uniformity in brands, quality, and prices throughout their chain of stores. Local retailers cannot price gouge like they were able to do in the past. Lowe's comes into a market and passes their huge discounts (obtained by large economies of scale) on to the consumer.

Many home buyers are willing to pay over $1 million to live near Capitola. Many of these homes are primary dwellings for Silicon Valley executives who commute to work each day. They generally have high paying jobs and are able to pay a high price to live the "beach lifestyle." They want to be like the "Big Kahuna," but with a bigger pad (and a job). Capitola seems to fit the bill.

Other properties in Capitola are used as second homes for people who live primarily in the San Francisco Bay Area. These people generally have good incomes and may be able to afford the high cost of a vacation home near the ocean. They are too far away from Capitola to use it as a primary dwelling and settle for a second home on weekends and holidays.

Home Prices vs. Median Incomes of the Locals

The value of the homes near Capitola do not come close to equating to median incomes of people who live in and around Capitola. The people who work in Capitola are forced to live somewhere else (usually inland) where home prices are cheaper and better equate to their incomes and socio-economic situations.

Hawaii

This commuting scenario seems to exist in many resort locations around the world. For example, in Hawaii the locals have areas where they can live and then commute to the tourist areas for work. However, since the internet has made marketing homes a lot easier and more efficient, cheaper areas in the islands for the locals have been steadily dwindling.

On Oahu, the northwest part of the island has cheaper homes where the locals live and commute to work. The area to the north is being encroached on as investors and second home buyers snatch up the newer construction heading in a northerly direction toward the locals' previous domain.

On Kauai, the Waimea area has traditionally been the cheapest area on the island. Locals have long lived there and commuted across the island to Poipu and Princeville for work in the resort areas. Interestingly enough, the Wiamea side is the sunniest on the island and the Princeville side is one of the wettest areas on the island (or anywhere else for that matter). You kind of wonder which hot-shot meteorologist figured that one out?

On Maui, the locals reside near Wailuku and Kahului. However, most of the homes are well out of range of the average local's income level. Maui is a real difficult island for locals because there are really no bad areas on the entire island. Many locals who own homes Upcountry are several thousand feet above the ocean (between Kahului and the top of Haleakala) and have a much lower average temperature than the homes located near the ocean. Again, the advent of the internet has increased these properties' prices and driven most of the locals out of the market. Locals who own homes tend to keep them in the family for generations.

On the big island of Hawaii, the locals live south of Kona and commute into town. They also live over on the Hilo side which is on the windward side of the island. Kona is too far of a commute from Hilo. Typically, the leeward side (Kona) is the sunny side with less rainfall. It also is impacted less by the trade winds during the summer. That is where the resorts are located because of the better weather and less wind. The windward side (Hilo) is the wet side of the island and receives much more rainfall than the leeward side. That is why all the lush gardens are located near Hilo.

Interesting also is the large green area made up of lawns at the mouth of Hilo Bay. It will never be developed (again) because it was hit by tsunamis in the 1940's and 1960's. Both tsunamis were a result of earthquakes off the coast of Alaska. Hilo bay has a shape that channels tsunami waves directly into the middle of the bay and caused quite a bit of destruction to the town of Hilo in the past.

So, it rains more in Hilo and has tsunamis. Even so, it's still a great place to hang out. Wait until you see a local guy toss a dip net from behind a rock and catch a huge parrot fish for dinner. Or a local palm tree climber cutting coconuts with a machete and selling them to tourists with a straw to drink the milk. The old Hawaii is still alive in Hilo.

Monte Carlo

The same problem for locals in resort locations occurs in Monte Carlo. To live in Monte Carlo you must deposit at least $100,000 US in a Monte Carlo bank. For this reason, most of the workers live in either Villa Franche or Nice and commute into Monte Carlo for work. They generally use one of the two main roads leading into the city (the old Roman road is too far up the mountain to be used for commuting). As with Hawaii and Capitola, traffic jams are common in the mornings and evenings during weekday commutes into and out of the resort locations.

The Story of Ron

Ron was an astute investor who always looked for a good deal. Either he found a good deal or he made one. He was vacationing on the island of Maui just after the terrorist attacks in New York City. It was a ghost town. Many vacationers had cancelled their vacations and the island was in a state of shock.

Ron realized that this may be a good time to invest in real estate on the island. His reasoning was that Americans would continue to vacation somewhere in the future; however, it would most likely be in a safe location. There would not be as much vacationing outside of the U.S. So, where was the most exotic location in the U.S? You guessed it, HAWAII.

Thinking further, which of the islands were the most exotic? Ron thought of Kauai and Maui. Oahu (with Honolulu) was too urbanized and the big island has an active volcano on it.

He personally checked out airport security in both Kauai and Maui. He found Maui to be a little better prepared than Kauai. Also, Maui didn't roll up its sidewalks when the sun went down (or so the story goes). For these reasons, he purchased a rental property on Maui.

Ron's Condo

Ron logged onto the local Maui multiple listing service (MLS) that lists properties for sale and found a condominium complex that looked like it was in pretty good shape. Prices had plummeted after the 911 attack. Canadian investors were already battling a horrible exchange rate (versus the U.S. dollar) prior to the attack. This added fuel to the fire and the Canadians were bailing out in droves.

Ron found a one bedroom condominium that had a pretty good ocean view and made an offer near list price. Ron felt the instrinsic value was much higher than the list price. The property was only a dozen years old, the unit had a good view, wonderful lanai (balcony), fee simple land tenure (he owns the land under the condo) and was located close to several resort areas. Ron wanted to rent the unit to one of the many executives who were working in the nearby tourist areas (or he hoped would be working again in the near future).

Ron theorized that the mass exodus out of Maui would be short-term and tourism would rebound. After the rebound, workers incomes would then increase as a result of the economic boom caused by increased tourism.

Ron thought that when Americans decided to take a vacation they would probably select Maui because it is one of the two most exotic locations in the U.S. (Kauai being the other one).

This actually happened. Tourism increased several fold during the next few years. With an increase in tourism, the median incomes of the locals increased and so did the rents of condos they lived in near the resort areas.

Ron had a choice when he was considering buying a condo. He could have purchased a vacation rental in one of the vacation rental areas. However, even though they had good rental rates; the management, marketing, and home owner association (HOA) fees were extremely high and made a vacation condo investment very risky—especially at the time he was investing. He would be able to use the rental himself when it was not rented out. However, some vacation rental companies charge their owners a cleaning fee when they stay in their own unit. No kidding, you can't clean the unit yourself, but must have a "professional" cleaning company clean it. The vacation property management company (of course) gets a kickback on a portion of the cleaning fee. Most property management companies, in general, get a kickback on everything they do. In Ron's estimation, vacation condos represented a lower intrinsic value than they were actually worth.

Ron opted for a monthly rental condo targeted at executives who work in the resort areas. Even though this type of rental property did not have as great a return as a vacation rental, it also didn't have the risk either. Some things that Ron considered were Hawaii's property taxes, excise tax, property management fees, cost to furnish the unit, and projected rental amounts.

He found an old World War II hut in Wailuku where they sold used hotel furniture on Saturday mornings. He purchased an entire set of furniture for pennies on the dollar and delivered it himself in a van he had rented at the airport. He took the seats out and brought the furniture to the unit himself.

The reason for not having it delivered is because even though Maui is beautiful, getting anything done is very expensive and time consuming. The locals are great people and make visiting the island a real pleasure; however, they are all on what is called “Hawaii Time.” This means they are not in a hurry. Isn’t that <u>why</u> people vacation there anyway—to relax? Since everything is so expensive on the island, if you are an outsider (called a “Howlee”) or even a transplant from the mainland (called a “Kamahina), you will get a different price than the “Locals” who were born there. The Locals have to protect themselves and that’s just the way it is on Maui.

Unfortunately, since the property was rented on a long-term basis, Ron and his family could not stay at their wonderful ocean view property while on the island. Ron made this up to his wife and kids by staying at the Sheraton Hotel and used their maid service, excellent amenities, and location on Kanaapali Beach to keep everyone in good spirits (especially the wife).

As things turned out Ron purchased the condo property, furnished it, and rented it out to an executive and his wife on a six month lease. Ron and his family continue to fly over to Maui each year to manage their rental property. They continue to stay at the Sheraton and the wife is still happy (a happy wife is a happy life!). His accountant must love doing Ron’s taxes. Ron received depreciation on the condo. The IRS allows Ron to depreciate the building portion of the condo over 27.5 years straight line (divided evenly each year). His accountant also deducted management expenses for him to fly over to manage his property. Life’s tough, but somebody’s got to do it! Ron plans on spending winters in his condo after he retires and the unit is paid off. Sounds like a good idea to me.

Value

After looking at the intrinsic value of a property in light of all other investments, we can now consider the fundamentals used to determine value. These same fundamentals are used by appraisers who appraise properties and will give you a good basic knowledge of how to value properties.

Elements of value include demand, utility, scarcity, and transferability. Is there demand for the single-family homes in a particular area? Does the home fit the needs of a particular target market of buyers who will be interested in the type of home, given its location, size, and price range? Is there a large amount of vacant land ready to be developed around the subject property, or is the land completely built out? Can the property be sold or willed? These are questions that will affect the value of a subject property.

Demand

Is the market a buyer’s market or a seller’s market? What is the demand for single-family homes in the local market area? Each local market is somewhat isolated from other markets, yet many markets follow the same trends because of attractive interest rates and speculators driving up prices in select markets.

For example, when California became less attractive for investors, they headed for Las Vegas and then Phoenix. These investors showed up with a huge amount of cash from selling their homes in California, and then drove the prices of single-family homes up in both of these markets. Since the price appreciation was induced by speculators (and not by local buyers) it was an “artificial inflation” of the market.

A home buyer must understand where the demand for homes is coming from and not jump into a speculative quagmire that results from speculators coming into the market. Its like a pyramid marketing scheme and you get stuck holding the bag.

Utility

A property must fit the market where it is located. If a property is located in an area of smaller homes, it will most likely be targeted at first-time home buyers. (An exception is resort areas where all of the homes are generally small.) A first time homebuyer will usually be considering cost, square footage, rooms for future family members (children), schools, and safety for the family. If the property fits these parameters, then it will have good utility and have good value for that particular target market.

One property was targeted at this market. However, it had a very small backyard, and two large "holes" in the front yard. First time home buyers would look at these two factors and reject the property because of safety to their children. By filling in the holes and expanding the backyard, the homeowner was able to mitigate these factors and sell the home for a good price. Another thing to remember: every property has its price. If you reduce the price low enough, there will usually be a buyer willing to overlook the inherent deficiencies in the property and buy it anyway. Smart buyers on the property mentioned earlier would purchase the property at the reduced price, fill in the holes in the front yard, and increase the size of the backyard themselves. This will increase value in the property for pennies on the dollar and give the homeowner some "sweat equity." Most home buyers; however, do not understand this concept, nor do they have time to do it.

Scarcity

Areas like the San Francisco Bay Area and the Los Angeles Area do not have any scarcity of land. Most of the land has been built out and there just isn't any more to develop. This leads to price stability and a corresponding stability of values.

In areas where there is a large amount of land available for development, many new homes are built and prices become unstable during a buyer's market. Since developers have a lower land cost and resulting lower building cost, as prices decline in a buyer's market they are able to offer incentives to artificially lower prices without really appearing to do so.

Homebuyers who purchased homes a year or two earlier are sitting with a home that has lost a considerable amount of value during a buyer's market. The builder does not want to reduce prices because the price decreases will affect the appraisals of properties that he currently has in contract. However, over time the builder will be faced with price decreases in order to keep up sales and these price decreases will be significantly below the prices of homes he sold previously.

Homeowners who purchased properties at the higher prices may not be able to sell their homes because they cannot compete with the builder's new prices. It's not the builder's fault, however, because the market is the market. The builder is just better able to compete in a buyer's market because he can lower his prices and continue to make a profit (except not as large a profit as he did in a seller's market).

This leads to a large amount of foreclosures in this type of market. Homeowners blatantly see the values of their homes decreasing weekly (and even daily) and become discouraged and let their homes go into foreclosure. I have always said that "time heals," and in the business of real estate this has generally been true.

A homeowner only loses if he sells. If he can keep his property (eventually) the value of his home will probably come back around and increase in the future. The homeowner must think of his home as a home and an investment. He still needs a home to live in. For the investment part, he must know that real estate markets are cyclical. If he can hold on and afford the loan payments (debt service), he may be in a good position when the market comes around again and turns into a seller's market. Control of the asset is critical to riding the next wave.

One thing that is really causing homeowners problems is the "pick-a-payment" option arm loans that were prevalent from 2001 to 2006. Many of these loans had a two year adjustment period. This means that if you were making the negative amortization payment, which is the lowest payment of your four choices and is where you are not paying any principal reduction (and in fact you were not paying all the interest that was due), you may have two adjustments: recast of the loan as a result of the negative amortization payment reaching its maximum level and an adjustment resulting from the adjustable loan index increasing.

These two adjustments occurring at the same time has caused many homeowners to experience huge increases in their loan payments. Some of these same homeowners used stated income 100% loan-to-value loans and may not come close to being able to afford the new payment structure (or the old one for that matter).

Transferability

Can the property be sold or willed? If the property has defects on title, you may have a difficult time selling the property because the buyer will not be able to obtain title insurance. For example, Seller Ted had owned the property for a very long time. He placed it on the market and found a buyer. When the preliminary title report arrived, he found two old deeds of trust that had been paid off many years earlier, but had not had a deed of reconveyance recorded to remove the deeds of trust from the public record. The amounts of the two deeds of trust were not listed on the preliminary title report. The title insurance company informed Seller Ted that they would not insure the title to the property. Since the title insurance company would not insure the title, the buyer could not get a loan on the property and the deal fell apart (almost).

Seller Ted was informed that he could either get a (cost prohibitive) performance bond or institute a quiet title action in court. The performance bond would place a bond against the two old deeds of trust, so if the title insurance company ended up paying out on them, the bonds would cover their costs. The quiet title action would let the courts remove the two deeds of trust from the public record. This was expensive and time consuming. Even though Seller Ted may have been able to get the courts to act with a motion short of a full-blown quiet title action (and save money and time), it still would have been too late to save the deal.

Seller Ted instead asked the title company to accept an affidavit from him stating that he would indemnify (pay for their loss) the title company if in the future any claims arose regarding the two old deeds of trust. The county manager for the title company agreed to insure around the two deeds of trust and the property sold and closed escrow.

Being able to will a property may be hampered by a life estate. For example, your Great Aunt Alice (she's a great aunt because she's a distant relative and she left you a life estate) left you a life estate (didn't I just say that?). You can do anything you want with the property during your lifetime; however, when you die the property either goes back to Great Aunt Alice or to someone she designates. Needless to say, your relatives would not be able to inherit any of the property if Great Aunt Alice used a life estate. You may see this type of estate if Great Aunt Alice likes you, but despises your "money-grubbing" relatives.

Substitution

The appraisal principle of substitution takes properties that have sold and compares them to your subject property. These are called sales comparables and are used to value many single-family homes. You must find properties that are close geographically to your subject property, close in age, close in architectural style, and with similar materials to your subject property. The sales comparables need to be as recent as possible as well.

You then "substitute" the properties that have sold for your subject property and come up with a value or range of values that the subject property will most likely sell for on the open market. You must, however, remember to make adjustments for differences among sales comparables and the subject property.

For example, if a sales comparable has a swimming pool and the subject property does not have one, you must subtract the value of the swimming pool from the sales comparable. We usually give the pool owner about ½ of the cost of building the swimming pool and add it onto the value of the home. You must subtract this amount from the sales comparable before substituting it for the subject property. This is called an adjustment.

Contribution

When a homeowner makes an improvement that increases the value of his property more than the cost of the improvement, this is called contribution. Modernizing a kitchen is usually a good way to increase the value of a property. Paint and landscaping are two other ways to increase value. The homeowner must be careful not to "over improve" (make improvements that will not increase the home's value) and end up wasting money in areas that will have no effect on value.

Regression

The best example of regression is the over-improver. For example, your house is 800 square feet and is worth $80,000 (I know, you can't buy a dog house for this price in some markets—but this makes the math easy). Your neighbor adds on to his house, and adds on to his house, and adds on to his house. You get the picture. His house is now 2,000 square feet. He says, "Your house is worth $100 per square foot and so is mine. So, 2,000 square feet x $100 per square foot = $200,000!!! WRONG!!! I always hate to be the bearer of bad news, but I sometimes am. Because of the appraisal principal of regression, his house will seek the level of the homes around him and pull him down in value. His house will probably be worth around $90,000 (no kidding). He may ask what happened to all the square footage he added to his home. I usually hope he built a long hallway on his 6 bedroom/ 1 bath "Winchester Mystery House" because he's going to need it when all of the family members line up at the bathroom door! Only kidding, of course.

In some markets regression is not a factor. I have seen areas where there are several multi-million dollar homes on a street, and next door is a pig farm. Somehow the pig farm does not affect the value of the homes around it. It depends upon the particular area whether regression is a factor or not.

However, most of the time the surrounding homes will affect the value of your property. There was a beautiful 4,400 square foot home with an equally beautiful home next door to it. This looked promising---except that the house on the other side was a geodesic dome with a dilapidated back deck and an old, beat up pick up in the driveway. Unfortunately, this sub-standard house brought the homes around it down in value through the principle of regression.

Progression

The opposite of regression is progression. When a homeowner purchases a small home around larger homes, the value of his property will generally increase as a result of the proximity to these higher priced properties.

One property owner purchased a 2,500 square foot home in an area where the homes ranged in size from 2,500 square feet to 4,100 square feet. Since most of the home were larger and more expensive, the value of his home increased also.

Another homeowner was really smart. He purchase a 3,300 square foot home that had the same frontal elevation as the surrounding 4,100 square foot homes in the neighborhood. He paid significantly less money when he purchased it; however, when he sold the price he obtained was really close to the 4,100 square foot model. The similarity brought the value of his property up near the larger property's value.

Anticipation

When you buy a rental property you anticipate a revenue stream from the investment. The appraisal principle of anticipation examines the relationship between a revenue stream and the risk of the investment.

Conformity

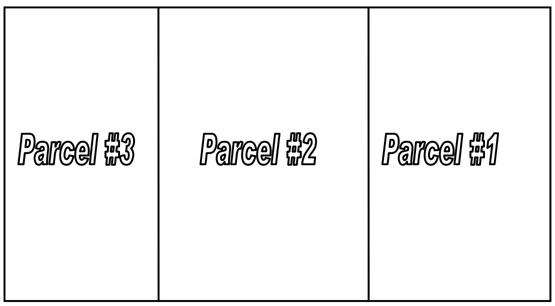
Does the property conform to proper land use objectives? In other words, did any planning go into the development of the area around the home? You must look at future land use in the community. Master Planned Communities are a good example of conformity. Developers consider schools, parks, open areas, recreational amenities, lakes, proximity to light rail for commuting, etc. in developing master planned communities.

A good example is Ladera Ranch in south Orange County. Ladera Ranch has several subdivisions in an area surrounded by open spaces and hiking trails. It has good proximity to job sources in Irvine and other areas throughout Orange County. It brings value because of its conformity and effective planning.

Assemblage and Plottage Increment

The act of placing two or more properties under one ownership with the resulting value of the parcel being greater than the total purchase price of the parcels is called assemblage. Also, when two or more properties are combined to make one property that is more valuable than the sum of the properties separately, this is called a plottage increment.

Figure 3.1



If you owned Parcel #1 on the corner, you could build a convenience store on it. If you owned Parcel #2 next to it, you could build a strip mall. If you owned Parcel #3 you could build a small office building on it. For example purposes, if the sum total value of Parcels #1, #2, and #3 were $3 million dollars, what if you purchased all three lots and built a neighborhood shopping center on the property and that was worth $5 million. This is called assemblage in anticipation of plottage increment. The act of purchasing all three parcels is assemblage. The increase in value that results from building the neighborhood center on the three parcels is called plottage increment.

You see Walgreens using this technique all the time. Whoever is running their operation really understands real estate values and how to leverage Walgreen's size to expand their locations. On one occasion, they purchased three adjoining parcels of land. The first parcel had an old 16 unit apartment building on it. The second parcel had a small strip center. The third parcel was vacant. Walgreens very gently over a period of time was able to move the tenants out of the property to other surrounding apartment buildings without being too aggressive. After all, many of these tenants were probably going to be customers of theirs when they relocated into the same area. As the strip center's three tenants' leases came due, Walgreens had given them plenty of notice to move their businesses. After Walgreens was able to get all the tenants in the apartment building and the three commercial tenants in the strip center out of the properties, they bulldozed both buildings down and built a new Walgreens on the land. The story doesn't end there. Walgreens then did a sale-leaseback where they sold the land and building to an investor for an acceptable rate of return, leased it back from the new owners on a long-term lease (usually 20+ years plus several 5 year options), and then took the money and acquired more land, built more Walgreens, and did more sale-leasebacks. Pretty smart way to expand.

Along with the appraisal principles we have just covered, there are three appraisal techniques that appraisers use to determine a property's true market value.

Three Appraisal Techniques

The three appraisal techniques used by appraisers and individuals to value properties are the Comparison/Market Data Approach, Income/Capitalization Approach, and Cost Approach. We will examine each of these in turn.

1. Comparison/Market Data Approach

The comparison or market data approach of appraising properties uses the principle of substitution. An appraiser uses sales comparables to value a subject property. Sales comparables are similar properties that have recently sold near the subject property. The closer the sales comparables are to the subject property in relation to size, amenities, and other characteristics the better suited they are to value the subject property. The sales comparison/market data method is used most often with single-family homes and unimproved land.

The market data method of real property appraisal is used most often to determine office building rents and apartment rents. Realistic rents for an office space can be determined through the comparison approach. An owner of an apartment building can rely upon the comparison approach to help determine what rent to charge for the units in his complex. The market data method is hindered by rapidly changing economic conditions.

In making comparisons (market data method) of residential property, an appraiser would use the entire property. When appraising a 12 year old home, the greatest consideration should be given to the current prices paid for other homes in the same neighborhood.

Adjustments

An appraiser must make adjustments between the subject property and sales comparables. For example, a sales comparable may have a swimming pool and the subject property does not have one. If this occurs, the appraiser will have to reduce the sales comparable by the value of the swimming pool in order to substitute it for the subject property and thus appraise its market value. In using the market data approach to value a property, an appraiser increases or decreases the sales prices of comparable properties because two properties are rarely similar.

Income/Capitalization Approach

The income approach or capitalization approach is used to appraise the value of income producing properties. This approach converts an income stream into value. The formula "I/RV" is defined as income divided by capitalization rate equals value. In other words, if an investor pays $1,000,000 for an apartment building and receives an annual income stream of $100,000, she has obtained a 10% return on her money. This return is called the capitalization rate. Capitalization rate is the rate of return an investor receives if she pays all cash for an income property.

Net Operating Income or "I" in I/RV

The following formula can be used to calculate the net operating income for an income property. The net operating income is the "I" in the formula I/RV.

Gross (Scheduled) Income (income if no vacancy)
less Vacancy
Effective Gross Income (income actually collected)
less Operating Expenses (both fixed and variable)
<u>Net Operating Income (income "I" used in IRV)</u>
less Mortgage Interest or Debt Service or Mortgage Debt
Before Tax Cash Flow
Plus principal reduction
Total Return or Broker's Return

Operating expenses include fixed and variable expenses. Fixed expenses may include property taxes and insurance. Variable expenses may include water, sewer, garbage, electricity, gas, maintenance, and other expenses.

Capitalization Rate or "R" in I/RV

Capitalization rate is the return an investor will receive if he pays all cash for an income property. It is the "R" in the I/R=V formula. A capitalization rate is used to determine the value from an income flow and is a process where an appraiser converts income into appraised value.

The income/capitalization approach is based primarily on the appraisal concept of anticipation because it places the greatest emphasis on the present worth of future benefits. For these reasons, the income approach considers the quantity, quality, and durability of income coming from an income property.

Gross Rent Multiplier

In addition to capitalization rate, income producing residential properties also use an annual Gross Rent Multiplier to determine a property's value. Gross Rent Multiplier or GRM is the number of times the Gross Scheduled Income of a residential income property will divide into the price of the property. This multiplier is not as effective as the capitalization approach; however, it is commonly used by investors to determine the number of times the gross scheduled income will divide into the price. Hence the name "times the gross." This measure gives an indication if the vacancy and expenses are out of line when the GRM does not equate to the NOI.

Formula: $$\frac{\text{sales price or sales value}}{\text{Gross (annual) rent}}$$

Next is a look at the cost approach to appraising value in a property.

3. Cost Approach

When using the cost approach, the land is valued using the market data approach and then the cost to build a house on the property is added to the value of the land to obtain an overall cost for the property.

Replacement Cost considers the cost to replace the property with a comparable structure (with the same UTILITY) using today's materials and building methods.

Reproduction Cost considers the cost to reproduce the property with an exact replica of the subject property.

The Cost Approach uses three methods to determine the cost to build a property: Quantity Survey, Unit-Cost-In-Place, and Square (cubic) foot method.

A. Quantity Survey

The quantity survey method takes into account every board, every nail, and virtually every item that goes into the construction of the property and totals them up to determine the total cost to build the property. This is the most accurate method of determining the cost to build a replacement property.

B. Unit Cost-In-Place

The unit-cost-in-place method considers each entire wall (for example) as a component part and totals up each component part to reach a cost to build a replacement property.

C. Square Foot/Cubic Foot Method

The square foot or cubic foot method considers the cost to build a similar property on a square foot basis for residential and most commercial construction; and cubic foot for warehouses. The appraiser selects an estimated cost per square foot to build an apartment building and multiplies it by the total square feet in the apartment building to arrive at an estimated cost to build a replacement property.

The Cost Approach is used to appraise special use or special purpose buildings such as libraries and fire houses. Since there has probably not been a lot of these structures built in the area recently, the comparison/market data approach will not work on a library or fire house. And they don't generate income, so the income/capitalization approach is also out. The only way to appraise them is with the cost approach.

The cost approach is also used to appraise new construction. Since the property was recently built, the appraiser will probably be able to determine how much it cost to build it.

I ran into an industrial building that did not measure up. The property generated a considerable amount of income; however, the construction of the property was not of a high-enough quality to justify the price of the building. I suspected that the tenant's rents may have been artificially inflated (a nice way of saying the seller was trying to put one over on me) to increase the income and hence, the value of the property.

After you have determined the land cost (comparison/market data approach) and add the replacement cost to build the building on the property using today's materials and building methods. You must then "depreciate" the property down to where it is today. Depreciation for appraisal purposes is loss of value for any reason or any cause. This is not the definition of depreciation you may have learned in an accounting class. That definition relates to taxation and is a paperwork loss the IRS let's you take.

Depreciation

Depreciation (from an appraisal standpoint) is described through physical deterioration, functional obsolescence, and economic obsolescence.

A. Physical Deterioration

When a property physically wears out it is called physical deterioration. Anything within the property lines that deals with wearing out is called physical deterioration. When looking at physical deterioration, you must consider a property's economic life versus its physical life.

Economic life is number of years a property can actually be used and/or provide income. In contrast, the physical life of a property is the number of years the property is actually standing, even though it may not be actually used in the later years. For these reasons, the economic life is generally shorter than the physical life of a property.

The economic life is the period when the building is yielding a return over the economic rent due to the land itself. This may not occur if the building is standing but not producing income.

Another factor to consider under physical deterioration is effective age versus actual age of the property. The actual age of a property is its age from the time it was built until present. The effective age of a property is the actual condition of the property (which could be more or less than the actual age).

For example, if the owner has performed consistent and good maintenance of the property and the property looks like it is 5 years old, when in fact it is really 20 years old, its effective age is 5 years old. Its actual age is 20 years old.

B. Functional Obsolescence

Functional obsolescence is the loss in value a property receives from factors <u>internal</u> to the property that deal with style. Anything that is within the property lines and causes a loss in value due to out-dated style would be considered functional obsolescence.

For example, a home that has 3 bedrooms and only 1 bathroom would be considered to have functional obsolescence. Especially when all the other homes around it have 3 bedrooms and 2 bathrooms. The loss in value due to having only 1 bathroom would be due to functional obsolescence. Another example would be an outdated kitchen.

Functional Obsolescence occurs when a property becomes "out of style." Examples are a one car garage in an area where the norm is two or three car garages. Of course, in an area such as San Francisco you are grateful (and pay through the nose for that gratitude) for even a one car garage. Having a garage at all is a real luxury in many urban areas where land is at a premium.

Another example of functional obsolescence is a one bathroom home in an area where two bathroom homes are the norm. In fact the norm in an area of older homes might be a small home, with small rooms, a one car garage, and one bathroom. If the home does have a second bathroom in the master bedroom, it is probably fairly small.

Conversely, if you purchased a home in an area of newer homes, you might expect a large house with big rooms, a three or four car garage, and at least three bathrooms.

The Established Neighborhood

One thing that is nice about an established neighborhood is that it *is* established. This takes the guess-work out of where a neighborhood is probably going to be ten, twenty, or thirty years down the road. A mature neighborhood in a higher socio-economic area is probably going to stay the same for a long time into the future.

Conversely, an older neighborhood in a lower socio-economic area may change over time and reduce in value.

Older neighborhoods have some negative aspects to them as well. Many have outdated plumbing lines, both on the property and the off-site improvements throughout the neighborhood. In addition, if the homes were built before 1978 may have been made with asbestos. Special care must be taken in replacing "popcorn" ceilings and sewer lines.

Another negative aspect of an older neighborhood is overhead power lines. Newer homes generally have underground utilities, including telephone lines. Newer homes may also have fiber optic lines that allow high-speed internet connections.

In some of the older neighborhoods, property lines may not be as definite as newer properties. The use of Global Positioning Satellites (GPS) units for surveying today's properties is much more accurate than the methods used years ago.

Schools

One of the disadvantages of older schools in lack of interconnectivity wiring. Older schools may not be wired for the most up-to-date internet connectivity and this may hinder the teachers' ability to utilize internet tools provided by present-day textbook publishers.

Another reason is that the schools are old. Why place your child in an old school when, for the same money, you could place them in a brand new school with all the latest amenities available to teachers?

The quality of the teachers may not be affected by the age of the school. However, socio-economics may affect teacher recruiting and retention. It is theorized by many who are more knowledgeable than I am, that the "better" teachers may want to work in a higher socio-economic area where parents tend to be more involved with their children and value their education. It's also easier teaching motivated students. . .and it begins in the home.

Some studies have proven that income and social class have very little to do with each other. How a person spends their money is a better indicator of a person's social class. For example, the upper-lower class is comprised predominantly of people who are in skilled blue-collar professions. A plumber is a good example. The lower-middle class is comprised predominantly of white-collar workers. A secretary would be an example of this social class. The plumber may have an income that is three times that of the secretary's, however, they spend their money differently. The plumber may buy a big 4x4 pickup truck to drive to work. The secretary might purchase a mid-size family car such as a Honda Accord.

Where someone lives also has an impact on their social class. The secretary will make every attempt to live in a white collar neighborhood. The plumber will be content to live in a blue collar area where he doesn't have to worry about offending the neighbors when he changes the oil to his truck in his driveway. Each person has his or her own lifestyle. More importantly, each social class tends to flock together. The schools will be indicative of this situation as well.

I have been an educator for many years. During this time, I have taught thousands of real estate students at my real estate schools, as well as many more thousands as a university professor and community college instructor. The most valuable insights, however, came from a stint as a GED instructor for disadvantages youths one summer a long time ago. This was supposed to be a contribution to "humanity." It turned out to be that, as well as a lesson in social interaction and social class structure.

I found that my daytime GED students behaved much differently than the graduate-level MBA students I was teaching in the evenings. During the daytime, I taught youths that had dropped out of high school for various reasons and were desperately trying to get their GED and move forward in their lives. I related Mazlow's Heirarchy of Needs to their plight.

Abraham Mazlow has tried to describe a person's needs. The students where I was teaching GED preparation were at the bottom of the diagram. Trying to obtain food and shelter was their primary objective. For this reason, they were a long way from being able to pass the GED exam. Their plight places demands on teachers not otherwise experienced in schools located in higher socio-economic areas. Teachers know this and many times look to the schools in the higher socio-economic areas for employment.

The Story of Steve

Steve was my star student at the GED school. He was trying very hard to get his GED. He had a group of "friends" he constantly kept with him and they were always very alert—watching everyone and everything.

It seemed that all the students were extremely intimidated by Steve, even though he wasn't a physically imposing individual. One day, Steve didn't return to school. He had been arrested for murder. A short time later, however, he arrived back at school with a smile on his face and a pencil in his hand. He said that he had been arrested "by mistake" and he was back for good.

Sometime later, one of Steve's "gang" made a threat against me for some reason that I really don't remember. I decided that discretion *was* the better part of valor and decided that I had done enough for humanity. Now it was time to let someone else deal with the humanity at this school.

A month or two after I had left the school, I found out that Steve was arrested once again for murder. This time the charges stuck. I wonder if he completed his GED via "home study?"

Two good things happened: the authorities caught him before he could kill anyone else and I wasn't one of them.

Many teachers know about the "Steves" of the world and try to avoid their types of problems before they start. With the incredibly low amount of compensation we pay our teachers, it's amazing we find any teachers at all. Teachers are some of the most important people in society because they have a profound affect on our children. Yet they are not paid what they are worth. Okay, no more soapbox talk, let's get back to business.

Entrenched Social Structure

Many times existing neighbors have an entrenched social structure. Where the neighborhoods are old and there is not too much new development in the area, you tend to see this entrenched social structure.

There is a town in the San Joaquin Valley of California called Lodi. You may have heard the song “Stuck in Lodi.” Well, this is where they were stuck. The residents I have met in Lodi love their town and are pretty nice people too. They are all third generation or longer residents of Lodi and anyone who moves into the town is considered a “newcomer” and “outsider.” One guy had lived there for ten years and was still considered a “newcomer.” He had a hard time breaking into the entrenched social structure. The residents know everyone in town and new residents were “not to be trusted.”

This type of situation is, unfortunately, quite common in small towns throughout the U.S. Joining groups and organizations is one way to break through an entrenched social structure and get to know the long-time residents.

If there are lot of new homes coming into an area, there is generally not an entrenched social structure because everyone is new to the area. For this reason, new homes have the attraction of placing everyone on an equal social footing, as well as new schools for the children. The children will all be new to the area and they will not have to deal with an existing social structure at school.

Many Retirees and Empty Nesters

In older, more established neighborhoods, many of the homeowners have gone through the progression of newlyweds, new parents, and then empty nesters. They many times stay in the home until they retire and even into old age.

Many retirees like to keep their home where the children grew up because of sentimental reasons. They also like to have the kids come back “home” to visit. This is especially true with their families during the holidays.

Over time there will usually be a transition from these retirees to newlyweds. . .and the cycle continues. Homes must be rehabbed or even torn down and rebuilt in some of the higher socio-economic areas.

Mello-Roos Bonds and Special Assessments

Many of the older neighborhoods were developed before the establishment of modern day Mello-Roos bonds or special assessments to pay for off-site improvements such as street lights, sidewalks, and schools. These older neighborhoods may have some minor assessments or fees that were agreed to by the existing homeowners, however, they are usually small in comparison to modern day assessments. A street lighting assessment is a common add-on assessment in older neighborhoods.

Homeowner’s Associations and CC&Rs

This can be a double-edged sword. CC&Rs and a strong homeowner’s association (HOA) to enforce them can help maintain values in a neighborhood. Some of your neighbor’s activities may seem like a good idea to them at the time; however, they may cause a reduction in value in your home.

For example, a homeowner who lives in a suburban area of California decided to paint his home purple. Even though the neighborhood had CC&Rs that prohibit such offensive house colors, there was not an existing homeowner’s association in place to enforce them. This situation devalued all the homes in the neighborhood because buyers didn’t want to purchase a home with this type of eyesore near it.

The appraisal principle of Regression occurs because the homeowner’s purple house is considered a substandard property and adversely affects the homes around it. Tighter CC&Rs and an active HOA would have prevented the neighbor from committing such a huge styling mistake.

On the other side of the spectrum, a too active HOA can make living in a neighborhood like dealing with the Gestapo. The HOA may site you for leaving your garbage can out in the front yard too long (no kidding).

I was considering building a home in a really nice neighborhood in Park City, Utah. After reading the hundred or so pages of CC&Rs, I realized that I could be sited for not planting the correct plants in my own front yard. It's nice to have some control over your own lives and it appears that I would have been giving up what plants I could plant in my own front yard! Needless to say, I decided not to build in that neighborhood and found one that had a little less restrictive CC&Rs.

As soon as you open escrow on a property, you will generally receive a copy of the preliminary title report, along with a copy of the CC&Rs. You should read both documents carefully prior to moving forward with any property purchase. Many times you can obtain a copy of the CC&Rs from the builder prior to even making an offer to purchase a property. This is the best-case scenario, but not always possible.

Many older homes have CC&Rs, however they are many times very vague and generally unenforceable. Newer homes generally have more up-to-date and enforceable CC&Rs, as well as more active HOAs.

Builders generally originate and establish the CC&Rs for the neighborhoods they build. The builder usually enforces the CC&Rs until there are enough homeowners to perform this function themselves.

Mature Landscaping

In existing older neighborhoods, the landscaping has generally been in the same condition for quite a long period of time. Hedges are in place and trees are full-size. This allows good aesthetics, as well as good protection from sun and wind.

Newer homes generally have smaller trees and no shrubs in place. It takes time for good landscaping to grow around a newer home.

In areas where there are large existing trees (i.e. majestic oaks, Ponderosa Pines, etc.) builders will many times either decide to or are forced to build around the trees. This gives the neighborhood immediate character. However, the roots to these trees (especially the oak trees) may be cut during excavation and the trees will usually die within a year or two from the time the home is completed. Pine trees have a long tap root that runs straight downward and is not as susceptible to excavation risks.

Many new home builders do not landscape the backyards of the homes they build. They leave this to the homeowner, who may landscape the backyard any way he likes. Some builders in a really hot market have been known to not only not landscape the backyard, but also not landscape the front yard either. Builders generally do landscape front yards because it helps to sell new homes during future phases of construction.

Swimming Pools

Pools can be good or bad. It depends upon the age of the pool and type of home being purchased. An existing tract home with a built in pool that is not too old is probably worth approximately 50% of the cost to build the pool. That is why it may not be a good financial decision to have a built-in pool installed in your home. The smart person is the second homeowner who takes advantage of the previous homeowner's loss. He gets a newer pool for about half the price.

An old pool in an older neighborhood may actually reduce the value of a home because of the required rehabilitation of the actual pool itself, as well as the wearing out of pool equipment.

The Story of Lori

Homebuyer Lori was considering buying a home built in the early 1960s. The home had a pool that was built about the same time as the home. The buyer placed an offer on the property and it was accepted by the seller. Based upon the contract between the buyer and seller, the buyer had 17 days to inspect the property and make a decision whether she wanted to buy it or not. In other words, the buyer had 17 days to remove the physical inspection contingency to the contract and move forward with the purchase.

Lori decided to obtain a home inspection for the property she intended to purchase. The home inspector thought the home was in pretty good condition; however, the pool was a major area of concern. The home inspector recommended that Lori have a professional pool inspector look at the pool and make a separate report.

The professional pool inspector informed Lori that she would have to refinish the pool exterior in the very near future if she intended to use the pool. The professional pool inspector recommended that a pool equipment expert also look at the pool equipment.

The pool equipment expert inspected the pool equipment and informed Lori that she would probably have to replace the pool equipment in the very near future. With the reports from the home inspector, pool inspector, and pool equipment inspector Lori realized that the pool would have to be rehabilitated in the very near future if she expected to use it at all.

Having these types of thorough inspections prior to purchasing a home is a huge benefit to a buyer. The buyer knows the true condition of the home before she moves forward with the purchase. You want to discover the problems with a property before you close escrow—not after.

A buyer's options for an old swimming pool are to rehab the pool or fill it in. Since Lori's pool was rectangular in shape (a common shape many years ago) it has some functional obsolescence causing a reduction in value.

Most modern swimming pools have curved sides; however this one was obviously old and outdated. The buyer negotiated a much lower price than the home would have been worth with a modern pool in the backyard. The negotiated price was actually less than what the buyer believed the home was worth without the pool!

It is generally best to purchase a newer home that already has a built-in swimming pool constructed on the property. The previous owner (and not you) will take the loss of approximately 50% of what they paid to have the pool built.

For example, if a homeowner paid $50,000 to install a pool, the resale value of the pool would be around $25,000. An owner would probably receive around $25,000 more for his property than a person with the same property who did not have a pool.

In large super custom homes in dry Mediterranean type climates (i.e. S. California, N. California's inland areas, Arizona, etc.), a pool may be an expected item by a buyer. Most large homes will come with a pool. If it doesn't have a pool the buyer may look elsewhere for a home that does have a pool.

I knew a custom home builder in Scottsdale who told me that a built-in pool in his market was an expected item and a cost of doing business. He installed a built-in swimming pool in every property he built.

Lastly, an above ground pool will generally not increase the value of a home at all.

Roofs

When buying either a new or existing home, roofs are a huge issue and should be considered before purchasing. Many new homes, in areas where a huge snow load is not present, have synthetic tile roofs. These roofs generally are expected to last around 40 years before they need to be replaced.

Other new homes have dimensional composition roofs ("comp" roof) that are generally expected to last around 20 years. The expected life of roof depends upon the harshness of the weather.

Extreme sun exposure and extreme snow seem to be the most destructive. A comp roof in Phoenix, Arizona may have a much shorter life than a comp roof located in the pacific northwest.

Along the same line, a home located in Park City, Utah may experience ice build up or ice bridging during the winter time. This could cause damage to the shingles. A commercial grade heat strip will generally rectify this situation. It melts the snow on the roof and prevents ice bridging.

Existing homes usually may have several different roof types of varying ages. When purchasing an existing home, you should always get a home inspection provided by a professional home inspector. The home inspector should also provide a projected useful life for the roof.

If the inspector has doubts about the roof's condition, he may refer you to a professional roofing contractor for an opinion. Try to find a reputable roofing contractor who will give you an honest opinion of the condition of the roof. This may seem like a daunting task, because roofing contractors make their revenue and profits from installing roofs, not from roof inspections (which usually cost around $100-$200). An honest roofing contractor will tell you if the roof needs replacing or not. A dishonest one will tell you the roof needs replacing whether it really does or not.

Another problem I have seen in California, is aging wood shake roofs. As these types of roofs become older, homeowners have two choices: (1) replace the wood shake roof with another wood shake roof, or (2) replace the wood shake roof with a dimensional composition shingle roof.

The first option is more expensive than option #2, and has some fire issues. Wood shake roofs are more susceptible to catching on fire than composition shingle and synthetic tile roofs.

I was inspecting a wood shake roof of a property and found an expended bottle rocket that had obviously landed on the roof during the last Fourth of July celebration. This is a big concern because the property could have burned to the ground and the occupants were at risk from the use of these illegal fireworks. It's always a good idea to check your smoke detectors to make sure they are working correctly, especially if you have a wood shake roof. Many of the newer homes have synthetic tile roofs that have a longer useful life (usually 40 years vs. 20-25 years for wood shake) and generally do not have the fire danger of wood shake roofs.

Replacing a wood shake roof with a dimensional comp roof is cheaper than replacing it with a wood shake roof, but it does have its challenges and drawbacks. The main challenge is that the 1" wooden slats under the wood shake roof will not support a comp roof. You will have to place plywood or OSB sheets over the slats before you can apply the underlayment and dimensional comp shingles. In the past, some roofing contractors placed the comp roof directly over the wood shake roof. This was a cheaper method, however, it has the possibility of pushing the roof load factor too much, especially in areas with heavy snow loads.

Today, placing one roof over another is generally not the norm in the industry. Many roofing contractors will usually tear off the existing wood shake roof and install plywood or OSB under a new dimensional comp roof.

A new comp roof may be a fast, cheap, and easy alternative to your existing wood shake roof; however, it will cause a reduction in the value of you home. A comp roof has a lower perceived aesthetic value than wood or synthetic tile roofs.

