

**NOTICE:** These questions must be returned with your answer sheet.

REAL ESTATE LICENSE SERVICES, 5059 NEWPORT AVENUE #209, San Diego, California 92107

# Real Estate Principles, Final Exam #1

## FINAL EXAM ANSWER FORM INSTRUCTIONS

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37. [A]  [B]  [C]  [D]

If you need to change an answer, make sure that you erase the old answer completely.

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- a. exit costs  
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41. Brokers who engage in more than \_\_\_\_\_ mineral, oil and gas license transactions are required to have a Mineral, Oil and Gas (MOG) license.  
a. 1  
b. 5  
c. 10  
d. a licensed real estate broker may engage in unlimited MOG transactions
42. The Federal Home Loan Mortgage Corporation is often referred to as:  
a. Freddie Mae  
c. Ginnie Mae
- b. Fannie Mae  
d. Freddie Mac
43. An individual employed by an owner or management company to manage a residential apartment building or smaller complex is referred to as:  
a. an individual building manager  
b. a superintendent  
c. a resident manager  
d. all of the above
44. The designation CPM stands for:  
a. Certified Property Member  
b. Certified Property Manager  
c. Certified Professional Marketing  
d. Certified Professional Member
45. A business normally consists of:  
a. personal property  
c. goodwill
- b. real property  
d. all of the above
46. Which of the following loans typically has the lowest interest rate?  
a. commercial bank loan  
b. VA loan  
c. CalVet loan  
d. FHA-insured loan
47. All persons who acquire or release an interest in a mobile home must notify the:  
a. Department of Real Estate  
b. Department of Motor Vehicles  
c. Department of Housing and Community Development  
d. Department of Federal Housing Administration
48. Acquiring title to real property by continued possession and payment of taxes for a continuous period of five years is called:  
a. adverse possession  
c. inverse occupancy
- b. reliction  
d. annexation
49. A built-in oven in a single-family dwelling is usually considered to be:  
a. separate property  
c. a fixture
- b. removable  
d. chattel
50. An easement is an example of:  
a. an encumbrance  
c. a chattel
- b. an emblemment  
d. a personal property
51. The Subdivided Lands Act is administered by:  
a. local governments

- b. California Department of Urban Planning  
c. California Real Estate Commissioner  
d. Department of Housing and Urban Development (HUD)
52. Under the Subdivided Lands Law, a Preliminary Public Report is good for a period of:  
a. 1 year    b. 2 years    c. 6 months    d. 9 months
53. Subdivision Map Act includes or applies to:  
a. agricultural leases  
b. contiguous parcels only  
c. financing or leasing of mobile home parks  
d. all of the above
54. The Act designed to control development in the vicinity of hazardous earthquake faults for the benefit of public safety is called:  
a. California Environmental Quality Act  
b. California Coastal Act  
c. California Earthquake Zones Act  
d. Alquist-Priolo Special Studies Zone Act
55. The act known as the Rumford Act is the:  
a. Unruh Civil Rights Act  
b. Housing Financial Discrimination Act  
c. California Fair Employment and Housing Act  
d. Civil Rights Act of 1968
56. The California Law that specifically forbids discriminatory loan practices by lenders is the:  
a. Unruh Civil Rights Act  
b. California Fair Employment and Housing Act  
c. Housing and Financial Discrimination Act  
d. Civil Rights Act of 1968
57. Which of the following exists when a tenant stays in possession of the property contrary to the owner's stated desire?  
a. estate for years  
b. estate at will  
c. periodic estate  
d. estate at sufferance
58. In connection with escrow, "impound" most nearly means:  
a. reserve  
b. attachment  
c. judgement  
d. principal and interest account
59. The Federal Reserve Board's Regulation Z enforces which federal law?  
a. Truth in Lending Act    b. Fair Practices Law  
c. Civil Liberties Law    d. none of the above
60. Which of the following best describes marketable title?  
a. flawless  
b. there is reasonable assurance as to the extent of rights or reservations to the use of a property  
c. doubtful but covered by a ALTA policy  
d. having severe defects but still sold through skillful techniques
61. Taxes levied on real estate by various government agencies and municipalities for the general support or operation of the government agency authorized to impose the levy are known as:  
a. excise taxes  
b. sales taxes  
c. ad valorem taxes  
d. none of the above
62. Proposition 13, the Jarvis Gann Initiative, limits real property taxes in California to \_\_\_\_\_ percent of the full cash value of the real property, plus the cumulative increase of \_\_\_\_\_ percent in market value each year thereafter.  
a. 5 and 10    b. 3 and 5    c. 2 and 3    d. 1 and 2
63. Real property taxes become a lien on:  
a. February 1    b. December 1  
c. March 1    d. November 1
64. When must an unmarried homeowner report the gain on the sale of a personal residence?  
a. when the homeowner is younger than 55  
b. when the gain exceeds \$1,000,000  
c. when the gain exceeds \$250,000  
d. when the gain exceeds \$100,000
65. The voluntary transfer of property from donor to donee free of charge, or for less-than-adequate consideration, is called:  
a. dedication  
b. tax evasion  
c. a gift  
d. stupidity
66. The income tax advantage for homeowners is:  
a. deductibility of mortgage interest  
b. deductibility of property taxes  
c. limited exclusion of gain on sale of personal residence  
d. all of the above
67. According to the MACRS recovery lives, non-residential real property is classified as:  
a. 31.5-year Class    b. 27.5-year Class  
c. 20-year Class    d. 15-year Class
68. According to the Tax Reform Act of 1986 there is a \_\_\_\_\_ percent credit for rehabilitation of buildings (other than certified historic structures) originally placed in service before 1936.  
a. 25    b. 20    c. 15    d. 10
69. An applicant for a real estate salesperson's license must be:  
a. 21 years old or older    b. 16 years old or older  
c. 19 years old or older    d. 18 years old or older
70. An applicant for a real estate salesperson license must answer at least \_\_\_\_\_ percent of the exam questions correctly.  
a. 70    b. 75    c. 80    d. 60
71. The conditional real estate salesperson license issued to a new licensee is valid for:  
a. 4 years    b. 2 years    c. 12 months    d. 18 months
72. The salesperson license permits activities as an:  
a. escrow agent    b. independent agent  
c. employee of the broker    d. all of the above
73. Under Section 10177 of the Real Estate Law, the Commissioner may suspend or revoke the license of any real estate licensee who has engaged in which of the following?  
a. induced the sale of property on the grounds that the entry into the neighborhood of persons of another race is causing the property to lose value.  
b. obtained the signatures of the prospective purchasers of a business prior to obtaining a written authorization to sell the business from the owner  
c. acted for more than one party in a transaction without the knowledge of all the principals  
d. all of the above
74. Licensees must keep all agreements, including listings, deposit receipts, leases, exchange agreements, etc. on file for a minimum of:  
a. 3 years    b. 5 years    c. 6 years    d. 10 years
75. The rights afforded an owner of land bordering on a water course, to use that water in a reasonable manner, are called:  
a. appropriation rights    b. riparian rights  
c. littoral rights    d. subjacent privileges

76. Which of the following is **NOT** a physical characteristic of land?  
 a. permanence                      b. scarcity  
 c. immobility                        d. non-homogeneity
77. Which of the following is formed to conduct business on a single project?  
 a. partnership                      b. corporation  
 c. trust                                d. joint venture
78. In a trust, the party which gives money or conveys property to a second party is called:  
 a. trustor                              b. trustee  
 c. beneficiary                        d. lender
79. A contract in which promises are exchanged by both parties is called:  
 a. an executory contract            b. a valid contract  
 c. a unilateral contract              d. a bilateral contract
80. According to the Statute of Limitations, an action for the recovery of real property must be brought within:  
 a. 5 years                              b. 4 years  
 c. 3 years                                d. 1 year
81. Contracts may be discharged by:  
 a. full performance                b. part performance  
 c. impossibility of performance    d. all of the above
82. Which of the following is **NOT** one of four main types of agency agreements used in real estate?  
 a. Closed Listing                    b. Open Listing  
 c. Net Listing                         d. Exclusive Agency
83. The party in a real estate transaction which becomes a trustee for the money and all the documents is known as:  
 a. principal                          b. broker  
 c. escrow agent                        d. seller's agent
84. Although the payment of closing cost is negotiable between the buyer and seller, the buyer usually pays for the:  
 a. real estate commission          b. recording fees  
 c. hazard insurance                 d. transfer tax
85. Ownership in severalty means ownership of property by:  
 a. several persons                    b. one person  
 c. a married couple                 d. a family
86. This form of ownership occurs when two or more people own property together with the right of survivorship:  
 a. tenancy in common                b. community property  
 c. tenancy by entirety                d. joint tenancy
87. A corporation that owns real estate for the sole purpose of providing housing for its shareholders is called a:  
 a. stock cooperative                b. limited equity housing cooperative  
 c. condominium cooperative        d. shared units cooperative
88. Which of the following is **NOT** an element of value?  
 a. utility                                b. demand  
 c. conformity                         d. transferability
89. A property maximum value is achieved when that property is situated in an area where the use of other property in the area is similar. This is the:  
 a. principle of conformity            b. principle of contribution  
 c. principle of substitution          d. principle of highest and best use
90. The appraisal method based on the principle that real property's highest price is equal to the value of the land plus the value of depreciated improvements on that land is called:  
 a. cost approach method            b. income approach method  
 c. market data approach method    d. value approach method
91. Which of the following are the forces affecting the value of real property?  
 a. physical forces                    b. economic forces  
 c. governmental forces              d. all of the above
92. The imprecise appraisal approach that produces only an informal indication of the value of property used for properties providing rental income is known as the:  
 a. income approach                 b. market data approach  
 c. cost approach                     d. gross rent multiplier
93. Standard length of the appraisal letter report is:  
 a. 10-15 pages    b. 1 page    c. 1-2 pages    d. 3-6 pages
94. A seller wishing to net a firm \$650,000 for his property works with a broker who charges a flat 5% commission. For how much should the broker list the property in order to achieve for his client the desired net?  
 a. \$682,685    b. \$658,369    c. \$684,211    d. \$675,500
95. How much will it cost to borrow \$700,000 for 30 years if the payments are \$6,000 per month?  
 a. \$1,300,000    b. \$1,420,000    c. \$1,460,000    d. \$1,520,000
96. A parcel of land sold for \$605,000. The buyer assumed the seller's \$453,000 mortgage. The transfer tax rate is \$0.55 per each \$500 of consideration paid, or fraction thereof. What is the amount of transfer tax due on the transaction?  
 a. \$170.50    b. \$167.20    c. \$190.25    d. \$200.70
97. Property being acquired by will is subject to a department of the Superior Court known as:  
 a. night court                        b. district court  
 c. estate court                        d. probate court
98. When a person dies without a will, the person is said to die:  
 a. without a way                      b. interstate  
 c. sotto voce                         d. intestate
99. The party granting a life estate is said to hold:  
 a. tenant interest                    b. human interest  
 c. co-ownership interest            d. reversionary interest
100. A qualification granted on conveyance which places a limitation on the buyer's ownership is called a(n):  
 a. inconvenience                    b. covenant  
 c. burden                              d. condition

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- 224 42. The Federal Home Loan Mortgage Corporation is often referred to as:  
 a. Freddie Mae                                      b. Fannie Mae  
 c. Ginnie Mae                                        d. Freddie Mac
- 240 43. An individual employed by an owner or management company to manage a residential apartment building or smaller complex is referred to as:  
 a. an individual building manager  
 b. a superintendent  
 c. a resident manager  
 d. all of the above
- 243 44. The designation CPM stands for:  
 a. Certified Property Member  
 b. Certified Property Manager  
 c. Certified Professional Marketing  
 d. Certified Professional Member
- 245 45. A business normally consists of:  
 a. personal property                                      b. real property  
 c. goodwill    d. all of the above
- 222 46. Which of the following loans typically has the lowest interest rate?  
 a. commercial bank loan  
 b. VA loan  
 c. CalVet loan  
 d. FHA-insured loan
- 253 47. All persons who acquire or release an interest in a mobile home must notify the:  
 a. Department of Real Estate  
 b. Department of Motor Vehicles  
 c. Department of Housing and Community Development  
 d. Department of Federal Housing Administration
- 82 48. Acquiring title to real property by continued possession and payment of taxes for a continuous period of five years is called:  
 a. adverse possession                                      b. reliction  
 c. inverse occupancy                                      d. annexation
- 22 49. A built-in oven in a single-family dwelling is usually considered to be:  
 a. separate property                                      b. removable  
 c. a fixture    d. chattel
- 80 50. An easement is an example of:  
 a. an encumbrance                                        b. an emblement  
 c. a chattel    d. a personal property
- 262 51. The Subdivided Lands Act is administered by:  
 a. local governments

- b. California Department of Urban Planning
- c. California Real Estate Commissioner
- d. Department of Housing and Urban Development (HUD)

262 52. Under the Subdivided Lands Law, a Preliminary Public Report is good for a period of:

- a. 1 year
- b. 2 years
- c. 6 months
- d. 9 months

267 53. Subdivision Map Act includes or applies to:

- a. agricultural leases
- b. contiguous parcels only
- c. financing or leasing of mobile home parks
- d. all of the above

269 54. The Act designed to control development in the vicinity of hazardous earthquake faults for the benefit of public safety is called:

- a. California Environmental Quality Act
- b. California Coastal Act
- c. California Earthquake Zones Act
- d. Alquist-Priolo Special Studies Zone Act

271 55. The act known as the Rumford Act is the:

- a. Unruh Civil Rights Act
- b. Housing Financial Discrimination Act
- c. California Fair Employment and Housing Act
- d. Civil Rights Act of 1968

271 56. The California Law that specifically forbids discriminatory loan practices by lenders is the:

- a. Unruh Civil Rights Act
- b. California Fair Employment and Housing Act
- c. Housing and Financial Discrimination Act
- d. Civil Rights Act of 1968

41 57. Which of the following exists when a tenant stays in possession of the property contrary to the owner's stated desire?

- a. estate for years
- b. estate at will
- c. periodic estate
- d. estate at sufferance

58. In connection with escrow, "impound" most nearly means:

- a. reserve
- b. attachment
- c. judgement
- d. principal and interest account

90 59. The Federal Reserve Board's Regulation Z enforces which federal law?

- a. Truth in Lending Act
- b. Fair Practices Law
- c. Civil Liberties Law
- d. none of the above

181 60. Which of the following best describes marketable title?

- a. flawless
- b. there is reasonable assurance as to the extent of rights or reservations to the use of a property
- c. doubtful but covered by a ALTA policy
- d. having severe defects but still sold through skillful techniques

282 61. Taxes levied on real estate by various government agencies and municipalities for the general support or operation of the government agency authorized to impose the levy are known as:

- a. excise taxes
- b. sales taxes
- c. ad valorem taxes
- d. none of the above

283 62. Proposition 13, the Jarvis Gann Initiative, limits real property taxes in California to \_\_\_\_\_ percent of the full cash value of the real property, plus the cumulative increase of \_\_\_\_\_ percent in market value each year thereafter.

- a. 5 and 10
- b. 3 and 5
- c. 2 and 3
- d. 1 and 2

283 63. Real property taxes become a lien on:

- a. February 1
- b. December 1
- c. March 1
- d. November 1

? 64. When must an unmarried homeowner report the gain on the sale of a personal residence?

- a. when the homeowner is younger than 55
- b. when the gain exceeds \$1,000,000
- c. when the gain exceeds \$250,000
- d. when the gain exceeds \$100,000

290 65. The voluntary transfer of property from donor to donee free of charge, or for less-than-adequate consideration, is called:

- a. dedication
- b. tax evasion
- c. a gift
- d. stupidity

295 66. The income tax advantage for homeowners is:

- a. deductibility of mortgage interest
- b. deductibility of property taxes
- c. limited exclusion of gain on sale of personal residence
- d. all of the above

301 67. According to the MACRS recovery lives, non-residential real property is classified as:

- a. 31.5-year Class
- b. 27.5-year Class
- c. 20-year Class
- d. 15-year Class

312 68. According to the Tax Reform Act of 1986 there is a \_\_\_\_\_ percent credit for rehabilitation of buildings (other than certified historic structures) originally placed in service before 1936.

- a. 25
- b. 20
- c. 15
- d. 10

159 69. An applicant for a real estate salesperson's license must be:

- a. 21 years old or older
- b. 16 years old or older
- c. 19 years old or older
- d. 18 years old or older

161 70. An applicant for a real estate salesperson license must answer at least \_\_\_\_\_ percent of the exam questions correctly.

- a. 70
- b. 75
- c. 80
- d. 60

161 71. The conditional real estate salesperson license issued to a new licensee is valid for:

- a. 4 years
- b. 2 years
- c. 12 months
- d. 18 months

163 72. The salesperson license permits activities as an:

- a. escrow agent
- b. independent agent
- c. employee of the broker
- d. all of the above

166 73. Under Section 10177 of the Real Estate Law, the Commissioner may suspend or revoke the license of any real estate licensee who has engaged in which of the following?