Many homes in lower socio-economic neighborhoods have comp roofs. Homes in higher socio-economic neighborhoods many times have wood shakes or synthetic tile roofs. Placing a comp roof in a higher socio-economic neighborhood may cause a "stigma" and change a neighborhood's desirability and corresponding home values as homeowners replace their wood shake roofs with dimensional comp roofs. I tend to avoid these types of neighborhoods when investing in single-family homes.

It is a good idea to watch out for neighborhoods that were built with wood shake roofs up until about 1990. As these home's roofs start to deteriorate, the replacement of comp roofs could cause a significant loss in value (called the appraisal principle of regression).

A composition roof ("comp") generally indicates medium to lower-end construction in most California markets. In areas with high snow loads, this may not be the case because the only roof that can handle the snow load will be either a comp roof or a metal roof.

Speaking of snow loads, comp roofs are susceptible to ice bridging where the ice builds up on the roof and may cause a leak into the house, especially during the Spring thaw. Metal roofs are generally more expensive than comp, however, they don't general experience ice bridging. I guess, you get what you pay for. . . .

One homeowner who had a real log home and metal roof (although not so high quality of a metal roof) found out how dangerous these types of roofs can be. When the snow on his roof melted and then refroze, it turned into an ice sheet that was as sharp as a knife. The log homeowner discovered this fact when he emerged from his home on a nice Spring day to find his 8" diameter aspen tree severed in half by a falling ice sheet. A huge chunk of ice slid down his roof to the ground and cut the poor, unsuspecting (and poorly located) tree in two just like a meat slicer.

Leaky roofs are one of the major disclosure issues then an existing home is sold. In California, you must disclose a leaky roof to a buyer. The statute of limitations (how long a buyer has to bring action against the seller for nondisclosure of a material fact) is generally around two years from close of escrow for nondisclosure of a physical defect—like a leaky roof. And it may be four years or longer if the buyer can prove breach of fiduciary duty by their agent. It always best to consult with an attorney on all legal matters.

C. Economic Obsolescence

Economic obsolescence is a loss in value due to <u>external</u> factors outside the boundaries of the subject property. When an airport is placed very near to a single-family home, this external factor may cause a loss in value to the subject property because of excessive jet engine noises.

Economic obsolescence is the hardest form of depreciation to correct. The incomes of people in an area decrease, causing the prices at which homes sell to decrease. An appraiser would attribute this reduction in price to economic obsolescence. Widespread unemployment causes a decrease of incomes of residents. As a result home prices decrease. An appraiser would attribute this decrease to economic obsolescence. An appraiser may reduce a property's estimate of value because of a city's sewer system is in need of repair. This decline would be called economic obsolescence. Economic obsolescence includes an increase in property tax levies, a decrease in gross payroll of companies in the area, and the widening of a freeway. However, it would NOT be inherent in worn out fixtures (physical deterioration). Economic obsolescence could result from misplacement of improvements, <u>new zoning laws</u>, and a city's leading industry moving out. However, it would not be an outdated kitchen (functional obsolescence). The impairment of desirability and usefulness of real property through economic changes is called obsolescence. If the county confiscates the front 20 feet of an apartment building's lot to widen the street, and the rental value of the buildings units decreases as a result, this is an example economic obsolescence. Economic obsolescence would be caused by a high rate of taxes from excessive civic improvements, residents having low incomes, airplanes frequently flying overhead, and major shops moving to a shopping mall far away. It would NOT be heating units wearing out (physical deterioration).

Now that we have taken a look at valuing real estate, we can next look at the advantages and disadvantages of being a landlord versus a tenant.

Rent vs. Own

The answer to this question may seem obvious, but it isn't as easy as it sounds. In a seller's market, prices are increasing and owning your own home is definitely the best way to capture appreciation in the value of a property as the market value increases. However, in a buyer's market renting may be a smart move as the market adjusts downward. Why ride the market downward as an owner and "lose" the appreciation you have gained? Why not sell at the top and capture the increase in equity. Once you sell, you will become a renter. The following are some issues you should consider when thinking of owning a home as an owner versus renting one as a tenant.

No Landlord

One of the biggest advantages of owning your own home is no landlord to deal with. After someone has owned a home for a period of time, it is difficult to go back to being a tenant. The hassle of submitting personal information on a rental application is one drawback of being a tenant.

This is personal information and just because some guy owns a home and you want to rent it, he wants to know things about you that he really may not need to know to make a decision to rent the property to you. Having your social security number can be an issue for identity theft. Just because this guy owns a home, doesn't mean he isn't involved in an identity theft ring. Also, there is the possible humiliation when he checks with your employer. This may have an affect on your "image" at work and possible promotions. However, it could be used as a means to get a raise too! You are in dire straights and need more money to make it. You might be a risk to leave the company in search of a higher paying job.

Home To Live In AND An Investment

A house is generally considered a home and an investment. You do need a place to live. While you are living there, why not make some money at the same time? The increase in value of a home is called appreciation. However, remember that real estate markets are cyclical: they go up and they go down. In a seller's market prices are going up and there are more buyers coming into the market than sellers willing to sell their properties.

Conversely, in a buyer's market prices go down because there are more sellers willing to sell their homes than buyers coming into the market. Supply and demand is a big factor (along with financing) in both types of markets. As demand goes up and supply stays the same, prices will rise in an open and competitive market. As demand goes down and supply stays the same, prices will drop.

Add into the mix an increase in housing supply (i.e. new homes being built in a local area) while demand goes down and you have a *huge* drop in prices. This has been seen in markets throughout California and are generally located in areas with a lot of land for development and a lot of homes being built on that land.

One constant is that you need a home to live in. If you purchase a home with a long-term fixed rate loan (no negative amortization or adjustable rate loans, PLEASE) and intend on being in the home for the long haul (5 years or more), then you may be able to ride out the down market and take advantage of the next up market. Adjustable rate and negative amortization loans are probably not a good idea. Your loan amount will be going up while the market is going down in value.

Since you need a place to live and you can handle the payment, why not ride the market down and then back up again. You only lose if you sell. Time (usually) always heals.

The other alternative is to sell your home at the top of the market. Use the capital gains exemption of $500,000 for a married couple and walk with the money. Put it in the bank and earn some interest on it. Then rent a single-family home on a long-term lease and let the landlord ride the market down. Your money is sitting (somewhat safely) in the bank and may be protected by FDIC insurance.

When the market bottoms out, you take the money out of the bank (with the added compound interest included) and buy another home and ride the market back up. In this manner you are always riding an up market and sitting on the sidelines in a down market. Investors use this same strategy when they ride a market up and then do a 1031 tax-deferred exchange into a property in another market. They keep moving money from one market to the next in an attempt to keep riding up markets and not lose their equity.

Of course, an investor concerned with cash flow is an exception to this strategy. The investor in this case is only interested in cash flow and doesn't really care what the asset is worth. Some day, many years down the road, your heirs will have to deal with the problem of what to do with all those millions of dollars. (An idea that might be more fun is to acquire a gambling habit, become a "whale" in Las Vegas-- spend like a drunken sailor, and leave your heirs nothing. Just an idea!)

Social Prestige

Owning your own home usually causes an increase in social status in the community. I have heard people say, "I'm just renting until my house is built." Making sure everyone knows they are renters only because their home has not been built yet. People don't want the stigma of being a "renter." Especially in an area of homeowners. It doesn't matter whether you are looking at a lower or higher socio-economic area, the stigma still persists.

As a homebuyer, you really need to time the market correctly. You need to buy near the bottom and sell at the top. I have seen homeowners move forward and purchase a home, even though it is probably not a good investment decision at the time. It may be at the top of the market with the "roller coaster to the moon syndrome" going on in people's minds. They buy the home because of social pressures to be a homeowner and not a renter.

These homebuyers think they are going to live in the property "forever" so timing is not important to them. Unfortunately, homeowners usually stay in their homes an average of five (5) to seven (7) years. If this is not enough time for the market to come back around (go up), then you may be dealing with a losing proposition. Staying on the sidelines as a renter with your money "safely" deposited in a bank may be a wiser option.

Tax Advantages

Homeowners may receive a mortgage interest deduction from the IRS. This is an itemized deduction on your taxes and can be a nice way to shelter some of your income. See your CPA for the exact details. When it comes to taxation, I know just enough to be dangerous. I use my knowledge for my own general tax planning; however, I consult with a tax advisor for the exact numbers.

Investors have an even better tax deduction with income properties. They can "depreciate" the improved or building portion of an income property. This is an even better tax shelter than the mortgage interest deduction.

Security

When you own your own home you have the security of not having a landlord to deal with. A landlord may, at the end of your leasehold estate, give you notice to leave. This will cause you to incur the expenses of moving all your earthly belongings to another rental, with the same hassles of new landlords, rental applications, credit reports, etc. . .not to mention the costs of moving.

Many times landlords purchase a residential single-family home, rent it out, ride the market up, give the tenants notice to leave, rehabilitate it (if needed) and then sell the property for a nice profit. The tenant ends up with the hassles of moving. That is why it is a better idea to own your home when the market is going up and rent when the market is going down (if possible). If you own several single-family homes, it is easier than if you own only one home.

Also, children are a big consideration. Staying in one place with their existing social structure is easier than moving with the market and having to continually be the "new kid on the block."

School issues are another big consideration. The area with predominantly homeowners will most likely have the "better" schools (i.e. usually do a better job teaching to the "standardized" test). Moving the children from one school to another may be a concern as well, especially if the school in the "homeowner neighborhood" is better than the school in the "renter neighborhood."

Privacy

A homeowner will most likely be living in a single-family detached home. They will not be living in an apartment complex where privacy is a bigger issue. Noise from stereos, loud car mufflers (or lack thereof), loud motorcycles, neighbors jumping up and down on second floor units, and many other things may invade your privacy in an apartment type environment.

Single-family home renters have more privacy, however, their privacy can be violated when the landlord enters the home to inspect it or change the HVAC filter. Many people don't like uninvited people coming into their homes. The landlord has the "right" to enter the premises if he gives appropriate notice prior to entering. This can be viewed by the tenant as an invasion of their privacy.

Fire Danger

Owning a home can be safer than renting. Many rentals are attached apartments, condominiums, townhomes, and halfplexes (1/2 of a duplex). Since these types of properties have common walls, there is a greater risk of a fire jeopardizing the safety of your family when living in one of these types of properties.

You cannot control your neighbors and if a fire breaks out in their unit, your only defense is a working smoke detector, rehearsed escape plan, and fast feet. You have better control with a single-family rental property, so this would not be an additional risk versus owning your own single-family home.

There are always pros and cons to everything. Just like there are advantages to owning a home, there are some advantages to renting a home. Especially in a downward trending, buyers market.

Riding The Market

The biggest reason to rent a home and not buy it is if the market is going down. In a buyer's market, where prices of properties are declining, it is best to rent a property while the market slides down. Near the bottom is the time to jump in and buy a home, thus riding the market back up.

Renter's Credit

Renters receive a renter's credit on their taxes. This is not much of a tax shelter, especially compared to the mortgage interest deduction experienced by homeowners and depreciation experienced by investors. However, at least it is something.

Leasehold Estate

As a tenant you have a leasehold estate. This is a possessory interest in the land for a very short period of time. Depending on the rental market and type of property you are renting, the landlord or professional property management company you are dealing with may want between a six and twelve month lease. This is designed to tie you into a long-term lease and give the landlord more security than a month-to-month type of tenancy where you renew the lease every month.

There are two schools of thought on this situation. If you think the market is going to bottom out before the end of the lease term, then you as a tenant probably don't want to sign a long-term lease. A long-term lease of six to twelve months locks you into an obligation to pay the rent on the property for that period of time. Remember, however, if you do look for a property at the bottom of the market, you will need time to find the property (usually 1-2 months), close it (another 30 days), and then move in. If you overlap the lease of your rental property with the ownership of your new home, you may have two payments (depending upon when you close) for one to two months after close of escrow. This will allow you to move into your new home at your leisure and reduce some of the stress and costs of moving.

Breaking A Lease

Two points mentioned above that need to be discussed. First, what are the realities of breaking a long-term lease? The truth is that landlords can go after you for the lost rent from a long-term lease. The landlord must make a good faith effort to rent the property to another tenant and then can go after you for the amount of loss between your vacating the lease and the time the property is rented up.

The realities are that it is difficult to go after tenants who break a lease. The landlord can damage your credit and send it to a collection agency, but the actual collection of the money is difficult and time consuming. The landlord must track the tenant down and drag them into court. In my experience, tenants who live in California have all the rights. If the tenant can show hardship (job transfer, etc.) he may be able to get out of the lease. Even if that isn't the case, the tenant can try to show habitability issues that affected his ability to stay in the property. The really smart ones bring up the “M” word: MOLD. This really freaks the landlord out because he now has a potential disclosure issue when he decides to sell the property—and it is now in the public record. In fact, tenants who bring up the “M” word at the very beginning of negotiations have a better chance of an early termination of a lease agreement (landlords will probably think “good riddance.”)

Interest Versus Rent

The second area we need to discuss is overlapping your rental property with ownership of your new home. When you pay interest on your new home loan it is different than paying rent. Rent is paid at the beginning of the month (i.e. January 1st for the month of January). Interest on a home loan is paid in arrears (i.e. February 1st for the month of January).   If you close on the last day of the month (i.e. January 31st) you will pay one day of prorated interest (for January 31) and then your first payment will be due March 1st (for February’s interest). If however, you close escrow on February 1st, the entire month of February’s interest will be prorated and you will pay the entire month at close of escrow (pay all of February’s interest on February 1st). Your first payment will be due on April 1st (for March’s interest).

As you can see, when you actually close escrow does not “save” you actual out-of-pocket money, it only saves you the time value of money. You pay interest for every day you own the property, however, if you are short on cash to close (i.e. you need your security/cleaning deposit from you rental property to pay the rent down the road), then you need to consider the timing of close of escrow on your new property.   In the past, when I used to do a large number of first time home buyers with FHA insured loans, I several times had the loan documents drawn on the last day of the month, but ended up signing them a few days into the following month because of factors out of our control. This gave the buyer the ability to take advantage of the time value of money and get security/cleaning deposits back from landlords so they can pay their debt service on the their new home loan.

Security/Cleaning Deposit—Fighting To Keep It

Security/Cleaning Deposits are definitely an issue for landlords and tenants. Landlords want a deposit to cover potential damages to their property, as well as lost rent if a tenant moves out early. By terming the deposit a “Security/Cleaning Deposit” you can cover both areas: cleaning of the unit and payment if the tenant leaves and doesn’t pay the last month’s rent. Not paying the last month’s rent is fairly common. Tenants think they have already paid the last month with the deposit and conveniently skip the last rental payment.   I sometimes ask for a security/cleaning deposit that is about $50 less than one month’s rent. That way there are no misunderstandings. The tenant cannot say their security/cleaning deposit was rent, because the amounts do not match up. However, if the tenant decides not to pay the last month’s rent and the landlord must use it to cover all or part of this rent, there may not be enough money left over to cover cleaning and repairs that are not due to normal wear and tear.

Some landlords (especially in large apartment complexes) routinely keep tenant’s security cleaning deposits as a revenue source. They make the tenant fight to receive any of their security/cleaning deposit back. Since most tenants don’t have the time, knowledge, or resources to fight for it, the landlord keeps it whether the cleaning and repairs were actually done. The landlord can easily obtain cleaning “receipts” from his usual vendors if the tenant challenges his deductions. Pretty bogus if you ask me.

Landlords who are honest have the property cleaned by professionals and submit the invoices to the tenant with any money that is left over from their security/cleaning deposit. Landlords who own one or two properties have the tendency to try to do all or some of the cleaning or repair work themselves to save money. This is a bad idea. If the tenant challenges you in small claims court for Bad Faith Retention, the judge will want to see receipts for the work that was completed. If you say you did the work yourself, you’re dead in the water. Also, it is a good idea to take still pictures of the property before the tenant moves in and after he moves out. The judge generally will not look at video, but still pictures are very powerful. Remember to change the locks as soon as the tenant moves out. I was a little slow one time getting the locks changed on a rental property and had it cleaned prior to changing the locks. The tenants came back into the property and took pictures after I had it cleaned and then took me to small claims court to say they had left the property in that (clean) condition. This was a “bold faced” lie and they knew it. They had taken the grating out of the fireplace when they left and then returned it when they took the pictures. My pictures did not have the grating in them and theirs did, proving they had re-entered the property after it had been cleaned. Prior to going before the judge, we were required to meet in the lobby outside the courtroom and try to work the situation out. When I confronted the tenants with this proof, they immediately dropped the case. If I had changed the locks ahead of time, I would not have had to deal with the dishonest tenants. They were willing to go up in front of a judge and commit perjury in an attempt to obtain a small amount of money from me. Amazzzzzzzing.

Landlord Concerns

One of a landlord’s greatest concerns is renting their property to destructive tenants. The ability to determine whether a prospective tenant will be destructive is an art in itself. Landlords many times look at a prospective tenant’s credit report, rental history, and job stability to help determine whether he is a good rental risk. Even with a good credit report, great past landlord references, and a stable job history you may still get a destructive tenant. You must remember that it is a rental property and an investment. Sometimes you win and sometimes you lose.

Destructive Tenants

One of the biggest landlord concerns is destructive tenants. Many landlords who rent out their own home have a hard time separating their “home” from an investment property. They have an emotional attachment to their home and many landlords continue to look at the property like it is still their own home and cannot handle the emotional stress of having a tenant beat up the property. Landlords need to look at a property in a detached and professional manner. It is an income producing property and, as long as it is still standing, it can be repaired and rented out again. In fact, many people cannot handle the stress of being a landlord because of this stress factor alone.

Credit Report

An investigation of a tenant’s credit report can give some clues regarding whether the tenant has taken care of properties he has rented in the past. However, I had at least two different tenants who had perfect credit reports and then stopped paying rent. I had to evict both of them. You never know for sure.

Previous Landlords

A call to previous landlords can be better than a credit report. The tenants’ present landlord is probably not a good indication. He may give you a good referral as a means to get rid of a poor quality tenant. The previous landlords, however, are usually a good indication of the quality of a tenant. Did they leave the property in good condition? The answer to this question is usually pretty indicative of how they will treat your property.

Job Stability

A call to the tenant’s employer will make sure he is actually employed. This is fairly quick and goes a long way in establishing credibility for the tenant with the landlord. Another way is to ask the prospective tenant to provide an actual pay stub. The landlord wants to make sure the tenant has the ability to pay the rent.

Insurance

When you change a property over from an owner-occupied single-family home to a rental property, you must remember to change your homeowner's insurance. When you owned the home you probably had a homeowner's insurance policy that protected you against fire and some liability protection. As your home changes to a rental property, you need to change your insurance policy to an Owner-Tenant Liability policy. This protects against fire, but also gives liability protection against the tenant and his guests. The OLT policy is generally a little cheaper than the homeowner's policy.

Eviction

It is a very good idea to change the locks after the tenant moves out. Also, don't let the tenant know where you live. Otherwise you may receive both toilet calls and possible eggs on your house when you have to evict them. P.O. Boxes work well. Use a message number with recorded message for repairs If it's too easy to complain, you will get too many toilet calls—many are unnecessary. The landlord needs to inspect the property periodically. Use the excuse to replace the HVAC filter to make sure the property is in good shape. Surrounding neighbor(s) may have your telephone number to let you know if there is a problem. It may be a double-edged sword when they start complaining about everything. Renting properties can be a cash flow machine with built-in appreciation potential. Don't get too attached to your home. Tenants will be tenants and beat the property up. You just have to look at it as a business, get over it, fix it, and get it back on the rental market.

Market Timing

Market timing is critical to being a landlord. In a seller's market, prices are rising and being a landlord can make you a lot of money. On the other hand, the rental market may get hit with less demand in apartments because more buyers are jumping into the market as homeowners. The single-family home rental market, conversely goes up because more rental properties are being converted to owner-occupied single-family homes.

As the market changes from a seller's market to a buyer's market, prices start going down. At this point, foreclosures increase as people who bought at the top of the market, many with negative amortization option arm loans, start the rate adjustments and recasts of their loans. As their loan payments increase by $300 to $1,000 per month, they may not be able to afford the payments. They can try to refinance the loan, but with no equity the loan-to-value ratio is not high enough and lenders will not be willing to make the loan. Many homeowners see no alternative but to walk away from their property and either do a short sale or let the lender foreclose through a trustee's sale.

The former homeowners who have now become tenants will generally look to rent single-family homes, condominiums, townhouses, halfplexes, or apartments. Since many of the single-family homes are in the process of (or on the way to) foreclosure, that market does not have a large number of available units. Since many homeowners purchased condominiums, townhouses, and halfplexes for owner-occupied use, these will also be involved in foreclosures. The only market that is quick and available is the apartment market. As more and more homeowners lose their homes, the apartment market will heat up and rents will increase as a result.

Later, after the buyer's market has run for awhile, there will be more single-family homes on the market and fewer owner-occupied buyers who can qualify to purchase them. Investors will swoop in (near what they think is the bottom of the market) and purchase a large number of these foreclosures at "rock bottom" prices. Investors will convert these single-family homes, condominiums, townhouses, and halfplexes into rental properties and tenants in the apartments will move out of the apartments and into these more desirable properties.

Therefore, in a buyer's market apartments initially benefit by an increase in market rents, however, single-family homes and other owner-occupied type of properties will later steal the apartment owner's tenants away because of the greater value (for the money) provided by single-family rental homes.

How About A Duplex For A First Home?

First-time homebuyers should really look at a duplex (two units on one lot) as their first home. A duplex has the benefits of a reduced debt service that reduces your monthly out-of-pocket cash flow, and it can be used as a rental property in the future.

Occupy One Side and Rent the Other Side Out

A first-time homeowner who purchases a duplex can occupy one side of the property and rent the other side out. The good news is, since he is occupying one side of the duplex, he most likely will be able to obtain owner-occupied financing for the entire property.

Owner-occupied financing generally has a lower interest rate than nonowner-occupied financing. Lenders perceive less risk of an owner-occupied homeowner defaulting on his loan than they do from an investor. Investors look at a property as an investment. Homeowners look at a property as their home.

With a lower interest rate and the other side rented out, duplex owners usually have a much lower debt service than their counterparts who own traditional single-family homes. This can be a big help when a homeowner is tight on cash and every dollar of disposable income saved can really impact an owner's lifestyle.

Tenant Proximity Issues

One of the negative factors with purchasing a duplex and living in one side, is the proximity of your tenants. It is a good idea (if possible) to not the let the tenants know you are the landlord and live next door. This is really difficult if you are managing the property yourself. If the tenant knows the landlord lives next door, you may get a bunch of toilet calls in the middle of the night. Also, if you get into a dispute with the tenant, he will know where to find you. Your duplex can be a big target for rotten eggs.

One solution is to use a P.O. Box as your contact address for the tenant. Have the tenant mail his rent check to the P.O. Box and not deliver it to your home. This will insulate you from potential problems that stem from being a landlord.

A separate cellular telephone can be used as your telephone number. These are easily cancelled, especially if you only use the cell phone for tenant calls. Use another cell phone for your personal calls. Definitely, do not give the tenant your home number. You will get calls at all hours of the day or night. It is generally best to limit tenant accessibility to you. A cell phone and/or voice mail tends to do a good job. Email can also be used as a point of contact.

Having tenants living next door to you and with a common wall, the risk of fire becomes apparent. A good smoke detector is a must when living in a multi-unit type property. A carbon monoxide detector is also a good idea.

Tenants may be loud and have late night parties. As a landlord, you have to consider this situation before selecting a tenant for the property. A little old lady may be less hassle than three college students.

Tenant Problems

A single-lady who had excellent credit rented an apartment from me several years ago. She had a good job and looked like an excellent rental prospect. Several months into her tenancy, I found out (from the neighbors) that a lot of people were coming and going into and out of the house at all times of the day and night. Shortly thereafter, she stopped paying rent. I immediately evicted her from the premises. I suspected that she was dealing drugs from the house and was going to have to give her notice to leave anyway—whether she was paying her rent or not.

Sometimes, I like to meet the neighbors around my rental properties. When I stop by (usually on summer evenings near dusk when everyone is out and about) I chit-chat with them about the neighborhood. If there are problems they will usually let me know.

One neighbor on another rental property called me up to inform me that my tenant had abandoned the property. I said, “What do you mean.” She informed me that the tenant had left the property two days ago and had left the front door wide open. The tenant had acquired two large Dobermans and was keeping them in the backyard. We did not have a pet deposit and I really did not want the liability of these two dogs on the property. If the dogs bite someone, in California they can sue the tenant AND the landlord. Which of the two do you think has the deepest pockets? I informed him that he would have to get rid of the Dobermans or I would have to give him notice to leave. He elected to leave. I then brought my bamboo rake into the home and raked up all the old clothing left on the floor. Generally, insurance companies will not insure a property if a Doberman, Pit Bull, Rotweiler, or trampoline (not a breed of dog) lives on the property.

Month-To-Month Lease vs. Long-Term Lease

Sometimes a month-to-month periodic tenancy can be more favorable than a long-term (estate for years) type lease. I have found in California that a long-term lease obligates the landlord, however, tenants seem to be able to break them with no problem. The landlord is held to the contract and tenant is not. This is a one-way street and I don’t think it is fair. The perceived security from a six month or one-year lease is just that—perception. In realty, the landlord has an obligation and the tenant may not.

After you live in the duplex for a while, you may decide to buy a single-family home. You can rent out the duplex (hopefully for a positive cash flow), get depreciation on the improved portion of the duplex, and then move into your new single-family home. Many times you see two single people (who have their own single-family homes) decide to get married and move in together (not necessarily in that order). They both may not be able to rent their homes out for a positive cash flow, so they must sell both their homes and purchase a new (bigger) home. The costs of the sale and commissions can be significant. Also, they may not have timed their marriage commitment with the market. For these reasons, if you had purchased a duplex when you were single, you could rent the duplex out and use it as an income property. You would then have a nice single-family home and a duplex rental property. If both people had duplexes, you would have two income properties, along with the new home. Something to think about (if you’re a clairvoyant). Buy a duplex, find a spouse with a duplex, get married at the start of a seller’s market. . .yeah, as if that’s going to happen.

Investment Strategy and Financing

You must also look at your investment strategy. How long are you going to hold the duplex? If you are going to keep it for a long time, do you get a conservative 30 year or a 15 year (amortized) fixed-rate loan? Can you obtain a break-even cash flow with the higher payment that results from a 15 year payment schedule, rather than paid over thirty years. Or do you want huge cash flow now and will sell it before the market goes down?

IRC 1031 Exchange

Lastly, after you hold the duplex for several years as an income property (you subsequently moved into your single-family home), do you sell it? If so, what are the capital gains taxes? Owners of investment properties can defer their capital gains taxes through an Internal Revenue Code (IRC) 1031 exchange. This is a “tax deferred” exchange, it is not tax free. You are able to take your proceeds from the sale of the duplex and reinvest them back into an income property and defer the capital gains taxes into the future. Someone will have to pay the capital gains taxes sometime in the future. The capital gains taxes are only deferred, not erased.

Next is a look at moving from being a renter to becoming an owner.

Moving From Renting to Owning

One of the first things you should consider when thinking of buying a home is market timing (have I mentioned this before?). Markets are cyclical in nature--they go up and they go down. If you are near the bottom of the market, you may be able to purchase a larger home than if you were near the top of the market.

Time usually heals the “real estate blues”, so if you can wait the market out you will most likely get your money back. However, when family considerations arise, timing may go “out the window!” A newly married couple may want a home without landlord concerns and threat of having to move every time their lease ends (or the property is foreclosed—whichever comes first). If the couple would like to start a family, then a home purchase will most likely be in the plans. Trying to time the market with family considerations is very difficult. Therefore, if the market is a buyer’s market and is heading downward, you can protect yourself by buying the smallest home possible in the highest socio-economic area available. The smallest house will have the least relative depreciation (loss of value) than other larger homes in the same area. In addition, high socio-economic areas generally have the lowest depreciation rates relative to their surrounding areas. This is because of desirability.

If you are facing a seller’s market, then prices will be rising and other problems present themselves. In a seller’s market there may be intense competition for homes, especially in higher socio-economic areas. For this reason, there may be a “frenzy” of buyers making emotional and often bad purchase decisions because of pressure coming from other buyers. Inside market information is critical in this type of market. The best properties many times never make the multiple listing service (MLS) so, unless your agent works for the company that listed the property, it will probably be sold before you know about it. You can periodically drive an area of particular interest and look for “For Sale” signs, however, the property might be sold even before the sign goes up.

I had a client who wanted to purchase a condo in Lake Tahoe. I was not “hooked up” with the local Multiple Listing Service (MLS) in Lake Tahoe. In fact, they had three SEPARATE MLSs in the Lake Tahoe area. I talked with a local agent and he told me that since it was a seller’s market, he had fifteen buyers for every listing he could get his hands on. There was no way I was going to find my client a property. I thanked him for his advice. I then went to the tax record database and mailed a letter to a couple of hundred condo owners who owned condos in the area my client was interested in. I received two responses by telephone. I showed the client both properties and he bought one of them. This is one method of going directly to the owners to get the best deal on a high quality property.

Back to buying a home. You must consider your employment situation, present and potential future family income, family size (now and in the future), personal goals & exit plan, savings in the bank, and your attitude toward debt (commonly measured using a FICO score). If all these factors line up (kind of like all the stars in the universe lining up), you then need to get pre-approved by a lender. Pre-approved is not the same as pre-qualified. In getting pre-qualified, the lender writes a letter that states, “Based upon unconfirmed information we think we can make a loan to this buyer, however maybe not.” Pre-qualified really doesn’t mean anything.

Pre-approved does mean something. It means that you have completed a loan application and it has been submitted to underwriting. The underwriter generally states that he will make a loan to you, subject to certain funding conditions (usually appraisal, verification of credit, etc.).

This is like going shopping with cash. The seller will know you can close the deal. The ability to close a purchase can be worth money to you. The seller may be willing to accept a smaller sale price if he thinks you can close quickly. Let’s look at each of the factors discussed above.

Present and Future Family Income

Many homebuyers make the mistake of buying too much house. Lenders will determine the maximum amount a buyer can qualify for a loan. The real estate agent may then assume that the buyer will want to purchase a home for this maximum amount. This may not be the best thing to do. The buyer must consider what their payment comfort level is and purchase a home in that range. I always ask clients where they want to live. This will dictate the size of the home they can get (if at all). You generally make a tradeoff between quality of neighborhood and size of home. In other words, you can usually get a nice large new home in a lower socio-economic area or a small old fixer upper in a high socio-economic area. Remember, location, location, and location.

Present and Future Family Size

The size of the family will affect the number of bedrooms needed in the home. Newlyweds may be able to handle a two bedroom home, while a family with four children may want a five bedroom home. If you think your family size will increase in the future, it might be a good idea to initially buy a home with a bedroom or two more than you presently need. This will give your family a chance to grow. . .and if it happens, great! If not, you can put the room to other uses.

Personal Goals and Exit Plan

Why is the buyer purchasing the home? Is it being purchased because of family considerations or as an investment, or both? Most home purchases are considered both a home and an investment. A buyer educating himself in the field of real estate is one way to protect himself during (probably) one of the largest investments of his lifetime. Hiring a team of professionals (i.e. lender, escrow officer, home inspector, and pest inspector) is critical to a favorable outcome when purchasing a home. As real estate agents, we refer many of these people to our clients. Generally, you as a real estate agent have handled the purchase of a lot more homes than your clients will in a hundred lifetimes. And you will most likely have people you work with who are professional and can perform on time. It is critical to obtain a team of professionals to handle each and every step of the transaction.

Also make sure you have an exit plan. When you purchase a home, have an idea how long you will be staying there and compare this to projected market timing of buyer's and seller's markets. This is critical when selecting your financing. If you are going to be in the home for 15 years, market timing will not be as critical and you may want to consider a conservative 30 year or 15 year amortized loan. If you are looking at staying in the home only a couple of years and it's a seller's market, then an aggressive ARM may be the answer. Your personal goals, tolerance for risk, and exit plan will dictate the type of home you purchase and the financing you will use to obtain it.

Savings In The Bank

With the changes in the financing markets, a down payment has become more critical to purchasing a home than it was during the Option ARM heyday. The NINJA (no income, no job, no assets, no problem) loans have been replaced by more responsible underwriting guidelines that use the traditional loan-to-value ratio as their first line of defense against foreclosure. For these reasons, savings in the bank are critical to finding a low interest rate loan.

Attitude Toward Debt (FICO Scores)

Your FICO (Fair Isaac and Company/Corporation) score is used as an indication of your attitude toward debt. It also attempts to measure your ability to successfully handle debt. Some people can handle more debt than other people. A "good" FICO score depends on lender underwriting guidelines at the time you are trying to obtain a loan. A person with a FICO score of 700 or higher is generally considered a good credit risk and will usually be able to obtain a lower interest rate ("A Paper" loan) than other less creditworthy borrowers who have lower FICO scores.

You should guard your credit rating closely by checking it at least once each year. See www.freeannualcreditreport.com for more information.

After you have decided whether to rent or to buy, if you do decide to buy you need to decide whether an existing home or a new one will be best.

Existing Homes vs. New Homes

A big decision that you must make prior to buying a home is whether to purchase an existing (used) home or a new one. Both have their own pros and cons, especially when performing your due diligence on either of them.

Existing Homes

When you purchase an existing home you must realize that you are purchasing a used home. The useful life of a home is generally thought to be around 40 years. It could be longer; however, the home probably will generally not maintain its aesthetic value longer than forty years. Functional obsolescence will set in and the home will need to be rehabilitated (rehabbed). With a new roof replacement every 20-25 years, the home could go even longer than the 40 year estimated useful life before rehabbing.

Maintenance

Older homes generally require more maintenance than new homes. Even though new homes may be a problem during the first year or two, they will generally not require as much maintenance as older homes do over their lifetime.

Older homes may require maintenance or replacement of entire systems in the home. The heating, ventilating, and air conditioning (HVAC) system only has a certain useful life and will need to be replaced. Each unit is different and useful lives vary greatly because of this. I have seen some units last twenty years and others last less than seven. It really depends on weather conditions and how much the unit is used.

Another item is the electrical system. Really old homes may occasionally still have fuses instead of modern day circuit breakers. GFCI (Ground Fault Circuit Interrupter) outlets are supposed to be located in the kitchen, bathrooms, and the exterior duplex receptacles around the home. They are designed to protect the homeowner from electrical shock (i.e. electrocution) wherever water and electricity have the possibility of coming into contact. Older homes may not have these and may pose a serious safety risk to homebuyers. Another safety factor is duplex receptacles with only two plugs instead of three. Older homes with only two plug duplex receptacles should usually change to three plugs. Many older homes may not be wired for ceiling fans with lights. You may have to rewire the home to obtain a ceiling fan and light. A licensed electrician is always the best choice to rewire a house. The possibility of fire is too great to have a do-it-yourselfer making these changes.

Plumbing can also be an issue. Many homes built in the 1940’s have asbestos soil pipes leading out of the house. Asbestos has been known to be potentially carcinogenic (cancer causing). Also, homes built around 1985 used some brands of ABS pipe (plastic PVC pipe) that was defective. Some ABS pipe manufacturers had defects in the pipe they produced during this time period. Over time the glue used to connect the pipe to fittings caused the pipe to crack and leak. This was the basis of a class action law suit and is a disclosure issue on many homes in California.

Homes built before 1978 could potentially have lead-based paint in them. Children who bite on a window sill, for example, could ingest the lead. Lead poisoning has been known to cause learning disabilities in children.

In addition, homes built prior to 1978 may have used asbestos in the blown ceilings in the home. When these “popcorn ceilings” break off into dust particles, they can be hazardous because asbestos has been deemed to be potentially carcinogenic. This type of ceiling must be either removed or sealed up to prevent the asbestos particles from becoming airborne and being breathed in by the occupants.

Why use a real estate agent?

With advent of the internet, it was initially thought that real estate agents would be a thing of the past. This has turned out not to be true. In fact, a real estate agent is needed today even more than ever before.

Real estate agents continue to serve several purposes:

1. Buffer between buyer and seller.
2. Negotiator between buyer and seller. Helps seller set a price that will sell.
3. Source of contracts, disclosures, and other technical items that the buyer and seller are not familiar with nor have access to.
4. Probes for seller motivation and is a means of weeding out sellers who are not really sellers (i.e. husband and wife cannot agree on a price, or even if they are going to sell the property). This reduces the number of undeliverable properties on the market.
5. Probes for buyers' ability to buy a home. Weeds out all the buyers who are ready, will, but not able to buy a home. An agent will get the buyer pre-qualified with a loan officer before starting to look for a property.
6. Agents provide industry expertise and industry contacts for escrow, title, pest inspections, home inspections, home warranties, etc.

Buffer Zone

A real estate agent is a great buffer zone between a seller and a buyer. A few years ago I was representing a buyer in the purchase of a single-family property. It was a buyer's market at the time, so he felt obliged to make a pretty low offer. I consulted with him regarding his options. The seller could accept his offer (which was not likely), the seller could make a counter offer (which was likely), or the seller could reject the offer and then my buyer would be "dead in the water." It's hard to make a counter offer to a seller's rejection. In other words, if the seller rejected his offer, he would be in the unenviable position of having to counter himself if he really wanted the property. This would put him in a bad position for a buyer, even in a buyer's market. That is the danger of making a really low offer on a property you really want.

Many times when a buyer and seller come face-to-face, dynamics come into play that may not favor either party, and may in fact jeopardize the whole transaction. There may be a personality clash between the buyer and seller that may blow the whole deal.

Also, each party may be able to get an emotional reading regarding how bad the buyer really wants to buy the property or how bad the seller needs to sell it. When an agent is involved (especially when there are two agents—one representing the buyer and one representing the seller) each party is only looking at the deal itself. "Negotiation gamesmanship" cannot come into play.

The agents are a buffer zone between the buyer and seller, thereby eliminating personality and emotional issues much like wearing sunglasses to a Texas Hold'em poker game. The other players (buyer or seller) cannot get a reading on you because you have your agent playing for you while you direct the action from the sidelines. In this manner, the other party is working in the blind and cannot use any perceived motivations or weaknesses against you.

Negotiator

The real estate agent is also a negotiator. She is able to advise the buyer and/or seller about market conditions. In a seller's market, where there are fewer properties offered for sale and more buyers coming into the market, the agent must educate the buyers about the possibility of multiple offers coming in on the property, and the probable price needed to obtain the property. Many times if there are multiple offers on a property, and many of them are OVER list price, the buyer will not believe the agent when he tells them they need to write an offer $XXX over list price if they want the property. Instead, they will tell their agent they want to write the offer UNDER the listed price. The agent will usually go ahead and write up the offer—knowing full well that there isn't a snowball's chance in you know what of the buyers obtaining this property. The sellers will reject the offer or there will be multiple counter offers—with the seller having the ability to accept the highest and best counter offer. After"losing" a few properties, the buyers will generally start listening to their agent.

Now that we have proven beyond a reasonable doubt why we are needed, let's take a look at single-family homes versus condominiums and see if we can figure out which one is best.

Single-Family Homes vs. Condominiums

Both single-family homes and condominiums (condos) have their advantages and disadvantages. It depends upon the owner's intentions and the location of the property. Where land is scarce and thereby expensive, condos work fairly well. Conversely, when land is plentiful and cheap, condos don't work as well as single-family homes.

For example, if you want to purchase a property on the island of Maui you would first look at the areas around the island and find some of the better locations. Most tourists want to be as close to the water as possible, hence ocean front or ocean view properties are generally considered the most desirable. You will probably next look at the weather both in the winter and during the summer trade winds. A careful analysis (you bought the book "Maui Revealed" which is the best source available and is sold by the PALLET load at Costco in Kahului) showed you that the best weather areas on the island are Kihei/Wailea/Makena (KWM) areas, as well as Lahaina/Kaanapalii (LK) areas. You then consult the local telephone directory and find out where and how high (up the shoreline) tsunamis have hit before and decide whether you need a home with stilts or not. It is interesting to note that Lahaina has generally had the best weather on Maui and very small waves hitting the beaches because it is protected by Lanai and Molokai. However, when a tsunami hits the waves wrap around Lanai and hit Lahaina pretty hard. The Kihei area, for example, seems to get hit less than Lahaina, even though Kihei is less protected and is sometimes hit by waves coming in from the Tasman Sea. Its winter time down under, hence the bigger waves (an old time surfer clued me in on that one).

Tsunamis are usually a threat from earthquakes located along the Alaskan coastline. In fact, on the windward (east side) of the big island of Hawaii lies Hilo Bay and the town of Hilo. In the 1940's and 1960's Hilo was hit by tsunamis originating out of Alaska. When you see the water quickly recede a good distance out to sea, run for higher ground. You probably have about one minute to get to high ground before a huge tsunami wave hits the beach where you are standing.

Once you have gotten your tsunami due diligence completed (and worries under control), you will probably look at other factors in your decision. Land tenure is a key area in Hawaii. On Maui, most of the single-family land is held fee simple. This means that you not only own the building, but you own the land under the home as well. This is a good thing, but not always the case in Hawaii.

In contrast, there are a fair number of condos that hold their land as a leasehold estate. This means you don't own the land underneath the condo. At some point in time you will have to buy the land separately (and it keeps going up in price) or, when your leasehold expires you will lose it. That's right, when the leasehold estate ends it will revert back to the landowner. In my opinion this is not a good thing. I generally stay away from these types of investments. If the property looks like it's "too good to be true," it probably is—check the land tenure and you'll probably find that you don't own the land under the condo. On the island of Oahu leasehold estates are much more common than Maui; however, Maui does have its fair share as well.

The KWM area is closer to major shopping in Kahului than LK. Tourists usually don't really care about mass merchandisers. They want a beach, and Kaanapalii beach is generally considered one of the best beaches in the world. I can't disagree either. In my humble opinion, Maui is one of the best places in the world to live or vacation. I really can't find a place with better weather, nicer people, and a more laid-back life-style than Maui. For example, the top speed for most of the drivers is around 45 mph. It's probably the only place I would consider riding a motorcycle on the road. Not too many four lane roads to get side swiped by a distracted driver, average speeds are fairly low, and no one (except more and more of the construction workers) is in a hurry. With the boom in construction over the last few years, the local police are having to crack down on speeders more than they used to. The locals know where their economy comes from, that's right--tourism. They don't want tourists inconvenienced in any way. I saw one construction worker who was drunk (at 2pm in the afternoon) and hit a light pole going into Kaanapalii beach. Two police quickly handcuffed the guy, stood him out in the hot summer sun for a while to make sure he understood the gravity of the offense, then hauled him off the jail. The traffic light pole was quickly replaced and everything was great in paradise again.

In my opinion, Kaanapalii beach is on a par or better than Bondi Beach in Sydney, Santa Cruz Beach and Boardwalk/Capitola Beach in California, all the Cabo San Lucas' beaches, Chakunab on Cozumel (dolphins and all), St. Thomas, Bahamas, and even Nice's cobblestone beachs on the southern coast of France. Seven Mile Beach on Grand Cayman Island is about even (I would say). I wonder if people are still swimming with the stingrays at Stingray City?

After deciding on Maui (Kauai is pretty good too, except they roll up the sidewalks before the sun goes down) as a place you want to live or buy a second home, you need to decide whether a single-family home or condo would be best for your needs (and pocketbook). When you start looking at single-family homes and condos in the two respective areas, you realize that single-family homes cost about TWICE as much as condos in the same area!!! On top of this, condo are generally better located because they can derive more income and value out of an ocean front or ocean view location than a single-family home.

So you're saying to yourself, "I can buy a condo in a better location and for one half the cost, there's nothing more to consider." Wrong. Before you start throwing your money down on a condo (and I hope your brought a duffle bag full of money, because you're going to need it), you really need to do a little more due diligence. You will find out that condos have a Homeowner's Association (HOA) and monthly costs are pretty steep (it rhymes with "cheap," but they don't mean the same thing). Many of the condo associations dues are over $1,000 per month. You don't have this cost with a single-family home. This evens things out (a little at least).

The HOA dues usually cover the costs of operating the HOA including management of the association, maintenance of the common areas--which include the pool, clubhouse, etc. The HOA also places a certain amount of money aside each month in a reserve to replace the exterior of the buildings as they wear out. I was in one small condo association near Lake Tahoe. The owners of each of the units starting going to the HOA board (comprised of condo owners who live or own one of the units in the complex) and asking for specific repairs to the outside of their units because of "snow damage." I was not impressed with the HOA or the management, so I sold the unit probably before I really wanted to because I didn't trust their ability to keep the units up and values in line with the other properties in the area. Sometimes the HOA can help you and sometimes it can really hurt you.

Back to my Maui story, of course you must decide what your objectives are before you even start the process. Do you want a second home that will stay vacant when you are not on the island? Or do you want a vacation rental that you can use periodically when it is available? Or lastly, do you want a permanent rental that caters to either people who are on the island a short period of time or locals/kamahinas who are working on the island and need a place to stay. Locals are people who were born on Maui, kamahinas are mainlanders who now live on the island (I hope I spelled that right).

Once you've made your decision, then you can decide on whether to buy a single-family home or a condo. Keep in mind, however, that single family homes tend to rent more easily and for more money for a permanent rental than condos. The tenant is more interested in peace and quiet than being on the beach. Condos generally do well with vacation rentals, because vacationers want to be on the beach for their short stay and don't care as much about peace and quiet. Vacationers also want the amenities that go with a condo: pool, clubhouse, exercise room, close to the ocean, close to shopping, etc.

When a single-family home or condo is being used as a vacation rental, Hawaii gets their grubby little hands into your pockets (and I thought this only happened in California) with a 10% Hawaii Excise Tax (HET). That's right, 10% of your rental income is taxed and goes to the State of

Hawaii (4% if the rental period is over six months). Most of time Hawaii takes care of their locals pretty well. However, if you're a "howly" (the wind howls through your ears—and I've had that problem for a long time) from the mainland, you better keep your hand on your wallet or purse because they tend to stick it to you pretty good. That's what you get for driving prices through the roof and sealing out the locals from being able to buy a home on their own island. Something to think about. . . .okay, I'm done thinking.

Oh by the way, since I tend to hang out over their quite a bit, I was made an honorary kamahina (transplant) and so I'm no longer a howly. This was done by a friend of mine who is an actual descendant of Hawaiian royalty (no kidding).

Once you do your financial analysis, you can also make a decision regarding whether to buy a single-family home or a condo. Vacation rentals generally cost a bit more to manage than permanent rentals. For example, property managers who specialize in vacation rentals may charge you 30% or more to manage your property. In contrast, a property manager of permanent rentals may charge you around 10% to manage these types of properties because there is less management intensity. It usually doesn't matter whether it is a single-family home or condo, the percentages are generally the same.

Once you do your analysis, you may find that owning either of the property types may be an expensive proposition. With permanent rentals you may experience a very low return on your investment. The capitalization rate may be around 2%-3% and you could get a better return in CDs or money market accounts. You do get pretty good depreciation on your taxes, however.

The two things you have going for you is a world-class location and good potential appreciation. Remember: location, location, and location. A condo may have a better location, but the HOA dues may kill you.

Location

Since condos can generally maximize the return of a well-located parcel of land better than single-family homes, they are generally better located than single-family homes—especially for the price. In other words, the number of condos that can be built on a particular parcel is much more than one single-family home. The combined value of these condos and resulting combined rental value is greater than the value of a single-family home. This comes back to the appraisal principal of highest and best use. The condo is a higher and better use than a single-family home.

For example, you purchase a vacant ocean front lot. If you build a single-family home on the lot, you will obtain a value (for example) of $1 million. However, you could build four condos on the same lot and each condo would sell for $500,000 each. A buyer would be willing to pay half a million dollars for the ocean front and ocean view location. Remember, "Location, Location, and Location." The resulting value of the condo development is $2 million in total value. Of course, the condo may cost a bit more to build, however, the resulting profit will be greater for the condos than a single-family home.

Let's head back to the mainland and talk about parking.

Parking

Single-family homes may have an advantage over condos because of a garage to park your car. In areas where snow and ice are prevalent, this can be a huge amenity. Condos might have an assigned parking spot, covered parking, or even a small garage. The price will usually go up accordingly.

Depending upon the size of the condo (i.e. number of bedrooms and bathrooms) the number of allocated parking spaces may be a big issue. For example, a 3 bedroom/2 bath condo rents for $1,500 and has one assigned parking space. If the tenants have more than one car (and that's a good possibility in a 3 bedroom condo) then the second and third car must park in unassigned parking spaces (hopefully) somewhere within hiking distance to the condo.

A single-family home might have a garage or carport. If it has a garage, it may hold three or more cars. There is no way you are going to get a decent size garage when you own a condo. In addition, when you are taking into account parking issues, HOA dues (that seem to continually go up), and other condo-related factors, a single-family home—even though it is more expensive—might be a better deal in the long-run.

Fire Danger

Condos have common walls between each unit and they place you at risk. If a fire started in another unit it could quickly spread to your unit and jeopardize you and your loved ones. The occupants of other units around your property may not be as careful as you are and there is not way to gauge their ability to keep from burning their unit (and you) to the ground. With a single-family home you can at least try to minimize the possibility of a fire. You control your own destiny in a single-family home, however, you don't in a condo. Of course, a good smoke detector installed in every room is the best course in both a single family homes and a condos.

Security

Many single women like condos better than single-family homes because of security factors. A second floor condo is perceived by many women as being more safe than ground floor condo units or single-family homes.

Many condos may be gated, which also gives a greater perception of safety. If a criminal cannot effectively plot his escape, he may not commit the crime in the first place. The good news is that the HOA will most likely pay for gate maintenance and security thorough your monthly HOA dues. Some single-family subdivisions have gates also.

Garages can also be a security issue. Many condos do not have garages, so you will have to park under a carport or the wide open spaces and walk to your condo. This is where you are most vulnerable to attack. Condos that do have garages many times are not attached to the condo and the owner must still exit the garage and be exposed to the dangers of attack.

Conversely, many single-family homes have attached garages. This allows you to exit your car and go into your home with the garage door in the down position. A single-family home or condo with an attached garage in a gated community is probably one of your safest bets. Although, a really big dog may not be a bad idea either.

Some condo complexes have security guards who patrol the complex and are paid through the monthly HOA dues. This may be an added degree of safety over a single-family home.

Noise

Because of the proximity of your neighbors in a condo, noise may be more noticeable than in a single-family home. However, because condos are usually freehold ownership, where you own the airspace fee simple and the common areas in common with all the other condo owners, you must have a fairly good job to be able to buy one. Condo owners are usually a little more serious and maybe a little more mature than young and more boisterous apartment dwellers.

For these reasons, noise will probably not be as bad a problem with owner-occupied condo owners versus condos that are rented out to tenants. If a condo is rented to a tenant and the tenant violates specific CC&Rs (Covenants, Conditions, and Restrictions), the HOA board of directors (usually comprised of condo owners in the complex) may possible levy fines against the owner's unit.

I was visiting a condo I owned and stayed there for a week while I was arranging some rehab work. While I was there, I met some neighbors who were barbequing near the pool. I was invited to attend their party and we were having a pretty good time. About 10pm (it was Thursday night) the complaints started coming in from the owners and tenants that we were having "too good" of a time and we were way too loud. The manager showed up and told us that the security guys were on the way and it might be a good idea for us to beat it. We did, just in front of a couple of huge guys who looked like they could take care of themselves—and us too. I was a bit put out, being a single-family homeowner I wasn't used to being treated like a common criminal--for having a good time in my own condo. On the other hand, this type of enforcement was good for my future tenants and hence my rental rates and property values stayed up and occupancy was high because of it. I was there for only ten days. I'll bet they were glad when the "party animal" owner went back to the mainland and a "nice, quiet tenant" moved into the property.

Appreciation/Depreciation

In general, I have seen single-family homes have a higher appreciation rate (increase in value) than condos. I assume this is due to desirability of single-family homes over condos. In addition, I have seen single-family homes have a lower depreciation rate (loss of value) than condos as well. Generally, appreciation rates correlate to seller's and buyer's markets. Single-family homes seem to go up faster than condos in a seller's market and down slower in a buyer's market.

CC&Rs

As mentioned earlier, CC&Rs stands for Covenants, Conditions, and Restrictions. CC&Rs protect you from your neighbors making "stupid moves" that will cause a devaluation of your home.

Condos generally have tighter CC&Rs than single-family homes. They also have a homeowner's association (HOA) to enforce them. In other words, when there are tight CC&Rs and an active HOA, it is harder for your neighbors in a condo complex to get away with doing something stupid to devalue your property.

Single-family homes sometimes have enforceable CC&Rs with an aggressive community association; however, they are generally in higher socio-economic neighborhoods where the homeowners pay monthly dues to cover the enforcement of these items.

Many new single-family home subdivisions don't have actually enforceable CC&Rs (even though the homeowners think they do). The CC&Rs seem to have a lot of teeth; however, without an actual and active HOA or community association to enforce them with warnings, fines, and injunctions they are not really much protection at all.

Tight CC&Rs and enforcement can actually backfire and turn a community into what some buyers have called "an armed camp." Many don't want Gestapo-type tactics by a HOA or community association that restricts their freedoms to do as they wish with their own condo or home.

I have mentioned condo and single-family home owners doing something stupid a couple of times. A great example that comes to mind is the story of the "Got Paint Lady" and her purple house. A discount house painter came into a neighborhood of semi-custom homes with weak CC&Rs and pretty much no way to enforce them. One of the homeowners decided that she wanted to paint her house purple—and she did. This devalued the houses in the entire neighborhood. Many of the neighbors tried to talk sense into her, but she was adamant about her purple house. How many millions of dollars in lost value she caused is hard to calculate. One anonymous homeowner used some white chalk to write on her driveway, "Got Paint?" Thinking it was funny. If she had taken my real estate class she would have kept her home a nice gentle, earth tone and the neighbors would not still be talking about her. Purple might be a color that works in France or Latin America, but it doesn't fly in the good ole US of A.

Another story that comes to mind is "The Crazy Lady and the Junk Man." As you may have noticed, I like to give nicknames to interesting people I meet. In this instance, a home seller decided to try to sell his single-family home. His neighbor across the street was a problem because his home was a real mess. His wife was locally known by the neighbors as "The Crazy Lady" because of her frequent trips to the mental hospital. All the neighbors were convinced that her husband "The Junk Man" was the cause of all her troubles. The Junk Man was a real piece of work. His one goal in life was to own a junkyard—and he did, his backyard. He liked to store old, beat up used car and truck tires in his backyard. His one apparent ambition in life was to one-up the notorious Wesley Tire Fires that occasionally occurred east of San Francisco.

He always kept at least five old jacked up cars in his front yard (I guess he didn't have room in the backyard), and he also kept an old beat-up RV in the front yard for relatives to stay in. . .and flock to. . .and maybe never go home. . .I think you see what I mean. It was impossible to determine the outside color of his house—because it had been so long since it was painted (if ever—and it was built in the 1960s). The Junkman also liked to keep a couple of incredibly huge, mangy, and vicious mongrels running around to protect his treasure trove from "thieves" (another name for the county authorities who were constantly trying to clean things up).

With neighbors like "The Crazy Lady and the Junk Man" you might think that some stiff CC&Rs might be used to get him to clean up his place—or sell it and move away. However, the subdivision where he was located had been built many years ago and had very weak CC&Rs. In addition, there was no HOA (or provision for one) to enforce the CC&Rs. The Crazy Lady and the Junk Man's neighbors were powerless to enforce the CC&Rs and get them to clean up their place. Their home caused a lot of homes in the area to lose value because of the appraisal principle of regression. Houses around The Crazy Lady and the Junk Man tended to seek the level of the Junkman's house and reduce in value accordingly. Their house caused economic obsolescence in the surrounding neighborhood. The Junk Man was effectively "thumbing his nose" at his neighbors.

The neighbors next tactic was to contact the local health department and file a complaint against the Junkman. The local authorities repeatedly asked him to clean up his place, but he ignored their requests and was as stubborn as ever. The authorities next tried to get his attention by fining him for his infractions. Since he didn't have any money to pay the fines, he laughed at those also. The last straw was when the authorities placed liens against his property. He still did nothing and let the fines accrue. He said he wasn't intending to sell the property, so who cares about a bunch of pesky fines? The neighbors were never able to get The Crazy Lady and the Junk Man to clean up their property. As far as I know, it still remains in the same dilapidated condition.

Sometimes an active HOA with tight CC&Rs can be a "double-edged sword." On the one hand, the active HOA has the ability to maintain property values in a neighborhood by protecting homeowners from people like the Junk Man. On the other hand, the active HOA may become a little overactive and start enforcing the rules a little overzealously. As mentioned earlier, this can breed a "Nazi" type of atmosphere in the neighborhood and can really get out of hand. "HOA Nazis" may start enforcing every little detail and infraction. This "nit picking" style of HOA enforcement can really infuriate homeowners because their little transgressions don't really affect the values of the surrounding homes and becomes a power-ego problem for the people enforcing the CC&Rs. For example, in one community with tight CC&Rs if you leave your garbage can out on the street a little too long, you can and will be sited and receive a fine. This borders on ludicrous. However, some homeowners like this type of "orderly" feel, regimentation, and control. Others just think the people are crazy to move there in the first place.

Swimming Pool

In areas of California that are hot and dry, such as most of California that is not along the coastline or in the high sierras, a pool is a much sought-after amenity. In areas like San Francisco, they might consider a swimming pool an "eccentric addition" that is really not necessary because of San Francisco's temperate weather. A pool might need to be heated to be used with any regularity in the summer. You may wonder why it is 68 degrees in San Francisco and 110 degrees in Sacramento, when both are only 90 miles apart. The reason is the Arctic Current that flows down from Alaska along the Pacific Coast. The water temperature is around 42 degrees Fahrenheit near Eureka and around 52 degrees by the time it reaches Monterey, since San Francisco is right in the middle, its temperature seems to be around 50 degrees—pretty cold. This causes fog to lay in during the summer time and reduce temperatures accordingly. Many times it burns off in the afternoon, yet the temperatures still remain 80 degrees or less. The best times I have found to visit the California coast is in the Fall. There is less fog and better weather. So that's why you might need a heated pool in San Francisco and one that is not heated in the Sacramento Valley.

Speaking of heated pools, with the advent of cost-effective solar heating systems, many swimming pools have solar heating. This extends the useable time when a pool can be used by the owners. You may get an extra month on each end of the summer, and it makes the kids happy too. Again, you may not get much back when you sell, but what the heck, you can enjoy it while you own it.

Along with a swimming pool, the condo complex may also have a fitness center where you can work out. If this isn't the case, you may need to join a local gym and that, of course, will cost you more money.

Yard

Single-family homes have a real advantage over condos when it comes to privacy. Single-family homes many times have large private yards that are really nice to relax in and get some peace and quiet. They are also great to entertain guests. Condos generally do not have yards (or much of a yard) and definitely usually don't have much privacy. A balcony or lanai with exterior blinds will probably be the best you can do for privacy in a condo.

Exterior Maintenance

As part of a condo's HOA dues, the association is usually supposed to hold back a certain amount in reserves. These monies are to be used to replace roofs, parking lots, exterior painting, pest repairs, and other exterior maintenance items.

A single-family home owner must perform all the maintenance on their home themselves. In my opinion, I have found that condo HOAs seem to cost an owner <u>more</u> than a single-family owner. The single-family owner who is responsible for his own maintenance has the flexibility of performing it when he desires (not when a HOA manager decides to because he's getting a kick back from the contractor who performs the work). The single-family owner can shop around and obtain several bids for the work, thus cutting costs. He can also defer some of the maintenance if he wants to. Single family homes will many times (especially in a hot seller's market) sell for the same price as a more cosmetically pleasing home located in the same neighborhood. In other words, single-family homes may get away with a little less maintenance than condos, especially if you sell when the market is good. Good market timing is, of course, always critical.

Exterior and Interior Insurance

A condo's HOA also usually pays for fire and liability insurance for the entire complex. It does not, however, usually cover a condo owner's personal belongings, nor liability incurred within the unit (i.e. a guest gets hurt while in your unit). If you (as an owner) would like insurance that will cover the inside of the unit, you can get a separate policy from most insurance carriers. They are generally fairly inexpensive, especially when compared to single-family homes. Some condo HOAs require condo owners to get their own unit coverage that is in addition to the blanket policy provided by the HOA.

A single-family homeowner will usually obtain a homeowner's policy that generally covers fire, contents, and some liability coverage. If the single-family home is a rental, you may obtain an OLT policy (Owner, Landlord, and Tenant) that covers, you guessed it, the owner, landlord, and tenant. This policy includes fire insurance and owner's liability resulting from having a tenant in the property. The tenant will be required (if they want it) to obtain their own renter's policy covering their contents in the unit. This will generally occur if the rental is a single-family home or a condo.

Schools

School considerations are generally not very different between single-family homes and condos. Both are fee simple owners (they actually own the property) and there is generally not too much difference socio-economically between the owners. However, there is a big difference between single-family homes and condos vs. apartment tenants.

Single-family home and condo owners both generally own their properties in a freehold estate (again, actually own the property and are not renters), so the socio-economic differences are not very apparent. An investigation of the local schools' academic performance index will give you a reasonable indication of the quality perceptions of a particular school and/or school district.

Disclosures

In California, single-family homes require a large number of disclosures that are required by law. Here is a partial list of required disclosures: Real Estate Transfer Disclosure Statement, Death Disclosure, Homeowner's Guide to Earthquake Safety, Commercial Property Owner's Guide to Earthquake Safety, Natural Hazards Disclosure (including mold and airport proximity), State Fire Responsibility Area Disclosure, Environmental Hazards and Earthquake Safety Booklets, Energy Rating Program and Booklet, Lead-Based Paint Disclosure/Lead Hazard Pamphlet, Smoke Detector Compliance, Alquist-Priolo Special Studies Zones, Subdivided Lands Law, Common Interest Subdivision Conversion, Mello-Roos Disclosure, Military Ordnance Disclosure, Seller Financing Disclosure, Notice of No Policy of Title Insurance, and Blanket Encumbrance on Subdivisions.

Condos require all the same disclosures required by single-family homes PLUS a bunch more. The amount of disclosures on condos is astounding. A partial list includes: Articles and Bylaws of the condo association, HOA operating expenses, CC&Rs, minutes to the last twelve months HOA meeting, as well as several others.

Potential Litigation Problems

There are many condo associations located throughout California that are in the middle of litigation against the developer who built the complex. Many of these lawsuits have resulted from inferior construction of the properties.

For example, one HOA sued their builder for a faulty foundation underlying all of the properties. The court ruled in favor of the HOA and condo owners against the developer, and required the developer to repair all of the foundations in all of the buildings throughout the complex. Needless to say, the condo owners would have a difficult time selling their properties during the litigation period because there is a legal requirement to disclose any existing or pending litigation that is or will be occurring against a seller's condo. This, of course, will probably scare off a would be buyer from buying it, at least at market value.

Stairs and Elevators

One thing about condos that are well-located with ocean views, they are usually built on multiple stories. If you have a third story condo and there is not an elevator, this can be a functional obsolescence issue. In other words, buyers may not want to pay a lot of money for a condo that they have to climb an excessive amount of stairs to reach. For example, there was one condo in Maui (not Maui again!?!) with 83 steps (yes, I counted them) from the parking lot to the third floor where the condo was located. Every time relatives would show up to use the condo they would start saying some unfriendly things about the condo—until they got inside the unit and saw the incredible 180 degree panoramic ocean view. Then all was good again.

Single-family homes with a two-story floor plan may also be difficult for older people, especially if the master bedroom is on the top floor. Single-family homes with the master bedroom located on the bottom floor are a little more functional for older people. For the average family, a two story home with all the bedrooms upstairs tends to have more of a sense of safety for the children. A bad guy would have to climb up and through a second story window to gain access or break in the bottom floor and use the stairs. If the parents master bedroom is on the top floor, they may have a chance to protect their family.

Hotel-Type Condos

Some types of condo properties are hotel-type. They were probably a hotel in the past and a developer may have bought the property and then subdivided each of the condos into their own parcel number and sold them out to owners and investors. Many of the hotel amenities like a front desk and concierge services are available to condo owners. In fact, you can rent out your condo on a daily, weekly, or monthly basis. Be aware, though that many lenders are a bit nervous about financing this type of property. So, you may have a problem obtaining reasonable financing.

Owner-Occupied vs. Non Owner-Occupied Condos

If you buy an owner-occupied condo, the lender may be nervous if there are too many investors who own condos in the same complex. Different lenders have different criteria, so you need to check ahead of time to see if you can even get a loan on a condo in the complex. When you have an accepted contract and are trying to get a loan on a condo, the lender will send out an appraiser to appraise the property. They will make sure the property is sufficient collateral for the loan. In the appraisal, the appraiser will provide a percentage of the condo units that are owner-occupied. If this is too low (sometimes under 70% owner-occupied is too low and other times under 50%), then the lender will not be willing make a loan on the purchase.

Condos On Leased Land

Fortunately, this doesn't happen very often in California. Even though land prices are pretty high in California, they are nowhere near the prices in Hawaii. On the island of Oahu quite a bit of the land is leased land. This means that when you buy a condo or house on leased land, you don't own the land. Some point in time the lease on the land will expire and you will lose the condo! No kidding!!! You will need to purchase the land down the road and it only keeps going up. Land is a limited resource in Hawaii and the prices reflect this fact.

Now that you know something about single-family homes and condo, let's take a look at rehabs.

When Rehabs Work—and You Do Too

Pollock Pines Rehab

I was searching through an area between San Francisco and Lake Tahoe called Pollock Pines. It is a retirement and resort location at around 4,000 feet elevation. I had checked the local MLS and found several (what I considered) over-priced properties for sale.

As I was approaching one of the over-priced properties, I saw an old "for sale by owner" sign with a faded telephone number on it. I figured either this was a total wild goose chase or a really good deal. I'll bet you know the answer to this one before I explain what happened.

I called the number and an elderly lady answered the telephone. I asked her what the price she wanted for the property and if I could see the inside. She told me the price she and her husband were asking.

I showed up at the property at the appointed time and really looked it over—inside and out. I saw an ugly green exterior paint, 3 bedroom/2.5 baths, electric AND propane heaters (the home had both), central air conditioning, public water, septic tank, good floor plan, and it looked like custom construction. When I asked the couple about the construction, I found that the husband had personally built the house twenty years earlier and they had used it as a vacation rental ever since. They had built the home for their son who was killed in a car accident before he could move into the home.

Whenever I hear of a personal tragedy like this one, I really feel sorry for the parents. It really must have been hard on them. However, from a business standpoint I could see that the couple had an emotional attachment to the home and really had not wanted to sell it in the past. That was why the "for sale by owner" sign in the front yard was faded and the home had not been sold.

The couple had only put the property on the market in a very half-hearted way. Since they had not previously listed the home with a broker, there was a deliverability issue that I was concerned about. They may not really (deep down) want to sell the property because of the memories of their son (who died twenty years earlier).

I really wanted the house; however, and I figured that an older couple with memories may want the home to go to someone who they like and their son would have liked also. It appears they liked my wife, kids, and I because we were able to purchase this wonderful rehab project.

The first thing I did was paint the outside of the "puke green" house (that's what my kids called it). I picked a light tan color at a local paint store. When I started spraying it on it turned out to be off white!!??!! My new neighbors started giving me a strange look (probably wondering why I changed from "puke" green to "ugly" off white). I explained that this was only the primer coat (what else could I say) and the real paint looked much nicer. I went straight to another local paint store and asked to see the paint before I purchased it. This time I got a nice "woodsy" looking tan color that everyone seemed to appreciate.

The next phase was painting the inside of the home. The guest bathroom was painted yellow, the master bath was painted blue, and the ½ bath in the utility room was painted orange (no kidding). My wife jokingly said, "the house was built in the 1980's, but decorated in the 1960's."

After painting the entire inside of the home, I then started to concentrate on the light fixtures. I went to Lowe's, where they generally have a good selection of light fixtures (I really don't own any Lowe's stock—or, at least I don't think I do) and purchased new light fixtures throughout the home. This really made a big difference. I also installed new fans with lights in all the bedrooms.

My next phase was to rehab the kitchen. I purchased and installed a new range with oven and new tile countertops. I did not use granite because of the price range of the house. I didn't believe I would get my money back when I sold the property. Spending money in the kitchen is probably the best place you can spend it because the kitchen is a critical part of the home. A lot of time is generally spent in the kitchen.

The next thing was a new floor in the kitchen and utility room. I then installed new windows in the sun room. I also installed new carpet throughout the rest of the house.

The last thing I did was paint the outside deck, reinforced it, and installed drains out into the front yard and into the road. A small retaining wall was used to keep the soil from further erosion.

My son was about five years old at the time of the rehab and was "helping" me paint the deck a nice redwood color. I heard a yell from him and discovered him in a corner with no way out. He had painted himself into a corner and didn't know what to do. We still laugh about that one.

I usually like to do the "paint and landscape" routine with rehabs. You can really over improve a property if you are not careful. I will many times purchase a property, rent it out in its present condition, and then perform the rehab just before selling it at the top of the market. I then exchange (called a 1031 exchange) the property for another income property in a down market that has appreciation potential.

Physical, External, and Financial Characteristics of
Single-Family Residential Income Properties

Physical Characteristics of single-family residential income properties include: location, structural functional obsolescence, and condition.

Location

The key to all single-family investments is location. This relates specifically to the socio-economic neighborhoods within a geographical areas. Generally, houses in higher socio-economic neighborhoods tend to have higher appreciation rates that those in lower socio-economic neighborhoods. This is due to the willingness of owner-occupied buyers to pay more to live in a specific neighborhood.

Locational characteristics of particular interest include: socio-economic neighborhoods, traffic & noise, flooding, earthquake zones, schools, water, public transportation, mello-roos/assessment districts, and locational exposure.

Traffic & Noise

A single-family home near a civilian or military airport can be a negative factor due to excessive noise levels. This can be seen by a prospective tenant as a burden on their enjoyment of the property. This in turn reduces the amount a prospective tenant will be willing to pay to rent or lease the property; in relation to other similar single-family rental properties in the same geographical area. Proximity to freeways, toll roads, and other busy roads can also be a traffic and noise problem.

Car and truck traffic noise can be minimized through sound walls, speed bumps, stop signs, traffic lights, and speed limit signs. However, there may not be much an investor can do if the property is located near a freeway or truck route. If traffic is heavy, commute time to work sources can also cause property desirability to decrease.

Flood Zone

A property located in a flood zone can also be a negative locational factor. Most lenders require flood insurance if the property is located within a designated flood zone. Flood insurance will protect the lender's collateral for the loan: the house. The Federal Emergency Management Agency (FEMA) has contracted in some areas with the Army Corps of Engineers to map flood prone areas. These maps help determine flood insurance premium rates which may be an additional cost to an investor. Flood zones should be determined during the due diligence period prior to removing the physical inspection contingency to the contract. Most insurance agents can readily ascertain whether a property is located within a flood area. They can also generally quote applicable flood insurance rates and premiums.

Earthquake Zones

Proximity to an earthquake fault may be another negative locational factor. Earthquake insurance can be purchased to protect against the possibility of an earthquake destroying a single-family investment property. California has enacted the Alquist-Priolo Special Studies Zones Act to control development of occupies properties in the vicinity of hazardous earthquake faults. An Earthquake Hazards Disclosure is also required on all one-to-four unit residential dwellings in California.

Schools

School overcrowding may be a factor that can devalue a single-family investment property. If a tenant's children, due to overcrowded conditions, cannot obtain admittance to the local public school system, the tenants will most likely look elsewhere to live. This is also true of future owner-occupied buyers who may purchase the property.

Water

Water has become a key issue in Southern California and other arid regions throughout California. A water shortage is definitely a negative factor. Many areas have instituted restrictions on water use. In addition, they have installed low-flow toilets and low-flow shower nozzles. Mandatory cutbacks with designated water days have been designed with regulatory "water cops" to enforce these laws. This seems to be more of problem in Southern California than anywhere else in the nation. Canals presently bring water into Southern California from Northern California and the

Colorado River Valley in Arizona; however, it is not enough to keep up with the large population in the Southern California. The astute investor may want to check this situation thoroughly prior to investing in single-family investment properties in this area.

Wells can be a positive factor and water meters a negative. It is generally a good idea for rural single-family investment properties with a well located on them to have a draw down test performed during the due diligence period prior to close of escrow. A draw down test determines the number of gallons per minute the well is able to pump out of the ground. It is determined by pumping the well dry and observing how fast the water replenishes itself in the well. A potability test may also be performed to make sure the water is useable for drinking. If the property has a septic system, then a percolation test or "perc test" should be performed. This test checks the functional characteristics of the septic tank leach lines, and/or dry wells.

Public Transportation

Proximity to light rail and rapid transit stations which regularly travel to and from a city’s central business district is a big positive for a single-family income property. Tenants view this as decreasing their commute time and costs to and from their job sources. It is also a convenience item. This proximity in turn, drives the demand for the property upward and rental prices up.

Proximity to bus stops going to and from local neighborhood shopping centers, regional malls, and the central business district can be seen as a desirable factor. Also, proximity for elderly tenants to medical facilities (and yes, casinos!) that are accessible by bus or cab is a definite plus.

Mello-Roos/Special Assessment District

A single-family income property may be subject to special tax assessments. One common assessment is called a Mello-Roos levy. It is used to support the sale of tax-exempt bonds for capital improvements within a local geographical area. This levy can be quite expensive and should be carefully considered prior to investment.

Locational Exposure

A single-family investment property will have a higher desirability and value in a cul-de-sac location, or less-heavily travelled street, than on a main street. Tenants and homeowners favor the less travelled areas for their childrens' safety, automobile ingress/egress safety, and noise levels.

After a thorough analysis of Locational Aspects of the Physical Characteristics of single-family investment properties, the Structural Functional Obsolescence aspects must be examined to provide an overall picture of the investment.

Structural Functional Obsolescence

Structural Functional Obsolescence can be described as all the physically and structurally related items that may affect the desirability of an investment property. Within these areas are curb appeal, number of bedrooms & bathrooms, size, style, energy efficiency, and evidence of hazardous waste materials.

Curb Appeal

A prospective tenant's first impression is the most critical area in the rental process. Qualified tenants may not bother to look inside the property to see its inherent charm if weeds are growing in the front yard and extensive physical depreciation is evident. The single-family investor must make sure that, even if the property is in poor condition, it can be transformed into the well-painted and well-landscaped property that will exude a good first impression and command top-of-the-market rents.

Once the tenant has decided to see the inside of the property, it must be similar in condition to the first curb impression. Prospective tenants will look at the size of the house (as it appears, not actual square footage); number of bedrooms & bathrooms; layout; carpet quality, color and condition; kitchen (especially important); size of the backyard; and the overall atmosphere of the property.

Some investors paint interior walls with a fairly inexpensive satin or semi-gloss white house paint and keep the existing carpet in the property, if possible. White paint presents itself well and opens the rooms up; however, it shows soil and spots fairly well. Satin and semi-gloss paints can usually be washed off and save an investor's valuable time. If the previous occupants were smokers, an extremely thorough carpet cleaning and deodorizing program should be completed prior to showing the property. New carpets should be installed prior to sale.

Bedrooms & Bathrooms

Due to the possibility of functional obsolescence, three and four bedrooms with two or three bathrooms have been popular in recent years. Many one bathroom properties have become functionally obsolescent, making the second bathroom a key rental and selling feature. An additional fourth bedroom is a plus for additional rent and higher sale price due to greater family desirability.

Style

Some single-family properties do not fit their surrounding neighborhoods due to garage conversions and amateur room additions. Problems can occur with owner re-modelers not obtaining the appropriate construction permits.

Energy Efficiency

Some areas have adopted residential energy audit and conservation regulations. The regulations vary and below are eight possible areas of compliance:

- Minimum R-19 attic insulation.
- Weather stripped no flow type doors.
- Minimum R-6 insulated water heater.
- Minimum R-5 duct insulation.
- Minimum R-4 for first 5 feet of hot water tank line.
- No broken windows or holes.
- Maximum 3 gallons per minute shower heads.
- Wall outlets and switch plates fitted with insulation gaskets.

Hazardous Waste

Hazardous waste can be described as asbestos, formaldehyde, lead, radon, and other hazardous waste materials. An excellent source of information is *Environmental Hazards: Guide For Homeowners and Buyers*, published by the California Department of Real Estate and California Department of Health Services.

Condition

Condition can be described as age, deferred maintenance, roof type & age, and pest infestation/dry rot.

Age

The age of a single-family income property is a determining factor for roof and electrical wiring replacement. Some older houses have fuse boxes instead of safe and modern circuit breakers. Fuse boxes can be very dangerous and impossible to insure against fire. Age is also tied very closely to deferred maintenance.

Deferred Maintenance

Physical deterioration may occur if the property is not properly maintained. Many older properties need a considerable amount of rehabilitation that can be very costly and will reduce the sale price accordingly. These properties can also be difficult to finance because lenders are not happy placing funds with a borrower that is using a questionable property as security for the loan.

Roof

A roof inspection is recommended on all single-family income properties purchased. A reputable roof inspector should inspect the roof and give some type of warranty or certification of the condition and probable useful life of the roof. A home inspector can inspect the entire property and roof for approximately $400+. A roof inspection alone will cost the investor approximately $75-$100.

Pest Infestation/Dry Rot

Subterranean termites enter wood that is in direct contact with soil. The pest infestation inspector also looks for water damage along the eaves and dry rot. Houses with wood floors are particularly susceptible to dry rot damage under the bathrooms.

Financial Investment Characteristics of Single-Family Residential Properties

Financial Investment characteristics of single-family residential properties include sales comparables, rental comparables, and an investment scenario.

Sales Comparables

A sales comparable is documented sale price, terms, and other pertinent information for a specific property. For a sales comparable or "sales comp" to be effective it should be as close as possible in geographic location, size, condition, and construction to the subject property. It should also be as recent as possible.

Sales comparables can be obtained through a local title insurance company. Many title insurance companies will perform customer service work at no charge. This means they will do research for real estate professional and investors at no charge. All that they ask is that you use them for escrow and title insurance work in the future. The information is generated from the local tax record database and is generally very accurate. Microfiche have been used in the past, now we use a computerized databases (on a CD) that is more efficient and makes sales comparables easier to locate.

An investor should base sales price on the market data appraisal method, which uses sales comparables. The income approach is not appropriate with single-family income properties because the investor is competing with owner-occupied buyers who have different financing terms and psychological motivations for purchasing a property than investors.

A preliminary title report will provide more extensive title information and a property profile will verify the owner's names and the existence of unknown owners. This will verify that the represented owner REALLY is the owner of record.

Interesting Story. . .

There was one occasion when a man tried to have his girlfriend pose as his wife in conveying title to a buyer. His wife had divorced him, remarried, and then died. She was still listed as a joint tenant on the property. He was not knowledgeable in real estate closing procedures and did not realize that this fraud would surface when the notary asked for her driver's license and thumb print. The girlfriend may have been able to produce a driver’s license, however, the thumbprint would have probably resulted in a really long “rap sheet.”

Owner-occupied buyers tend to drive the prices of homes up or down as a function of available housing in the area, employment sources, prevailing wages, and owner-occupied single-family loan interest rates (FNMA, FHLMC, GNMA, FHA, and VA).

Investors look at single-family income properties as an investment vehicle that will derive a projected rate of return, at an acceptable risk, over a projected holding period. Therefore, an investor may base her investment decision on projected appreciation in single-family homes in a particular geographic area and NOT on projected increases in income derived from increased rents. This is the main difference between single-family and multi-unit residential investment decisions.

Rental Comparables

To perform a rental analysis, a single-family investor should physically inspect the area around a subject property. A few calls to "For Rent" signs will provide a general rental range from the property. Also, calls to a few property management companies may be helpful in determining market rents. A conservative estimate is usually the best course.

Investment Scenario

The following is an investment scenario for a dual income household.

Year 0 Husband and wife investors purchase a $110,000 single-family home in Chico, California. The investors can qualify for $180,000, however, their payments will be higher than the house will rent for in the future when the property becomes a rental. Therefore, the investors purchase less house, put their egos in the closet, and plan for the future. They pick a middle socio-economic neighborhood, instead of the more affluent neighborhoods where their friends live and their income qualifies them as a dual income household.

Example:
Property purchase:

$110,000	Purchase price
$11,000	Down payment
$99,000	Promissory note secured by a 1st deed of trust, 7.0% fixed rate,30 year amortization rate, due in 30 years..

Monthly Payment:

$658.65	Principal and Interest
$ 92.00	Taxes
$ 30.00	Homeowner's Insurance
$ 40.00	Private mortgage insurance (PMI)
$41.25	Property management fee (5% of gross collected rents) (Paid when the property becomes a rental.)
$861.90	Principal, Interest, Taxes, Insurance, (PITI) + PMI+ Property Management Fee

An investor must first perform a market rental analysis for single-family homes in the area where they intend to purchase. This can be accomplished by scanning the local newspaper "For Rent" section and calling local property managers. An investor wants (at least) to have a break-even cash flow.

Example:
Break-Even Analysis

Market Rental Range	=	$850-$900/month
PITI+PMI+PM	=	$861.90

If an investor does not achieve a break-even cash flow, he must continue to bring the purchase price downward and increase the down payment until this balance is achieved. If the appropriate single-family homes are in too low a socio-economic neighborhood for their families and they can expect destructive tenants in the future, they may want to take a look at halfplexes, townhouses, and condominiums in better neighborhoods.

In our example:

Real Property Purchase Information	
Scheduled Gross Income (annual)	$10,200
<u>Less</u> Vacancy	$-0-
Gross Operating Income	$10,200
Expenses	
($1,104 Taxes)	
($ 360 Insurance)	
($ 480 PMI)	
($ 495 PM)	
<u>Less</u> Total Expenses	$2,439
Net Operating Income	$7,761
<u>Less</u> Debt Service	$7,903
Before Tax Cash Flow	($ 142)

This is very close to a break-even cash flow.

Year 4 The husband (or wife) receives a promotion and must move to the San Fernando Valley in Southern California. The real estate market nationally has rebounded, but not Southern California. It is two years or more behind the rest of the U.S. and still trying to recover from the earthquake, floods, fires, and riots.

The single-family residential property the investors bought in Year 0 may have lost some value because of a economic recession. However, since they purchased an entry-level home, their devaluation is not near as severe as the homes in the $180,000 "move-up" price range.

The new value of their Chico home is $100,000. Since their loan is $99,000 (less four years of principal reduction which is not considered in this example), the employer will be required to step in and purchase the house from the husband and wife, sell it, and pay the difference (loss). The difference can be significant because closing costs and sales commissions will be approximately $10,000. Total out of pocket to the employer will be approximately $11,000. There have been many employer-related relocation losses over $100,000, and the employee left the company soon after!!!

When the employer purchases the employee's home, the employee will go to Southern California without any equity in his pockets. He and his wife will be starting over. They will be relegated to renters once again. Independent wealth and early retirement will still be the same distance away as in Year 0.

The other alternative is to turn the Chico home into a rental property. By purchasing below their means and, by not making the usual homeowner over-improvements, they will be able to rent the property near a break-even cash flow and in a “not too spruced up” rentable condition. Many improvements do not increase the rental value of a home. Interior and exterior paint and trimmed landscape are usually the only costs a landlord should incur. Make all the major renovations (new carpet, appliances, and fixtures) just prior to selling at the end of the holding period many years down the road.

Investors should try to purchase a property built after 1978 because of potential hazardous materials that may exist in a property.. Many pre-1978 properties have asbestos in their ceiling material and lead-based paint throughout the home. This can be a potential liability problem and should be avoided. Post-1978 properties are still fairly new and will generally have less maintenance costs than older properties. Older properties have higher maintenance costs as appliances, sinks, fixtures, and other items wear out and are replaced.

Since the investors have been living below their means in Chico, they should have been able to save some money. This takes discipline and budget planning. In year 4, when they move to Southern California, they will have enough money for a down payment. In addition, loan qualification will be enhanced as the new position probably pays more money and the wage scale for the other spouse is much higher in Southern California.

The Investors perform the same financial analysis as in Chico, trying to find a break-even cash flow. The investors end up settling on a condominium. It is the only purchase that comes close to a break-even cash flow.

When the investors qualify for the new loan, they will be required to absorb the rental in Chico. However, with a verifiable lease agreement, the lender will usually credit up to 75% of the rental amount toward loan qualification. To qualify for owner-occupied financing, the investors will be required to convince the lender that they will actually be living in the condominium. This should not be too difficult. It is usually accomplished by purchasing up in price or moving out of the area.

Since the investors intent is for a long-term hold of 15-30 years, they should look at market interest rates. Since interest rates were very low (7% fixed) in Year 0 and will probably go up in the future, a fixed rate loan was a good idea in Year O. At this point (4 years later) interest rates have increased to 11%. If the investors think the interest rate will go down, they should institute an adjustable rate loan and ride the decrease in interest rates downward. They should do a cash flow analysis over the holding period and make their own assumptions.

Year 8

The "Hot Shot" executive spouse is promoted again. This time to New York City. The cost of living index in Chico is 100, San Fernando Valley 130, and New York 235. Even with the one spouse's incredible income, the investors can only afford to purchase a home 3 hours commuting distance from work. The spouse pays for this promotion with time and stress. The investors will purchase their third and last home with owner-occupied financing. They will probably not have enough income to purchase a fourth home with this type of financing in the future. They will purchase future homes through non-owner occupied institutional financing, seller financing, VA vendee financed repossessions, and other lender owned real estate (REO's).

Year 12

The spouse is promoted again. This time to Vice-President and another move. . .this time to Chicago, Illinois. The national economy is peaking. The investors purchase their fourth home with a large down payment and a seller-carry loan at the prevailing market interest rates.

Year 16

The investors' loans have started to amortize with significant principal reduction and additional equity is built up through appreciation in value.

If the investors are able to acquire ten of these properties over their careers, they should have close to $1 million in equity as they reach age 55. This strategy is not a bed of roses, however. Costs include tenant hassles, maintenance costs, and the headaches of being a landlord.

Single-family residential investment is comprised of Physical, External, and Financial Investment Characteristics that affect the value of real property.

Physical, External, and Financial Investment Characteristics of Multi-Unit Residential Properties

The Physical Characteristics of multi-unit residential properties include location, building & lot, units, and tenants.

Location

It seems that everyone has heard the phrase, "Location, location, location." Since it is very difficult and costly to relocate a multi-unit residential property, location is an unchangeable factor in the success of the property. It is generally accepted that price, terms, and condition can be changed; however, location is the one factor that is unchangeable. Hence, the investor should look at location above all other Physical Characteristics.

An example is a 32 unit apartment building. The building is within one mile of three major retail shopping centers, two miles from a major university, and three miles from the downtown business district. Proximity to these areas will dictate the overall leasing strategy for the property.

Proximity to job sources, shopping, and schools effect the type of tenant, desirability of the property, rental amounts, and occupancy/vacancy rate for the property.

Another area of concern is future trends in the area. It is necessary to properly assess the number and type of properties that are coming into the area and the possible risks of economic obsolescence.

Building & Lot

A multi-unit residential property can be investigated through age, style, design, and construction.

A new residential property in a high socioeconomic neighborhood will command high rents and will probably have lower vacancy levels that other older properties in the same area. This type of investment opportunity is easy to analyze and is based upon quality. Newer properties in high socioeconomic areas are generally able to attain top-of-the-market rents.

A good example of an old residential property in a high socioeconomic neighborhood is the 32 unit property mentioned earlier. The property is 16 years old and in a high socioeconomic-economic area. A rental analysis reveals that the property is not achieving top-of-the-market rents for its units. An examination of market factors reveals that the property has not had a rental increase in two years, the market absorption rate is starting to exceed new units coming on line in the area, and the property has been subjected to deferred maintenance resulting in a lack of physical aesthetics. In addition, the tenant socioeconomic profile does not conform to the surrounding area. This has resulted in a higher than average rate of bad checks, late payments, rental skips, and evictions. This property can become a solid investment opportunity through a physical cosmetic rehabilitation, appropriate rental increases due to demand, resulting tenant profile change caused by the higher rents (within Fair Housing laws, of course), and the addition of carports as an amenity to retain non-destructive tenants and physically justify higher rents.