- a. induced the sale of property on the grounds that the entry into the neighborhood of persons of another race is causing the property to lose value.
- b. obtained the signatures of the prospective purchasers of a business prior to obtaining a written authorization to sell the business from the owner
- c. acted for more than one party in a transaction without the knowledge of all the principals
- d. all of the above

170 74. Licensees must keep all agreements, including listings, deposit receipts, leases, exchange agreements, etc. on file for a minimum of:

- a. 3 years
- b. 5 years
- c. 6 years
- d. 10 years

21 75. The rights afforded an owner of land bordering on a water course, to use that water in a reasonable manner, are called:

- a. appropriation rights
- b. riparian rights
- c. littoral rights
- d. subjacent privileges

- 15 (76) Which of the following is NOT a physical characteristic of land?  
a. permanence                      b. scarcity  
c. immobility                         d. non-homogeneity
- 28 (77) Which of the following is formed to conduct business on a single project?  
a. partnership                        b. corporation  
c. trust                                 d. joint venture
- 29 (78) In a trust, the party which gives money or conveys property to a second party is called:  
a. trustor                                b. trustee  
c. beneficiary                         d. lender
- 124 (79) A contract in which promises are exchanged by both parties is called:  
a. an executory contract                b. a valid contract  
c. a unilateral contract                d. a bilateral contract
- 130 (80) According to the Statue of Limitations, an action for the recovery of real property must be brought within:  
a. 5 years                                b. 4 years  
c. 3 years                                 d. 1 year
- 127 (81) Contracts may be discharged by:  
a. full performance                      b. part performance  
c. impossibility of performance        d. all of the above
- 135 (82) Which of the following is NOT one of four main types of agency agreements used in real estate?  
a. Closed Listing                         b. Open Listing  
c. Net Listing                             d. Exclusive Agency
- 142 (83) The party in a real estate transaction which becomes a trustee for the money and all the documents is known as:  
a. principal                              b. broker  
c. escrow agent                         d. seller's agent
- 145 (84) Although the payment of closing cost is negotiable between the buyer and seller, the buyer usually pays for the:  
a. real estate commission                b. recording fees  
c. hazard insurance                      d. transfer tax
- 43 (85) Ownership in severalty means ownership of property by:  
a. several persons                        b. one person  
c. a married couple                        d. a family
- 44 (86) This form of ownership occurs when two or more people own property together with the right of survivorship:  
a. tenancy in common                    b. community property  
c. tenancy by entirety                    d. joint tenancy
- 46 (87) A corporation that owns real estate for the sole purpose of providing housing for its shareholders is called a:  
a. stock cooperative                      b. limited equity housing cooperative  
c. condominium cooperative            d. shared units cooperative
- 326 (88) Which of the following is NOT an element of value?  
a. utility                                 b. demand  
c. conformity                             d. transferability
- 328 (89) A property maximum value is achieved when that property is situated in an area where the use of other property in the area is similar. This is the:  
a. principle of conformity                b. principle of contribution  
c. principle of substitution              d. principle of highest and best use
- 338 (90) The appraisal method based on the principle that real property's highest price is equal to the value of the land plus the value of depreciated improvements on that land is called:  
a. cost approach method                b. income approach method  
c. market data approach method        d. value approach method

- 329 (91) Which of the following are the forces affecting the value of real property?  
a. physical forces                        b. economic forces  
c. governmental forces                d. all of the above
- 344 (92) The imprecise appraisal approach that produces only an informal indication of the value of property used for properties providing rental income is known as the:  
a. income approach                      b. market data approach  
c. cost approach                         d. gross rent multiplier
- 350 (93) Standard length of the appraisal letter report is:  
a. 10-15 pages                        b. 1 page                              c. 1-2 pages                              d. 3-6 pages
94. A seller wishing to net a firm \$650,000 for his property works with a broker who charges a flat 5% commission. For how much should the broker list the property in order to achieve for his client the desired net?  
a. \$682,685                              b. \$658,369                              c. \$684,211                              d. \$675,500
95. How much will it cost to borrow \$700,000 for 30 years if the payments are \$6,000 per month?  
a. \$1,300,000                            b. \$1,420,000                            c. \$1,460,000                            d. \$1,520,000
96. A parcel of land sold for \$605,000. The buyer assumed the seller's \$453,000 mortgage. The transfer tax rate is \$0.55 per each \$500 of consideration paid, or fraction thereof. What is the amount of transfer tax due on the transaction?  
a. \$170.50                              b. \$167.20                              c. \$190.25                              d. \$200.70
97. Property being acquired by will is subject to a department of the Superior Court known as:  
a. night court                            b. district court  
c. estate court                            d. probate court
98. When a person dies without a will, the person is said to die:  
a. without a way                         b. interstate  
c. sotto voce                            d. intestate
99. The party granting a life estate is said to hold:  
a. tenant interest                        b. human interest  
c. co-ownership interest                d. reversionary interest
100. A qualification granted on conveyance which places a limitation on the buyer's ownership is called a(n):  
a. inconvenience                        b. covenant  
c. burden                                  d. condition

**NOTICE:**  
When you complete this exam, these questions must be returned to your monitor with your answer sheet. Both those items must be mailed by your monitor to:  
  
Real Estate License Services  
5059 Newport Avenue, #209  
San Diego, CA 92107  
  
If you have any questions, please telephone (619) 222-2421.



### 1.3.1 THE SPANISH PERIOD: 1513 - 1822

The Spanish period began with Balboa's discovery of the Pacific Ocean (1513) and lasted until Mexico's independence from Spain (1822). In 1513 the Spanish explorer Vasco Nunez de Balboa sighted the Pacific Ocean and claimed its waters and shores, including the land we now call California, for the King of Spain. From 1513 until 1822 all the land in California was held in the name of the King of Spain, and technically belonged to him. Ownership and transfer of property rights were governed by Spanish law which was an outgrowth of Roman Civil Law, as distinguished from the Common Law followed in England and its American colonies.

Briefly, under the Civil Law, judges were guided by elaborate codes imposed by the sovereign, usually the King or Queen or their representative. Under Common Law judges gave weight to both the unwritten law of custom and usage of the people as well as the written law of the sovereign and legislature. Specifically, under the Civil Law of Spanish Rule in California, the use of land could be acquired only by political or military agencies of the King. The grants were not outright transfers of title but instead were limited to specific usages such as agriculture or grazing.

### 1.3.2 THE MEXICAN PERIOD: 1822 - 1846

Mexican Rule of California began with the Mexican independence from Spain (1822) and ended with the military and political victory of Americans over Mexico in California (1846). Upon independence from Spain, the Mexican government encouraged the colonization of California and established governors who had absolute discretion in the selection of persons who could receive land. These grants were made through a system that included an application to the governor, and upon his approval, ratification by the Mexican legislature. These grants, known as "expedientes," were filed and recorded in government archives. The shapes and names of many California communities were determined long ago by these Mexican land grants. Many communities today in Central and Southern California trace their boundaries and histories back to these original Mexican land grants.

### 1.3.3 THE AMERICAN PERIOD: 1846 TO THE PRESENT

American Rule in California starts with the period of the victory of Americans over Mexico in California 1846 and includes the admission of California to the Union in 1850. Mexico's inability to maintain its sovereignty in California and other areas of the current Southwestern United States, coupled with the impetus of American settlers into those territories, led to tension and finally to the Mexican-American War (1846-1848).

In those early days of American presence in California, the difficulty of making land surveys and the lack of an adequate land recording system

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resulted in land title problems to the extent that for a time accredited landowners were required to keep the evidence of their titles in their physical possession.

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California's transition from Mexican to American sovereignty became final with the **Treaty of Guadalupe Hidalgo (1848)** under which California became an American possession. The Treaty required that existing property rights under Mexican rule be respected. California was admitted to the Union in 1850. To resolve land title disputes growing out of this period, Congress established the **Board of Land Commissioners (1851)** to hear and determine all private land title claims, subject to final review by the courts. The adjudications of this Board uniformly has been held to be conclusive as to the validity of the grants of title and of the boundaries involved.

## 1.4 DEVELOPMENT OF OWNERSHIP RIGHTS

Two historical models of land holding developed in Europe and are of historical significance, the *feudal system* and the *allodial system*.

### 1.4.1 FEUDAL SYSTEM

The feudal land holding system influenced all of the early Common Law concerning real property, and despite the fact that the *feudal system* never existed in the United States, it has played a vital role in shaping modern land law. The *feudal system* was both a system of government and a means of holding property in medieval Europe, especially in England. **Under this system, the King owned all the property and parcelled out holdings to royal vassals or lords for their use and occupancy in return for their pledge of loyalty and services.** In return, the vassals also parcelled out this land to their subordinates under similar terms. This process ultimately resulted in a chain of relationships that stretched from the King down to the lowliest vassal. **The king however never relinquished ownership of the land. The land held by the vassal under this system was called a "fief" or "feud," the source for the word "feudal."**

### 1.4.2 ALLODIAL TENURE SYSTEM

As the *feudal system* decayed, it was replaced by the *allodial tenure system of landholding*. The *allodial system* reflected the decline of the power of the Crown and the growth of the power of the individual. **This system recognizes the right of the individual to own land freely and absolutely without obligation to any political superior.** The unit of land under this system was called an "allod" or "allodium." Under this system, every parcel of land has a title which legally confers ownership. **Whoever**

### 1.8.2 U.S. GOVERNMENT SURVEY

A second method of land description used in California is the U.S. Government *Section and Township* method. This system was instituted by Congress in 1785 to standardize land descriptions in the territories of the Northwest Ordinance (Ohio, Illinois, Indiana, etc.); and, with the exception of the eastern seaboard states and Texas, this method is used throughout most of the United States today.

### 1.8.3 BASE LINE AND MERIDIANS

The key to the U.S. Government *Section and Township* method is the use of *base lines* and *meridians* starting from precise surveying points located throughout the country.

*Base lines* are horizontal lines which run east and west from a given starting point. Each *base line* is marked in six-mile increments called a *range*. *Meridian lines* are vertical lines that run north and south from a given starting point. *Meridian lines* are also marked off in increments of six miles called "*townships*." There are three starting points in California or principal *base line* and *meridians*. They are:

- A. Humboldt *Base Line* and *Meridian* (Northern California)
- B. Mt. Diablo *Base Line* and *Meridian* (Central California)
- C. San Bernardino *Base Line* and *Meridian* (Southern California)

See Figure 1-1 on the previous page, shows the principal *base lines* and *meridians* in California.

### 1.8.4 TOWNSHIPS

Note that *meridians* and *range lines* run north and south; *base lines* and *township lines* run east and west. The term "*township*" is used not only to describe the east-west lines every six miles above or below the *base line*, but the term "*townships*" refers to the area between the intersections of the *base line* and the *meridian*. A township is a square of land measuring six miles by six miles, containing thirty-six square miles. The location of any *township* is determined by its distance from the nearest *base line* and *meridian*. The *range lines* are the north-south lines separating *townships* on a government survey map, and the *township lines* are the east-west lines on the survey maps. Reference will be made in each *township* as to how far east or west and north or south it is from the principal *meridian* or *base line*. For instance, "T2N R3W, Mount Diablo *Base Line* and *Meridian*" means *Township 2 North* (i.e. 2nd

Property includes everything capable of being owned. Property may be real or personal. *Real property* is referred to as immovable. *Personal property* is referred to as movable.

## 2.4 REAL PROPERTY

*Real property* is the *land* and appurtenances (buildings and improvements) affixed to the *land*. *Real property* consists of four elements: *land*; anything permanently attached to the *land*; anything incidental or appurtenant to the *land*; and that which is immovable by law.

### 2.4.1 LAND

Under the law of *real property*, *land* is not only earth, but it is also water and air. *Land* is the solid material of the earth such as soil, rock, or other substances. The definition of *land* includes water flowing on *land* and the air space above it. The definition of *land* is all-encompassing; *land* includes the surface of the earth, the sky above, and everything to the center of the earth.

There are four rights flowing directly from the physical nature of *land*. These four rights are said to attach to the *land*. They are:

- A. Mineral rights
- B. Lateral support rights
- C. Airspace rights
- D. Riparian rights (also called Water rights)

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#### A. Mineral Rights

An owner's right to material on, in and below the surface of the *land* is called *mineral rights*. Holding *mineral rights* entitles the owner to mine ore, drill for oil and gas and to enjoy the profits derived from these rights. Mineral resources are considered *real property* so long as they remain in the ground; once extracted, they become *personal property*. The key factor to remember is that minerals may become movable.

An owner's right to withdraw ore from the owner's property differs from the right to withdraw hydrocarbons, such as oil and gas. Ore deposits are solid and their veins are stationary in the ground so that an owner can remove them without affecting adjacent properties. Unlike ore deposits, oil reserves exist in a liquid state and gas reserves exist in a gaseous state, so their deposits are in flux under pressure within the ground and may lie in a single pool and under several properties owned by different parties. The effect of one owner removing a hydrocarbon under pressure may likely deplete that resource.

from a location under another owner's property. This action is allowed under the *law of capture* which provides that an owner can capture hydrocarbons from reserves extending beyond the limits of the property so long as the owner drills from a point inside the owner's property.

#### B. Lateral support rights

The right of lateral support states that an owner of *real property* has the right to have the *land* supported and held in place from the sides by the adjoining neighbor's *land* in its natural condition. For example, a neighbor excavating the backyard for a swimming pool is required to assure lateral support for the adjoining properties in order that they do not collapse into the pool excavation.

#### C. Airspace rights

The common law concept of *land* includes both the space below as well as above the surface of the *land* (*airspace rights*). Air rights serve an owner's interest in two important ways. These rights act as a shield against a non-owner's encroachment on the owner's airspace. For example, a neighbor may not build a structure, such as a balcony or protruding roof over the adjoining neighbor's property. Secondly, the right allows the owner to maximize the use of the property by selling or leasing the airspace above the property to another party. For example, an owner may lease the airspace for the construction of a building. Although an owner may own the airspace above the *land*, the courts have recognized that the public has a right to use airspace for air transportation if such usage does not unreasonably interfere with the owner's enjoyment of the property.

#### D. Water rights

Water rights include two types of property rights that may apply to *land*. The first are known as *riparian rights*, which are the rights of a landowner to water on, under, or adjacent to the owner's *land*. The second are known as *littoral rights*, which are the rights of a landowner whose property borders a lake or ocean. Although the owner of *land* bordering on a river or other watercourse has no absolute ownership of the waters, the owner has the right to the reasonable use of water flowing past the *land*. *Riparian rights* provide that an owner's property may be increased or decreased by the natural action of water upon the owner's property. *Accretion* is the gradual and imperceptible addition of sediment to the shore by the flowing action of water. The *land* which results as an act of *accretion* is called *alluvium*. *Alluvium land* may consist of earth, sand or gravel. *Reliction* is the addition of *land* by the withdrawal of water, such as the permanent receding of water from a riverbed or lakebed. Also, an owner has the right to take water from the ground by drilling wells under the principle of *percolating rights*.

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## 2.4.2 ANYTHING PERMANENTLY ATTACHED TO THE LAND

Any object, whether natural or man-made, that is affixed to or forms a part of the *land* permanently is *real property*. Trees fall into this category as well as man-made objects such as building, bridges, fences, and built-in household appliances. There are instances however, whereby agreement of parties through a contract or by operation of law deems an object to be *personal property* when it would otherwise be *real property*. An example is *emblems*, which are growing crops that are cultivated for production. They are harvested annually and are considered *personal property* rather than *real property*.

## 2.4.3 FIXTURES

*Fixtures* are items of *personal property* that are attached to the *land* in such a manner as to be considered part of the real estate. Whether an item is considered a *fixture* depends upon the particular circumstances surrounding the item, including the nature of the item and the intention of the parties dealing with the item. For example, a lighting fixture will not be considered a *fixture* in the legal sense if it can be easily removed. Area carpets are not fixtures, but wall-to-wall carpeting may be. A built-in oven or a furnace will almost always be considered a fixture. The issue of whether an item is a *fixture* frequently arises when a house or other structure is bought or sold or when a tenant makes improvements and later the lease ends.

Certain items have been defined by code as *fixtures*. These include anything that is attached to the *land* by its roots, including trees, vines, and shrubs; or imbedded in the *land*, such as walls; or anything permanently attached to a building, such as cement, plaster, nails, bolts and screws.

When disagreement gives way to a lawsuit, the courts use a five-part test to determine whether an item is a *fixture*. The criteria for this test are often remembered by the acronym **MARIA**:

- M** 1. Method of attachments
- A** 2. Adaptability of the item for ordinary use
- R** 3. Relationship of the parties
- I** 4. Intention of the owner
- A** 5. Agreement (if any) between the parties

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### 2.4.5 ANYTHING IMMOVABLE

By law anything immovable is *real property*. Uncut timber, vines, shrubs, as well as a house, a barn, a garage, an in-ground pool or spa, a fence, and a well are all immovable and thus a part of the *land*.

## 2.5 RIGHTS OF OWNERSHIP

*Real property* also includes the “*bundle of rights*” inherent in the *ownership* of real estate. These are: the right to possess it; the right of use and quiet enjoyment; the right to encumber it; the right to dispose of it; and the right to exclude others from using it. Each of these rights is both *severable* and *divisible*. The term “*severable*” means that an owner can separate one right from another. Thus, an owner may separate the airspace in his property and lease it to a third party while continuing to retain all his remaining rights. The term *divisible* means that several owners can divide the rights among themselves. Accordingly, where there are two owners of a property, they may provide that one owner has the *airspace rights* while the other has the *mineral rights*, while all remaining rights are held by both of them. *Real property* consists not just of real estate alone but also of the rights of *ownership* which attach to it.

## 2.6 CHARACTERISTICS OF LAND

*Land* possesses seven basic characteristics, three of which are physical and four of which are economic. Combined, these characteristics demonstrate why *land* is unique.

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### 2.6.1 PHYSICAL CHARACTERISTICS OF LAND

#### A. Permanence

*Land* is **permanent**. Neither the actions of man nor nature destroy *land*. The face of the *land* may change as when trees are planted, topsoil is added or lost and buildings are built or razed, but the underlying nature of *land* itself makes it indestructible and durable.

#### B. Immobility

*Land* is **immobile**. While some of the substances of *land* are removable such as trees, topsoil and buildings, the earth's surface always remains. **The geographical location of any given piece of real estate can never be changed, it is fixed and rigid.**

### C. Non-homogeneity

**Land is non-homogeneous.** Each parcel of real estate is unique because no two parcels are ever the same. Every parcel of real estate differs geographically from every other parcel of real estate. Accordingly, because of this characteristic, courts will enforce by the remedy of specific performance the delivery of title to a specific parcel of real estate contracted for under the principle that no one can be required to accept a substitute for the actual real estate purchased, no matter how similar it may be in nature.

## 2.6.2 ECONOMIC CHARACTERISTICS OF LAND

### A. Scarcity

*Land* is deemed to be scarce in the sense that *land* is a finite commodity because the total supply is fixed. The supply of land will not increase in the future; its supply is static and closed. This characteristic of scarcity is also applicable in the specific sense of supply and demand. *Land* is viewed as scarce in those geographical areas that experience population or industrial expansion and require *land* as the basis for growth.

### B. Modification

The *modification* of a parcel of real estate affects the value and utilization of adjoining properties. This characteristic of *modification* affecting surrounding properties can extend through entire communities. As an example, the building of an airport in a community may result in a devaluation of nearby residential areas due to the increased traffic, while at the same time it may result in increased value for local commercial business properties for the very same reason.

### C. Fixity of location

**Improvements to a parcel of real estate by way of capital and labor are a fixed investment.** The income return on this fixed investment in real estate is usually long term, relatively stable, and in most instances extends over the economic life of the improvement. The construction of a building and its attendant service needs such as sewage, drainage, water and electrical are made with an eye to long-term usage because they cannot be economically moved or changed in character without a resultant loss.

### D. Situs

Every parcel of real estate is physically unique as described in the *non-homogeneous* characteristic above. The characteristic of *situs* adds to this



physical characteristic of uniqueness the economic characteristic of uniqueness. Since each parcel of real estate is unique physically, it follows that each parcel also has a unique economic profile, thus *situs*, which is also called area preference, reflects peoples' preferences which result in different valuations being attributed to similar parcels. What makes one location preferable to another is largely a matter of personal choice. The criteria for *situs* for a residential owner may include the accessibility of schools, recreation and stores, while for a commercial owner it might include street location, traffic patterns and parking availability.

## 2.7 PERSONAL PROPERTY

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As stated earlier, *personal property is everything that is not real property. Choses in action are items of intangible personal property, representing a right to something of value but which in itself is not valuable, such as a stock certificate or trust deed.* Another example of *intangible personal property* is a contract. A lease is a contract to use the land of another and is referred to as a *chattel real*. *Choses in possession* are items of *tangible personal property* such as furniture and automobiles. It is the possibility of mobility that distinguishes *personal property* from *real property*.

## 2.8 OWNERSHIP BY BUSINESS ENTITIES

People may own property or do business as individuals or they may choose to group together in *ownership*. When people group together to do business it is known as a **business entity**. The type of business entity involved may determine the way property can be held. A particular method of *ownership* may be chosen for a variety of reasons, including the relationship of the parties, tax aspects, and the desire for management and control or to minimize individual liability.

### 2.8.1 SOLE PROPRIETORSHIPS

The most common form of business entity is a business owned by one individual. This is known as a sole proprietorship. The owner is responsible for all of the income of the business and is liable for all its debts.

### 2.8.2 GENERAL PARTNERSHIPS

Two or more people who join together to conduct a business for profit are known as a **partnership**. Business is done in the name of the partnership and title to partnership property should be held in the partnership name. By law, each partner has the right to make contracts or execute

documents that bind the whole partnership. Each partner in a partnership enjoys equal possession rights of property, though not necessarily an equal *ownership* share in the partnership. Partners have unlimited liability for partnership debts. A creditor may collect all monies owed from any one partner if desired. Taxes are paid by the individual partners on income from the partnership.

### 2.8.3 LIMITED PARTNERSHIPS

To overcome the disadvantage of unlimited liability, California and many other states allow the formation of limited partnerships. There are one or more general partners who manage the business and have unlimited liability for all debts. Other partners are limited partners who are permitted only a very nominal part in management of the partnership, but have no liability for the debts of the partnership; the most they stand to lose is the money they have invested. If the limited partners are active more than nominally in the management of the partnership, they may lose their status as limited partners and be considered general partners with all the attendant duties, responsibilities, and liabilities.

Limited partnerships have been a popular method of investing in real estate and most syndications in California take this form of *ownership*. Limited partners receive the tax advantage of a partnership and the limited liability of corporation shareholders on invested money.

### 2.8.4 JOINT VENTURES

If two or more people join together to conduct business on a single project, it is known as a joint venture. A joint venture is very similar to a partnership and is governed by almost all the same rules, including unlimited liability for debts of the venture.

### 2.8.5 CORPORATIONS

A corporation differs from sole proprietorships and partnerships in that it must obtain a charter from the state in which it incorporates, and for many purposes it is treated as a person by law. People or other corporations buy shares in a corporation and elect a board of directors responsible for overseeing the management of the business. A corporation can sue and be sued in its own name, but the shareholders have liability limited to the value of their shares. In general, the corporation, not the shareholders, is liable for debts and liabilities. Corporations pay income taxes directly and shareholders are taxed on dividends or distributions of corporate profits.

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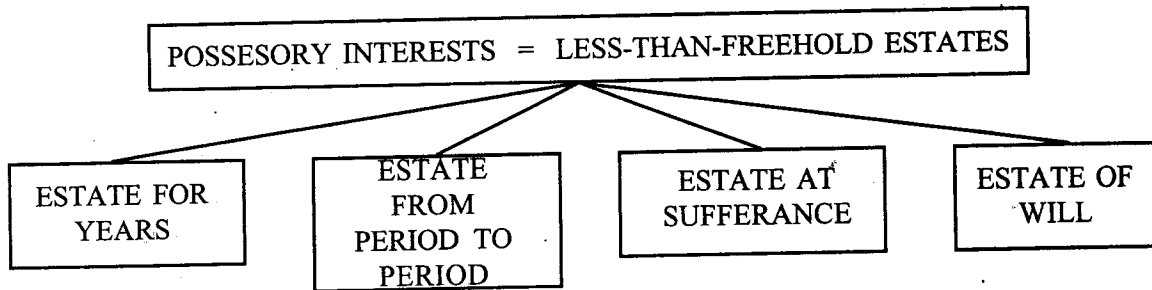
### 2.8.6 TRUSTS

**A trust consists of three parties, a trustor, a trustee and a beneficiary. The trust is an arrangement in which property is held by one party for the benefit of another. The trustor gives money or conveys property to a second party, known as the trustee, to hold and use for the benefit of a third person, known as the beneficiary. A trustee or beneficiary may be an individual, an institution, or a corporation.** Trusts are often set up to make sure that property is preserved and managed for the beneficiary, or for tax advantages. The trustee is bound to act in the beneficiary's interest when administering the entrusted property. The powers of the trustee are set out in the written agreement creating the trust, which may be a formal trust agreement, a deed, or a will.

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### 2.8.7 REAL ESTATE INVESTMENT TRUSTS (REITS)

**A special form of trust set up specifically to invest in real estate and which enjoys special income tax advantages is the Real Estate Investment Trust, popularly called a "REIT."** Investors buy shares and the trustee then invests the money in real estate or mortgages. Equity trusts invest in real estate, mortgage trusts invest in mortgages and combination trusts invest in both real estate and mortgages. To qualify for tax advantages under the Internal Revenue Code, REITs must meet specified criteria, including the disbursement of 95 or more percent of their ordinary income to shareholders.



The term *estate* refers to the degree, quality, nature and extent of interest that a person has in real property. The *estate* one has in real property determines the extent of ones ownership.

### 3.4 CLASSIFICATIONS OF ESTATES

*Estates* are divided into two classifications: *freehold estates* and *less-than-freehold estates*. The basis for these classifications is the duration of each *estate*.

#### 3.4.1 FREEHOLD ESTATES

*Freehold estates* are *estates* of indeterminable duration. Indeterminable means a duration which is not known in advance. A *freehold estate* is an *estate* whose term can not be ascertained at the time of its creation. *Freehold estates* may be *fee simple absolute*, *fee simple qualified*, or *life estates*.

##### A. Fee simple absolute

The *estate* in fee is the largest *estate*. It is of infinite duration, lasting forever. The owner of an *estate in freehold* owns all rights incident to the real property. The owner can dispose of the *estate* by sale or gift, or on death by will or intestate succession. Unless otherwise specified by the conveyance of title, there is a presumption at law that an *estate* in fee is being conveyed whenever there is any grant of real property. The term *estate in fee simple absolute* means the owner holds the *estate* in fee without any qualifications attached to it. The terms *estate* in fee and *estate in fee simple* are interchangeable.

##### B. Fee simple qualified

The term *estate in fee simple qualified* means the owner holds the *estate* in *fee simple* but with a condition attached to it. It is qualified by condition or limitation and is also called a determinable fee *estate*. Breaking any condition or limitation of the transfer terminates or causes a revocation of the *estate*.

- Is responsible for taxes, routine annual expenses, and a just proportion of extraordinary assessments.
- Can not pass the property on to designated heirs. (It is this restriction on inheritability that basically distinguishes the *life estate* from the other types of *freehold estates*.)

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The party granting a *life estate* holds an *estate in reversion* or a *reversionary interest*. The property is returned to him/her upon the death of the *life estate* holder.

If an owner granting a *life estate* names another person to receive title upon the death of the holder of the *life estate*, that other person claims an *estate in remainder* or a *remainder interest*. The holder of an *estate in remainder* has no right to the use and enjoyment of the property until the life tenant dies, at which time the remainderman acquires the *estate fee simple*, without the limitations that attach to the *life estate*.

### 3.4.3 LESS-THAN-FREEHOLD ESTATES

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Less-than-freehold estates are rights to the use of real property for a period of time. The term "less-than-freehold" derives from common law and dates back to the Middle Ages in England. These estates are commonly referred to as "leases" or "rental agreements" (possessory interests in realty). The lessor, or landlord, gives the right to exclusive possession and use of the property to the lessee, or tenant. The lessee does not have an ownership interest in the property but a leasehold estate. The lessor retains title to the property and the lessor's right to receive possession of the property after the lease term is expired is known as reversion. The lease or rental agreement is considered personal property as there is no true ownership of the property.

#### A. Types of leases

*Leases (less-than-freehold estates)* are distinguished by their duration:

- a. Estate for years
- b. Estate from period to period
- c. Estate at will
- d. Estate at sufferance

##### a. Estate for years

An *estate for years* is a *lease* that has a fixed duration agreed upon by the lessor and lessee. "For years" can be misleading because the fixed duration of the *lease* may be any defined period with a specific starting and ending time, for example, a week, month, year, or number of years up to a maximum of 51 years for agricultural or horticultural land or 99 years for property within

a city or town. If a *lease* is for any specific set term, it is an *estate for years*. An *estate for years* terminates automatically at the end of the agreed term. In most instances the lessor is the owner of the *leased* property. There are times however, when the lessor is also a lessee. For example, if a lessee *leases* to another person, the first lessee becomes the sublessor and the second lessee becomes the sublessee. A sublessee can never acquire a greater right than that possessed by the sublessor. A lessee who has a ten-year *lease* can only sublease to a sublessee the ten years to which the lessee is entitled.

**b. Estate from period to period**

An *estate from period to period* (also called a periodic tenancy) is one that has no fixed duration and continues from period to period as designated by the lessor and lessee in the *lease* agreement. The period may be any specified time of a day, week, month, year, or any combination. **The most common example of an *estate from period to period* or periodic tenancy is a month-to-month *lease*.**

**c. Estate at will**

An *estate at will* is one that has no fixed duration and can be terminated at will or by the unilateral decision of either the lessor or the lessee. This form of *lease* is no longer common because the lessor's acceptance of periodic payments (e.g., monthly rent) will be deemed to have created an *estate from period to period* under California law. In order to avoid any injustice that might occur by the abrupt termination permissible under an *estate at will*, the law requires 30 days' notice of termination by the lessor or the lessee in order to end the *lease*.

**d. Estate at sufferance**

An *estate at sufferance* is created when a lessee who took possession under a *lease* wrongfully retains possession of the property after the *lease* term has ended. A tenant who continues in possession of the property (this is called holding over) after the term of a *lease* has ended is a tenant at sufferance.

**3.5 LEASES**

A *lease* states the conditions under which the tenant may occupy and use the property and the term of that occupancy. A *lease* has a dual function. First, it is a conveyance of an *estate* in real property. Secondly, it is a contract between the lessor and the lessee regarding the use of the property. The relationship between the lessor and lessee and the obligations of one to the other are established by those obligations growing out of the landlord-tenant relationship and those arising from contract.

### 3.5.1 ELEMENTS OF A LEASE

There are seven elements to a *lease*:

- A. Identification of parties and capacity to contract
- B. Adequate description
- C. Agreement of parties
- D. Stated consideration and duration
- E. Rights and obligations
- F. Legal purpose
- G. Lessor must execute

#### A. Identification of parties and capacity to contract

The parties to the *lease* must be named in the *lease* and have legal capacity to enter into the *lease*. The term legal capacity means that a person is of legal age to contract and is not suffering a legal disability such as acting under duress or not being of sound mind.

#### B. Adequate description

The premises to be *leased* must be adequately described.

#### C. Agreement of parties

Both parties must agree to the term, conditions, and covenants in the *lease*. The word "term" means the length of time for which the *lease* will last. For example, a *lease* with a one-year term ends one year after the date the *lease* begins. The word "conditions" means the obligations which both the lessor and lessee must abide by during the term of the *lease*. The word "covenant" means a promise to do or not to do some act.

#### D. Stated consideration and duration

The amount of the consideration for the *lease*, usually specified as the rent, and the duration, or term, of the *lease* must be stated. California law requires that the length of the *lease* term be stated. California law also set limits on the duration of different types of *leases*. Agricultural land may be leased for a maximum period of 51 years while urban property may be leased for a maximum of 99 years.

No *lease* in California may be made for a term in excess of 99 years.

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### E. Rights and obligations

The rights and obligations of each party must be stated.

### F. Legal purpose

The purpose of the *lease* must be legal. If the underlying purpose for the *lease* is to permit an illegal activity to occur (for example, the *lease* of office space for illegal gambling), then the *lease* may not be enforced by the courts because enforcement would be against public policy.

### G. Lessor must execute

Because a *lease* is considered to be, in a technical sense, the conveyance of an interest in real property, the *lease* must be signed by the lessor. The tenant need not sign the *lease* so long as he has taken actual physical possession of the property.

## 3.6 STATUTE OF FRAUDS

The California Statute of Frauds states that a *lease* that will not be fully performed within one year of its signing must be in writing. The law further requires that any alterations to the *lease* terms must be in writing. Failure to observe these formalities may render the *lease* or any alteration unenforceable.

## 3.7 VARIOUS TYPES OF TITLE

Title is a combination of all the elements constituting proof of ownership. It indicates the fee position of lawful ownership or right to property and the bundle of rights possessed by an owner.

### 3.7.1 SEVERALTY

Severalty or sole ownership is the ownership of property by one person, the rights of ownership are not shared. The word "*severalty*" can be misleading since it does not mean several but actually means one. Since corporations are legal entities regarded as a person, property held by a corporation may be owned in *severalty*.

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### 3.7.2 CONCURRENT OWNERSHIP

*Concurrent ownership* means simultaneous ownership by two or more persons. *Concurrent ownership* is also known as co-ownership or joint ownership. In California the forms of *concurrent ownership* are *tenancy in common*, *joint tenancy*, *community property* and tenants in partnership.

#### A. Tenancy in common

*Tenancy in common* is an interest held by two or more persons, each having a possessory right in the same piece of property. *Tenancy in common* is characterized by the unity of possession. Though co-tenants may have unequal shares in the property, they are each entitled to equal use and possession. Thus, each is said to have an undivided interest in the property. An estate held as a *tenancy in common* may be partitioned, sold, or encumbered.

Each owner of a *tenancy in common* may sell, transfer or will his interest separately from the other owners. The recipient of the interest then takes the place of the prior tenant and the *tenancy in common* continues as before. **If the owners of the property are unable to agree among themselves as to the management of the property, then any one of them may apply to the Court for an order that the property be sold and that the profits from the sale, if any, be divided in the same proportion as each owner has in the tenancy. This procedure is called a partition suit.**

When a conveyance is made and there is no direct reference to taking the property as joint tenants, tenancy in partnership, or *community property*, a *tenancy in common* is presumed.

#### B. Joint tenancy

**Joint tenancy occurs when two or more people own property together with the right of survivorship. If one of the owners dies, his interest is split among the surviving owners.** No new deed is required for the *joint tenancy* to continue, and no probate is required for the interest to transfer. The term *joint tenancy* carries within its definition the principle of right of survivorship. It is not necessary to specify the right of survivorship as long as the term *joint tenancy* or joint tenant is utilized.

**A joint tenancy has four unities:**

- A. Interest - All owners share an equal interest.
- B. Title - All owners are granted title to the property by the same instrument.
- C. Time - All owners obtain title at the same time.
- D. Possession - All owners have an equal right to possess the property.

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## E. Tenancy in partnership

Tenancy in partnership refers to two or more persons, as partners, who own property for partnership purposes. As noted earlier, a partnership is an association of two or more persons joined together for business purposes. Strictly speaking, a partnership does not meet the precise definition of *concurrent ownership* since, like a corporation, a partnership can own property as a single legal unit. Each partner in a partnership enjoys equal rights to possession of partnership property for partnership purposes though not necessarily an equal ownership share, in the partnership. Each partner shares an equal interest in the income and expenses of the property unless otherwise agreed upon. If one partner dies, title vests in the surviving partner(s) to carry on the business but only for the purpose of winding up the partnership affairs.

## F. Co-ownership

In recent years there has been a growing popularity for co-ownership concerns. These include *condominiums*, *stock cooperatives*, *planned development projects* and *time shares*.

### a. Condominiums

A *condominium* is an *estate* consisting of a separate ownership (undivided interest) in some particular space or unit in a parcel or real *estate*, together with an interest in common (divided interest) with others on other parts of the parcel. On the common areas, which generally consist of the land along with all structural portions of the buildings, title is held by all owners as tenants-in-common. With respect to duration of its enjoyment, a *condominium estate* or interest may be a *fee simple estate*, a *life estate*, or an *estate for years*. Owners are entitled to a separate tax bill and can encumber and insure their interest. *Condominiums* may be residential, industrial or commercial.

### b. Stock cooperatives

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A *stock cooperative* is a corporation that owns real estate for the sole purpose of providing housing for its shareholders. Legal title to the entire project is vested in the corporation (or association) itself, which holds the property in *severalty*. Shareholders in the cooperative are usually called members of the cooperative. The share of stock or certificate of beneficial interest entitles the shareholder or member to the exclusive use of one of the units under a special kind of lease known as a *proprietary lease*. A *proprietary lease* is a lease that provides the cooperative shareholder member with rights that are more than an ordinary renter's but less than a full owner's rights. In effect, the cooperative member leases a housing unit from the cooperative as contrasted with the

## 4.3 ACQUISITION OF PROPERTY

The California Civil Code specifies **five ways by which property may be acquired: will, succession, accession, occupancy, and transfer.** Disposition of an owner's property when he or she dies is handled by *will* or *succession*. *Accession* occurs by the processes of *accretion*, *reliction*, and *annexation*. *Occupancy* may take the form of *adverse possession*, *prescription* or *abandonment*. Transfer may be voluntary or involuntary and is acquisition by an act of the parties or of the law.

### 4.3.1 WILLS

#35 ( A will is an instrument used to direct who will receive property upon the death of its owner. The person drawing up a *will* is called a "testator," if male, and a "testatrix," if female. The *will* only becomes effective at the time of death. An *executor* or *executrix* is the male or female person named in a *will* to carry out its provisions as to the disposition of the estate. The devisee is the person who receives real property by *will*. There are three types of wills recognized in California: the witnessed will; the holographic will; and the statutory will.

#33 The nuncupative will is no longer valid in California.

#### A. Probate court

#97 Property being acquired by will is subject to a department of the Superior Court known as the probate court. Probate procedure commences with a "petition for probate" of a will or for letters of administration if there is no will. Notice to creditors must be published giving all creditors four months within which to file their claims against the estate. During the probate period property may be sold by the executor or executrix subject to court approval.

##### a. Probate court sales of realty

The initial offer in a *probate* real estate sale must be for a price at least **90 percent of the property's appraised value.** The court may be petitioned to confirm the sale, and at the hearing any interested person may bid. **Bids must be in excess of the original bid by at least 10% of the first \$10,000 bid and 5% of the bid in excess of \$10,000.** After confirmation of a sale, normal escrow procedures are used to consummate the transaction on the terms and conditions approved by the court. Once the time for filing creditors' claims has expired, an accounting must be filed of all receipts and disbursements for the estate and the court petitioned for a distribution of the remaining assets to the proper heirs and devisees.

## B. Witnessed wills

A witnessed *will* is a formal written document signed by the maker and declared to be his or her last *will* in the presence of at least two witnesses who must also sign the *will* in the presence of the maker. It is not necessary for the witnesses to be aware of the contents of the *will*. A witnessed *will* is ordinarily prepared by an attorney, but statutory *wills* which merely require the insertion of necessary information are permitted when prepared in accordance with the authorized format and properly witnessed.

## C. Holographic wills

A *holographic will* is one entirely written, dated, and signed in the *testator's* own handwriting. No other formalities are required. *Holographic wills* frequently result in lawsuits if unclear.

## D. Statutory wills

A statutory will is a basic fill-in-the-blank form, which forms a legal will when the instructions are followed. Anyone of sound mind and over the age of 18 may execute a California statutory will. The execution of the attestation clause in the California statutory will by two or more witnesses satisfies the requirements of the California Probate Code.

### 4.3.2 *INTESTATE SUCCESSION*

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When a person dies without a *will*, the person is said to die *intestate* and the Statutes of *Succession* provide for disposition of the property to the heirs. In the simplest cases, separate property is equally divided between a surviving spouse and one child, or split one-third to the surviving spouse and two-thirds to the children if there is more than one child. The surviving spouse receives all community property regardless of the number of children. Should a person die without known heirs, title to the property will *escheat* to the State of California. Estates permanently *escheat* to the state if they are unclaimed after five years.

### 4.3.3 *ACCESSION*

*Accession* refers to an addition to property through the efforts of man or by natural forces. As discussed in Chapter 2, *accretion* is the process of gradual addition of land bordering a stream, river, lake, or ocean shoreline from natural causes. The land deposited as the result of *accretion* is known as "alluvium" or "alluvion." *Accession* also occurs by *reliction* when land that has been covered by water is exposed by the receding of water. When land is torn or washed rapidly away by the action of water, it is called *avulsion*.