A new residential property in a lower socioeconomic area tends to do well initially, but do not command high rental rates.

An older residential property in a lower socioeconomic area is the most difficult to analyze. An example is a 40 unit apartment building that is 37 years old and in a low socioeconomic area. Physical deterioration is an ever-present problem in properties of this type. Inexpensive, low quality construction can cause physical deterioration sooner than it would arise in higher quality properties. Another area of concern is the roof. A professional roof inspector should be consulted before the property is purchased. You should inspect the roof of *every* property you intend to purchase. This inspection is generally completed during the due diligence period prior to close of escrow. The buyer generally removes the physical inspection contingency and then proceeds to close escrow.

Other problems associated with these types of properties are rental collection problems and lower rental rates in comparison to other higher socioeconomic neighborhoods. These properties are very dangerous investments for the inexperienced investor.

Style and design of a residential property is important due to tenant eye appeal and correspondingly higher rents. A garden style apartment building may be preferred in a metropolitan area versus a high rise in an urban area. Style is also important when considering a rehabilitation project and possible future rents.

Construction is another key to a multi-unit residential property's success. T1-11 siding is generally the least costly material used for sheathing.

Some factors related to a lot (parcel) are its dimensions, land for additional development, and space & functional utility. The more uniform the shape of the lot, the increased usefulness regarding existing structures on the lot and possible future additional development on the site.

Zoning is also a critical issue that must not be overlooked. Dwelling Units per Acre (DUA) designations are important also. You should also examine set back requirements and other building restrictions during the due diligence period.

Units

The size and type of the individual units have an impact on the desirability of a multi-unit residential property. Most of the units in the United States average in size from 600 to 1,000 square feet. Unit types include:

Bachelor (no kitchen)
Studio (1 bedroom with open entry)
1 Bedroom/1 Bath
2 Bedroom/1 & 2 Baths
3 Bedroom/1,2,& 3 baths
Townhouses with 1,2, and 3 baths

The layout of the individual units is important to tenant desirability and resulting willingness to pay premium rents. It is difficult to ascertain a "good" versus a "poor" layout, however, key factors seem to be functional utility and ease of use.

The unit mix is important as the number of 1, 2, and 3 bedroom units should be indicative of present and future market trends in a local area. A large number of older properties have 2 or 3 bedrooms with only 1 bathroom. Recent trends indicate that tenants desire at least 2 bathrooms in their apartment units, and most new construction has adhered to this fact. Hence, the investor will not get top rents from out-dated 1 bathroom units and will remain with a functionally obsolete multi-unit residential property.

It should be noted that furnished apartments tend to have artificially inflated rents and the tenants tend to be transient in nature.

Tenants

Tenants can be analyzed through descriptive market factors, tenant risks, and quality tenant attributes.

Descriptive Market Factors include age, sex, lifestyle, and income. These combine with proximity to work place and mobility to delineate a tenant mix. This information creates a picture that will help an investor examine and judge his or her present tenant mix and ascertain whether to keep or change this target market.

Tenant risks include payment risks and physical destruction. Payment risks include late payments, eviction, bad checks, and rental skips. An investor should examine historical trends to determine past payment problems, as well as look at the risk of physical destruction due to tenant disregard for the physical property.

Quality Tenant Attributes relates directly to descriptive market factors, as well as tenant risks. The investor should examine:

Family versus adult tenants
Pride versus destructive tenants
Management intensity required

32 Unit Apartment Building Example:

The 32 unit apartment building mentioned earlier is a prime example of the Physical Characteristics working together to project a true picture of the property to the investor. The example multi-unit residential property is characterized as follows:

Location has excellent appreciation potential due to high rental rates and low historical vacancy. Demand is exceeding supply in the local area.

Building & Lot indicates no land for additional development. It is an older property in a higher socioeconomic market and is 16 years old.

Style & Design indicates garden style with a pitched tile roof.

Construction is woodframe & stucco exterior. Also:

- Central Heating, Ventilating, and Air Conditioning
- (HVAC) system.
- Untrimmed landscaping.
- Paint in fair condition.
- Pool in good condition.
- Picnic area.
- Concrete slab foundation.
- Mix of low pile and shag carpeting.
- Pest inspection indicates only *minor* repairs are
- needed to obtain a "clear" report.
- Fences are in good condition.
- No Car ports.
- No signage..
- Laundry room is in good condition. Commercial
- grade washing machines and dryers are also in
- good condition.
- Stairway is in moderate condition.

Units contain good carpeting, drapes, and paint. Bathrooms have real tile, appliances include a gas range, single door refrigerator, gas oven, garbage disposal, and dishwasher. There are no storage units. The units are unfurnished. The unit mix:

8 - 1 bedroom/1 bath units 600 square feet
24 - 2 bedroom/1 bath units 700 square feet

Tenants include 15% families. Mostly blue-collar professionals with a stable base. Some children in evidence and good proximity to employment sources. A poor payment history is a large tenant risk. Tenant quality is related to destructiveness, management intensity, and family orientation.

Proposed Strategy

The astute investor will immediately see an investment opportunity to physically create value in the property. The investor can improve eye appeal through new exterior and interior paint, better landscaping, a new sign in the front of the property, construction of car ports, and change the target market to a mix that will minimize tenant risks (within Fair Housing guidelines of course).

Once the investor has ascertained the Physical Characteristics of a multi-unit residential property, an examination of the External Characteristics must be completed to obtain a good picture of the quality of the investment vehicle.

External Characteristics

External Characteristics of multi-unit residential properties include: competition, development trends in the area, condition of the surrounding area, local & national political/economic conditions, population trends, and job sources.

Competition

The competition should be investigated through the number, condition, and vacancy levels of existing multi-unit residential properties in the area surrounding the subject property. A look at the "Apartment For Rent" section of the local newspapers and discussions with local on-site and off-site apartment managers are the best ways to obtain this information.

Development Trends

Development trends can be examined through construction on line, rehabilitation projects on line, zoning changes in process, and availability of vacant land for development. A check of the number of building permits that have been issued in the same geographical area may help the analysis. The local city or county planning department is a good source of zoning changes in process. In semi-developed areas these changes generally effect commercial retail and office projects more than residential properties, because the differences in land costs between lower and higher density residential zoning is generally not very significant. However, the land value disparity between residential and commercial zoning is generally quite significant. Commercial land is usually valued at 5 to 30 times higher than residential, depending upon the location.

In undeveloped areas, zoning changes from agricultural to high density residential can also have a significant impact on the value of the land. The agricultural land is generally valued on a per acre basis (43,560 square feet/acre). In contrast, the higher density residential land suitable for multi-unit apartment development is valued on a per square foot basis. Large tracts of agricultural land can be purchased at an incredibly low per square foot cost, subdivided into smaller parcels, and then sold or developed on a per square foot basis, at a good profit.

Some planning departments will issue a "special use permit" to allow a particular use for a parcel that does not have the correct zoning. The developer must have a specific use in mind, pay for a local neighborhood impact study to determine the intended project's impact on the community (the study generally costs $3,500 or more), and then wait 4 or more months to receive the approval. The attitude of the local county board of supervisors or city council will dictate the probability of success. If the specific use is aligned with the General Plan for the city or county, it may be successful. New apartment buildings in low socioeconomic areas are generally welcomed, because many times buildings in these communities are old and have a significant amount of deferred maintenance. The new project will put pressure on the existing "slum lords" to upgrade their buildings to compete with the new projects coming into the area. Remember, these are Sector IV properties and can be very dangerous investments. The investor must compare the land and development costs to projected income stream risks, to ascertain an optimal investment criteria.

Condition of the Surrounding Area

Descriptive factors can be marginal, average, or good. These include other multi-unit residential properties, shopping centers, office buildings, and all other properties that may have an influence on the desirability of the area.

Local & National Political/Economic Conditions

The political situation on a local (city, county, state) basis determines zoning restrictions and development policies. Growth moratoriums and rent controls originate at this level. The national (federal) political situation can impact a multi-unit residential property through economic instability, monetary policy, inflation, and tax policies (1031 exchanges and capital gains).

Population Trends

Population trends may significantly affect housing demand in a local geographic area. The multi-unit residential investor must determine whether people are coming into or leaving a local geographical area. In the 1980's people moved out of the northeast part of the United States in favor of the Southwest. This made places like Phoenix, AZ a very popular location to invest in multi-unit residential properties.

Job Sources

Another area of concern is the probability of job sources coming into an area. If a large company has plans to relocate to a particular area, then demand for rental properties may increase in that area. Large companies are always looking for low cost labor sources to manufacturer their products. Along with this low labor cost, they also desire a good standard of living for their employees. The adage, "A happy employee is a productive one," may hold true. Rents many times follow local wages, thus employers are able to keep their employees happy. As more large companies come into an area, competition for the existing apartment units increases, which in turn, drives rental rates up.

An area that has one major employment source can be a source of risk itself. If this major company goes out of business or moves its operation, rental rates may plummet.

All of the preceding Physical and External Characteristics combine to give the investor some indication of the potential of a particular investment property. An analysis of these factors should be performed during the due diligence period prior to close of escrow.

After the investor has adequately determined if the Physical and External Characteristics indicate a good investment opportunity, then an investigation of the Financial Investment Characteristics must be conducted to determine the investment's financial feasibility.

Financial Investment Characteristics of
Multi-Unit Residential Properties

Financial Investment Characteristics are the last and most important determinant of a multi-unit residential property's investment value. The Financial Investment Characteristics combine with the Physical and External Characteristics to provide the investor with a clear perspective of the subject property's present and potential future value. The Financial Investment Characteristics analysis is comprised of a determination of value, financial analysis, and the use of rental and sales comparables.

Value

Value is created by two different methods: ordinary and extraordinary rent increases. Ordinary rent increases are those that occur due to market supply and demand. These rental increases occur in relation to supply and absorption levels in the local market area. These trends tend to be cyclical due to development trends, absorption level changes due to population increases/decreases, vacancy levels, and affordability of single-family housing in the area. The investor has a strategic window of opportunity that he or she must utilize to take advantage of these ordinary rental increases.

Extraordinary rental increases include an increase of below market rents to market level, correction of deferred maintenance, an upgrade of management talent, and a proximity to a changing economic area. These extraordinary rent increases are the factors that an investor can tangibly alter to increase the value of the property.

The 32 unit example property has both ordinary and extraordinary rent increase potential. The ordinary increases will occur as expected market rents increase. The extraordinary rent increases may occur through an increase of the rents to market level, correction of deferred maintenance, new management, and any resulting increases from positive neighborhood changes.

Financial Analysis

The financial analysis of multi-unit residential properties is comprised of several key numbers and ratios. In the 32 unit example property:

Price	$1,195,000
GRM	7.7
CAP	7.8
GLA	21,600
Down payment	315,000
% of sales price	26%
# of units	32
Cost/unit	37,343
Age	16
1st Loan secured by a trust deed or mortgage Terms: 9.85% variable loan,30 year amort., due in 10,8.1% teaser rate for six months, 2.25% margin over the FHLBB's cost of funds index (7.6%)	$880,000
2nd Loan and trust deed or mortgage	-0-
Terms	N/A

Annualized Operating Information

Scheduled Gross Income	$155,196
Less Vacancy	7,760
Gross Operating Income	147,436
Less Expenses (35%)	55,420
Net Operating Income	92,016
Less Debt Service	81,149
Before-Tax Cash Flow	10,867

Scheduled Income

# units	*Bed/Baths*	*Sq.Ft.*	*Mo.$/Sq.Ft.*	*Mo.$*
8	1/1	600	$360	$2,880
24	2/1	700	$408	$9,790

Total Scheduled Rent	$12,670
Laundry Income	240
Other Income (vending)	23
Total Monthly Scheduled Gross Income (SGI)	$12,933
Total Annual SGI	$155,196

Annual Expenses

Fixed:	Taxes	$13,350	
	Insurance	3,000	
	Total	16,350	
Variable:	Water	925	
	Electricity & Gas	6,805	
	Maintenance	11,200	
	On-Site Management	5,000	
	Off-Site Management	5,897	
	Sewer	2,400	
	Garbage	2,250	
	Miscellaneous	4,593	
	Total	34,477	
Total Expenses: ($1,731/Unit)		$55,420	($2.56/Sq. Ft.)

Annualized Tax Situation

Net Operating Income	$92,015
less Interest (annual)	86,456
less Depreciation (15/85)*	36,936 (27.5 year S.L.)*
Less Depreciation of Personal Property ($32,000)	4,560 (7 year D.D.B.)**
Passive Income/(Loss)	(35,937)

* 15/85 land/building ratio is for depreciation purposes. Residential properties use a 27.5 year straight-line depreciation method. Leased investments use 39 year straight-line depreciation.

** 7 year Double-Declining Balance depreciation method. Equates to approximately 14.25% per year, over 7 years.

Certain areas of particular interest to the investor include price, gross rent multiplier, capitalization rate, cost per unit, cost per square foot, existing & proposed financing, vacancy level, age, expenses, before-tax cash flow, and cash-on-cash return. Each of these areas are discussed with the context of our 32 unit example property.

Down Payment

The down payment is the equity that will be required from the investor. In our example, the 32 units are priced at $1,195,000 with a $315,000 down payment. this is 26% down and about average for an income property of this type.

Gross Rent Multiplier

Gross rent multiplier is defined as the Scheduled Gross Income (SGI) divided into the sales price. It is merely an indicator of the number of times the SGI will divide into the sales price, hence, "Times the gross." In our example:

$$\frac{\$1{,}195{,}000}{\$155{,}196} = 7.7 \text{ times the gross or GRM}$$

Capitalization Rate

Capitalization rate is an expression of the riskiness of an investment. It is calculated by dividing the Net Operating Income (NOI) by the sales price. In our example:

$$\frac{\$92{,}016}{\$1{,}195{,}000} = 7.8\%$$

The investor generally has two of these three numbers and can algebraically manipulate them to obtain the desired unknown. Generally, the investor obtains the NOI from the subject property's existing operating information sheet. The capitalization rate is a measure of risk in comparison of other similar multi-unit residential properties and other investment vehicles, such as domestic and foreign securities. The investor compares the riskiness of the subject property to these other investment vehicles (with tax considerations), and sets a market capitalization rate for similar properties and investments. This "cap rate" is set by the investor based upon his or her perceived risk. In our 32 unit example, the seller is asking for a cap rate of 7.8%. A layperson definition of capitalization rate is the annual return the investor receives if he or she purchases the property with all cash.

Cost Per Unit

This is a ratio that is used to compare one multi-unit investment to another. It is calculated by dividing the sales price into the number of units. In our example:

$$\frac{\$1{,}195{,}000}{32 \text{ units}} = \$37{,}344/\text{ unit}$$

Cost Per Square Foot

This is calculated by dividing the sales price into the net rentable square feet. In our example:

$$\frac{\$1{,}195{,}000}{21{,}600} = \$55.32/\text{Sq.Ft.}$$

Existing and Proposed Financing

Existing financing is a definite advantage during tight lending periods and when financing is difficult to arrange. In a loan assumption the investor should ask to see a copy of each of the notes and trust deeds/mortgages during the due diligence period which occurs between the contract date and close of escrow. When a purchase contract is signed it is commonly called, "Going into contract." The physical inspection contingency should specify the physical examination of the notes and trust deeds/mortgages, and each document should be examined very closely by the investor and legal council. Approval of the new buyer should take place through a separate Financing Contingency that is removed through lender approval. The following areas should be considered in a loan assumption:

Loan Terms

Length of Loan and Balloon Date

Most multi-unit residential loans are amortized over 20-30 years, and are many times due in 10. This allows the borrower to pay a low enough principal and interest payment to operate the property, while the lender is able to minimize their long-term risk with the balloon date. Lenders increase their yields and provide cash flow through the fees derived from loan origination. The balloon date also helps the lender obtain more interest:

The lender obtains more interest during the early years of a loan. Consequently, the balloon date insures that more interest and less principal is paid on the loan during its life.

Interest Only

An interest only loan is also called a *straight note* because the investor pays interest on the original principal balance and does not pay any principal reduction. At the end of the payment period the entire original balance is due. These are prevalent in junior (2nd, 3rd, etc.) trust deeds and mortgages that run up to 7 years in length.

Existing financing for our 32 unit example includes a variable interest rate loan, 225 basis points (2.25%) over the Federal Home Loan Bank Boards cost of funds index, 30 year amortization schedule due in 10 years (balloon date), assumable with cost of assumption 1% of loan balance.

Variable interest rate loan (VIR) is commonly referred to as an adjustable rate loan (ARM) in the single-family residential arena. In the multi-unit residential and other commercial property arena it is more generally referred to as a variable rate loan, variable loan, or simply VIR. A VIR loan generally floats over a predetermined index. Common indexes include the Federal Home Loan Bank Board's Cost of Funds Index, Prime Interest Rate, various Treasury indexes, or the London Interbank Offered Rate (LIBOR). In our 32 unit example:

January 1

Close of escrow
VIR loan
8.1 initial "teaser" rate
30 year amortization, due in 10 years
1.00% loan origination/assumption fee
80% Loan-to-value ratio
1.10:1 Debt coverage ratio

Property sales price equals appraised value
No negative amortization
July 1

6 month "kick in" to a fully adjusted 225 basis points over the Federal Home Loan Bank Board's Cost of Funds Index, which is presently 7.6% (example only). Therefore, 7.6% + 2.25% = 9.85%, which is the fully adjusted interest rate.

The payments on a variable loan with a low initial starter rate increase after the expiration of this "teaser." The buyer's payments jump from $6,519 to $7,625 per month. This increase is called *rate shock*. The loan will stay at this level and adjust upward or downward depending upon the variations in the index used, and floors and caps on the movement of the rate. A typical floor is 3% and cap 5% movement over the life of the loan. There may also be a maximum movement of 1% for each 6 month adjustment period. The buyer should be aware of the results of rate shock and compensate for it in their financial analyses.

The buyer may find a *negative amortization loan* at their disposal. This type of loan starts at a very low rate of interest and requires the buyer to actually **add** to the principal amount of the loan. This is the reverse of principal reduction and is used in time of high interest rates or an appreciating market. These are very dangerous loans for the inexperienced investor.

Commercial VIR and fixed rate loans typically have a debt coverage ratio (DCR) associated with them. This is calculated as the Net Operating Income divided by the Debt Service:

$$\frac{\text{NOI (Net Operating Income)}}{\text{DS (Debt Service)}} = \text{DCR (Debt Coverage Ratio)}$$

The Debt Coverage Ratio (DCR) required by each lender varies by property type, riskiness of the investment, down payment, and points charged for the loan. Apartment buildings generally have 1.00 to 1.05:1 DCRs. Leased investments, such as shopping centers and office buildings, generally have 1.10:1 and above DCRs because of their greater risk. Variable rate loans generally have a balloon date of 10 years or less.

Variable loans usually have a down payment of 25-30% and a minimum LTV of 75-80%. If the down payment involves a split down payment, then the investor must generally pay 15% down at close of escrow, and the balance within 6 months or less.

Fixed rate loans, as their name implies, have a fixed rate of interest throughout the life of the loan. An example:

$880,000	Loan Balance
9.85%	Fixed rate of interest
30	Year amortization schedule
$7,625/month	Principal and interest payment

The monthly principal and interest payment is the amount the buyer/borrower will pay throughout the life of the loan. As you can see, there are no surprises and most of these are not assumable. It is best to acquire a fixed rate loan during times of low interest rates.

Proposed New Financing is the financing the investor will be required to originate if he or she does not assume the existing loan or pay cash.

Vacancy levels are an indication of the external rental market or poor management/maintenance of the property. This is where the Physical Characteristics combine to help the investor ascertain possible courses of action to increase the value of the property. The Financial Investment Characteristics are used to calculate the financial feasibility of physical and management changes. This is related to the market rents column within the annualized operating information of the property.

Age and Expenses

Age and expenses directly correlate to the costs of operating a multi-unit residential property. New property expenses tend to operate at approximately 30% of the Gross Operating Income. Older properties operate at approximately 35-40% of GOI because of increased maintenance costs. The percentage of expenses is calculated by dividing the total fixed and variable expenses into the Gross Operating Income.

$$\frac{\$55{,}420 \text{ (Total Expenses)}}{\$147{,}436 \text{ (Gross Operating Income)}} = 37.6\% \text{ (Expenses)}$$

Multi-unit residential property expenses are generally expressed through Cost Per Net Rentable Foot which is calculated by dividing the Total Expenses into the Net Rentable Square Feet of the building.

$$\frac{\$55{,}420}{21{,}600} = \$2.57\text{/Net Rentable Square Foot}$$

$$\frac{\$55{,}420}{32 \text{ units}} = \$1{,}732\text{/Unit}$$

Fixed Expenses include taxes and insurance. Taxes are many times based upon the sales price of the property. This price is multiplied by a specified factor to obtain the annual property taxes for the property. Our example property is located in California and a 1.15% factor is appropriate. Insurance can be estimated through an insurance quote by a reputable carrier.

Variable Expenses include all the remaining expense items which include water, sewer, garbage, gas, electric, maintenance & repair, on-site & off-site management, and other miscellaneous items.

Before-Tax Cash Flow and Cash-On-Cash Return

Before-Tax Cash Flow is a function of potential rents less vacancy, expenses, and debt service to reach an actual monetary return before taxes. In our 32 unit example the is a $10,867 annual Before-Tax Cash Flow on the $315,000 equity investment. Cash-On-Cash return is the return the investor achieves on the equity invested. It is calculated by dividing the Before-Tax Cash Flow into the Down Payment.

$$\frac{\$10{,}867}{\$315{,}000} = 3.5\% \text{ Cash-On-Cash Return}$$

These two measures should not be the only bottom-line financial factors the investor should consider in making an informed investment decision. The investor should look at the tax implications as well as a proforma sensitivity analysis over the intended holding period. An excellent source for tax information is your CPA and/or tax attorney. It is recommended that you consult with both of these entities prior to any investment decision.

The 32 unit example has the following passive loss:

Net Operating Income	$92,016
less Interest (annual)	$78,697*
less Annual Depreciation (15/85)	$36,936
less Annual Depreciation of Personal Property ($32,000)	$ 4,560
Passive Income/(Loss)	($28,177)

* Calculated: First 6 months at 8.1% interest (teaser) rate = $39,111 principal and interest, $35,581 is interest and $3,530 is principal reduction. Second 6 months at 9.85% interest rate, new loan balance is $876,470, $45,568 principal and interest payment, $43,116 is interest and $2,452 is principal reduction.

Rental Comparables

Our subject 32 unit example property has the following rental comparables:

Attribute	**Subject**	**#1**	**#2**	**#3**
# Units	32	41	98	60
Age	22	16	23	17
Bldg. Exterior	5*	5	5	5
# of Stories	2	2	2	2
Cleanliness	5	5	5	5
Parking	5	5	5	5
Carports	No	Yes	No	Yes
Carpets	5	5	5	5
Patio/Balcony	Both	Both	Patio	Patio
Drapes	5	5	5	5
Dishwashers	Yes	Yes	Yes	Yes
Garbage Disposals	Yes	Yes	Yes	Yes
Electric/Gas Range	Gas	Gas	Gas	Electric
Central/Wall HVAC	Wall	Central	Central	Central
Air Conditioning	Yes	Yes	Yes	Yes
Pool	Yes	Yes	Yes	Yes
Recreation Room	No	No	Yes	Yes
Neighborhood	5	5	5	5
Pets	Yes	No	Yes	No
Adult/Children	Both	Both	Both	Both
Tenant Rating	5	5	5	5
Landlord Pays	**W/S/G	W/S/G	W/S/G	W/S/G
1 Bedroom Rent	$360/Mo.	$375	$340	$385
Sq.Ft. & Rent/Sq.Ft.	600 Sq.Ft./$.59	618/.61	612/.56	900/.52
2 Bedroom Rent	$408/Mo.	$420	$420	$465
Sq.Ft. & Rent/Sq.Ft	700 Sq.Ft./$.58	800/.53	878/.48	900/.52
Units Vacant	1	2	5	1

* 1= not comparable, 5= very comparable
** denotes water, sewer, and garbage.

Rental comparables delineate the local competitive market situation. It is important to compare similar properties in the surrounding geographical area. The rental comparables for the 32 units can be considered average in comparison.

Sales Comparables

Sales comparables delineate the sales market in the geographic region that the multi-unit residential property is located. The following are the sales comparables for our 32 unit example:

Comparable	**# Units**	**Terms**	**Age**	**GRM**	**Price**	**Date**
#1 (address)	16	Unk.	7	8.8	$600,000	-
#2	41	New 1st TD	18	7.6	$1,375,000	-
#3	38	5% Dn 15	7.1		$1,270,000	-
#4	48	16% Dn	14	7.8	$1,900,000	-

Sales comparables tend to be more geographically dispersed than the rental comparables because recent ones are much more difficult to obtain. The key sales comparable data is age, size, price, GRM, financing, and recency of the sale. All of these factors combine to form a market trend analysis that will give the investor an idea of the property's relationship to the sales market.

Overall, multi-unit residential income properties have three distinct areas of concern to the investor: Physical, External, and Financial Investment Characteristics. The Physical Characteristics include the location of the property, building & lot, units , and tenants. External Characteristics include the general neighborhood, surrounding real estate quality, development trends in the area, competition, and political/economic influences. Finally, Financial Characteristics include several key numbers and ratios associated with multi-unit residential properties.

Appreciation

Appreciation is an increase in a property's value over a holding period (time the purchaser owns a property). For example:

Purchase Price		*$100,000*
X Appreciation Rate	*20%*	
= Increase in Value	*$20,000*	
Property's New Value	*$120,000 ($100,000 + $20,000)*	

Leverage

When a purchaser of real property places 20% of the purchase price as down payment toward the purchase of a $100,000 property, he is using leverage to acquire the property. For example:

Sale Price	*$100,000*
Down Payment	*$ 20,000 (20%)*
Loan	*$ 80,000 (80%)*

If he pays all cash for the property, and the property value increases to $150,000, then the purchaser's return on investment is:

<u>$50,000 increase in value</u> = *50% return on investment*
$100,000 original purchase price

However, since the purchaser only placed $20,000 as down payment, he is using leverage to increase his return on investment.

Therefore,

$\underline{\textit{\$50,000 increase in value}}$ = *250% return on investment*
$20,000 original investment

Tax Shelter

One of the most important decision-influencing factors regarding the purchase of real estate is the tax implications. Homeowners have a different tax situation than investors.

Homeowners

Homeowners may deduct mortgage interest from their real estate loans in the same year it is incurred. In addition, a homeowner who has lived in his home (primary dwelling) two years out the last five years, may receive $250,000 (single person) or $500,000 (married couple) in net proceeds from the sale of their home <u>without</u> paying capital gains taxes. There are many variations and exceptions to this law, so always advise your clients to consult a tax expert and real estate attorney prior to any real estate endeavor.

Investors

Investors may deduct all mortgage interest paid on real estate loans, most property expenses, and some capital improvements made to a property in the year they occur. This gives an advantage to an investor because she can reduce her active or passive income tax liability on a yearly basis.

An investor may also depreciate the building (improved) portion of a residential property over 27.5 years straight-line depreciation. All other non-residential investment properties use a 39 year straight-line depreciation schedule.

An investor is allowed to exchange his property for another property and defer his capital gains taxes on the relinquished property. The investor must sell his relinquished or “down leg” property and then purchase a new acquired or “up leg” property within 180 days of the sale of the original relinquished property (45 days to designate or identify). This is called a “1031 Exchange” and has derived its name from IRC 1031 of the Internal Revenue Code. It is also called a “Starker” and took this name from the court case T.J. Starker v. U.S. Government. This is the landmark court case that allowed delayed exchanges of real property. There are many restrictions to these exchanges. You should always advise your clients to consult a tax expert (and exchange expert in this case) prior to making any real estate decision.

Amortization

Amortization is the systematic liquidation of a debt obligation on an installment basis over a period of time. Most of the monthly payment is interest in the early years of the loan. Lenders realize that most property owners sell or refinance their properties every five to seven years (or less). Consequently, most properties do not reach the point in time where a significant amount of the monthly payment is reducing the principal balance of the loan. The astute real estate owner realizes this fact and operates accordingly.

The old rule, “2% interest rate below your present rate of interest triggers a refinance” is not always the best course if the property owner is ten years or more into a thirty year fully-amortized loan. She may want to keep the property and amortize the loan until maturity. When loan origination fees are taken into account for a refinance, she may want to place the same amount of funds against the principal balance of the existing loan, rather than institute a new loan and start another thirty-year amortization schedule.

This concludes Accredited Real Estate Schools’ <u>Real Estate Update</u> course. We hope you enjoyed it.

Agency

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

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

Civil Code

An agent is a person who represents another (called a principal) in dealings with third persons (CC 2295).

In real estate transactions, the *agent* is a licensed real estate broker representing his principal in the transaction. The *principal* is usually the seller, buyer, lessor, or lessee in the transaction. *Third parties* are other parties in the transaction who have dealings with the agent.

An agency relationship is established between the principal and agent when a written employment agreement (called a listing agreement) is executed between them. However, it should be noted that an agency relationship can also be established by actual or ostensible authority. (CC 2298).

An agency is actual when the agent is really employed by the principal (CC 2299).

An agency is ostensible when the principal intentionally, or by want of ordinary care, causes a third person to believe another to be his agent who is not really employed by him (CC 2300). An agency may be created by precedent authorization (listing agreement) or by subsequent ratification (ostensible) (CC 2307).

An agent can never have authority, either actual or ostensible to perpetrate fraud upon the principal (CC 2306).

Consideration (bargained for exchange) is not required for an agency relationship (CC 2308).

Even though not common in the real estate industry, an oral authorization is sufficient to establish an agency relationship; except, when an instrument is required to be in writing (Statute of Frauds), then the agency can only be conferred in writing (CC 2309). Since all real estate contracts are required to be in writing (except leases of a year or less) because of the Statute of Frauds, agency relationships are normally established in writing in California.

A ratification may be rescinded when made without such consent as is required in a contract, or with an imperfect knowledge of the material facts of the transaction ratified, but not otherwise (CC 2314). A principal can ratify an agency relationship by accepting the agent's actions, and thereby ratifying the agency. However, the principal can rescind the ratification if he is not in possession of the material facts relevant to the transaction. If the purported agent has not disclosed all material facts, then the principal may be able to rescind the ratified agency relationship.

One who assumes to act as an agent thereby warrants, to all who deal with him in that capacity, that he has the authority which he assumes (CC 2342). When an agent acts as an agent for a principal, he is warranting that he has the authority to act for the principal. He could be liable for damages if he does not indeed have this authority.

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

- When, with his consent, credit is given to him personally in a transaction.
- When he enters into a written contract in the name of his principal, without believing, in good faith, that he has authority to do so.
- When his acts are wrongful in their nature (just about everything else) (CC 2343).

The Civil Code requires that all real estate transactions of one-to-four unit residential properties (and mobilehomes), including options, ground leases, and real property sales contracts where an agent is involved in the transaction, an *agency relationship disclosure* must be given to both the buyer and the seller (CC 2079.1).

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

The standard of care owed by the broker is the degree of care that a "reasonably prudent real estate licensee would exercise." This is measured by the degree of knowledge through education, experience, and examination (CC 2079.2).

The broker may employ salespersons who are sub-agents of the broker. For example:

Principal (seller or buyer)
Agency
Agent (broker)
Subagency
Subagent (salesperson)

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

It is the duty of a real estate broker or salesperson to a prospective purchaser to *disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal.* This requires the broker to have a written contract with the seller to find or obtain a buyer, or is a broker who acts in cooperation (MLS for example) with that broker to find and obtain a buyer (CC 2079(a)).

The property inspection does <u>not</u> include areas that are reasonably and normally inaccessible. It also does <u>not</u> include an affirmative inspection of areas off the site of the subject property, public records, permits concerning the title or use of the property. The property inspection does not include a planned development, condominium, or stock cooperative or more than the unit(s) offered for sale (CC 2079.3).

A breach of duty regarding an agency relationship shall not exceed two years from the date of possession, which means the date of recordation, date of close of escrow, or the date of occupancy, whichever occurs first (CC 2079.4)

Nothing shall relieve the buyer of the duty to exercise reasonable care to protect himself or herself, including those facts which are known to or within the diligent attention and observation of the buyer or prospective buyer (CC 2079.5)

Division 4 (commencing with Section 10000) of the Civil Code does <u>not</u> apply to transfers that require a public report by the Real Estate Commissioner (CC 2079.6). An example would be a subdivision of new homes.

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

If the Homeowner's Guide To Earthquake Safety booklet is delivered to a transferee (buyer) in connection with the transfer of real property a seller or broker is not required to provide additional information concerning geologic and seismic hazards (CC 2079.8(a)). This does not alter the seller or broker's duty to disclose the existence of known hazards on or affecting the real property (CC 2079.8(b)).

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

If the Commercial Property Owner's Guide To Earthquake Safety booklet is delivered to a transferee (buyer) in connection with the transfer of real property a seller or broker is not required to provide additional information concerning geologic and seismic hazards (CC 2079.9(a)). This does not alter the seller or broker's duty to disclose the existence of known hazards on or affecting the real property (CC 2079.9(b)).

If the informational booklet concerning the statewide home energy rating program is delivered to a transferee (buyer) in connection with the transfer of real property (including manufactured housing) a seller or broker is not required to provide additional information concerning home energy ratings (CC 2079.10(a)). This does not alter the seller or broker's duty to disclose the existence of known home energy rating program affecting the real property (CC 2079.10(b)).

Every lease or rental agreement for residential real property and every contract for sale of residential real property comprising one-to-four units (entered into after July 1, 1999), shall contain, in not less than eight-point type, the following notice (CC 2079.10a.(a)):

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

Upon delivery of the notice to the lessee or transferee of the real property, the lessor, seller, or broker is not required to provide information in addition to that contained in the notice regarding the proximity of registered sex offenders. The information in the notice shall be deemed to be adequate to inform the lessee or transferee about the existence of a statewide data base of the locations of registered sex offenders and information from the data base regarding those locations. The information in the notice shall not give rise to any cause of action against the disclosing party by a registered sex offender (2079.10a (b)).

That Sections 2079 to 2079.6, inclusive, of this article should be construed as a definition of the duty of care found to exist by the holding of Easton v. Strassburger, 152 Cal. App. 3d 90, and the manner of its discharge, and is declarative of the common law regarding this duty. However, nothing in this section is intended to affect the court's ability to interpret Sections 2079 to 2079.6, inclusive.

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

Agency Terms Defined

"Agent" means a person acting under provisions of Title 9 (commencing with Section 2295) in a real property transaction, and includes a person who is licensed as a real estate broker under

Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code, and under whose license a listing is executed or an offer to purchase is obtained (CC 2079.13.(a)).

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

The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent. When an associate licensee owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the associate licensee functions (CC 2079.13.(b)).

"Buyer" means a transferee in a real property transaction, and includes a person who executes an offer to purchase real property from a seller through an agent, or who seeks the services of an agent in more than a casual, transitory, or preliminary manner, with the object of entering into a real property transaction. "Buyer" includes vendee or lessee (CC 2079.13.(c)).

"Dual agent" means an agent acting, either directly or through an associate licensee, as agent for both the seller and the buyer in a real property transaction (CC 2079.13.(d)).

"Listing agreement" means a contract between an owner of real property and an agent, by which the agent has been authorized to sell the real property or to find or obtain a buyer (CC 2079.13.(e)).

"Listing agent" means a person who has obtained a listing of real property to act as an agent for compensation (CC 2079.13.(f)).

"Listing price" is the amount expressed in dollars specified in the listing for which the seller is willing to sell the real property through the listing agent (CC 2079.13.(g)).

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"Offering price" is the amount expressed in dollars specified in an offer to purchase for which the buyer is willing to buy the real property (CC 2079.13.(h)).

"Offer to purchase" means a written contract executed by a buyer acting through a selling agent which becomes the contract for the sale of the real property upon acceptance by the seller (CC 2079.13.(i)).

"Real property" means any estate specified by subdivision (1) or (2) of Section 761 in property which constitutes or is improved with one-to-four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobilehomes, when offered for sale or sold through an agent pursuant to the authority contained in Section 10131.6 of the Business and Professions Code (CC 2079.13.(j)).

"Real property transaction" means a transaction for the sale of real property in which an agent is employed by one or more of the principals to act in that transaction, and includes a listing or an offer to purchase (CC 2079.13.(k)).

"Sell," "sale," or "sold" refers to a transaction for the transfer of real property from the seller to the buyer, and includes exchanges of real property between the seller and buyer, transactions for the creation of a real property sales contract within the meaning of Section 2985, and transactions for the creation of a leasehold exceeding one year's duration (CC 2079.13.(l)).

"Seller" means the transferor in a real property transaction, and includes an owner who lists real property with an agent, whether or not a transfer results, or who receives an offer to purchase real property of which he or she is the owner from an agent on behalf of another. "Seller" includes both a vendor and a lessor (CC 2079.13.(m)).

"Selling agent" means a listing agent who acts alone, or an agent who acts in cooperation with a listing agent, and who sells or finds and obtains a buyer for the real property, or an agent who locates property for a buyer or who finds a buyer for a property for which no listing exists and presents an offer to purchase to the seller (CC 2079.13.(n)).

"Subagent" means a person to whom an agent delegates agency powers as provided in Article 5 (commencing with Section 2349) of Chapter 1 of Title 9. However, "subagent" does not include an associate licensee who is acting under the supervision of an agent in a real property transaction (CC 2079.13.(o)).

Agency Agreement

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

- Mutuality of agreement between the principal and his agent.
- Legal Purpose. The agent cannot be used to fly drugs from Colombia into the U.S.

- Both parties must have the capacity to enter into an agency contract. Minor and incompetents cannot contract and, therefore cannot enter into agency relationships. Minors can contract if they are emancipated by the courts, married, or in the U.S. armed forces.
- There must be consideration (except gratuitous agents), which is a bargained for exchange. The principal agrees to pay the agent a commission if she finds a suitable property for her to purchase.
- The agreement must be in writing, if required by law.

Termination of Agency Relationship

An agency agreement may be terminated by:

- The expiration of the term.
- The extinction of its subject matter (house burns down).
- The death of the agent.
- The agent's renunciation of the agency.
- The incapacity of the agent to act as such.
- Revocation by the principal.
- The death of the principal.
- The incapacity of the principal to contact.

Agency Disclosure Requirements

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

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

DISCLOSURE REGARDING
REAL ESTATE AGENCY RELATIONSHIP
(As required by the Civil Code)

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

SELLER'S AGENT

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

To the Seller:

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

To the Buyer and the Seller:

(a) Diligent exercise of reasonable skill and care in performance of the agent's duties.

(b) A duty of honest and fair dealing and good faith.

(c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, theparties.

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

BUYER'S AGENT

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

To the Buyer:

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

To the Buyer and the Seller:

(a) Diligent exercise of reasonable skill and care in performance of the agent's duties.

(b) A duty of honest and fair dealing and good faith.

(c) A duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties. An agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above.

AGENT REPRESENTING BOTH SELLER AND BUYER

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

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

(a) A fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either the Seller or the Buyer.

(b) Other duties to the Seller and the Buyer as stated above in their respective sections.

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

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

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

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

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

____

Agent	(date)	Buyer/Seller (Signature)	(date)

____

Associate Licensee (Signature)	(date)	Buyer/Seller (Signature)	(date)

As soon as practicable, the selling agent shall disclose to the buyer and seller whether the selling agent is acting in the real property transaction exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and the seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the selling agent prior to or coincident with execution of that contract by the buyer and the seller, respectively (CC 2079.17.(a)).

As soon as practicable, the listing agent shall disclose to the seller whether the listing agent is acting in the real property transaction exclusively as the seller's agent, or as a dual agent representing both the buyer and seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller and the listing agent prior to or coincident with the execution of that contract by the seller (CC 2079.17.(a)).

The confirmation required by subdivisions (a) and (b) shall be in the following form (CC 2079.17.(b)):

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

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

No selling agent in a real property transaction may act as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction (CC 2079.18).

The payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is <u>not</u> necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship (CC 2079.19).

Nothing prevents an agent from selecting, as a condition of the agent's employment, a specific form of agency relationship not specifically prohibited by this article if the requirements of Section 2079.14 and Section 2079.17 are complied with (CC 2079.20).

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

This section does not alter in any way the duty or responsibility of a dual agent to any principal with respect to confidential information other than price (CC 2079.21).

Nothing in this article precludes a listing agent from also being a selling agent, and the combination of these functions in one agent does not, of itself, make that agent a dual agent (CC 2079.22).

A contract between the principal and agent may be modified or altered to change the agency relationship at any time before the performance of the act which is the object of the agency with the written consent of the parties to the agency relationship (CC 2079.23).

Nothing in this article shall be construed to either diminish the duty of disclosure owed buyers and sellers by agents and their associate licensees, subagents, and employees or to relieve agents and their associate licensees, subagents, and employees from liability for their conduct in connection with acts governed by this article or for any breach of a fiduciary duty or a duty of disclosure (CC 2079.24).

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

- The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement (CC 2079.14.(a)).
- The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form pursuant to subdivision (a) above (CC 2079.14.(b)).
- Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the

selling agent may be furnished to the seller (and acknowledgment of receipt obtained for the selling agent from the seller) by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his or her last known address, in which case no signed acknowledgment of receipt is required (CC 2079.14.(c)).

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

In any circumstance in which the seller or buyer refuses to sign an acknowledgment of receipt pursuant to Section 2079.14, the agent, or an associate licensee acting for an agent, shall set forth, sign, and date a written declaration of the facts of the refusal (CC 2079.15).

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

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

Common Law Cases

There are several recent court cases that give additional information on the status of agency law and agency disclosures in California. We have selected two cases that reflect the opinions of the California Appeals Court. The following cases are both educational and quite entertaining.

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

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

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

FACTS OF THE CASE

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

Brown acquired the subject property, a large residence in Beverly Hills, on January 13, 1994. Some three months later, in April 1994, he listed it for sale with another broker. The asking price was $ 3,950,000. Over the course of the next 20 months, Brown successively reduced the listing price for the property, and relisted it. By June 1995 the asking price had been dropped to $ 2,895,000.

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

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

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

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

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

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

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

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

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

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

The next day, June 4, 1996, Barbara told Brown that it was time to go to escrow, and they did. Up to then, there was <u>no written offer or signed agreement for purchase and sale of the residence</u>. At the escrow office, Brown signed documents presented to him by Barbara for execution. Barbara identified the escrow instructions and asked

Brown to sign them. Brown looked at the first page, saw that the agreed-upon purchase price was correctly stated, and read nothing more. He signed or initialed each of the succeeding pages and attachments as indicated. One of the attachments he initialed was a document entitled "Real Estate Agency Relationships." Paraphrasing the statute, it states the duties of the seller's agent and the buyer's agent, and then deals with the case where the same agent represents both. That is legal, it states, only with the knowledge and consent of both seller and buyer. The dual agent has "a fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either the Seller or the Buyer," and may not, without express permission, disclose to the buyer that the seller will take less than the listing price, or that the buyer will pay more than the amount offered. Barbara gave this document to Brown and directed him to sign it, but he did not know what it was. He thought it was merely a form to facilitate consummation of the transaction.

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

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

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

Sid declared that when he showed the property to Lafferty, Sid "verbally told plaintiff Harry Brown that I was representing Mr. Lafferty." As we have seen, Brown denies this. According to Brown, he learned of the dual agency from his girlfriend, several days after the close of escrow, when she was leafing through the transaction documents. <u>He had never consented to a dual agency.</u>

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

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

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

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

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

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

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

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

The referenced provision, Civil Code section 2079.16, provides: "The disclosure form required by Section 2079.14 shall have Sections 2079.13 to 2079.24, inclusive, excluding this section, printed on the back, and on the front of the disclosure form the following shall appear: "Disclosure Regarding Real Estate Agency Relationship (As required by the Civil Code)
"When you enter into a discussion with a real estate agent regarding a real estate transaction, you should from the outset understand what type of agency relationship or representation you wish to have with the agent in the transaction."