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#### 4.5.4 OTHER CONVEYING INSTRUMENTS

##### A. Installment sale contracts

An installment sale contract or an installment land sale contract is an agreement whereby an owner agrees to convey legal title to real property after the purchase price is paid in installments over a long period of time. Legal title is retained by the seller until the final payment has been received by the seller, then a *deed* is delivered, but equitable title passes to the buyer at the time of initial sale. With equitable title the buyer may be able to encumber the contract interest, declare a homestead on it, or *transfer* it. Should the buyer default, the payments may be forfeited.

##### B. Bill of sale

Should the buyer of real property also want to acquire some of the seller's personal property, such as furniture, the document used to effect such a *transfer* is called a bill of sale. **The bill of sale is the written instrument given to pass title of the personal property from the seller (vendedor) to the buyer (vendee).**

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##### C. Assignments

While the bill of sale transfers title to tangible personal property, intangible personal property is transferred by a document called an assignment. Assignments are frequently used with the transfer of certificates of stock in mutual water companies. If a *transfer* of the certificates is necessary or desired, the certificates are surrendered to the water company with an assignment from the owners. New certificates are then issued to the purchaser by the water company which may charge a *transfer* fee and require all outstanding bills and assessments to be bought current.

Assignments are also used extensively in transferring a tenant's rights under a lease if under the terms of the lease the lease is assignable.

#### 4.5.5 DOCUMENTARY TRANSFER TAX

California allows a county or city to adopt a documentary *transfer* tax to apply on all transfers of real property located in the county. Notice of payment is entered on the face of the *deed* or on a separate paper filed with the *deed*. Documentary *transfer* taxes will be discussed later in this book in the chapter on taxation.

5.3 LIENS

A lien is a form of money encumbrance which usually makes specific property security for the payment of a debt or discharge of an obligation. Liens may be classified as voluntary, those which the owner can prevent and freely accepts, or involuntary, those which an owner does not wish to accept or those created by operation of law. In California, the most common voluntary lien is the deed of trust used as security for a loan. In other states the use of a mortgage as a financing instrument is common. Real property subject to a trust deed or mortgage has been hypothesized as security for payment of a debt or other obligation. Such property has been made subject to a voluntary lien. Failure to satisfy the debt or obligation can result in the seizure of the property and its sale to satisfy the lien against it. These voluntary liens will be discussed in detail in Chapter 10 Real Estate Finance. The most common involuntary liens include mechanic's liens, judgments, and tax liens.

~~Liens are also described as specific liens or general liens: A specific lien is a charge against a particular parcel or one subdivision, whereas a general lien affects all property of a particular owner.~~

5.3.1 MECHANIC'S LIENS

A mechanic's lien is a lien created by statute which exists against real property in favor of persons who have performed work or furnished materials for the improvement of real property. The term "mechanic" includes anyone who performs labor, bestows services, or furnishes material or equipment on a construction project. A mechanic's lien must be founded upon a valid contract with the property owner, general contractor, or subcontractor.

A. Notices

In order to qualify for a mechanic's lien, a written Preliminary Notice must be filed with the owner, general contractor and construction lender within 20 days after the work on the property has begun or materials supplied. The notice may be served by hand delivery, or first class, registered, or certified mail. Failure to give the preliminary notice within 20 days does not preclude the right to give a preliminary notice at a later time, but claim rights may be subordinated to other claims.



### 5.3.2 ATTACHMENT LIENS

An *attachment lien* is a court process by which property may be seized and held as security for a possible future *judgment* by levy of a *Writ of Attachment*. The *attachment* is a valid *lien* against the property seized for a three-year period after the day of levy of the writ unless sooner released or discharged. An *attachment* does not terminate upon the death of a defendant. The property cannot be sold while under a *writ of attachment*, but is retained in the custody of the court pending the outcome of the lawsuit. The law places numerous limitations on obtaining a prejudgment *attachment* and, therefore, they are not as common as *judgment liens*. One reason may be that the court requires a substantial bond from the party seeking the *attachment* in order to protect the other party if the *attachment* proves wrongful, i.e. it was not necessary.

### 5.3.3 JUDGMENT LIENS

A *judgment* is the final determination of the rights of the parties involved in an action or court proceeding. A *judgment* does not automatically create a *lien*, the *lien* is created once the court establishes personal liability of the debtor for a definite sum and a properly certified *Abstract of Judgment* or court decree is recorded. At that time a *lien* is created on all real property, not exempt, owned or acquired by the debtor in the county where the judgment is recorded. The *lien* continues for ten years from the date of entry of the *judgment* and is subject to renewal for another ten years if the *judgment* is not satisfied during the original ten year period.

### 5.3.4 LIS PENDENS

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~~A *lis pendens* is a notice filed or recorded for the purpose of warning all persons that title or right to the possession of certain real property is in litigation; literally it means "suit pending". The *lis pendens* acts as a cloud on the title until removed, the action dismissed, or a final *judgment* rendered.~~

### 5.3.5 TAX LIENS AND SPECIAL ASSESSMENTS

Tax *liens* are involuntary *liens* resulting from the burden or charge imposed against property by cities and counties empowered to levy and collect property taxes. Tax *liens* tend to be paramount to all other claims and *liens* against a property because of their importance to government. The specifics of tax *liens* and special assessments will be discussed in Chapter 14.

## 5.4 HOMESTEADS

A *homestead* is a special provision of the California law which allows homeowners to protect their home from forced sale to satisfy their debts, within certain limits. By law, a *homestead* consists of a family dwelling, along with all outbuildings and the land upon which they rest. This can include condominiums, cooperative housing units, mobilehomes, and leaseholds with an unexpired term of two years or more. It is required that the claimant actually reside in the *homestead* as a residence.

In order to qualify for the *homestead* exemption the following requirements must be met: the signatures of the claimant(s) notarized and the exemption recorded. Omission of any one of the requirements can invalidate the *homestead*.

- A. A statement showing the name(s) and status of the person(s) filing.
- B. A statement that the claimant is residing on the premises and claims it as his or her *homestead*.
- C. A description of the premises.

### 5.4.1 AMOUNT OF HOMESTEAD EXEMPTION

Once a valid Declaration of *Homestead* is executed by a claimant, acknowledged, and recorded with the county recorder, the owner's equity is protected to the extent of:

- A. \$150,000 For anyone 65 or older (single or married) or persons who are mentally or physically disabled, regardless of age, and certain low income homeowners 55 years or older.
- B. \$75,000 For a married person or head of household.
- C. \$50,000 For all other single persons.

### 5.4.2 SALES OF REALTY BY CREDITORS

Under a *homestead*, a home can be sold by *judgment* creditors if the equity in the property exceeds the *homestead* exemption. The proceeds are distributed in the following order:

- A. To discharge all *liens* (if any) prior to the *judgment* creditor.
- B. To the *judgment* debtor to the extent of the exemption.
- C. To discharge the amount of claim by the *judgment* creditors.
- D. Any remaining proceeds go to the *judgment* debtor.



### 5.4.3 EFFECT ON TAX LIENS, MECHANIC'S LIENS, OR TRUST DEEDS

A *homestead*, even though valid, will not defeat tax *liens* or *mechanic's liens* or trust deed and mortgage instruments.

### 5.4.4 TERMINATION OF HOMESTEAD EXEMPTION

Once a valid declaration of *homestead* is filed, it may only be terminated by the claimants filing a new *homestead* on another property or by the claimant filing a Notice of Abandonment of *Homestead*. Sale of the property terminates a *homestead* and the proceeds will be exempt for up to six months following the sale. Removal or destruction of the dwelling does not terminate the *homestead*. A dissolution of marriage or death of a spouse will not terminate a *homestead* if one spouse remains in possession of the title.

## 5.5 EASEMENTS

An *easement* is a non-money *encumbrance* and is an interest in the land of another that entitles the owner of the *easement* to use the land for a limited purpose.

*Easements* fall into two classes: *appurtenant easements* and *easements in gross*. *Appurtenant easements* attach to a parcel of land for the benefit of that land, known as the "*dominant tenement*." The land that is subject to, or burdened with, the *easement* is known as the "*servient tenement*." An *appurtenant easement* is said to "run with the land." That is, it does not belong to any one individual but attaches to the land itself. Thus, when the land is sold, providing the *easement* is properly recorded, the *easement* will pass with title to the land to the new owner.

*Easement in gross* refers to *easements* that do not have a *dominant tenement* and are not appurtenant to any particular parcel of land, such as those given to a telephone company to install and maintain wires and poles or to a gas company to run pipelines or to an electric company to install and maintain its wires.

### 5.5.1 CREATION OF EASEMENTS

Easements may be created by a number of means; the most common of which are:

- A. Mutual agreement
- B. Necessity or implication
- C. Dedication
- D. Prescription
- E. Condemnation

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#### A. Mutual agreement

The parties involved may mutually agree to create an *easement*. A property owner may mutually agree with another to permit the running of a driveway over the first owner's land to serve the second owner. This agreement must be set forth in writing in the form of a written agreement such as a deed or contract. The *easement* must comply with all the necessary essentials of a deed and be signed by the owner of the property (*servient tenement*) over which the *easement* lies.

#### B. Easement by necessity or implication

Implicit in the ownership of real property is the right of ingress and egress to it. Therefore, land which is "landlocked" may claim an *easement of necessity* over adjoining land. An owner of land which is otherwise inaccessible may appeal to the courts and ask for an *easement* over land the seller of the landlocked parcel may own. Should the seller of the landlocked parcel not have an adjoining parcel upon which an *easement* may be granted, the buyer of the landlocked parcel may be permanently landlocked. An *easement* may also be implied as when an owner of property grants an *easement* for water rights on his property, and this would imply an *easement* for ingress and egress so that the owner of the water rights can, in fact, obtain the water.

#### C. Easement by dedication

A property owner may voluntarily dedicate certain portions of land for public use. Examples include widening and extension and creation of new streets, and the grants of open space and parkland for public use.

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D. Easement by prescription

In the event a party makes open, hostile, exclusive and notorious use of another's property over a period of time, an *easement by prescription* may be created. The use must be without the owner's consent and the *easement* is created in much the same manner as title is obtained through adverse possession of property. The failure of the owner to defend his or her rights gives rise to the *easement*.

E. Easement by condemnation

Just as public or quasi-public agencies may acquire real property by condemnation, they are also empowered to acquire *easements*. When *easements* are acquired by condemnation, due process of law is required and the property owner must be paid just compensation.

5.5.2 TERMINATION OF EASEMENTS

*Easements* may be terminated in a number of ways, including:

- A. Merger of the tenements
- B. Voluntary relinquishment
- C. Non-use for five years (prescriptive *easement* only)
- D. Destruction of the servient tenement

A. Merger of the tenements

In the event that a dominant and *servient tenement* are joined under a single ownership, the *easement* through the *servient tenement* will terminate.

B. Voluntary relinquishment

The holder of an *easement* may give it up voluntarily, either through express release, with the owner of the *dominant tenement* issuing a quit claim deed to the *servient tenement* owner or through the filing of a formal abandonment.

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C. Non-use for five years

If the owner of a *servient tenement* uses it in such a manner as to make the *easement* impossible, the *easement* may terminate after five years. Termination by non-use only applies to prescriptive *easements*, but not to deeded *easements*.

#### D. Destruction of the servient tenement

A stairway *easement* or right to pass through may terminate if the building in which it is located is destroyed without fault of the owner. A roadway *easement* along a riverbank may terminate when the road collapses into the adjacent river without any fault of the owner.

### 5.6 ENCROACHMENTS

#9

**An encroachment is the unauthorized use of another's property.** It arises when the property of one owner encroaches on the property of another (trespass), as when a fence is built too far over the actual property line. An owner has only three years in which to bring an action for the removal of the *encroachment*. If the *encroachment* is allowed to exist for over three years without action being taken, it may give rise to an *easement* by prescription. If the *encroachment* is above the ground, it constitutes a nuisance and has no statute of limitations for action to be taken.

### 5.7 LICENSES

Licenses are not *easements* but permission for the short-term use of real property. A license is the grant of a privilege rather than a right and, unless it contains a determinate date for termination, is revocable by the owner at any time. Because it is personal in nature, it cannot be transferred.

### 5.8 RESTRICTIONS

Restrictions are limitations on the use of real property and fall into two general classifications: private and public. Private restrictions may take the form of a condition or covenant while public restrictions must promote general public welfare or health and consist primarily of zoning laws.


#### 5.8.1 PRIVATE DEED RESTRICTIONS

Private restrictions are created by private agreement of property owners and limit or restrict the use of the property by an owner. Restrictions are usually referred to as "CC&Rs," an abbreviation for covenants, conditions, and restrictions.

## A. Covenants

A covenant is an agreement to do or not to do a particular act such as a promise to build a house in a particular architectural style or to use property in a certain way. If a grantee (buyer) violates a covenant, the grantor (seller) may institute a proceeding for dollar damages or for an injunction prohibiting continuation of the violation of the restriction.

## B. Conditions

 A condition is a qualification granted on conveyance and places a limitation on the buyer's ownership. The main difference between covenants and conditions relates to the penalty should a breach occur. If a grantee violates a condition, the grantor may demand the forfeiture of the grantee's title to the property, with title reverting back to the grantor or creator of the conditions.

Private deed restrictions may be set forth in full in each of the deeds or recorded in a separate document known as a "Declaration of Restrictions," the terms of which can be incorporated into each deed by including a reference to the declaration. Not all restrictions are enforceable. An example of a restriction which would be unethical, illegal, and unenforceable would be a restriction against transfer of property to individuals of a certain race or faith, which is discrimination prohibited by both state and federal law.

## C. Termination of restrictions

Restrictions may have a designated termination date and expire as of that date. They may also be terminated by agreement of the grantor and grantee, or by the merging of ownership. **Subdividers may chose to insert a clause in deed restrictions permitting modification or alteration of the restrictions at a later date with the consent of a specified number of lot owners. CC&Rs may also terminate by action of law when their original purpose cannot be realized or if the restrictions prove to be inequitable to the property owner involved.**

### 5.8.2 PUBLIC RESTRICTIONS

Through its police powers, the State is empowered to protect the health, safety, morals and general welfare of the public through the imposition and enforcement of laws. In turn, the State may delegate the exercise of the police power to local government. The most common public *encumbrances* or restrictions include zoning restrictions, building codes, and health codes.

Other public controls will be discussed in Chapter 13.

## D. Health codes

Health codes pertain to water supply, sewage disposal, plumbing, drainage, and general property condition and are administered by the California Department of Health Services and local health officers. These are also augmented by various federal, state, county, and local environmental protection legislation and regulations.

## 5.9 TITLE INSURANCE

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Title is marketable when there is reasonable assurance as to the extent of rights or reservations to the use of a property. In California, *title insurance* companies research and certify title to property and offer insurance to guarantee that a buyer will be protected against receiving an unmarketable title. As well as establishing a marketable title, title insurance policies show what the title is subject to in the way of taxes, trust deeds or mortgages, and other liens and encumbrances, including CC&Rs or deed restrictions, easements, and other similar rights or reservations of record.

### 5.9.1 HISTORY OF TITLE INSURANCE

Prior to the time of *title insurance*, people relied upon abstracts which traced and summarized the chain of title to property and an attorney's opinion as to the validity of ownership. These summaries were called Abstracts of Title and contained all pertinent information discovered in the *title search*. As the people who prepared abstracts accumulated extensive files and useful data, the files came to be known as "title plants" and references to all recorded documents were arranged according to the particular property affected. The final *abstract of title* and related legal opinion were no longer necessary. The abstract company simply would study the records and furnish the customer with a Certificate of Title in which it was stated that it found the title vested in the present owner, subject to noted *encumbrances*. The next step was the Guarantee of Title under which the abstract company not only certified the correctness of its research and examination, but guaranteed the title of the owner. Since the company agreed to indemnify the title against loss if the title proved to be other than as described, they were deemed to be in the insurance business and subjected to regulation as such. While *title insurance* is used extensively in California, abstracts of title, certificates of title or guarantees of title may be used in other parts of the country.

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Of purely historical interest in California (although still found elsewhere) is the Torrens system of land title registration, patterned after the system of registering title to ships. It was adopted in California in 1914 as the Land Title Act and provided for registration after a court decree. The system never became popular and its use was confined almost exclusively to the southern counties of the state. In 1955 the Torrens Act was repealed. All Torrens

# CHAPTER SIX

## AGENCY

**NOTE: The bold face text in this chapter is the text of greatest importance.**

### 6.1 TERMS USED IN THIS CHAPTER

Most italicized words are explained in the Chapter Glossary on page 118

<i>Agency</i>	<i>General Agency</i>
<i>Broker</i>	<i>Sales Person</i>
<i>Commission</i>	<i>Special Agency</i>
<i>Fiduciary</i>	<i>Trust Fund</i>

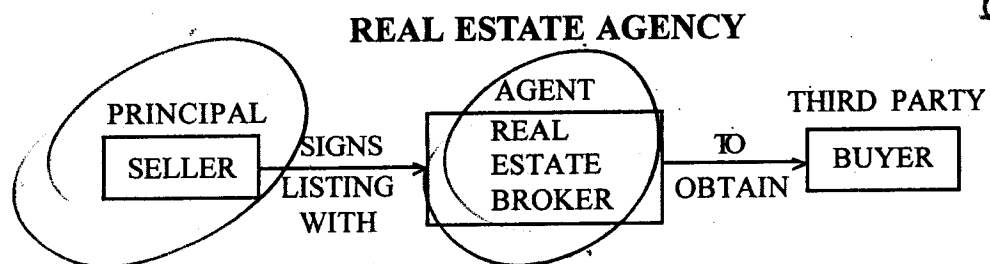
### 6.2 INTRODUCTION

The *agency* relationship and the duties, rights, and responsibilities of an agent, his or her *fiduciary relationship*, relationship to the *broker*, and trust relationship are covered in this chapter.

### 6.3 AGENCY

In an *agency* relationship, the principal delegates to the agent the right to act on his or her behalf in business transactions or other dealings with the purpose of bringing the principal into legal relationships with third persons. The listing agreement in real estate transactions usually establishes an *agency*.

The *agency* relationship is considered to be a triangular relationship. Although it begins as a dual relationship between a principal and agent, in a matter of contract rights, it becomes a triangular relationship at the time that the agent deals with third parties on behalf of the principal. Each of the three has rights, duties, and obligations towards the others.



*Agency* differs from an employee-employer relationship in that an employee is under an employer's supervision and control and operates under the name of the employer, while an agent is not under the control of the principal and operates under his or her firm's or own name. *Agency* also differs from an independent contractor relationship. An independent contractor is only responsible to an employer for the final results of a job and the employer has no control over the process by which the independent contractor obtains the final results, while an agent must obey the lawful instructions of the principal.

Under the California Civil Code, there are two types of agent authority: actual and ostensible. Actual authority is when the agent is really employed by the principal. Authority 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. When differentiating between an actual and ostensible agent, an actual agent is appointed by the principal orally or in writing; an ostensible agent is appointed through the principal's actions rather than words. A principal does not incur liability for acts of an agent beyond the scope of the agent's actual or ostensible authority. Third parties dealing with an agent are under a duty to ascertain the scope of the *agency*.

An *agency* which gives an agent authority to do anything and everything that the principal can do in a particular area is known as a *general agency*. For example, a *salesperson* is a general agent of his or her employing broker.

An *agency* which gives the agent authority for a specific act or business matter for the principal is a *special agency*. A broker is considered a special agent, as a rule, even if authorized to act in several property transactions, because only limited authority is given in each transaction to act on behalf of the principal.

**6.3.1 CREATION OF THE AGENCY RELATIONSHIP**

The relationship of the principal and the agent is ordinarily created by express contract, by ratification, or by estoppel. When created by an express contract, such as with a listing agreement, the basic principles of contract law apply, with the exception of the requirement for compensation. One may gratuitously undertake to act as an agent and still be held to certain standards demanded of an agent acting for compensation.

An *agency* relationship is created when: (1) the agent consents to the delegation, (2) the principal delegates authority to the agent to perform acts on behalf of the principal. Ratification is the adoption or approval of an act performed without previous authorization. Estoppel is a legal theory under which a person is barred from asserting or denying a fact because of the person's previous acts or words.





### 6.3.2 LISTING AGREEMENT

A listing agreement authorizes a *broker* to solicit offers to buy the listed property on terms and conditions acceptable to the seller and establishes a principal-agent relationship between the owner and the *broker*. The usual language authorizes the *broker* to find a purchaser but does not bind the owner to sell the property. Should the *broker* procure a qualified buyer willing to meet the exact terms of the listing agreement and the owner refuse to enter into a sales contract with the buyer, the *broker* would be entitled to collect a *commission*. Unless the listing agreement provides for accepting a deposit, the *broker* is not authorized to accept one, and if a deposit is accepted, the *broker* accepts it as agent of the buyer rather than as agent of the principal.

A listing agreement or any agreement authorizing an agent or *broker* to purchase or sell real estate for compensation must be in writing. This is an extension of the "equal dignities" rule which states that to be enforceable the authority to enter into a contract required by law to be in writing must be in writing. *The Residential Listing Agreement – Exclusive* (Form RLA) printed by the California Association of Realtors is commonly used as a listing agreement.

Most listing contracts authorize the listing *broker* to delegate some of the work of procuring a buyer to cooperating *brokers*. Subagents are approved by such a listing. In general an agent may not delegate authority granted to him or her in the *agency* agreement unless the act is purely mechanical, the agent cannot do it alone, the subagent can lawfully perform and it is customary to do so. Discretionary powers cannot be delegated unless authorized by the principal or in an emergency to protect the principal's interest.

### 6.4 AGENCY IS A FIDUCIARY RELATIONSHIP

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The *agency* relationship is a *fiduciary relationship* whereby the agent is a *fiduciary* with respect to the principal. As a *fiduciary*, the agent must exercise the utmost good faith, loyalty, and honesty because the relationship is based on trust and confidence. An agent is under a duty to use reasonable care and skill when acting in an *agency* capacity, to obey the directions of the employer, and to make a full disclosure of all material facts relating to the subject matter of the *agency*. Generally, duties are performed personally by the agent with the exception of administrative type tasks.

An agent is prohibited from personally profiting by virtue of the *agency* except through the receipt of the agreed upon compensation for services. This *fiduciary* obligation of the agent to a principal

## 6.8 AGENCY LIABILITIES

### 6.8.1 BREACH OF CONTRACT

Law defines a breach as an unjustified or unexcused failure to perform a contract. Any breach, total or partial, causing a measurable injury, gives rise to damages. A total breach excuses performance only if the breach is material. A partial breach at the beginning is more likely to be considered material, whereas, a partial breach after the contract has been substantially performed may not. A breach occurs only after the nonperformance or repudiation of a covenant. The nonperformance of a condition does result in a breach even if the promisor acted in good faith. Hindrance on the part of one party is a breach giving the other party the affirmative remedies for breach.

Parties may rescind an agreement by mutual consent, however if they do not agree to rescind, an action for specific performance and for damages is the remedy.



### 6.8.2 BREACH OF FIDUCIARY DUTY

*Fiduciary duties and obligations of an agent are fulfilled by:*

- A. Performing the duty personally.
- B. Following the principal's instructions.
- C. Disclosing all pertinent facts.

#### A. Grounds for license revocation

Failure to meet his or her *fiduciary* duties under the law of *agency* can lead to the revocation of a license. The following are the most common *agency* violations:

- A. Misrepresentation
- B. False promise
- C. Commingling
- D. Conversion
- E. Secret profit
- F. Dual *agency*

## B. Remedies for fraud

An agent's violation of *fiduciary* duty is a breach and also a tort (fraud). Remedies are:

- A. The agent may be held for damages caused to a principal.
- B. The principal may rescind a sale if there has been secret profit or a personal gain by the agent.

### 6.8.3 MISREPRESENTATION

A misrepresentation by a *broker* or *salesperson* may be material or immaterial. If the representation is slight or would not have a measurable affect on the person relying upon it, it is not a material fact. **When an agent misrepresents his or her authority to act as an agent for someone, he or she may be held liable to the person who relies on the misrepresentation.**

There are basically three types of misrepresentations:

- A. **Innocent misrepresentations are false statements that are not known to be false at the time they were made.**
- B. **Negligent misrepresentations are statements believed to be true, but made without reasonable ground, and are, in fact, false.**
- C. **Fraudulent misrepresentations are statements made at a time when the agent knows the statements are false.**

Agents are cautioned to carefully check out all possibilities which can lead to misrepresentation.

### 6.8.4 NEGLIGENCE AND CONSTRUCTIVE FRAUD

Agents can be disciplined under Section 10177(g) which reads, in part, where the licensee has "demonstrated negligence or incompetence in performing any act for which he or she is required to hold a license."

**Some misrepresentations constitute fraud even though made by an agent with no fraudulent intent, even if the person believes them to be true.**

**Constructive fraud as defined in the California Civil Code includes any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or anyone claiming under him, by misleading another to his prejudice, or to the prejudice of anyone**

promise is bound to keep it. A unilateral contract therefore exchanges a promise for an act, e.g. an offer in a newspaper of a reward to the general public of \$5,000 cash for finding a 40-acre parcel in north San Diego County which has a final map providing for 80 single family residences.

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### 7.3.2 **BILATERAL CONTRACTS**

If promises are exchanged by both parties, it is a *bilateral contract*. A unilateral contract needs only to be signed by the party initiating the contract, a *bilateral contract* must be signed by both parties. The terms unilateral and bilateral refer to "content of the agreement." Real estate contracts are generally *bilateral contracts* where an agent promises to use due diligence in return for an owner's promise to convey the property if a buyer is found under the terms of the contract.

With reference to the "extent of performance" required, contracts are considered to be executed when both parties to the contract have completely performed and fulfilled their obligations. An *executory contract* is one in which all terms of the contract have yet to be completed.

### 7.3.3 **LEGAL EFFECT OF CONTRACTS**

In regard to the "legal effect," contracts are classified as *void*, *voidable*, *valid*, or *unenforceable*. A *void* contract is an agreement that the courts will consider to have no effect, in other words it is considered to be no contract at all. A *void* contract will result when the subject of the agreement is against the law. A *voidable* contract is a contract that is still binding, but because of some deficiency may be rejected by one or more of the parties (e.g., a contract induced by fraud may be *voided* by the victim). Legal action may or may not be required to *void* such a contract, however until rejected or *voided* it is *valid* and enforceable. A *void* contract has no legal effect, a *voidable* contract is one that a party is able to have declared *void*. A *valid* contract is a binding and enforceable contract. An *unenforceable* contract is *valid* but is one that cannot be proved or sued upon by one or both of the parties (e.g., a contract that cannot be enforced because of the passage of time and the *statute of limitations*).

## 7.4 **ESSENTIAL ELEMENTS OF A CONTRACT**

The essential elements of a contract are:

- A. Parties capable of contracting
- B. Mutual consent
- C. A lawful object
- D. Sufficient consideration

several distinct objects, the contract is normally *valid* as to those parts that are lawful, e.g. if "T" wants to lease "L's" 40-acre parcel of farmland in order to farm 30 acres and to dump untreated hazardous waste on the remaining 10 acres, the lease in general should be *valid* with respect to the use of all of the land for farming, but not the use of any of the dumping of the untreated hazardous waste.

#### 7.4.4 SUFFICIENT CONSIDERATION

Consideration is the price paid for a promise and may be another promise, money, property, benefit conferred, or act of forbearance. Ordinarily the nature of the consideration is reflected in the written agreement of the parties. The consideration must meet the test of legality. **Gross inadequacy of consideration may be a circumstance which, together with other facts, will tend to show fraud or undue influence. Each side must be given consideration by the other. Otherwise, there is no contract.**

### 7.5 INTERPRETATION OF CONTRACTS

The language of a contract governs its interpretation and should be clear and concise. The execution of a contract in writing supersedes all negotiations and agreements prior to executing the contract. When a contract is partly written and partly printed, written parts control the printed parts and the parts that are purely original control those which were copied from a form. The question of time is often a significant one in contracts. **If no time is specified for performance in the contract, it must be carried out instantly or a reasonable time is allowed.**

#### 7.5.1 DISCHARGE OF CONTRACTS

Contracts are usually discharged by full performance, but they may also be discharged:

- A. By part performance
- B. By substantial performance
- C. By impossibility of performance
- D. By agreement between the parties
- E. By release
- F. By operation of law
- G. By acceptance of a breach in the contract

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## 7.8 STATUTE OF LIMITATIONS

~~The Statute of Limitations sets forth the maximum limits within which to bring legal action for breach of contract.~~ The policy of the law is to aid the vigilant, and the person who "sleeps upon his rights" may be barred from relief. When the right to sue is expired, it is said to have "outlawed". The following real estate actions must be brought within the time limit specified:

- |    |                    |   |
|----|--------------------|---|
| A. | Within<br>90 days  | Civil actions for the recovery of or conversion of personal property left at a hotel, motel, boarding house, or furnished apartment.  |
| B. | Within<br>1 year   | An action for libel or slander, or for injury or death caused by wrongful act or neglect of another.  |
| C. | Within<br>2 years  | An action upon a contract, obligation or liability not founded upon an instrument in writing; or an action founded upon a contract, obligation or liability evidenced by a policy of title insurance. |
| D. | Within<br>3 years  | An action upon a liability created by statute, other than a penalty or forfeiture; action for trespass upon or injury to real property; action for relief on the ground of fraud or mistake.          |
| E. | Within<br>4 years  | <u>An action upon any contract, obligation or liability founded upon an instrument in writing.</u>  |
| F. | Within<br>5 years  | <u>An action for the recovery of real property.</u>   |
| G. | Within<br>10 years | An action upon a judgment or decree of any court of the United States, or of any state within the United States.  |

The doctrine of laches is related to the *Statute of Limitations*. Laches is delay or negligence in asserting one's legal rights. The injured party may lose the right to relief if he or she inexcusably fails to exercise these rights within a reasonable time, even though action is brought within the time limits set by the *Statute of Limitations*. Laches is an equitable defense based on the premise that the opposing party is injured or damaged by reason of the other party who does not exercise his rights within a reasonable time period. Usually the injured or damaged party has changed its legal position to its detriment based on reliance of the other party's action or inaction.

# **CHAPTER EIGHT**

## **REAL PROPERTY CONTRACTS AND ESCROW**

**NOTE: The bold face text in this chapter is the text of greatest importance.**

### **8.1 TERMS USED IN THIS CHAPTER**

Most italicized words are explained in the Chapter Glossary on pages 148 and 149

<i>Closing Costs</i>	<i>Open Listing</i>
<i>Escrow</i>	<i>Option Listing</i>
<i>Exclusive Agency Listing</i>	<i>Procuring Cause</i>
<i>Exclusive Right to Sell Listing</i>	<i>Proration</i>
<i>Multiple Listing</i>	<i>RESPA</i>
<i>Net Listing</i>	<i>Rider</i>
<i>Offer to Purchase</i>	

### **8.2 INTRODUCTION**

Real property contracts include listings and offers to purchase real property. This chapter will deal with contracts for the sale or exchange of real property and includes the purpose and procedures of an *escrow*.

### **8.3 LISTING AGREEMENTS**

**A listing agreement is an authorization to sell, contract and create an agency. The listing of a property with a real estate broker is usually the first step in a real estate transaction. All listings for the sale of, lease for more than one year, or the exchange of real property must be in writing. A salesperson may take a listing on his or her broker's behalf but the listing belongs to the broker. The broker must be licensed at the time the listing is taken and at the time the authorized act is performed. At the time of signing, a copy of the listing must be given to each party who signs the contract. A listing cannot be recorded.**

There are four main types of agency agreements used in real estate: the *exclusive right to sell*; the *exclusive agency*; the *open listing*; and *net listing*.

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The selection of an *escrow* company and payment of the *escrow* fee is nature.

Escrow involves a binding contract between a buyer and the seller and the conditional delivery of transfer instruments to a third party known as an *escrow* agent. The neutral *escrow* agent becomes a trustee for the money and documents necessary for the seller and purchaser to complete the sale until such time as the contingencies of the agreement have been met. The buyer and seller are the principals in the *escrow*. Each of the principals will give to the *escrow* agent *escrow* instructions which supplement the original contract and set out the conditions under which the delivery of transfer instruments are to be made. These are very important and should be detailed in

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8.9 ESCROW

The California Residential Purchase Agreement and Joint Escrow Instructions is designed for a straightforward transaction. If the seller chooses not to accept the offer, but wishes to keep negotiations open a counteroffer may be submitted. Acceptance of an offer must be unqualified; a qualified acceptance or changes or additions made by the seller on a written offer form constitutes a counteroffer or a new offer. Printed counteroffer forms are neater and safer, but if an amended contract is used, each change and addition must be accepted and initialed by the person making the original offer, and some change in the wording of the acceptance clause is necessary to reflect the amendments.

- J. Details of Structural Pest Control Report.
- K. Contingency of offer on buyer receiving a loan commitment.
- L. Deposit increase (if any).
- M. Statement of occupancy.
- N. Reports incorporated in the transaction.
- O. Signature of buyer(s).
- P. Signature of seller(s).
- Q. Liquidated damages clause.
- R. The time allotted for acceptance.
- S. The name, address, and phone number of the brokerage firm and the signature of the agent taking the offer.
- T. The address and phone number of the buyer(s) and their signatures.
- U. The amount of commission.
- V. The address and phone number of the seller(s) and their signatures.



Typical recurring costs include:

- A. Hazard insurance for the first year.
- B. Taxes prorated during the year of sale.
- C. If the loan is a PITI loan, tax and insurance reserves are paid into *escrow*.
- D. Interest which may be due before the first loan payment is also paid into *escrow*.

Typical buyer-paid non-recurring costs are:

- A. A loan origination fee charged by the lender for the expenses of processing a loan.
- B. An appraisal fee charged by an appraiser for estimating the value of the property.
- C. A credit report fee charged for checking the buyer's credit history.
- D. A structural pest inspection fee charged for the inspection of the property for pests and other structural defects.
- E. A tax service fee charged for the annual inspection of tax records to assure a lender that the buyer is paying property taxes and assessments.
- F. Recording fees paid for the recordation of the deed and other documents.
- G. Notary fees paid to notarize the signatures on documents which must be recorded.
- H. An assumption fee if the buyer takes over the seller's existing loan.
- I. Title and *escrow* fees in areas where it is customary for the buyer to pay such costs.

#### B. Seller's closing costs

The seller's *closing costs* are all non-recurring payments since at the close of *escrow* a seller is relieved of title to the property and all expenses that accompany ownership of the property. As noted, costs borne by either party are subject to agreement, but the following items are generally paid by the seller:

- A. The transfer tax charged when property is transferred, also called a documentary transfer tax.
- B. The prepayment penalty which may be charged by a lender when the seller pays off a loan prior to the time it is due.
- C. Any fee charged for structural pest control work which is required as a result of the inspection paid for by the buyer.

\$20.00 per month.  $\$20.00 \times 8 \text{ months} = \$160.00$ . The closing statement will show the buyer is charged (debited) \$160.00 for insurance and the seller is credited \$160.00 for the unused portion.

#### D. Termination of escrow

**Escrows are terminated by completion of the sale and closing or by mutual consent and cancellation.** The conditions required by the *escrow* instructions must be performed within the time limit set forth in the *escrow* agreement and the *escrow* agent has no authority to enforce or accept the performance after the time limit provided in the instructions. When the time limit provided in the *escrow* instructions has expired and either party to the *escrow* has not performed in accordance with the terms of the *escrow* agreement, the parties may cancel the *escrow* and are entitled to the return of respective papers, property and documents from the *escrow* agent. Cancellation of an *escrow* does not rescind the purchase contract unless the parties mutually agree to do so. If an *escrow* is not completed, the *escrow* agent is generally entitled to partial payment of fees for services rendered.

#### 8.10 RESPA

**The Real Estate Settlement Procedures Act (RESPA) is a federal law which requires a lender to disclose to a buyer certain information and an estimate of closing costs.** The Act prohibits the taking of any kickbacks or unearned fees and *closing costs* and imposes criminal sanctions on violators. The burden of complying with *RESPA* falls upon the lender, although the *escrow* agent becomes involved by using the government's Uniform Settlement Statement. This statement itemizes all closing costs. If requested, the *escrow* agent must permit the buyer to inspect the Uniform Settlement Statement at least one day before the close of *escrow*. All parties must receive a copy after completion of *escrow*.

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## 9.5 LICENSE APPLICATION

An applicant meeting the prerequisites for a license, filing the proper application and paying the necessary fee will be scheduled to take the qualifying examination. Application must be made on the proper form which is furnished by the Department of Real Estate. All license applicants must also submit a classifiable set of fingerprints. An application is valid for two years, and there is no limit on the number of times an applicant may take the examination after having failed.

Real estate law permits the *Commissioner* to suspend without hearing, within 90 days after issuance, the license of any real estate licensee who procured his or her license by fraud, *misrepresentation* or deceit, or made any material misstatement of fact on the application.

### 9.5.1 REAL ESTATE BROKER'S LICENSE

An applicant for a real estate *broker's license* must:

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- ~~A.~~ Be 18 years old or older.
  - ~~B.~~ Show proof of legal presence in the United States.
  - ~~C.~~ Be honest and truthful.
  - ~~D.~~ Complete the prescribed college level courses.
  - ~~E.~~ Have two years' full-time licensed salesperson experience within the last five years (or equivalent.)

### 9.5.2 EXPERIENCE REQUIRED

A *broker license applicant* must have been actively engaged as a real estate salesperson for two of the five years immediately before the application or prove to the satisfaction of the Real Estate *Commissioner* that the applicant has general real estate experience that would be the equivalent of such. The applicant must have completed the following three-semester unit (or equivalent) college courses:

- A. Real Estate Practice
- B. Legal Aspects of Real Estate
- C. Real Estate Finance
- D. Real Estate Appraisal
- E. Real Estate Economics or General Accounting\* and three\* of the following courses:
  - 1. Real Estate Principles
  - 2. Business Law
  - 3. Property Management

4. Escrows
5. Real Estate Office Administration
6. Mortgage Loan Brokering and Lending
7. Advanced Legal Aspects of Real Estate
8. Advanced Real Estate Finance
9. Advanced Real Estate Appraisal
10. Computer Applications in Real Estate
11. Common Interest Developments

\* If an applicant has completed both Real Estate Economics and General Accounting, only two courses from the last group are required.