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

It should be noted that the statute requires disclosure to the seller "as soon as practicable *prior* to presenting the seller with an offer to purchase" unless disclosure already had been made. (Civ. Code, § 2079.14, subd. (b), italics added.) <u>The contemplated disclosure is to be in writing. The only written disclosures in this case were made when the escrow instructions were signed. Sid claims to have informed Brown, orally,</u> that he was representing Lafferty when he first brought Lafferty over to see the property. But Brown denies that this occurred, leaving an unresolved triable issue of material fact.

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

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

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

There are at least two reasons this doctrine is not sufficient to secure victory to respondents. First, the statute and common sense require that the dual agent call attention to the fact of dual agency, and Brown has submitted substantial evidence that they failed to do so. He was not on notice that any of the documents he signed or initialed was anything other than a routine instrument technically required for consummation of the sales transaction. Second, by the time the escrow papers were being signed, Brown already had "broken" HIS PRICE: he could hardly then demand a greater price, particularly since, so far as the record discloses, the buyer was guilty of no impropriety except through his dual agent.

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

- First, the asking price of $ 2,495,000 is only 3.8 percent greater than the sales price.
- Second, Lafferty had an urgent need for a suitable residence to house himself and his passel of dogs: He was demanding occupancy for himself and ouster of the resident-owner, all within a few days.
- Third, Lafferty himself had made it clear to Forbess that it was his money and that he was going to buy the place.

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

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

CLARIDGE v. THE PINES RESORTS addresses a breach of fiduciary duty owed by an agent to his principal.

JOSEPH CLARIDGE et al., Plaintiffs, Cross-Defendants, and Appellants, v.THE PINES RESORTS, Defendant, Cross-Complainant, and Appellant; Rudolf R. Shulte et al. Defendants, Cross-defendants, and Respondents; Stephen Welch et al., Defendants and Respondents.

FACTS OF THE CASE

Plaintiffs in this case are Gail and Joseph Claridge (the Claridges). Joseph Claridge is a retired police officer. He holds a real estate sales license. Gail Claridge is an interior designer who owns her own design firm. Her projects have included renovations of large estates and commercial shopping centers. She holds a general contractor's license. In the 1980's, the Claridges designed and constructed a 7,000 square foot house in Northridge which was their primary residence for many years.

Defendants include a corporation, the Pines Resort; Rudolf Schulte; and Stephen Welch. The Pines owns and operates several businesses in Bass Lake, a resort town in Madera County. Rudolf Schulte owns most of the stock in the Pines. Stephen Welch has a 2 percent ownership interest in the Pines, and is a manager of a number of businesses operated by the Pines. Welch is a licensed real estate broker. (For convenience, we sometimes refer to these defendants collectively as the Pines).

The other defendants are Donna Pride, Pride Land Company, and The Land Office, a realty company in Bass Lake. (We refer to these defendants collectively as the Land Office). The Land Office was owned 25 percent by the Pines and 75 percent by Pride Land Company. Pride Land Company is owned by Donna Pride, a licensed real estate broker, and her husband, who is not a party in this action. Donna Pride managed the day-to-day affairs of the Land Office. Welch assisted her with the business as needed.

The Pines owned a resort lodge known as Ducey's, located on approximately 20 acres of land overlooking Bass Lake. In June 1988, the Ducey's lodge was destroyed by fire. After conducting a land use study, the Pines determined that the best use for the Ducey's property was residential. It decided to sell the 20-acre parcel to a developer and use the proceeds to build a new lodge at a different location in Bass Lake. The Pines listed the Ducey's property for sale at $ 1.9 million, hoping for a quick sale.

Soon after putting the property on the market, the Pines received two offers from developers, one for $ 1.9 million, and the other for $ 1.8 million. While the Pines was considering these offers, Garry Morris, a real estate expediter who owned a house near Bass Lake, became interested in the Ducey's property. Morris knew Gail Claridge from projects they had worked on together. Morris's proposal was to buy an option on the Ducey's property, which would be exercised upon locating an investor for the purchase price. He intended to take a 25 percent interest, and offered the Claridges a 25 percent interest in return for Gail's assistance in configuring the lots and designing homes for the subdivision. The remaining 50 percent interest would go to an investor who would contribute the funding for the purchase and development of the property.

The Claridges went to Bass Lake in early January 1990 to view the property with Morris and his wife. They met with Welch and Pride. Pride and the Land Office represented the Pines as seller, and also represented the prospective purchasers. Welch and Pride told the Claridges and Morrises that this project was a once-in-a-lifetime opportunity because this land could be sold in fee simple, while the other land in the area was long-term leasehold, and that the lots should sell "like hotcakes."

On January 7, 1990, the Morrises and Claridges offered to purchase the Ducey's property for $ 2 million in cash. They each deposited $ 10,000. The Pines accepted the offer and the parties agreed to a four-month escrow. The agreement recited that the Land Office was representing both sellers and purchasers; that the Pines owned a 25 percent interest in the Land Office; that Pride and Welch were both real estate brokers; that Welch had an ownership interest in the Pines; and that Joseph Claridge was a licensed real estate agent.

After execution of the purchase agreement, the Claridges and Morrises formed a corporation, Clarmor, for the purpose of taking title to the property. They each owned 25 percent of the stock; the remaining 50 percent was to be sold to investors in the project.

As of May 1, 1990, Morris had been unable to find an investor, and the Pines agreed to extend the closing date to July 28, 1990. During that period, the Claridges invested approximately $ 20,000 more for gas tank removal and other work on the property. In early July, Morris told the Claridges he was unable to interest an investor with an offer of only 50 percent, and asked them to withdraw from the project. He said if they withdrew, when the project was complete he would give them one of the lots or $ 100,000. The Claridges reluctantly withdrew.

Morris still could not find an investor. In a September 14, 1990 letter, Morris informed the Pines of this, and suggested that the Pines become an investor in the project. Morris stated in the letter that he had discussed this with Gail Claridge, who still liked the Ducey's project and had $ 270,000 which she needed to invest by October 2 to qualify for a tax-free property exchange.

Garry Morris and Gail Claridge met with Schulte at his ranch in Santa Barbara in late September. Welch was present but Donna Pride was not; she had not been invited to this meeting. Morris asked that the Pines become a partner in the project, but Schulte rejected that proposal. The Pines wanted cash from the sale of the property to put into the construction of the new lodge. Morris and Claridge asked the Pines to return their deposit and allow them to cancel the transaction. Schulte proposed instead that Morris or Claridge purchase the property themselves. They each told Schulte they did not have $ 2 million in cash. Claridge told Schulte she had $ 275,000 available from the property exchange.

One or two days after the meeting, Schulte asked Gail Claridge to meet with him at his office in Santa Barbara to discuss the transaction further. Claridge and her adult daughter met with Schulte and his financial advisor. Neither Welch nor Pride was present. Schulte proposed that the Claridges purchase the property themselves. According to the proposal, if the Claridges applied the $ 275,000 from the property exchange, and obtained $ 1 million from a second trust deed on their home, the Pines would carry a note for $ 725,000 which was to be repaid from the sale of the developed lots on the property.

Gail explained that even if they were able to obtain funds to purchase the property, they had no money for development costs. Schulte told her she would be able to get a construction loan for development costs, and that the Pines would subordinate the balance due on the $ 725,000 note to a construction loan to cover development costs, which were estimated at $ 1 million. Schulte volunteered to have his attorneys draw all the papers to enable the exchange to be completed by Gail's impending deadline.

The Claridges agreed to the transaction. The purchase agreement was drafted as an amendment to the original purchase agreement entered into by the Pines as seller and the Claridges and the Morrises as purchasers. The Claridges signed the necessary documents at the office of the Pines' attorney. The Claridges had no attorney or real estate broker with them when they executed these documents.

The "Amendment to Escrow Instructions," dated September 28, 1990, provided that the Claridges would purchase the property for $ 2 million. Of that amount, the Claridges would pay $ 275,000 from their tax free property exchange; the balance would come from two notes secured by the property. One note, for $ 1 million, was due in 120 days. The other, for $ 725,000, was due in two years. The agreement also provided that the Pines would subordinate its second note for up to $ 1 million in construction financing from an institutional lender. The Claridges agreed to use the proceeds from the construction loan "solely for purposes of development of the real property subject of this sale."

The amendment contained a default provision, in the event the Claridges were unable to pay the $ 1 million note by February 1. Under those circumstances, upon their voluntary conveyance of good title to the seller, the seller agreed to execute a noninterest bearing note in the amount of $ 275,000, less any transactional costs, payable in three years. In the event sellers received more than $ 2 million for the property, they agreed to reimburse the buyers up to $ 50,000 from the excess.

Escrow closed on October 1, 1990. The Land Office received an $ 80,000 commission for the sale of the Ducey's property. The Pines paid Welch a commission on the sale.

Shortly after the close of escrow, the Pines sought some changes in the agreement. The Claridges retained an attorney, Laurence Mandell, to review the proposed changes. Mandell entered into a series of negotiations with the Pines' attorney as to several terms of the agreement, including the default provision.

The terms of this default provision were subsequently renegotiated when the Claridges retained counsel. The revised terms reduced the period of the note to two years, and increased their potential reimbursement to $ 100,000.

At the same time, the Claridges sought a second mortgage on their home to pay off the $ 1 million note. They were unable to obtain a loan from an institutional lender, but did obtain a loan from a private lender, secured by their home and a property owned by Gail's mother. After deducting points and interest, they received less than $ 1 million in net proceeds. The Pines accepted this amount and agreed that the difference could be added to the $ 725,000 note. The Claridges and the Pines entered into a note modification agreement on February 15, 1991 which reflected the modifications worked out by the attorneys, the payment by the Claridges of $950,000 on the first note, and the increased amount of the second note.

The Claridges were unable to obtain a construction loan from an institutional lender. Instead they obtained funds from private lenders, including a $ 500,000 loan in July 1991 through Ty Ebright; a $ 200,000 loan in November 1991 from their neighbor, Jim McGraw; and a $ 125,000 loan in January 1992 through Ty Ebright, in the total amount of $ 825,000. The Pines subordinated to these three loans.

The Claridges retained surveyors, engineers, a general contractor and various subcontractors. The tentative subdivision map was approved in November 1991, and construction began in mid-1992. By late 1992, the Claridges had defaulted on payments due to their general contractor and other providers. The Claridges also defaulted on their construction loans. In October 1992, when the Pines' note was due in full, the Claridges defaulted on that note. In December 1992, they transferred the property to a business trust, the Gold Coast Trust. This transfer was without the knowledge or consent of the Pines or Ebright.

McGraw gave notice of default in February 1993, and the Pines agreed to subordinate to another loan in favor of McGraw to prevent foreclosure. In May 1993, Ebright scheduled a foreclosure sale. The Pines paid the delinquent interest the Claridges owed to Ebright, adding approximately $ 93,000 to the amount owed on its note. By late 1993, when the Claridges were unable to obtain any other financing for the project, they put Gold Coast Trust into bankruptcy; that action was dismissed as a bad faith filing on motion of the bankruptcy trustee.

By April 1994, the Claridges were again in default on the Ebright note. The Pines foreclosed in April 1994, repurchased the property at the foreclosure sale, and cleared all liens and notes on the property. The Pines completed the project, and as of the time of trial, had sold two of the lots.

In September 1995, the Claridges filed a complaint against the Pines, Schulte, Welch, the Land Office, Donna Pride and Pride Land Company, alleging breach of fiduciary duty, negligence, breach of contract, and fraud arising from the purchase and loss of the Ducey's property. The Pines cross-complained against the Claridges, alleging the Claridges breached their contract by diverting proceeds from construction loans to other purposes. The Claridges filed a cross-complaint against Schulte, Pride, and the Land Office, seeking indemnity for any liability they might have on the Pines' cross-complaint. Trial was by jury. The jury received no instructions on the indemnity cross-complaint.

The jury rejected the Claridges' fraud claims, but found defendants liable for breach of fiduciary duty and negligence, and awarded the Claridges $ 2.5 million. The jury awarded the Pines $ 300,000 on its cross-complaint. After judgment was entered, defendants moved for judgment notwithstanding the verdict or new trial on the complaint. The court granted both motions. The Claridges' motions for judgment notwithstanding the verdict or for new trial on the Pines' cross-complaint were denied. The Claridges appeal from this judgment in case number B119180. In a cross-appeal, the Pines seeks correction of the judgment as to their award on the cross-complaint.

Justice Epstien had the follow response(s): A real estate broker has the same obligation of undivided service and loyalty to his or her client as a trustee has to his or her beneficiary. (*Ford v. Cournale* (1973) 36 Cal. App. 3d 172, 180, 111 Cal. Rptr. 334.) This relationship not only imposes on the agent "'the duty of acting in the highest good faith towards his principal but precludes the agent from obtaining any advantage over the principal in any transaction had by virtue of his agency. [Citation.] "Such an agent is charged with a duty of fullest disclosure of all material facts concerning the transaction that might affect the principal's decision. [Citations.]"'" (*Jorgensen v. Beach ' N'Bay Realty, Inc.* (1981) 125 Cal. App. 3d 155, 161, 177 Cal. Rptr. 882.) There is a stricter standard of materiality regarding information which must be disclosed by one acting in a dual fiduciary capacity; a fact will be considered material in this context "'"if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent to the agent to enter into the particular transaction on the specified term."'" (*Id.* at p. 162.) Materiality of the information is a factual question for the jury. (*Id.* at p. 161.)

"A broker's fiduciary duty to his client requires the highest good faith and undivided service and loyalty. [Citations.] 'The broker as a fiduciary has a duty to learn the material facts that may affect the principal's decision. He is hired for his professional knowledge and skill; he is expected to perform the necessary research and investigation in order to know those important matters that will affect the principal's decision, and he has a duty to counsel and advise the principal regarding the propriety and ramifications of the decision. The agent's duty to disclose material information to the principal includes the duty to disclose reasonably obtainable material information. The facts that a broker must learn, and the advice and counsel required of the broker, depend on the facts of each transaction, the knowledge and the experience of the principal, the questions asked by the principal, and the nature of the property and the terms of sale. The broker must place himself in the position of the principal and ask himself the type of information required for the principal to make a well-informed decision. This obligation requires investigation of facts not known to the agent and disclosure of all material facts that might reasonably be discovered.' (2 Miller & Starr, Cal. [*18] Real Estate 2d (1989) Agency, § 3.17, pp. 94, 96-97, 99, fn. omitted.)" (*Field v. Century 21 Klowden-Forness Realty* (1998) 63 Cal.App.4th 18, 25.)

The Claridges based their breach of fiduciary duty claim on the defendants' failure to disclose to them or properly advise them as to the financial viability of the transaction in light of the Claridges' financial circumstances and their real estate investment and development experience. The Claridges presented the expert testimony of Dr. Cynthia Mertens as to the standard of care expected of a real estate broker. According to Dr. Mertens, that standard requires a broker to consider the suitability of the project for the client. This includes making sure that "the client understands all of the potential ins and outs of the transaction. And to give some examples directly related here, if you need to go out and borrow what amounts to $ 2 million, you send your client out to see if they financially qualify for that $ 2 million before you get them committed to the deal with the potential of losing their money."

Gail Claridge testified that at the Santa Barbara meeting in which Clarmor withdrew from the transaction, she and Garry Morris both informed Schulte and Welch that they did not have the money to purchase the property, and that the only cash they had available was $ 275,000 to invest in a tax-free property exchange. Yet two days later, without additional information or research as to the Claridges' financial circumstances, the Pines, through Schulte, advised them that they could obtain the necessary funding, without explaining the risks or costs of obtaining loans of that size in light of their personal finances. Gail also testified that at the time Schulte suggested that the Claridges purchase the property themselves, he assured her that she and her husband would have no difficulty completing the project, despite the fact that they had no prior experience in subdivision development. He reassured her that their living far from the property would not be a problem, since the Pines had all the right people to do the work, and she really would not need to be at Bass Lake.

Neither the Land Company nor the Pines explained the terms of the October 1, 1990 amended escrow agreement to the Claridges. Welch was aware that Donna Pride had not participated in the amendment of the transaction, yet he did not refer the Claridges to Pride for any explanation of the terms and conditions of the purchase agreement. It is undisputed that the Claridges were not accompanied by counsel or a broker at the time they entered into the purchase agreement. From this, the jury could reasonably find a breach of the broker's fiduciary duty to explain the important details of the transaction and ascertain the client's ability to qualify financially for the transaction.

Dr. Mertens testified that a broker should include sufficient contingencies in the purchase contract to protect the client, including contingencies about the source of the financing; the contract should provide that if the necessary loan is not available from appropriately defined sources, the client will be able to cancel the transaction without losing the deposit money. Similar contingencies should be in place with regard to obtaining necessary construction financing. The standard of care requires the broker to structure the transaction so that if the contingencies cannot be met, the client can get out of the transaction "whole."

The jury had before it the contract, as amended, with regard to the purchase of the Ducey's property. It contained no cancellation contingency with regard to obtaining construction financing. While it contained a default clause permitting the Claridges to withdraw from the contract if they were unable to pay the $ 1 million note by February 1, 1991, they would not be able to obtain an immediate refund of their $275,000 upon withdrawal; that money would only be repaid to them after a period of two years or completion and sale of the project. That would give the Pines use of their money for a lengthy period of time. The jury was entitled to consider this contingency inadequate to protect the Claridges. The jury also could conclude that this provision favored the sellers over the buyers, reflecting a *breach of the dual agents' fiduciary duty to the buyers*.

The fiduciary duty of a broker to a client precludes the broker from gaining an advantage over the client by means of the transaction. Dr. Mertens pointed to the clause in the contract giving the Land Office the exclusive listing for resale of the lots as indicating that the dual agent placed its own interests above those of the client. The jury was entitled to reach the same conclusion.

This is not the only evidence that the exclusive listing clause resulted in the broker putting its own interests above those of the client. In 1992 or 1993, Donna Pride received a verbal inquiry about an as-is purchase of the property, in bulk, for $ 4 million. According to Gail Claridge, Ms. Pride recommended against pursuing the offer, stating, "Why would you want to take $ 4 million for the property? You're almost done with it, you know. It'11 be worth 10 million in another, you know, few months." According to the contract, the Land Company would receive a commission if it sold the lots individually, but the contract did not provide for a commission to the Land Company if there was a bulk sale. The jury could have credited Claridges' testimony as to Pride's recommendation, and considered that Pride's advice was premised on the Land Company's own interest in receiving commissions from subsequent sales of the lots.

Encouraging the Claridges to continue with the transaction rather than entertain an offer of a bulk sale is even more questionable in light of evidence that before this bulk sale opportunity, Stephen Welch had indicated to the Claridges' construction lender that he did not believe the Claridges had the financial ability to complete the project. Welch stated that they were "tapped out," and also indicated that Gail Claridge had no experience in this type of project.

The Claridges presented testimony of another expert, John Reed, as to the standard of care of a real estate broker to an investment client interested in purchasing real estate. According to Mr. Reed, the standard of practice requires a broker to proceed with three specific steps: first determine the client's goals; next determine the client's ability, based on financial ability and expertise; and then analyze the particular purchase. Mr. Reed utilized these steps to analyze the Ducey's purchase, with the assumption "that the purchaser of the property was fairly naive as far as the development process and unaware of the market conditions and the real estate market and how it worked in the Bass Lake area."

Utilizing what he considered a realistic selling price for the lots, and taking into account closing costs, commissions, the cost of carrying construction loans for at least a two-year period, and the cost of the land, Mr. Reed concluded the project would result in a net loss of $ 296,000. For that reason, he would have advised the Claridges that "this project doesn't make any sense at that purchase price." It was his opinion that The Land Office "highly overestimated" the prospective sales price of the lots to be sold.

Based on his review of the documents relating to the transaction, Mr. Reed found "it is very clear that they did not have the money to subdivide the property; otherwise, they would not have needed all of the loans, seller financing and all of the hard money, high-priced personal loans they had to go out and pay for in order to try to keep the project alive." Mr. Reed had seen the Claridges' balance sheet that showed they had total assets of approximately $ 14 million and a net worth of approximately $ 8 million. Asked whether the $ 8 million in net worth was "worth something," Mr. Reed replied: "Not if you can't draw on it. Not if you've got to pay an engineer or a bulldozer operator right there, write him a check. You can have a net worth of $200,000,000. If you can't get the cash, you're in trouble."

Defendants' own real estate expert, Brad Ditton, testified that if a broker is dealing with a client who is unfamiliar with the local real estate market, the broker has the duty to advise the client about that market. This includes informing the client of "the broker's best opinion of what the lots will sell for when they're created." According to Gail Claridge, Donna Pride advised her that the lots could be sold for between $ 99,000 and $ 150,000. The Claridges' expert, John Reed, testified that a realistic selling price for the lots was substantially lower. This opinion could support the conclusion that the *broker failed to advise the client accurately about the local real estate market.*

Mr. Ditton testified that he ascertains his clients' financial capabilities, asking them if they have the money and informing them about the cost of the project; he does not verify whether the clients can actually perform. In analyzing a potential transaction, he would not rely on appraisals, but would "do the numbers" himself to determine "whether this project does or doesn't make any sense" in terms of cost and potential profit for an investor. He then would relay that information to his clients. Mr. Ditton was asked what he would do if he concluded that his clients did not have the financial capability or the experience to complete a project. He replied, "I'd tell them to go home."

Ken Neal, who was the contractor on the Ducey's project, testified that he had ongoing conversations with Gail Claridge throughout the course of the project. Based on those conversations, he believed Claridge did not know anything about the construction process or how to develop a subdivision. Both Gail and Joseph Claridge provided similar testimony. Gail also testified that she did not understand the financial risks of the transaction, which were not explained to her by any of the defendants.

There was a great deal of evidence presented which conflicted with what we have summarized. But in ruling on a judgment notwithstanding the verdict, the trial court is not entitled to weigh the evidence, or judge the credibility of witnesses. Disregarding conflicting evidence and indulging all legitimate inferences which can be drawn from the Claridges' evidence, we conclude that there is sufficient evidence to support the verdict in their favor on the basis of breach of fiduciary duty.

This conclusion as *to breach of fiduciary duty* necessarily carries over to the negligence verdict. The same conduct which supports the conclusion that *the broker failed to meet its duty as a fiduciary also supports the conclusion that the broker failed to exercise the requisite standard of care required of a real estate broker.*

The trial court erred in granting defendants' motions for judgment notwithstanding the verdict.

The court characterized as "preposterous and incredible" Gail's testimony that she did not need the tax benefit from the tax free exchange because she had other losses, and that it was the sellers who had the urgent need to close the transaction. The court correctly observed there was no evidence the sellers had a specific deadline for concluding the transaction. It found that "Gail's testimony that she was reluctant, but importuned, overwhelmed and misled into taking over the purchase by Schulte during a single meeting is irreconcilable with all of the documented and largely undisputed evidence of the economic elements of the transaction and Gail's accomplishments and persona." A reasonable trier of fact could have reached this conclusion based on the evidence at trial.

The court was unconvinced by the Claridges' claim that they were misled regarding sales prices and demand for finished lots. The court relied on undisputed evidence that the real estate market suffered a "catastrophic drop" which would affect the sales price of the lots. The court noted that Gail Claridge's testimony regarding Donna Pride's miscalculations of sale prices ignored that phenomenon, and ignored the Claridges' right to set their own sales prices. Our review here is in the light most favorable to the trial court's ruling. Under that standard, we find the ruling amply supported.

The court rejected the Claridges' evidence that they entered into the transaction without appropriate advice from their fiduciary. The court also took the view that the default provision permitting the Claridges to withdraw from the transaction prior to February 1, 1991 and receive a note for later repayment of their $ 275,000 and possible reimbursement of expenses provided a full remedy for any possible misrepresentations which preceded that date. The court believed that if the Claridges justifiably relied on representations by the defendants, that reliance was no longer justified once the Claridges retained their own attorney to assist with the transaction
The court disbelieved Gail Claridge's testimony that she did not exercise the contingency because defendants did not offer to return her down payment in cash. Instead, the court believed "Gail turned down the offer clearly because she remained enamored of the substantial profits which had been the lure" since she and Gary Morris first independently evaluated the project. The evidence, while conflicting, supports the court's view.

In case number B119180, the order granting judgment notwithstanding the verdict as to the Claridges' complaint is <u>reversed</u>. The order granting a new trial as to the Claridges' complaint is <u>affirmed</u>, and the cause remanded for new trial.

Sometimes it's difficult to decide who's the hero and who's the villain.

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

Ethics, Professional Conduct, and Legal Aspects of Real Estate

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

Business and Professions Code Section 10176

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

(a) Making any substantial misrepresentation.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(b) Notwithstanding any other provision of Article 1.5 (commencing with Section 1102) of Chapter 2 of Title 4 of Part 4 of Division 2 of the Civil Code, and in lieu of any other civil remedy, subdivision (a) of this section is the only remedy available for violations of Section 1102.6b of the Civil Code by any real estate licensee within this state.

Business and Professions Code Section 10177

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

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

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

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

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

(e) Willfully used the term "realtor" or any trade name or insignia of membership in any real estate organization of which the licensee is not a member.

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

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

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

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

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

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

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

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

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

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

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

10177.1. The commissioner may, without a hearing, suspend the license of any person who procured the issuance of the license to himself by fraud, misrepresentation, deceit, or by the making of any material misstatement of fact in his application for such license. The power of the commissioner under this section to order a suspension of a license shall expire 90 days after the date of issuance of said license and the suspension itself shall remain in effect only until the effective date of a decision of the commissioner after a hearing conducted pursuant to Section 10100 and the provisions of this section. A statement of issues as defined in Section 11504 of the Government Code shall be filed and served upon the respondent with the order of suspension.

Service by certified or registered mail directed to the respondent's current address of record on file with the commissioner shall be effective service. The respondent shall have 30 days after service of the order of suspension and statement of issues in which to file with the commissioner a written request for hearing on the statement of issues filed against him. The commissioner shall hold a hearing within 30 days after receipt of the request therefor unless the respondent shall request or agree to a continuance thereof. If a hearing is not commenced within 30 days after receipt of the request for hearing or on the date to which continued with the agreement of respondent, or if the decision of the commissioner is not rendered within 30 days after completion of the hearing, the order of suspension shall be vacated and set aside. A hearing conducted under this section shall in all respects, except as otherwise expressly provided herein, conform to the substantive and procedural provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code applicable to a hearing on a statement of issues.

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

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

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

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

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

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

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

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

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

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

CASE #1: BRIAN GALLOP, ET AL., Plaintiffs and Appellants, v. CASA GRANDE, ET AL. (Called Broker A), Defendants and Respondents. B143366, COURT OF APPEAL OF CALIFORNIA, SECOND APPELLATE DISTRICT, DIVISION THREE, filed February 28, 2002. Judges: Croskey, with Klein and Kitching concurring.

This case arises from the sale of residential real property. Plaintiffs Laurie Gallop and Brian Gallop ("plaintiffs") are the buyers. They sued the seller, the real estate agency that represented both seller and plaintiffs, and the home inspection company that inspected the property on behalf of plaintiffs. Plaintiffs appeal from a judgment entered against them and in favor the seller, Betty Caldwell ("Caldwell"), after a jury trial. Plaintiffs contend the trial court should have granted their motions for new trial and partial judgment not withstanding the verdict as to Caldwell because the jury found in favor of plaintiffs on all elements of their cause of action against Caldwell for breach of contract. Plaintiffs contend she breached the sale contract by failing to disclose to them that there were foundation, structural and other defects in the house that make it worth substantially less than the price they paid for it.

Plaintiffs' complaint, which was filed on November 6, 1998, asserted causes of action for breach of contract, fraud, negligent misrepresentation, and negligence against all defendants, as well as breach of fiduciary duty against Broker A. The home inspection defendants entered into a good faith settlement with plaintiffs in the amount of $ 63,000. That settlement, however, did not specify how much of it was attributable to plaintiffs' claimed economic damages and how much, if any, to their claimed non-economic damages.

The case was tried to a jury and concluded on May 4, 2000. On the various causes of action against Caldwell, the jurors found that

(1) plaintiffs and Caldwell entered into a contract for the purchase of Caldwell's home,
(2) plaintiffs performed under the contract,
(3) Caldwell concealed or suppressed a material fact,
(4) she did not intentionally conceal or suppress it with the intent to defraud plaintiffs,
(5) she did not breach the sale contract, and
(6) she was not negligent.

The jurors found Broker A was negligent and its negligence was a cause of damage to plaintiffs. Plaintiffs were found to be damaged in the amount of $ 110,000. The jury also found that plaintiffs were contributorily negligent (43%) and their negligence was *a* cause of their damages. Collectively, the Broker A defendants were found to be 57% negligent.

On the fraud and concealment cause of action against Broker A, the jury found that defendant agent Joseph D. did not conceal or suppress a material fact, but defendant Broker A did. The jury found, however, they did not do so with an intent to defraud plaintiffs.

Plaintiffs' appeal and Broker A's cross-appeal followed.

ISSUES

Plaintiffs contend:

(1) their motions for JNOV (judgment notwithstanding the verdict) and new trial should have been granted,

(2) the trial court erred in applying their settlement with the home inspection defendants as an offset to the jury's award of damages against Broker A,

(3) because they prevailed in their suit against Broker A, they are entitled to their costs, and

(4) the trial court erred in not instructing the jury on their cause of action against Broker A for breach of fiduciary duty.

In its cross-appeal, Broker A contends there is insufficient evidence to support the jury's finding that it was negligent in the sale transaction.

Broker A also contends its motion for new trial should have been granted because:

(1) it was error to permit plaintiffs to assert personal injury in an "economic injury" case such as this,

(2) Broker A should have been permitted to present evidence about an arbitration clause,

(3) Broker A was entitled to costs, and

(4) the special verdict form for the negligence count was prejudicially harmful because it named a fictitious entity as a defendant.

Plaintiffs engaged the services of defendant Joseph D. to help them locate a home in La Mirada. Joseph D. told plaintiffs about Caldwell's house, which had been listed for sale by another agent in Joseph D's office. Plaintiffs offered Caldwell $ 220,000 for her house and she accepted the offer. She had lived in the house for 22 years.

Caldwell signed a transfer disclosure statement. In it, she listed two things in the house that were problems--a crack in the floor of the garage and the fact that the spa was not working. She testified the crack appeared while she lived at the house and it got larger over the course of time. She herself filled it in with cement because "it was where you walk and it didn't look good," however, "over time it reappeared again." Caldwell said it would be hard to not see the crack if you went into the garage. She considered it a significant defect in the garage.

The transfer disclosure statement asked Caldwell whether she was "aware of any significant defects/malfunctions in any of the following," and then listed interior walls, ceilings, floors, exterior walls, insulation, roofs, windows, doors, foundation, slab, driveways, sidewalks, walls/fences, electrical system, plumbing/sewer/septic/ and other structural components. Caldwell answered "no." She also answered "no" to the question, on the transfer disclosure statement, whether she was aware of "any settling from any cause, slippage, sliding, or other soil problems." At trial, Caldwell was asked whether she was aware, when selling her house, that she would have to "disclose items that she felt might have some impact on the house." She answered that she was aware of that obligation.

She also testified she showed her agent, that the sunroom she had added onto the house in the late 1980's had separated from the house, but she did not list the separation on the disclosure statement. Asked if she believed, when she was selling the house, that the separation was something she should disclose to her agent, given her disclosure obligations, she answered "yes." She stated her agent told her not to worry about it because it was not attached to the foundation. Her agent testified he did not recall any conversation with Caldwell about the sunroom. He stated the sunroom is at the rear of the house. Caldwell testified the separation was visible from the outside, and while plants covered up the separation, "you could see it up above that." She never spoke to plaintiffs about the sunroom.

The trial court asked her whether she had ever detected a slant in any of the floors in her house, and she stated she had not, but when the court asked if she had ever dropped anything on the floor and had it roll to a corner, she stated that had happened "in that washroom where the water ran down," apparently meaning the laundry room when the washer overflowed.

Caldwell testified that right after she moved into the house in 1996, she had "shims" (wedges of wood) installed so that the floors in two rooms towards the rear of her house (living room and dining room) would stop squeaking. She also had some of the doors in the house shaved because she had carpet installed throughout the house and some doors would not close because the carpet "was too high." Additionally, the dining room door would not stay open. It moved towards the rear of the house. She testified at her deposition that water in the laundry room ran "towards the door." Asked if she felt the floor was uneven, she stated that most floors are uneven and if you spill water, the water runs one way or another and she did not believe the floors were uneven in her house.

Kip Kennedy, a building inspector for the city of Los Angeles who had been employed in that position since December 1988, and who had been a general contractor before assuming that position, testified at trial that he had inspected in excess of 10,000 homes, that he can tell old damage from new damage, and he believed the shims in the subject house had been in place from one to eight years, not the 20-some years that Caldwell stated they had been there.

Regarding the plaintiffs' damages, Tallas Margarve testified he is an engineering and building contractor and a licensed land surveyor and his company stabilizes and levels buildings that have failed. He testified it would cost approximately $ 108,000 to do such work on plaintiff's house and then replace the concrete areas of the house that had to be removed. Plaintiff Brian Gallop testified that if he had known of the things he was not told about by Caldwell or her agents (shims under the house, water running toward rear of house, separation of sunroom from rest of house) he would not have purchased the house.

Appelate Court Opinion:
As noted above, the jurors specifically found that:
(1) plaintiffs and Caldwell entered into a contract for the purchase of Caldwell's home,
(2) plaintiffs performed under the contract, and
(3) Caldwell concealed or suppressed a material fact. The first two findings were in the special verdict for the breach of contract cause of action, the third was in the special verdict for the fraud cause of action.

Based on these findings, and on the fact that the jury found plaintiffs suffered damages in connection with the purchase of the house, plaintiffs contend on appeal that the elements of a cause of action for breach of the purchase agreement were found by the jury and therefore the jury's additional finding that Caldwell did not breach the contract is not supported by the evidence. We agree. In the purchase agreement, there is an implied promise by Caldwell that she would not conceal material information about the house she was selling to plaintiffs.

Paragraph 9 of the purchase agreement signed by Caldwell states in part: "Whether or not seller warrants any aspect of the property, seller is obligated to disclose known material facts and to make other disclosures required by law." By this express acknowledgement of her duty to disclose known material facts, Caldwell impliedly promised to do so. Moreover, paragraph 6 of the purchase agreement required Caldwell to disclose to plaintiffs, prior to close of escrow, any material inaccuracies in disclosures made to them, including making disclosures in the transfer disclosure statement. Caldwell's testimony shows that when she sold the house to plaintiff she had personal knowledge of the many facts that indicated the house might not be level. Caldwell admitted at trial she knew she had to disclose "items that [she] felt might have some impact on the house itself." Whether Caldwell intentionally concealed information to defraud plaintiffs (and the jury found she did not), is of no relevance to the cause of action for breach of contract. Plaintiffs note that when a breach of contract is alleged, the law does not require that the breach be intentional before a plaintiff may recover. (*Linden Partners* v. *Wilshire Linden Partners* (1998) 62 Cal.App.4th 508, 531-532.)

Civil Code section 1102 et seq. also required Caldwell to provide plaintiffs with a transfer disclosure statement that disclosed the matters addressed in such statement, including settling, soil problems and slippage and sliding. Section 1102.4 provides that a seller such as Caldwell is not liable "for any error, inaccuracy, or omission of any information delivered pursuant to [the transfer disclosure statement statutes] if the error, inaccuracy, or omission was not within the personal knowledge of the [seller]." Section 1102.13 states that a "person who willfully or negligently violates or fails to perform any duty prescribed by any provision of [the transfer disclosure statutes] shall be liable in the amount of actual damages suffered by a purchaser."

Thus, the trial court should have granted plaintiffs' motion for a partial JNOV (judgment notwithstanding the verdict) as to Caldwell on the breach of contract cause of action against her. We shall remand this case and direct that a judgment notwith-standing the verdict be entered against Caldwell, and in favor of plaintiffs, in the amount of $ 110,000, together with costs. Setoff from the good faith settlement between plaintiffs and the home inspection defendants is not an issue with Caldwell because such defendants are not co-obligors on the contract between plaintiffs and Caldwell. (Code Civ. Proc., §§ 877 & 877.6.)

The jury found Caldwell was not negligent. On appeal, plaintiffs assert that the very conduct of Caldwell that gives rise to a breach of contract cause of action against her also supports their cause of action against her for negligence.

One of plaintiffs' causes against Broker A was for breach of fiduciary duty, wherein they alleged that by acting as plaintiffs' agent for purposes of purchasing the subject property, Broker A assumed a fiduciary relationship with plaintiffs and thus owed plaintiffs the duties of a fiduciary. Plaintiffs alleged that Broker A breached its fiduciary duty by advising plaintiffs to purchase property that contained numerous defects and had a value far less than what plaintiffs paid, and by advising plaintiffs to hire an inspection company that lacked the expertise to properly inspect the subject property and discover those defects. Plaintiffs alleged that by this breach of duty, Broker A caused them to pay substantially more for the property than it was worth and to incur future considerable expense when plaintiffs make the necessary repairs and modifications to the property.

Initially, the trial court rejected plaintiffs' request to have the jury instructed on breach of fiduciary duty, saying breach of fiduciary duty is not a separate cause of action but rather is "the result of the violation of some other right where there is a relationship of confidence and trust." Caldwell's attorney asked: "So wouldn't it just be a standard negligence verdict with a higher standard of care that can be argued?" The court responded that it did not believe the standard of care was higher but the duty of a fiduciary is higher. The court said that "whether it's an ordinary duty or a fiduciary duty, a breach is a breach and the consequential damages are the consequential damages. Breach of a fiduciary duty could lead to the imposition of exemplary damages. But, here, there is a total absence of any willful, reckless disregard, any of the horribles that are paraded in 13.95 . . . oppression, malice. That's totally absent." Plaintiffs' attorney replied that "it can lead to recovery of general damages though." The court agreed. Plaintiffs' attorney then stated he believed breach of fiduciary duty is a separate cause of action and plaintiffs were entitled to instruction on a different standard, namely an obligation to use "utmost care, honesty and integrity." Broker A's attorney stated that if "we can get an instruction on what a fiduciary duty is, that can instruct the jury as to what that item is or that concept is, and then they could apply that to either negligence or fraud." The court stated that "without an instruction of what it is, it's hard to find a remedy. " Plaintiffs' counsel stated he would find an instruction because he had "all the cases here." The court suggested he look in BAJI.

On appeal, plaintiffs argue the jury was not permitted to consider whether the Century 21 defendants breached their fiduciary duties to plaintiffs. Plaintiffs cite cases wherein the courts at least impliedly recognized causes of action for breach of fiduciary duty (*Field* v. *Century 21 Klowden-Forness Realty* (1998) 63 Cal.App.4th 18, 20-23 [suit against real estate broker for negligence, negligent misrepresentation and breach of fiduciary duty, and the "case was submitted to the jury with instructions regarding negligence, and negligent misrepresentation based on fiduciary relationship]; *Wyatt* v. *Union Mortgage Co.* (1979) 24 Cal.3d 773, 157 Cal. Rptr. 392, 598 P.2d 45).

In *Wyatt*, the court stated real estate agents have the same obligations towards their clients as trustees have towards their beneficiaries to exercise undivided service and loyalty, to act in the highest good faith, to not obtain any advantage over the client, and to make the fullest disclosure of material facts about the real estate transaction such as might impact the client's decision. (*Wyatt*, at p. 782.)

In *Field*, the court said this common law *fiduciary* duty of brokers towards their clients was not changed by the duties towards prospective buyers that section 2079 of the Civil Code places on a seller's agent and broker, and that the common law duty is "substantially more extensive than the *nonfiduciary* duty codified in section 2079."

Plaintiffs cite trial evidence which they contend demonstrates Broker A's breach of fiduciary duty, and they contend that if the jury had been given the opportunity to render a verdict on a breach of fiduciary claim, "the issue of apportioned fault would likely have been significantly different." Broker A responds that there was no conflict of interest in its dealings with plaintiffs because:

(1) plaintiffs signed the portion of the purchase agreement where it stated that Broker A represented both Caldwell and plaintiffs, and
(2) Caldwell and plaintiffs had separate agents from Broker A who were skilled realtors. Broker A also argues that plaintiffs did not present expert testimony on the standard of care of a reasonably prudent realtor, and that there was no failure to disclose defects. Plaintiffs respond by arguing that a separate disclosure of dual agency was required, that expert testimony was not needed, and that defects in the property were not disclosed.

While it is possible that resolution of this issue might have rested on the facts of Broker A's dual representation of the buyer and seller, a procedural matter will actually decide the issue. That procedural matter is plaintiffs' failure to *pursue* the issue of a jury instruction on breach of fiduciary duty after the trial court left the door open to them. The discussion about that issue ended with the court indicating it needed an instruction on what a fiduciary duty is from the common law.

" 'Where a duty is found to exist, a real estate agent must fulfill it by exhibiting the degree of care and skill ordinarily exhibited by professionals in the industry. [Citations.] The degree of care and skill required to fulfill a professional duty ordinarily is a question of fact and may require testimony by professionals in the field if the mater is within the knowledge of experts only. (*Padgett* v. *Phariss* (1997) 54 Cal.App.4th 1270, 1279.)

Duties to Seller:

Caldwell, the seller in this real estate transaction, was represented by Broker A, which acted as both listing agent and selling agent. Under the Civil Code, as Caldwell's agent, Broker A had several duties to plaintiffs. They are as follows.

Section 2079 of the Civil Code requires a seller's broker to "conduct a reasonably competent and diligent visual inspection of the property," and to "disclose to [the] prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal." Section 2079.2 states the broker's standard of care "is the degree of care that a reasonably prudent real estate licensee would exercise and is measured by the degree of knowledge through education, experience, and examination, required to obtain a license." The broker is not required to inspect areas "that are reasonably and normally inaccessible to such an inspection." (§ 2079.3.)

Section 2079.17 required Broker A to disclose to plaintiffs that it was acting as agent for both plaintiffs and Caldwell. Broker A complied with this disclosure duty by filling in necessary information in the residential purchase agreement. Subdivision (d) of section 2079.17 states that such disclosure "shall be *in addition to* the disclosure required by Section 2079.14." (Italics added.) Section 2079.14 required Broker A to give plaintiffs a document that sets out the nature of the obligations of agents who represent only the seller, only the buyer, and both the buyer and seller, *as such obligations are described in section 2079.16* (discussed next). Section 2079.14 states the form is to be both given to, and signed by, the buyer and the seller. Caldwell testified she signed the section 2079.16 form. However, *the form was not given to plaintiffs* . The broker for the Broker A office stated he did not believe his office was required to use that form for Caldwell's sale of her house because the form is dated 1997 and the sale occurred in February 1998. (These statutes were enacted in 1995.)

Plaintiffs contend they were also not given page six of the six-page residential purchase agreement, which is the "buyer's inspection advisory" form. This form advises buyers to "conduct a thorough inspection of the Property, personally and with professionals." It is mentioned in the purchase agreement under "other terms and conditions." Each of the six pages of the purchase agreement indicates it is "page 1 (or 2, 3, 4, 5 or 6) of 6 pages." Asked whether he told his agent that page six was missing from the purchase agreement, plaintiff Brian Gallop testified he did not and he "never read the documents." This was in contrast to defendant Joseph D's testimony that he went over each page of the purchase agreement with the plaintiffs, including page six, the buyer's inspection advisory form/page, which comes after the signature page of the purchase agreement. This form is the only page in the purchase agreement that was not signed or initialed by plaintiffs.

This form also sets out the section 2079 duties of a seller's agent and identifies them as duties of a "broker," thus giving the false impression that a broker who acts as both the seller's agent and buyer's agent has only section 2079 duties and not fiduciary duties to the buyer. The companion portion of the purchase agreement also gives such impression. As discussed above, such is not the case. Under both case law and Civil Code section 2079.16, Broker A owed plaintiffs certain fiduciary duties.