The experience requirements are not fulfilled simply because an applicant has been licensed for the necessary period. The *Commissioner's* office furnishes forms on which the employing *broker* or *brokers* can verify the applicant was, in fact, actively engaged as a real estate salesperson during two of the preceding five years. All claims of "equivalent" qualifying experience must be supported.

### 9.5.3 STATE EXAMINATION

Broker  
75%

The appropriate fee must be submitted with a Broker Examination Application, and the DRE Web site will provide the most current fee schedules. To pass the broker examination and become eligible for a license, examinees must correctly answer **at least 75 percent** of the questions on the test. An applicant failing the examination may apply for reexamination and must pay the appropriate fee. There is no limit to the number of reexaminations, but an application is valid for only two years.

The relative weight assigned to each segment in the respective licensing examinations is as follows:

- Property Ownership and Land Use Controls and Regulations (Broker 15%, Salesperson 18%)
- Laws of Agency (Broker 12%, Salesperson 12%)
- Valuation and Market Analysis (Broker 11%, Salesperson 12%)
- Financing (Broker 13%, Salesperson 13%)
- Transfer of Property (Broker 10%, Salesperson 9%)
- Practice of Real Estate and Mandated Disclosures (Broker 27%, Salesperson 24%)
- Contracts (Broker 12%, Salesperson 12%)

### 9.5.4 REAL ESTATE SALESPERSON LICENSE

An applicant for a real estate *salesperson* license must be at least 18 years old, show proof of legal residence in the United States, be honest and truthful, and complete the required college-level courses. The applicant must complete college-level courses in Real Estate Principles (prior to applying for a license), Real Estate Practice (either prior to applying for a license or

within 18 months of license issuance), and one course (prior to applying for a license or within 18 months of license issuance) from the following:

Real Estate Appraisal  
Property Management  
Real Estate Finance  
Real Estate Economics  
Legal Aspects of Real Estate  
Real Estate Office Administration  
General Accounting

Business Law  
Escrows  
Mortgage Loan Brokering  
and Lending  
Computer Applications in  
Real Estate  
Common Interest Develop-  
ments

Agent 70%  
#70

#### A. State examination

A correct score of 70% is necessary to pass the examination. An applicant who successfully passes the salesperson exam may apply for a four-year original license by submitting (within one year of the examination date) an application, license fee, transcripts showing completion of required courses, and completed fingerprint card, proof of legal residence, and fee. If the applicant does not submit evidence of completion of the two remaining required courses when applying for the license, the fee is increased. The license will be conditional and will automatically be suspended if evidence of completion of the remaining two courses is not submitted within 18 months.

## 9.6 RENEWALS

All real estate licenses are issued for a period of four years and are renewable without examination upon submittal of the appropriate fees and completion of the required continuing education. Each renewal applicant must show completion of 45 clock-hours of approved courses meeting the mix approved by the Department of Real Estate within the four-year period preceding license renewal. This mix includes the study of ethics, agency relationships, trust fund accounting, fair housing, consumer protection, and other courses and programs that will enable licensees to achieve a high level of competence in serving the objectives of consumers.

### 9.6.1 REAL ESTATE SCHOOLS

Entities offering the required courses must provide testing or other means of evaluating an attendees performance and must also provide a certificate evidencing completion.

If a real estate salesperson obtains a *broker's* license before the time to renew the salespersons license, the new *broker* will not need to meet the *continuing education* requirements until the renewal date of

**principal business.** The *fictitious business name* is in addition to the existing license, and the *broker's* main office license certificate will display on its face the *fictitious business name*. The "DBA" on a *broker's license* does not affect the licenses of the salespersons in the *broker's* employ.

#### 9.7.2 CORPORATE BROKER LICENSE

In the event a *broker* elects to establish and do business as a *corporation*, the *corporation* must be licensed to do business as a *broker*. An individually licensed *broker* must be an officer of the *corporation* and must act as the *corporation's* designated *broker-officer*. A *corporation* must pay the required fee and file with the Department of Real Estate a Certificate of Status obtained from the Office of the California Secretary of State, showing that a *corporation* is duly formed and authorized to do business in California. A Certificate of Qualification is required for a foreign *corporation*.

#### 9.7.3 SALESPERSON LICENSE

The salesperson license covers persons who are to be employed under the control and supervision of a licensed *broker*. It permits activities as an employee of the *broker* and not as an independent agent. The salesperson can be compensated for work as an agent only by the employing *broker*. The salesperson in many instances is an independent contractor for all other legal and tax purposes. Occasionally, he or she will be an employee of the *broker*.

#### 9.7.4 BRANCH OFFICE LICENSE

If a *broker* maintains more than one office within the state, a branch office license must be obtained and available for inspection at each additional place of business. Licenses of all real estate salespeople must be on file in the principal place of business.

#### 9.7.5 MINERAL, OIL, AND GAS LICENSE

Effective January 1, 1994, DRE no longer issues original mineral, oil, and gas (MOG) broker licenses. MOG activities can be performed by currently licensed MOG brokers or by licensed real estate brokers.

#### 9.7.6 PREPAID RENTAL LISTING LICENSE

A *Prepaid Rental Listing License* is required of those who supply prospective tenants with residential real property for rent and collect a fee. Negotiation of rental or lease agreements is not a part of this

licensee is served with a statement of the issues and may appear with or without counsel. Evidence is taken in much the same manner as in civil court and an impartial hearing officer presides and proposes a decision. The *Commissioner* is empowered to accept or reject the proposed decision. The licensee, in turn, may appeal any decision to the courts. If the charges are not substantiated, they are dismissed. If wrongdoing is found the licensee's license may be revoked (loss of the license) or suspended (a temporary loss of license). After a license is revoked, the person affected may not apply for reinstatement until one year has passed.

### 9.9.3 MENTAL INCAPACITY

While not a disciplinary action, the *Commissioner* may also suspend or revoke the license of a licensee who has been committed or adjudged insane, mentally ill or *incompetent* by any court of competent jurisdiction.

## 9.10 TYPES OF VIOLATIONS

The general provisions for license suspension or revocation are set forth in Sections 10176 and 10177 of the Real Estate Law. These provisions do not constitute all of the violations for which sanctions may be imposed, but are the most common and should be understood by all licensees.

### 9.10.1 MISREPRESENTATION

An act of *misrepresentation* or the failure of a *broker* or salesperson to disclose a fact that a principal should be told is grounds for disciplinary action. The fact misrepresented or not disclosed need not be material in the legal sense. The Real Estate Law is concerned with the conduct of licensees and not with the assessment of damages between the parties.

### 9.10.2 FALSE PROMISE

A false promise is a misstatement as to what the person making the promise will do in the future. It is different from a *misrepresentation* which is a misstatement of a fact. A false promise is also grounds for discipline.

### 9.10.3 CONTINUED MISREPRESENTATION

This entails a course of conduct involving *misrepresentation* or false promises in a continuing and flagrant manner.

Further, the *Commissioner* is empowered to issue regulations to aid in the enforcement and the interpretation of the law, which themselves have the force of law. Licensees should be familiar with these regulations.

### 9.11 ACCOUNTING RECORDS

Records, books and accounts of licensed real estate *brokers* and their salespeople may be inspected and audited by the *Commissioner* at any time. The employing *broker* must initial the contracts of all salespeople in his or her employ. Licensees must keep all agreements, including listings, deposit receipts, leases, exchange agreements, etc. on file for a minimum of three years.

### 9.12 REAL ESTATE EDUCATION, RESEARCH, AND RECOVERY ALLOCATION

California law provides for a portion of the license fees collected to be allocated to education and research and to a "recovery account." The recovery account underwrites the payment of otherwise uncollectible court judgments obtained on the basis of fraud, *misrepresentation*, deceit, or conversion of trust funds in a transaction in which the judgment debtor participated as a licensee.

If an aggrieved person has obtained a judgment and has discovered that the judgment debtor (licensee) has no real or personal property, or other assets from which to satisfy the judgment, he/she may within one year post a bond and apply for recovery from the Real Estate Education, Research, and Recovery Fund. The maximum a person can collect is \$20,000 from any one transaction. If several people were injured in the same transaction, they may have to share the \$20,000 recovery fund payment on a pro rata basis. The maximum amount that can be paid out against any one licensee during his or her lifetime is \$100,000. Upon payment of a sum from the Real Estate Education, Research, and Recovery Fund, the *Commissioner* may proceed against the licensee to be reimbursed for such monies.



A *negotiable* instrument is one that is capable of being negotiated, assigned or transferred in the ordinary course of business, in other words, it is an instrument that can circulate as money does. One example of a *negotiable* instrument is a check. A check or note must meet certain requirements to be a *negotiable* instrument. To qualify it must be:

- A. Signed by the maker.
- B. An unconditional promise or order to pay a certain sum of money.
- C. Payable on demand or at a definite time.
- D. Payable to order or bearer.

If one of the above is missing the *promissory note* is not *negotiable* but may still be valuable and transferable as an ordinary contract.

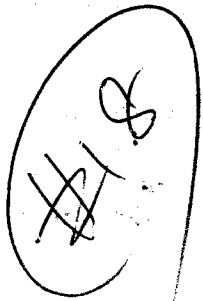
### 10.3.1 NEGOTIATION

A *negotiable* instrument can be transferred by assignment or by *negotiation*. Assignment is the transfer of ownership from one person to another and can be accomplished by a bill of sale or other document assigning the check or note. The assignee receives no more benefits than the assignor (original payee) had. *Negotiation* is when the original holder effects a transfer to a third party under certain conditions and may result in a favored position for the third party, known as a "*holder in due course*." If the instrument is payable to "the order of," it is negotiated by delivery with any necessary endorsement. If payable to "bearer," no signature is needed for *negotiation*, it is negotiated by delivery.

### 10.3.2 ENDORSEMENT

The most common forms of endorsement are:

- A. Blank endorsements where the holder simply signs his or her name on the back of the instrument.
- B. Special endorsements where the holder writes "Pay to the order of" (named transferee) and then signs.
- C. Restrictive endorsements where the holder restricts future *negotiation*, as by writing "Pay to the order of State Bank, for deposit only" and then signs.
- D. Qualified endorsements where the holder adds the words "Without Recourse" to what would otherwise be a simple blank or special endorsement. This means that if the maker refuses to pay, the endorser will be liable for the amount.



### 10.3.6 TYPES OF PROMISSORY NOTES

With a *promissory note* the maker promises to pay the payee a specified sum of money. *Promissory notes* may be categorized as:

- A. Straight notes which call for the payment of interest only during the term of the note with the principal sum becoming due and payable on a certain date.
- B. Installment plus interest notes which call for periodic payments on the principal, such payments being separate from the interest payments.
- C. Installment notes, including interest which demand certain periodic payments of fixed amounts, which include both interest and principal. These are popularly referred to as amortized payments.
- D. Adjustable rate notes where the interest rate in the note varies upward or downward over the term of the loan depending on the money market conditions and an agreed upon index.
- E. Demand notes which does not become due until the holder makes a demand for its payment.

## 10.4 REAL ESTATE FINANCING INSTRUMENTS

Along with the *promissory note* or evidence of the debt lenders require a security interest. Security interest is a term designating the interest of the lender in the property of the debtor whereby certain assets of the borrower are identified and set aside so that the lender can reach or sell them if the debtor defaults on his or her obligation. To make real estate security for a debt, a security instrument, either a *deed of trust* or a *mortgage* is executed.

### 10.4.1 DEED OF TRUST

A *deed of trust* is a written instrument by which title to land is pledged for a loan or other consideration. A *deed of trust* has three parties: the *trustor*, the beneficiary, and the *trustee*. The borrower is the trustor, the lender is the beneficiary and an impartial third party, the trustee, is appointed to hold legal title to the property. The *trustee* is generally entrusted with two functions: the power to sell the property if the debt is not paid in accordance with the terms of the note, and the power to reconvey the property to the *trustor* when the debt is repaid.

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the title is conveyed to a *trustee*. In terms of the Statute of Limitations the enforcement of a *mortgage* is barred when the Statute of Limitations of four years runs out on the principal obligation (the note). The power of sale under a *deed of trust* can still be exercised even though the statute has run out on the obligation, for the *trustee* has title and can still sell to pay off the debt. In terms of remedy the ordinary *mortgage* contains only the remedy of foreclosure. With a *deed of trust* judicial foreclosure is permitted but more commonly a nonjudicial sale by the *trustee* is utilized. In terms of reinstatement, borrowers may reinstate the loan debt by curing the default; but with a *trust deed*, reinstatement must be made within three months after recording of the Notice of Default. If the power of sale is exercised and under a *mortgage*, the borrower may reinstate any time before the judicial decree of foreclosure. In terms of redemption the right of redemption exists with the sale of a property by judicial foreclosure (court action); there is no redemption period following a *trustee's* sale under a *deed of trust*. In terms of a *deficiency judgment* where a mortgagee or beneficiary elects to foreclose by power of sale rather than by judicial foreclosure, a *deficiency judgment* is automatically barred, but in a judicial foreclosure the defaulted party may be able to obtain a *deficiency judgment*. In terms of satisfaction a *deed of trust* requires a deed of reconveyance while a *mortgage* requires a certificate of discharge.

#### 10.4.7 TYPES OF TRUST DEEDS

There are three major types of *trust deeds*. These are the:

- A. Purchase money trust deed
- B. Non-purchase money trust deed
- C. All inclusive trust deed or wrap-around loan

##### A. Purchase money trust deed

A purchase money *trust deed* secures payment of the purchase price of real property. Such a *trust deed* is given priority over other liens against the property. As a general rule, with a purchase money *trust deed* the purchaser is not liable for any deficiency if the sale of the property does not generate sufficient funds to repay the amount owed. In the event there is more than one purchase money *trust deed*, priority is established by the date of recordation. The *trust deed* recorded prior in time is superior to subsequent *trust deeds*.

##### B. Non-purchase money trust deed

A non-purchase money *trust deed* is used to secure a loan which will be used for some purpose other than the purchase of real property. Such loans are subject to *deficiency judgments* in the event of default.

## 10.7 TENTATIVE MORTGAGE INSTRUMENTS

*Alternative mortgage instruments* are the result of lenders and borrowers responding to the realities of today's uncertain economy. The key feature of these loans is that the interest rate and/or monthly payment is not fixed but fluctuates. There are a variety of *alternative mortgage instruments* tailored to satisfy the needs and best interests of various borrowers. While the term *mortgage* is used, in California the security instrument is generally the *trust deed*.

### 10.7.1 ADJUSTABLE RATE (ARM) OR VARIABLE RATE MORTGAGE (VRM)

An adjustable rate *mortgage* also known as a "variable rate mortgage" is a loan which provides for adjustment of its interest rate as market interest rates change. The interest rate is tied to an index, and as the index fluctuates, so does the interest rate. A variety of published indexes exist, including the Federal Reserve Discount rate and the Cost-of-Funds Index published by the Federal Home Loan Bank Board. The initial interest rate is lower than the rate available for fixed rate loans since borrowers share with lenders the risk of rising market interest rates.

Under the Truth-in-Lending laws, where the annual percentage rate originally disclosed may later increase, there must be a disclosure of:

- A. The circumstances under which the rate may increase.
- B. Any limitations on the increase ("ceiling" or "cap").
- C. The effect of an increase.
- D. An example of the payment terms that would result from an increase.

### 10.7.2 GRADUATED PAYMENT MORTGAGE (GPM) AND GRADUATED PAYMENT ADJUSTABLE MORTGAGE (GPAM)

#21  
Negative

The graduated payment *mortgage* has a fixed interest rate through the life of the loan. With the graduated payment adjustable *mortgage* the interest rate will fluctuate. In either case the payments are lower at the start of the loan term, increasing in future years. The graduated payment *mortgage* involves negative amortization in the early years of the loan and an early sale could result in the borrower having to repay the lender more than the original amount of the loan. The loan is designed to assist borrowers whose salary increases will put them in a higher income bracket later on, but who would otherwise be unable to initially qualify, e.g., a borrower's monthly payment, principal and interest, might be \$750 the first 3 years, \$1,000 the next 2 years, and \$1,200 thereafter.

although monthly payments are amortized on a 25 or 30 year basis. Monthly payments are calculated in the same manner as a conventional *mortgage*, with the term decreasing in increments of five years to permit full payment at the maturity specified at the time of origination.

## 10.8 INTEREST

The rate of interest to be charged to the borrower for the loan is of significant importance. A slight variation in the interest rate can cost the borrower many more thousands of dollars over the life of the loan.

The total interest to be paid on a loan can be calculated by multiplying the amount of each payment by the total number of payments to be made. The principal amount of the loan is subtracted from this result, which leaves the amount of interest to be paid over the life of the loan.

### 10.8.1 USURY

*Usury* is charging a rate of interest greater than that permitted by law on a loan. The maximum legal interest rate in California is 10 percent or 5 percent above the Federal Reserve Bank discount rate, whichever is higher, unless the lender is exempt. California law exempts banks, savings and loan associations, credit unions and any transaction handled by a licensed broker from the *usury* laws. Also exempt is a seller who takes back a *promissory note* secured by a *deed of trust* as part of the purchase price of real property. Should a note where interest is implied but not stated be signed the legal rate of interest, 7 percent per year, will be assumed.

### 10.8.2 POINTS

Points are used to increase the yield to a lender. Each point is equal to one percent of the total loan. A borrower may be charged one or more points by a lender. Lenders may use discount points to equalize the interest rate of a loan and the prevailing market interest rates. These points are in effect prepaid interest. They may also charge service points for originating and servicing the loan. Points may be paid by a borrower or seller but are usually paid by the borrower. On VA loans, borrowers are not permitted to pay more than one point.

## 10.9 TRUTH IN LENDING (REGULATION Z)

In 1969, Congress passed the Truth in Lending Act (TILA) as part of the Federal Consumer Protection Act. TILA was designed to enable

~~consumers to make informed loan decisions by requiring lenders to make certain disclosures concerning loan terms and conditions. TILA is enforced by Regulation issued by the Federal Reserve Board.~~

Regulation Z applies to all residential real estate loans made to individuals and contains guidelines regulating three aspects of the lending process. These are:

- A. Disclosure of loan costs
- B. The right of rescission
- C. Fair advertising practices

#### ***10.9.1 ANNUAL PERCENTAGE RATE***

Regulation Z requires that the cost of a loan be disclosed in terms of an annual percentage rate (APR). The APR combines the interest rate on the loan with the other costs of the loan to indicate the true annual cost of the loan to the borrower. Costs that are included in calculating the APR of a loan are lender's points, loan origination fees, finder's fees, premiums for health, accident, loss of income or credit life insurance, and insurance against default.

#### ***10.9.2 LOAN DISCLOSURES***

The Truth in Lending Act requires that 18 specific disclosures be made to a borrower. The lender must prepare and deliver to the borrower before the loan is made a formal loan disclosure statement. The two most conspicuous disclosures must be the finance charge and the annual percentage rate. Included in the items which must be contained in the disclosure statement are:

- A. The date the finance charge begins to accrue
- B. The annual percentage rate
- C. The number of monthly payments
- D. The due date of the payments
- E. Prepayment penalties
- F. Balloon payments
- G. Default and delinquency charges
- H. Legal description of property
- I. The amount of credit which will be made available to the borrower
- J. The credit sales, cash price and total unpaid balance

Other restrictions on the types of loans, and the terms of such loans, are generally as determined by the associations own board of directors. The "loan-to-value ratio may not exceed the maximum permitted for that class of loans, as determined by the associations board of directors. . . ."