Duties Owed to a Real Estate Purchaser by His or Her Own Broker

Broker A also acted as the plaintiffs' own agent. Section 2079.16 states that in such a dual capacity, Broker A owed to plaintiffs (and Caldwell) "a fiduciary duty of utmost care, integrity, honesty and loyalty in its dealings with plaintiffs," together with the "diligent exercise of reasonable skill and care in performance of its duties," "a duty of honest and fair dealing and good faith," and "a duty to disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties."

We note that section 2079 appears to conflict with section 2079.16. The former states the seller's agent has a duty to prospective purchasers "to conduct a reasonably competent and diligent visual inspection of the property" *and* "to disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal." The latter section imposes on the seller's agent a duty to the buyer to "disclose all facts known to the agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of, the parties." Perhaps the conflict is resolved, at least for our purposes, by the admonition in section 2079.16 that "an agent is not obligated to reveal to either party any confidential information obtained from the other party that does not involve the affirmative duties set forth above," and one of those duties is a fiduciary duty to exercise the "utmost care, integrity, honesty and loyalty in his or her dealings with the buyer and seller. As discussed, we find that the separation of the sunroom from the house fits within the description of matters that Broker A had to disclose to plaintiffs.

Under the common law, which was not changed by section 2079, the buyer's agent "is hired for his professional knowledge and skill; he is expected to perform the necessary research and investigation in order to know those important matters that will affect the principal's decision, and he has a duty to counsel and advise the principal regarding the propriety and ramifications of the decision. *[He must] disclose reasonably obtainable material information*." (*Field* v. *Century 21 Klowden-Forness Realty, supra*, 63 Cal.App.4th at p. 25, italics added.) He must also " 'refrain from making representations of facts material to the client's decision to buy the property without advising the client that he is merely passing on information received from the seller without verifying its accuracy.' " (*Id*. at p. 26.)

In *Assilzadeh* v. *California Federal Bank* (2000) 82 Cal.App.4th 399, 414, the court stated that a dual agent (broker acting on behalf of both seller and buyer) has fiduciary duties to both, and that *Field's* discussion of fiduciary duties is "informative as to the scope of fiduciary duty."

Liability can be imposed on an agent or broker for both an affirmative and intentional misrepresentation of material facts, and for nondisclosure of them, since not disclosing information " 'amounts to a representation of the nonexistence of the facts which he has failed to disclose [citation].' " (*Padgett* v. *Phariss, supra*, 54 Cal.App.4th at p. 1286.)

The Issue of the "As Is" Provision in the Purchase Agreement

Broker A contends there is insufficient evidence to support a finding favorable to plaintiffs on the first two elements of a cause of action for negligence--duty and breach of duty. It relies on certain language in the purchase agreement.

The purchase agreement states that buyer and seller agree that the broker does not guarantee the condition of the property and will not be responsible for defects that are not known to the broker and not visibly observable in reasonably accessible areas of the property. The purchase agreement also states that the property was being sold "as is" in its present physical condition and there were no warranties "except as specified below, and elsewhere in this agreement." Broker A contends that when there is an "as is" sale, "there can be no negligence verdict." Broker A relies on *Loughrin* v. *Superior Court* (1993) 15 Cal.App.4th 1188.

In *Loughrin*, the real estate sale contract stated the property was being sold in an "as is" condition, the seller made no warranty with respect to the condition of the property, and the buyer relied solely on his inspection or his contractor in determining the condition of the property. The *Loughrin* court stated that except in cases of fraud or misrepresentation where the seller intentionally conceals material defects not otherwise observable or visible by the buyer, a sale of property in an "as is" condition is a sale of it in its present condition and relieves the seller of liability for defects in that condition. (At p. 1192.) Later, the court stated that "an added provision in the waiver clause, such as contained in this case, indicating the buyer relies on his own inspection of the property, presumably waives any obligation the seller or his broker may otherwise have to inspect the property for defects, and hence may avoid a claim for negligent failure to know of and advise of such defects." (At p. 1195.)

While Broker A relies in this analysis in *Loughrin* to support its assertion that there is no substantial evidence to support a jury's findings in favor of plaintiffs on the first two elements of a cause of action for negligence, Broker A neglects to mention certain things. First, the Loughrin court *also stated* in its very next breath that augmenting an "as is" clause with a clause that the buyer relies on his own inspection of the property, "does not address the issues of:
(1) intentional misrepresentation,
(2) fraudulent concealment, or even
(3) negligent concealment not related to failure to inspect."

Second, the Legislature stated in Civil Code section 1102.1 that "the delivery of a real estate transfer disclosure statement may not be waived in an 'as is' sale, as held in *Loughrin* v. *Superior Court* (1993) 15 Cal.App.4th 1188."

Third, section 1102.1 states that agents should place their section 2079 disclosures in the transfer disclosure statement.

Fourth, section 1102 states that waivers of the requirements of the transfer disclosure statement statues are void as against public policy.

Therefore, "as is" clauses and "buyer relies on his own inspection" are not effective to relieve sellers and their agents from their duties under the transfer disclosure statement statutes. Here, of course, Broker A did not disclose, in the transfer disclosure statement, the fact of the sunroom separation.

Broker A's citation to *Assilzadeh* v. *California Federal Bank*, *supra*, 82 Cal.App.4th 399, 417 wherein the court stated that a buyer purchasing residential property in an "as is" condition has "a duty to investigate to determine the actual condition of the property," adds nothing to the discussion. Plaintiffs do not deny that they were under a duty to investigate. Their duty does not affect Broker A's own obligations. Plaintiffs' duty just forms the basis of the comparative negligence findings that the jury made, holding plaintiffs 43% negligent.

The Finding That Broker A Was Negligent Is Supported by Substantial Evidence

Caldwell's agent had a duty to plaintiffs to inspect the subject property and disclose to plaintiffs facts materially affecting its value or desirability. Caldwell told her agent that the sunroom had separated from the house. Caldwell's agent breached his duty to plaintiffs.

Plaintiffs' agent, defendant Joseph D., had a duty to disclose, to plaintiffs, reasonably obtainable information. Given that the seller's agent was from the same real estate office as Joseph D., Joseph D. had ready access to information that Caldwell's agent knew about the subject property, such as the sunroom separation. From the fact that Joseph D. did not tell plaintiffs about the separation, it can reasonably be inferred that he did not ask Caldwell's agent whether there were any material facts about the property that he should convey to plaintiffs, or that he asked Caldwell's agent but the agent did not tell him about the sunroom separation, or that Caldwell's agent told Joseph D. but the latter did not pass the information on to plaintiffs. All three scenarios represent a breach of duty by Broker A.

Such information was certainly material, as it would indicate there might be a problem with the foundation, settlement, soil compaction, etc. Broker A does not cite us to evidence that such separations are ordinary events. Clearly Broker A's failure to disclose the fact of the separation is a material breach of its statutory and common law duty. No expert testimony was required to help the jury draw such a conclusion. This breach of duty, coupled with plaintiffs' evidence that had they known the true facts about the condition of the house, they would not have purchased it, comprise sufficient evidence to support finding of negligence.

Broker A argues that plaintiffs knew the sunroom door was not operable because the inspection report provided by the house inspection defendants revealed that problem. However, that is not the same thing as knowing that a structure that had been attached to the house was now unattached. Moreover, Broker A is not relieved of its statutory and common law duties of disclosure merely because a professional inspection of the house was undertaken by plaintiffs.

Plaintiffs and Broker A raise other matters which they assert impact the question of Broker A's negligence. These include the effect of the El Nino rains on the crack in the garage floor, discrepancies found by plaintiff's expert witness geotechnical engineer respecting the depth of compacted fill reported in the "original reports" made when the house was built in or about 1960, and whether California regulations required Broker A's broker to inspect the subject purchase agreement. Given that the nondisclosure to plaintiffs of the sunroom separation constitutes sufficient evidence to support the jury's finding that Broker A was negligent, we decline to address the significance of any of these other matters.

The judgment in favor of Caldwell and against plaintiffs is reversed and the trial court is directed to enter a judgment notwithstanding the verdict, in favor of plaintiffs and against Caldwell, in the amount of $ 110,000, together with an award of costs for plaintiffs. The trial court is further directed to amend the judgment in favor of plaintiffs and against the Broker A defendants in the amount of zero dollars by deleting the directive that the Century 21 defendants and the plaintiffs "shall bear their own costs and disbursements on the negligence claim," and inserting, in its place, an award of costs for plaintiffs. Plaintiffs shall recover costs on appeal from the Broker A defendants and Caldwell, who shall all bear their own costs on appeal.

CASE #2: FSR BROKERAGE, INC. et al. (called Broker F), Petitioners, v. The Superior Court of Los Angeles County, Respondent; Michael Chernuchin et al,. Real Parties in Interest. B156982, COURT OF APPEAL OF CALIFORNIA, SECOND APPELLATE DISTRICT, DIVISION ONE, filed April 16, 2002. Judges: Vogel, with Spencer and Mallano concurring.

In June 1998, Michael Chernuchin and Janis Diamond purchased real property on Benedict Canyon Drive from Jordan Ostrow. Plaintiffs, as buyers, were represented by Broker F; Ostrow, as seller, was represented by Broker C.

In May 2001, Plaintiffs filed an amended complaint against Ostrow, Broker C, Broker F, and others included in our references to Broker C and Broker F, alleging nine separate causes of action for breach of contract, fraud, breach of fiduciary duty, and negligence. Among other things, Plaintiffs allege that Ostrow failed to disclose that:

- a gate was broken and in need of replacement (which allegedly cost more than $ 10,000),
- that the heater didn't work and had to be repaired (which allegedly cost about $ 770),
- that the swimming pool and a koi pond leaked and the pool heater was broken (which together cost about $ 9,900 to repair), and
- that the chimney had suffered earthquake damage (which allegedly cost about $ 6,900 to repair).

As against Ostrow, Plaintiffs claim damages for these alleged non-disclosures on theories of breach of contract, fraud, and negligent misrepresentation. As against Broker F, Plaintiffs claim damages for breach of fiduciary duty and fraud based on alleged misrepresentations about an easement and about construction on adjacent property.

As against Broker F and Broker C, Plaintiffs also claim damages for fraud based on the Realtors' alleged failure to disclose all known defects in the property, including the fact that there "was a significant amount of dirt touching wood on the side wall adjacent to the retaining wall buttressing against the hillside slope of the property." According to Plaintiffs' first amended complaint, "real estate agents in Los Angeles know, or should know, that dirt touching wood is a serious problem, because it permits destructive pests and organisms to attack the structure." With regard to damages, Plaintiffs allege that Diamond "has experienced extreme health problems due to asthma and allergies. Her problems became so severe that she had to be hospitalized. Since her hospitalization, she has experienced chronic asthma and allergy problems that require her to take steroids and other medication. Prior to purchasing the property, Diamond never experienced any episodes of asthma or allergies."

More specifically, Plaintiffs allege that Diamond's "condition seemed to be exacerbated when she entered the side corner room, which has as its outside wall, the place where the dirt was touching wood . . . ." A contractor hired by Plaintiffs discovered a dirt-filled "hole between the outside and the inside of the house" which was a "conduit for pests and organisms to enter into the inside of the house from the outside." The contractor found "mold, spores, fungus, rat excrement and other detritus." Had Plaintiffs known about this problem, they would not have purchased the house. <u>Based on the mold problem, Plaintiffs claim damages for fraud, constructive fraud, negligent misrepresentation, and negligence</u>.

At some point, Plaintiffs moved out of the Benedict Canyon house and into a furnished apartment on Ocean Avenue.

Defendants answered and discovery ensued, including a request by Broker F to inspect and test both the Benedict Canyon Drive residence and Plaintiffs' current Ocean Avenue apartment. In its demand to inspect the two residences, Broker F explained that its purpose was "to photograph and inspect the property, test for the presence of mold and other contaminants at the property . . . and also to sample the air both inside and outside the improvements on the property. The testing will be non-destructive." Plaintiffs objected to the demand to inspect the Ocean Avenue residence, claiming the inspection would be "irrelevant and not capable of leading to relevant evidence," that it would constitute an invasion of privacy, and that it would be burdensome and harassing.

Broker F filed a motion for an order compelling Plaintiffs to allow the inspection of the Ocean Avenue property. Broker F explained that since Diamond's "injuries have substantially abated since she left the Benedict Canyon residence, if testing of Plaintiffs new residence also finds mold, their claims that mold was the cause of Diamond's symptoms will be substantially discredited." Elsewhere in its motion, Broker F put it this way: "Broker F is attempting to establish the possible sources of Plaintiffs' alleged injuries, either by exclusion of the . . . Ocean Avenue residence as a potential source or other means. Clearly, it is highly relevant if the same sorts of mold are present at Plaintiffs' current residence that are alleged to have caused their injuries at their former residence. Plaintiffs say their symptoms have improved since they left the prior residence. Needless to say, if they are still being exposed to the same molds, then there is another source for their problems."

Plaintiffs opposed the motion, contending that Broker F wanted to impose on their privacy by conducting tests on property that is not the subject of this litigation. Plaintiffs claimed, without authority, that Broker F's motion fails because it does not show "any probability that Plaintiffs' current residence contains the same type of mold" as the Benedict Canyon property.

Neither side offered any expert testimony about mold.

The trial court denied Broker F's motion, commenting that "there are so many different kinds of mold" that the proposed inspection of the Ocean Avenue property was not relevant, and that there had to "be some reason to do it other than just a mere statement that there might be mold there."

<u>The appelate court stated the Broker F's motion should have been granted.</u>

Broker F had only to show that its proposed inspection was relevant, which it is if the results of the inspection would themselves be admissible or if the inspection appears reasonably calculated to lead to the discovery of admissible evidence. As FSR explained, an inspection that reveals mold at the Ocean Avenue apartment that is similar to the mold allegedly present at the Benedict Canyon house is relevant to Plaintiffs' claim that her symptoms were caused by mold -- particularly since her condition has improved since she moved out of the Benedict Canyon house. At a minimum, such evidence would tend to persuade the trier of fact that Diamond's condition was not caused by the mold. (See *Manzetti v. Superior Court* (1993) 21 Cal.App.4th 373.)

If no mold is found, Broker F may decide to reevaluate its case.

In short, fishing expeditions *are* permissible, and the discovery statutes must be liberally construed.

Finally, we reject Plaintiffs' suggestion that the inspection and testing will invade their privacy. They have not explained how this would occur, and they have not offered any authority to support their conclusory assertions. As a result, they have abandoned this objection. (*People ex rel. 20th Century Ins. Co. v. Building Permit Consultants, Inc.* (2000) 86 Cal.App.4th 280, 284.)

The petition is granted, and a peremptory writ shall issue commanding the trial court (1) to vacate its order of February 27, 2002, insofar as that order denies FSR's motion to compel inspection and testing of the Ocean Avenue property, (2) to enter a new order granting FSR's motion to inspect and test, (3) to schedule the inspection for a time mutually convenient for FSR's expert and Plaintiffs, and (4) to set a new trial date. Our stay order, dated March 15, 2002, is vacated. Broker F was awarded its costs of these writ proceedings.

CASE #3: STEVEN LARNER AS Co-Trustee, etc., et al., Plaintiffs and Appellants, v. VIRGINIA CLINE, Et Al., Defendants and Respondents. B148497, COURT OF APPEAL OF CALIFORNIA, SECOND APPELLATE DISTRICT, DIVISION SIX, filed December 10, 2001. Judges: Coffee, with Gilbert and Yegan concurring.

Appellants purchased property which they later learned was adjacent to an abandoned landfill. They filed a complaint against the realtors who sold them the property for allegedly failing to disclose this defect. The realtors moved for summary judgment on the ground that they had no knowledge of the landfill, thus were under no duty of disclosure. The trial court granted the motion. We affirm.

Stevan and Christine Larner as trustees of the Larner Family Trusts (appellants), filed a complaint for damages against realtors Ken K., Virginia C., Jim B. and Broker B (respondents).

All three realtors were employed by Broker B. Appellants were represented in the transaction by Ken K. The seller, John Grimes, was represented in the transaction by Virginia C. and Jim B.

Appellants purchased a 133-acre cattle ranch from Grimes, intending to convert it to a vineyard and winery. One month after escrow closed, an article appeared in the Santa Barbara News Press concerning an abandoned landfill located across the road from appellants' property. The article suggested that the landfill, which was closed in 1969, might be polluting the groundwater.

One year before appellants purchased the property, Grimes had listed it with Kent T. of Broker C and another agent, T. H. That transaction failed for reasons unrelated to the landfill. At that time, Grimes had filled out a transfer disclosure statement that revealed the existence of the abandoned landfill.

Grimes showed Virginia C. a copy of the transfer disclosure statement from the failed transaction. It was an illegible carbon copy that had little writing on it. Grimes called his previous listing agent, Kent T., to obtain a better copy, but Kent T. indicated that he had lost the file. Virginia C. gave Grimes a blank transfer disclosure statement, which he completed without disclosing the existence of the landfill. After appellants had purchased the property, the original disclosure statement was recovered. It was in the possession of the buyer's agent in the failed transaction.

The existence of the landfill could not be determined by visual inspection because the property looked like a field covered with grass. The real estate purchase agreement signed by the parties specified that the realtors would not investigate the existence of environmental hazards and nuisances, including water and soil contamination. The parties were advised to conduct their own investigations. After consulting with a wine expert, appellants conducted water and soil tests and ordered a physical inspection of the property. After the inspections, they released all contingencies in the purchase agreement.

Following publication of the newspaper article, appellants filed their complaint. They contended that respondents had failed to disclose that the property was located adjacent to a former solid waste dump. This information, they argue, should have been discovered by respondents in the course of the performance of their fiduciary duties.

Respondents moved for summary judgment or, in the alternative, summary adjudication. The trial court granted the motion, ruling that it was undisputed that <u>none of the realtors were aware of the existence of the landfill</u>. Thus, they had no duty to investigate its existence or obtain the prior disclosure statement.

Motion for Summary Judgment (Appelate Court response)

In their motion for summary judgment, respondents argued that a realtor is only required to make disclosures based on a visual inspection of the property. They contended that there were no facts that would have triggered a duty to investigate a previous listing and obtain a prior transfer disclosure statement.

Attached to respondents' motion were the declarations of Ken. K., Virginia C. and Jim B. They gave detailed descriptions of the real estate transaction and disavowed any knowledge of the closed landfill. Ken K. declared that the multiple listing concerning the Grimes' property did not mention a landfill. Virginia C. was unaware of any communications from the County of Santa Barbara to the real estate community disclosing the presence of a landfill. Also attached was the declaration of Marvin B. Starr, co-author of Miller and Starr's treatise on California Real Estate law. It was Starr's expert opinion that respondents were not required to obtain the prior transfer disclosure statement.

In their opposition to the motion for summary judgment, appellants claim that respondents breached their fiduciary duty because Virginia C. failed to inform them that she had seen the carbon copy of the prior transfer disclosure statement. Because this information was in existence, appellants reason, respondents were under a duty to question their fellow agents concerning the contents of the prior disclosure.

Duty of Disclosure

A real estate broker is under a duty to conduct a reasonably competent and diligent inspection of the property. He must disclose to the purchasers any facts revealed by the investigation that materially affect the value or desirability of the property. (

Easton v. Strassburger (1984) 152 Cal. App. 3d 90, 102, 199 Cal. Rptr. 383.) There is no duty of disclosure, however, where a realtor lacks knowledge of a defect or of facts giving rise to a duty to inquire further. (*Padgett v. Phariss* (1977) 54 Cal.App.4th 1270, 1286 realtor had no knowledge of pending litigation concerning construction defects.)

In opposition to the motion for summary judgment, appellants filed a separate statement of disputed and undisputed facts, challenging respondent's allegations. Following are three of the disputed statements:

1) Respondents alleged they had never seen a completed copy of a transfer disclosure statement from the previous listing agent that disclosed the presence of a landfill. Appellants disputed this statement, claiming that Virginia C. testified she knew where the disclosure from the previous escrow might be located. They contend that she did not tell them about the illegible disclosure statement and failed to explain that it could lead to a complete disclosure by Kent T. and the buyer's agent in the failed transaction.

Virginia C. recounted in her deposition that Grimes had attempted to obtain a more legible copy of the disclosure statement from Kent T., but he had lost the file. Virginia C. testified that she had not asked Grimes if there were other realtors who might have had a copy of the completed Transfer Disclosure Statement. Although she was aware that T. H. was a co-listing agent with Kent T., it did not occur to her to contact him. Contrary to appellants' characterization of this evidence, Cline did not testify that she knew the possible location of the previous disclosure statement, only that she had seen an illegible copy.

2) Respondents alleged that Virginia C. and Jim B. (listing agents at Broker B) had no knowledge of the landfill before the close of escrow. Appellants disputed this statement, asserting that Virginia C. held herself out as knowing the Santa Ynez Valley because she was born and raised there. They claimed that Becker testified at his deposition that he could not remember when he learned of the previous disclosure statement, but that Virginia C. had informed him of its existence.

The portion of Virginia C's deposition included in the record does not contain any reference to her background or her knowledge of the Santa Ynez Valley. Becker testified that Virginia C. told him of an incomplete and illegible statement from the failed transaction. He did not recall when this conversation occurred. There is no factual support for appellants' allegation that Virginia C. had special knowledge of the Santa Ynez Valley. Jim B's knowledge of an illegible disclosure statement does not show that he had knowledge of the landfill.

3) Respondents alleged that there was no evidence that Ken K. (appellants' agent at Broker B), knew about the landfill. Appellants disputed this statement, contending that this information was "common knowledge in the Real Estate Community and had been put into the Multiple Listing Book and Data Base by Wayne N."

Real estate agent Wayne N. testified that he provided information concerning the landfill to the Santa Ynez Multiple Listing Service (MLS). The statement, "Contact agent regarding landfill" was inserted in the MLS data sheet. At that time, T. H. was the listing agent for the ranch. Wayn N. did not communicate with T.H. concerning the landfill. Appellants fail to allege facts to show that Ken K. had direct or imputed knowledge of the contents of the MLS or information in the real estate community concerning the landfill.

Respondents had <u>no</u> fiduciary duty to investigate the circumstances surrounding the previous disclosure statement. In short, they were not required to obtain a prior disclosure statement from a different agent relating to a separate transaction. Appellants have failed to raise a triable issue of fact that respondents knew of the existence of the landfill before the close of escrow. We need not reach appellants' arguments concerning dual agency, the fee dispute or their objections to the declaration of respondents' expert.

Trial court's order granting summary judgment is affirmed. Costs on appeal are awarded to Respondents.

Ethics in real estate transactions are an important part of the practice of real estate in California. The previous cases emphasize the urgency regarding disclosure of both physical defects as well as agency relationships.

TRUST FUNDS

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INTRODUCTION

Real estate brokers and salespersons receive trust funds in the normal course of doing business. They receive these funds on behalf of others, thereby creating a fiduciary responsibility to the funds' owners. Brokers and salespersons must handle, control and account for these trust funds according to established legal standards. While compliance with these standards may not necessarily have a direct bearing on the financial success of a real estate business, non-compliance can result in unfavorable business consequences. Improper handling of trust funds is cause for revocation or suspension of a real estate license, not to mention the possibility of being held financially liable for damages incurred by clients.

This chapter discusses the legal requirements for receiving and handling trust funds in real estate transactions as set forth in the Real Estate Law and the Regulations of the Real Estate Commissioner. It describes the requisites for maintaining a trust fund bank account and the precautions a licensee should take to ensure the integrity of the account. It explains and illustrates the trust fund record keeping requirements under the Business and Professions Code and the Commissioner's Regulations.

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

GENERAL INFORMATION

Trust Funds and Non-Trust Funds

Since trust funds must be handled in a special manner, a licensee must be able to distinguish trust funds from non-trust funds. Trust funds are money or other things of value that are received by a broker or salesperson on behalf of a principal or any other person, and which are held for the benefit of others in the performance of any acts for which a real estate license is required. Trust funds may be cash or non-cash items. Some examples are; cash; a check used as a purchase deposit (whether made payable to the broker or to an escrow or title company); a personal note made payable to the seller; or even an automobile's "pink slip" given as a deposit.

The discussions in this chapter pertain to real estate trust funds received by licensees, and not to non-trust funds such as real estate commissions, general operating funds, and rents and deposits from broker-owned real estate. These other types of funds, as long as not commingled with trust funds, are not subject to the Real Estate Law and Commissioner's Regulations. It should be noted, however, that under certain circumstances the Department of Real Estate does have the jurisdiction to look into transactions involving non-trust funds.

Why a Trust Account?

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

An important reason for designating a trust fund depository as a trust account is the protection afforded principals' funds in situations where legal action is taken against the broker or if the broker becomes incapacitated or dies. Trust funds held in a true trust account cannot be ‘‘frozen" pending litigation against the broker or during probate.

Trust funds also have better insurance protection if deposited into a trust account. The general counsel of the FDIC, in an opinion in 1965, held that funds of various owners which are placed in a custodial deposit (trust account) in an insured bank will be recognized for insurance purposes to the same extent as if the owners' names and interests in the account are individually disclosed on the records of the bank, provided the trust account is specifically designated as custodial and the name and interest of each owner of funds in the account are disclosed on the depositor's records. Each client with funds deposited in a trust account maintained with a federally insured bank is insured by the FDIC up to $100,000, as opposed to just $100,000 for the entire account, as long as the regulatory requirements are met.

Trust Fund Handling Requirements

A typical trust fund transaction begins with the broker or salesperson receiving trust funds from a principal in connection with the purchase or lease of real property. According to Business and Professions Code Section 10145, trust funds received must be placed into the hands of the owner(s) of the funds, into a neutral escrow depository, or into a trust account maintained pursuant to Commissioner's Regulation 2832 not later than three business days following receipt of the funds by the broker or by the broker's salesperson.

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

1. the check by its terms is not negotiable by the broker, or the offeror has given written instructions that the check shall not be deposited or cashed until acceptance of the offer; and
2. the offeree is informed, before or at the time the offer is presented for acceptance, that the check is being held.

If the offer is later accepted, the broker may continue to hold the check undeposited only if the broker receives written authorization from the offeree to do so. Otherwise, the check must be placed, not later than three business days after acceptance, into a neutral escrow depository or into the trust fund bank account or into the hands of the offeree if both the offeror and offeree expressly so provide in writing.

According to Business and Professions Code Section 10145, a real estate salesperson who accepts trust funds on behalf of the broker under whom he or she is licensed must immediately deliver the funds to the broker or, if directed ***to do so*** by the broker, place the funds into the hands of the broker's principal or into a neutral escrow depository or deposit the funds into the broker's trust fund bank account.

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

Identifying the Owner(s) of Trust Funds

A broker must be able to identify who owns the trust funds and who is entitled to receive them, since these funds can be disposed of only upon the authorization of that person. The person entitled to the funds may or may not be the person who originally gave the funds to the broker or the salesperson. In some instances the party entitled to the funds will change upon the occurrence of certain events in the transaction. For example, in a transaction involving an offer to buy or lease real property or a business opportunity, the party entitled to the funds received from the offeror (prospective buyer or lessor) will depend upon whether or not the offer has been accepted by the offeree (seller or landlord).

Prior to the acceptance of the offer, the funds received from the offeror belong to that person and must be handled according to his/her instructions. If the funds are deposited in a trust fund bank account, they must be maintained there for the benefit of the offeror until acceptance of the offer. Or, as discussed in the previous section, if the offeror wishes, his/her check may be held uncashed by the broker as long as he/she gives written instructions to the broker to do so and the offeree is informed before or at the time the offer is presented for acceptance that the check is being so held.

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

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

TRUST FUND BANK ACCOUNTS

General Requirements

Trust funds, such as a purchase money deposit check, received by a licensee that are not forwarded directly to the broker's principal or to a neutral escrow depository or for which the broker does not have authorization to hold uncashed must be deposited to the broker's trust fund bank account. (Business and Professions Code Section 10145)
Business and Professions Code Section 10145 and Commissioner's Regulation 2832 require that a trust account meet the following criteria:

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

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

Trust Account Withdrawals

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

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

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

Interest-Bearing Accounts

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

1. The account is in the name of the broker as trustee for a specified beneficiary or specified principal of a transaction or series of transactions.
2. All of the funds in the account are covered by insurance provided by an agency of the federal government.
3. The funds in the account are kept separate, distinct, and apart from funds belonging to the broker or to any other person for whom the broker holds funds in trust.
4. The broker discloses the following information to the person from whom the trust funds are received and to any beneficiary whose identity is known to the broker at the time of establishing the account:
    - the nature of the account;

- how the interest will be calculated and paid under various circumstances;
- whether service charges will be paid to the depository and by whom; and
- possible notice requirements or penalties for withdrawal of funds from the account.

5. No interest earned on funds in the account shall inure directly or indirectly to the benefit of the broker or to any person licensed to the broker, even if the funds' owners would permit such an arrangement.

6. In an executory sale, lease, or loan transaction in which the broker accepts funds in trust to be applied to the purchase, lease, or loan, the parties to the contract shall have specified in the contract or by collateral written agreement the person to whom interest earned on the funds is to be paid or credited.

The only other situation where a real estate broker is allowed to deposit trust funds into an interest-bearing account occurs when the broker is acting as an agent for a financial institution which is the beneficiary of a loan. In this case the broker may, pursuant to Commissioner's Regulation 2830.1, deposit and maintain funds received from or for the account of an obligor (borrower) into an interest-bearing trust account in a bank or savings and loan association in order to pay interest on an impound account to the obligor in accordance with Section 2954.8 of the Civil Code, as long as the following requirements are met:

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

Commingling Prohibited

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

Commingling occurs when:

1. Personal or company funds are deposited into the trust fund bank account. *Except for what is provided in Section 2835 of the Commissioner's Regulations as noted below,* **this is a violation of the law even if separate records are kept.**

2. Trust funds are deposited into the licensee's general or personal bank account rather than into the trust fund account. In this case the violation is not only commingling, but also handling trust funds contrary to Business and Professions Code Section 10145. It is also grounds for suspension or revocation of a license under Business and Professions Code Section 10177(d).

3. Commissions, fees, or other income earned by the broker and collectible from the trust account are left in the trust account for more than 25 days from the date they were earned.

A common example of commingling is depositing rents and security deposits on broker-owned properties into the trust account. As these funds relate to the broker's properties, they are not trust funds and, therefore, may not be deposited into the trust fund bank account. Likewise, the broker may not make mortgage payments and other payments on broker-owned properties from the trust account even if the broker reimburses the account for such payments. Conducting personal business through the trust account is strictly prohibited and is a violation of the Real Estate Law.

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

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

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

(c) The deposit into a trust account of broker-owned funds in connection with mortgage loan activities as defined in subdivision (d) or (e) of Section 10131 of the Business and Professions Code or when making, collecting payments on, or servicing a loan which is subject to the provisions of Section 10240 of the Business and Professions Code provided:

(1) The broker meets the criteria of Section 10232 of the Business and Professions Code.

(2) All funds in the account which are owned by the broker are identified at all times in a separate record which is distinct from any separate record maintained for a beneficiary.

(3) All broker-owned funds deposited into the account are disbursed from the account not later than 25 days after their deposit.

(4) The funds are deposited and maintained in compliance with item (d) below.

(5) For this purpose, a broker shall be deemed to be subject to the provisions of Section 10240 of the Business and Professions Code if the broker delivers the statement to the borrower required by Section 10240.

(d) The trust fund account into which the funds are deposited is maintained in accordance with the provisions of Section 10145 of the Business and Professions Code, the Commissioner's Regulations, and the provisions of Title 10, California Code of Regulations, Section 260.105.30.

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

1. Up to $200 to cover checking account service fees and other bank charges such as check printing charges and service fees on returned checks. Trust funds may not be used to pay for these expenses. (The preferred practice, however, is for the broker to have the bank debit his/her own ***personal*** account for any trust account fees and charges.)
2. Commissions, fees, and other income earned by a broker and collectible from trust funds may remain in the trust account for a period not to exceed 25 days. Regulation 2835 recognizes that it may not always be practical to disburse the earned income immediately upon receipt. For instance, a property management company may find it too burdensome to collect its management fee every time a rent check is received and deposited to the trust account. Therefore, as long as the broker disburses the fee from the trust account within 25 days after deposit there is no commingling violation. Note, however, that income earned ***shall not*** be taken from trust funds received ***before*** depositing such funds into the trust bank account. Also, under no circumstances may the broker pay personal obligations from the trust fund bank account even if such payments are a draw against commissions or other

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

Trust Fund Liability

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

Funds on deposit in the trust account must always equal the broker's aggregate trust fund liability. If the trust account balance is ***less*** than the total liability a ***trust fund shortage*** results. Such a shortage is in violation of Commissioner's Regulation 2832.1, which states that the written consent of every principal who is an owner of the funds in the account shall be obtained by a real estate broker prior to each disbursement if such a disbursement will reduce the balance of the funds in the account to an amount less than the existing aggregate trust fund liability of the broker to all owners of the funds. Conversely, if the trust account balance is ***greater*** than the total liability, there is a ***trust fund overage*** and the broker may be in violation of Business and Professions Code Section 10176(e) for commingling.

A trust fund discrepancy of any kind is a serious violation of the Real Estate Law. Many real estate licenses have been revoked after a DRE audit disclosed a trust account shortage. To ensure that the balance of the trust account always equals the trust fund liabilities, a broker should implement the following procedures:

1. Deposit intact and in a timely manner to the trust account all funds that are not forwarded to escrow or to the funds' owner(s) or which are not held uncashed as authorized. This practice, required under Commissioner's Regulation 2832, lessens the risk of the funds being lost, misplaced, or otherwise not deposited to the trust account. A licensee is accountable for all trust funds received whether or not they are deposited. DRE auditors have seen numerous cases where trust funds received were properly recorded on the books but were never deposited to the trust account.
2. Maintain adequate supporting papers for any disbursement from the trust account. Record the disbursement accurately in both the Bank Account Record and the Separate Beneficiary Record. The broker must be able to account for all disbursements of trust funds. Any unidentified disbursement will cause a shortage.

3. Disburse funds from a beneficiary's account only when the disbursement will not result in a negative or deficit balance (negative accountability) in the account. Many trust fund shortages are caused by disbursements to a beneficiary in excess of funds received from or for account of that beneficiary. The excess disbursements are, in effect, paid out of funds belonging to other beneficiaries. A shortage occurs because the balance of the trust fund bank account, even if it is a positive balance, is less than the broker's liability to the other beneficiaries.

4. Ensure that a check deposited to the trust fund account has cleared before disbursing funds against that check. This applies, for example, when a broker who has deposited an earnest money check for a purchase transaction has to return the funds to the buyer because the offer is rejected by the seller. A trust fund shortage will result if the broker issues the buyer a trust account check and the buyer's deposit check bounces or for some reason fails to clear the bank.

5. Keep accurate, current and complete records of the trust account and the separate record for each beneficiary. These records are essential to ensure that disbursements are correct.

6. On a monthly basis, reconcile the cash record with the bank statement and with the separate record for each beneficiary or transaction.

Summary - Maintaining Trust Account Integrity

In summary, to maintain the integrity of the trust fund bank account, a broker must ensure that:

1. his/her personal or general operating funds are not commingled with trust funds;
2. the balance of the trust fund account is equal to the broker's trust fund liability to all owners of the funds; and
3. the trust fund records are in an acceptable form and are current, complete and accurate.

ACCOUNTING RECORDS

General Requirements

An important aspect of the broker's fiduciary responsibility to the client is the maintenance of adequate records to account for trust funds received and disbursed. This is true whether the funds are deposited to the trust fund bank account, sent to escrow, held uncashed as authorized under Commissioner's Regulation 2832, or released to the owner(s) of the funds. These records:

1. provide a basis upon which the broker can prepare an accurate accounting for clients.

2. state the amount of money the broker owes the account beneficiaries at any one time. (This is especially important when there are a large number of transactions.)
3. prove whether or not there is an imbalance in the trust account. Some brokers audited by DRE have disagreed that their trust accounts had a shortage or an overage in the amount disclosed by the audit, but could not provide documentation to support their position.
4. guarantee that beneficiary funds deposited in the trust account will be insured up to the maximum FDIC insurance coverage.

There are two types of accounting records that may be used for trust funds: columnar records in the formats prescribed by Commissioner's Regulations 2831 and 2831.1; and records other than columnar that are in accordance with generally accepted accounting practices ***which include details specified in subdivision (a) of the Regulations and are in a format that will readily enable tracing and reconciliation in accordance with Section 2831.2***. Regardless of the type of records used, they must include the following information:

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

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

Columnar Records

A broker may decide to use the columnar records prescribed by Commissioner's Regulations 2831 and 2831.1. The records required will depend on whether the trust funds received are deposited to the trust account or are forwarded to an escrow depository or to the owner of the funds. These records are:
1. Columnar Record of All Trust Funds Received and Paid Out - Trust Fund Bank Account (DRE form RE 4522);
2. Separate Record for Each Beneficiary or Transaction (DRE form RE 4523); and

3. Record of All Trust Funds Received - Not Placed in Broker's Trust Account (DRE form RE 4524).

The first two records are required when trust funds are received and deposited to the trust fund bank account.
The third record is required when trust funds received are not deposited to the trust account, but are instead forwarded to the authorized person(s).

If the trust fund account involves clients' funds from rental properties managed by the broker, the Separate Record for Each Property Managed (DRE form RE 4525) may be used in lieu of the Separate Record for Each Beneficiary or Transaction.

A broker who has an escrow division pursuant to Financial Code Section 17006(a)(4) must keep the above mentioned records for escrow funds. (Commissioner's Regulation 2951)

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

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

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

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

This record is used to keep track of funds received and not deposited to a trust fund bank account. In this situation, the broker is handling the funds and must keep records of same. Examples are:

1. earnest money deposits forwarded to escrow;
2. rents forwarded to landlords; and
3. borrowers' payments forwarded to lenders**.**

This record must show the date funds were received, the form of payment (check, note, etc.), amount received, description of property, identity of the person to whom funds were forwarded, and date of disposition. Trust fund receipts are recorded in chronological sequence, while their disposition is recorded in the same line where the corresponding receipt is recorded.

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

An exception to this record keeping requirement is provided in Commissioner's Regulation 2831(e), which states that a broker is not required to keep records of checks made payable to service providers, including but not limited to escrow, credit and appraisal services, when the total amount of such checks for any transaction does not exceed $1,000. However, a broker shall retain for three years copies of receipts issued or obtained in connection with the receipt and distribution of such checks and, upon request of the Department or the maker of the checks, a broker must account for the receipt and distribution of the checks.

Separate Record for Each Property Managed

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

OTHER ACCOUNTING SYSTEMS AND RECORDS

A broker may use trust fund records not in the columnar form as prescribed by Commissioner's Regulations 2831 and 2831.1. Such records must be in accordance with generally accepted accounting principles ***and must include detail specified in subdivision (a) of these Regulations and be in a format that will readily enable tracing and reconciliation in accordance with Section 2831.2***. Whether prepared manually or by computer, they must include at least the following:

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

To comply with generally accepted accounting principles, there must be one set of journal, cash ledger, and beneficiary ledger for each trust fund bank account.

Journal

A journal is a daily chronological record of trust fund receipts and disbursements. A single journal may be used to record both the receipts and the disbursements, or a separate journal may be used for each. To meet minimum record keeping requirements, a journal must:

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

Cash Ledger

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

Beneficiary Ledger

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

RECORDING PROCESS

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

1. Record transactions daily in the trust fund bank account and in the separate beneficiary records.
2. Use consistently the same specific source documents as a basis for recording trust fund receipts and disbursements. (For example, receipts pertaining to real estate resales will be recorded based on the Real Estate Contract and Receipt for Deposit form, and disbursements will always be recorded based on the checks issued from the trust account or debit notices from the bank.)
3. Calculate the account balances on all applicable records at the time entries are made.
4. Reconcile the records monthly to ascertain that transactions are properly recorded on both the bank account record and the applicable subsidiary records.
5. Reconcile the trust records to the trust account bank statement on a monthly basis to ascertain that amounts per the bank are in agreement with amounts per the trust fund records.
6. If more than one trust fund bank account is maintained, keep a different set of properly labeled columnar records (cash record and beneficiary record) for each account.

RECONCILIATION OF ACCOUNTING RECORDS

Purpose

The trust fund bank account record, the separate beneficiary or transaction record, and the bank statement are all interrelated. Any entry made on the bank account record must have a corresponding entry on a separate beneficiary record. By the same token, any entry or transaction shown on the bank statement must be reflected on the bank account record. This applies to columnar as well as to other types of records.

The accuracy of the records is verified by reconciling them at least once a month. Reconciliation is the process of comparing two or more sets of records to determine whether their balances agree. It will disclose whether the records are completed accurately.

For trust fund record keeping purposes, two reconciliations must be made at the end of each month:
1. reconciliation of the bank account record (RE 4522) with the bank statement; and,
2. reconciliation of the bank account record (RE 4522) with the separate beneficiary or transaction records (RE 4523).

Reconciling the Bank Account Record With the Bank Statement
The reconciliation of the bank account record with the bank statement will disclose any recording errors by the broker or by the bank. If the balance on the bank account record agrees with the bank statement balance as adjusted for outstanding checks, deposits in transit, and other transactions not yet included in the bank statement, there is more assurance that the balance on the bank account record is correct. Although this reconciliation is not required by the Real Estate Law or the Commissioner's Regulations, it is an essential part of any good accounting system.

Reconciling the Bank Account Record With the Separate Beneficiary or Transaction Records
This reconciliation, which is required by Commissioner's Regulation 2831.2, will substantiate that all transactions entered on the bank account record were posted on the separate beneficiary or transaction records. The balance on the bank account record should equal the total of all beneficiary record balances. Any difference should be located and the records corrected to reflect the correct bank and liabilities balances. Commissioner's Regulation 2831.2 requires that this reconciliation process be performed monthly except in those months when there is no activity in the trust fund bank account, and that a record of each reconciliation be maintained. This record should identify the bank account name and number, the date of the reconciliation, the account number or name of the principals or beneficiaries or transactions, and the trust fund liabilities of the broker to each of the principals, beneficiaries or transactions.

Unexplained Trust Account Overages

When a broker performs a reconciliation pursuant to Commissioner's Regulation 2831.2, the broker may find an unexplained overage. An unexplained overage is defined as funds in a real estate broker's trust account which exceed the aggregate trust fund liability of such account where the broker is unable to determine the ownership of such excess funds.

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

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

A broker must keep a separate record of unexplained trust account overages including a separate subsidiary ledger to record the potential trust fund liability. Such records must include the date of recording and the date on which such funds became an unexplained trust account overage. A broker holding unexplained trust account overages must perform a monthly reconciliation of such funds in accordance with Commissioner's Regulation 2831.2.

Suggestions for Reconciling Records

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

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

- erroneous calculations of entries used to arrive at account balances
- missing beneficiary records
- bank errors

DOCUMENTATION REQUIREMENTS

Activities and Related Documents

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

Activity: Receiving trust funds in the form of purchase deposits from buyers.

Documentation: real estate purchase contract and receipt for deposit, signed by the buyer.

Activity: Receiving trust funds in the form of rents and security deposits from tenants.

Documentation: collection receipts

Activity: Receiving trust funds in the form of other receipts

Documentation: collection receipts

Activity: Depositing trust funds

Documentation: bank deposit slips

Activity: Forwarding buyers' checks to escrow

Documentation: receipt from title/escrow company and copy of check

Activity: Returning buyers' checks

Documentation: copy of buyer's check signed and dated by buyer, signifying buyer's receipt of check

Activity: Disbursing trust funds

Documentation: checks issued; supporting papers for the checks, such as invoices, escrow statements, billings, receipts, etc.

Activity: Receiving offers and counteroffers from buyers and sellers

Documentation: real estate purchase contract and receipt for deposit, signed by respective parties; Agency disclosure statement; Transfer disclosure statement

Activity: Collecting management fees from the trust fund bank account

Documentation: property management agreements between broker and property owners. (Note: If only one trust fund check is issued for management fees charged to various property owners, there should be a schedule or listing on file showing each property and amount charged, and the total amount, which should agree with the check amount.); cancelled checks

Activity: Reconciling bank account record with separate beneficiary records

Documentation: record of reconciliation

ADDITIONAL REQUIREMENTS - DOCUMENTS

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

Person Signing Contract to be Given Copy

Under Business and Professions Code Section 10142, any time a licensee prepares or has prepared an agreement authorizing or employing that licensee to perform any acts for which a real estate license is required or when the licensee obtains the signature of any person to any contract pertaining to such services or transaction, the licensee must deliver a copy of the agreement to the person signing it at the time the signature is obtained. Examples of such documents are listing agreements, real estate purchase contract and receipt for deposit forms, addenda to contracts, and property management agreements.

AUDITS AND EXAMINATIONS

Because of the importance of trust fund handling, the Commissioner has an ongoing program of examining brokers' records. As necessary, audited licensees are made aware of deficiencies in trust fund handling and record keeping. If an audit discloses actual trust fund imbalances or money handling procedures which may cause monetary loss, appropriate disciplinary proceedings are initiated.

Section 10148 of the Business and Professions Code provides that a real estate broker shall retain for three years copies of all listings, deposit receipts, canceled checks, trust records, and other documents executed by or obtained by the broker in connection with any transaction for which a real estate broker license is required. The retention period shall run from the date of the closing of the transaction or from the date of the listing if the transaction is not consummated. After notice, such books, accounts and records shall be made available for examination, inspection and copying by the Commissioner or a designated representative during regular business hours, and shall, upon the appearance of sufficient cause, be subject to audit without further notice, except that such audit shall not be harassing in nature.

SAMPLE TRANSACTIONS

To demonstrate the record keeping requirements discussed in this chapter, we have simulated trust account records for typical real estate transactions occurring over a thirty-day period. To set the stage, let us assume that James Adams, a real estate broker, owns and operates a one-man real estate office specializing in residential sales and property management. Broker Adams has one trust fund bank account. We will look at the trust account activity for this office for the month of ***May, 2000***.

The use of columnar records to record these transactions is illustrated in Exhibits 1 - 10 at the end of this chapter. As previously discussed, a broker may use other types of records as long as they meet generally accepted accounting standards.

2000 TRANSACTIONS

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

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

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

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

Property	***Tenant's Name***	***Rent Received***
a. 1538 South Ave.	B. Hamns	$600
b. 3490 Tower St., Unit 1	R. Robertson	350
c. 2351 Kingston Way	I. Warren	450
		$1,400

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

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

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

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

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

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

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

Check No.	Payee	Purpose	Amount
1001	ABC Mortgage Co.	Mortgage payment for 1538 South Ave.	$450
1002	Anycity Treasury	Utilities for 1538 South Ave.	35
1003	Professional Cleaners	Cleaning for 3490 Tower St.	55
1004	Mr. Handyman	Minor repairs on 2351 Kingston	25
		TOTAL	**$565**

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

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

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

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

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

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

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

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

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

Background Information

James Adams keeps four types of columnar records:

1. Record of all Trust Funds Received and Paid Out - Trust Fund Bank Account (hereinafter referred to as "Bank Account Record"). This record is required under Commissioner's Regulation 2831 for each trust account a broker has.
2. Record of all Trust Funds Received - Not Placed in Broker's Trust Account (hereinafter referred to as "Record of Undeposited Receipts"). This is required under Commissioner's Regulation 2831.
3. Separate Record For Each Beneficiary or Transaction (hereinafter referred to as "Separate Beneficiary Record"). This is required under Commissioner's Regulation 2831.1.
4. Separate Record For Each Property Managed (hereinafter referred to as "Separate Property Record"). This serves the same purpose as the Separate Beneficiary Record.

To illustrate the recording process, listed below are the entries made on the books by James Adams as well as the documents prepared or obtained as support for each transaction. The actual entries are shown on the forms/exhibits at the end of this chapter.

Note that:

- Each entry to any record shows all the pertinent information of the transaction, such as the date, name of payee, name of payor, amount, check number, etc.

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

Step-By-Step Narrative of Trust Account Entries
(Actual recording shown on Exhibits 1 - 10 at end of chapter.)

Transaction ***Date***	***Documentation***	***Entries***
May 1	Deposit slip prepared by broker.	Record the deposit on: 1. The Bank Account Record. Balance is $100. **(Exh. 1)** 2. A newly prepared Separate Beneficiary for James Adams. Balance is $100. **(Exh. 2)**
May 1	Management agreements signed by property owners and broker.	No entries needed since there was no receipt nor disbursement of trust funds.
May 3	Collection receipts Nos. 2, 3 and 4 issued to B. Hamns, R. Robertson, and I. Warren, respectively.	Record the $1,400 receipt on: 1. The Bank Account Record. New balance is $1,500. **(Exh. 1)** 2. Newly prepared Separate Beneficiary Records for: T. Eddie - balance is $600 **(Exh. 4)** L. Stewart – bal. is $350 **(Exh. 5)** S. Manly - balance is $450 **(Exh. 6)**
May 5	Real Estate Purchase Contract and Receipt for Deposit signed by Mr. and Mrs. White. Collection receipt No. 1 issued to the Whites.	Enter transaction on the Record of Undeposited Receipts. **(Exh. 3)** No Separate Beneficiary Record is necessary since the check was not deposited.
May 5	Collection receipt No. 5 issued to T. Sundance. Receipt showed that $500 of the $750 was for rent and the other $250 was for security deposit.	Record the $750 deposit on: 1. The Bank Account Record. **(Exh. 1)** 2. Separate Beneficiary Records for: J. Bird - Sundance's Security Deposit, bal. is $250. **(Exh. 7)** J. Bird - balance is $500. **(Exh. 8)** (Since security deposits will be accounted to the

		tenant in the future, James Adams keeps a separate record for deposits. Total liability to the owner is the sum of the two records - one for security deposits, another for rents and other transactions.)
May 5	Real Estate Contract and Receipt for trust funds were received for Deposit signed by Mr. and Mrs. Jensen.	No entries were made since no trust funds were received or disbursed.
May 6	Deposit receipt prepared by broker.	Record $2,000 deposit on: 1. Bank Account record. New balance is $4,250. **(Exh. 1)** 2. A newly prepared Separate Beneficiary Record - Mr. and Mrs. White/Mr. and Mrs. Jensen. Account balance is $2,000. **(Exh. 9)** 3. Record of Undeposited Receipts. **(Exh. 3)** Shows disposition of check previously entered on the record.
May 8	Exclusive Listing Agreement signed by sellers and broker.	
May 9	Collection receipt No. 6 issued to W. Allen.	Record receipt on: 1. The Bank Account Record. New balance is $5,250. **(Exh. 1)** 2. A newly prepared Separate Beneficiary Record - W. Allen. Balance is $1,000. **(Exh. 10)**
May 10	Checks issued by broker. Supporting papers for each check.	Record disbursements on: 1. Bank Account Record. New Balance is $4,685. **(Exh. 1)** 2. Separate Beneficiary Records for: T. Eddie - New balance is $115. **(Exh. 4)** L. Stewart - New balance is $295. **(Exh. 5)** S. Manly - New balance is $425. **(Exh. 6)**
May 14	Real Estate Purchase Contract and Receipt for Deposit signed by B. Sun.	Record receipt on the Record of Undeposited Receipts. **(Exh. 3)**
May 15	Real Estate Purchase Contract and Receipt for Deposit signed by R. Jays.	No entry was needed since there was no receipt or disbursement of funds.
May 16	Receipt issued by Title Escrow Company.	Note disposition of check on the Record of Undeposited Receipts. **(Exh. 3)**
May 19	Check issued by broker. Receipt issued by First Title Company.	Record disbursements on the: 1. Bank Account Record. New balance is $2,685. **(Exh. 1)** 2. Separate Beneficiary Record - Mr. and Mrs. White/Mr. and Mrs. Jensen. New balance is $0. **(Exh. 9)**

May 22	Real Estate Purchase Contract and receipt for Deposit signed by R. Olive.	
May 24	Real Estate Purchase Contract and Receipt for Deposit rejected by T. Evans.	Post the return of check on the Record of Undeposited Receipts. **(Exh. 3)**
May 31	List showing the breakdown of the check amount, showing the charge to each owner.	Record disbursements on the: 1. Bank Account Record. New balance is $2,685. **(Exh. 1)** 2. Separate Beneficiary Records for:
	(NOTE: A list is necessary as support for a check disbursement chargeable to a number of beneficiaries. Posting the entries on the separate records without such a list is not sufficient.)	**New Owners** / **Balance** T. Eddie $70 L. Stewart $195 W. Allen $920 S. Manly $365 J. Bird $455

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

FIRST COUNTY BANK STATEMENT

MAIN BRANCH
5 Main Avenue
ANYCITY, CA 90002

PAGE 1 of 1

DATE OF THIS
STATEMENT 05/31/00

JAMES ADAMS
TRUST ACCOUNT
8310 ORANGE AVENUE
ANYCITY, CA 90002
CUSTOMER SINCE 1995

CHECKING ACCT.
123456

SUMMARY: PREVIOUS STATEMENT BALANCE ON 04/30/00……………..	00.00
TOTAL OF 5 DEPOSITS FOR……………………………………………………	5,250.00
TOTAL OF 4 CHECKS FOR……………………………………………………...	2,540.00
TOTAL OF 1 OTHER DEBIT FOR………………………………………………..	7.00
STATEMENT BALANCE ON 05/31/00………………………………………….	2,703.00

CHECKS/OT CHECKS
HER DEBITS

CHECK NUMBER	DATE POSTED	AMOUN
1001	5/14	450.00
1002	5/16	35.00
1003	5/16	55.00
1005	5/21	2,000.00

	OTHER DEBITS DATE POSTED			AMOUNT
	05/31	SERVICE CHARGE	7.00	
DEPOSITS/ OTHER CREDITS	DEPOSITS			
			DATE POSTED	AMOUNT
			5/1	100.00
			5/5	1,400.00
			5/5	750.00
			5/6	2,000.00
			5/9	1,000.00

DAILY BALANCE	DATE	AMOUNT	DATE	AMOUNT
	5/1	100.00	5/14	4,800.00
	5/5	2,250.00	5/16	4,710.00
	5/6	4,250.00	5/21	2,710.00
	5/9	5,250.00	5/31	2,703.00

James Adams
Bank Reconciliation
First County Bank
May 31, 2000

Balance per bank statement, 5/31/00		$2,703.00
Add deposits in transit		-0-
Less outstanding checks:		
check #1004		$25.00
#1006	330.00	<355.00>
Adjusted bank balance, 5/31/00		$2,348.00
Balance per books, 5/31/00		$2,355.00
Less May bank service charge		<7.00>
Adjusted balance, 5/31/00		$2,348.00

James Adams
Reconciliation Report
First County Bank
Account No. 123456
May 31, 2000

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

(Agrees with bank account record balance.)

QUESTIONS AND ANSWERS REGARDING TRUST FUND REQUIREMENTS AND RECORD KEEPING

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

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

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

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

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

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

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

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

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

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

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

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

Q. If the buyer and seller decide to go directly to escrow and the buyer makes out a check to the escrow company and hands it directly to the escrow clerk, do I have to maintain any records of this check?

A. No. You must maintain records only of trust funds which pass through your hands for the benefit of a third party.

Q. How long must I keep deposit receipts?

A. Deposit receipts must be maintained for three years.

Fair Housing

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

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

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

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

Federal Fair Housing Laws

Civil Rights Act of 1866

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

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

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

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

Federal Fair Housing Act (Civil Rights Act of 1968)

The Federal Fair Housing Act prohibits discrimination in:

- sale, rental, or advertisement of residential dwellings;
- brokerage services;
- appraisal of real estate; and
- real estate loans and loan purchases.

Discrimination is based on a person's:

- race;
- religion;
- national origin;
- sex;

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

- refuse to sell or rent for discriminatory reasons;
- evict a tenant for discriminatory reasons;
- use different qualification criteria for selling or purchasing a residential dwelling;

- impose different sale or rental charges for discriminatory reasons;
- use different terms, conditions, and privileges in the sale or rental of residential dwellings;
- perform differing maintenance activities for certain persons;
- limit use of common areas or facilities to certain persons; and
- refuse to provide service due to a person's refusal to provide sexual favors.

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

A broker also may not use advertising that discriminates in the sale or rental of real property. This relates to all advertising used in the course of business.

A broker may not attempt to induce or actually induce a person to sell or rent their real property because of the entry of a certain class of people into the neighborhood. This is called *blockbusting* as is illegal.

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

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

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

California Fair Housing Laws

Unruh Civil Rights Act of 1959

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

It stated:

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

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

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

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

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

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

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

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

Housing Financial Discrimination Act of 1977 (Holden Act)

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

They placed a RED LINE circle around these areas, thus coined the term "*Redlining*." The Holden Act place restrictions on this practice by making it illegal to:

"Consider the racial, ethnic, religious, or national origin composition of trends in neighborhoods surrounding a housing accommodation."

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

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

- race;
- color;
- religion;
- ancestry;
- sex;
- martial status; and
- national origin.

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

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

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

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

Real Estate Commissioner's Regulations

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

- race;
- color;
- sex;

- ancestry;
- religion;
- disability;
- marital status; and
- national origin.

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

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

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

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

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

- Refusing to negotiate for the sale, rental, or financing of the purchase of real property or otherwise making unavailable or denying real property to any person because of such person's:
    1. Race
    2. Color
    3. Sex
    4. Religion
    5. Ancestry
    6. Physical handicap

7. Marital status
8. National origin

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

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

- Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin against any person in the
  1. Sale,
  2. Purchase,
  3. Negotiation,
  4. Solicitation of the sale or purchase
  5. The collection of payments
  6. The performance of services in connection with contracts of sale of real property.
  7. The performance of services in connection with loans secured directly or collaterally by liens on real property.
  8. Business opportunities.

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

- Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin against any person in the terms, conditions, or privileges of sale, rental, or financing of the purchase of real property.

  This does not prohibit the sale price, rent, or terms of a housing accommodation containing facilities for the physically handicapped to differ reasonably form a housing accommodation not containing such facilities.

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

  1. Processing applications differently,

  2. Referring prospects to other licensees because of the prospects' race, color, sex, religion, ancestry, physical handicap, marital status, or national origin,

  3. Using with discriminatory intent or effect, codes or other means of identifying minority prospects,

  4. Assigning real estate licensees on the basis of a prospective client's race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

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

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

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

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

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

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

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

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

  1. Assisting in any effort to coerce any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status, or national origin to move from or not to move from a particular area.

  2. Punishing or penalizing real estate licensees for their refusal to discriminate in the sale or rental of housing because of the race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of a prospective purchaser or lessee.

  3. Evicting or taking other retaliatory action against any person for having filed a fair housing complaint or for having undertaken other lawful efforts to promote fair housing.
- Soliciting of sales, rentals, or listing of real estate from any person, but not from another person within the same area because of differences in race, color, sex, religion, ancestry, physical handicap, marital status, or national origin of such persons.

- Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin in informing persons of the existence of waiting lists or other procedures with respect to the future availability of real property for purchase of lease.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Establishing or implementing rules that have the effect of limiting the opportunity for any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status, or national origin to secure real property through a multiple listing or other real estate service.
- Assisting or aiding in any way, any person in the sale, rental, or financing of the purchase of real property where there are reasonable grounds to believe that such person intends to discriminate because of race, color, sex, religion, ancestry, physical handicap, marital status, or national origin.

Section 2781 Panic Selling

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

Section 2725(f) Duty to Supervise

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

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

Fair Housing Overview

Civil Rights Act of 1866

The Civil Rights Act of 1866 gave all citizens in the United States the right to purchase real estate.

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

Civil Rights Act of 1968

The Civil Rights Act of 1968 prohibited discrimination in the sale and rental of real estate

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

The Civil Rights Act of 1968 prohibited discrimination in the:

- sale,
- rental,
- advertising,
- offer of brokerage services,
- loans, and
- appraisal services.

Discriminatory actions based on a person's:

- race
- color
- religion
- sex
- marital status
- national origin, and
- handicap.

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

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

A broker may not discriminate in advertising. This is both oral and written.

A broker may not induce people to move out of a neighborhood because minorities are coming into the area. This is called blockbusting and is illegal.

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

Americans With Disabilities Act

A disability is a physical or mental condition that limits a person’s normal life activities. Public and private buildings must be built or altered to comply with ADA.

A person discriminates against a person with a disability may be liable for civil damages in the amount of $50,000.

Unruh Civil Rights Act

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

California Fair Employment and Housing Act

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

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

Equal Credit Opportunity Act

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

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

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

Housing Financial Discrimination Act

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

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

- Race,
- Color,
- Religion,
- Marital Status,
- Sex,
- Ancestry, and
- National origin.

Home Mortgage Disclosure Act

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

Lenders must disclose:

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

AIDS Disclosure

If the occupant died as a result of AIDS and the buyer asks the broker a direct question, the broker must disclose that the occupant died from AIDS.

Advertising Guidelines

It is discriminatory to use words or phrases that request particular buyer or tenant. Words such as “white”, “black”, “single”, etc. Are discriminatory.

However, advertising that requests people age 55 years and old is not discriminatory. This is many times used in adult communities.

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

Department of Real Estate

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

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

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

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

Next is a look at a recent court case that impacts fair housing in California.
FERNWOOD MOBILE HOME PARK et al., Cross-defendants and Appellants, v. EUGENE ALMEYDA et al., Cross-complainants and Respondents. COURT OF APPEAL OF

CALIFORNIA, FOURTH APPELLATE DISTRICT, DIVISION THREE, December 20, 2002, Filed
JUDGES: LEARY, J. I CONCUR: BEDSWORTH, ACTING P. J. FYBEL, J., Dissenting.

Appellants challenge a permanent injunction prohibiting them from engaging in housing discrimination based on familial status. We find no reversible error, thus we affirm the judgment, but not without disapproving the court's inappropriate and insensitive posttrial expressions of opinion regarding the nature of appellants' conduct in operating and managing a mobilehome park. Notwithstanding those remarks, we are convinced from our painstaking review of the entire record that there is no hint of judicial bias or prejudice affecting the outcome.

Fernwood Mobilehome Park (Fernwood) is a 165-space "'blue collar'" mobilehome development in Stanton, California. Established in 1970 as an adults-only community, it was operated as such until 1989, when federal law mandated it be opened to families with children. Fernwood entered the new housing rights era reluctantly, to say the least. It adopted a stifling set of rules and regulations targeting children and outlawing virtually every outdoor play activity in which they normally engage, and it warned applicants their children were not going to like living in the park because there was nothing for them to do. The tactic was effective. Notwithstanding a very tight market for affordable family housing in Orange County, 12 years after Fernwood relinquished its adults-only status, the park stood in stark population distribution contrast to the surrounding community: Only 18 percent of its households were occupied by families with children, as opposed to 68.4 percent of households in its census tract and 74 percent countywide.

The federal Fair Housing Amendments Act of 1988 (Pub.L. No. 100-430, § 13(a) (Sept. 13, 1988), 102 Stat. 1636), codified at 42 United States Code section 3601 et seq. in the Fair Housing Act, extended anti-discrimination coverage to familial status, defined, in pertinent part, as persons under the age of 18 who reside with their parent or legal custodian. (42 U.S.C. §§

3604(a)-(e) & 3602(k)(1).)

Seven years earlier, our Supreme Court held the Unruh Civil Rights Act (Civ. Code, § 51 et seq.) prohibits housing discrimination against families with children. (*Marina Point, Ltd. v. Wolfson* (1982) 30 Cal.3d 721, 724, 180 Cal. Rptr. 496, 640 P.2d 115.) The court stated, "Whether the exclusionary policy rests on the alleged undesirable propensities of those of a particular race, nationality, occupation, political affiliation, or age, in this context the Unruh Act protects individuals from such arbitrary discrimination." (*Id.* at p. 726.) Despite the *Marina Point* decision, Fernwood maintained an express policy excluding children until the amended federal Fair Housing Act took effect.

Elizabeth Pierson, president and chief executive officer of the Fair Housing Council of Orange County, testified the discouraging comments and the overly restrictive rules, even if not enforced, would have a "dramatic impact," "a chilling effect" on a parent's desire to move into the property because "people don't want to live where they're not wanted or [will not] be welcome or think they're going to have problems."

In 1997, Angelina Almeyda needed a place to live when the home she and her family had rented for four or five years was sold. She wanted to buy, rather than rent, "to have some stability for my family, a place to call our own, and a home for my kids." She had saved enough money over the course of a few years to make a down payment on a mobilehome.

Fernwood was listed as a family park. Angelina found an affordable mobilehome for sale at space 95. It was sufficient to accommodate the family--Angelina, her husband, Gene Almeyda, three children, Ryan Almeyda, age 5, Steven Almeyda, age 11, Frank Martinez, age 15, and their family pet, Pepper, a Lhasa Apso. Angelina bought the unit for $ 25,000.

The park's approval of the residency application took a few days, after which Angelina and her sons went "to meet the [Fernwood] management and go over park rules and regulations and the lease [of space 95]." Fernwood's manager, Elaine Crammer, warned the family that kids weren't going to like it there." Angelina thought "it sounded like trouble[,]" but despite her reservations, she signed the rules and regulations and the lease, as did Gene at a later time.

The children also signed the rules and regulations. Five-year-old Ryan printed his name in block letters. Crammer said the children asked to sign and she wanted to make them feel they were part of the process.

The initial meeting between Crammer and the family turned out to be the high point of a relationship that thereafter followed an unswerving downhill path leading straight to the courthouse and the Almeydas' difficult decision to give up their home and seek a less hostile environment in which to raise the children. Facts will be discussed, *post*, as relevant to the legal issues on appeal. For present purposes, suffice it to say Fernwood sued the Almeydas for unlawful detainer and lost. It then filed the underlying action, alleging causes of action for breach of contract and abatement of nuisance, both claims based on the family's alleged violation of rules and regulations. These claims were dismissed, but Fernwood obtained a preliminary injunction against the Almeydas based on Gene's harassment and threats. The Almeydas cross-complained and prevailed in a jury trial on their theories of negligence and unlawful discrimination against families with children. Fernwood does not challenge the jury verdict or award of damages. However, the Almeydas also obtained a permanent injunction against Fernwood, prohibiting it from engaging in further unlawful conduct, and that injunction is at issue here.

Fernwood challenges the court's issuance of a permanent injunction prohibiting discrimination against families with children. To place the matter in context, we set forth the relevant background.

Fernwood's 14-page single-spaced rules and regulations in effect in 1989 recited, "Fernwood Mobile Home Park is a family community with no minimum age requirements for Residents." However, there were special rules for children. Rule 12(E) provided, "Children (those persons under the age of 18 years) must be quiet and orderly and shall not be allowed to play in the street, on other Resident[s'] property, on vacant homesites, or to do anything which might be cause for complaint. Residents must acquaint all visiting children with the Park Rules and Regulations. Children must always be under the supervision of an adult. Children are not permitted in the clubhouse or in common areas unless accompanied by an adult Resident."

Rule 12(G) prohibited "baseball, football or ball throwing of any kind . . . within the Park, including on Resident's homesite, except on designated playground areas designed for such." n6 Under rule 12(I), a resident could babysit "on an infrequent basis, without compensation and for family and friends only[,]" but could not provide foster care or licensed child care unless complying with five conditions, including obtaining a $ 1 million liability insurance policy and giving 60-days notice to management. Rule 14(C) barred children under the age of 16 from being in the clubhouse, except for the library room, without an accompanying resident.

"Resident" was defined as "a homeowner or other person who lawfully occupies a mobilehome."

There *were* no designated playground areas, thus there was no place to play ball at Fernwood.

With regard to the swimming pool, no "swim fins, diving masks, rubber floats, [or] the like" were permitted; the park did not allow "screaming, running, horseplay and loud noises" in the recreational areas; swimmers had to wear "only manufactured swim wear in good condition[,]" and "'homemade' swim wear" was prohibited. Rule 15(G) required that an adult resident accompany children under 16 in the pool area. Babies and children not yet "'potty trained'" were not allowed to use the pool under any circumstance. Shoes or sandals were required attire in the pool area "at all times."

The billiards room was off limits to children under 16 unless accompanied by an adult resident. Skateboarding and roller skating were absolutely prohibited within the park. Bicycles could be ridden "only . . . on the roadways and not on sidewalks, grass, vacant homesites or any other paved area." The rules and regulations alluded to additional rules and regulations posted at various locations within the park.

In addition to the written rules, Fernwood enforced a number of unwritten rules, with Crammer haranguing or writing up reports for children doing such things as riding a bike "'near a house[,]'" giving someone a lift on the handlebars, not wearing helmets, riding bikes on streets other than their own, having no lights on their bikes at night, bouncing a ball, climbing over fences, going in the Jacuzzi, or hanging on the pool stair handrail. Children were not allowed to trick-or-treat at any house not specifically authorized by Crammer. The Almeydas were singled out for special attention: After Fernwood was unsuccessful in its unlawful detainer action, Crammer kept a watchful eye on the children, taking pictures of them to document alleged "incidents."

The jury found Fernwood discriminated against children. That finding is not challenged on appeal, nor does Fernwood dispute the evidence showing children were severely restricted in their usual and customary activities. As Angelina testified, "It's not a family park. They shouldn't call it a family park. If kids can live there why can't kids do kid things." A former resident used stronger language to describe how threatened he and his wife felt with Crammer constantly watching them and their children. He stated, "We were supposed to be living in comfort, at ease in a community, and all of a sudden we found ourselves in a hell. That's ridiculous. A person like [Crammer] as a manager instead she should be in the army." The same witness testified Crammer observed him walking with his children on one occasion, approached him, and said, "'Don't walk around too much because the old people can't think . . . and get scared that somebody's going to rob them.'" He said his children were not allowed to play in Fernwood, but had to go outside to the public streets, where they were at risk. They could not make any noise, even at family celebrations. The witness said Fernwood was "like a jail." In effect, children were not allowed to be seen or heard.

The Almeydas also proved there was selective and uneven enforcement of the rules and regulations. Some residents received favored treatment, Crammer indulging their flagrant, repeated violations of the rules, belligerent and abusive conduct, cursing and foul language, public scenes, physical threats, and wild disturbances. Others, such as the Almeydas and similar families with children, were watched from the day they moved in, harassed, upbraided, cited, written up, embarrassed in front of guests, and, in the Alemydas' case, ultimately presented with a six-page letter from Fernwood's attorneys, set forth in legalese notifying them their residency was in jeopardy due to unspecified violations of "all the terms and conditions as set forth in the lease agreement." n7

Fernwood's enforcement policy required utilization of a three-step process, consisting of a verbal request, a written "friendly reminder," and finally a formal written seven-day notice to comply with rules and regulations or terminate. The policy was not followed in the Almeydas' case: Crammer admitted there were no friendly reminders, despite a hefty measure of seven-day notices, violations citations, and incident reports.

The seven-day notice which traumatized Angelina and led to a final confrontation between Gene and Crammer advised the Almeydas they had "multiple violations of the Park's Rules and Regulations[;]" they were "bound by the terms and conditions of the Rules and Regulations, Rental Agreement, and Residency Documents of the Park[;]" their tenancy could be terminated under statute, and they had "consistently failed and refused to abide by and conform to" provisions of the residency documents, inter alia, the provision requiring them to "abide and conform with all applicable laws and ordinances, all terms and conditions of this Agreement, the Rules and Regulations, all rules, regulations, terms and provisions contained in any document referred to in this Agreement, and said rules, regulations, terms and provision as may, [from] time to time, be amended, modified or otherwise changed by Owner as permitted by the terms of this Agreement."

Against this backdrop, replete with other pertinent facts too numerous to recount, but well known to the parties, the court conducted posttrial hearings to determine the appropriateness of the Almeydas' request for a permanent injunction. After due consideration, it issued the subject injunction. It noted the jury found discrimination against families with children and the court had "reserved jurisdiction over the parties to cure illegal and/or discriminatory acts and practices and to prevent illegal and/or discriminatory acts and practices in the future for the benefit of the general public and the residents[.]" It stated the order was "intended to be prohibitory in that the Park shall not engage in [the business of renting sites for mobilehomes] unless it complies with all Applicable Law and every term of this order."

The injunction prohibits Fernwood from "engaging in any business practice that discriminates against, or has a discriminatory impact on, families with children." It orders the park to remove all signage inconsistent with the injunction, directs each cross-defendant to complete eight hours of training in fair housing law, and orders all park enforcement personnel, [*12] present and future, to participate annually in fair housing training. It provides specific criteria for advertising vacancies and directs Fernwood to exhibit in a conspicuous location the federal fair housing advisement and to install permanent signage at the entrance to the facility stating, "'FAMILIES WELCOME.'" The injunction contains a broad prohibition against "illegal, invalid or discriminatory terms in any Writing signed by a resident," as further specifically set forth in detail.

It orders Fernwood's counsel to serve a copy of the order and a federal fair housing rights booklet in appropriate language on each cross-defendant and present and future enforcement personnel, each present resident of Fernwood, each future applicant for residency, and "each manufactured home sales agent or broker within a three mile radius of the facility." The injunction requires Fernwood to "maintain written and verified documentary evidence of compliance . . . and . . . make such records available for inspection and copying upon the request of any person free of charge during normal business hours at the office of the business property."

Finally, it directs Fernwood to file an annual declaration containing specified information about compliance and the existing family-with-children residency composition of the park.

Fernwood contends the Almeydas lacked standing to obtain a permanent injunction. The Almeydas alleged Fernwood's housing practices violated, inter alia, California's Fair Employment and Housing Act (FEHA) (Gov. Code, § 12900 et seq.), the Unruh Act (Civ. Code, § 51), and California Business and Professions Code section 17200. Fernwood claims the Almeydas have no standing under FEHA because they failed to exhaust their administrative remedies before filing their civil suit for damages and have no standing under the Unruh Act because they moved out of the park. Finally, it asserts the Almeydas lack standing under [*14] Business and Professions Code section 17200 because (1) they failed to properly allege the elements of a cause of action under that statute, and (2) they did not submit instructions to the jury or request findings on it. Because we agree with the trial court that standing exists under the Business and Professions Code, we need not decide the issue as it pertains to the state's fair housing laws.

With regard to the adequacy of the allegations to state a cause of action under Business and Professions Code section 17200, we find Fernwood's argument frivolous. Under the statute, an unlawful business practice "includes '"anything that can properly be called a business practice and that at the same time is forbidden by law."' [Citation.]" (*People v. McKale* (1979) 25 Cal.3d 626, 632, 159 Cal. Rptr. 811, 602 P.2d 731.) The pleading states "with reasonable particularity the facts supporting the statutory elements of the violation [citations]." (*Khoury v. Maly's of California, Inc.* (1993) 14 Cal.App.4th 612, 619.) It alleges specific facts of an unlawful business practice--familial status discrimination--summarized, *ante*, and subsequently proved to the jury. (See *People v. McKale, supra,* 25 Cal.3d at p. 637 [complaint adequate on theory that operators of mobilehome park discriminated against applicants and tenants on basis of religion and ancestry in violation of Health & Safety

Code § 35720 & Business & Professions Code § 17200].)

Nor did the Almeydas' failure to propose jury instructions based on the Business and Professions Code constitute an abandonment or waiver of that theory of recovery when they subsequently sought the equitable remedy of injunctive relief from the court. Fernwood cites no apt authority for its waiver theory, and we have found none. The jury determined Fernwood had engaged in unlawful discrimination. As noted, *ante*, an unlawful business practice under Business and Professions Code section 17200 "includes '"anything that can properly be called a business practice and that at the same time is forbidden by law."' [Citation.]" (*People v. McKale, supra,* 25 Cal.3d at p. 632.) Running a mobilehome park in a discriminatory manner qualifies as a violation of the Business and Professions Code as a matter of law, requiring no special jury finding.

The judgment is affirmed. The Almeydas shall recover their costs and attorney fees on appeal.

O'LEARY, J.

I CONCUR:

BEDSWORTH, ACTING P. J.
DISSENTBY: FYBEL
DISSENT: FYBEL, J., Dissenting:

I respectfully dissent.

The Almeydas asserted that Fernwood, the mobilehome park operators, discriminated against their family by creating and enforcing rules governing where and how children may play and make noise in the park. The court repeatedly equated Fernwood with Nazis. The trial court said:

. "There's a lot of injustice there. These folks are running it kind of weird. It was a Nazi camp."

. "I got the impression [the jury] didn't like either side. They didn't like the park Nazi and they didn't like the husband."

. "So [the Almeydas] run to [an attorney] and he comes in and files basically a private attorney general-type thing on behalf of all people, similar situation, all mobile home parks run by park Nazis, sure. [The Almeydas are] out of [Fernwood] because allegedly [the responsible people are] park Nazis. If they weren't park Nazis [the Almeydas would] still be there. They'd be happy. You guys wouldn't be here."

. "Once this injunction is in place, the park will be run, trained, signs, stuff printed, and they're walking--should be walking on egg shells, and if they don't, someone's going to bring that to my attention . . . and we'11 have a hearing and if I hear the stuff . . . that sounds like discrimination to me, . . . someone's going to be in deep trouble. . . . That's unconscionable conduct and all that Nazi park ranger-type of [*36] thing."

. "You don't know how that offended me. I thought of all those nice folks in Germany saying 'What ovens'? 'What Jewish problem'? 'What camps'? 'We smell nothing[.] This is dust settling on us.' That offended the hell out of me that these nice people come in, they were nice people, came in, testified, 'We didn't know what's going on, we didn't,' and that's fine. I understand they're investors, but they've got to know what's going on. Now that I know what was going on there they've got to know so they make sure . . . the guy they turn the reigns over to has got to walk the line or they're in trouble again, they're in court again, money is on the line again."

The Nazis committed genocide, murdering millions of innocent children, women, and men in the Holocaust. The Nazis caused World War II in which American and Allied soldiers and others died. The trial court in this case equated Nazis to mobilehome park operators who had restrictive rules about noise and where children could play.

"Where the average person could well entertain doubt whether the trial judge was impartial, appellate courts are not required to speculate whether the bias was actual or merely apparent, or

[*37] whether the result would have been the same if the evidence had been impartially considered and the matter dispassionately decided [citation], but should reverse the judgment and remand the matter to a different judge for a new trial on all issues." (*Catchpole v. Brannon* (1995) 36 Cal.App.4th 237, 247.) The trial court in this case both trivialized what the Nazis did and exaggerated beyond the pale what Fernwood did.

I acknowledge my colleagues' recognition that the trial judge's comments were "thoughtless and unfortunate," "inappropriate and insensitive," and "insensitive and uninformed." But, as the majority also recognizes, the test to be applied to determine disposition is whether the comments by the judge would cause a reasonable person to doubt the impartiality of the judge or would cause us to lack confidence in the fairness of the proceedings. The issue in this case is: Did the trial court meet the standard of fairness and the appearance of impartiality [*39] when it repeatedly equated enforcement of rules of a mobilehome park with the conduct of the Nazis? For fairness and impartiality to have any meaning, the answer to this question should be a resounding no.
FYBEL, J.

This concludes Fair Housing.

Risk Management

Understanding the Basic Concept of Risk Management

The management of risk by real estate licensees is extremely important in today's litigious society. A real estate company's success may be hindered or enhanced depending upon how they manage the risks associated with real estate brokerage, lending, and/or property management in California.

There are several key terms and definitions that are important to understanding real estate risk management in California.

Terms and Definitions

Standard of Care: Some duties have a higher standard of care than others. For example, a fiduciary duty is a much higher standard of care than the duty of honest and fair dealing. A fiduciary duty requires utmost honesty, loyalty, integrity, competence, confidentiality, and truth. Whereas the duty of honest and fair dealing owes the duty to disclose all material facts regarding a property.

Contract Preparation: The contracts most often encountered by real estate professionals include the listing agreement, purchase agreement and receipt for deposit, counter offers, and addendums. All of these contracts contain inherent risk and must be completed with skill and diligence by the licensee.

Property Condition: A property's condition must be observed by the real estate professional through a visual inspection of accessible areas. Items of concern for most one-to-four unit residential properties are generally noted in the Real Estate Transfer Disclosure Statement.

Property Ownership: Real property ownership includes land, items affixed to it, and anything appurtenant or incidental to the land. Affixed to the land includes fixtures and emblements (trees and bushes). Items appurtenant or incidental to the land includes appurtenant easements, prescriptive easements, easements in gross, CC&R's (Covenants, Conditions, and Restrictions), stock in a mutual water company, and riparian water rights.

Trust Fund Handling: Trust fund handling includes the broker's trust account that is held in trust for his clients. Earnest money checks, property management rents, and security/cleaning deposits are deposited into a broker's trust account. A broker and any bonded employees can access the account. Too much control over the account by one employee can cause embezzlement problems and is a trust fund violation according to the DRE.

Material Fact: A material fact is a fact that will affect the value of a property. Agents under both fiduciary duties and duties of honest and fair dealing are required to disclose all material facts regarding a property. Material facts are generally disclosed (on one-to-four unit residential properties) using the Real Estate Transfer Disclosure Statement.

RESPA: RESPA denotes the Real Estate Settlement Procedures Act.

There are several key areas that must be examined:

1. Lenders cannot pay referral fees on one-to-four unit owner-occupied property (dwelling) loans.
2. Lenders must provide a good faith estimate and Settlement Costs and You booklet within three business days of the borrower applying for the loan.
3. Lender must provide the HUD-1 (Uniform Settlement Statement) by close of escrow.
4. Lenders cannot charge a fee to provide the HUD-1.
5. Plus several other requirements that lenders must be aware of in today's lending environment.

Conflict of Interest: Agents cannot compete with their principles in the purchase of a property. They also do not want to get into a conflict of interest in lending and brokering a home to prospective purchaser—without disclosing this to both the buyer and seller.

Negligent Advice: When an agent gives a client advice that is incorrect and the agent should have known that it was incorrect, this is called negligent advice. If, in light of a normal agent's education, training, and experience, the agent should have known certain facts regarding a property or gave bad advice to the principal regarding that property, then the agent is liable for his actions. The broker may also be liable through vicarious liability.

Agency Duties: There are several duties that come into existence when an agent represents his principal in a transaction. Both agents owe fiduciary duties to their principals. Each agent owes a duty of honest and fair dealing to the other principal on the other side of the transaction (i.e. listing agent to buyer or selling agent to seller).

Dual Agency: When an agent represents both the buyer and seller in the same transaction, this is called dual agency. Dual agency must be disclosed to BOTH the buyer and seller in the transaction.

Secret Profit: An agent may not make a secret profit. Clients are relying on real estate licensees to price their properties. For this reason, agents may not make a secret profit on a piece of real property. An unlicensed person <u>can</u> make a secret profit on a parcel of real estate.

Ostensible Agency: If there is no written or verbal agency relationship existing between a principal and real estate licensee, and the licensee starts acting as if he is the principal's agent—and the principal starts acting as if the licensee is his agent—then the licensee <u>is</u> considered his agent through ratification. This is called ostensible agency.

Gratuitous Agent: When an agent accepts all the liabilities of being an agent—without being paid, he is called a gratuitous agent.

Agency Disclosure: In 1988 agency disclosure became a new law in California for one-to-four residential properties where an agent is involved. Agents must complete the agency disclosure form and deliver it to the seller and buyer as soon as possible. The agency disclosure form goes with the listing agreement and also goes along with the purchase agreement when it is presented.

Patently Frivolous Offer: The agent is relieved of the obligation of presenting a patently frivolous offer. An offer to purchase a one million dollar residence for one dollar would be considered a patently frivolous offer.

Contracts: A contract is an agreement to do or not to do something.

Express: An express contract is an agreement to do something that is either written or oral.

Implied: An implied contract is a contract that is implied by the actions of the parties. If a party has relied on someone else and that person caused them harm, the party who was harmed can pursue a cause of action under the Doctrine of Promissory or Equitable Estoppel. In other words, if there is no written or oral contract between the parties, the courts will make a contract (under detrimental reliance by one of the parties) and file suit under the Doctrine of Promissory or Equitable Estoppel as a cause of action.
Unilateral: A unilateral contract is a contract that contains a promise for an act. An open listing agreement is considered a unilateral contract. The act of bringing in the buyer results in the promise by the seller to pay a commission.

Bilateral: A bilateral contract is a contract that contains a promise for a promise. An example is an exclusive authorization and right to sell listing agreement. The agent promises to use diligence in finding a buyer if the seller promises to pay him a commission.

Valid: Elements of a valid contract include: Competent parites (cannot be declared incompetent in a court of law), Capacity to contract (not under 18 years of age---unless married, divorced, emancipated by the courts, or in the military), Mutuality (meeting of the minds), Consideration (bargained for exchange between the parties), and Writing. All real estate contracts (except leases of one year or less) must be in writing. In addition to all real estate contracts, all contracts (real estate or not) that are not to be performed within one year of their making must also be in writing according to the Statute of Frauds.

Voidable: A voidable contract can be voided by one of the parties to the contract. A contract signed under duress is an example of a voidable contract.

Void: A void contract is a contract that has no legal basis. There is no contract at all.

Aliens: Non-resident aliens have the capacity to own real property in California.

Minors: Someone under 18 years of age is called a minor and is restricted from contracting in California.

Statute of Frauds: The Statute of Frauds came from England and states that all real estate contracts must be in writing (except leases of one year or less).

Power of Attorney: When one person gives another person the ability to act for them (i.e. sign documents), this is called a power of attorney. The person acting for another is called an attorney-in-fact.

Specific Performance: Each parcel of real property is unique and cannot be replaced. If a buyer has a contract to purchase a property and the seller refuses to perform (convey title), the buyer can institute an action called specific performance and try to compel the seller to sell the property according to the terms of the contract.

Liquidated Damages: On one-to-four unit residential dwellings, if a buyer and seller initial the liquidated damages clause in the purchase agreement, then the damages will be set ahead of time if the buyer "flakes out" and does not close the sale of the property. Of course, collecting this can be difficult since the earnest money funds are generally in escrow and cannot be released without the buyer's signature.

Options: An option is a contract to keep an offer open for a specified period of time.

Fair Housing: There are numerous federal and state fair housing laws, including the Civil Rights Act of 1968, Redlining, Unruh Civil Rights Act, Rumford Act, Holden Act, Steering and Panic Peddling, and Americans With Disabilities Act (ADA).

Intentional Misrepresentation: When an agent intentionally misrepresents information regarding a property, this is called fraud.

Negligent Misrepresentation: When an agent accidentally or innocently makes a mistake regarding a property, this is called negligent misrepresentation.

Concealment of Material Facts: If an agent conceals material facts that will affect the value of a property, this is a major infraction by the licensee.

Unlicensed Assistant: Unlicensed assistants are restricted from providing property information of any kind. An unlicensed assistant can call for an appraisal; however, the assistant cannot provide property information to the appraiser. An unlicensed assistant cannot write an advertisement, the assistant can only provide to the newspaper (or other advertising medium) what her broker or agent told him or her to write.

Risk Management Policy: Each broker should have an office policy and procedures manual outlining office policy regarding all of the items in this course.

Broker-Salesperson Agreement: This is a written agreement between the broker and salesperson. The agreement between the broker and salesperson must be in writing, however, the form of the agreement is not regulated by law.

Office Policies and Procedures Manual: This is a manual that each office should have available to the agents. The manual outlines policies and procedures for handling day-to-day issues that face a real estate office. All of the risk management items in the manual are covered throughout this course.

Custodian of the Public Interest: Agents are the custodians of the public interest and must work for the benefit of the public in general.

Statutory Duties of Licensee: Statutory duties of licensees are duties that are prescribed by legislative law. Laws enacted by the California State Legislature are called "Statutes" and must be understood and followed by real estate licensees.

Mediation, Arbitration, and Litigation: Mediation is non-binding and non-judicial (not through the courts) dispute resolution. Arbitration is binding dispute resolution, also not through the courts. Litigation is binding dispute resolution through the courts, with an appeal process.

Department of Real Estate: Called the "DRE", regulates licensees in California.

Real Estate Commissioner: Appointed by the governor, head of the DRE.

District Attorney and the Criminal Courts: The district attorney prosecutes people who act as if they have a real estate license—but does not have one. If a person brokers real estate without a real estate license, the district attorney in the county where the activity occurred will prosecute that person in the criminal courts.

With the previous terms and definitions in mind, let's take a look at risk management for real estate licensees in California.

The Probability of Risk

It is imperative that real estate agents understand the risks involved in real estate transactions, real estate lending, property management, leasing, business opportunities, as well as several other areas covered by a real estate license. As litigious as California has become over the last many years, an understanding of risk management—as well as a plan to manage risks is essential to a successful career in real estate.

Standard of Care Issues

The standard of care owed by a broker under article 2079.2 of the Civil Code is the degree of care a reasonably prudent real estate licensee would exercise and is measured by the degree of knowledge through education, experience, and examination required to obtain a real estate license.

After a basic understanding of the concepts of risk management, a look at common areas of risk to real estate licensees is important to avoid potential litigation in the future.

Common Areas of Risk

Some common areas of risk include contract preparation, investigation of the property condition, property ownership, trust fund handling, broker supervision of employees, failure to research, investigate, and disclose material facts, RESPA violations, conflicts of interest, and negligent advice.

Contract Preparation

An agent should consider the risks inherent with contract preparation and understand the basic elements of contract law.

Particular areas of concern are competent parties, capacity to contract, mutual consent, lawful objective, sufficient consideration, and in writing.

A capacity issue is a real estate contract to a minor. Unless the minor has been emancipated by the courts, in military service, or married/divorced, they are restricted from contracting in California. Minors do have the ability to contract for necessity items, however, real estate is not considered a necessity item.

Contracts with someone who has been formally committed to a mental institution are void—at least while they are formally committed to the institution. Once they are released they may, however, be able to once again obtain the power to contract.

Contracts with someone who has been declared incompetent by a court of law are also void. There have been instances when a person was NOT declared incompetent by a court of law; however, their medical doctor declared that the person did not fully understand what was going on around her. In this instance, it is a good idea to contact her medical doctor and a competent attorney prior to proceeding with any contracts with that person.

All of these contracts are void and have no force or effect.

Property Condition

The agent is required to make a visual inspection of all accessible areas and note his findings on the Real Estate Transfer Disclosure form. The listing agent should inspect the property condition and note any obvious conditions that are material facts that must be disclosed to the buyer.

Property Ownership

Areas of concern regarding property ownership include the land, any affixed to the land, and anything appurtenant or incidental to the land.

Land

Land includes the soil, rocks, and other substances that compose the earth. It also includes the space below the surface all the way to the center of the earth, as well as the airspace up to the heavens (at least as much as a property owner can reasonably use). Courts have recognized a public right to use the airspace above real property as a highway as long as it does not unreasonably interfere with the landowner’s enjoyment of the property.

In addition, the courts recognize the fluid nature of subsurface gas and oil and a property owner has the right to drill vertically to capture these substances. However, an adjoining landowner does not have the right to drill slantwise to capture a neighbor’s subsurface gas or oil.

An agent should consider not only the surface area, but the area underneath and airspace above the parcel.

Anything Affixed To The Land

This includes buildings, trees, and anything permanently affixed to the land. Real property does not usually move. Examples include houses and things permanently attached to a house, which may include (for example) a built-in microwave oven or kitchen cabinets. Since these types of items are immovable, they are considered real property.

If a microwave oven is sitting on the top of a kitchen counter (instead of being built into the cabinets) it will probably be considered personal property because it is movable and mobile.

Fixtures are personal property that is incorporated into the land and thus becomes real property. Kitchen cabinets and a built-in microwave oven would generally be considered fixtures and, therefore, real property.

Tests for a fixture include:

1. Method of attachment

This is the method by which property is incorporated into the land. The degree of permanence of the annexation is also important. If the fixture is attached by cement or concrete it is probably classified as a fixture, and therefore considered real property.

2. Adaptability or Annexation

Personal property that is attached to the land and being used as an ordinary use in connection with the land is usually considered a fixture. A house key is a good example.

3. Relationship

The relationship between the person who placed the item (possible fixture) on the property and the person who disputes its classification is another important test in determining whether an item is a fixture. Since the buyer/seller relationship is adversarial in nature, the agent must specify in the purchase agreement particular items that may be disputed by the parties.

4. Intent

Intent is the most important test for a fixture. Window coverings are an example of conflicts of intent. The seller's intent is that the item is personal property and will go with him when he sells the property. The buyer's intent is that the item is real property and will stay with the property. Since the buyer's and seller's intents are in conflict, the only answer is what the agent specifies in the purchase agreement.

5. Agreement

When there is a clear agreement between the buyer and seller, whether an item is a fixture should not be in dispute. It should be plainly determined through the agreement.

Emblements

Emblements include planted trees, vegetation, and trees in nature. When emblements are severed they become personal property. A growing corn crop is considered and emblement and real property since it is attached to the land. However, once it is severed (harvested) it becomes personal property. Therefore, the un-harvested corn crop is real property unless specified in the purchase contract. If the seller of the real property would like to harvest the corn crop after the sale, and he doesn't state this in the contract, the corn transfers with the property and is now owned by the buyer. If, however, the growing crop was sold (even if it is still on the stalks) it is considered personal property.

Anything Appurtenant To The Land/Incidental To The Land

An appurtenance is anything that is used with the land for its benefit. Hence the name, "runs with the land." Examples of appurtenances include: easements, water company stock, covenants, and riparian water rights.

Easement

An easement is the right to use someone else's land. For example, an easement over "B's land benefits A. The easement is appurtenant to A's parcel and must stay with that parcel. If owner Smith who owns Parcel A decides to sell it, the easement across Parcel B (which is in the deed) must STAY with the property. Smith cannot take the easement with him when he leaves the property. Any future owners of Parcel A will enjoy the rights to drive across Parcel B.

There are generally three major types of easements: appurtenant easement, prescriptive easement, and easement in gross.

Appurtenant Easement

Property owned by Anderson has an easement from Baker over Baker's property, this is called an appurtenant easement. Appurtenant easements are always held by the dominant tenement.

An appurtenant easement must benefit one tenement and burden another, parcels of land must be owned by two different persons, and the easement is transferred with the dominant tenement. Remember, however, the dominant and servient tenements do not have to abut or adjoin each other (touch each other). However, an appurtenant easement does benefit adjoining landowners.

Prescriptive Easement

A prescriptive easement is a way of gaining the right to use another person's property without their permission. The use must be open and notorious, uninterrupted for five (5) years or more, claim of right, and hostile to the owner's intent.

Adverse possession is very similar to a prescriptive easement. An adverse possessor must be open and notorious, used continuously for five (5) or more years, have a claim of right, and be hostile to the owner's intent. In addition, an adverse possessor must pay the property taxes on the portion of neighbor's property being used. If he does all of these things (including paying the property taxes), he acquires title and owns the property. A quiet title action will perfect his title. Conversely, a prescriptive easement holder only has the right to *use* the property—he does not own it (as in adverse possession).

Easement in Gross

Farmer gave Bryan an irrevocable right to cross his farm and fish for "lunker trout" in his crystal clear trout stream. Bryan has an *easement in gross*. Utility company easements area considered easements in gross. An easement in gross is irrevocable and a license is revocable.

Stock in a Mutual Water Company

Water users may organize a mutual water company in order to secure an ample water supply at a reasonable cost. In most cases, the stock is made appurtenant to the land; that is, each share of stock is attached to a particular parcel of land and cannot be sold separately. This enables the water company to plan its distribution more easily and prevents speculation in shares. No cash dividends are given to the mutual water company stockholder; however, credits are given if there is a water surplus. If operating revenues are not covered, then a special assessment may be levied to make up the loss.

Covenants, Conditions, and Restrictions (CC&R's)

A covenant is usually defined within the framework of "CC&R's." This stands for Covenants, Conditions, and Restrictions. CC&R's usually run with the land and are thus appurtenant to the land and automatically go to the new owner.

CC&R's can be created by deed, agreement, or recorded declaration of restrictions. A breach of a covenant (promise) is a minor breach and is remedied by monetary damages. A breach of a condition is a major breach and is remedied by loss of title to the property. Because of loss of title, a condition must be contained in the deed. A restriction is a private deed restriction and restricts the use of the property. An injunction is used to enforce private deed restrictions.

Riparian Water Rights

Riparian water rights allow a parcel that is adjacent to a river, stream, or watercourse to use as much water as they can reasonably use. This right runs with the land and can be a great advantage to agricultural properties.

Trust Fund Handling

Trust funds are funds held in trust by a broker for his principal. Trust funds fall into two categories, (1) earnest money deposits collected in the course of sales transactions and (2) property management rents (and security/cleaning deposits) collected from tenants.

When a broker mixes his own money with the money or property of others it is called *commingling*. The broker must deposit or place trust funds received into the hands of the principal, into escrow, or into a trust fund account within three (3) business days after receipt. The broker may not keep buyer's cash deposit in the broker's safe, it must be in the trust account.

A broker must keep trust fund checks for a minimum of three years. He can keep up to $200 of his own money in the account to cover the costs of the account.

If a broker negotiates a deal between a buyer and seller and then opens escrow, and the buyer deposits an earnest money check directly into escrow, the broker must log the deposit in his trust account ledger as un-deposited funds. It is illegal for a broker to place rents collected on his own apartment building into his client's trust account. Employees who have access to the account must have divided duties to guard against potential embezzlement of the trust funds. Giving one employee too much control over the account is a trust fund violation according to the DRE.

The broker or an unlicensed employee of a broker who is authorized in writing can make withdrawals from the broker's trust account provided the employee is covered by a fidelity bond for at least the amount of the funds to which the employee has access at any given time

A broker must reconcile his trust fund account on a monthly basis. A broker must deposit his trust account all monies paid to him specifically for advertising, etc.

Broker Supervision

It is the broker's duty to properly supervise each salesperson under his broker's license. If the broker does not properly supervise these subagents, he can be liable for their actions through vicarious liability.

Failure to Research, Investigate, and Disclose Material Facts

According to Civil Code sections 1102-1102.7, agents must make a visual inspection of all accessible areas and disclose any material facts that result from the inspection. A material fact is a fact that will affect the value of a property. Material facts must be disclosed to both buyers and sellers.

For most resale one-to-four unit residential properties, a Real Estate Transfer Disclosure Statement (TDS) is required in the sale of the property. The TDS may not be waived in an "as is" sale. With an "as is" sale, the seller is not going to fix anything—however, he must disclose all material facts regarding the property to the buyer.

RESPA Violations

Section 8(a) of RESPA prohibits giving and receiving any fee, kickback, or thing of value for the referral of settlement services. Things of value are broadly defined under RESPA's rules and may include monies, trips, an opportunity to win a prize, free advertising, and stock in a company.

Some examples of prohibited practices include:

1. Title companies, mortgage broker, and lenders offering real estate agents a free chance to win a contest or prize, such as trips, money, coupons, and discount certificates.
2. Mortgage brokers, lenders, and title companies offering to pay or defray any costs that real estate brokers or agents would otherwise have to incur, such as providing continuing education or paying disproportionate costs for joint advertising.
3. Mortgage brokers, lenders, and title companies providing "thank you" gifts to real estate agents for referring business.
4. Mortgage brokers or lenders paying "finders fees" to friends and past customers for referring new business (soliciting business, not a mere introduction).

The provisions under Section 8 of RESPA do NOT prohibit compensation for providing actual goods, facilities, or services. However, compensation must be reasonably related to the market value of such goods, services, or facilities. HUD may consider any excess payment as compensation for referring business.

Here are some situations to avoid involving compensation for goods, facilities, and services:

1. Mortgage brokers paying commissions to lenders or other mortgage brokers for their turndowns or so-called “leads.” It is okay to purchase lead lists as they are considered “goods.” However, compensation based on the outcome of the lead is not permissible.
2. Title companies paying real estate agents for performing duplicate or unnecessary work.
3. Mortgage broker or lenders attempting to employ real estate agents as loan officers to pay them a percentage of the loan amount for performing minimal, duplicative, or unnecessary services, such as completing or helping with loan applications.
4. Real estate agents receiving additional payment without performing additional work, remember that providing referral services is not a compensable service.
5. Real estate brokers receiving above-market rates for renting desk or office space to loan officers, mortgage brokers, lenders, or title companies. Or, collecting rent for desk or office space that is rarely used by the loan officer, mortgage brokers, lenders, or the title companies.
6. Real estate brokers and agents who enter into marketing agreements with lenders to provide marketing services, but only provide referral services.

In 1983, Congress amended RESPA to permit referrals between settlement service providers in an Affiliated Business Arrangement (AfBA), under certain conditions. An AfBA exists when a person in a position to refer business, or their “associate,” owns more than one (1) percent of a provider of settlement services, and either person directly or indirectly refers business to that provider. An associate of a person in a position to refer business includes a partner, employer, officer, spouse, parent, or child; or where an entity is a corporation related to another corporation as parent to subsidiary by an identity of stock ownership.

Under the 1983 rule, referrals made between affiliates do not violate RESPA so long as the following three conditions are met:

1. The consumer receives a written disclosure of the nature of the relationship and an estimate of the affiliate's charges. (This disclosure must be provided at the time the referral is made, by the person making the referral. HUD provides the format for this disclosure at Appendix D of the regulations, 24 CFR 3500.)
2. The consumer is not required to use the affiliate.
3. The only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest.

An example of a RESPA-compliant AfBA might include a real estate broker who owns a mortgage brokerage company and the real estate agents refer loan business to the broker. Under this scenario, the broker and agents would satisfy the law provided the agents give the customer the AfBA disclosure at the time they make the referral, the broker does not require agents to refer loan business, and the broker does not compensate agents for making referrals.

Participation in "sham" affiliated business arrangements violate RESPA's anti-kickback and unearned fee provisions. HUD recently increased its investigation and enforcement activity of sham affiliated business arrangements as more settlement service providers try to circumvent RESPA's prohibitions by establishing shell settlement service businesses to function as a conduit for paying referral fees.

Often, title companies or lenders create sham arrangements with persons in positions to refer business. Additional guidance of AfBAs is contained in HUD's 1996-2002 Statement of Policy, "Sham Controlled Business Arrangements."

The following are a couple of examples of sham arrangements:

1. A title company and a real estate firm establish an affiliated title agency. The affiliated title agency has the same business address as the partner title company, the real estate firm is the affiliated title agency's sole source of business, and employees of the partner title company perform the core title functions.
2. Several real estate agents create an LLC to purchase an interest in a title company. The title company and the LLC share profits based upon their ownership interest. However, the LLC disburses profits to its member real estate agents based on the volume of title business referrals.

All licensees should operate in compliance with RESPA, particularly the provisions of Section 8, as the violation of this part may carry a fine of up to $10,000 or imprisonment of up to one year, or both. For more information on RESPA, visit HUD's website at www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm or call HUD at (202) 708-0502.

Referrals to Vendors and Third Parties

Agents need to be particularly careful referring vendors and third parties. RESPA does not allow referral fees to be paid between loan officers and agents if the property is an owner-occupied (dwelling) and one-to-four units.

As mentioned earlier, some companies have affiliated business arrangements that allow them some flexibility in this area.

Conflicts of Interest

An agent has a duty not to compete with his principal. If a property is offered for sale, the agent must not move forward and make an offer to purchase the property when his principal is attempting to purchase the property also.

Negligent Advice

An agent must not be negligent in giving advice to his client. In light of the normal education and training that goes into being a real estate agent, an agent must not give negligent advice to his clients. If knowledge of the circumstances should have been within the agent's diligent observation, then he will be guilty of negligence.

Next is a look at licensee activities that are likely to contribute to risk.

Licensee Activities Likely to Contribute to Risk

Licensee activities that are likely to contribute to risk include agency duties, authorization to accept a deposit, secret profit, ostensible agency, gratuitous agency, agent acting in excess of his authority, patently frivolous offers, preparation, formation, interpretation, performance, and termination of contracts, express contracts, implied contracts, unilateral contracts, bilateral contracts, executory contracts, executed contracts, elements of a valid contract, minors, aliens, handwritten items vs. preprinted clauses in the contract, sufficient consideration, statute of frauds, voidable contracts, void contracts, attorney-in-fact, novations, statute of limitations, specific performance, liquidated damages, and options.

Agency Duties

An agency relationship is created when one person (the principal) gives another person (the agent) the right to act on his behalf. These acts are generally limited to a special agency of a broker listing a property for sale. In this instance, the agent is employed to find a ready, willing, and able buyer to purchase the property; and can neither sell the property for the principal nor bind him to any contract for the sale of the property.

An agency gives rise to a fiduciary duty of utmost care, honesty, integrity, and loyalty of the agent to the principal. This is a higher standard of care that the agent must exercise when acting for his principal. The agency relationship is terminated at close of escrow.

The best way to avoid litigation between a principal and a broker is to have a written contract or agreement.

An agency relationship/fiduciary duty can be terminated by revocation by the parties, agreement of the parties, or death of one of the parties.

An agency gives rise to a fiduciary duty of truth, confidentiality, and competence. A real estate agent generally acts as a fiduciary. The relationship between principal and agent is called a fiduciary obligation.

Broker Owes Buyer

The listing agent owes the buyer the duty of honest and fair dealing. This is disclosure of all material facts related to the property. The same duty is owed by the selling agent to the seller (however, he usually doesn’t know anything about the property).

Dual Agency

Dual agency occurs when a broker represents both the buyer and the seller in a real estate transaction. Thus, the broker has fiduciary duties to both the seller and the buyer and must act with extreme care. Loyalty and confidentiality can be easily compromised for each party.

If an agent does NOT disclose dual agency to both parties, he may be disciplined by the Real Estate Commissioner, he may not receive his commission, and it may be grounds for either party to rescind the contract.

Mr. Brown hired a broker to find a warehouse for lease and agreed to pay a commission for the service. Several days later, Mr. Green tells the broker he has a warehouse lease and agrees to pay a commission if he finds a tenant. The broker writes the lease that is signed by both parties. Mr. Brown knows that the broker was representing Mr. Green, but Green did not know that the broker was representing Mr. Brown. In this case NEITHER is liable to pay a commission. Acting for more than one party in a transaction without the knowledge or consent of all parties is called a divided agency (not dual agency). Dual agency occurs when the agent informs and obtains consent from each principal. Then he may collect a commission from each.

Therefore, a dual agency is legal if the buyer and seller consent to it.

Accidental Dual Agency

When a real estate agent acts as an agent for both the buyer and seller in a transaction, but does not specifically reveal this fact because he is unaware that both consider him their agent, he is involved in accidental dual agency.

Authorized to Accept Deposit

Able, the owner of Blackacre, lists a property for sale with Broker Baker. Able fails to authorize the agent to accept the deposit on his behalf. Buyer Charlie makes an offer on Blackacre and gives Broker Baker a check for $5,000 as a deposit. Under these circumstances, Broker Baker can accept the deposit check on behalf of Buyer Charlie and place the monies in his broker's trust account.

The agent is required to do as his principal instructs him to do. However, he must inform the seller of the any check held by the broker because this is a material fact.

Secret Profit

A broker cannot receive secret profits. It is a violation of the Real Estate Law, laws of agency, he is subject to disciplinary action by the Real Estate Commissioner, and subject to a civil suit by the seller or buyer.

A licensee may not receive a secret profit from the sale of one of his listings or other purchase he is involved in as a licensee.

A person who is NOT a licensee may make as many secret profits as possible on the transaction.

Licensee must disclose to his principal the full amount of commission or profit if he purchases the property.

A licensee must reveal to the other party (buyer or seller) that he has a license when involved in real estate transactions as a principal. He cannot buy through a "dummy" buyer.

If the buyer is a close relative (brother), the broker must reveal this fact to the seller.

Ostensible Authority

An agency relationship can result from the conduct and actions of the parties, even though there is no express agency agreement between the broker and principal(s) in the transaction.

Ostensible authority occurs when Seller Able lets Buyer Baker assume that Broker Charlie is his agent.

Gratuitous Agent

Compensation is not essential to establish an agency relationship. An agent who acts without compensation is still held under certain standards of care to his principal. A gratuitous agent assumes all the liabilities of an agent who is being paid a commission in the transaction, yet doesn't receive a commission.

Agent Acting In Excess Of His Authority

The seller is not liable for the broker's actions if the broker acts in excess of his authority.

Agency Disclosure

As soon as practical or practicable an agent must disclose who is representing whom in a real estate transaction. This includes who is representing the seller, buyer, and if a dual agency exists. This disclosure must be in writing.

Patently Frivolous Offer

A broker is relieved of the obligation to present an offer to purchase real property to the principal when the offer is patently frivolous, he is acting under express written instructions of his principal, or the property is sold and escrow has closed.

Preparation, Formation, Interpretation, Performance, and Termination of Contracts

A contract is an agreement to do or not to do something. It is a legally enforceable agreement between competent parties who have agreed to perform certain acts for consideration or refrain from performing certain acts.

Express Contract

An express contract is a contract where the parties put their intentions and the terms of the agreement in words, either written or oral.

Implied Contract

An implied contract is a contract where the agreement between the parties is shown by acts or conduct rather than words.

Enforceable Contract

A purchaser may make a contract contingent upon obtaining satisfactory leases (inspection of an existing lease and approving it). This would be considered an enforceable contract. However, if a purchaser attempts to make an offer subject to obtaining a satisfactory lease, this is called an illusory contract and is not a contract.

Bilateral Contract

A bilateral contract is a promise for a promise. The promise of one party is given in exchange for the promise of the other party. For example, when a seller promises to pay the agent a commission when the home is sold and the agent promises to use diligence in marketing the property, this is called a bilateral contract. A listing agreement is usually considered a bilateral contract. Able gave Broker Charlie a listing and promised to pay him a 6% commission if he finds a suitable buyer. This is a bilateral executory contract.

Unilateral Contract

A unilateral contract is a promise for an act. A promise is given by one party to induce an act by the other party. For example, A promises to pay B $10 if she will walk across Brooklyn Bridge. B walks across Brooklyn Bridge, therefore, A owes B $10. B performs her requirements under the contract with an act rather than a promise. An example of a unilateral contract is an open listing.

Executory Contract

An executory contract is a contract that is in the process of being performed and has not yet been completed.

Executed Contract

An executed contract is a contract that has already been completed.

Valid Contract

There are four essential elements of any valid contract (all contracts):

1. **Competent Parties/Capacity To Contract** – The parties to the contract must not have been declared incompetent in a court of law. In addition, the parties to the contract must have the capacity to contract—specifically, minors may not contract for real property. The exceptions to this rule are minors who are married, divorced, in the military, or emancipated by a court of law.

2. **Mutual Consent** – This is mutuality of agreement. In other words, what the buyer thinks he has agreed to in the contract the seller thinks he has agreed to also. There is a meeting of the minds. Genuine offer and genuine acceptance is used to facilitate a meeting of the minds.

3. **Lawful Objective** – The purpose of the contract must be of a legal purpose. A contract to smuggle illegal drugs into the U.S. would not be a valid contract because it has an unlawful objective.

4. **Sufficient Consideration** – Consideration is the bargained for exchange that occurs when two people contract to do or not to do something. For example, if Able gives Baker $100,000 for Baker's real property and Baker signs the deed conveying the real property to Able, there is sufficient consideration and a valid contract. Able's $100,000 is consideration on his part, and Baker's conveying the property to Able is Baker's consideration.

5. Real estate contracts have a fifth element: **in writing**. Not all contracts are required to be in writing, however, real estate contracts are require to be in writing (except leases of a year or less are not required to be in writing).

Minors

A minor can receive title to real property by gift or inheritance without court approval. However, the minor cannot convey the real property without court approval.

A single young man enters into a contract to sell real property he owns. After escrow had closed and the deed was recorded, the title company determines that the young man is under 18 years of age. In this circumstance, the transaction was void.

A minor can receive a parcel of real property by gift or inheritance without court approval. He cannot sell it without court approval.

A married or divorced person under 18 years of age has the capacity to contract and is not considered a minor.

Aliens

Non-resident aliens have the capacity to contract. Minors, convicts, children, and incompetents are all restricted from contracting. Non-resident aliens who are not citizens of the United States of America, however, do have the capacity to contract.

Handwritten vs. Preprinted Clauses

Many real estate contracts contain preprinted clauses and spaces for information to be handwritten. In a legal dispute, when there is a conflict between the preprinted clauses and the handwritten information, the handwritten information takes precedence over the preprinted clauses.

Sufficient Consideration

Consideration is required for a valid contract. Anything of value can be used as consideration (bargained for exchange).

Consideration is defined as services rendered, a promise to perform an act, an act of forbearance, or an exchange of money.

Statute of Frauds

The Statute of Frauds is an old concept that came from England (where it was abandoned a few years ago). However, it is still used in California. The Statute of Frauds states that all real estate contracts must be in writing including any and all agreements that are not to be performed within one year of their making (real estate or not). Since a lease of a year or less WILL be performed within one year of its making, it does not fall under the statute. Thus, a lease of one year or less is not required to be in writing. All other real estate contracts must be in writing.

Unenforceable Contract

An unenforceable contract is a contract that is valid, however, for some reason cannot be proved or sued upon. An example is when a contract cannot be enforced because of the passage of time within the statue of limitations. Another example of an unenforceable contract is an oral contract to purchase real estate. However, an oral agreement may be enforced if the purchaser has gone into possession, paid part of the purchase price, and made improvements to the property.

Voidable Contract

A voidable contract is a contract that appears valid and enforceable but is subject to rescission by one of the parties who acted under a disability. In other words, one of the parties is able to void the contract or go through with it at their discretion. An example of a voidable contract is one that is signed under duress. The person who was held under duress while signing a contract can void the contract (rescind it) or enforce it at their sole discretion.

Void Contract

A void contract has no legally binding effect. It is unenforceable from the very beginning and is not a contract at all.

Examples of void contracts include:

- contracts to commit a crime.
- real estate contracts with minors.
- contracts with someone who has been formally committed to a mental institution.
- contracts with someone who has been declared incompetent by a court of law.

Power of Attorney

A power of attorney is a written instrument giving authority to an agent. For example, Brother #1 is in Sydney, Australia and would like Brother #2 to sign for him in the conveyance of a home purchased by the two of them some years ago. Brother #1 signs a power of attorney form at the American Consulate in Sydney, has it notarized, and sends it to his brother in the U.S. Brother #2 then acts as attorney-in-fact for Brother #1 and signs escrow instructions on his behalf.

Attorney-In-Fact

An attorney-in-fact is a person who is authorized to act on behalf of another person. Brother #2 in our previous example would be considered an attorney-in-fact for Brother #1.

Assignment

An assignment is the transfer of rights, interests, or title to property of a person (assignor) to another person (assignee). A typical assignment is when trust deeds are sold from one lender to another.

Novation

A novation is the substitution of a new contract for an old one. For example, when the lender releases a seller from the obligation to pay the loan in a loan assumption, and substitutes the buyer as the one responsible to repay the debt, this is called a novation.

Statute of Limitations

The statute of limitations is the amount of time in which a person can bring an action in court. A purchaser of real property generally has two (2) years to bring a claim in court if it is related to disclosure on a Transfer Disclosure Statement. Breach of fiduciary duty is generally four (4) years from the close of escrow or when the defect is discovered by the plaintiff in the lawsuit. If these time periods are exceeded, then the statute of limitations takes effect and the person is prevented from bringing an action in court.

Specific Performance

Specific performance is a court action brought to force a party to carry out the terms of a contract. Specific performance is usually used to force a party to convey real property as stated in a purchase agreement. Each piece of real estate is considered unique and legal damages are many times not adequate to compensate a buyer for a seller's breach of contract. Therefore, the courts force the seller to convey the property to the buyer under the terms of the contract. Consideration for the contract, however, must be reasonable or sufficient relative to value for the courts to require specific performance.

Liquidated Damages

Liquidated damages are the predetermined amount of damages the parties a the contract agree to as the total amount of compensation an injured party will receive if the other party breaches the contract.

For example, a buyer and seller initial the liquidated damages clause to a real estate purchase agreement. The buyer removes all contingencies to the contract and then defaults on the purchase of the property (changes his mind and does not go through with the contract). The maximum amount of damages the seller can receive from the defaulting buyer has already been predetermined by the liquidated damages clause in the contract. The amount is usually 3% of the sales price or the earnest money deposit, whichever is lower for all one-to-four unit dwellings in California.

The liquidated damages clause in a real estate purchase contract must be initialed by both buyer and seller. If the buyer subsequently receives news of a job transfer and decides not to buy the property. Under these circumstances, the deposit is generally split 50% seller/50% listing broker.

Option

An option is an agreement to keep an offer to sell or lease real property open for a specified period of time. Options are commonly used in the purchase of raw land, allowing the buyer to resolve zoning, entitlement, and feasibility questions prior to committing the funds necessary to purchase the property. An option must be accompanied by consideration. Options are assignable.

If the optionee decides to exercise his or her option during the period specified, then the optionor must perform and sell the property as per the contract.

Next is a look at the broker's risks associated with advertising.

Advertising

Risks associated with advertising include blind ads, misleading advertising, and a broker breaking his promise to advertise.

Blind Ad

A blind ad does not have the name of the agent or broker who has the property listed for sale. Blind ads are illegal because "agt.", "bro.", "bkr.", or the name of the broker must accompany each advertisement for the sale of the property.

A licensee must disclose when advertising, that he is an agent. A blind ad makes the agent appear to be the owner. It does not identify the broker.

Misleading Advertising

Advertising cannot mislead a prospective buyer regarding the condition or other facts about a subject property. A "fixer" property should be called a "fixer," and not a "move right in" dream home.

Broker Breaks Promise to Advertise

A broker breaking his promise to advertise is illegal. If a broker promises to advertise a property and then does not do as promised, she may be liable for damages under actual fraud.

Next is a look at fair housing risks.

Fair Housing

Fair housing risks include Federal Fair Housing Laws, State Fair Housing Laws, race restrictions on a deed, marital status discrimination, and the Americans With Disabilities Act (ADA).

Federal Fair Housing Laws

The main federal fair housing law was the Civil Rights Act of 1968. This Act has been instrumental in prohibiting discrimination in the sale and lease of housing throughout the U.S. In 1968 the U.S. Supreme Court prohibited all racial discrimination when real property is sold or rented.

The Civil Rights Act of 1968 allows all prospective buyers to be given the same opportunity to purchase residential properties without racial restrictions.

If a seller asks a broker to disclose a buyer's race, the broker should not disclose the purchaser's race because it is not a material fact.

Redlining

Redlining occurs when a lender obtains a map and places a red line around an area where he does not want to make loans. This is called "redlining" and is illegal.

State Fair Housing Laws

There are four important fair housing laws that have been enacted in the State of California:

California Fair Housing Act – The owner of a single-family residence may take in a boarder and be exempt from the California Fair Housing Act.

Unruh Civil Rights Act – prohibited discrimination in business establishments in California.

Rumford Act – prohibited discrimination in the sale and rent of residential properties in California.

Holden Act – prohibited discrimination in lending in California.

Housing Financial Discrimination Act of 1977 (Holden Act)

For example, XYZ Savings and Loan Association negotiates a $200,000 loan with Maria Gomez. Maria speaks no English. In order to complete the transaction XYZ provides loan forms written in Spanish. In the escrow closing statement Maria is charged a 1/8% higher interest rate than other borrowers who speak English. Under these circumstances the lender could not impose the extra charge. This is a violation of the Housing Financial Discrimination Act of 1977.

If a loan broker asks a person applying through the broker's office for a new loan to fill out a questionnaire in which the borrower's race and marital status are requested, the applicant can refuse disclose his race or marital status.

Steering

Steering occurs when an agent steers a client out of communities that are not of his ethnic race. Steering is illegal.

A real estate licensee has a practice that when he is approached by members of minority groups who want to be shown property, he avoids showing them property in integrated areas. This would be an example of steering.

Panic Peddling and Blockbusting

Panic peddling and blockbusting are very similar terms. For example, when an agent goes into a neighborhood and informs the homeowners that they should sell their homes now because minorities are coming into the neighborhood and their homes will suffer a loss in value, this is called panic peddling or blockbusting. Both of these activities are illegal.

A real estate broker who undertakes to canvas a neighborhood area that is very near to a section into which minorities have recently moved telling the people to whom he talks that they should sell now as their property might suffer a loss in value in the future, this is called panic peddling and blockbusting. Again, both are illegal.

A licensee who contacts owners of homes in an area indicating that they should list their homes for sale with him because minorities may be moving into the area, this practice would be considered blockbusting, panic peddling, and illegal.

Race Restrictions On A Deed

Regarding the conveyance of a deed including race restrictions, the deed is valid but the race restrictions are unenforceable. Race restrictions on a deed are unenforceable because they violate the U.S. Constitution.

When a deed includes race restrictions, the race restrictions can be changed with a court order.

Marital Status Discrimination

It is illegal for a landlord to require a tenant to have a co-signor because he or she is not married. This is marital status discrimination and illegal.

Americans With Disabilities Act (ADA)

The Americans With Disabilities Act (ADA) requires equal access to public buildings for all handicapped persons.

Real Estate Commissioner Creates Color Blind Industry

The Real Estate Commissioner's policy is to create a "color blind" industry. This means that agent's should maintain an attitude that is color blind and free of bias, race, creed, and color are not material facts in a real estate transaction, and agents should treat all people like they themselves would like to be treated.

Next are some practical examples of high risk areas for licensees.

Practical Examples of High Risk Areas

Practical examples of high risk areas for licensees are fraud, misrepresentation, non-disclosure, concealment of material facts, and unlicensed assistants.

Fraud/Misrepresentation/Non-Disclosure

Fraud is a nice word for lying. Misrepresentation occurs when the agent misrepresents the condition of the property or some other material fact(s) about a property. Non-disclosure occurs when a licensee or his clients (seller or buyer) do not disclose material facts that are pertinent to the purchase of real property.

When an agent makes a promise that influences a person to enter into a transaction, this is called a False Promise.

Misrepresentation

Misrepresentation has two categories:

- intentional misrepresentation (another name for fraud or lying)
- negligent misrepresentation (unintentional mistake).

Obvious knowledge by the broker is considered misrepresentation.

Concealment of Material Facts

A material fact is a fact that affects the value of a property and if a buyer knew about the fact she probably would not purchase the property. Examples of material facts are leaky roofs and extensive plumbing repairs.

Unlicensed Assistant

If a broker has his unlicensed receptionist schedule an appraisal for a property, she cannot give the appraiser information concerning the property. She can only schedule the appraisal. If she were a licensed assistant, then she would be able to provide information regarding the property.

An unlicensed receptionist cannot advertise (design and make advertisements) for the broker. She can only place what the broker told her to write in the newspaper or other advertising medium.

If a real estate broker has his unlicensed assistant hand out door hanger fliers in his farm area and make telephone cold calls soliciting prospective buyers, sellers, and borrowers, this is unlawful for both the broker and the unlicensed assistant.

Next is a look at some risk reduction techniques to help licensees reduce their exposure to risk.

Risk Reduction

Risk reduction techniques include a company adopting an official risk management policy; risk can be minimized by planning, training, supervision, and enforcement; broker delegating document review to salesperson; it is the responsibility of brokers, office managers, and supervisors to manage risk by educating, training, and supervising employees and associates; broker-salesperson agreements; goals of risk management clearly stated and communicated to agents and employees; consequences of illegal and unethical behavior; need for licensees to stay current; and risk is ongoing and reduced through proper training, supervision, and enforcement of office policies.

Companies Should Adopt an Official Risk Management Policy

It is advisable for real estate companies to adopt an official risk management policy. This policy should cover areas of risk to the company and its licensees, as well as the company's policies dealing with each area. This should be contained in the company's office policy and procedures manual.

Risk Can Be Minimized by Planning, Training, Supervision, and Enforcement

Risk to the real estate company can be minimized by planning, training, supervision, and enforcement. The company should plan to train, supervise, and enforce the policies set forth in their office policies and procedures manual.

Planning: A formal plan regarding minimizing risk as set forth in the office policies and procedures manual.

Training: Coverage of risk reduction issues within the company's formal training program for new agents and on-going training for experienced agents.

Supervision: All broker-officers and sales managers should be aware of risk reduction issues when supervising licensees. Corrections should be made to on-going licensee training as needed to reduce risk to the company.

Enforcement: Licensees who do not follow the company's risk reduction policies should be reprimanded and then, if the policies are not followed, subsequently terminated by the company.

Broker Delegates Document Reviews to Salesperson

It is quite common for large real estate brokerage operations to delegate to a salesperson (usually called a sales manager) within an office the ability to review and initial documents completed by other salespersons within the office. The broker can delegate these reviews to a salesperson who has at least two (2) years full-time experience as a real estate salesperson within the past five (5) years.

The Responsibility of Brokers, Office Managers, and Supervisors to Manage Risk by Educating, Training, and Supervising Employees and Associates

It is the responsibility of brokers, office managers, and supervisors to manage risk by educating, training, and supervising employees and associates. These responsibilities should be covered within the office policies and procedures manual. Educating, training, and supervising should be covered within the post-license training program for new licensees—as well as on-going training during office meetings. The broker-officer and sales managers should adequately supervise the licensees under their responsibility.

Broker-Salesperson Agreement

A written broker-salesperson agreement is required between all real estate brokers and salespersons in California. A written agreement between the broker and salesperson is required by the Real Estate Commissioner's regulations. A salesperson is legally an employee of the broker; however, he is an independent contractor for tax purposes. The broker must keep a copy of broker-salesperson agreements for three (3) years after termination of employment. The agreement between a broker and salesperson is not required to be approved by the Department of Real Estate. However, it must be in writing.

Goals of Risk Management Clearly Stated and Communicated to Agents and Employees

Brokers during initial and on-going training, office meetings, and in their Policies and Procedures Manual should clearly state risk management goals. Proper completion of all contracts and disclosures is critical to file management and resulting risk reduction.

Consequences of Illegal and Unethical Behavior

The consequences of illegal and unethical behavior is either a correction of the agent's actions or termination and notification to the DRE.

Need for Licensees to Stay Current

All real estate licensees should stay current in their area(s) of expertise by reading industry publications and completing continuing education requirements as prescribed by the DRE.

Risk is Ongoing and Reduced Through Proper Training, Supervision, and Enforcement of Office Policies

As mentioned earlier, risk reduction is a constant and ongoing process and can be reduced by training, supervision of agents, and enforcement of office policies.

Next is a look at risk management and the consumer.

Risk Management and the Consumer

Risk Management and the Consumer investigates the impact of the consumer's increased access to information and the consumer's demand for greater value from a licensee's services. Licensees are custodians of the public interest when conducting licensed activities and have fiduciary duties to the consumer.

Impact of the Consumer's Increased Access to Information and the Consumer's Demand for Greater Value from a Licensee's Services

With the advent of the internet, information is much more accessible than ever before. For this reason consumers are demanding more value from their agents.

Agents bring several things to a real estate transaction:

1. Knowledge of the contracts.
2. Knowledge of the disclosures.
3. Knowledge of the real estate market.
4. Knowledge of financing.
5. Knowledge of inspections and repairs.
6. Buffer zone between the seller and buyer.
7. Negotiator and advocate for their client in the transaction.

Licensees are Custodians of Public Interest When Conducting Licensed Activities

Real estate licensees are custodians of the public's interest when conducting licensed activities. For this reason, the DRE takes its regulatory duties very seriously.

An agent who harms members of the general public and then skips town and does not pay any judgments against them, is definitely the exception and not the rule in California.

The DRE has a Recovery Fund or Recovery Account that can be used by members of the general public who have un-collectable judgments against a licensee. Part of all license fees go into the Recovery Fund. If there is an un-collectable judgment against a real estate licensee, the consumer who was harmed may collect up to $20,000 from the fund. However, the DRE will pay a maximum of $100,000 for each licensee. So if there are more than five consumers harmed by the licensee, the sixth will receive nothing (5 x $20,000= $100,0000.

Fiduciary Responsibility

An agency relationship gives rise to a fiduciary duty of utmost care, honest, integrity, and loyalty of the agent to the principal. This is a higher standard of care that the agent must exercise when acting for his principal. Fiduciary obligations include truth, confidentiality, and competence. A real estate agent has a position of trust and generally acts as a fiduciary.

The following are two major breaches of an agent's fiduciary duty to his principal:

1. A listing agent informed the buyer that the seller will take less money for the property. This is a breach of fiduciary duty to the seller.
2. A selling agent cannot reveal anything negative about his buyer to the seller. This is a breach of fiduciary duty to the buyer.

Next is a look at the legal responsibility placed on real estate licensees.

Legal Responsibilities

Legal responsibilities include vicarious liability for individuals, supervisors, and the company; statutory duties and responsibilities for licensees; legal claims based on mediation, arbitration, and litigation; license discipline; the Real Estate Commissioner; claims stemming from self-regulation, such as grievances/arbitration; and the district attorney and criminal courts.

Vicarious Liability for Individual, Supervisor, and Company

If a salesperson does something unethical or illegal, the salesperson and the broker are both liable. If the broker does something unethical or illegal the salesperson is NOT liable for the broker's action.

Statutory Duties and Responsibilities of the Licensee

There are many statutory duties for licensees that have been imposed by the State Legislature. Some duties to consider are disclosure of material facts, agency disclosure, and natural hazards disclosure.

Legal Claims Resolved by Mediation, Arbitration, or Lawsuit

Legal claims between licensees and principals can be resolved by mediation, arbitration, or litigation (lawsuit). Mediation is voluntary.

A mediator hears the case and makes a determination. The mediator's ruling is non-binding.

An arbitrator hears the case and makes a determination. His determination is binding between both parties. Both the buyer and seller must agree to the type of dispute resolution used by initialing the arbitration clause in the purchase agreement and/or listing agreement. A binding arbitrator (usually a former judge or real estate attorney with at least five years experience) hears the case and makes a determination. There is generally no appeal—and arbitration can cost more than litigation.

In litigation, a judge or jury hears the case. They make a determination and there may be an appeal process. Generally the trial courts hear the case, and the one of the appellate courts in California reviews the case on appeal. The three appellate court justices check the rules of law that relate to the trial court's decision.

In lieu of litigation, both plaintiff and defendant may agree to alternative dispute resolution which entails mediation of the dispute. This is generally a cheaper and easier way to decide the matter.

License Discipline by the Department of Real Estate

The Real Estate Commissioner suspends and revokes real estate licenses. When an agent has done something wrong, the Real Estate Commissioner first issues an accusation. The licensee can then plead his case and the Commissioner may suspend his license for a certain period of time or revoke it entirely. The DRE Bulletin is now published on their website and lists all of the agents who are in trouble.

Real Estate Commissioner

The Real Estate Commissioner is appointed by the Governor of the State of California. The Real Estate Commissioner has primary regulatory authority over all real estate subdividers and licensees in California.

The Real Estate Commissioner revokes real estate licenses. In addition, the Commissioner issues cease and desist orders to subdividers who do not follow the real estate laws.

The Real Estate Commissioner will start an action against a licensee with an injunction and has three years to take action on a violation.

The maximum fine the Real Estate Commissioner can levy against a broker who pays an unlicensed person for soliciting borrowers or negotiating loans is $10,000.

Claims Stemming from Self-Regulation of the Real Estate Industry, Such as Grievance/Arbitration

The National Association of Realtors (NAR) is a national industry group associated with the California Association of Realtors (CAR) and local associations. A licensee MUST be a member of NAR to call themselves a “Realtor.”

If a licensed real estate broker is not a member of the California Association of Realtors or the National Association of Realtors and in his advertising he indicates that he is a Realtor, he is subject to disciplinary action by the Real Estate Commissioner.

Should a dispute regarding a commission arise between two sales licensees who are members of the National Association of Realtors, by provisions of that organization’s Code of Ethics they will settle the matter by arbitration.

Misuse of the name "Realtor" is a violation of the California Real Estate Law.

District Attorney and the Criminal Courts

The district attorney would prosecute a non-licensee who performs acts required by a real estate license. In the event a non-licensee performs an act for which a license is required, the party that would prosecute the non-licensee is the district attorney in the county where the activity occurred.

For example Jones, who does not have a real estate license, is the owner and president of an investment firm. He advertises and sells properties for his clients. Since these transactions involve real estate, the district attorney will prosecute him for violating the real estate law.

Risk management is a critical area for real estate licensees to consider in all of their real estate endeavors. The Risk Management course has been designed to address some of the most pressing areas that confront licensees on a day-to-day basis and it is hoped that real estate licensees will be able to reduce their risk in today's litigious environment.

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