### 11.3.3 COMMERCIAL BANKS

Commercial banks account for the second greatest number of residential mortgage loans. All banks are insured by the Federal Deposit Insurance Corporation to a maximum of \$100,000 for each insured depositor. Real estate loans represent only a portion of the commercial banks overall loan activity. Banks also make home improvement and consumer loans (e.g., autos, boats, appliances, etc.). Commercial banks are the primary source for short-term construction financing, and large banks play a major role in financing business and commercial properties.

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Banks make conventional real estate loans for up to 90 percent of appraised value for as long as 30 years on a single-family residence. Banks place an emphasis on strong collateral and the integrity and previous experience with the borrower in order to ensure loan repayment without recourse to foreclosure. Interest rates charged are generally less than those charged by savings and loans, but higher than the rates charged by life insurance companies.

The U.S. banking system is unique in that it is regulated by a dual system, i.e., both federal and state regulatory agencies are involved with the chartering, regulation, and supervision of banks.

From a general regulatory viewpoint, commercial banks (i.e., institutions that may accept federally insured deposits) may be divided into national banking associations and state licensed banks.

#### A. Specifics of national banks

##### a. General regulatory framework

National banks fall under the control of the Comptroller of the Currency, a division of the Treasury Department. As such they are subject to the National Banking Act and the regulations promulgated by both the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC). Additionally, the Comptroller of the Currency periodically issues "interpretive rulings," which further define the parameters within which national banks must operate.

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**F. Other sources of real estate financing**

Other sources of real estate financing include syndications, credit unions, endowed universities, and trust departments of banks. Syndications are groups of individuals who band together to finance, develop or purchase a piece of property. Credit unions are mutual, voluntary, cooperative organizations of people who group together to save money and provide money for loans to their members. Traditionally, credit unions have only been a source of short term loans but law changes now permit long term real estate lending. Endowed universities and trust departments of banks also have funds which are available for investment for real estate loans. The lending practices of these other sources are beyond the scope of this course but the real estate professional should be aware of their existence.

**11.4.5 FEDERAL AND STATE GOVERNMENT PARTICIPATION IN FINANCING**

**A. Public programs to insure and guarantee loans**

Prior to the Great Depression of the 1920s and 1930s, loans made for the purchase of real property were not insured or guaranteed by the government. The only security for the lender in the event of default by the borrower was foreclosure on the property itself. Because of the severe losses suffered by lenders during the Depression, various federal government programs were created to provide insurance for the lender in the event of loan default. **The three major government-backed loan programs are the Federal Housing Administration, Veterans Administration and the California Farm and Home Purchase Program.**

**B. Federal Housing Administration loan program**

In 1934, because of large losses being suffered by residential property lenders, Congress created the Federal Housing Administration (FHA) to insure mortgage lenders for losses incurred due to nonrepayment of mortgage loans. The FHA presently has over fifty programs providing assistance to homeowners and other borrowers, including

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- A. Title I Home improvement loans
- B. Title II Home mortgage insurance
- C. Title VII Military housing
- D. Title X Mortgage insurance for land development



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The actual amount of entitlement which a veteran receives in a particular loan transaction is determined by an appraisal of the subject property by a VA appraiser.

The report of the appraiser is contained in a Certificate of Reasonable Value (CRV), detailing the appraised value of the property and informing the veteran of the maximum VA guaranteed loan which a lender would make on the property. The use of the veteran's entitlement in securing a loan depletes the veteran's entitlement to the extent of the VA guarantee on that particular loan. Should the VA guarantee be less than the full amount of the veteran's entitlement, the remaining portion of the entitlement is available to secure a loan on another property.

**a. Restoration of the entitlement**

A used entitlement may be restored to the veteran by (1) repayment of the loan; (2) assumption of the loan and release of the veteran's obligation on the loan by the VA; and (3) a sale of the subject property to another veteran who assumes the loan and substitutes his or her own entitlement for that of the selling veteran.

A veteran's entitlement is not restored while the veteran remains liable on the loan or while the veteran continues to occupy the property.

**P. Default under a VA loan**

If there is a default on a VA guaranteed loan, the first step is usually foreclosure on the property by the lender. The lender then resells the property. The VA reimburses the lender for the difference between the amount received on the resale of the property and the amount remaining on the loan, up to the guaranteed amount.

An alternative procedure in the event of default is for the VA to purchase the property from the lender, take title to the property, and resell the property.

**Q. CalVet Home Loans**

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CalVet loans were created in 1921 to assist qualified California Veterans in acquiring suitable farm or home property at a low financing cost. This program is administered by the California Department of Veteran Affairs. The state secures money through the sale of bonds and the amount advanced by the state for the veteran to purchase the property is utilized with a real property sales contract as the security instrument. Interest rates are typically below the rates for FHA or VA loans. Since the bonds that fund the program are 30-year bonds, loans are for 30-year terms. Veterans must apply for a CalVet loan before acquiring an interest in the property.

As demand for mortgage credit grew, a regional mismatch developed between deposit flows and the demand for mortgage credit. In older, slower growing areas of the country, the supply of mortgage credit available for lending exceeded the demand for it by homebuyers. At the same time, faster growing regions faced great demand for new housing but had relatively few deposits to lend.

Through its purchase of mortgages in the faster growing regions and sales of mortgages in the slower growing regions, the secondary mortgage market redistributed the available money by transferring funds from capital surplus to capital deficit areas.

In addition to redistributing funds, the secondary mortgage market links the capital and mortgage markets through its sales of mortgages in forms, particularly mortgage backed securities, that have attracted investment from outside the traditional mortgage investment community.

The need for new sources of investment in residential mortgages has increased in recent years as the demand for mortgage credit nationwide has grown more rapidly than the deposit bases of traditional lending institutions in a deregulated environment.

#### **11.6.1 GOVERNMENT-RELATED SECONDARY MARKET**

Three entities were created by Congress to develop the residential secondary mortgage market. They have become important elements in its continuing growth. They are the *Federal Home Loan Mortgage Corporation (Freddie Mac)*, the *Federal National Mortgage Association (Fannie Mae)*, and the *Government National Mortgage Association (GNMA)*.

#### **11.6.2 FEDERAL HOME LOAN MORTGAGE CORPORATION (FREDDIE MAC)**

*Freddie Mac* was created by Congress in 1970 in conformance to Title III of the Emergency Home Finance Act of 1970, 12 U.S.C. 1451, et seq. Its purpose was to enhance the liquidity of mortgage investments and increase the availability of funds for mortgage lending by developing and maintaining a nationwide *secondary market* for conventional residential mortgages.

*Freddie Mac* links mortgage lenders and capital markets through its purchase and sales functions. It buys conventional single family (one-to-four units) fixed rate and adjustable rate loans, FHA and VA fixed rate loans, multifamily loans, and home improvement loans. It buys

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### 12.3.2 REAL PROPERTY MANAGERS

There are three general types or levels of *property managers*:

- A. Resident manager
- B. Individual building manager or superintendent
- C. Property manager

### 12.3.3 RESIDENT MANAGER

An individual employed by the owner or by a *property management* company to manage a residential apartment building or smaller apartment complex is known as a *resident manager*. The *resident manager* lives on the premises and will receive free rent in partial or complete compensation for services rendered. In California, any residential property with sixteen or more units must have a *resident manager*.

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### 12.3.4 INDIVIDUAL BUILDING MANAGER OR SUPERINTENDENT

An individual employed by an owner or management company to manage a single large property, usually a high-rise or apartment structure is referred to as an *individual building manager* or *superintendent*. The building manager or superintendent is concerned chiefly with maintenance and operations and hires and supervises the work of janitors, elevator operators and maintenance people.

### 12.3.5 PROPERTY MANAGER

A *property manager* is a self-employed individual or an employee of a management company or management division of a brokerage who is engaged in the business of managing properties for various owners on a full-time, ongoing basis. A *property manager* may specialize in one or more types or sizes of properties and may hire or supervise *resident managers* or *individual building managers* to handle the day-to-day management concerns of specific properties.

### 12.3.6 PURPOSE OF THE PROPERTY MANAGER

Owners retain outside *property managers* or *property management* firms to manage property for three reasons:

- A. Convenience
- B. Expertise
- C. Cost savings

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### 12.3.12 CERTIFICATION

In an effort to retain competent *property managers* instead of inexperienced or unqualified individuals, various private industry organizations have been established. One example is the Institute of Real Estate Management (IREM). IREM currently trains, tests, and certifies different skill levels of *property managers*, from the Accredited Resident Manager (ARM) to the Certified Property Manager (CPM). These certifications are not legal requirements for engaging in *property management* activities but are often desired or required by owners, lenders, brokers or others when hiring *property managers*.

### 12.3.13 REGULATION OF REAL ESTATE LICENSEES

Although *property managers* are not licensed by the state, the state does impose certain regulations and requirements upon licensed real estate brokers and salespersons who engage in *property management* activities. Licensed personnel cannot engage in *property management* activities unless they are able to demonstrate adequate training, preparation or experience in the area of *property management*. Violators are subject to disciplinary action or loss of license.

### 12.3.14 PROPERTY MANAGEMENT RELATIONSHIP

The creation of the *property management* relationship involves both the law of contracts and the law of agency. A *property manager* has an agency relationship with the owner as principal and the *property manager* as agent for the owner. This relationship must be established by a contract between the owner and the *property manager*.

As an agent the *property manager* is subject to all of the legal restrictions generally imposed upon an agent, as well as those specifically included in the contract for *property management* services generally referred to as a management contract or management agreement. Although an enforceable contract may be entered into verbally, it is highly advisable that it be written.

The fiduciary duties owed by the *property manager* to the owner are stringent and strictly enforced. The general scope of the duties to be performed by the *property manager* can vary greatly, depending on the desires of the owner and the nature of the managed property. The specific tasks to be performed by the *property manager* may differ substantially from situation to situation. As a result it is critical that the management contract be specific to prevent misunderstandings and detail the exact tasks to be performed by the *property manager* on behalf of the owner.

#### 12.4.1 SELLERS

Owners of business enterprises desire to sell for a variety of reasons including the desire to relocate, retire, change careers, or dispose of a difficult or unprofitable business.

#### 12.4.2 BUYERS

Persons desiring to buy an existing business do so for a variety of reasons also, including the desire to be one's own boss, expand an existing business, work in an area of specific enjoyment, or motivated by the desire to profit by purchasing an undervalued business.

A business enterprise that is defunct or encumbered by heavy losses will have little or no value and will likely be unsalable. However, there are situations where buyers will be interested in a business with a loss record if the buyer feels the losses are due to poor management or otherwise does not reflect the true potential for the business enterprise.

#### 12.4.3 BUSINESS ENTERPRISES

The U.S. Small Business Administration (SBA) defines, for research purposes, a small business as an independent business having fewer than 500 employees.

According to the Small Business Administration (SBA), small businesses represent 99.7 percent of all employer firms. Typically, two-thirds of new employer establishments survive at least two years, and 44 percent survive at least four years. There are approximately 24 million small businesses in the United States.

Major factors in a firm's remaining open include an ample supply of capital, the fact that a firm is large enough to have employees, the owner's education level, and the owner's reason for starting the firm.

#### 12.4.4 ELEMENTS OF A BUSINESS ENTERPRISE

A business normally consists of three elements:

- A. Personal property
- B. Real property
- C. Goodwill

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**H. Fictitious name filing**

Business opportunities conducted under a name other than the true name of the owner(s) must file a Fictitious Business Name Statement with the County Recorder's office.

**I. Covenant not to compete**

The purchaser may be concerned that the seller will open up a competing business and divert patronage from the purchaser. To prevent this action the purchaser may want to insist that the seller sign an agreement not to compete in the same field or in the same general area for a period of time.

**J. License transfers**

Many business opportunities require state or local government licenses. For example, sales of alcoholic beverages require liquor licenses. Handling of businesses involving liquor licenses is a specialty all to itself. At the present time, where limited liquor licenses are involved, a proper notice of intention to sell or transfer must be recorded at least 12 business days before the transfer can be applied for and a certified copy of the notice must be presented to the Department of Alcoholic Beverage Control.

**K. Closing statement**

A closing statement reflecting and summarizing the *business opportunity* transaction must be provided by the agent to both the seller and purchaser within one month after closing. The agent must retain all transaction related documents for a period of three years.

**12.5 MINERAL, OIL, AND GAS BROKERAGE (MOG)**

#41  
original  
CO deals

Effective January 1, 1994, the DRE no longer issues original mineral, oil, and gas (MOG) broker licenses or permits. However, real estate brokers may conduct mineral, oil, and gas transaction activities under their individual broker or real estate corporation licenses.

Those who still hold a valid mineral, oil, and gas broker license issued before the statute change are not required to possess an individual real estate broker or corporation license to conduct MOG licensed activities.

The licensee is responsible for the proper completion and delivery of title to the buyer. All persons who acquire or release an interest in a mobilehome must notify the Department of Housing and Community Development within 20 days of the date of release or acquisition and all fees must be paid to the Department of Motor Vehicles within 20 days of the sale date. The licensed agent must be conversant with all the licensing and regulation requirements in order to properly handle a mobilehome transaction.

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A broker is prohibited from maintaining a place of business at any location where two or more *mobilehomes* are displayed and offered for sale, unless the broker is also licensed as a *mobilehome* dealer.

#### 12.6.5 MOBILEHOME PARKS

A *mobilehome park* is defined as "...any area or tract of land where two or more mobilehome lots are rented or leased or held out for rent or lease to accommodate mobilehomes used for human habitation." *Mobilehome parks* are regulated by state statutes and comprise a special area of landlord/tenant law. The sale or lease of five or more lots within a *mobilehome park* falls under the jurisdiction of the Real Estate Commissioner and the provisions of the Subdivided Lands Act.

required before a map will be accepted for final recordation. Local agencies which will be ultimately responsible for providing water, sewer or educational services to the *subdivision* may require the payment of fees prior to the recordation of the *subdivision* map.

b. Final planning stage

The final planning stage is the period during which plans for the *subdivision* are finalized, including governmental approvals, permanent financing, and marketing programs.

c. Start-up

The start-up carries the process to recordation of a final *subdivision* map with local authorities. The final *subdivision* map will incorporate conditions imposed by those agencies which will be responsible for providing public services when the *subdivision* is completed and sold.

13.3.2 THE SUBDIVIDED LANDS LAW

The Subdivided Lands Law is administered by the Real Estate Commissioner through the DRE and ordinarily applies to a *subdivision* of five or more lots or parcels. The division of land into five or more parcels excludes divided parcels of 160 acres or more (unless used for mineral, oil or gas purposes) and industrial and commercial *subdivisions*. Included in the act are time shares of 12 or more estates or memberships having terms of five years or more.

No newly subdivided property may be offered for sale in California unless the Real Estate Commissioner has issued a Public Subdivision Report. This report is a disclosure of the factual circumstances of the *subdivision* and is not issued until the Commissioner is satisfied that the subdivider has met all statutory requirements, especially those related to financing the completion and maintenance of all improvements shown in the offering of the property to the public.

A Notice of Intention to Subdivide must be filed with the Real Estate Commissioner. Filing may be done by the owner, subdivider, or an agent for the subdivider. The Commissioner's *Public Report* must be received before the property is offered for sale or lease.

If the owner, subdivider, or subdivider's agent has not complied with all the required provisions of the Act but the Commissioner feels that they will be completed within a reasonable period of time, a *Preliminary Public Report* may be issued. A *Preliminary Public Report* is good for one year, or until there is a material change in the *subdivision*, whichever comes first, and permits the owner, subdivider, or

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If the *subdivision* is within the boundaries of a school district providing elementary education, the subdivider may be required to dedicate land deemed necessary for elementary public education for the benefit of future residents of the *subdivision*. Such dedication is required at the time of approval of the tentative map and must be accepted by the school district within 30 days after it is required. Failure of the school district to accept the dedication within that time automatically terminates the dedication. If the dedication is accepted, the school district must pay for the land at its original cost to the subdivider plus the costs of improvements, interest, taxes and site maintenance.

### 13.4 DIFFERENCES IN APPLICATION OF THE SUBDIVISION MAP ACT AND THE SUBDIVIDED LANDS LAW

The *Subdivision Map Act* and the *Subdivided Lands Law* are not equally applicable to all divisions of property. The major differences in application are as follows:

#### SUBDIVISION MAP ACT

#### SUBDIVIDED LANDS LAW

Two or more parcels.

Five or more lots or parcels.

Parcels must be contiguous.

No requirement of contiguity.

Includes "proposed divisions."

No provision for "proposed divisions."

No exemption for parcels 160 acres or larger.

Exempts parcels designated by government survey as 160 acres or larger.

Does not include financing or leasing of mobilehome parks.

Includes long-term leasing of spaces in mobilehome parks.

Includes commercial and industrial subdivisions

Exempts *subdivisions* expressly zoned for commercial or industrial uses.

Does not cover agricultural leases.

Includes agricultural leases.

Does not cover time shares.

Includes time shares.

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## 13.6 OTHER PUBLIC CONTROLS

### 13.6.1 CALIFORNIA ENVIRONMENTAL QUALITY ACT OF 1970

The *California Environmental Quality Act of 1970* was enacted to ensure that no projects are undertaken within California unless their potential effects on the environment are first considered. The Act requires consideration of all discretionary projects within the state requiring government approvals. The *subdivision* of property falls within the definition of projects as that term is defined by the Act. In most local jurisdictions an Environmental Impact Report (EIR) is required prior to final approval of any *subdivision*. The EIR is a detailed examination of the environmental setting of the project and the impact it will have upon the surrounding environment. It also examines alternatives to the project, including, by law, the effects of no project. The EIR is prepared by the subdivider and submitted to the local governing body for approval.

### 13.6.2 CALIFORNIA COASTAL ACT

The *California Coastal Act* establishes a coastal zone along the coast of the state and governs development within that zone. Most local governing bodies with jurisdiction over land within the zone have adopted local programs for the implementation of the Act.

The coastal zone starts at the mean (average) high tide point and runs the length of the state from the sea inland about 1,000 yards, with wider spots in certain scenic or ecologically sensitive areas.

Any subdivider planning to develop a tract of land or any owner planning any improvement within the coastal zone must be prepared to satisfy local government requirements and obtain a coastal development permit or an exemption under the exclusion from permit requirements.

### 13.6.3 ALQUIST-PRIOLO SPECIAL STUDIES ZONE ACT

#54  
The Alquist-Priolo Special Studies Zone Act established zones for property within the vicinity of known, potentially active seismic zones. The Act was designed to control development in the vicinity of hazardous earthquake faults for the benefit of public safety. Geological reports are required for *subdivisions* proposed within such special study zones. Real estate licensees selling property within such zones must disclose that fact to potential buyers of the property.

Under the federal act the prospective purchaser must receive a document entitled "State Property Report Disclaimer" in addition to the final *public report*. This disclaimer must state that OILSR has not inspected the property or passed upon the accuracy of the report or any of the advertising material.

### 13.6.5 FAIR HOUSING LAWS

At both the federal and state level laws have been enacted to prohibit discrimination in the sale, lease or financing of property.

### 13.6.6 UNRUH CIVIL RIGHTS ACT

The *Unruh Civil Rights Act* makes it unlawful for persons engaged in business in California to discriminate based upon race, sex, color, religion, ancestry or national origin. It has also been held to apply to age discrimination in apartment rental and condominium properties because they are considered to be businesses subject to this act.

### 13.6.7 CALIFORNIA FAIR EMPLOYMENT AND HOUSING ACT

*#55*  
The California Fair Employment and Housing Act (also known as the Rumford Act) prohibits discrimination based on race, color, religion, sex, marital status or national origin when providing housing accommodations. The term "discrimination" includes refusal to sell, rent, or lease housing accommodations, including misrepresentation as to availability, inferior terms, cancellations and so forth. Complaints are filed with the Department of Fair Employment and Housing.

### 13.6.8 HOUSING AND FINANCIAL DISCRIMINATION ACT

*#56*  
The Housing and Financial Discrimination Act forbids discriminatory loan practices by financial institutions. The law applies to loans on owner-occupied residences of four units or less. The Act also prohibits "redlining" - lenders cannot consider the racial, ethnic, or religious composition of a neighborhood or geographical area when establishing their loan practices.


### 13.6.9 CIVIL RIGHTS ACT OF 1968

This comprehensive federal law declared that its purpose was to provide "within constitutional limitations. . .for fair housing throughout the United States."

## 14.4 REAL PROPERTY TAXES

There are basically two types of real estate taxes: (1) general real estate taxes (ad valorem) and (2) special assessment (improvement). Both of these taxes are levied against specific parcels of property and automatically become liens on those properties when unpaid.

### 14.4.1 GENERAL TAXES


 Taxes levied on real estate by various government agencies and municipalities for the general support or operation of the government agency authorized to impose the levy are known as "ad valorem taxes." Ad valorem taxes are charged in proportion to the value of the property. Therefore, the higher the value of the property, the greater the tax.

#### A. Tax rates

The process of determining the real estate tax rate begins with the adoption of a budget by the city council or board of supervisors of the city or county. In determining this budget, the projected needs of the individual elements within the taxing body (school districts, flood control districts, etc.) must be considered.

The budget must encompass all income to be raised from all fees, revenue sharing, and other sources and include an estimate of all expenditures. The net amount remaining to be raised from the real estate tax is then established.

Following this determination, the taxing body authorizes the expenditure of funds and provides for the source of money in a step called *appropriation*. This procedure generally involves passage of a law or the adoption of an ordinance setting forth the specifics of the proposed taxation.

 The formal action to impose the tax by a vote of the taxing district's governing body is known as a tax "levy." This levy is the amount imposed on property owners.

Real estate is assessed by the county assessor, subject to the limitations of Proposition 13. "Assessment" refers to the valuation of property for the purpose of levying a tax. The term also means the amount of the tax levied.

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**B. Tax bills**

~~Proposition 13, the Jarvis Gann Initiative, limits real property taxes in California to one percent of the full cash value of the real property, plus the cumulative increase of 2% in market value each year thereafter.~~ Improvements made after March 1, 1975, are added to value in the year they are made. If ownership has changed after March 1, 1975, the tax is limited to 1% of the market value plus the 2% cumulative increase each succeeding year. This amount is known as the *assessed valuation*. Note that voted indebtedness may increase this rate beyond 1% from local area to area with voter approval.

Property is immediately reassessed upon two occurrences: (1) A change in ownership, or (2) completion of an improvement to the property. The Assessor's Office enters the new property value onto the assessment roll the first of the month following the month in which the change occurs. The amount of the supplemental assessment is still determined in accordance with *Proposition 13*. Depending on the date that property is purchased or construction is completed, property owners may receive one or more tax bills in addition to their regular tax bill.

Not all transfers result in a reassessment. Transfers between spouses, such as changing a deed of title from one spouse to another, or changing title from joint tenancy to community property are not considered transfers for property tax purposes. No reassessment is made where an original grantor remains on title upon creating a new joint tenancy with others or reserves a life estate in the property.

Property owners who dispute the assessed value of their property may present their objections to a local board of appeal or *Board of Equalization*. Appeals should be directed to the *County Board of Equalization* in the county in which the property is located between July 2 and August 26 (in most counties). In larger counties, a special Tax Appeals Board may be established. After it considers the case the Board may change the assessment. Protests or appeals may ultimately be taken to court.

**C. Tax liens**

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In effect, taxes due upon real property are liens against the property. A lien is a charge, hold or claim upon the property of another as security for some debt or charge. In California, the fiscal tax year runs from July 1 through June 30. Property taxes for the following fiscal year become a lien against the real property on March 1 of the current year, four months before the official start of the fiscal year. The first installment of half the taxes becomes due on November 1. The second installment of the property tax is due February 1.

California's *Inheritance Tax* Law was repealed in 1982 as the result of passage of Proposition 6, but at the same time the California state tax was enacted. This tax takes advantage of a provision in the federal law which allows the state to claim a credit against the federal estate tax for death taxes paid to the state. This tax does not cost the estate anything as it is fixed to the maximum amount that the federal government will allow as a credit (if it were not paid to the state, it would have to be paid to the federal government). **The return is due and any tax liability payable on or before nine months after the date of death.**

A federal estate tax return must be filed for the estate of every U.S. resident whose gross estate, at the date of death, exceeds an amount established each year by the federal government. If the decedent and spouse owned everything as community property, this amount doubles. Although a return is due, the property may not be subject to tax. For example, any property left to the surviving spouse is not taxed at the first death. The estate tax return is due nine months after the date of death. There are several ways to reduce, or in some cases avoid, the payment of estate tax, including the use of inter vivos or testamentary trusts, but these should be discussed with an attorney.

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### C. Gift taxes

The gift tax law was also repealed at the state level in 1982 with the passage of Proposition 6, but gifts are still subject to tax at the federal level. A gift is a voluntary transfer of property from the owner (called the donor) to the receiver (called the donee). To be a gift real and/or personal property is transferred free of charge, or for a less-than-adequate consideration.

Federal law provides for an annual exemption per donee. Special rules apply for gifts to a spouse. Frequently, the gift tax exclusion is utilized by a person during their lifetime to save on estate and *inheritance taxes* upon death

## 14.5 MISCELLANEOUS TAXES

### 14.5.1 SALES AND USE TAXES

The California state sales tax is imposed upon retailers for the privilege of selling tangible personal property at retail. Use tax is imposed upon the storage, use, or other consumption of tangible personal property purchased or leased under certain conditions from a retailer.

While a person's tax bracket depends on how much he or she earns, this is only part of the story. The tax bracket depends on taxable income, regardless of the source of that income. For example, a person can move into a higher tax bracket because of increased investment income or a distribution from a pension plan.

#### 14.6.2 TAX BENEFITS INVOLVED IN REAL ESTATE INVESTMENTS

Traditionally, homeowners and investors in real estate have enjoyed benefits from the favorable position real estate held in regard to taxable income. Although the Tax Reform Act of 1986 made substantial changes in the treatment of taxes attributable to real estate, benefits are still available to many people.

##### A. Homeowner tax advantages

The major income tax advantages for homeowners are:

1. Deductibility of mortgage interest
2. Deductibility of property taxes
3. Exclusion of gain on sale of personal residence

##### 1. Deductibility of mortgage interest

Mortgage interest on the taxpayer's principal residence and one additional residence is deductible subject to limitations. It is called "qualified residence interest" composed of acquisition indebtedness (cost of acquiring the realty) and *equity* indebtedness (*equity* loans after acquisition). Acquisition indebtedness is the debt incurred in acquiring, constructing, or substantially improving a qualified residence.

If any of the acquisition debt is refinanced, the debt is still considered acquisition indebtedness to the extent that the amount does not exceed the amount of the principal balance of the acquisition debt.

Home *equity* indebtedness is all other debt that is secured by a mortgage on the qualified residence to the extent that it does not exceed the acquisition debt.

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will assume the property was depreciated when the eventual sale of the asset takes place.

Only *straight-line depreciation* can be used for real property purchased currently under the present tax law. Different depreciation periods apply for residential and nonresidential property. Residential property is defined as a building with 80% or more of its rental income from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations. Hotels, motels and inns which rent more than half of their units on a transient (temporary) basis are not considered dwelling units.

## 14.9 METHODS OF DEPRECIATION

Which depreciation method is available for use is dependent upon when the property was put into service.

### METHODS OF DEPRECIATION

Placed into service:

After 1986: MACRS (Modified Accelerated Cost Recovery System)	After 1980 & before 1987: ACRS (Accelerated Cost Recovery System)	Before 1981 & Assets excluded from MACRS & ACRS: ADR (Asset Depreciation Range)
(includes GDS & ADS) <u>CLASSIFICATION</u> 3 yr. property 5 yr. property 7 yr. property 10 yr. property 15 yr. property 20 yr. property 27.5 yr. property * 31.5 yr. property **	(Refer to IRS Form 4562)	Each asset has a specified class and a class life. (Refer to IRS Form 4562)

\* = Residential real property.

\*\* = Non-residential real property.

ACRS depreciation applies to property placed into service before August 1, 1986, with recovery periods as long as 19 years and alternate recovery periods as long as 45 years. It deserves discussion here because many people used this system of depreciation before the later Modified Accelerated Cost Recovery System, and a comparison of the two systems may be helpful.



The AMT is payable to the extent it exceeds the taxpayer's regular tax liability. The AMT applies to a broader income base than regular income tax, and real estate is affected as a "tax preference item" (receiving special tax breaks) included in the definition of Alternative Minimum Taxable Income.

The following items concerning real estate are considered "tax preference items" and included in the definition of Alternative Minimum Taxable items:

- Use of the installment method of accounting.
- Accelerated depreciation/cost recovery on real property placed in service after 1986 to the extent it exceeds 40 year straight-line (Alternative Depreciation System).

In computing the AMT the following are now effective:

- The passive loss rule for regular income tax is applied to the AMT.
- The definition of investment interest for the AMT is the same as for regular tax purposes.
- A carryforward is provided for disallowed interest deductions.

This subject is also complex requiring consultation with a CPA or tax attorney.

#### **14.14.3 REHABILITATION CREDIT**

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The rehabilitation credit, as a result of the 1986 Act, applies to costs incurred for rehabilitation and reconstruction of certain buildings. Rehabilitation includes renovation, restoration, and reconstruction. However, it does not include enlargement or new construction.

Generally, the percentage of costs which can be taken as a credit is:

- 10% for buildings placed in service before 1936
- 20% for certified historic structures

Rehabilitation expenditures must be qualified and incurred in connection with a "substantial rehabilitation" that satisfies the following requirements:

- 75% of existing external walls must remain in place as external walls, or
- 75% of the external walls must be retained in place as either external or internal walls, and at least 50% of existing internal walls must remain in place as external walls, in addition at least 75% of the buildings internal structural framework must be retained in place.

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### 15.3.1 ELEMENTS OF VALUE

- A. Utility
- B. Scarcity
- C. Effective demand
- D. Transferability
- E. Principles of value

#### A. Utility

Utility is the ability of property to satisfy an actual need or perceived desire. To have utility, real property should have the ability to provide shelter, income, or specific amenities.

#### B. Scarcity

Scarcity is the present or anticipated supply of a real property in relation to the demand for that property.

#### C. Demand

Demand is the buyer's willingness to purchase property. To be effective, demand must be accompanied by the buyer's ability to purchase the property. Otherwise, demand is merely a want.

#### D. Transferability

Transferability is the ability to readily transfer the property from seller to buyer. *Value, price or cost* is directly affected by the ability to transfer the property from one party to another.

#### E. Principles of value

In addition to the four *elements of value* discussed above, ten *principles of value* have a direct bearing on the *value* of real property. These principles are:

- a. Supply and demand
- b. Highest and best use
- c. Change
- d. Competition
- e. Substitution
- f. Increasing and decreasing returns
- g. Contribution
- h. Anticipation
- i. Conformity
- j. Balance

respective pieces of property. Given two equally desirable parcels in the same area, a potential purchaser will buy the less costly one. If two identical homes are located in the same neighborhood, the principle of substitution states that a potential buyer will choose the home that costs less.

**f. Increasing and decreasing returns**

The principle of increasing and decreasing returns defines whether improvements to realty are economically sound to make. **When an improvement no longer produces an increase in the *value* of land proportionate to the money spent on the improvements, then the principle of decreasing returns applies. Conversely, when an improvement produces an equal or greater increase in the *value* of the real property, then the principle of increasing returns applies.** For example, the installation of air conditioning in an apartment which results in increased rents sufficient to pay for the *costs* of the installation, and which increases the *value* of the property, results in increasing returns.

**g. Contribution**

The principle of contribution is concerned with the economic effect of the improvement of one particular aspect of a property on the whole property. Unless the improvement produces an increased net return on the property as a whole, then the improvement is not justified. **The principle of contribution is illustrated by an owner of property who installs storm windows to increase the *value* of the property as a whole and sells the property for a higher *price*.**

**h. Anticipation**

**The principle of anticipation states that a property's present *value* is influenced by a buyer's anticipated future benefits from its ownership and use.** Anticipated future benefits from the property tends to increase *value*, while anticipated detrimental changes to the property decrease *value*. For example, anticipated redevelopment of an old area of town may cause property *values* in the immediate area to rise in anticipation of future benefits.

**i. Conformity**

**The principle of conformity states that a property's maximum *value* is achieved when that property is situated in an area where the use of other property in the area is similar.** A reasonable degree of building similarity in the area maximizes property *values*. Homes located in areas specifically zoned for residential development tend to have higher *values* than homes located in areas of mixed-use development.

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j. Balance

The principle of balance states that the *value* of property is best maintained when all contrasting, opposing, or interacting elements surrounding the use of the property are in balance. Balance includes the proper mix of land uses in the area, developing the property to its highest and best use, and neither over improving the property nor under improving it.

15.3.2 FORCES AFFECTING VALUE

#91  
There are four other main forces in addition to the four essential elements of value and the ten economic principles of value that create, maintain and increase or decrease the value of real property. These forces are:

- A. Physical forces
- B. Economic forces
- C. Social forces
- D. Governmental forces

A. Physical forces

The *value* of real property is affected by geographical and economic factors. Real property *value* is in part determined by its location. When the appraiser evaluates the physical factors affecting real property valuation, the following elements are considered:

- a. Climate
- b. Topography
- c. Size and shape
- d. Assemblage
- e. Available shade
- f. Orientation
- g. Soil characteristics
- h. Environmental deterioration
- i. Environmental hazards and nuisances

a. Climate

The nature of the climate in a particular area affects the *value* of the property, depending upon the use to which the property will be put. For example, warmer climates may be desirable for residential uses of real property, while colder climates may be desirable for winter sports facilities.

### C. Step 3: Valuing the adjustments

After analyzing the differences between the comparison properties and the subject property, a dollar or percentage *value* is assigned to each of the differences. Adjustments are then made by adding to the *price* of the comparison properties the *value* of features present in the subject property but not present in the comparison properties, and by subtracting from the *price* of the comparison properties the *value* of features present in the comparison properties but not present in the subject property.

### D. Step 4: Valuing the subject property

After making the adjustments, the *prices* of the comparison properties are compared with the subject property and the determination of *value*, based upon the comparison of the respective properties, is made. This determination is based on an analysis of the *price* at which the comparison properties tend to gather or cluster and by emphasizing the *value* of those properties which are most similar to the subject property.

### 15.5.2 COST APPROACH METHOD

The cost approach method is based on the principle that real property's highest price is equal to the value of the land plus the value of depreciated improvements on that land.

The *cost approach* method consists of five steps:

#### A. Step 1: Value the land as if vacant

The *appraiser* estimates the *value* of the land as if it were a vacant parcel of real property. In valuing the land as if it were vacant, the *appraiser* uses the *market data approach* to establish *value*. Comparable parcels of real property which have been recently sold or are currently on the market are compared with the subject land in accordance with the land's highest and best use.

#### B. Step 2: Estimate reproduction cost of existing improvements

In order to estimate the *cost* of new construction of the building and improvements currently on the subject property, one of three approaches is used. They are:

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**FORMULA: INCOME divided by RATE = VALUE**

**Example:**

A 200 unit apartment building generates \$500 per month for 100 units and \$600 per month for the other 100 units. It has a 5% annual vacancy factor and its operating expenses are 30% of the adjusted gross revenue. What is the *value* of the apartment building if investors are only buying them if the yield at least 8% on the investment.

100 units x \$500 per mo. =	\$ 50,000
100 units x \$600 per mo. =	\$ 60,000
Gross Income:	\$110,000
Less: 5 % vacancy:	\$ 5,500
Adjusted Gross Income:	\$104,500
Less: 30% operating expenses:	\$ 31,350
NET OPERATING INCOME:	\$ 73,150
ANNUAL NET OPERATION INCOME (Monthly Times 12)	\$877,800
CAPITALIZATION RATE:	8%
Formula to determine value:	\$877,000 / .08 = \$10,972,500

**VALUE OF APARTMENT BLDG \$10,972,500**

**15.6 THE GROSS RENT MULTIPLIER**

*#92*

The *gross rent multiplier* (GRM) is not a precise *appraisal* approach like the market data, *cost* and *income approaches*, although many confuse it with the *income approach*. The GRM approach produces only an informal indication of the value of property. The GRM is a comparison factor that relates the gross rent produced by a property to its purchase price. The GRM is used for properties providing a rental income, and is determined by dividing the sales price of a property by its gross rental. Small rental properties utilize monthly gross rental in the calculation while larger residential and commercial rentals utilize an annual gross rental figure in the calculation. The GRM uses gross rental figures, and does not account for variations in the expenses of operating properties.

Assuming that comparable properties have been sold for *prices* which indicate a fairly consistent GRM (*sales price* divided by gross rental), the use of the GRM presumes that the subject property can be *valued* by multiplying its gross rents by a multiplier indicated by the comparables.

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A letter report should contain all the essential elements of an appraisal report but may incorporate supporting data only by reference. The description of the subject property may be brief and only a summary of the factual data and its analysis included. Standard length is between three and six pages.

EXAMPLE:

"SUPREME APPRAISAL COMPANY  
123 Main Street  
San Diego, CA 92111  
(619)555-1111

Mr. & Mrs. John Doe  
6555 Houston Avenue  
San Diego, CA 92110

RE: APPRAISAL OF 7889 Ponderosa Blvd., San Marcos, CA

Dear Mr. & Mrs. Doe:

I have inspected the above property and the surrounding neighborhood and reviewed comparable properties in the area and have concluded that the *value* of this property is \$155,000.

Sincerely,

Albert Apple, MAI, Chief Appraiser"

## 15.8 APPRAISAL GUIDELINES AND STANDARDS

The Uniform Residential Appraisal Report (URAR) must be used when preparing *appraisals* to be used by Fannie Mae, Freddie Mac, HUD, the VA and the Farmers Home Administration. Depending on the purpose of the appraisal, different rules and guidelines apply. The word "Uniform" refers to the fact that the report has been adopted for use by five different organizations and not to the guidelines involved. For example, Fannie Mae will allow the URAR to be used only for *appraisals* of single-family residences, while HUD and VA allow it to be used for *appraisals* of up to four-family residences.

A typical residential *appraisal* package will contain additional photo exhibits, sketches and written comments in addition to the URAR or other form report. *Appraisal* guidelines, lender requirements and local custom dictate the elements of the complete package. As an example the required forms, exhibits and addenda required for Fannie Mae, Freddie Mac, HUD, the VA and the Farmers Home Administration are highlighted as follows: