Real Estate Law and Business

Students' Guide and Supplement to Real Estate Law and Business (2016)

Brokering, Buying, Selling, and Financing Realty

George Lefcoe

FLORINE AND ERVIN YODER PROFESSOR OF REAL ESTATE LAW

UNIVERSITY OF SOUTHERN CALIFORNIA GOULD SCHOOL OF LAW

With the Assistance of:

Jonathan Acheampong Frimpong USC Gould '18

Kimberly Miller USC Gould '17

Maxwell Montgomery USC Gould '19 &

Mimi Sanicola USC Gould '17

Carolina Academic Press
700 Kent Street
Durham, North Carolina 27701
Telephone (919) 489-7486
Fax (919) 493-5668
E-mail: cap@cap-press.com
www.cap-press.com

I dedicate this book to my life partner, Leon Chiu,

the light of my life over three decades now

Contents

Introduction

This manual offers: (a) summary highlights of each chapter in the textbook; (b) suggested issues for class discussion; (c) supplemental material students might find helpful in addressing those issues; and (d) my revised questions that appear in the text at the end of each of the fifteen chapters.

BUYING AND SELLING REALTY: AN OVERVIEW

Chapter 1 is an overview of how the typical purchase and sale transaction is phased from start to finish. For readers encountering the real estate sales process for the first time, their eyes may glaze over as they try to imagine what really transpires in each stage of the process.

The pivotal document in a typical realty sale is the purchase and sale agreement, whether the property is a modest tract house or a downtown office tower. One difference, though, is that broker-drafted forms are likely to be the document of choice for most houses and rental properties with fewer than 50 units, while attorneys are usually called upon to draft purchase and sale contracts for multi-million dollar commercial properties.

At the end of the first chapter, there is a form drafted for use as a purchase and sale contract for commercial real estate. It comes with escrow instructions jointly agreed by seller and buyer. This form is worth reviewing for the many issues it resolves and contemplates, besides the obvious ones of identifying the parties to the transaction, the subject property of the sale, and the purchase price. A far less comprehensive purchase and sale contract would still be enforceable.

To be enforceable, an agreement needs to meet certain requisites of contract law. And if the agreement concerns real property, state laws called Statutes of Frauds require that it be in written form. This manual offers a summary of the contract law norms and Statutes of Frauds provisions that figure in determining if a realty purchase and sale agreement is enforceable in court if the buyer or seller decides not to complete the sale. Disregarding these laws, buyers and sellers who have a falling out may discover that their deal is unenforceable.

Realty buyers may be drawn to a particular property even though they might not be completely sure that the property is exactly right for them before they have had a chance to check it out. Most potential buyers are reluctant to spend time and money learning about a property until they have obtained a legally enforceable right signed by the seller to purchase it for an agreed price. But sellers are wary of signing binding contracts with potential buyers who are just shopping around before they have learned anything about the buyer's financial ability and past real estate dealings. They need to agree to a purchase and sale contract that addresses their reciprocal concerns by including exit contingencies, or they can bargain for an option agreement giving the buyer the right but not the obligation to purchase the property. The text describes the subtle differences between a call option and a contingent purchase and sale contract, and why a buyer or seller would prefer one over the other.

The manual for Chapter I is divided into six parts:

I. An Overview of the Realty Purchase and Sale Transaction Process
II. When Purchase and Sale Contracts Are Enforceable: Norms of Contract Law and the Statute of Frauds
III. Observations about Identification of the Parties to the Purchase and Sale Contract
IV. Should House Flippers: (a) Close, Take Title and Sell or (b) Assign their Purchase Contracts?
V. Why Not Purchase Options Instead of Purchase and Sale Agreements for Home Buyers and House Flippers?
VI. Rent to Own: Lease Purchase or Lease Option Agreements
VII. REVISED QUESTIONS

I. An Overview of the Realty Purchase and Sale Transaction Process.

This first chapter identifies eight distinct stages in the realty purchase and sale process. [1]

(1) *Buyer searches for a property to acquire and seller markets a property for sale.* The seller could contract with a real estate broker or make other arrangements for marketing the property. The buyer could contract with a broker or other advisors for assistance in finding and evaluating properties to acquire.

(2) *Pre-contract period*. Buyer and seller or agents representing them come together to negotiate the basic deal terms. Commercial buyers and sellers sometimes sign a letter of intent or term sheet

(3) *Contract formation and execution*. Buyer and seller conclude negotiations and sign a contract containing all material terms of their agreement.

(4) *Escrow entered*. Buyer and seller designate a third party to oversee the fulfillment of the reciprocal promises they made to each other in the purchase and sale contract—the seller to sell and the buyer to buy the subject property. Their designate closing agent could be a title company, escrow firm or an attorney, depending on local custom and practice.

Among other administrative functions, this neutral agent usually holds the buyer's cash and the seller's deed which the agent may have assisted the seller in executing, arranging for the simultaneous exchange of cash for deed at closing.

[1] There is nothing sacrosanct about this division into eight. Professor John G. Sprankling in his excellent hornbook, Understanding Property Law (4th ed., 2017) combines the process into four basic stages. In my earlier textbook, Real Estate Transactions, Finance, and Development (6th ed. 2009), I described real estate sales as a process in three acts. Regardless of how the process overviews are organized, they describe virtually identical transactions sequences.

(5) *Executory period.* This is a legal term referring to the time from when the buyer and seller sign an enforceable the purchase and sale contract to the exact moment title shifts from seller to buyer in fulfillment of all contract conditions.

During the executory period, the seller retains legal title and the buyer is regarded as the equitable owner, entitled to specific performance of the seller's promise to deed the property to the buyer once the buyer has met all the requisite contract conditions.

(6) *Due Diligence Period*. Quite commonly, purchase and sale contracts are drafted to accommodate the buyer's anxiety about being locked into a transaction that she comes to regret. There could include property defects she overlooked on her quick walk-through before she signed the contract, objectionable aspects of the seller's title of which she was unaware when she made her offer, a queasy feeling that she overpaid based on home sale prices falling after she signed her contract, or a bit of slippage in her own financial situation reducing her credit score and raising her cost of borrowing.

A purchase offer can be drafted to empower the buyer to cancel the deal if she believes any of the above contingencies materialized.

The exact duration of the due diligence period is quite significant because in many purchase and sale contracts, buyers have the option of canceling the contract basically at will before the due diligence date expires.

Buyers who elect to cancel within the due diligence period become entitled to refunds of any deposits they had made. Buyers who do not cancel within the allowable due diligence period surrender their funds to the seller. The funds are said to go "hard" at that point. They belong to the seller whatever happens next. There are three possibilities.

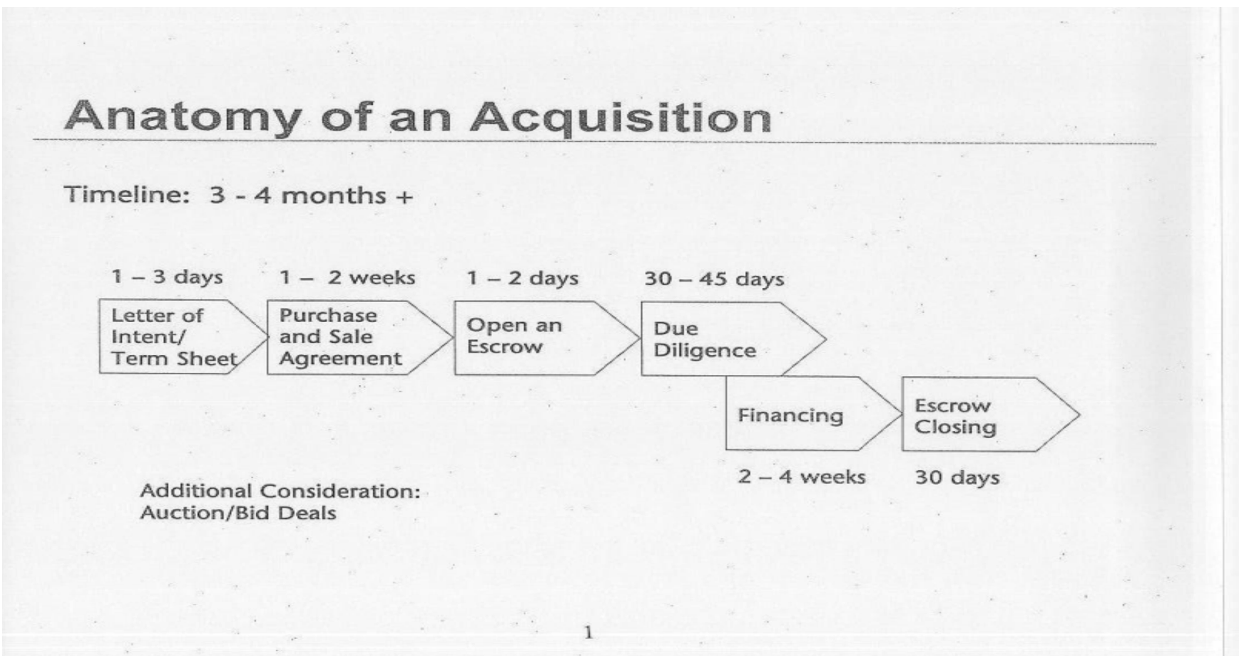
(1). The contract could close as contemplated in which case the seller would credit the buyer towards the sum owed on the purchase price. (2) The buyer could breach the contract by canceling for no good cause, giving the seller the right to retain the funds as liquidated damages. (3) The buyer could cancel the contract, invoking one of the reserved contract contingencies. Had the buyer agreed to pay a sum of money as a 'due diligence' fee, the seller could keep it.

Many commercial real estate investors including private equity funds decline to accommodate sellers' needs for timely, definitive "in or out" decisions from prospective buyers. They condition their purchase offers on investment committee review and approval, however long that may take. Meanwhile, sellers receive no compensation for what can sometimes become quite protracted delays.

(7) *Closing*. Real estate sales are said to "close" at the moment that the buyer and the seller keep the promises they made to each other, usually in written purchase and sale contracts. Typically, the seller vacates on or before the closing date, and the buyer moves in, having arranged for such details as uninterrupted utility service and insurance coverage.

(8) *Post-closing.* The seller may have made warranties about the condition of the property that were drafted to allow buyer enforcement after the closing, if necessary. After taking possession, the buyer could go after the seller to cure previously concealed or undisclosed defects—faulty plumbing, leaky windows or roofing. Another possibility is that the seller agreed to deter part of the purchase price, taking back the buyer's note, secured by a deed of trust on the property sold. The buyer's obligation on that debt could continue for many years after the closing.

Transaction times vary greatly. Here is a suggested time line for a commercial transaction. Establishing tentative deadlines enables deal participants to track progress, move things along, detect and perhaps cure the source of delays.



The seller's title is in limbo during the executory period. And the seller is burdened with delivering the property at closing in the same condition as when the contract was signed. Unless buyers deposit cash or other security upon signing the contract, they have no "skin in the game," nothing at risk during the executory period. It is no surprise, then, that for sellers, the bigger the buyer's down payment, the better.

II. <u>Purchase and Sale Contracts: Contract Norms and the Statute of Frauds</u>

For a realty purchase and sale contract to be enforceable, it must satisfy two independent sets of criteria: (1) The agreement must comport with the basic requirements of contract law; (2) The agreement must be evidenced by a writing compliant with the Statute of Frauds.

The familiar contract norms can be gleaned from case law: legally competent parties, an offer, an acceptance, words showing an intent to buy and sell, a "meeting of the minds" on all "essential" elements including the price and a description of the property, and consideration.

> Consideration is the benefit that each party gets or expects to get from the contractual deal—for example, Victoria's Secret gets your money; you get the cashmere robe. In order for consideration to provide a valid basis for a contract—and remember that every valid contract must have consideration—each party must make a change in their "position." Consideration is usually either the result of: a promise to do something you're not legally obligated to do, or a promise not to do something you have the right to do (often, this means a promise not to file a lawsuit). Sometimes this change in position is also called a "bargained-for detriment."[2]

Consideration in a bilateral realty contract is found in the reciprocally binding promises of the buyer to buy and the seller to sell.

In an option agreement, the buyer has the right but not the obligation to compel the seller to sell (a call) or the seller has the right to compel the buyer to purchase but no obligation to sell (a put). These separate buy and sell options lack the reciprocity of a purchase and sale contract in which the buyer and seller can each require the other to perform. To validate the option, consideration takes the form of small cash payments.

III. Observations about Identification of the Parties to the Purchase and Sale Contract[3]

Identification of Parties.

The Statute of Frauds requires that all parties be identified in writing. If the seller had simply contracted to sell to herself or placed the word assignee where the name of the grantee should appear, the Statute of Frauds will bar enforcement of the contract because it lacks a designated assignee. But as long as the contract identifies some existing person or entity as the buyer, the Statute is no bar to later written substitutions of a new buyer for the original one. Following this same line of reasoning, as long as an undisclosed principal's agent is identified, the principal need not be.

[2] Richard Stim, *Consideration: Every Contract Needs It*, NOLO, http://www.nolo.com/legal-encyclopedia/consideration-every-contract-needs-33361.html (last visited July 17, 2017.

[3] A substantial portion of the text from this section is taken from my book Real Estate Transactions, Finance, and Development (6th ed. 2009).

The Grantor.

Ordinarily, the seller is the current legal title holder, or holds a contract or option to buy from the title holder. Understandably, home buyers assume that anyone residing in a home and marketing the property for sale actually owns it. Usually, this assumption proves correct, though not always. Unfortunately, in the ordinary residential sale, sellers seldom recite that they have the authority to convey and the buyer won't be told much about the condition of the title until a number of days after she has signed a binding purchase-and-sale contract. Then, she will receive a preliminary report from a title company cryptically listing defects the insurer won't cover. True, the contract will allow the buyer to exit the deal with impunity upon disapproval of exclusions and exceptions to coverage contained in the preliminary title report. Yet, most buyers would have preferred knowing of serious title problems before bothering to formulate their offers and negotiate the terms of their sales contracts.

Successful commercial developers often run title checks before making offers to verify that the person who purports to own the property really does. In this way, they don't waste time negotiating with someone who can only deliver partial title or no title at all. Also, early title searches usefully reveal recorded evidence of sellers in big financial trouble–recently incurred mortgage debt, liens for unpaid mortgage or property tax bills, and judgment creditors' liens.

The Grantee.

Sometimes buyers choose to conceal their identity from the seller before closing by arranging for an intermediary, colloquially called a "straw," to take title in their place. Celebrities often become undisclosed principals, using straws to avoid seeing their street addresses in "Maps of the Stars' Homes." The notoriously rich use straws to avoid being overcharged. Developers assembling contiguous sites for major redevelopment worry about the "hold out" who learns of the indispensability of her property and quadruples its price overnight.[4] To escape the brunt of racial, ethnic, or other forms of prejudice, people who are apprehensive about being discriminated against sometimes use "straw men." The straw's promise to acquire realty on behalf of a principal is subject to the Statute of Frauds.[5]

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[4] A good example of this was Disney's secret assembly of over 27,000 acres for Disney World. Most of the acquisition was of swamp land valued at $80 per acre before public disclosure of Disney's identity as the purchaser. After the disclosure, the price of acreage in the area rose to an impressive $80,000 per acre. *See* Derek Potter, *Theme Park History: Walt Disney and the Beginning of His* 'World', THEME PARK INSIDER (Dec. 15, 2013 11:39 AM), http://www.themeparkinsider.com/flume/201312/3819/.

[5] In *Ravosa v. Zais*, 661 N.E.2d 111 (Mass. App. Ct. 1996), a broker reneged on his promise to acquire a particular improved parcel, a "hold out", for an attorney trying to assemble numerous properties for a private redevelopment project. The agent had promised to sell the property to the attorney for his actual acquisition price plus a fee of $25,000. The agent managed to buy the property for $535,000 but demanded $990,000 for it. The attorney grudgingly paid the price and sued for damages for breach of the agency agreement. The jury found for the attorney buyer but the court ruled for the agent notwithstanding the verdict because the agreement between the broker and attorney concerning the acquisition of the realty had been oral and hence violated the Statute of Frauds.

The law of agency liberally allows undisclosed principals to sue[6] or be sued[7] on contracts entered on their behalf by their designated agents–although undisclosed principals may be denied the equitable remedy of specific performance when the seller is unfairly disadvantaged by not knowing the buyer's identity.[8] Sellers have the option of proceeding either against the undisclosed principal or against agents personally who pretend to be acting on their own behalf.

Setting Aside the Sale to An Undisclosed Principal.

The seller who wishes to avoid dealing with an undisclosed principal should place language in the purchase-and-sale agreement to that effect. The seller can also ask for reassurances from purchasers that they are acting on their own behalf (though sellers seldom do).

Assume the contract made no mention of undisclosed principals but the seller asked the buyer if she was acquiring the property for someone else and the buyer lied, or volunteered the misinformation. To set aside the sale upon learning the buyer was a straw, the seller must assert and prove: (1) a fraudulent misrepresentation, (2) on which the seller reasonably relied, and (3) which was material to the deal. To reap substantial money damages, the seller needs to prove how knowing the identity of the true buyer would have made a difference in the price or the decision to sell.

Because most of the determinative issues in misrepresentation cases are questions of fact, not law, it is relatively easy for plaintiffs to put defendants to the burden of a trial. Sometimes sellers recover significant sums when intermediaries lie about whom they are representing. For

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[6] An undisclosed principal upon whose account an agent has acted within his power to bind the principal in making a contract, unless excluded by its terms, may require the other party to render performance to him instead of to the agent, except in the case of personal services or where performance to the principal would subject the other to a substantially different liability from that contemplated.

RESTATEMENT (SECOND) OF AGENCY § 310 (AM. LAW INST. 1958).

> . . . if the nondisclosure is more than mere concealment and amounts to affirmative misrepresentation, specific performance may be refused. Also, specific performance will be denied if the personality of the party who was acting for another without disclosing that fact was an element in inducing the contract, if elements of trust or confidence between the parties were material, or if such party, acting as agent for another, made misrepresentations upon which the other party relied in connection with the identity of the person for whom he or she was acting, even though the other party to the contract suffered no pecuniary loss because of such misrepresentations.

71 AM. JUR. 2d, *Specific Performance* §68 (1977).

[7] "Not only is an undisclosed principal generally liable on a contract made by an agent within the scope of the agent's authority, but, as a general rule, a person who contracts with the agent of an undisclosed principal, when the agent intended to contract on the principal's behalf within his power to bind the principal, is generally liable to the principal, and the principal can enforce a contract made by the agent without disclosure of the agency, so long as the principal has furnished consideration, either himself or by his agent.

12 RICHARD A. LORD, WILLISTON ON CONTRACTS §35:46 (4th ed. database updated July, 2004).

[8] The agent was denied specific performance in *Essex Corp. v. Herrald* because of its written promise to use the land for non-subsidized retirement housing, a use favored by the seller, when it was acting as an agent for a grocery store, a use the agent knew the sellers disfavored. See Essex Corp. v. Herrald, 2001 WL 195097 (Iowa Ct. App. 2001).

instance, a New York jury once awarded $1 million in damages to sellers who relied on the buyer's claim he was acting as a sole principal when, in fact, the buyer was assisting a subsidiary of Citicorp to acquire land for Citicorp Center.[9]

Sellers sometimes fail in their efforts to repudiate and modify a contract they entered with an undisclosed principal from whom the seller would have demanded a higher purchase price, had they only known the identity of the true buyer. For example, a South Carolina court turned away a seller who sued an agent for surreptitiously purchasing his land for the Duke Power Company. The seller had even asked the buyer "why he wished to purchase this property and why he wished to conclude the transaction so rapidly."

In response to this inquiry, instead of truthfully disclosing his purchase of the property for defendant Duke Power Company at a large profit for himself, Dalton (the buyer) falsely "represented to plaintiff [seller] that he had just come into a large sum of money which he wished to reinvest promptly in a long range timber investment for his children and that he wished to purchase plaintiff's land for that purpose since he already owned an adjoining tract."[10] The seller claimed he would have charged six times more for the property had he known the buyer's true identity. Apparently, the trial judge doubted this and found the buyer's misrepresentations to have been immaterial.

Assignment of the Contract. The Default Rule Regarding Assignment.

Any buyer could simply arrange to resell after taking title. But assigning the contract has advantages to the buyer bent on selling right away. By assigning before closing and without ever taking title, the interim buyer doesn't have to finance the acquisition, never assumes the liabilities of ownership, and minimizes closing costs since one closing is cheaper than two.

Generally, the law allows a buyer freely to assign her interest in a purchase-and-sale agreement. One justification for the rule favoring assignability is that the buyer is not performing a personal service, just promising to pay money. Cash is cash. The seller should not care where the cash comes from as long as the seller receives the promised purchase price at the closing. The buyer's promise to pay and the seller's promise to deliver good title are concurrent; unless both promises are kept, there is no closing.

Sometimes buyers convince sellers to defer receiving some or all of the purchase price at closing and, instead, to take back the buyer's note and deed of trust or mortgage. In these situations, diligent sellers will have checked out the buyer's financial resources and perhaps satisfied themselves that the purchase money had not come from a racketeer money-laundering scheme[11] or an OFAC prohibited transaction.[12] They are not just selling the property to the

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[9] *See* Morris Kaplan, *Realty Suit Wins $1-Million Award*, N.Y. TIMES, Sept. 24, 1975, at 46. *See also* Zlotoff v. Tucker, 201 Cal. Rptr. 692, 695–696 (Ct. App. 1984) (awarding seller $22,500 when buyer breached promise not to sell to either of two specified persons for at least ten years).

[10] Finley v. Dalton, 164 S.E.2d 763 (S.C. 1968).

[11] Under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-68 (1992), one violates the statute by engaging in a "pattern of racketeering activity." Helping drug dealers launder money by selling houses to them could represent a relationship with a "threat of continuing activity." If so, it would justify

buyer; they are extending credit to the buyer in the form of a purchase money loan. Buyers have no more right to force the seller to accept a "purchase money" assignee than a lender could be forced to accept a substitute borrower without the lender's prior approval.

Why Sellers May Not Welcome Assignees.

Buyers could assign under either of two quite distinct circumstances. One scenario arises when the buyer isn't quite sure how to hold title—whether individually, through an entity the buyer already owns, or through a new entity formed exclusively to take title to the asset that is the subject of the sale. The buyer often wishes to wait until near the closing to decide, perhaps forming a special entity in which to vest title. Sellers rarely have any problem with this. Alternately, buyers may contract for property they intend to 'flip' (sell) before closing. Some sellers resist allowing assignment under such circumstances.

The seller may be reasonably confident in the initial buyer's ability to perform but unfamiliar with the resources and history of the proffered assignee. True, the original buyer remains liable on the contract. But sellers want closings as promised, not law suits against assignors who no longer have a direct stake in the subject property.

Sellers may care about the habits, reputation and lifestyle of the purchaser when they plan to continue residing in the neighborhood, or don't want to stick their former neighbors with a noisome newcomer. They may also be concerned when the purchase contract contemplates the buyer performing post-closing obligations. The buyer could be a developer who has promised to build a road connecting land retained by the sellers through the buyer's new tract to a main highway. The seller may be running a successful business nearby and not want to sell to a potential competitor. A restrictive covenant might be a good idea in this situation, complemented by a restriction barring assignment. Finally, some sellers wield assignee approval rights to discriminate on the basis of race, religion, ethnicity, gender, nationality or sexual orientation.

Assignment Provisions.

The buyer and seller can select from a menu of possible assignment choices. (a) Affirm the common law rule and specifically allow the buyer to designate the grantee, inserting the phrase "buyer or assignee". (b) Restrict the buyer's right to assign without the seller's prior consent, specifying whether the seller has the right to withhold consent in its sole and absolute discretion, or must be reasonable in withholding consent. (c) Absolutely prohibit assignment.

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confiscation of the sale proceeds or the house. H.J., Inc. v. Nw. Bell Tel. Co., 492 U.S. 229 (1989). However, an owner's lack of knowledge that her home has been purchased with the proceeds of illegal drug transactions constitutes a defense to a forfeiture proceeding. See United States v. 92 Buena Vista Ave., 507 U.S. 111 (1993) (suspended by the CAFRA Legislation in 2000). *See also* Ron Champoux, *Real Property Forfeiture Under Federal Drug Laws: Does the Punishment Outweigh the Crime?*, 20 HASTINGS CONST. L.Q. 247 (1992).

[12] The Office of Foreign Assets Control (OFAC) is an agency of the Treasury Department that oversees trade sanctions and economic restrictions against foreign entities or persons.

Avoiding The Sand Trap: "Purchaser or Nominee."

A purchaser risks not being able to enforce a contract which identifies the grantee as "purchaser or nominee" because the phrase "or nominee" could be construed as giving the purchaser the absolute right to disclaim liability under the contract by designating anyone as the nominee. The purchaser's obligation could be faulted as illusory and the contract deemed unenforceable for lacking mutuality of obligation.

To head off this lurking disaster, Professor Roger Bernhardt suggests the purchaser should add the following language to the contract: "Use of the word 'nominee' shall not be construed as excusing Purchaser from the duty of performing any and all obligations specified in this agreement or otherwise imposed by law upon her."[13] This language protects the purchaser who wishes title to vest in a name or entity other than the one that appears on the contract. Perhaps at the time she signed the contract, she had yet to form the entity in which title was to vest. The same language entitles the purchaser to "flip" the contract to someone other than herself though remaining liable on the contract. By the purchaser promising continuing liability, she avoids handing the seller a plausible excuse not to perform.

Sometimes, the purchaser may not wish to remain liable after assigning the contract. Professor Bernhardt advises such a purchaser to obtain the vendor's promise of a full release from liability once the vendor consents to the transfer and the assignee assumes all of the purchaser's contract obligations.[14]

IV. <u>Should House Flippers: (a) Close, Take Title and Sell; (b) Assign their Purchase Contracts; or (c) Acquire Options Instead of Entering Purchase and Sale Contracts?</u>

The term "house flippers" refers to home buyers looking for a quick buck and not a place to live. Some of them intend to renovate "ugly duckling" houses for re-sale to well-healed buyers seeking fully upgraded properties. Others are just taking their chances on rapidly rising land and housing values.

House flippers choose one of two routes for completing their deals. After entering a purchase and sale agreement with a seller, they could take title by closing—fulfilling their obligations under this purchase agreement, and taking title, before searching for a buyer—or they could compress the process by assigning their original contract to a new buyer who would take the house flipper's place under the original contract. A seller may resent a buyer making a substantial profit on a contract "flip" and based on that, withhold approval of an assignment, hoping to share some of the buyer's gain by renegotiating a higher purchase price. Anticipating buyers challenging such refusals as unreasonable, sellers reserve the right to grant or withhold

[13] Roger Bernhardt & Jon H. Sylvester, *The Problem with Nominees*, ROGER BERNHARDT: ARTICLES & COLUMNS (Jan. 28, 2005 22:28), http://rogerbernhardt.com/index.php/ceb-columns/196-nominees.

[14] *See* Id.

approval in their "sole and absolute discretion." Alternately, if their contract already includes a list of "reasonable" bases for disapproval, they could add to the list the buyer's assignee paying a higher price.

Closely comparing these alternate strategies illuminates the real estate sale step-by-step from contract to closing. Fortunately, the transaction process is clearly laid out in blogs written by house flippers re-counting how they make quick profits buying houses cheaply from motivated sellers at below market prices and re-selling quickly by marketing to pools of already identified buyers.

This section begins with an anecdotal introduction to house flipping from a Los Angeles Times article about how enterprising millennials are thriving in the house flipping business. Then, we present differing viewpoints by house flippers on whether it is best: (a) to close escrow on the original contract with the seller, and then market the property; (b) assign the purchase and sale contract to the "flip" buyer, or (c) enter an option to buy with the original seller instead of signing a full-blown purchase and sale agreement at the outset.

Meet a New Breed of Hipsters: Flipsters, Millennials Who Flip Homes[15]
By R. Daniel Foster

That ever-present real estate breed, the home flipper, has spawned a new progeny: flipsters, or hipsters who flip homes—often to a hipster market. If you picture millennial flippers wearing flannel and pork pie hats as they peer through ironic eyewear at fixer-uppers; that might be a fairly accurate—if stereotypical—summation of the group that's finding its niche in real estate.

Paul Habibi, a professor at UCLA Ziman Center for Real Estate, said he's seeing a growing number of flipsters. "In my classes, I always talk about 'eating your own cooking,'" Habibi said. "It's easier to design something that's palatable to both you and the end user. Hipsters know what other hipsters like best."

Think of hipsters as updated 1940s hepcats or '50s beatniks: youth who favor a style and sensibility found outside the cultural mainstream (stereotypically beards, obscure music and bicycles in car-smitten Los Angeles).

Since 2013, Alan Quach, 28, has flipped about a dozen homes in the L.A. area with his high school friend Thomas Bayles, 30. Their flips take from four to six months to complete, with sale prices ranging from $750,000 to $2.4 million.

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[15] R. Daniel Foster, *Meet a New Breed of Hipsters: Flipsters, Millennials Who Flip Homes*, L.A. TIMES (Apr. 21, 2017 6:30 AM), http://www.latimes.com/business/realestate/hot-property/la-fi-hp-flipsters-20170422-story.html.

The duo's home buyers are all millennials, said Quach, qualifying his team as purebred flipsters. Though Quach, whose success with Bayles now includes new builds as part of their company, Urban Asset Group, notes: "I wouldn't say I'm hip."

These flipsters—who also include older flippers who deal in hipster-centric neighborhoods—are rousing today's market with more than a cheeky name. There's a flipster aesthetic that begins with a home's (literally) flipped fence. Instead of a traditional vertical fence, flipsters are said to favor horizontal board fences that boldly box in front yards. "That immediately identifies a house—OK, someone has come in and hipsterized this," said David Raposa, who heads Los Angeles-based City Living Realty. It's a way for flipsters "to put their stamp on a house, a kind of advertisement for buyers who can then expect an upgraded, hip house."

Flipster Sheena Schwartz has put in three horizontal fences out of the four homes she has flipped that included new fences. "I like the continual clean, crisp line," said Baldwin Vista-based Schwartz, who began flipping in 2014.

Schwartz, 36, has flipped five homes; her just-sold 1920s Spanish Jefferson Park flip is her biggest success to date. She bought the home last June as a duplex for $490,000, invested $200,000 in converting the property into a single-family 2,200-square foot residence and sold it for $940,000. "In my opinion, it was uninhabitable," Schwartz said of the duplex, citing an aboveground sewer pipe that traversed the backyard to an illegal bathroom. She tore that out, along with interior walls, gracing the new home with an "organic modern look" that blends pervasive white interiors with warmer wood accents.

Quach and Bayles favor a "transitional style" (sans the flipster fence), blending elements of "super-modern, contemporary and traditional" in their flips.

All three flipsters source their looks through Pinterest boards and home design sites. Designs are skillfully executed by trusted contractors — Quach quickly burned through his first contractor and needed to redo some features. "You learn by making mistakes," he said. "At first it was trial by fire." The trio of flipsters borrowed money from family for their initial flips, covering 20% of total costs; they've used hard-money loans for the bulk of financing.

Excellent industry networks help the flipsters lure cash-rich young buyers.

Schwartz got her start in late 2010 "scraping paint off windows" for a real estate developer. She became a flip project manager within six months. Bayles is a loan officer who is well-connected to Realtors, which helped him and Quach launch Urban Asset Group.

And, of course, flipsters have plenty to work with in Southern California. Flipsters, and their hipster clientele, key to locales where they can find stocks of older, cheaper homes in highly urban areas—perfect for young buyers who disdain long commutes. Those neighborhoods include among others: West Adams, Mid-City, Baldwin Hills, Jefferson Park, Baldwin Hills, Atwater Village, Echo Park, Silver Lake, Chesterfield Square, Historic Filipinotown and Vermont Knolls.

Why Assigning Contracts Is One of the Worst Business Models for Real Estate Wholesalers[16]
By Brett Snodgrass

I'm not going to lie, I'm extremely frustrated today. I've mentioned in other articles that in my nine years as a real estate investor, I have never assigned a contract. Well, that was true until a week ago, and boy, I will never make that mistake again!

Assigning contracts is honestly a stupid business model. I'm sorry to put it out there like that, but it's true. As a wholesaler, I want to officially lay out the contrast between what 99 percent of people do and what the top one percent does when it comes to wholesaling real estate. And after today, if you're a wholesaler, I don't want you to EVER do the former again!

The Story Behind My First Assignment

There was a property that had some pretty interesting things going wrong, and I really didn't want to deal with it anymore. The seller was a little sketched out and had backed out twice already (and then came back and wanted to proceed), and I was just kind of done. So I decided I'd assign the contract, even though my original intent was to follow through with the purchase. But as things progressed, it was really clear it wasn't something I wanted to close.

I approached an investor buyer who I've worked with before and who lives in my state. I thought assigning the contract would all go fine, but then closing day came, and the money hadn't been wired to the title company. I had told the seller that we would close on Friday, and so she shows up and doesn't get a check! Who do you think got yelled at because of the actions of this investor-buyer?

Now, don't get me wrong. I work with this end buyer a lot, and he has always come through on deals, but because of some issues with the wiring process, the money didn't get to the title company in time for closing. Whose reputation was on the line, though? It was me and my company.

You see, assigning contracts is just as if you were to tell your girlfriend you want to marry her and on the wedding day, she finds out you got paid to hand her off to some other guy.

What Are the Alternatives?

When it comes to wholesaling real estate, a lot of newbies don't even know that alternatives to assigning contracts are available.

[16] Brett Snodgrass, *Why Assigning Contracts Is One of the Worst Business Models for Real Estate Wholesalers*, BIGGER POCKETS, https://www.biggerpockets.com/renewsblog/2016/01/26/assigning-contracts-stupid-business-models-real-estate-wholesalers/ (last visited June 13, 2017).

I want to take some time to outline these different alternatives and then open the hood of my business and let you know what I do.

Assignment: When you get a property under a purchase agreement between yourself and the seller and then go find an investor buyer to whom you sell the contract for a fee.
Double Closing: When you get a property under a purchase agreement between yourself and the seller and then actually close and within the same day, resell it to an investor-buyer.
Closing and Then Reselling Later: When you get a property under a purchase agreement between yourself and the seller and then actually close. Then once it's yours, you market it and resell it as-is.
Whole-tailing: When you get a property under a purchase agreement between yourself and the seller and then actually close. Then once it's yours, you do minor repairs and clean up, market it and resell it as-is.

Why Assignment is the Worst Option of the Four

When you assign a contract, you're forfeiting your control. When it came to my situation with the property last week, I was left looking like a scam artist, all because this other investor was irresponsible. Now, to his benefit, the funds did end up coming in, she got her check and everything ended up working out the following Monday—but what if it hadn't? What if this guy just randomly decided to back out?

All it takes is the seller (who got my direct mail) to tell her friends that I'm a fraud, who will then in turn tell their friends and so on, and the reputation of my business would end up in shambles! Your reputation is EVERYTHING in this business, and I can't afford to have it dependent upon the actions of others.

Another thing is that when you assign a contract, you have to disclose to the investor-buyer how much you're making on the transaction.

If you got a grand-slam deal, say, a property with an ARV of $100,000 for $20,000, only needing cosmetic repairs of $10,000, and you sell the contract for a fee of $15,000, even though there is plenty enough spread for the buyer (he'd be getting it for $30,000, plus 10,000 rehab, meaning his profit would be $50K+), he might think you are a chump for trying to make a $15,000 wholesale fee. Or he might not, but you at least are taking that risk.

Every investor has an amount that they deem appropriate for wholesalers to charge in this type of transaction. A lot of the investors I've talked to say they hate working with wholesalers because they rip them off and charge them too much. If you don't assign, you never have to worry about this! There is no reason you have to disclose the amount you purchased the property for otherwise.

Our Business Model and Our Strategy

We utilize the strategy of "closing and reselling later" because, for one, this is the real definition of wholesaling. Any industry outside of real estate considers the selling of products to businesses for retail purposes to be the very definition of wholesaling. Look it up on dictionary.com if you don't believe me!

We buy our properties at steep discounts, then resell them to other businesses (investors) at a slightly higher fee than what we purchased them for, and then the buyers use our properties to make money. Sounds like the conventional definition for wholesaling to me!

Another reason we actually close and then resell later is because I just think it's a cleaner process. No one will question the legalities of me selling my own house. No one will question how much money I make on the transaction because they won't know. I don't have to worry about asking to show the property, marketing, nothing! It just becomes a very simple and clean transaction this way.

Also, I think doing business this way is simply more honest. If I tell someone and enter into a legal contract with them saying I'm going to buy their house, I'm going to actually purchase their house. It's just the right thing to do, man!

Now, at this point there may be some questions that arise like, "Don't you make less money doing it this way because of closing costs?" The answer is yes, in the short term.

But wouldn't you rather have a business that people can trust? Don't you think that long term if people know you follow through with what you say, that you'll get more repeat buyers and sellers? I do, and it's worked for me for close to a decade now.

My biggest point in all this is that we need to step it up as an industry. Wholesalers, for too long we have been dubbed the scum of the earth, and it's because we do things like assigning contracts. Let's get out of the grey and keep things black and white. Deal?

Wholesaling Made Simple! A Comprehensive Guide to Assigning Contracts[17]
By Seth Williams

For a long time, my land investing business followed a pretty simple model that worked extremely well about 80% of the time. I was able to find boatloads of motivated sellers, make some ridiculous, low-ball offers to them (10 to 30% below market value), and when I found a seller who was willing to accept, I was able to buy their property outright and pay cash for it (usually just a few hundred bucks per property). Once I owned a property, I could turn around

[17] Seth Williams, *Wholesaling Made Simple! A Comprehensive Guide to Assigning Contracts*, RETIPSTER, http://retipster.com/wholesaling-made-easy/ (last visited June 13, 2017).

and list it for sale (usually within 24 hours) and flip it for a MUCH higher price than I paid for it. In the best case scenario, I could move through the entire process in just a few weeks.

The Problem With a Cash Business

It was surprisingly easy for me to find cheap properties and buy them free and clear with the cash I had on hand – but the real challenge was getting these properties sold quickly.

After my first dozen deals or so, I started to learn that some properties were MUCH harder to sell than others. I'd have the misfortune of dealing with the inconvenience of a property that just wouldn't sell.

This was a problem for two primary reasons:

1. I had a limited supply of cash to work with.
2. It was never easy to predict when a property would sell.

Once I started pushing up against the limitations of my finite supply of cash AND my inability to predict the future, I started thinking to myself, "There MUST be a better way to monetize these deals without putting up any of my own money."

It was about this time that I started exploring the idea of assigning contracts (i.e. – wholesaling, arbitrage, etc.). Rather than signing a purchase agreement and buying each property outright, there was an ingenious way of signing a purchase agreement and then selling that contract to another investor so that THEY could buy it outright – with me just acting as a middle man in the deal. This contract was like a paper asset, which I could sell to a third-party and get paid an "assignment fee" without ever owning the property myself.

This presented a few obvious benefits: I didn't need to put up any of my own cash. I didn't need to shoulder any liability as a property owner. I didn't need to stress out about finding a buyer immediately (because once the trial period expired, I was free to walk away from the deal).

As I found myself increasingly strapped for cash (all while the opportunities continued to pour in faster than I could handle), this whole "Assignment" business sounded like the PERFECT solution to my problem.

Disclaimer: Before we get any further, please be aware that I am not an attorney and the information in this article should not be interpreted as "legal advice". Every state has different laws and every real estate transaction has unique variables that can affect the legality of the steps listed below. Even though these are the exact steps & documentation I use when wholesaling real estate – don't assume that this information is the "gospel truth" in the area where you're working. Before you act on anything described below, be sure to consult with an attorney in your area to confirm that these are the correct procedures to follow where you're working.

The Mechanics of Assigning a Contract

Now, the idea of assigning contracts (aka – "wholesaling") always sounds great on paper – but let me tell you, I struggled for YEARS to understand the mechanics of how this process really works.

What kind of Purchase Agreement was I supposed to use? What kind of "Assignment Agreement" needed to be signed? How was I supposed to get the deal closed? Where could I find the right title company or closing attorney? When would I get paid? What if the buyer went behind my back and talked to the Seller? What if I couldn't find a buyer before the original contract expired?

Since I struggled with it for such a long time, I'm going to save you a ton of hassle and confusion by laying it all out for you below.

How Wholesaling Works

Wholesaling is (in theory) a pretty simple concept. When an investor ("Buyer A") finds a great real estate deal and signs a Purchase Agreement with the Seller, they have the option (if their Purchase Agreement contains the right language) to "assign" (aka – sell) this piece of paper to another investor ("Buyer B").

When Buyer A sells/assigns the Purchase Agreement to Buyer B, they do it with a simple, 1-page document called an "Assignment Agreement". This document legally transfers all of Buyer A's rights to Buyer B. It also releases Buyer A ("Assignor") from any liability or obligation and substitutes Buyer B ("Assignee") in their place.

Essentially, Buyer B jumps into the shoes of Buyer A and can purchase the property directly from the Seller, at the same price, at the same terms, with the same deadlines, everything that was stated in the original Purchase Agreement now applies to Buyer B instead of Buyer A.

Stage 1: Contract Signed between You (Buyer A) and Seller
Stage 2: You (Buyer A) Find an Outside Investor (Buyer B)
Stage 3: You (Buyer A) Assign the Contract to the Outside Investor (Buyer B) and Get Paid a Non-Refundable Deposit
Stage 4: Outside Investor (Buyer B) Closes With the Seller and You (Buyer A) Get Paid the Balance of Your Assignment Fee

As you can see, the Wholesaler (i.e. – You/Buyer A/Assignor) is acting as the "middle man," getting paid in the form of an "Assignment Fee" from the Outside Investor (i.e. – Buyer B/Assignee).

In the process I follow (which I'm about to explain further), a portion of this payment is made when the Assignment Agreement is signed by both parties (Stage 3 – above) and the remainder is paid when the deal is closed and the property officially changes hands (Stage 4 – above).

The Typical Process

Over the years, I have heard numerous explanations (all of which were very different) as to how the wholesaling process is supposed to flow, from start-to-finish. Most of these explanations only got me about 80% of the way to the finish line. They never closed the loop on how to get through the closing process, abide by the law, get paid AND not be a scumbag along the way. The process outlined below seems to check all of these boxes and get the job done.

<u>Step 1: Find the Motivated Seller</u>.

<u>Step 2: Explain Your Intent & Get the Contract Signed</u>

When you start making offers to these motivated sellers, your offer needs to be accompanied by a thorough explanation of what you intend to do.

Wholesaling is a very different type of transaction than buying a property outright. The Seller needs to know what you're planning to do (because by itself, your Purchase Agreement doesn't imply what is actually going to happen).

If you don't explain your intentions to the Seller, they're going to get confused (and probably upset at you) because when you fail to properly set a person's expectations, things can get ugly.

To put it simply, there are a few key points your Seller needs to be aware of: You're not planning to buy their property yourself. You're planning to sell the contract to someone else and then THEY are going to buy it outright. You will communicate with the Seller throughout the process (they won't ever be left in the dark). If you aren't able to find a Buyer, the contract will expire and the transaction won't happen.

Given that a wholesale transaction involves a couple of additional steps along the way, it might be tempting for you to over-complicate the story as you're trying to explain things to the Seller.

It's important to explain all the basics, but you'll want to avoid bombarding them with information that they don't need to know. You don't want to confuse the Seller, because rather than being made to feel stupid, most people will just say "No" to save their pride (even if this arrangement really is in their best interests).

When I explain the process to a potential Seller, my email/letter/conversation will look/sound something like this:

> *"Thanks for contacting us regarding your property! After reviewing the specific details of your property, we would be interested in marketing your property to our nationwide network of real estate investors.*
>
> *For the next 180 days, we would be willing to invest our time and resources to*

find a cash buyer at no cost to you. If/when we are able to find a buyer, we will coordinate with you and the buyer to schedule a closing and ensure that you are paid the full amount listed in this purchase agreement.

You will not incur any costs in this process. We will be compensated by the buyer (which we will find) and when the transaction is closed, you will receive the full sale price stated in the attached purchase agreement.

In order to start the process, we will need a signed copy of the attached purchase agreement. In this contract, our company will be listed as the Buyer and our intent will be to assign this contract to another cash buyer in our network."

In order to assign your purchase agreement (as explained above), you need to make sure your contract contains an "assignment clause" allowing you to assign it to a third-party (because without this clause, the rest of this process isn't going to work).

There are many different ways to state this in your contract, but if you need an example, this is what my Assignment clause looks like:

ASSIGNMENT: Buyer has an unqualified right to assign its rights under this contract to a third-party. No notice to the Seller of an assignment is necessary. Such an assignment will create a novation and release the original Buyer from this contract and substitute the assignee in its place.

Reminder: Whatever documentation or language you end up using, you'll want to make sure you're running it by an attorney in your area to make sure it's a valid, legal document that abides by your local, state and federal laws.

Step 3: Due Diligence & Property Prospectus Report

Since you're not the actual end-buyer, it's not imperative that you learn every intricate detail about the property you have under contract. However, you do need to know the basic, relevant details about it, because you are going to market this thing to the public, to your buyers list (if you have one) and to anyone else who may be a potential cash buyer.

So how much do you need to know? As a general rule, I try to uncover any potential disasters that would kill a deal if I were buying it outright (i.e. – what kinds of things would make me turn and run the other direction?). I also need to gather enough information to fill out a property prospectus report.

What is a property prospectus report? It's just a single page that lists all of the basic details about the property. Mine looks something like this –

Listing Price:

$20,000

Property Address:
1234 Anywhere Ave.
City, State, Zip

Parcel Number: 123-456-789-10

Legal Description: Section 3, Lot 47, Block 82, Shanty Creek Red: 3455-020222

Property Size: 9 Acres

Terrain: Rolling Hills

Road Access: Yes - Dirt

Improvements: No visible improvements – old slab foundation near southwest corner of property.

Utilities Available: Owner reports that there is a well on the property.

Comparable Property Listings:
Comparable #1
Comparable #2
Comparable #3

Cost to Purchase:
Owner Payoff: $3,000.00
Assignment Fee: $2,000.00
Delinquent Taxes: $0.00
Closing Costs (approx): $950.00
TOTAL Cost to Purchase: $5,950.00

Other Issues:
Neighboring property has mobile home that is out of compliance with zoning.

The information disclosed in this property report was generated by an independent researcher. This report has not been prepared or reviewed by an appraiser, attorney or a tax professional. While this information is deemed reliable, it is not guaranteed. All numbers are estimates and all information was taken from public records of the property. Serious buyers should verify all information prior to purchasing.

The goal with this document isn't to inform them of every last detail about the property. The point is to tell them just enough to make it obvious that they're looking at a deal with some great potential.

That being said, if I do find any big problems in my due diligence process, I'll either walk away from the deal (if I don't think I'll be able to sell it for a profit) or at the very least, I'll be sure to disclose any "Other Issues" that I'm aware of at the bottom of the report.

Step 4: Find the Buyer, Assign the Contract, Collect the Deposit

When you start getting calls and emails from interested buyers, you're likely to find that there are A LOT of tire-kickers out there. People will get your hopes up, only to go AWOL when it's time to sign on the dotted line. People are extremely fickle, so if someone wants you to take their offer seriously, they're gonna have to agree to it in writing AND put their money where their mouth is.

When I find an interested buyer, this is how I would communicate the next steps to them:

> *"Thanks for your interest in this property! If you'd like to move forward with this purchase, I'll need two things from you:*
> *1. Please sign the attached Assignment Agreement and fax or email it back to me by 5:00pm today.*
> *2. Please send us a $______ deposit by 5:00pm today via wire transfer.*
> *Note: The property will not be reserved until both items are received.*
> *Once both items are received, the property will be reserved in your name and we will contact <<Title Company Name & Location>> to begin the closing process. They will contact you in the next few days and will send you the closing documents and preliminary title report for your review and approval.*
> *Our tentative goal is to close this transaction by <<30 days later>>. This means you will need to submit your funds and all the required paperwork to <<Title Company Name>> by (or before) that time."*

Notes Regarding the Deposit:

When it comes to the deposit, I usually ask for anywhere from $1,000 (for the cheaper deals of $10,000 and below) to $3,000 (for anything $30,000 and up). For anything in between, I'll ask for approximately 10% of the total purchase price.

When you collect these funds from the buyer, don't run out and spend this money just yet. You need to wait until the transaction is closed and the property has been transferred from the seller to your buyer.

Believe me – there are all kinds of obstacles that can get in the way of closing (title issues, funding issues, inspection issues, you name it). With this in mind, you should NEVER touch this deposit until the deal is done. Just take a look at this section from my Assignment Agreement:

"Assignee has the right to a full refund of the Down Payment, upon demand, if any action or inaction of either Buyer/Assignor or Seller prevents the closing of the sale of Property according to the terms of the Purchase Agreement."

Remember, even though you have this money in your bank account, you're still "on the hook" to pay it back until the deal is done, so hang onto it until you've crossed the finish line!

Notes Regarding the Assignment Agreement:

You might find that some people (buyers, sellers, closing agents, etc.) will have a tendency to over-think this document, simply because they don't have experience with assignments and they aren't familiar with its function.

As I explained above, this agreement is a relatively simple document that takes your rights as the original "Buyer" of the property and transfers them to a third-party (i.e. – the new person or entity that has the cash and desire to jump into your shoes and become the actual end buyer of the property).

Step 5: Deliver Documentation to Title Company, Close, Get Paid

Once you have both the Assignment Agreement and the funds required for your deposit, you'll need to deliver the following documentation to your Closing Agent (i.e. – Title Company or Closing Attorney): Copy of the fully executed Purchase Agreement; copy of the fully executed Assignment Agreement; proof of the funds that you've received for the deposit.

This should be everything they need to order title insurance, prepare the necessary paperwork for all parties to sign and then move forward with closing the transaction.

Given that this is a cash deal (with no mortgages or outside financing involved), this shouldn't be a terribly complicated transaction for your closing agent to pull off. That being said – I should warn you that not all closing agents are created equal.

When I first started trying to assign contracts, I found that some title companies have no idea what they're doing (they acted like I was asking them to move heaven and earth or do something illegal). The title companies in my area seem to be particularly incompetent with these deals – and it threw a huge wrench in my progress for a long time.

If you run into this dilemma, just keep calling around to various title companies or closing attorneys in your area until you find someone who understands what you're talking about. Don't let their ignorance act as an obstacle to the evolution of your business.

Knowing When to Wholesale

When I look back on all the properties I've listed and sold on my own behalf, most of them sold in about 6 months or less (assuming the properties were desirable, usable, priced right and I was marketing them consistently).

Whenever a property took longer than 6 months to sell, it was usually because of one or two issues:

- My assumptions about the property's market value were WAY off (and I didn't have the kind of profit margin I thought I would).
- Something was fundamentally wrong with the property (e.g. – it didn't perc, it wasn't buildable, the location was terrible, etc).

As you can imagine – neither of these things are ever a fun realization to have, but whatever the case may have been, I found that when a property sat on the market for more than 6 months and the sale still hadn't occurred, something big needed to change.

Here are some issues that typically push me to consider wholesaling rather than buying outright:

- When I'm not very confident about the property's true market value.
- There are potential problems with the property that I can't get resolved.
- I don't have the money to invest myself and buy it outright.
- The Seller isn't willing to lower their asking price to my liking (but there's still enough meat on the bone to make a hefty profit).
- The property isn't local and I don't want to take on the liability of ownership.

It's important to remember that even if you do have money to buy a property, it doesn't necessarily mean you should. There are all kinds of menacing issues that can come up with any property – and in some cases, these issues can become MAJOR obstacles to getting it sold. For many investors, this kind of uncertainty is more than enough reason for them to stick to wholesaling almost exclusively.

Drawbacks to Wholesaling

While there are certainly a lot of benefits that can come with wholesaling, there are a few drawbacks that you should be aware of as well. When your intent is to assign a contract, you'll have to deal with a few limitations (which may or may not be a problem – depending on what you're trying to do). For example:

- You won't be able to make any improvements to the property (because you don't own it and it's not yours to improve).
- You won't have the freedom of offering seller financing (because you're not the Seller and it's not yours to finance).
- You'll have a much shorter window of time to get the deal done (because your contract won't last forever).
- The closing process will require more attention to detail than the simplicity of a cash closing (which can be done in-house if needed).
- Your buyer MUST have the ability to pay all-cash (because most mortgage lenders aren't willing to deal with the minor complexities of an assigned contract).

It's also worth noting that some states (like Ohio, for instance) have laws and statutes that essentially make it illegal to market a property you don't own in your name. It's considered to be the "brokering of real estate" – and if you don't have a real estate license in that state, you could get fined and/or charged with a misdemeanor for working outside of this box.

One potential way to get around this is to make it abundantly clear in your listing that you are selling a CONTRACT to purchase the property, not the property itself. For example, you could include a short paragraph in your listing that reads something like this…

> *"This property is available via our Assignment Program. We have entered into a purchase contract with the current owner to buy the property for $________ (this price includes payment to the owner and all associated fees and estimated closing costs) and for an assignment fee of $_______, we will sell our rights in this contract to a third party. A reputable title company and/or attorney will be enlisted to handle the closing and transfer of title."*

With this kind of statement included in your listing, it should be clear to any interested parties that you are not the current owner. You are simply selling a piece of paper that gives you (and ultimately, your end buyer) the right to purchase the property for a certain price.

When you decide to buy a property outright and flip it (i.e. – the old-fashioned way), there are a lot of freedoms you'll have that simply aren't available when you choose to assign the contract. So before you swear off buying properties outright, remember that every deal has a number of considerations you need to think about. Depending on your end goals, these issues may or may not make the property an ideal fit for wholesaling. As with anything, there are pros and cons to every approach.

It's An Ongoing Education

I'll be completely honest – at the time of this writing, I still don't consider myself an "expert" in wholesaling (because I've only been through the process a handful of times myself). On the same coin, I can say that I've been through enough wholesale deals to know that this process works.

Wholesaling is a great way to make money in real estate, but it's still not my primary technique for handling most deals. My experience with wholesaling hasn't reached the same comfort level that I have with simply buying properties for cash.

That being said, wholesaling is an extremely helpful sidearm to have at my disposal when I come across deals that don't fit perfectly inside the "cookie-cutter mold" that I like to see (and as you can probably imagine, this happens pretty frequently).

My goal is to get a lot more experience with this technique, because there are PLENTY of times when wholesaling would have been a much better fit for some of the deals I've pursued in the past.

Questions About House Flipping

(1) Which "flipper" is right—the one who urges flippers to take title first, and then sell, or the one who prefers assigning the original contract to the flip buyer?

(2) Based on the assignment provision in the CAR form, paragraph 30, the seller reserves the right to consent but not to withhold consent unreasonably. House flippers are reluctant to accept a provision like this, concerned that sellers will feel justified in denying consent when they come to realize that the buyer is just speculating on rising property values. At a minimum, sellers will want the "flip" buyer to take the risk of fluctuating property values by closing escrow and becoming the owner of the property before re-selling. Sellers would prefer reserving the right to deny approval in their "sole and absolute" discretion. "Flip" buyers would prefer no provision at all concerning their right to assign because the default rule favors "alienability."

(a) Do you see any way that these conflicting positions can be compromised to avoid the assignment issue becoming a deal breaker?

(b) Would it be reasonable for a seller under paragraph 30 to reject a proposed assignee because the flipper never explained to the seller that the originally agreed purchase price was considerably below market value?

An Option to Purchase Real Estate: How to Creatively Buy, Sell, and Profit with Options[18]

By Ankit Duggal

What is a Real Estate Option?

In legal language, a real estate option is an agreement that grants the party owning the option, the optionee, the exclusive, unrestricted, and irrevocable right to purchase property from the party selling the option, the optionor, during the specified period of time that the option is in effect.

Real Estate options have six key elements:

1. *Optionee*: Optionee is the party buying a real estate option.
2. *Optionor*: Optionor is the party selling a real estate option.
3. Real estate option: When an optionee buys a real estate option, he or she buys an exclusive, unrestricted, and irrevocable right and option to purchase a property at a fixed purchase price within a specified option period.
4. *Option consideration*: the amount of money paid by an optionee to buy a real estate option from an optionor.
5. *Option period*: the specific period of time stated in the real estate option agreement in which the option is in effect.
6. *Exercise of option*: The exercising of a real estate option occurs when the optionee notifies the optionor, in writing, that he or she is going to exercise the real estate

[18] Ankit Duggal, *An Option to Purchase Real Estate: How to Creatively Buy, Sell, and Profit with Options*, BIGGERPOCKETS, https://www.biggerpockets.com/renewsblog/2013/04/22/an-option-to-purchase-real-estate-how-to-creatively-buy-sell-and-profit-with-options/ (last visited June 13, 2017).

option and purchase the property under option.

What are the Benefits of a Real Estate Option Strategy?

If you are a speculative real estate investor then options can be more beneficial than flipping hard real estate. I know that most investor talk about flipping real estate and making tons of money in under 6 months. There is a grain of truth to those strategies but at times some authors forget to mention the roadblocks to flipping real estate:

1. Title seasoning.
2. Property appraisals.
3. Scrutiny from lenders and title and escrow agents for possible fraud.

When used properly, real estate options strategy is an excellent low-risk, high-profit potential property control technique.

What are the Best Types of Properties for an Option Strategy?

Buy options on assets that are in demand or are going to be in demand through creative repurposing or added demand from potential space users. Below are a few key types of assets that can be targeted for options strategy:

- Properties that can be upzoned for the highest and best use.
- Mismanaged rental properties that can be turned around.
- Dirty, filthy, run-down properties that can be cleaned up.
- Properties with functional obsolesce that can be put to other uses.

How to Find Option Assets?

You need to develop a multipronged attack to find sellers of assets that would consider option strategy. The best techniques that I would recommend are as follows:

- Classified Ads
- Direct Mail
- Internet Marketing

I prefer direct mail that is geared towards marketing to out-of-town owners. Why out-of-town owners? Most out-of-town or absentee property owners become that way because they either inherited a property or, for whatever reason, were forced to relocate and failed to sell their property before they left town. Hence they are usually highly motivated and are looking for a solution to their problems. Send them a letter or a postcard, which should be relatively short, sweet, and to the point.

How to Resell Your Option for a Profit!

Lets assume that you searched, negotiated and tied up an option. Make sure to record an option memorandum at the county records vault so that your option position is noted within the chain of title. The next question that comes up is how to make a profit with this option?

The first step in the process of reselling a real estate option is to calculate its resale value. Always try to sell real estate options for at least 5 to 10 percent of the property's market value with the option buyers end position in mind.

For example, on a property with a fair market value of $100,000 that you have an option to buy for $60,000, in such a situation I would price my option at $10,000. This way, I would be fairly compensated for the time and effort that it took me to get the property under option while the option buyer got a $30,000 discount from the fair market value.

The second step in reselling a real estate option is to create an information packet that provides the following pieces of information:

1. The year the property was built, along with the type of construction and architectural style.
2. The property's geographical location, to include any special features or benefits about the area.
3. A brief description of the building's interior including but not limited to square footage and geometrical shape of the building, spacing between interior support columns, ceiling and overhead door heights, type of heating and cooling system, and the size and shape of the lot.

Market the property, not the option. What you are really selling is the real estate asset that underlies the real estate option agreement itself.

Question About Options for House Flippers.

An option is only as good as the terms of the underling purchase and sale agreement. Where optionor and optionee defer reaching agreement on the ultimate purchase and sale contract they are prepared to enter, do you believe they risk not being able to reach agreement on the details once it becomes clear to the seller that the flipper is on the cusp of realizing a huge gain at the original seller's expense?

V. For Home Buyers: Why Not Purchase Options Instead of Purchase and Sale Agreements?

Option Contracts for Buying & Selling Real Estate[19]
By Brian Farkas, Esq.

"Option contracts offer buyers a chance to put a property "on hold" until they're ready to complete the purchase for the option.

[19] Brian Farkas, *Option Contracts for Buying & Selling Real Estate*, LAWYERS.COM, http://real-estate.lawyers.com/residential-real-estate/option-contracts-for-buying-and-selling-real-estate.html (last visited June 13, 2017).

Imagine that Bob is interested in purchasing Mary's home in Brooklyn for $600,000 cash. However, he is awaiting a job offer that might force him to move to Washington, DC. Bob obviously wouldn't want to buy the house now, if within a month, he might learn that he needs to sell it and move. Mary realizes that she has a potentially good buyer, but that Bob will have to refuse the purchase until he knows for sure about his job.

Mary and Bob decide to enter into an option contract. Mary agrees that, for 30 days, Bob has the exclusive right to buy the home for $600,000 cash. Bob pays Mary $250 for this exclusive right. The two set the terms of this agreement in writing, and sign it. They have created an option contract, in which both have benefited: Mary has a potentially good buyer "on the hook," and Bob has bought himself some time to figure out his career situation. The option contract is supported by $250 of consideration.

If the option is exercised according to its terms and conditions, a binding contract is created. The seller must sell, and the buyer must buy, for the price or consideration and on the terms stated in the contract.

Option contracts can be beneficial to both the buyer and the seller of property, but are often particularly helpful for the buyer.

Let's start with what the seller gains through this arrangement: namely an immediate payment of money (commonly between 3% and 10% of the property's market value) and the prospect of a future sale. Why wouldn't the seller just put the property on the open market? Not every piece of real estate is an easy sale, and marketing a property takes work no matter what. Keeping one potential buyer interested can overcome a variety of marketability issues. If the sale goes nowhere, the seller at least gets to keep the option money (in most cases).

The benefits that the buyer of the option gains are many: time in which to secure financing or save up a down payment, investigate zoning laws, and inspect the land, and all without the threat that the seller might sell to someone else first. The option can also be used as an investment: Someone buys the option, waits for the land's value to increase, then exercises the option, buys the property, and makes a profit on its sale.

In an option contract, only the seller is bound. That is, the buyer is not required to buy. And the seller is required to sell under only the specific terms of the option contract. In other words, a buyer and a seller of property could enter into an option contract but, for whatever reason, the buyer could ultimately decide not to exercise the option to buy.

Although an option contract is in some ways open-ended, a seller might "breach" or violate it in a number of ways. Clearly, there's a breach if the seller refuses to sell after the optionee properly exercises the option, or if the seller cancels the option early without the optionee's consent.

Using the example above, imagine if another buyer came along and offered Mary $650,000 a few days after she made the option agreement with Bob. If Mary were to take the extra money, this would be a breach of her contract with Bob.

What if the seller sells the land to someone else during the option period? So long as the seller sells the land subject to the continued existence of the option, there is no breach. If the actual buyer had notice of the option at the time of the sale, the optionee can enforce the option against the new buyer. So, for example, if the sales contract with the buyer stated that there was an option, the buyer is bound by it. However, if the buyer was unaware of the prior option at the time of the sale, the optionee's rights are terminated, and the seller is in breach of the option contract.

If a seller violates or "breaches" the option, the buyer's remedies can include:

1. Specific performance, in which a court order forces the seller to sell the land to an optionee who has exercised the option.
2. Money damages, including any money that the optionee spent in connection with deal, such as having a survey made, or the difference between the price the optionee paid for other land and the price of the land stated in the option.

Like any contract that pertains to land, an option agreement must comply with the "statute of frauds," and so it must:

1. Be in writing, as should any cancellation or change ("modification") of the option, and
2. Be signed, at a minimum by the seller, but ideally by both parties."

Questions about Using Options.

(1) Would you have counseled Mary and Bob to try to negotiate an option for the house they want instead of signing a purchase and sale agreement? Assume that neither the option nor the "due diligence" period on the contract would expire before they knew for sure whether a job relocation was imminent?

(2) Even if the title is good, the property is in flawless condition and the buyer has access to ample financing, would the buyer under the CAR contract, reprinted at the end of Chapter 1, be entitled to a full refund of the down payment, terminating the contract without specifying a reason, as long as the termination took place before the expiration of the contract due diligence period?

(3) What practical differences are there between an option and a purchase and sale contract if the contract buyer who just changes his mind forfeits no more than a specified sum as liquidated damages—typically, a percentage of the purchase price that the buyer advanced upon signing the contract?

Hypothetical about Puts and Calls.

A housing tract subdivider would like to build 200 homes on what is now a 40-acre alfalfa farm. She is uncertain whether the local government will approve her requests to change the zoning for a 200-lot subdivision of five units per acre.

As an alfalfa field, the property is worth \$10,000-\$12,000 per acre. If the land use requests are approved for the 200-lot subdivision, the land would be worth \$30,000-\$40,000 an acre. The subdivider estimates that it could take one to two years before the local government reaches a final decision on its zoning and subdivision petitions.

Call Option. It is likely that the subdivider will try to negotiate a call option with the farmer, entitling her to the right but not the obligation to purchase the land. This is ideal for the buyer, because if the land use requests are rejected, then the subdivider can simply walk away from the deal with nominal loss and not exercise her option. The farmer would have no right to compel a sale to the subdivider under this option.

Put Option. The farmer will likely try to negotiate an option contract in the form of a put, which would entitle him to compel a sale to the subdivider. If the subdivision is approved, the approval will likely come with the cost of obligations imposed by the city in exchange for the zoning designation. The seller will not want to be exposed to these burdens and obligations, so the ideal strategy in avoiding this risk would be to limit the buyer's ability to walk away from the deal by enforcement of a put option. This option will likely be contingent upon the subdivision approval, as the buyer will not agree to the risk of being compelled to purchase without the subdivision rights. Holding the power to compel the sale as a put option, the farmer will be able to gauge whether the subdivider is a serious buyer, while also limiting exposure to the obligations of the new zoning designation.

Renegotiation. When land use entitlements are involved in purchasing real estate, it is common for the purchase price to be renegotiated over the course of the transaction. Often times, the approvals aren't exactly in line with the expectations of the buyer or seller, and the result can have a significant impact on the feasibility of the deal's completion. In our example, perhaps instead of granting the request for subdivision allowing five units per acre (totaling 200 units as planned), the approval included a density restriction of three units per acre (totaling 120 units). From the buyer's perspective, this would have a substantial effect on the financial implications of the deal, and would likely render the project infeasible as an investment. This determination is of course dependent on the valuation of the purchase price, and instead of walking away from the deal, the buyer may try to renegotiate the purchase price based on the outcome of the zoning designation.

VI. Rent To Own: Lease Option or Lease Purchase Agreements[20]

Rent-To-Own Homes: How The Process Works[21]
By Investopedia

In a conventional traditional home purchase and sale contract, buyer and seller agree on a price and terms, the buyer makes a down payment, inspects the property, reviews the title, and arranges financing. At an agreed date, the seller executes a deed to the buyer in exchange for the buyer remitting the balance of the purchase price. Typically, buyers use a mortgage to finance the bulk of the purchase.

An alternative way to buy a home is through a rent-to-own agreement. In an own-to-rent format, the owner agrees to rent the house to the prospective buyer as a tenant for a period of time, typically one to three years. The potential buyer gets to move into a house right away. In addition to a standard rental agreement, ideally, the seller and prospective buyer accompany their lease with a complete purchase and sale contract, such as the one reproduced at the end of this chapter.

A rent-to-own transaction takes either of two forms: a lease option or a lease purchase. Under the lease-option format, the buyer pays the property owner a one-time non-refundable option fee in exchange for the right to buy the property at the end of the lease term.

In a lease-purchase format, the buyer obligates herself to acquire the property at a particular time for a pre-determined price. This may be a good thing for the buyer if the house rises in value and the buyer can raise the cash needed to complete the sale at closing. But if the buyer would prefer not to complete the sale, perhaps because the house is worth less than it was when she contracted to buy it, she will be legally liable to the seller for the difference between the contract price she promised to pay and the value of the house on the date she shirked her obligation to purchase.

The economics of these deals is explained by Richard Schulman, a Los Angeles realtor:

> *Tenant/Buyer leases a property from Owner for $2,000 per month, with a $5,000 option fee, with a price of $250,000. The monthly market rent is $1,500 per month and $500 accrues to the principal. This all sounds good in theory, but there are some severe flaws. Let's think about it from the seller perspective:*

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[20] The lease option and lease purchase agreements should not be confused with a comparable acquisition method called a 'contract for deed.' In a **contract for deed** sale, the buyer agrees to pay the purchase price of the property in monthly installments and occupies the property not as a tenant but as the purchaser under an executory purchase and sale contract. See Federal Reserve Bank of Minneapolis, Risks and realities of the contract for deed. https://www.minneapolisfed.org/publications/community-dividend/risks-and-realities-of-the-contract-for-deed. See also, Kellogg v. Shushereba, 82 A. 3d 1121, 2013 VT 76 (Vt. Sup. Ct. 2013).

[21] Much of this excerpt on the own-to-rent arrangement is a version of an Investopedia entry as modified by the author of this supplement and his research assistants.
Rent-To-Own Homes: How The Process Works, INVESTOPEDIA (June 16, 2016), http://www.investopedia.com/articles/personal-finance/100714/renttoown-homes-how-process-works.asp

- They tie up their property.
- If the price goes up, the buyer can exercise the option and buy the property (if they are able), the seller gains no advantage.
- If the price level goes down, the buyer can walk away, and the seller has a property that has lost value.
- If the buyer defaults on the rent, or fails to exercise the option, seller keeps the option fee and the monthly premium.

Why would any rational seller want to enter into this agreement? Thus, we can assume that a seller only enters into an agreement if he can get an advantage on buyer – charging a higher rent than market, or a high contract price for the home.[22]

Renting vs. Owning a Home: Pros and Cons[23]

If an owner is having trouble selling, rent-to-own provides an alternative to lowering the home's price, taking the home off the market, or renting the home out long term. Because a selling price is established in the lease-option contract, the current homeowner knows exactly what to expect if a sale goes through. If the market declines slightly during the lease period, the sale price is already locked in, but the tenant will probably still be interested in buying the property because of the previously paid rent credit - the money he or she has already put towards the house, which was included in rental payments. Meanwhile, the owner gets help paying the mortgage, property taxes and insurance. Also the tenants are more likely to take care of a lease-option property because they have the option to purchase it. The owner also has a long-term renter who will care for the house more than most tenants would.

Own-to-rent has some advantages for buyers. By living in the home before deciding to purchase it, a buyer has the advantage of a lengthy test drive on the home before jumping into a major financial commitment.

Buyers don’t need to overpay. They can compare their own-to-rent monthly payments and agreed purchase price with rents and prices of similar houses. Discovering they are paying a premium might not be a deal-killer for buyers who like the house and are seeking time to save up for a down payment. They might also need time or to improve their credit rating to qualify for a mortgage on terms they can afford.

The main reason why a rent-to-own agreement appeals to buyers is the financial one, of course – no need to come up with a substantial down payment or qualify for a mortgage. The buyer also does not have to worry about immediately coming up with the money for property taxes, private mortgage insurance or homeowners insurance (though they should carry renter's insurance, as noted above).

[22] *The Truth About Rent To Own, Nov. 14, 2011*. http://richardschulman.com/2011/11/14/truthaboutrenttoown/
[23] http://www.investopedia.com/updates/rent-to-own-homes/

By signing a contract now, the buyer locks in a purchase price, which means no worrying about rising home prices. Bear in mind, however, that in a rapidly appreciating real estate market, a savvy owner would probably want to add a clause to the contract allowing for the price of the home to increase, especially if the lease is for several years.

Those who can afford to buy a home the traditional way, using financing, are probably better off doing so to lower their total costs of homeownership. But for those who just need to buy some time, or need to keep their options open or their funds liquid, renting to own can be a way to reside in their dream home now, and pay in full for it later.

VII. REVISED QUESTIONS

Question 1: ***Letters of Intent, Purchase and Sale Contracts, or Options?***

The subject property is a 57- unit apartment house in a working class neighborhood of a mid- size California city near the center of the state. The seller has owned the property for over a decade, and is earning a positive cash flow. Apartment house values have risen slowly and steadily over the years, and the seller is hoping to "trade up" into a larger building. The buyer is a recent college graduate and a business major, using borrowed funds from family and friends to become a first- time apartment owner/ manager/ investor. They happen to meet at an alumni social event at a college they both attended, start talking about apartment investments, and realize they might strike a mutually satisfactory deal for the purchase and sale of the apartment house. The seller has yet to list the property with a broker. Compare the advantages and drawbacks of their negotiating a letter of intent, a purchase and sale contract, or an option for the apartment house?

Question 2: ***Alternatives to a Written Agreement for Realty.***

An aspiring sculptor meets the owner of a 10,000 square foot downtown warehouse at a cocktail party, and they start talking about whether the aggregation of homeless people in the area is going to prevent it from ever becoming viable for the millennials who enjoy the edginess and low prices of places like these in other cities. Their casual meeting leads to a serious discussion in which the owner agrees to rent the space to the sculptor on a one year lease at $1,000 a month, a very low rent for the warehouse.

The sculptor moves in, feels very much at home, and would be willing to spend $100,000 to $130,000, installing a designer kitchen, two well equipped bathrooms, lighting similar to that of a four star hotel, and ceramic floors. But the landlord must agree to extend the lease for two more years, holding the rent increases to prevailing market rents of comparable units that are unimproved. The owner agrees, and also volunteers that if she should ever decide to sell, she would want the sculptor to have the right to purchase the warehouse at its appraised fair market value, at the pre-improved value of the warehouse.

Fortunately, they have a mutual friend who invests in the area and is willing to serve as their resource for setting the rent and, if necessary, determining fair market value.

The sculptor makes the improvements. One year later, the owner lists the property for sale with a real estate broker. The sculptor only learns of this when the broker knocks on the door one morning to show the property to a prospective buyer. Since the sculptor and the owner had no written agreement, does the sculptor have any basis for remaining in possession another year, and purchasing the warehouse if he can raise the money?

Question 3: ***Curbing the Enforceability of Letters of Intent.***[24]

The developer of a new shopping center is negotiating letters of intent simultaneously with a major retailer, a grocery chain, and a multinational consumer technology company. The center could use all three. The challenge for the developer is that all three have indicated great interest in their leases including an option to buy the shopping center at some point during or at the end of their lease terms.

Before deciding on whether to grant any of them an option to buy the center (which he is not keen to do), he figures that maybe during informal negotiations over lease terms, he will learn which of the three leases is best for him, and he will be able to assess whether he really needs to grant an option to any of them to induce them to enter the lease.

Understandably, it is very important to the developer that the negotiations concerning the letters of intent each be confidential so that the three prospective tenants are not in a position to compare notes with each other. And, of course, the developer would not want to be bound by any of the tentative deal terms he negotiates with any of the three until he has concluded negotiating all three of the lease LOIs.

The developer's attorney has cautioned that occasionally courts have enforced letters of intent despite clear language in the LOI that a formal agreement is to follow and that the parties have no obligation to continue negotiating after a date specified in the LOI. At the same time, the developer wants its LOI to bind the parties to confidentiality.

The attorney has an idea of how to stonewall any attempt the tenants might make to enforce an LOI. The Statute of Frauds applies to leases for more than a year just as it applies to contracts for the purchase and sale of realty (including options). With this in mind, the attorney advises the developer: "Just don't sign the LOI. That way, the LOI language concerning leases and options will be unenforceable. Don't worry about the enforceability of the confidentiality provisions; the Statute of Frauds does not apply to them."

In your opinion, is this good advice?

[24] The wording of this question varies slightly from what is in the text.

Question 4: ***Back up Offers and "No Shopping" Clauses.***

Quite commonly, letters of intent contain a "no shopping" clause in which the seller promises not to negotiate with anyone else while LOI negotiations are pending. But once sellers enter a purchase and sale contract, they are, typically, free to obtain "back up" offers contingent on the termination of the extant purchase and sale agreement.

Real estate brokers welcome the chance to continue marketing the property. With an accepted offer in hand, it is easier for them to attract a second offer on even better terms for the seller. With a backup offer in hand, the brokers have a chance to earn a commission even if the first deal falls through.

(a) How can a seller justify "shopping" a purchase and sale contract that resulted from a letter of intent with such provisions in it?

(b) Suppose a buyer, having negotiated a letter of intent, insists upon the purchase and sale contract containing the same exclusivity and confidentiality provisions that were used in the LOI. How can the seller reasonably refuse such a request?

Question 5: ***Financing Contingencies.***

A prospective buyer has saved $25,000 for a down payment on a house or condo. She has heard that she could afford monthly housing costs of approximately 30% of her income after deducting her student loan and car repayment obligations. She has also found a mortgage loan calculator and figured out approximately the size of a loan she could afford. She finds a house she would like to buy. She would hate to forfeit the down payment as liquidated damages if she cannot finance her purchase. Does she need to determine exactly how she plans to finance the acquisition before signing the purchase and sale contract, or will the standard financing contingency provision protect her from this risk?

Question 6: ***Why the "Free Look" Purchase and Sale Agreement Instead of an Option?***

A thoughtful home seller, reviewing the terms of the standard real estate purchase and sale agreement form, asks why she should enter a contract with a buyer who has several weeks to decide whether to buy or not.

During that time, the buyer and the buyer's inspectors have access to the property. If the buyer discovers anything negative during an inspection and discloses it to the seller, the seller must disclose that information to future buyers, even if the inspecting buyer's information is incomplete or misleading.

She will have to fill out an extensive disclosure form herself concerning the property and emphasizing all of its defects. She will have to contract with a title company to prepare a preliminary title report. She will not be able to sell the house during the time the buyer is deciding whether to purchase.

(a) For all of this effort, the seller receives no compensation at all if the buyer walks away. Why should she or any other seller be expected to sign such a one-sided contract form?

(b) Most sellers who list their houses for sale with real estate brokers would be far more wary of accepting an option than a purchase offer, even turning down a non-refundable option fee if the optionor elected not to buy. Why do you suppose this is true?

Question 7: ***Comparing The Process of Renting with Buying.***

If you have ever rented an apartment, what were the steps in that process? Why was it so much simpler than what is involved in buying a house?

Question 8: ***Comparing New York and Western Style Closings.***

(a) When buyers and sellers live outside the jurisdiction where the property is located, which type of closing will prove most convenient — New York or western?

(b) When one of the parties wants to "re- trade" (that is, re- negotiate) the terms of the transaction, which style of closing facilitates that?

VALUING REAL ESTATE

This chapter is about how real estate is valued. The first section reviews the three main methods for appraising particular real estate assets. The second and third sections describe two ways of comparing investment yields across asset classes: cash on cash return and IRR (internal rate of return). The fourth section on the distinction between debt and equity, and the advantages and disadvantages of property owners mortgaging their properties to the max. The fifth section compares the pros and cons of owning with renting places to live, and places to work

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I. Three Methods of Appraising Real Estate

The Sales Comparison Approach to Value

A procedure to conclude an opinion of value for a property by comparing it with similar properties that have been sold or are for sale in the relevant marketplace by making adjustments to prices based on marketplace conditions and the properties' characteristics of value.

The Cost Approach to Value

A procedure to estimate the current costs to reproduce or create a property with another of comparable use and marketability.

The Income Approach to Value

A procedure to conclude an opinion of present value by calculating the anticipated monetary benefits (such as a stream of income) for an income-producing property.

Real Estate Appraisals: The Income Capitalization Approach[1]
By Leonard Baron

Appraising a multi-unit property is usually more complicated than appraising a single-family home. Two-, three-, or four-unit buildings are sometimes subject to confusion when it comes to arranging a loan for purchase or refinancing.

Generally, appraisers use the market approach when appraising these properties. They will look at sales of comparable properties, typically within the past 12 months and within a 1-mile radius in a suburban market.

However, the income approach—determining the fair market rent of each unit based on comparable rents for other properties—often comes into consideration.

This is especially true if there aren't many comparable sales to be found within an acceptable time frame or geographical boundary.

The cost method—comparing the cost of buying the property with the cost of building new—often bears looking at if the property is less than 10 years old. If sufficient comps exist, it's best to stick to like-kind properties, comparing duplexes to duplexes, fourplexes to fourplexes.

Approaching Multi-Unit Appraisals

Nikole Avers, Nashville, Tennessee–based QC review appraiser at DartAppraisal, says all three approaches are relevant to these multi-unit appraisals.

"On a single-family purchase, you think of the property in terms of the borrower/buyer moving in and living there," she says. "If it's a duplex, triplex, or fourplex, the purchaser probably is not going to occupy it, so their thinking, in terms of why they're buying, will be different. Their approach to value won't necessarily be the sales comparison approach. Sales comps are still important, but you want to give more scrutiny to the income approach. This gives you a fairer set of checks and balances. You should be able, by using both approaches, to determine the value very well."

"One crucial difference between single family and these multi-unit properties is that the comparison basis changes. Other than location, primary considerations in single-family residential assignments are generally gross living area, the number of bedrooms, and style. In two- to four-family residential, location still tops the list, but the first consideration is not price per square foot. Gross living area isn't the first thing investors think about. They have to think like a renter. Renters think 'number of bedrooms,' so price per bedroom is a major consideration. We review the rental comps and look for well-supported gross rent multipliers."

[1] Leonard Baron, *Real Estate Appraisals: The Income Capitalization Approach*, FOX BUSINESS (Mar. 22, 2013), http://www.foxbusiness.com/features/2013/03/22/real-estate-appraisals-income-capitalization-approach.html

The cost approach—comparing the purchase price of a property to what it would cost to build new—is often relevant to newer properties, Avers adds. The cutoff point for considering the cost approach, she says, is usually 10 years.

"The collateral underwriter is gradually shifting the market to a more uniform appraisal," she concludes, "and appraisers are noticing this. From single-family, to two to four units, to condo appraisals, lenders want appraisers to be more uniform in their approaches and appraisals. Appraisers need to write a little more and realize that the people they communicate with—the appraisal management company—are a second set of eyes on their reports. We're their backup group. We want to make sure the appraisal, the appraisers, and the appraisal management company all look as good as possible."

Many of these properties, Avers points out, are conversions from large single-family properties, so "highest and best use" will come into play. Should the property convert back to single-family for best value? Has the owner added a unit that violates the housing code, such as a basement apartment? If so, the new owner won't be able to use that unit as part of the income stream.

Real Estate Appraisals: The Income Capitalization Approach[2]
By Leonard Baron

There are three commercially recognized valuation models for real estate: the "comps," (comparable market analysis) approach, the "income" or "cap rate" approach (cash flows) and the replacement value approach.

If you're looking to buy an investment property, you'll likely want to use the income capitalization approach to determine whether you'd be getting a fair deal. Here's a breakdown of how it works:

Comps vs. Income Method

As a refresher, the comparable market analysis approach theorizes that a property that is similar in size, style, age, finishes, location, views and all other characteristics should be worth about the same amount as other comparable properties in its general vicinity around the same date of sale. One property is comparable to another.

The income capitalization approach does the same thing, except instead of using the comparable information about the physical aspects of the property, you primarily use the net operating income (NOI) the property can generate as the comparable feature and determinant of value.

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[2] Leonard Baron, *Real Estate Appraisals: The Income Capitalization Approach*, ZILLOW (Mar. 18, 2013), https://www.zillow.com/blog/real-estate-appraisals-the-income-capitalization-approach-114451/

Determining NOI and Cap Rate

NOI is calculated as the rental income, less all the operating expenses, before taking out the mortgage payment.

Net Operating Income

NET OPERATING INCOME ILLUSTRATION				
Purchase Price =	**$**	**2,000,000**		
Rental Income			$	175,000
Expenses:				
Water	$	9,000		
Property Taxes	$	17,000		
Insurance	$	5,000		
Gardening	$	3,000		
Repairs/Mainten.	$	9,000		
Miscellaneous	$	7,000		
TOTAL Expenses			$	75,000
Net Operating Income			**$**	**100,000**

Example: Let's say apartment Building A in La Mesa, CA has NOI of $100,000 and sells for $2,000,000. That's a capitalization rate of 5 percent — NOI divided by purchase price.

If 20 separate apartment buildings in the general vicinity of La Mesa sold with cap rates of 5 percent in the past 90 days, and another apartment building comes on the market, it probably would also sell for a 5 percent cap rate.

Let's say a building with NOI of only $35,000 comes on the market. Because the general average cap rate is 5 percent, you'd divide $35,000 (NOI) by .05 (cap rate) to get a value of $700,000. So any apartment building income stream in a similar area can be capitalized by the average cap rate to get an approximate valuation.

This method works best when comparing similar types of buildings, such as apartment buildings to apartment buildings, not apartments to retail or apartments to office.

Buyer beware

The income capitalization approach provides an approximation of value and can never supplement determining your cash-on-cash returns on any particular property.

So use the income approach to valuation as you like but always fall back on this question: Are the realistic cash-on-cash returns that I project I will earn on this deal fair enough to make this investment an attractive option?

Components of the Cap Rate by Property Metrics[3]
By Robert Schmidt

What are the components of the cap rate and how can they be determined? One way to think about the cap rate is that it's a function of the risk free rate of return plus some risk premium. In finance, the risk free rate is the theoretical rate of return of an investment with no risk of financial loss. Of course in practice all investments carry even a small amount of risk. However, because U.S. bonds are considered to be very safe, the interest rate on a U.S. treasury bond is normally used as the risk-free rate. How can we use this concept to determine cap rates?

Suppose you have $10,000,000 to invest and 10-year treasury bonds are yielding 3% annually. This means you could invest all $10,000,000 into treasuries, considered a very safe investment, and spend your days at the beach collecting checks. What if you were presented with an opportunity to sell your treasuries and instead invest in a Class A office building with multiple tenants? A quick way to evaluate this potential investment property relative to your safe treasury investment is to compare the cap rate to the yield on the treasury bonds.

Suppose the acquisition cap rate on the investment property was 5%. This means that the risk premium over the risk free rate is 2%. This 2% risk premium reflects all of the additional risk you assume over and above the risk free treasuries, which takes into account factors such as:

- Age of the property.
- Credit worthiness of the tenants.
- Diversity of the tenants.
- Length of tenant leases in place.
- Broader supply and demand fundamentals in the market for this particular asset class.
- Underlying economic fundamentals of the region including population growth, employment growth, and inventory of comparable space on the market.

When you take all of these items and break them out, it's easy to see their relationship to the risk free rate and the overall cap rate. It's important to note that the actual percentages of each risk factor of a cap rate and ultimately the cap rate itself are subjective and depend on your own business judgment and experience.

Is cashing in your treasuries and investing in an office building at a 5% acquisition cap rate a good decision? This of course depends on how risk averse you are. An extra 2% yield on your

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[3] Robert Schmidt, *What You Should Know About the Cap Rate*, PROPERTYMETRICS (June 3, 2013), https://www.propertymetrics.com/blog/2013/06/03/cap-rate/

investment may or may not be worth the additional risk inherent in the property. Perhaps you are able to secure favorable financing terms and using this leverage you could increase your return from 5% to 8%. If you a more aggressive investor this might be appealing to you. On the other hand, you might want the safety and security that treasuries provide, and a 3% yield is adequate compensation in exchange for this downside protection.

Identifying Factors in Setting Cap Rates.

"Cap Rate can be thought of as the current yield on the investment. It is also the inverse of a "price/earnings" ratio

Three major determinants of the cap rate are:

(1) Opportunity Cost of Capital - from the capital market. Considers how much investors could earn on other types of capital assets. Higher OCC implies higher cap rate.

(2) Growth Expectations – from the space market. Considers how much investors think net cash flows will increase in the future. Higher growth implies lower cap rate.

(3) Risk – from both the space and capital markets. Considers how risky a property is relative to other properties and other asset types. Higher risk implies higher cap rate."[4]

Real Estate Price Dynamics and the Value of Flexibility[5]

Investment property assets are traded in the property asset market, but their value derives ultimately and fundamentally from their ability to produce income, which is generated in the space market. Thus, two separate and distinct markets are relevant. The space market is the rental market, with user/occupants (tenants) on the demand side and property owners on the supply side. The equilibrium in this market determines the rents and occupancy that governs the operating cash flows generated by the property assets.

The asset market is where investors trade ownership of the income-generating assets, effectively a branch of the global capital market. The prices in the asset market, in effect the capitalization of the assets' future net operating cash flows, reflect the flow of financial capital (money) into and out of and within the asset market, as investors make their allocation decisions.

Thus, property asset price dynamics are governed by actions, events, and phenomena in both the space market and the asset market. We need to consider both of these markets when thinking about property price dynamics.

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[4] Dr. Norm Miller, Real Estate Space and Asset Markets.. www.normmiller.net/wp-content/uploads/2012/.../Ch-2-GM-from-Marcus-Allen5.ppt

[5] Geltner, David and de Neufville, Richard, Real Estate Price Dynamics and the Value of Flexibility (June 30, 2017). Available at SSRN: https://ssrn.com/abstract=2998832

If rents in the space market rise 10 percent with other things equal, property prices may rise 10 percent. But if typical yields in the asset market rise from 10% to 11% with other things equal, property prices will fall by nearly 10 percent.

The space market is not integrated across locations and building types. Shopping centers in Denver do not compete for tenants against office buildings in New York. This allows for large, systematic cross-sectional dispersion in asset prices and price dynamics even though the asset market is relatively integrated, with investment money able to flow relatively freely between types and locations of property.

II. Cash-on-Cash Return[6]

The cash-on-cash return is a quick way to analyze an investment's cash flow. Specifically, it will produce a percentage rate that measures the received pre-tax cash flow relative to the amount of money invested to acquire the asset.

How to Calculate Cash-on-Cash Return By Brandon Hall

Calculating cash-on-cash return is simple. We simply divide the received net cash flow for the year by the amount of cash invested.

$$Cash - on - Cash\ Return = \frac{Annual\ Pre\ Tax\ Cash\ Flow}{Actual\ Cash\ Invested}\ x\ 100\%$$

The overarching equation isn't bad at all. It's the variable, such as annual pre-tax cash flow and actual cash invested that can become somewhat tricky.

Annual Pre-Tax Cash Flow

The formula to calculate your annual pre-tax cash flow is as follows:

$$\begin{aligned} &Annual\ Pre - Tax\ Cash\ Flow \\ &\quad = Gross\ Scheduled\ Rent + Other\ Income - Vacancy - Operating\ Expenses \\ &\quad - Annual\ Debt\ Service \end{aligned}$$

Let's break each of these variables down.

Gross Scheduled Rent

When you are evaluating a property's performance, "gross scheduled rent" will be the

6 Brandon Hall, *How to Calculate Cash-on-Cash Return*, BIGGERPOCKETS, https://www.biggerpockets.com/renewsblog/2016/06/10/cash-on-cash-return-2/ (last visited July 24, 2017).

property's gross rents, multiplied by 12. This reflects the maximum amount of income you can expect to receive from a property.

Other Income

Think about all of the other earning opportunities the property may present. Will you allow pets and receive pet income and non-refundable deposits? Do you have parking spaces available? Do you get reimbursed for utilities or charge a flat rate regarding such? All of this miscellaneous income will be included in "other income" for our cash-on-cash return analysis.

Vacancy

If you already own the property and you are wanting to produce the cash-on-cash return to understand your property's performance, you will want to use actual vacancy here. The actual vacancy should be measured by the numbers of days your property was vacant multiplied the daily rental rate. Essentially, this is the rental income you lost, on a daily basis, due to a tenant not being in place.

If instead you are analyzing a property's potential performance, you will want to use *potential* vacancy. This should always be a conservative number. You can guesstimate potential vacancy by calling up property management firms in the area or asking a real estate agent to run an analysis on how long a unit stayed on market. You will be able to generate a percentage rate of vacant days compared to the entire year. Whatever that rate is, I'd go ahead and add 2%. This will help create a small buffer as you learn the ins and outs of the market and what tenants expect a rental unit to look like.

For example, if a unit sat unrented on the market for 45 days, then the vacancy rate is 12.33% (45/365). Go ahead and round up to 14% for your projected vacancy rate.

Now we'll take that vacancy rate and multiply it by the gross scheduled rent. The result will be the amount of rental income you expect to not collect due to the unit not being rented. This can also be considered your opportunity cost.

Operating Expenses

Operating expenses will range from insurance, taxes, maintenance, HOA and bank fees, property management, and repairs. Operating expenses do not include debt service (principal and interest), nor do they include depreciation or amortization.

Annual Debt Service

For the purposes of learning how to calculate cash-on-cash return, this number will be your monthly payment to cover both principal and interest related to your loan. This does not include insurance and taxes.

[Ed. Note: This paragraph shows two ways in which cash-on-cash return differs from Net Operating Income (NOI). NOI excludes debt service, facilitating the comparison of investments as if they were debt-free. Otherwise, the investor risks conflating the project's financial performance with the loan terms the investor negotiates for a particular project such as individual personal guaranties of the loan or pledges of collateral in addition to the mortgage on the project being underwritten.]

Actual Cash Invested

OK, now that we know how to calculate the annual pre-tax cash flow, let's figure out how to calculate the actual cash invested.

$$Actual\ Cash\ Invested = Down\ Payment + Closing\ Costs + Pre\ Rental\ Improvements/Repairs$$

Let's also break each of these variables down.

Down Payment
This has nothing tricky to it. It will simply be the amount of money you pay as required by your lender to obtain the property. Very simple.

Closing Costs
Closing costs are also somewhat simple. Basically, you will add up your *net* closing costs associated with obtaining the property. To do this, add up all of the costs you paid (not including your down payment) and then subtract from that any seller or lender credits given to you.

Pre-Rental Improvements/Repairs
Remember, we really only want to use cash-on-cash return to analyze a return based on the cash we have actually invested into the property. I suggest only using pre-rental improvements and repairs because I think the cash-on-cash return should really only be utilized in the first year of ownership. More on that later.

Pre-rental improvements/repairs will include anything you pay out-of-pocket to fix prior to renting the units out. This is the part where the cash-on-cash return loses some of its value, as it doesn't do a good job of analyzing returns when you are injecting more cash into the asset after renting out the property.

So there you have it. I explained how to calculate cash-on-cash return in just 800 words. Is your head spinning yet? No? Good. Time to move on to the theory and application of using cash-on-cash returns.

Why the Cash-on-Cash Return is a Good Metric

The cash-on-cash return is a great metric and is widely used throughout the real estate industry both investors and real estate agents. The primary reason for this is due to the metric's simplicity in calculating the percentage return.

The cash-on-cash return specifically drills down in the return on the capital invested. It does so by only considering returns that are driven by the property's net cash flow. It is an essential part to value investing because it does not take into account asset appreciation.

Because the cash-on-cash return is only looking at the net cash flow and comparing it to the actual amount of cash invested, it's a great indicator for the effect of leverage. Using leverage will decrease your cash-on-cash return, which makes the metric a good way to measure different levels of financing.

Many investors are not sophisticated enough to use things like the Internal Rate of Return (IRR) or Modified Internal Rate of Return (MIRR). These two metrics can be quite encumbering to learn and fully understand. And even though they provide much more insight, they also require much more work.

On the other hand, it's easy for everyone to understand how cash-on-cash returns are calculated. It's simply the physical cash you have in hand after 12 months, divided by the physical cash you've invested. Since investors can easily understand the calculation, that's what sellers and agents use when discussing potential returns on the properties they are marketing.

Because of its simplicity, it's also a great way to run a "back of the napkin" analysis. I personally use it as a screening tool when evaluating potential deals. The calculation can be run in literally 10 minutes or less and will likely get you within 2-5% of the actual return on equity in most situations. If you're analyzing hundreds of deals a week, something like the cash-on-cash return makes a lot of sense.

The cash-on-cash return also allows you to easily compare different investments. You can compare rental property to lending, investing in stocks or bonds, and even starting a business. Granted, risk factors are not considered (which is a limitation we'll discuss in a minute), but the cash-on-cash return does allow for a universal comparison between different investments.

Why the Cash-on-Cash Return is a Bad Metric

The number one limitation, in my opinion, to the cash-on-cash return is that it doesn't indicate your actual return. There are two reasons for this: (1) taxes and (2) loan pay down.

Your tax situation is unique to you and will greatly impact your *actual* return on investment. Many investors argue that your tax situation doesn't impact the asset's performance — it is independent of you. Therefore, taxes should not be taken into account.

However, the tax impact of investment decisions should absolutely be assessed. While your tax situation may not impact the asset's performance, the asset's performance will directly or indirectly impact your tax situation. The effect can greatly increase or decrease your actual returns.

For instance, let's say your annual pre-tax cash flow is $10,000, resulting in a 10% cash-on-cash return (assuming you invested $100,000). If you are in the 25% tax bracket, your after-tax cash flow is $7,500 resulting in a 7.5% actual return.

Further, we have to take depreciation and the deductibility of mortgage interest payments into account. [Tax factors are explained in Chapter 4 part III.] Another wrinkle to all of this is that the cash-on-cash return does not take into account equity appreciation. [To calculate value appreciation would require periodic re-appraisals to determine the property's fair market value. Some investors just assume that the value of their equity is going up with each payment they make to reduce their mortgage debt. But this is only true as long as the value of the property exceeds the amount due on the loan.]

As you can see, the cash-on-cash return uses pre-tax numbers and doesn't account for equity appreciation. Also, the cash-on cash-return ignores the risks associated with investments and disregards the investor's opportunity costs.

How You Should Use the Cash-on-Cash Return

I wouldn't suggest using the cash-on-cash return to evaluate the performance of a property you have held for more than 12 months. At that point, you will have far more reliable information—the actual net operating income. Cash on cash return is only useful as a pre-acquisition estimate. After that, a better metric to use is the IRR.

III. Internal Rate of Return

What is IRR and How Does it Work?[7]
By Robert Schmidt

The internal rate of return (IRR) is a widely used investment performance measure in commercial real estate, yet it's also widely misunderstood. What is IRR exactly? How is it used, and what are its limitations? In this article we'll discuss what IRR is and how it works. We will also identify some common misconceptions and finally clarify these ideas with some relevant examples.

What is IRR?

First of all, what is IRR? Simply stated, the Internal Rate of Return (IRR) for an investment is the percentage rate earned on each dollar invested for each period it is invested. IRR is also another term people use for interest. Ultimately, IRR gives an investor the means to compare alternative investments based on their yield.

Step-by-Step Example and Proof of IRR

Memorizing equations is one thing, but truly understanding what's actually happening with IRR will give you a big advantage. Let's walk through a detailed example of IRR and show you exactly what it does, step-by-step.

[7] Robert Schmidt, *What is IRR and How Does it Work?*, PROPERTY METRICS, (June 9, 2014) https://www.propertymetrics.com/blog/2014/06/09/what-is-irr/.

Suppose we are faced with the following series of cash flows:

Year	Cash Flow
0	-$100,000
1	$0
2	$0
3	$0
4	$0
5	$161,051

IRR 10.00%

This is pretty straightforward. An investment of $100,000 made today will be worth $161,051 in 5 years. As shown the IRR calculated is 10%. Now let's take a look under the hood to see exactly what's happening to our investment in each of the 5 years:

Outstanding "Internal" Investment				Return On Investment		Return Of Investment		Total Cash Flow
$100,000	X	10.00%	=	$10,000	+	-$10,000	=	$0
$110,000	X	10.00%	=	$11,000	+	-$11,000	=	$0
$121,000	X	10.00%	=	$12,100	+	-$12,100	=	$0
$133,100	X	10.00%	=	$13,310	+	-$13,310	=	$0
$146,410	X	10.00%	=	$14,641	+	$146,410	=	$161,051
				$61,051	+	$100,000	=	$161,051

As shown above in year 1 the total amount we have invested is $100,000 and there is no cash flow received. Since the 10% IRR in year 1 we receive is not paid out to us as an interim cash flow, it is instead added to our outstanding investment amount for year 2. That means in year 2 we no longer have $100,000 invested, but rather we have $100,000 + 10,000, or $110,000 invested.

Now in year 2 this $110,000 earns 10%, which equals $11,000. Again, nothing is paid out in interim cash flows so our $11,000 return is added to our outstanding internal investment amount for year 3. This process of increasing the outstanding "internal" investment amount continues all the way through the end of year 5 when we receive our lump sum return of $161,051. Notice how this lump sum payment includes both the return of our original $100,000 investment, plus the 10% return "on" our investment.

This is much more intuitive than the mathematical (and typical) explanation of IRR as "the discount rate that makes the net present value equal to zero." While technically correct, that doesn't exactly help us all that much in understanding what IRR actually means. As shown above, the IRR is clearly the percentage rate earned on each dollar invested for each period it is invested. Once you break it out into its individual components and step through it period by period, this becomes easy to see.

What IRR is Not

IRR can be a very helpful decision indicator for selecting an investment. However, there is one very important point that must be made about IRR: **it doesn't always equal the annual compound rate of return on an initial investment**.

Let's take an example to illustrate. Suppose we have the following series of cash flows that also generates a 10% IRR:

Year	Cash Flow
0	-$100,000
1	$15,000
2	$15,000
3	$15,000
4	$15,000
5	$84,475

IRR 10.00%

In this example an investment of $100,000 is made today and in exchange we receive $15,000 every year for 5 years, plus we also sell the asset at the end of year 5 for $69,475. The calculated IRR of 10% is exactly the same as our first example above. But let's examine what's happening under the hood in order to see why these are two very different investments:

Outstanding "Internal" Investment				Return On Investment		Return Of Investment		Total Cash Flow
$100,000	X	10.00%	=	$10,000	+	$5,000	=	$15,000
$95,000	X	10.00%	=	$9,500	+	$5,500	=	$15,000
$89,500	X	10.00%	=	$8,950	+	$6,050	=	$15,000
$83,450	X	10.00%	=	$8,345	+	$6,655	=	$15,000
$76,795	X	10.00%	=	$7,680	+	$76,795	=	$84,475
				$44,475	+	$100,000	=	$144,475

As shown above in year 1 our outstanding investment amount is $100,000, which earns a return on investment of 10% or $10,000. However, our total interim cash flow in year 1 is $15,000, which is $5,000 greater than our $10,000 return "on" investment. That means in year 1 we get our $10,000 return on investment, plus we also get $5,000 of our original initial investment back.

Now, notice what happens to our outstanding internal investment in year 2. It decreases by $5,000 since that is the amount of capital we recovered with the year 1 cash flow (the amount in excess of the return on portion). This process of decreasing the outstanding "internal" investment amount continues all the way through the end of year 5. Again, the reason why our outstanding initial investment decreases is because we are receiving more cash flow each year than is needed to earn the IRR for that year. This extra cash flow results in capital recovery, thus reducing the outstanding amount of capital we have remaining in the investment.

Why does this matter? Let's take another look at the total cash flow columns in each of the above two charts. Notice that in our first example the total $161,051 while in the second chart the total cash flow was only $144,475. But wait a minute, I thought both of these investments had a 10% IRR?! Well, indeed they did both earn a 10% IRR, as we can see by revisiting the definition or IRR: *The Internal rate of return (IRR) for an investment is the percentage rate earned on each dollar invested for each period it is invested.*

The internal rate of return measures the return on the outstanding "internal" investment amount remaining in an investment for each period it is invested. The outstanding internal investment, as demonstrated above, can increase or decrease over the holding period. It says nothing about what happens to capital taken out of the investment. And contrary to popular belief, the IRR does not always measure the return on your initial investment.

The Myth of The Reinvestment Rate Assumption

One of the most commonly cited limitations of the IRR is the so called "reinvestment rate assumption." In short, the reinvestment rate assumption is that interim cash flows are reinvested at the IRR, which of course isn't always feasible.

As shown in the step-by-step approach above, the IRR makes no such assumption. The internal rate of return is a discounting calculation and makes no assumptions about what to do with periodic cash flows received along the way. It can't because it's a DISCOUNTING function, which moves money back in time, not forward.

Should you take into account the yield you can earn on interim cash flows that you reinvest? Absolutely, and there have been various measures introduced over the years to turn the IRR into a measure of return on the initial investment.

Some of the more popular approaches include the modified internal rate of return (MIRR), the capital accumulation method, and the external rate of return (ERR). These approaches are beyond the scope of this article, but will be explored in the near future.

Conclusion

The Internal Rate of Return (IRR) is a popular measure of investment performance. Understanding what IRR is at an intuitive level will go a long ways towards improving your ability to analyze potential investments.

IV. Illustrations of the Advantages and Disadvantages of Debt

The following chart summarizes very well the relationship between levels of leverage and the rate of return on equity that a real estate asset will yield. The chart assumes that an investment of $500,000 will appreciate every year by 4% (500,000/.04=$20,000).

The first column shows the results of the equity investor borrowing 80% of the $500,000, or $400,000. In the second column, the equity investor borrows 66 2/3 of the required $500,000. The third column shows the equity investor borrowing 50% of the $500,000. The more the investor borrows, the larger the investor's rate of return on its investment from the annual appreciation. The example assumes that the equity investor reaps 100% of the annual appreciation and takes no account of the cost of debt. The excerpt following this one is about the relationship between the cost of debt and the equity investor's rate of return on equity.

Calculating Impact of Financial Leverage on Rate of Return Due to Value Appreciation

• Levels of Leverage	80%	66 2/3%	50%
• Debt	400,000	333,333	250,000
• Equity	100,000	166,667	250,000
• Total Invested	500,000	500,000	500,000
• Annual Appreciation	4%	4%	4%
Increase in Year One	$20,000	$20,000	$20,000
• Rate of Return on Equity:			
•	***$20,000/$100,000***	***$20,000/$166,667***	***$20,000/$250,000***
	20%	***12%***	***8%***

THE MORE HIGHLY LEVERAGED THE INVESTMENT,
THE GREATER THE PERCENTAGE BY WHICH THE INVESTOR"S
EQUITY WOULD BE DIMINISHED.

Negative Leverage and Why Debt Doesn't Always Improve Yield[8]
By Robert Schmidt

Understanding Leverage

Most people in the commercial real estate industry are familiar with the benefits of leverage. It's true that acquiring a property with debt rather than all cash can improve the yield to

[8] Robert Schmidt, *Negative Leverage and Why Debt Doesn't Always Improve Yield*, PROPERTY METRICS, (Nov. 21, 2013) https://www.propertymetrics.com/blog/2013/11/21/negative-leverage/.

an investor. But too often this gets extrapolated into "the more leverage the better." However, placing as much debt as possible on a property is not always a good idea because sometimes you'll end up with negative leverage. In this short article, we'll take a look at how negative leverage works, how much debt is too much debt, and then tie it all together with an example.

First of all, what is positive leverage? Positive leverage occurs when placing debt on a property improves the overall rate of return. Whenever the return component in the property is higher than the interest rate on the debt, positive leverage will occur. Consider the following series of cash flows:

Discount Rate: 10.00%

EOY	Levered Before Tax
0	($1,025,000)
1	$33,164
2	$50,914
3	$68,662
4	$86,407
5	$95,149
6	$94,889
7	$94,626
8	$94,361
9	$94,093
10	$2,097,944
IRR	12.55%
NPV	$211,804

EOY	Unlevered Before Tax
0	($3,025,000)
1	$185,000
2	$202,750
3	$220,498
4	$238,242
5	$246,985
6	$246,725
7	$246,462
8	$246,197
9	$245,929
10	$3,470,658
IRR	8.01%
NPV	($384,529)

As shown above, the unlevered cash flows produce an internal rate of return (IRR) of 8%. The acquisition price of this particular property is $3,025,000, as is indicated in time period 0. In the levered series of cash flows above there is $2,000,000 of debt placed on the property at a 4.5% interest rate amortized over 10 years. Because the interest rate component of the loan (4.5%) is less than the return component of the property (8.0%), positive leverage occurs and the levered IRR improves to 12.55%.

Now let's consider a scenario where the same $2,000,000 of debt is placed on the property with a 10 year amortization. But this time the interest rate is 10%.

Discount Rate: 10.00%

EOY	Levered Before Tax
0	($1,025,000)
1	($46,605)
2	($28,855)
3	($11,108)
4	$6,637
5	$15,380
6	$15,120
7	$14,857
8	$14,591
9	$14,323
10	$1,778,566
IRR	5.43%
NPV	($370,724)

EOY	Unlevered Before Tax
0	($3,025,000)
1	$185,000
2	$202,750
3	$220,498
4	$238,242
5	$246,985
6	$246,725
7	$246,462
8	$246,197
9	$245,929
10	$3,470,658
IRR	8.01%
NPV	($384,529)

As you can see from the levered IRR above, this is a negative leverage situation. In this case more debt is not better. The IRR in the levered example actually decreases to 5.4%. This happens because the interest rate component of the loan (10.0%) is higher than the return component of the underlying property (8.0%).

Many people in the commercial real estate industry think more debt is always better. If you have a fixed amount of equity to invest, then you could invest in one single property without any debt, or instead invest in several properties using leverage to achieve a higher return. This is the typical argument for placing debt on a portfolio of properties. But as shown in the simple examples above, this is not always the case.

V. The Rent or Buy Decision for Individuals and Firms

Should You Buy a Home or Keep Renting?[9]

For generations, buying a home was considered the cornerstone of the American dream. However, in recent years, people have been debating whether buying a home is always better than renting. "A lot of financially savvy people are starting to question whether it's economically

[9] *Should You Buy a Home or Keep Renting?*, FIDELITY, (Mar. 2, 2017), https://www.fidelity.com/viewpoints/personal-finance/rent-vs-buy

rational to buy a starter home or to wait and buy that dream house where they'll live 30 years," says Adheesh Sharma, a vice president at Fidelity's Strategic Advisers, Inc.

There are arguments both for buying and for continuing to rent, depending on a potential homeowner's individual circumstances. To help you understand these variables and evaluate your own situation, this article offers five important questions to consider as you make the buy-or-rent decision. We've also included an interactive calculator that lets you plug in your own numbers to see the difference that buying or renting might have on your long-term finances.

Note: The following questions assume that you're in a financial position to choose home ownership—with good credit, not too much debt, a stable income, and adequate savings. If you're not sure whether you're ready to buy, see the two previous articles in this Fidelity Viewpoints series: "Are you ready to own a home?" and "How much house can you afford?"

1. How long are you planning to stay where you are?

Your intended length of stay has a huge impact on whether it makes more sense to buy or rent. The process of buying and selling a home involves many different costs, some of which buyers often overlook—including brokers' fees, appraisal fees, title insurance, and mortgage origination fee. For the purchase of a $200,000 home, these fees cost an additional $2,128, on average.

The longer you remain in a house, the more time you have to spread out these costs. If you sell within a few years, the value of your house might not have appreciated enough to offset these fees.

What's more, you almost certainly would use a mortgage to buy the house. A mortgage is a loan that you must pay back, and that can add risk.

To reduce your risk, it's important to stay in a house long enough to reduce your debt and to allow for meaningful price appreciation. "If you're planning to stay less than three years, it's likely that buying a home will prove to be a financially questionable decision," says Sharma. Aside from absorbing the closing costs of buying and selling a home, you will also pay capital gains taxes on the sale if you hold it for less than two years.

2. Do house prices always go up?

Before the collapse of the real estate market that began in 2007, many people assumed that home prices always rise each year. But that is not the case. The bursting of the housing bubble showed that home prices can suffer major declines. The median home price in the United States dropped nearly 13% between 2007 and 2009, falling from $247,900 to $216,700. In some overheated markets, such as Las Vegas and Miami, prices declined as much as 62% and 51%[2] from the peak.

Before buying a home, consider how your finances would fare if your house's value increased slowly or not at all. With 3% annual price appreciation, a $250,000 house would be worth more than $337,000 in 10 years. With a 1% annual price increase, the same house's value would grow to just $276,000 over the same time period.

House prices, both indexes and individual homes, historically experience smaller average annual fluctuations than the stock market, but this seeming lack of volatility could mask other risks. First, housing price indexes aren't a good indicator of the growth potential for your house. The reason: Indexes represent a collection of homes in a broad region, whereas actual house prices depend on a host of individual circumstances related to the local market environment and the condition of the home in question.

Second, over the long-term, putting too much of your savings into a single, leveraged investment (your house) could actually be more risky than investing in a diversified investment portfolio of stocks and bonds. If you buy more house than you need, the large mortgage payments might not leave anything left over to save for unexpected emergencies (like medical expenses), your retirement, or for college tuition (if you have kids).“Buyers who are focused solely on the idea of a house as an investment need to understand that it can be very risky,” says Sharma.

3. Are you throwing away money on rent?

A common argument in favor of home buying is that owners are building equity in a valuable asset that can boost their long-term net worth. By contrast, paying a landlord rent each month seems like spending, rather than saving. But buyers who focus simply on the monthly mortgage payment versus monthly rent might overlook some additional, hidden costs of ownership.

You need to budget for the cost of property taxes, insurance, and regular maintenance (including your time and effort as a homeowner). Many specialists recommend budgeting at least 1% of the value of your home each year to cover routine maintenance. There are also potential unforeseen expenses, such as replacing a heating system or a roof. And if you don't save enough for a 20% down payment, you'll probably have to make mortgage insurance payments, which add even more to the cost of owning a home. Also, if you're buying a condominium or a single-family home in a planned development, you will most likely have homeowner or maintenance fees to consider.

Buyers hoping a home will improve their net worth should also make sure they are actually building equity in that asset. A low credit score could force you to pay a higher interest rate, and therefore pay more in interest, meaning that your house might need to appreciate in value more quickly than is realistic to have any hope of building up equity.

4. How much will you save on taxes?

Many buyers assume that the additional costs of home ownership will be offset by tax savings generated by the mortgage interest deduction. Before you start counting on those savings, consider the following factors.

Homeowners must itemize their tax deductions in order to receive the benefit. But with the median house price in the United States around $200,000 and mortgage interest rates below 5%, the interest deduction for many homeowners may be less than the $12,600 standard deduction for married couples who file taxes jointly, Sharma points out.[4] This means that you might not be able to even utilize the mortgage deduction if your overall itemized deductions are less than the standard deduction for your situation.

Even if you purchase an expensive house and expect to have a large monthly mortgage payment, there's another consideration: Your tax benefit may decrease each year. A typical mortgage amortization schedule dedicates the majority of the monthly payment to interest in the first several years of the loan. Over time, more and more of each monthly payment is applied toward the loan's principal—meaning you pay less interest and receive a smaller deduction.

5. Are you comparing apples to apples?

Making an accurate comparison between the financial impact of renting and buying starts by factoring in the complete costs of home ownership—not just mortgage versus rent payments—as well as an accurate assessment of how owning would affect your taxes.

Rather than simply focusing on monthly or annual costs of the buy versus rent decision, consider which option would have a greater positive impact on your overall wealth at the end of your stay. For example, let's say your total costs of ownership were $2,000 a month and you could rent a similar property for $1,800 a month. You might consider how that additional $200 a month could grow if you were to invest it in a diversified portfolio and compare it with all the home equity you will build up during the same time through your mortgage payments.

A quick rent vs. buy comparison could be done using the price-to-rent ratio. Price-to-rent ratio is calculated by dividing the home value by the annual rent amount. Generally speaking, if the price-to- rent ratio is less than 20, buying might be a better option. On the other hand, if the ratio is greater than 20, renting might be better. Needless to say, any ratio or comparison is meaningful only if you are comparing similar properties.

However, the price-to-rent ratio is just a rule of thumb. Use Fidelity's calculator to begin testing your own scenarios. That way, whether you decide to buy or to keep renting, you can be more confident that your choice is financially sound.

It's also important to weigh the differences between the properties you're considering. For example, you might be thinking about renting a three-bedroom apartment in a multi-unit building in the city or buying a new, single-family home with a yard. Your decision should take into account the non-monetary benefits each property offers, such as how important outdoor space or proximity to downtown is to you.

Rent or Buy Office Space?

Very few law firms own their own space, and some of the largest and most successful business firms in the U.S. are tenants as well. Why is this so? Hopefully, you will find these next two essays useful in deciding whether there are situations in which business or professional firms should become owners of the spaces they occupy.

The Pros and "Condos" Of Business Space[10]

There may come a time in the growth cycle of a business when owners have to decide whether to continue to lease office space or purchase an office condo.

There are pros and cons to whatever decision ownership makes. Understanding those pros and cons can help lead you to the right decision for your company.

Cash Outlay

Initial cash outlay is usually lower when the company leases space. Purchasing an office condo that costs $150,000 could require a cash outlay of a 20% down payment, or $30,000. In some cases, that business capital could be used to grow the business in other ways – new equipment, more staff, increased marketing.

Cost Stability

When you purchase an office condo, your loan payments are usually fixed, so you know what it will cost each month for you to occupy the office.

When you lease, your business office expenses are tied to the rental market. In a tight market, one in which the building owner has space in demand, your company may face rent increases—especially on a short-term lease in which the rent is calculated annually, or every three years.

Adding Value to Your Business

When you purchase an office condo, you increase the value of your business because you now own real estate. In other words, you're not only in your primary business, you're in the real estate business, as well, as the owner of a business condo. This may add value over time as property values increase. Adding business value also increases the sale price if you plan to sell the business in the future.

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[10] *Should You Buy an Office Condo? The Pros and "Condos" of Business Space*, NEVADA SMALL BUSINESS .COM, https://nevadasmallbusiness.com/owning-vs-renting-your-office-space/ (last visited Jun. 13, 2017).

Business Growth

If you outgrow your leased office space, you may be able to lease more space in the same office building. However, if you own the space, expanding is more complicated, and may be a lot more expensive.

How quickly is your business growing? When considering the purchase or lease of office space, look to the future to avoid having to move the entire operation into a bigger space 36 months from now. If determining business growth over a few years is difficult, you may be better off leasing your office space until you have a clearer picture of just where your company will be five years from now.

Tax Advantages or Disadvantages

If you lease office space, rent is routinely deductible as a business expense in the year the expense is incurred, i.e., you can deduct office rent each year.

Buying an office condo allows you to depreciate the value of the property over 39 years. In this case, you may not have as big a deduction as a commercial property owner as you'd have as a business property renter—at least year to year. Consult your CPA or tax advisor to see how this would pencil out for you.

Considerations before Buying a Business Condo

Here are some basic questions to ask before signing that purchase agreement for a business condo:

1. *How stable are company revenues?*

Can you depend on revenues remaining steady, or growing in the years ahead? Do you have a stable base of clients who require repeat services? Can you predict, with some certainty, your company's growth rate?

If revenues are growing, chances are, so is your business. If you aren't sure how quickly your company will grow, you may be stuck with an obsolete office that's too cramped. Track revenues over a period of time to identify trends and help predict future growth.

2. *Is financing available?*

Start-ups and companies with a short history may have difficulty securing financing to purchase a business condo, no matter how good the balance sheet looks. Talk to the commercial loan officer at your bank to learn what financing options are available, and what the lender may require to secure a mortgage on an office condo.

3. *Would you put up personal assets as security?*

A lender may require collateral to support a commercial business loan. That collateral may come in the form of a second mortgage on your home, or some other collateral from your personal asset portfolio. Putting up personal assets may secure a commercial loan, but are you willing to bet the farm on your business? Under what terms? What's your tolerance for risk?

4. *What are the real costs of owning versus leasing?*

Before you buy or lease, perform a detailed cost analysis using a variety of scenarios—including a worst-case scenario.

Lease your space now? Okay, what would your company do if the rent increased 30% when your current lease runs out? Would you have to move? What would that cost?

Work with your business accountant, legal counsel and commercial bank to develop an accurate cost analysis of leasing versus owning the company office space.

5. *Should you work with a commercial real estate professional?*

In most cases, it's a good idea. These business "space" professionals know the market. They know what space is available and how to negotiate a lease or a purchase, and they can advise on cost-per-square-foot comparisons. In other words, a commercial real estate professional can provide the advice you need to "test the market" before deciding to keep leasing or to purchase your next office space.

Each company is different, with different needs and different objectives. Whether to buy or lease your company office space depends on a number of factors—factors that should be evaluated with the help of professionals.

Before you make a move, get the input you need to make the right decision regarding your business space.

Top 10 Mistakes Made When Buying an Office Condominium[11]

1. Not Understanding That 1 Square Foot Does NOT Always Equal 1 Square Foot

There are a host of square foot measurement techniques that are vastly different, the most common being rentable square feet,[12] usable square feet[13] and gross square feet.[14] A company

[11] *Top 10 Mistakes Made When Buying an Office Condominium*, REALESTATE LAWYERS, http://www.realestatelawyers.com/resources/real-estate/commercial-real-estate/buying-office-condo.htm (last visited Jun. 13, 2017).

[12] Useable square footage, or USF is the space the tenant actually occupies. Rental agents often quote this figure to prospective renters, but it represents only part of the lease arrangement. http://www.wikihow.com/Measure-Commercial-Square-Footage

[13] Rentable square footage, or RSF is the combination of the useable square footage and a percentage of the common-area square footage of the building. Common areas, which are parts of a building all tenants benefit from, include the lobby, elevators, hallways and stairwells.
http://www.wikihow.com/Measure-Commercial-Square-Footage

may be renting 1,500 square feet in an office building, enter into a contract to purchase a 2,000-square-foot condominium unit, and end up with less usable square feet than when it was leasing only the 1,500 square feet. The square footage of many office condominiums already includes a "core factor" which is the pro rata share of the main lobby, elevator shafts, janitor's closet, and other similar space. Some condominium buildings have a core factor more than 20%, meaning that a 2,000-square-foot office condominium unit would consist of 1,600 usable square feet.

2. Not Designing the New Space Prior to Purchase

Similar to not understanding the different measurement systems used, many buyers fail to have a space planner lay out their office or do a test-fit. In a buyer's market, many sellers will allow a buyer to have the seller's space planner design space on behalf of the buyer at the cost and expense of the seller, or will provide a $1,000 or $1,500 allowance for ensuring that the space will be sufficient for the buyer's needs. Failing to properly design the space may cause a buyer to end up with a condominium unit that does not meet his or her company's business needs.

3. Not Anticipating Future Growth

When a company leases space it is much easier to grow. In a large office building, the landlord can move tenants to alternative space, including different floors. If an individual purchased a house and needed more space for the family, additions could be added to the main house structure—this is rarely possible in an office condominium setting. My advice for growing businesses is to either consider purchasing a smaller additional condominium unit adjacent to the one that is being purchased or request a right of first refusal to purchase the adjacent unit at a later time from the developer. If a company is looking to purchase a 4,000-square-foot condominium unit, then there may be an extra 1,000 square feet available adjacent to the 4,000-square-foot unit. The 1,000-square-foot unit could be leased until the extra space is needed. When designing the 4,000-square-foot unit, plans for future growth should be included, along with a plan that would show how to incorporate the 1,000-square-foot unit into the 4,000-square-foot unit to make it all work together.

4. Not Understanding the Expenses

When leasing office space, there is typically a base or minimum rent which is based on a price per square foot, along with the responsibility for payment of a percentage of the operating expenses of the building which frequently include insurance, taxes, electricity, and maintenance costs. However, when leasing office space, the office lease may exclude certain items from being included in those operating expenses, such as capital items like replacing the roof of the building, replacing HVAC equipment, and structural repairs related to the building. Within an office condominium regime, the budget includes all of these items, both for repair and maintenance as well as capital expenditures. In addition, sufficient funds should be set aside on a monthly basis to ensure that there will be money available in 10 years when capital repairs,

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[14] Gross square footage, or GSF is the entire rentable square footage of a building. http://www.wikihow.com/Measure-Commercial-Square-Footage

maintenance or replacements need to be done, such as repaving and restriping the parking lot and replacing the light poles in the parking lot.

In addition, the initial budget prepared by the developer is an estimate only. A prospective buyer should have a qualified third-party review this budget carefully to determine if it includes all applicable categories such as pest removal, maintenance of interior HVAC units which serve the common space, electricity expenses for common areas of the building, maintenance of exterior stairs and railings, repair and maintenance of exterior storm water management systems, etc. Furthermore, a prospective buyer should ask to see the capital repair and replacement schedule and estimate which would provide information on how much time is needed before the roof needs to be replaced, along with a budget for doing so. A prospective buyer should then review the budget to determine if sufficient funds have been set aside or are being set aside to pay for the replacement of said capital item. Some office condominium regimes do not set aside sufficient funds for capital items and this may cause the association to have a one-time special assessment in order to pay for the $150,000 roof replacement.

5. Not Understanding Restrictions or Not Anticipating the Lack Thereof

The condominium regime is governed by a declaration and by-laws. In addition, there are frequently additional restrictions in the granting deed or other title documents such as a master declaration. To the extent that the condominium building is located within an office park, there may be other restrictions imposed upon owners and their future use contained within the master declaration. During the due diligence period, the title company should provide a title commitment that lists all documents to which the condominium unit will be subject, as well as providing a complete copy of these documents. A prospective buyer should have a qualified professional carefully review these documents after gaining a thorough understanding of the nature of the company's business. Frequently these documents may have use restrictions which may conflict with a company's business. For example, in an office condominium, these documents may prohibit the sale of certain items and this may impact an optometrist's ability to sell eyeglasses to his/her patients.

In addition, a prospective buyer should carefully review the restrictions as it relates to understanding that neighbors could adversely impact business operations. While the main purpose of the condominium regime may be for office use, it is possible, unless otherwise expressly restricted in the underlying documents, for a restaurant or bar to open in the building or for an abortion clinic, veterinarian or methadone treatment clinic to be operated in the condominium regime. If a prospective buyer is purchasing space in the building to run a sleep clinic, it may not want a restaurant or bar in the building.

6. Not Understanding the Finish Condition

With regards to existing condominium units that are being purchased from an existing user, the finish condition is very easy to understand as it is the existing condition of the space unless otherwise provided for in the contract of sale. However, many times the condominium unit is being purchased from the developer of the building in a raw condition or put under contract prior to the completion of the building. With regards to when the condominium unit is being purchased in a raw condition or prior to the completion of the building, then it is necessary to understand the following:

To the extent the purchaser is buying the condominium unit from the developer, then the developer frequently provides the purchaser with a tenant improvement allowance to fund the expense of the build-out.

7. Not Reviewing any Restrictions or Limitations with regards to the Parking

Not only is it important to review the current parking ratio for the building, but also assess whether there will be enough parking in five years and what type of parking space users may be in the building. The current parking ratio is determined simply by reviewing the total number of parking spaces not including any handicapped spaces and dividing this by the gross square footage of the building. While the marketing or sale flyers for the building will typically state the parking ratio as X spaces per thousand square feet, it is important to fully review the underlying documents to verify that the parking ratio is correct.

It is also important to understand whether there will be reserved parking spaces established by the developer or whether the condominium association has the right to establish a reserved parking regime at a later time.

To the extent that there are no restrictions on uses in the building, then it is possible that some heavy parking users (i.e. a telephone calling center, a large medical office or a sit-down restaurant) may purchase space in the building and there may not be sufficient parking spaces for all owners in the building.

8. Not Asking Questions about Signage

Be sure to ask questions and understand what signage is allowed and what signage will be prohibited. The condominium by-laws frequently have many restrictions on the size and type of signage that is allowed. Will there be any exterior building signage allowed? Will the developer be providing a marquee sign outside the building which will list the name of each company in the building? Or will the developer provide interior building signage on a central directory or through an electronic building display? Also, be sure to determine if there are any restrictions on a realtor's ability to place for-sale signs at the property at the time of re-sale.

9. Not Reviewing the Zoning, Site Plan & Condo Plat

It is extremely important to review the permissible uses of the property according to the current zoning regulations. If the purchaser plans on fabricating and manufacturing computer cables at the condominium, does the underlying zoning allow the purchaser to do so?

Also, of equal importance is to review the site plan and the condominium plat. The site plan may have further limitations or restrictions as it relates to limiting the amount of retail use or the number of parking spaces that may be used by any one condominium unit. Furthermore, the condominium plat may designate reserved parking spaces and will frequently designate the perimetrical boundaries of the condominium unit. It is important to understand if the vertical boundaries of the condominium unit are the interior face of the demising walls, the mid-point of the demising walls, the exterior face of the exterior walls or some other boundary. Equally important is to understand where the bottom of the condominium unit begins and where the top of the condominium unit ends. These perimetrical boundaries not only impact how utilities are run, but also impact the condominium budget and tie into what needs to be insured under the condominium master insurance policy.

10. Failing to Hire the Right Professionals

All of these mistakes can be prevented by working with an attorney who really understands the legal issues that small businesses face when purchasing an office condominium. Although some business owners believe that they don't need a real estate attorney because they already have a commercial real estate broker involved, this approach may often end up costing the business owner more because most real estate brokers are not trained as an attorney, to spot the issues and problems. Taking the time to find a lawyer who meets your needs is one of the best investments you will ever make in the growth of your business.

VI. REVISED QUESTIONS

Question 1: *Valuing Houses for Mortgage Loans.*

When mortgage lenders determine the maximum loan-to-value ratios they will lend, which method of appraisal is likely to be the one that makes the most sense for them to use?

Question 2: *Valuing Houses as Rental Properties.*

During the 2008 mortgage crises, house values plummeted, and major financial firms including Blackstone and Colony Capital went on a buying spree for distressed properties — properties selling for historically low prices. Each of these entities acquired about 15,000 houses, and pooled their holdings into a joint enterprise. Their business plan was to rent the houses and eventually sell them when housing markets recovered. What method of appraisal would be the most relevant to a potential investor in the funds that these firms created? [15]

[15] For a study of 57,853 properties that were securitized by the financial firms between November, 2013 and June, 2015, with a market value of $11.4 billion, secured by $8.2 billion in first-priority mortgages, see Desiree Fields et al., *The Emerging Economic Geography of Single-Family Rental Securitization* (Federal Reserve Bank of San Francisco, Working Paper 2016-2, 2016).

Question 3: ***The Relevance of the Cost Method of Appraisal.***

Why might the purchaser of a newly built apartment complex care what the reproduction/replacement cost of the complex would be?

Question 4: ***Why DCF Instead of a Gross Rent Multiplier?***

A client, the trustee of a large family trust, complains that she is spending a lot of money on a DCF analysis of a shopping center she is about to purchase for the trust. "They can't predict the future," she notes. "Wouldn't I be OK just using a gross rent multiplier to justify my investment decision?" How would you respond?

Question 5: ***Appraisal Contingencies.***

What advice would you offer the buyer who posted the following episode online at Trulia?

"Appraisal contingency? I just had an accepted offer on a house and the appraisal came in almost 20 thousand below the agreed offer. Our agent put in the original offer contingent on inspection and appraisal, and during the negotiation the seller rejected the appraisal contingency.

This was NOT mentioned to me by my agent, much of the back and forth was over the telephone. When we agreed on a price my agent had me come in and sign the offer, which at this point had the appraisal contingency removed. Again, this was not pointed out to me, and initially I made it clear that this contingency be in the offer.

When the appraisal came in low, the seller refused to negotiate the price. I don't want to overpay and am walking away. The seller is threatening to sue for the earnest money and this is becoming a huge pain.

I spoke with the appraiser, even went over the comps with him and his number makes sense. My agent is trashing the appraiser and encouraging me to make the deal. I am furious at the agent and once they sort this out will fire (him or her)."[16]

Question 6: ***Estimating Yields on Real Estate Investments.***

(a) What is the difference between rate of return on total cost and return on equity?

(b) What is the difference between NPV and IRR?

[16] John M, Appraisal Contingency? I Just Had an Accepted Offer on a House and the Appraisal Came in Almost 20 Thousand Below the Agreed Offer, Trulia (Tue. Aug. 2, 2011), http://www.trulia.com/voices/Home_Buying/Appraisal_contingency_I_just_had_an_accepted_off-310233 (Last visited 3/28/2016).

(c) What is the point of having two ways to estimate future yields? Would not one or the other suffice?

(d) Why do some mortgage lenders insist that borrowers set aside reserves for the eventual replacement of major building components, such as the roof, air conditioning and heating systems, and elevators?

(e) Project developers often obtain some or all of their equity capital from investors to whom they promise cash returns based on the financial performance of the project. Hence, developers' returns are often based on NOI and IRR calculations. Why might developers try to keep lender reserve requirements to a minimum?

Question 7: *Income Capitalization Approach.*

(NOTE: THE QUESTION, MISSTATED IN THE TEXT, HAS BEEN CORRECTED HERE.)

(a) The question should have been worded: How is it possible for an investor to profit from the same project "buying high and selling low" and "buying low and selling high"?

(b) An investor acquires a rental property for $5,000,000 producing an NOI of $500,000 a year from short-term leases to mom and pop tenants with a high turnover rate. The investor signs up a NYSE listed retailer willing to rehabilitate the property and occupy all of it on a long-term lease with a starting annual rent of $600,000. Once the property is improved and occupied under the new lease, it would command a cap rate of 5%. What would the property then be worth all other factors being equal?

Question 8: *Applying Valuation Methods to Resolve Purchase and Sale Issues.*

A client who just entered escrow on a purchase and sale agreement to sell an office building for $100,000,000 calls her attorney for advice because the buyer wants an $8,000,000 reduction in the purchase price. One of the building's tenants has just filed for bankruptcy, and the purchase price had been predicated on the estimated future cash flow from rental income. The seller has an accountant and access to an appraiser. But the seller wants the attorney's advice on how she should determine whether the $8,000,000 price reduction is reasonable under the circumstances. What advice should the attorney give?

Question 9: *Finding the Right Debt-Equity Balance.*
(NOTE: THIS QUESTION WAS MISSTATED IN THE TEXT AND HAS BEEN CORRECTED HERE.)

You have a chance to buy a very beautiful four-plex constructed in the 1920s. It was recently restored with new plumbing, electrical, roof, window, doors, and appliances. You estimate that each unit will rent for $3000 a month. Calculating 30% of your gross income for maintenance, property taxes and insurance, you estimate a net operating income for the project of about $100,000. The firm asking price is $300,000 per unit, $1,200,000 total. You can obtain a mortgage loan for $900,000, interest only for ten years at 7%. Which of these two arrangements would you prefer if you have $150,000 in the bank to invest?

(1) The seller will take back a purchase money second deed of trust for up to $150,000 at an annual interest rate of 11% payable monthly, no principal amortization, the entire debt due and payable in three years.

(2) Your distant cousin Ida will lend you $300,000 for 50% of the annual cash flow after paying the debt service on the first mortgage plus 50% of any gain on sale above $1,200,000 plus closing costs. She wants the right to compel a sale any time after the first six years of ownership.

Question 10: ***Money Now or Money Later?***

Some methods of valuation are time-sensitive and others are not. Under what circumstances might investors or savers not prefer money sooner than later?

Question 11: ***Calculating the Blended Cost of Capital.***

An individual acquires a house with the idea of holding it as a rental property and eventually selling it, hopefully at a big profit. She has $20,000 to invest in this venture. She acquired the house for $400,000. She was able to obtain an acceptable mortgage loan from a private equity fund that specializes in providing mortgage loans for rental homes. That loan was for $280,000 at an interest rate of 7%. A business associate managing a family trust was willing to provide $100,000 as a loan from the trust at an interest rate of 10% if it was secured by a second mortgage on the property. What is the investor's blended cost of capital?

Question 12: ***To Own or Rent?***

(a) What factors prompt your personal choice between owning and renting a residence?

(b) Would you feel differently if you believed that rents were going to rise by about 2% annually and house prices by 5% over the next decade in the city where you would like to live and work?

(c) Considering the historic volatility of house prices, do you believe you are better off deferring buying a house and renting until house prices hit a slump, or buying as soon as you can and trading up when you can?

(d) If you bought a house, would you leverage to the max by borrowing as much as you could?

REAL ESTATE BROKERS AND LISTING AGREEMENTS

I. The Professional Responsibilities of Real Estate Brokers

Observations About the Real Estate Brokerage Profession.

Although all licensed real estate brokers and sales agents are held to the same standards of professional competence, their skills and success vary wildly.[1]

Many people who obtain licenses represent few, if any, clients. They engage in buying and selling houses or income properties for themselves, hoping to shave brokerage commission costs and benefiting from inside information about property values. Real estate licensees form a significant contingent of all house flippers, hoping to make quick profits in rising markets. "Many licensees remain technically 'inactive.' They present themselves as licensees to speculate in property as principals or negotiate purchases for family members, all without being employed by a broker."[2] As house prices rise and fall, the number of licensees balloons and deflates.[3]

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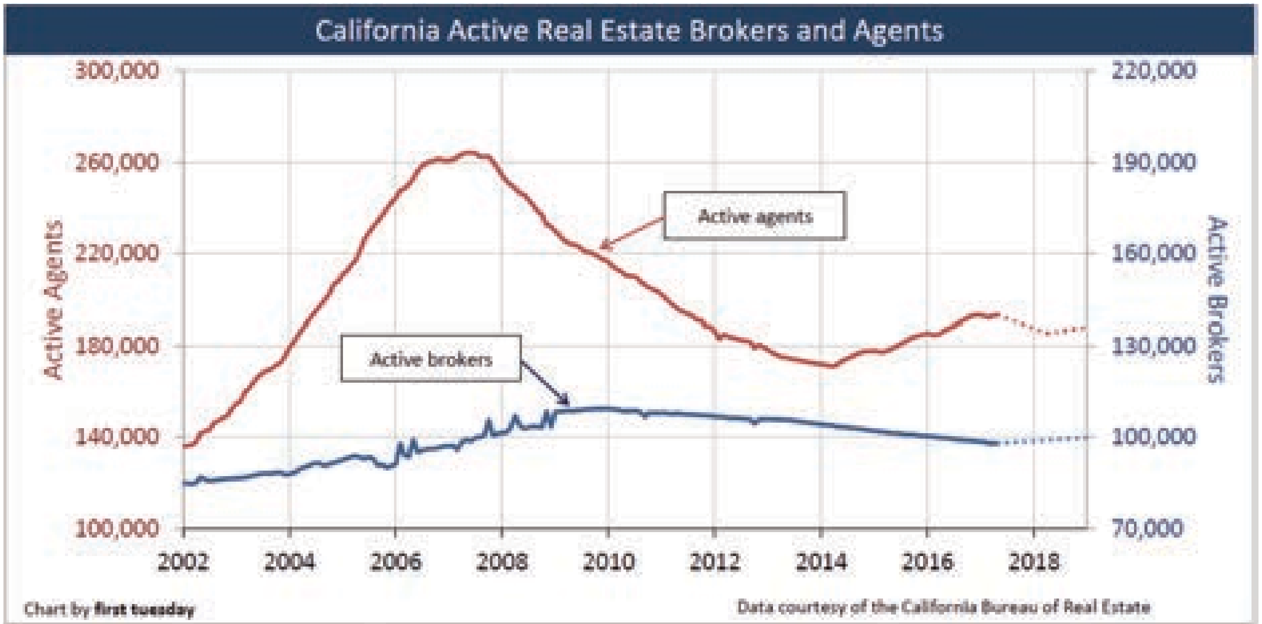
[1] The median annual wage for real estate brokers was $56,860 in May 2015. The median wage is the wage at which half the workers in an occupation earned more than that amount and half earned less. The lowest 10 percent earned less than $23,400, and the highest 10 percent earned more than $166,940. The median annual wage for real estate sales agents was $43,370 in May 2015. The lowest 10 percent earned less than $21,780, and the highest 10 percent earned more than $110,560.

Real Estate Brokers and Sales Agents, MYPLAN.COm: CAREERS, http://www.myplan.com/careers/real-estate-brokers/articles-41-9021.00.html?art=7 (last visited June 18, 2017).

[2] *The Rise and Fall of Real Estate Brokers and Agents*, FT JOURNAL (May 19, 2017), http://journal.firsttuesday.us/the-rises-and-declines-of-real-estate-licensees/2983/.

[3] Have you ever asked yourself if you should get your real estate license for flipping houses? Not surprisingly, you aren't alone. Whether or not you should get your real estate license for flipping houses is often a heated debate among those in the investor community. On the down side, actively using your real estate license can open you up to a little more liability than using another agent. It requires you to provide additional disclosures and can take up more of your valuable time. Additionally, if you join the local Realtor association, you are held to a strict code of ethics and can increase your risk of having complaints filed against you. However, the upside offers huge advantages when it comes to flipping houses." Paul Esajian, *Should You Get Your Real Estate License for Flipping Houses?*, FORTUNEBUILDERS (Sep. 16, 2010), https://www.fortunebuilders.com/should-you-get-your-real-estate-license-for-flipping-houses/.



The Legal Obligations of Real Estate Licensees.

The text lists the main functions that brokers customarily undertake. A more precise list of nearly 200 items, detailing what realtors do for clients, can be found at NEFAR.[4] This list was prepared by the Orlando Regional Realtor Association.

While brokers promulgate these lists to demonstrate the varied and useful tasks that real estate brokers are capable of undertaking for their clients, these same lists may be introduced as evidence by disappointed clients in law suits faulting their brokers for having been negligent, having fallen short of industry standards. Suppose a broker skips a task or two, and a seller or buyer incurs monetary damages as a result. The broker (and the broker's errors and omissions carrier) could be on the hook if a court concludes that the broker was negligent. As an example, consider the following case.

In Rangel v. Denny,[5] after the buyers contracted to acquire the sellers' house but well before the scheduled closing date, the sellers wanted to be sure they had a place to stay once the deal closed. So they moved out early once they signed a six-month lease on suitable apartment.

The sale never closed for lack of financing. The lender's appraised value of the house was not high enough to justify the loan they required. The sellers filed suit against the listing broker for a list of shortcomings. Among these, the sellers contended that their brokers should have done more to assist the buyers in finding financing, maybe organizing another appraisal of

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[4] *See What a Realtor Does for You*, NEFAR, https://www.nefar.com/northeast-florida-realtor.php (last visited June 17, 2017) ("A multitude of important services and steps required in a real estate transaction are carried out by the Realtor or the brokerage staff. Most of these steps have traditionally been viewed simply as part of a Realtor's professional responsibilities to the client. But, without them, the transaction could be placed in jeopardy.").

[5] Rangel v. Denny, 47381 (La. App. 2 Cir. 08/08/12) 104 So. 3d 68.

the property or locating a willing lender. They also faulted the listing broker for not having cautioned them against moving out before closing.

The listing broker objected to the sellers trying to pin on him the costs they had incurred solely as a result of the buyers' breach. The trial court agreed with the listing broker and dismissed the case but the appeals court remanded the case for further proceedings to explore whether the broker had neglected to fulfill all the tasks required of brokers.

At that point, the listing broker's insurer stepped in and negotiated a cash settlement between the listing broker and the sellers.[6]

II. Misrepresentations and Undisclosed Property Defects

A significant number of lawsuits and license suspensions arise from claims that a real estate licensee misrepresented or failed to adequately disclose the condition of the property. One of the leading California cases on this subject is described next.

Furla v. Jon Douglas Co.[7] Two years after George Furla acquired a home from sellers represented by the Jon Douglas company, he filed a suit for damages against the broker and the sellers upon discovering that the house he purchased had 20% less square footage than the 5500 square feet advertised in the multiple listing service (MLS) information.

> *During the negotiations with the seller and the listing agent, George said "OK 5500 square feet. I'll pay $170 a square foot." The seller accepted George's purchase offer.*
>
> *Two years later George decided to sell the house. He interviewed another realty agent John and told him the house is 5500 square feet. John replied, "A knowledgeable Realtor would easily recognize that this residence is substantially less than 5500 square feet."*
>
> *George then hired a real estate appraiser who said the living area is only 4615 square feet. A second appraiser measured the house as well and reported it as just 4437 square feet. After George sued the seller Leonard and the broker Marni for misrepresentation, evidence presented at the trial by the mortgage lender showed their appraisal was based on 4311 square feet.*[8]

Here is the *Furla* case as described by the attorney who represented the buyer:

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[6] Email to author from James C. McMichael, Jr., counsel for Dowling, the listing broker .Mon 6/12/2017 10:13 AM.

[7] Furla v. Jon Douglas Co., 65 Cal. App. 4th 1069 (1998). *See generally* Paul J. Weinberg and Nola McGuire, *How Big a House Are You Really Getting? California And North Carolina Raise the Bar for Brokers In Making Accurate Disclosures In Residential Real Estate Sales*, 23 ZONING & PLANNING L. REP. 73 (October, 2000).

[8] Robert J. Bruss, *Misrepresented Square Footage Is Cause for Liability*, SOUTHCOAST TODAY (Jan. 11, 2011, 6:54 AM), http://www.southcoasttoday.com/article/19980926/news/309269933.

After the buyer receiving this information (about the actual square footage) and confronting the seller's broker (with no success), Furla retained our firm and sued the seller and seller's broker (listing agent that exclusively represented seller) for fraud and deceit, alleging, among other things, that defendants should have known the house was actually smaller than represented to Furla.

What followed was a civil procedure journey that took several dramatic turns. After extensive discovery, defendants brought a motion for summary judgment contending that there was no triable issue of fact as a matter of law, since the plaintiff did not reasonably rely upon the misrepresentations. Further, the plaintiff failed to exercise due care for his own interest as a buyer in not investigating and affirming the square footage.

Defendants presented substantial evidence that plaintiff was repeatedly warned in the purchase agreement and in the disclaimer language of the MLS that all statements concerning square footage were approximations only, not to be relied upon, and to be confirmed by buyer if he chose to do so (which he did not attempt during escrow). Note: In my experience, having both retained appraisers and also having examined opposing appraisal expert witnesses, the calculation of "gross living area," particularly when dealing with unusual hillside or irregularly-shaped custom homes, is not an exact science.

Further, the broker defendants claimed that they reasonably relied on the square footage information provided to them by seller's daughter, who built the home and had architectural plans. Defendants also pointed out that the Los Angeles County Assessor, the appraiser who did the "Freddie Mac" appraisal for seller and the property profile for the house all stated that it contained 5,500 square feet. Defendants argued that they reasonably relied on such information and should not be held liable for its inaccuracy.

The trial court (Hon. Alexander H. Williams III) agreed with defendants and granted summary judgment in their favor. Undeterred, plaintiff appealed, which resulted in lengthy briefing, including amicus briefs from the California Association of Realtors and numerous defense firms, including the distinguished appellate firm of Haight, Brown & Bonesteel. After considering all of these briefs and hearing lengthy oral argument (albeit predominately by appellate counsel Roy Weatherup for defendants), the Court of Appeal (Charles S. Vogel, Presiding Justice) reversed the summary judgment and gave George Furla a hard-fought victory (defendants ultimately settled with Furla for a substantial amount).

The Court of Appeal published its decision that has since been frequently cited in legal treatises and lawyer's briefs. Among other holdings, the *Furla* decision held that a buyer is ordinarily entitled to rely on the representations of the owner or the owner's agents regarding the size of the property without having to hire his own experts to affirm such representations. Further, a statement expressed as an opinion, by one having superior or special knowledge (a broker) can be an actionable misstatement of fact if the opinion is incorrect. The issue as to whether a statement is actionable is a question of fact for the jury to decide, as opposed to being summarily disposed of by summary judgment or other procedural pre-trial tactic.

Understandably, the seller and his agents need to be concerned about making any representations of fact, particularly if they are not absolutely certain of the accuracy of such representations. "As is" clauses and similar exculpatory provisions are oftentimes ineffective. Even a purchase agreement's inclusion of an integration clause stating that there are no promises, representations, understandings or agreements outside of the written agreement are oftentimes ineffective.[9]

Observations on Furla, the Law of Broker Liability for Misrepresentations and Undisclosed Defects, and the Unrealistic Expectations Courts And Legislatures Are Imposing on Real Estate Brokers.

"Upon discovering undisclosed or misrepresented material facts, the buyer feels cheated and seeks justice, usually in the form of a court or arbitration proceeding for damages. Potential targets include not only the seller, but the seller's broker/agent and, sometimes, even the buyer's agent, each of whom has different duties of disclosure."[10]

When these unhappy buyers find representation to find vindication and compensation, legal norms vary widely from state to state. In some states, buyers are expected to look after their own interests in deciding whether they find the condition of the property to be acceptable, considering how they plan to use the property and their purchase price. In these states, courts enforce broker and seller disclaimers and admonitions to the buyer to seek professional guidance in assessing the suitability of the property.

In California, it is the duty of a real estate broker to conduct a reasonably competent and diligent visual inspection of the property offered for sale and to disclose to that prospective purchaser all facts materially affecting the value or desirability of the property that an investigation would reveal, "if that broker has a written contract with the seller to find or obtain a buyer or is a broker who acts in cooperation with that broker to find and obtain a buyer."[11]

There are situations in which brokers in all states risk their commissions, their licenses and their errors and omissions coverage: when a broker acts in concert with a seller to conceal a property defect, knowingly makes a false statement to a buyer, makes a statement to a buyer without knowing whether it is true or false, or later learns that the statement was false or misleading and fails to inform the buyer.

An experienced real estate attorney offers an example of concealment: "In one case, we represented a couple that purchased a multi-million-dollar ocean view home, only to discover that there was mold inside the structure when they later remodeled the house, there was some circumstantial evidence of active concealment. When the seller's broker noticed an odor emanating from one room, the seller assured him that it was odor from pet urine that remained in the carpeting. The seller's agent burned candles and baked cookies during an open house,

[9] *See* John S. Gleason, *Anatomy of a Real Estate Fraud Case: A Case Study*, BRIDGEFORD, GLEASON & ARTINIAN (Aug. 11, 2015), http://www.bridgfordlaw.com/articles/anatomy-of-a-real-estate-fraud-case-a-case-study/.
[10] *Id.*
[11] CAL. CIV. CODE § 2079 (Deering 2000).

allegedly to mask the smell. When such facts were learned through discovery, a substantial settlement was obtained."[12]

The reality is that real estate sales personnel with limited knowledge and training are held accountable for much more than they could reasonably be expected to know.[13]

Depending on the vagaries of state court decisions and statutes, real estate brokers could find themselves being held accountable for expert knowledge in such fields as building and construction, law, finance, surveying, appraisal, and other ancillary fields—in short: "training no one can practically possess," and training that greatly exceeds the actual educational and career preparation of realtors as well as the broker and salesperson licensing requirements of the 50 states.

For salespersons and brokers alike, no college degree generally is required, and even the most stringent of state licensing laws require only 90 to 180 hours of training for real estate salespersons and 120 to 720 hours for brokers.

This was contrasted with the formal education of other professionals like engineers, architects, and lawyers, which though it includes general education, requires between 4800 and 8800 hours of study and at least one university degree.

III. The Importance of the Listing Agreement in Broker Compensation Claims

In the first chapter on purchase and sale agreements, there was a discussion of the statute of frauds that calls for denying judicial enforcement of oral contracts related to real estate. It is not illegal for real estate buyers and sellers to do business without written agreements, but if they cannot agree on a contract's terms or whether they had a contract to begin with, they cannot expect courts to discern their intentions in the absence of some evidence either from written memoranda, part performance or "reliance."

Real estate brokerage agreements are also subject to statutes of frauds or separate statutory provisions requiring brokerage agency agreements to be in writing. But the exceptions for part performance and equitable estoppel are rarely made for brokers. They are held to a higher standard than real estate buyers and sellers and cannot hold their clients liable on oral promises to pay commissions except under very unusual circumstances. .

In *Westside Estate Agency, Inc. v. James Randall, et al.,*[14] prospective buyers asked a long-time friend, and the co-founder of a real estate brokerage firm that specialized in high end

[12] *See* Gleason, *supra* note 9.

[13] Ann Morales Olazábalaa1 & René Sacasas, *Real Estate Agent As "Superbroker": Defining and Bridging the Gap Between Residential Realtors' Abilities and Liabilities in the New Millennium,* 30 REAL EST. L. J. 173 (Winter 2001–2002).

houses in Los Angeles, to find a house for them. He did. After haggling maneuvers, they paid $46.25 million for the house but managed to short change him out of the 2% 'cooperating broker' commission that the sellers and the listing broker had promised. Unfortunately, the broker—Stephen Shapiro, had no contract with the buyers. Brokers representing buyers often rely on the seller's listing agreement to satisfy the Statute of Frauds. Here is the cautionary episode that brokers representing buyers might keep in mind when they rely on the good faith of their client buyers instead of on commission agreements signed by those buyers.

Westside Estate Agency, Inc. v. James Randall, et. al.—Get It in Writing![15]
By Debra Tash

In legalese, the term "statute of frauds" refers to the requirement that certain kinds of contracts be memorialized in writing, signed by the party to be bound by the contract, with sufficient content to evidence the contract. One such type of contract that must be in writing pursuant to California Civil Code section 1624(a)(4) is any "agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate" (i.e., a commission agreement). At issue in this case was a $925,000 commission claimed by a brokerage but not evidenced by a written agreement with the consumer.

The facts of the case, as detailed by the court, indicate that in early 2014, James and Eleanor Randall ("Buyers") told their long-time friend and real estate broker Stephen Shapiro ("Broker") that they were looking to buy a home in Los Angeles. Broker agreed to represent them in locating such a home but no written agreement was entered into between Buyers and Broker.

In October 2014, Broker located a multi-million-dollar estate in Bel Air for Buyers. The listing for the property offered a 2% cooperating broker commission. During the negotiation process for the offer, Buyers asked Broker, their friend, to apply the cooperating commission toward their purchase price, effectively waiving any commission. Broker refused. A $45 million offer was prepared by Broker and presented nonetheless. After significant negotiations and Buyers consultation with their attorney, Broker was instructed by Buyers to "cancel [the] offer" because the Buyers were "turned off on [the property]."

Three months later, in February 2015, the Buyers made a $47 million offer on the property with their attorney acting as their broker. Escrow closed a month later for a final purchase price of $46.25 million, $1.25 million more than the offer made through Broker a few months earlier. The Buyer's attorney applied the $925,000 cooperating broker's fee against the purchase price.

As a result, the Broker (through his brokerage) sued the Buyers for breach of an implied contract and sued their attorney for intentional interference with an implied contract. At the pleading stage, Buyers defended the suit on the grounds that they were not bound to pay a commission to Broker because there was no written agreement to pay a commission as required

[14] Westside Estate Agency, Inc. v. Randall, 6 Cal. App. 5th 317, 319 (2016).
[15] Debra Tash, *Westside Estate Agency, Inc. v. James Randall, et. al.—Get It in Writing!*, CITIZENS JOURNAL (Jan. 7, 2017), http://citizensjournal.us/westside-estate-agency-inc-v-james-randall-et-al-get-it-in-writing/.

by the statute of frauds. The trial court agreed and dismissed the case without trial, reasoning that such a commission agreement was "squarely within" the statute of frauds, fell outside any of the exceptions to the statute, and that any unwritten agreement was consequently unenforceable as a matter of law. Given the absence of any enforceable contract, the court went on to rule that the attorney for the Buyers could not have interfered with a valid contract as a matter of law.

The Broker appealed making 5 separate arguments as to why the statue of frauds did not apply to this case. The appellate court summarily rejected all of these arguments and upheld the ruling of the trial court. In summing up its decision the appellate court wrote:

"Over a century ago, the Court of Appeal held: 'Merely putting a prospective purchaser on the track of property which is on the market will not suffice to entitle the broker to the commission contracted for, and even though a broker opens negotiations for the sale of the property, he will not be entitled to a commission if he finally fails in his efforts, without fault or interference of the owner, to induce a prospective purchaser to buy or make an offer to buy, notwithstanding that the owner may subsequently, either personally or through the instrumentality of other brokers, sell the same property to the same individual at the price and upon the terms for which the property was originally for sale.' (Cone v. Keil (1912) 18 Cal. App. 675, 679-680.) This holding is just as valid today, and renders futile any amendment by [Broker]."

To add insult to Broker's injury, the appellate court ordered Broker to pay the Buyers' costs for the appeal. Broker could have avoided this loss by obtaining an executed buyer's representation agreement from his "friends" when they first started discussing the potential property acquisition.

[There is a distinct benefit in the requirement that listing agreements be in writing. The provisions of that agreement delineate when the broker becomes entitled to a commission. It is an agreement creating an agency relationship between the real estate broker and the client, either the buyer or seller. The buyer and seller, acting in concert, cannot abrogate this agreement by mutually terminating their purchase and sale agreement.]

Buyers and Sellers Terminating Their Purchase and Sale Contracts Remain Liable on Their Agreements with their Brokers. *Schaffter v. Creative Capital Leasing Group, LLC.*[16]

Brokers are entitled to compensation even when the buyer and seller they brought together mutually decide to terminate their purchase and sale contract. Quite often, brokers have no right to a commission on failed deals except when the deal failed because either the buyer or seller breached. In this case, the purchaser had contracted to buy a total of 14 condominiums in two separate projects, expecting to re-sell the condos for quick profits in what had been a rising market. When the condo market softened, the buyer informed the seller that they were not going to complete the contracts they had entered.

Instead of haggling with the buyers or suing them for having defaulted, the seller acquiesced in cancelling the contracts, returning the buyer's deposits and waiving any liquidated or actual damage claims. Instead, the seller put the condos back on the market and sold them for just about the same prices that the buyer would have paid.

To acquire condos for the buyer-investors, Schaffter, a real estate agent working with the Prudential brokerage firm, entered a contract with CCLG to purchase condos for them in a San Diego project called Park Place. Schaffter was to earn a 2.3 percent commission on each unit, with a reduction for the 1.5 percent commission Park Place paid to referring brokers. Under the standard contract, commissions were earned when the buyer entered into a purchase agreement, and they were payable on the close of escrow or the buyer's default. Schaffter sued for his commission on the purchase and sale contracts his client had breached.

As the court explained: "We conclude that under the plain terms of the Renaissance and Pacific Terrace purchase agreements, CCLG defaulted and that triggered the payment of commissions under the Buyer Broker Contract. CCLG (the buyer) cites no evidence the developers' (sellers) ultimate cancellation of the purchases was beneficial to them, and rather the evidence shows they merely chose to avoid litigation.

In any event, a seller's post default conduct is, of course, immaterial to determining whether the buyer defaulted. As CAR explains in its amicus curiae brief, the "default" provision of the Buyer Broker Contract recognizes that when a buyer defaults under a purchase agreement, it would not be fair to deny the broker the right to be paid for services rendered under the Buyer-Broker Contract. Nonpayment would obviously be unfair to a performing broker regardless of whether a seller pursued damages from a defaulting buyer.[17] The court awarded the brokers their commissions and attorney's fees.

The message of the case is clear. Even if the buyers and sellers who signed a purchase and sale contract decide to cancel, they will each remain accountable to the brokers whom they agreed to compensate for bringing them together. The common law default rule is that brokers earn their commissions when they bring willing, ready and able buyers and sellers together. Buyers and sellers who want to limit their liability for commissions to transactions that actually

[16] Schaffter v. Creative Capital Leasing Grp., LLC, 166 Cal. App. 4th 745, 746 (2008).

close, regardless of the reasons for transactions not closing, need to specify that in their listing and buyers' brokers contracts.

IV. REVISED QUESTIONS

Question 1: ***Decision to Use a Broker.***

(a) Explain to a friend who is about to sell her home, and wants to save money on a brokerage commission, what she would have to do to succeed in a "For Sale By Owner" (FSBO) situation, forgoing the help of a qualified, competent broker?

(b) Why do most home sellers who start out as FSBOs end up selling their properties through a broker?

(c) In addition to the reasons that home owners probably do better with brokers than without them, what other reasons could persuade the owner of, say, a small hotel, to list with a broker?

Question 2: ***Broker Licensing Laws.***

(a) How do consumers benefit from broker licensing laws?

(b) Why do state laws permit home owners to market their own homes even though they have no real estate licenses?

(c) A second-year law student learns that her landlord wants to sell the apartment building in which she resides, and she happens to know someone who might be interested in buying it. Although she doesn't have a broker's license, under what conditions might she be able to enforce the landlord's oral promise to pay her a fee if she locates a suitable buyer?

Question 3: ***Negotiating the Terms of the Listing Agreement.***

(a) What is the main distinction among the types of listings: exclusive rights to sell, exclusive agencies, and open listings?

(b) How can a seller, about to list her home, avoid having to pay a commission if her next-door neighbor, who has long expressed a keen interest in acquiring the property, becomes her buyer?

(c) A couple on the verge of dissolving their relationship decide to list the home they own together. Shortly after they sign an exclusive right to sell agreement with a licensed real estate broker, they reconcile and decide not to sell the house after all. Under the terms of California Association of Realtors Listing Agreement, they owe their broker the full commission for withdrawal, even though she has yet to produce a single offer. Under these circumstances, why might a prudent broker decide to waive her rights to a commission under the withdrawal clause?

(d) If you were advising a home or condo owner about what to include in a listing agreement, would you cut and paste the numbered items that appear in the list of functions of residential seller's brokers?

(e) A seller insists upon modifying the listing agreement to insert a "no closing, no commission" clause, applicable even if the seller rejected a full price offer. The broker balks, asking why the seller should not be obligated to pay the broker a commission after the broker did her part by finding a buyer willing to make a full price offer. How could the seller possibly justify such a modification?[18]

(f)(1) The seller, a busy accountant, has owned a 20-unit apartment house for seven years. It produces a steady positive cash flow but the seller has never had much luck with resident managers, and is now on his third one.

He lists the building for sale. A buyer from out of state makes a full price offer. The buyer had the idea of residing in the building and managing the place herself.

Buyer and seller sign a purchase and sale agreement.

During the due diligence period, the buyer presents a long list of improvements she insists upon the seller making. If asked, she would say these are previously undisclosed property defects. To take one example, there are hairline cracks at various places in the building.

The buyer wants the seller to pay for an engineer to determine if the building is sound. Even if it is, she wants the seller to paint the building. The building was repainted three years ago and looks just fine to the seller. The seller refuses to comply with the buyer's requests or to continue dealing with her.

What language in the listing agreement would the buyer's broker wish to see to preserve the right to a commission if the seller repudiates the purchase and sale contract?

(f)(2) What language would the seller hope to find in the listing agreement to remove any doubt that he has any obligation for a brokerage commission if he calls the deal off because the buyer is too annoying and unreasonable to continue dealing with?

(g) A friend or family member is about to list their home for sale with a broker. The standard form listing agreement calls for payment of the full commission if the property is withdrawn from sale or leased during the term of the listing. The same agreement disavows liability for the negligence of the broker and its agents even though the agreement calls for a lock box allowing any broker or agent with the lock box number to enter the property. You suggest to

[18] This question has been modified and it's slightly different from the version in the textbook.

your friend or family member that they insist upon the listing agreement containing a right to cancel at will, and use the same assumption-of-negligence form for commercial realty that appears in the text. Can you imagine any convincing reasons that would justify a broker refusing to accommodate these requests?

(h) A seller proposes to insert a "no closing, no commission" clause and striking out language in the listing agreement making him liable for a commission if he causes a purchase and sale contract not to close. The broker asks why she should forego a commission she earned by finding a "ready, willing, and able" buyer because the seller derailed the sale. Should the seller acquiesce? If not, is there any coherent way to explain his refusal?[19]

(i) Interviewing potential brokers, the seller hears Broker A explain that although the property is worth about $400,000, it should be listed at $350,000 to spur potential buyers into making offers, eventually engaging in a bidding war with each other. Broker B agrees that the property is worth about $400,000 but recommends listing it at $450,000. For one thing, buyers like to haggle over price. For another, the higher the listing agreement pegs the price, the higher the eventual sales price is likely to be. If you believe either broker is right, explain why. If you believe neither is correct, what listing price would you regard as optimal for the seller?

Question 4: ***Buyers and Their Brokers.***

Based on what you have read in this chapter, would you recommend to a friend about to look for her first home to contract with an exclusive buyers' broker, sign a dual agency agreement with the listing broker, work with as many brokers as are willing to assist her with no strings attached, or go it alone?

Question 5: ***Obligations of Listing Broker to Sellers and Buyers.***

An office building seller, after signing a binding purchase and sale contract, confesses to his broker that the heating and air conditioning system will probably need to be replaced in the next year or two, and the building's major tenant is about to file bankruptcy and go out of business. The seller wants the broker to keep these facts to herself.

Does the broker have any obligation to disclose this information to the buyer?

Question 6: ***Buyers' Broker's Duty to Buyers and Sellers.***

A buyer's broker knows that her clients have a seriously flawed credit history, and may have great difficulty obtaining a mortgage loan. Does she owe the seller a duty to pass along this information?

[19] This question has been modified and it's slightly different from the version in the textbook.

Question 7: ***When Brokers Buy Their Own Listings*****.**

A seller doesn't realize how much the house is worth, and lists it for sale with a broker at a price considerably below market. Under what conditions is the listing broker free to buy it without having to worry about the seller later suing successfully for the lost profit?

Question 8: ***When is a Realty Sale a Security?***

An architect-developer buys 'fixer uppers' in good neighborhoods, refurbishes and sells them, usually for tidy profits. To attract equity investors, he solicits friends and from time to time, runs ads in newspapers including the Wall Street Journal.

(a) He usually lists his houses for sale with the same real estate broker. He asks the broker to find investors for him. Would the broker need to be licensed to sell securities in order to help in this way?

(b) Would the architect-developer need to comply with federal and state securities laws?

ENTITY SELECTION: LIMITED LIABILITY, TAX ISSUES, OPERATING AGREEMENT DEAL POINTS AND FIDUCIARY DUTIES

This chapter begins with a comparison of the various choices available to buyers of a commercial real estate asset for taking and holding title. For many buyers, the entity of choice is the limited liability company (LLC) because LLC members, like corporate shareholders, are sheltered from personal liability for entity obligations and yet they are entitled to the favorable federal income tax treatment available to individuals and partnerships. This favorable tax treatment allows the members to retain considerably more of their "after" tax income than if they had been taxed as corporations.

In the second section, we consider the tax implications of the entity selection decision.

When two or more individuals form an LLC, the basic terms of their relationship should be memorialized in an operating agreement. The text describes the main issues likely to arise between members who conceive a project and intend to take an active role as entrepreneurs, and other members who provide all or most of the equity financing, but expect to take a more passive position.

The final section contains a revised version of the questions at the end of chapter 4 in the text.

I. The Pros and Cons of LLCs

The authors of the two articles in this section of the manual address LLCs from very different perspectives. The first essay explains the conventional view on why LLCs work so well in most commercial real estate situations. The second article is written by a cost-conscious, novice investor in multi-family projects of modest size who convincingly concludes that sometimes forming an LLC, which is always burdensome, can also be inefficient and ineffectual.

Forming an LLC for Real Estate Investments: Pros & Cons[1]
By Jeff Weaver, Esq.

Over the last decade, limited liability companies (LLCs) have become one of the most preferred forms of business entities through which to hold title to investment real estate properties. The insulation from personal risk exposure for real estate investors provided by LLCs, coupled with the relative ease of administration and potential tax benefits, make ownership of investment property through an LLC a very desirable option in most instances.

LLC vs. Liability Insurance

Although there are many benefits to holding real property assets through an LLC, a limited liability company may not be the best holding vehicle for every property owner. For many real estate investors, the trouble of forming and maintaining a company isn't worth the protection from the theoretical threat of a lawsuit, particularly when affordable liability insurance is available.

That said, real estate investors that rely solely on insurance as a means of protection from personal liability take a significant risk. Liability policies typically have limits, exceptions and carve-outs. While the chance of a loss that exceeds policy limits may be remote, if it happens, the consequences can be devastating.

LLCs Limit Personal Liability

First and foremost, LLCs limit personal vulnerability to potential lawsuits related to the property. Consider the situation in which the owner of an investment property leases it to a tenant who decides to throw a big party, during which one of the tenant's guests falls over a balcony. In today's legal climate, it is quite possible that the injured guest would pursue a claim based on the "unsafe condition" of the rental dwelling. More often than not, the owner would be named in any lawsuit resulting from the incident.

If that rental property were owned by a real estate investor individually, he or she would be named in the lawsuit and would have to defend his or her personal assets from the plaintiff's claims. In contrast, if that property were owned by an LLC, the owner's risk exposure would be insulated by the protection of the company, leaving only the assets owned by the LLC (as opposed to all of the owner's personal assets) exposed to potential lawsuits.

LLCs Avoid "Double Taxation"

Real estate holding companies that have several owners are known as "multimember" LLCs and are generally taxed by the IRS like partnerships, meaning that the LLC files an "informational" tax return, but does not actually pay taxes itself.

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[1] Jeff Weaver, *Forming an LLC for Real Estate Investments: Pros & Cons*, LEGALZOOM (Jan. 2014), https://www.legalzoom.com/articles/forming-an-llc-for-real-estate-investments-pros-cons.

Multimember LLCs also enjoy the benefits of pass-through taxation as the LLC passes its profits and losses through to its members, who report their portion of the LLC's business income or losses on either a Schedule C, K or Form 1065 with their individual income tax returns. This means that *both* single member and multimember LLCs offer the benefits of pass-through taxation of profits and losses *and* limited liability and personal protection for the owners.

LLCs Can Make Business Life Easier

LLCs offer numerous other general benefits relative to other entity forms that aren't necessarily unique to—but certainly apply to—the use of LLCs to hold real estate investments.

- When delegating management responsibilities, LLCs enjoy much greater flexibility than either a corporation or partnership. While corporations are statutorily required to have officers and directors, the LLC can be easily managed by its owners or third-party managers.
- In the many states that impose increased fees based on the authorized number of shares, LLCs may pay lower state registration and maintenance fees than corporations.
- Owners of LLCs can take advantage of the tremendous flexibility in the distribution of profits, as determined by the LLC's operating agreement. Cash flow distributions do not have to be pro rata according to ownership like an S corporation, which gives the owners the ability to financially reward the "sweat equity" effort of select members through appropriate distributions of available cash flow.
- Unlike an S corporation, foreign ownership and investment in U.S. real estate is possible through an LLC.
- LLC owners can also easily transfer their ownership in real estate holdings by proactively gifting the company's membership interests to their heirs each year. Over time, it is entirely possible to effectively pass ownership of real estate owned by an LLC to loved ones without ever having to formally execute and record a new deed. This enables property owners to avoid transfer and recording taxes and fees, which can be substantial in many states.

Although not every company will seek these particular benefits, it's safe to say that LLCs can offer steep rewards to companies that choose to take advantage of them.

Explore Your Options

Many business owners choose to form an LLC because they are unfamiliar with the many legal nuances between different entity choices, and they simply assume that an LLC offers the most protection from risk because it has "limited liability" in its name.

In reality, a properly formed and operated LLC does indeed limit the personal liability of the owners, as much as U.S. law allows, by affording the owners no personal risk above and beyond their investment in the company—but, in many instances, so do corporations and certain partnerships.

Of course if a small business owner of any entity form fails to respect the separate and distinct identity of the business or observe statutorily required corporate formalities (such as co-mingling personal and business funds, paying owners instead of creditors, or failing to maintain a registered agent), the integrity of the corporate shield provided by law will be compromised and potentially expose the owners to personal liability. Generally speaking, though, the basic requirements to operate an LLC within the confines of the corporate statutes are not particularly onerous.

An LLC may not offer any more or less protection from outside lawsuits than a properly formed and operated corporation or limited liability partnership, but it does offer many other advantages that make it the most desirable form of entity in many cases, particularly with respect to real estate holding companies.

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5 Reasons I Do NOT Invest in Real Estate Using An LLC[2]
By Scott Trench

I cringe when I hear the following question from newer investors: *"Should I invest in real estate through an LLC?"* Often, this question is quickly greeted by intimidating big shot investors and lawyers saying things like, "Yes, you MUST use an LLC. There's no debate about it." I'd suggest that you **never** listen to people who use this type of language.

I don't know whether or not you should use an LLC. The answer differs from person to person. I can tell you that I personally do NOT use an LLC or other business entity to protect myself.

As a young, first-time investor, I believe that I have an intelligent rationale for investing this way. I hope that as I explain my rationale for investing under my name, other young, first-time investors will benefit from my reasoning and make an intelligent decision for themselves. At the very least, I hope to be a thoughtful counter to those who dogmatically proclaim that an LLC is a must.

My Investment

To give you a little background, I used virtually the entirety of my savings to purchase and repair my first little duplex back in November of 2014. Having put in work to make it livable, I now rent out one unit to some wonderful tenants and live in the other half with a roommate. I purchased the property with 5% down using FHA financing, own the property under my own name, and manage the tenants myself.

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[2] Scott Trench, *5 Reasons I Do NOT Invest in Real Estate Using an LLC*, BIGGERPOCKETS.COM, https://www.biggerpockets.com/renewsblog/2015/06/06/5-reasons-do-not-invest-using-llc/ (last visited June 20, 2017)

And I think I'd be a fool to operate it under an LLC.

I had (and continue to benefit from) several immense advantages in owning this property under my name. These advantages would have been forfeited should I have moved the property into an LLC or other business entity. It's my belief that these advantages vastly outweigh the benefits of operating the property out of an LLC. Further, in my case, I believe that the protections of an LLC are minimal, easily lost, and expensive at best for investors in similar situations to my own.

5 Advantages to Investing in Real Estate Under My Own Name

1) Access to Financing

In my case, I used an FHA loan insured by the Federal Government to finance my property. This type of loan allows first time home buyers to put down as little as 3.5% on their properties. This type of loan is available to people purchasing primary residences only, not companies. Under their rules, the property that I bought was exactly that—a primary residence. It just happened to also be a duplex with a very rentable second unit. The same bank that allowed me to purchase this property for just 5% down would have required 20% at least for "The TrenchPire, LLC" to buy the property.

My duplex cost $240,000. Putting down 5%, or $12,000, is a very different proposition than putting down 20%, or $48,000. My entry into real estate investing would have been delayed by *years* if I had elected to invest through an LLC and purchase the property with $48,000 in savings.

2) Lower Interest Rates

My 30-year interest rate for my home mortgage is 3.475%. Try getting that through an LLC.

3) Special Tax Breaks

Interest on a mortgage for a primary residence is tax deductible on your personal income. Furthermore, I pay mortgage insurance on my FHA loan, which is also tax deductible. I might not be able to claim either of these tax breaks on my personal tax return were I to move the property into an LLC. These tax breaks are especially important to highly leveraged owner-occupiers like me who pay lots of interest and mortgage insurance each month in the first few years of ownership. Even in pass-through entities like single-member LLCs, these tax breaks are minimized because investors can't leverage as much. Putting down 5% or less through an LLC is a rare feat I have yet to hear of done through an LLC upfront.

4) Tax-Free Capital Gains

Assuming that I live in the property for at least two years and assuming that the property appreciates over that timeframe, I have the option to sell my investment for a tax-free capital gain. This gain caps at $250,000 for a single person and is limited to primary residences only. Unlike a 1031 exchange, the money is truly tax-free and can be spent on my next vacation, a manicure, or other non-real estate assets.

Assuming that my property appreciates 10% over the next two years, I'm looking at a cool $20,000, instead of perhaps $13,000 after taxes. That's a meaningful difference to me.

5) Flexibility in Mixing Business With Personal

I try to run my property as professionally as I can, using separate email addresses, bank accounts and credit cards for property-related expenses. But because this is my house, at the end of the day, I have the option to cheat when necessary by mixing personal and business assets. I have no corporate veil to defend, and thus have more flexibility in moving assets around, managing tenants, doing work on the property, etc.

2 Disadvantages to Owning the Property Under My Name (& Why They're Minimally Relevant to Me)

Disadvantage #1: Potentially Unlimited Liability

Let me start this off by saying that millions of investors, some of whom have high net worth, invest in real estate without using LLCs. They protect themselves from liability through umbrella insurance policies, which have worked for decades, and that I trust to work for me. That said, there are two reasons why this advantage to the LLC was not something that I felt was of paramount importance to me.

First, I have an umbrella insurance policy that covers me for up to $1M. In the event that someone successfully sues me for more than that, then yes, my personal assets are at risk. In that event, I lose everything I own. So what? As a 24-year-old kid, I have virtually nothing to my name besides a few small retirement accounts (relatively hard to lose in a judgment), the property, and some savings I hope to invest in the next property.

Oh well. I'll just start over and be right back here in a year or two. Not a big difference between waiting two more years to save up enough to put down 20% in an LLC.

Oh, and, by the way, something would have to go very wrong for that to happen. I like to think that I am a respectful and attentive landlord and that I do my best to make sure to respond to any questions or concerns from my tenants. Bad things happen, but I believe that a $1M+ mistake on this little rental would be an extraordinarily unlikely event.

Secondly, LLCs and other businesses only protect their owners from unlimited liabilities if they are run correctly, preventing the opposition from piercing the corporate veil. I see running my business this professionally as something that would be very difficult to do correctly, given that I live in the property and could be considered a customer.

I believe that I am unlikely never to conduct personal business in the property that I live in in a manner that a savvy lawyer could not use against me. I also believe that I am perhaps not legally savvy enough to be perfect in my accounting for which improvements to the duplex are luxuries for my personal happiness, as opposed to improvements for the business. I'm 24 and am running my first ever business out of my home. That corporate veil might have been as easily swept away as the blinds in my living room. (Are they my blinds? Or the LLC's?)

Disadvantage #2: I Cannot Remain Anonymous Behind the LLC

Many real estate investors prefer to distance themselves from their properties to make it difficult to sue them and to put a barrier between themselves and their tenants. An LLC can be a great way to do that. In my case, and for many first-time investors who are owner-occupiers or owner-managers, this advantage is likely forfeited from day one. I live right next door to the tenants. They see me mowing the lawn, painting, installing shutters, making repairs, and painting walls. It's kind of obvious.

Conclusion

Should I use an LLC? You tell me. At the very least, I think that a reasonable person can make the case that I have strong reasons for investing in real estate under my own name.

As an afterthought, I'll mention that aside from the massive expenses and disadvantages to operating property under an LLC that I outlined earlier, there are sometimes expensive costs directly related to operating LLCs. These costs, like setup fees, accounting time/expense, and legal expenses in drafting operating agreements, vary from state to state and can be either immaterial or cost thousands and thousands of dollars.

I plan on using LLCs and protecting my assets when and if I build net worth into the hundreds of thousands or millions of dollars. If I were 50 with three kids to put through college and a few million in assets to lose, then that would be a different story, and I'd probably use an LLC. I wouldn't want legal liability from my rentals to touch me or my family with a ten-foot pole.

But for now, an LLC sounds about as useful as a colonoscopy. And probably a lot more unpleasant.

II. Tax Factors in Real Estate Investment

Tax Benefits of Real Estate Investment Properties–IRS Rules Explained[3]
By Michael Lewis

Renting versus buying can be a difficult choice. Still, according to The Wall Street Journal, almost two-thirds of American households own homes. Many more own rental properties or second vacation homes. By contrast, a Gallup Poll found that only one-half of Americans own stocks.

Owning real estate has some unique financial advantages. For example, homeowners can deduct their mortgage interest, mortgage insurance premiums, and property taxes from ordinary income. Also, proceeds from the sale of a house are treated as capital gains for taxes—up to $250,000 of the gain can be excluded from income for a single taxpayer or $500,000 for a couple filing a joint return.

Owning a home or investment real estate offers huge advantages to both society and you individually. Here's how to get the most out of your investment.

Real Estate as an Investment

Owning an investment property is significantly different than owning the property in which one lives. While investors share many common risks—illiquidity, lack of transparency, political and economic uncertainty—each investment property is unique, varying by use, location, improvement, and permanence.

Each investment can be subject to a bewildering collection of tax rules, all of which affect the net return on investment.

Types of Real Estate Properties

The term "real estate" encompasses different types of property, including:

- *Undeveloped Real Estate*. Investors acquire raw land for a variety of purposes including farms and ranches, natural resource exploitation such as harvesting timber or mining coal, subdivision and lot sales, or future development.

- *Residential Properties*. These properties—ranging from a single duplex to developments with hundreds of rental units—require constant maintenance and active management to maintain occupancy and increase value.

[3] Michael Lewis, *Tax Benefits of Real Estate Investment Properties—IRS Rules Explained*, MONEY CRASHERS, http://www.moneycrashers.com/tax-benefits-real-estate-investment-properties/ (last visited July 17, 2017). *See also, e.g.*, KEITH A. WOOD, THE CPA'S CHECKLIST FOR SELECTING THE RIGHT BUSINESS ENTITY FORM, (Nov. 2, 2009), http://crlaw.com/news/wp-content/uploads/2012/01/The-CPAs-Checklist-for-Selecting-the-Right-Business-Entity_11-02-09.pdf.

- *Commercial Properties*. This segment includes office buildings, retail properties such as grocery stores and shops, and industrial properties including warehouses and manufacturing plants. Property owners regularly contend with legal, zoning, and environmental issues.

Real estate properties are also categorized as:

- *Unimproved*. Unimproved properties are raw land that has not been changed by human action, i.e., without any buildings, structures, roads, artificial ponds or lakes upon it.

- *Improved Property*. Improved properties are land that has been altered by the addition of buildings and man-made structures, residential or commercial.

Real Estate Tax Rules and Regulations

Owning a real estate investment property can provide significant tax benefits to the owner if properly organized and managed. The general rules of thumb applying to tax treatment of investment real estate are:

1. Costs associated with the property acquisition (title charges, recording fees) are added to the cost basis of the property and depreciated
2. Costs related to financing a property (lender fees, mortgage application fees) are amortized over the life of the loan
3. Costs incurred as a result of operating the property (taxes, insurance, utilities) are deductible as current expenses

However, the tax rules are complex, and their application depends on the type of property, as well as the tax classification of its owner. In other words, one investor may be able to shelter other income from taxes while another cannot.

The Issue of Passive Income

According to the IRS, passive income is income that is the result of a rental activity or a business in which the taxpayer does not materially participate. Losses from passive income can only be offset against passive gains—the loss cannot be used to reduce the taxpayer's ordinary income and subsequent tax burden.

Since most improved real estate ventures generate taxable losses in the early years of ownership due to the use of accelerated depreciation, an inability to offset such losses with ordinary income is a disadvantage for many property owners.

Real Estate Investor Definitions

Whether or not rental income is treated as passive or non-passive income depends upon the taxpayer's identity in one of the four IRS categories for real estate investor:

1. *Real Estate Investor*. A real estate investor is an entity (individual or legal organization) that purchases a property with the intent of holding the property and producing a capital gain. Income and losses for a taxpayer classified as a real estate investor are considered "passive" and cannot be used to offset ordinary income from other sources. There is one exception: Investors with a modified adjusted gross income (MAGI) of less than $100,000 and who actively participate in rental activities of a property can offset ordinary income under a special $25,000 allowance under IRC Section 469 (Form 8582). Passive losses more than passive income and the special allowance can be carried forward until extinguished. Also, real estate investors are entitled to capital gains treatment at the sale of their property.

2. *Real Estate Dealer*. A real estate investor is characterized as a dealer if his intent is to purchase real estate for sale, rather than investment—in other words, buying and selling real estate in numerous frequent or continuous (such as selling lots in development) transactions. The major advantage of being a dealer is that income and losses are considered ordinary and can offset other income. At the same time, property classified as dealer-owned cannot use capital gains treatment, installment sale treatment (Publication 537) or like-kind exchanges (IRC Code Section 1031). Also, income received as a real estate dealer is subject to self-employment tax.

3. *Real Estate Professional.* Real estate investors may qualify as a real estate professional if they spend at least 750 hours each year in the real estate business and more than one-half of their working hours are spent performing specific real estate activities. A qualified real estate activity is any development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or sale of real estate. If you have a full-time job unrelated to real estate, you are unlikely to qualify for the classification. Also, proper records-keeping including a log of your hours is critical as the IRS is likely to challenge your use of the classification. Real estate professionals are taxed similarly to real estate investors except that they can deduct 100% of passive losses from ordinary income.

   While a real estate professional's rental income is specifically excluded from self-employment taxes paid by a real estate dealer, their income is subject to the 3.8% surtax on net investment income included in the Health Care and Education Reconciliation Act of 2010.

4. *Real Estate Developer.* A person or entity who remodels or constructs a property is considered a real estate developer by the IRS. A developer must capitalize all of the costs or development of the property. This includes direct costs such as interest on loans, taxes, and construction expenses as well as indirect costs like administration, management and the ongoing costs of running the business. No deductions are available for tax purposes until the property is either put into service or sold. The primary disadvantage of the developer classification is the inability to offset expenses when incurred under the Uniform Capitalization Rules.

When determining the classification of a real estate owner, the IRS looks at his initial intent when purchasing the property as well as the amount of his time spent on real estate and his stated business purpose. While the determination is often subjective, a classification has significant tax impact upon the taxpayer.

The issue is further complicated since the designation can vary from property to property. In effect, a real estate owner might be considered as a real estate investor for one property and a real estate dealer for another. As a consequence, real estate owners often use a variety of legal entities to acquire, develop, and hold properties to gain the maximum tax advantage.

Additional Real Estate Tax Considerations

Investors who own improved real estate can utilize a variety of tax treatments to reduce their income tax liability including:

Depreciation

Depreciation is the process of recovering the cost of an asset over its useful life. While land, having an infinite life, is not depreciable, nonresidential real estate buildings and improvements have a useful life of 39 years, and residential rental property a life of 27.5 years according to IRS Publication 946.

Depending upon the property class, real estate owners can use either straight-line or an accelerated method of depreciation. The first method provides a consistent amount of deductible each year over the life of the property (the cost of the improvements divided by the useful life in years, i.e., $3,500,000 cost/39 years = $89,744 depreciation each year). Accelerated depreciation generates the greatest depreciation costs in early years and declines after that.

Investors often separate the various components of a structure for tax purposes due to their different useful lives. For example, leasehold improvements—those accommodations made for a particular renter—can be depreciated over a 15-year period or less while office furniture and fixtures have a life of 7 years. By segregating the assets, depreciation is maximized, generating a taxable or “paper” loss.

Section 179 of the IRS Code allows the purchase of certain qualifying equipment (such as air conditioning or heating units) to be expensed up to a limit of $500,000 in the year of acquisition. Also, Congress provides for bonus depreciation in some years above the 179 limits, currently at $2 million.

Capital Gains and Losses

When sold, personal or investment assets are subject to a capital gains tax. The gain or loss on an asset is determined by the difference between the “basis” price—the purchase price including adjustments, such as depreciation, as defined in IRS Publication 551—and the net sales price. Profits or losses are considered short-term if held for less than one year or long-term if the holding period is greater than one year.

Properties owned by real estate developers must include all costs—direct and indirect—in the basis calculation until the property is put into use or sold. Income from the sale of properties owned by real estate dealers are considered ordinary income and are not eligible for capital gains treatment.

Short-term capital gains offset short-term capital losses while long-term capital gains offset long-term capital losses. The remaining short-term loss or gain is matched with the remaining long-term loss or gain. If the net result is a long-term capital gain, one-half of the gain is tax-free and one-half is subject to the taxpayer's ordinary income tax rate. Since the maximum tax rate is 39.60%, a long-term capital gain will be taxed at a maximum up to 19.8%. Short-term gains are taxed at the taxpayer's ordinary rate.

A maximum of $3,000 of long- and short-term losses can be deducted from ordinary income in a single year, with the remaining loss carried forward. Tax filers use Schedule D of Form 1040 to report capital gains and losses.

Taxes on the profits from the sale of properties owned by real estate investors can be deferred if reported as an installment sale under the rules of Topic 705—Installment Sales. This treatment is especially advantageous for short-term capital gains as the profit and tax liability is spread over several years. Each payment consists of portions of tax-free return of capital, interest, and a capital gain.

Real estate investors can also use IRS Section 1031 to postpone taxes on any gains if they trade their property for a similar property in a like-kind exchange. The basis in the new property remains the same as the basis in the old property, thereby keeping the possible future gain intact. However, the basis of the old property is also transferred to the new property to calculate depreciation.

Final Word

While the tax treatment of real estate investments is often confusing, investors can use tax strategies to reduce risk and improve returns. Retaining competent tax advisors and tracking changes in the rules and regulations will pay dividends far beyond their costs.

III. Drafting Real Estate Joint Venture Agreements

For a good overview of the topics covered in a real estate joint venture operating agreement, see Joshua Stein.[4]

[4] *See* Joshua Stein, *Agenda for A Joint Venture Agreement*, THE PRACTICAL LAWYER (Apr. 2010), http://www.real-estate-law.com/PDF/Joint_Venture_Agreement_Agenda_165.pdf.

One of the most difficult aspects of LLC agreements to draft well, called "the waterfall," is the distribution of cash flow among the LLC co-venturers. The PropertyMetrics analysis is available online.[5]

IV. REVISED QUESTIONS

Question 1: *Entity Selection and Member Liability for Entity Debts*.

A real estate broker specializing in home sales and a general contractor who builds custom houses decide to become co-venturers in the business of buying houses in bad repair, and renovating them for sale or rent.

They each plan to contribute $250,000 to the entity, and to borrow additional funds as needed from "bridge" lenders who provide short-term loans for co-venturers like themselves. Neither of them wishes to be liable for entity debts for more than their initial $250,000 contribution, nor to have their projects side-tracked by their co-venturer's creditors.

They plan to share decision-making authority, profits and losses equally, and to come up with a fair way of compensating each other for services rendered to their new enterprise. They contemplate the broker receiving a commission for finding and then selling co-venture-owned properties. The contract would receive a customary contractor's fee for overseeing the renovation.

(a) Which of the entities described in this chapter would be suitable for them, and why?

(b) Which entities should they avoid selecting, and why?

(c) Which would you recommend, and why?

(d) They choose an LLC. The operating agreement specifies that both of them are to approve any property acquisitions, financing, construction contracts, and sales or rentals. They agree on their first acquisition, set a fixed price budget for the renovation, and a contractor's fee of 5% on satisfactory and timely completion at or below the budget.

During construction the contractor orders a number of upgrades without consulting the broker, exceeding the project budget by 25%. The market softens and the two LLC members recoup only 90% of their invested capital.

Do you believe the general contractor has breached the duty of care it owed the broker by ordering the upgrades without the broker's approval?

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[5] *See* Robert Schmidt, *What You Should Know About Equity Waterfall Models in Commercial Real Estate*, PROPERTYMETRICS (May 4, 2016), https://www.propertymetrics.com/blog/2016/05/04/what-you-should-know-about-equity-waterfall-models-in-commercial-real-estate/.

The contractor believed that the upgrades would spark interest in the house and lead to a rapid sale at a price higher than the two had thought they could achieve based on the original renovation plans.

(e) Would your answer depend on whether the statutory standard of care was defined as “gross negligence” or a duty to act “with the care an ordinarily prudent person would exercise in similar circumstances?”

Question 2: *An LLC Assignability Hypothetical.*[6]

The seller is a family trust contracting to sell a “B” quality office tower in downtown Los Angeles for $120,000,000 that it has owned for decades. The trust is liquidating all of its real estate assets. This is one of the reasons why the trust had not invested the funds necessary to upgrade the property to “A” quality.

The purchaser is a real estate investment fund with substantial cash to invest, and a great interest in renovating properties in prime locations that are underperforming, but could potentially produce considerably improved net operating income with the right major upgrades.

Both the family trust and the private equity investment fund are LLCs. Each of them has three members who manage their respective LLCs. The three members of the purchaser LLC, the real estate fund, are prominent and hugely successful real estate investors, widely respected among their peers in commercial real estate equity and debt markets.

The seller’s board is extremely interested in closing a sale as quickly as possible. The Board responded favorably to the private equity investment fund because of its substantial access to equity and debt capital. The Board is wary of buyers who are eager to “flip” the property instead of improving it, because all of the property’s major systems (HVAC, elevators, public areas) are outdated. They are looking for a buyer who understands that the price is fair but the buyer will have to make substantial investments in the building for this acquisition to make financial sense. The Board would not enter a contract with a buyer lacking the competence and resources to transform this “B” asset into an “A” one.

The buyer had deposited with a neutral third party $1,000,000 at the time that the purchase and sale agreement was signed. The contract called for the buyer to deposit an additional $4,000,000 at the end of the “due diligence” period. Until that time, the buyer has the option of terminating the contract virtually at will simply by notifying the seller in writing that it wishes to cancel the contract, and executing appropriate termination documents. The terminating buyer is entitled to a prompt return of all of their deposited funds except for nominal fees incurred for services performed by third parties, including the stakeholder. Terminating the contract after that date labels the buyer in breach, and obligates relinquishment of all the funds previously placed with the neutral stakeholder as liquidated damages. In this transaction, that sum would be $5,000,000.

[6] The wording of this question has been adjusted from the version in the text.

(a) Does the agreement allow the individual board members of the real estate investment fund acquiring the property to dispose of their individual membership interests in the purchasing LLC? When might the seller be well advised to consider limiting one or more of those board members from assigning their interests in the LLC?

(This question has been re-written. The original text asked whether the agreement allowed the purchaser to dispose of its membership interest in the LLC. In fact, the "purchaser" was a real estate investment fund, an LLC, governed by a three-member board. So the question was incoherent. "The purchaser"—the fund—could not dispose of its membership interest in the LLC because it was the LLC.)

(b) What language should the seller have placed in the assignment provision to make sure the original buyer did not assign its interest to a less qualified buyer, leaving the seller at risk if the value of the asset declined during the executory period?

Question 3: ***Avoiding Double Taxation in Entity Selection.***

(a) Which entities are subject to double tax?

(b) Can you imagine any reason why a real estate developer, sponsor, promoter or equity investor would ever consider doing business as a C Corporation?

(c) How could an S Corp manage to avoid forfeiting its privileged tax status if a shareholder sold her shares to a nonresident alien or divided her shares among several individuals, pushing the total number of S Corp shareholders above 100?

Question 4: ***Inclusion of Borrowed Funds in Basis; Loss Pass-Throughs.***

(a) Which of the entities allow the inclusion of entity-borrowed funds into the basis of individual entity members, partners, co-tenants or shareholders — partnerships general and limited, C and S corporations, tenancies in common, LLCs?

(b) Why do LLC members or partners regard the pass through of losses from the entity to themselves individually to be a good thing?

Question 5: ***Restrictions on REIT Ownership, Portfolio Composition and Earnings Distributions.***

(a) A REIT avoids tax at the entity level only by observing certain limitations on ownership, portfolio composition and earnings distributions listed in I.R.C. § 856. Generally, what is the purpose of these restrictions?

(b) Despite distributing almost all their taxable income to their shareholders, how do REITs manage to accumulate cash flow to facilitate growth?

(c) A REIT cannot protect its distributed income from taxation unless most of its earnings are from 'passive' sources. Income earned from operating hotels, casinos and racetracks is characterized as active for tax purposes. How, then, can REITs profit from the ownership of such assets without jeopardizing their privileged tax status?

THE CONDITION OF THE SUBJECT PROPERTY, FIXTURES, AND RISK OF LOSS DURING THE EXECUTORY PERIOD

I. The Physical Condition of the Subject Property: Seller Disclosures

5 Things You Need to Know About Real Estate Disclosures[1]
By Brendon Desimone

KNOW-HOW

Whether you're a buyer or a seller, disclosures are a key part of your real estate transaction.

It’s standard practice in real estate to give a home a fresh coat of paint before putting it on the market. Nine out of ten times, the intention is to show the property at its best. But every so often, the seller paints the house in hopes of covering something up.

In most parts of the country, sellers (and agents) are required to document any known defects—whether current or past—to potential buyers. But some sellers don’t play by the rules and will try to get one past a buyer.

Whether you’re listing a home for sale or in the market to purchase, here are five things you should know about real estate disclosures.

What is a disclosure?

Disclosure statements, which can come in a variety of forms, are the buyer’s opportunity to learn as much as they can about the property and the seller’s experience in it.

Potential seller disclosures range from knowledge of leaky windows to work done without the benefit of a permit, to information about a major construction or development project nearby.

Not only do disclosure documents serve to inform buyers, but they can also protect the sellers from future legal action. It is the seller’s chance to reveal anything that can negatively affect the value, usefulness or enjoyment of the property.

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[1] Brendon Desimone, *5 Things You Need to Know About Real Estate Disclosures*, ZILLOW (Sep. 24, 2016), https://www.zillow.com/blog/real-estate-disclosures-62807/.

How does a seller make a disclosure?

Disclosure laws vary from state to state, even down to the city and county level. California has some of the most stringent disclosure requirements. The law requires that sellers (and their agents) complete or sign off on dozens of documents, such as a Natural Hazards Disclosure Statement, Local and State Transfer Disclosure Statements, Advisories about Market Conditions and even Megan's Law Disclosures.

Disclosure typically comes in the form of boilerplate documents (put together by the local or state real estate association), where the seller answers a series of yes/no questions about their home and their experience there.

Additionally, sellers must present any documented communication (between neighbors, previous owners, the seller or the agents) about a substantial defect or item that could have an adverse impact on value.

Depending on where you live, sellers can be on the hook for what they disclose (or fail to) for up to 10 years. Sellers should err on the side of caution. If you know it, put it out there. If you try to hide something, it can come back to haunt you in the form of an expensive lawsuit.

What do sellers disclose to potential buyers?

Previous improvements, renovations or upgrades done by sellers are typical disclosures, as well as whether work was done with or without permits.

Buyers should cross check the seller's disclosures with the city building permit and zoning reports. Work completed without a permit, or approval by the municipality, may not have been performed to code, which could result in a fire or health hazard.

Other standard disclosures include the existence of pets, termite problems, neighborhood nuisances, any history of property line disputes, and defects or malfunctions with major systems or appliances. Disclosure documents often ask sellers if they are involved in bankruptcy proceedings, if there are any liens on the property, and so on.

Is a disclosure the same as an inspection?

Disclosure is something given to the buyer by the seller documenting their knowledge of the property. It is not the same thing as an independent inspection by a third party. An examination may reveal defects that the seller may not have been aware of.

The buyer should always do a full property inspection, before moving forward with the purchase. The inspector checks all systems and components from the roof to the basement. Often, in the interest of the ultimate in full disclosure, a seller hires a property inspector before going on the market and supplies the written report to the buyer.

When does the buyer receives disclosure statements?

In most markets, disclosure documents are provided to buyers once the seller has accepted their offer. In addition to their inspections or loan contingency, the buyer has an opportunity to review the seller's disclosures. If the buyer discovers something negative about the property through disclosure, she can usually back out.

In some markets, sellers provide these disclosures to the customers before an offer. Smart sellers let buyers know everything they need to know up front. It's smart because it saves everyone time, hassle, and expense by preventing deals from falling apart once they're in escrow.

Buyers must sign off on all disclosures and reports. So, it's important to review them carefully and ask questions if you need to. Full disclosure upfront is the way to go. Providing full disclosure can help a seller. By laying their cards out, sellers can give buyers a sense of comfort or peace of mind, making their home more desirable than a competing one.

II. Property Inspections and Repairs

"Most home buyers and sellers don't think much about what might derail their purchase or sale. But here's a sobering fact: One of every 20 sales contracts blows up along the road to closing. And roughly 1 of every 4 runs into an issue that delays the scheduled settlement…. Guess what's the No. 1 deal-killer? Home inspections."[2]

Inspections: The Seller's View.

Inspections can only take place with the seller's consent. Sellers rarely consent to open-ended inspections. They want to control how and when inspections take place to avoid inspectors disrupting occupants, damaging the seller's property or injuring anyone on the premises. Also, home sellers may want the inspection conducted soon after the purchase and sale contract is signed to shorten the period of time during which the buyer can cancel the contract due to what the inspector discovers. [3]

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[2] Kenneth R. Harney, *Home Inspections Can Be Valuable, but Sometimes They Go Too Far*, WASHINGTON POST, April 25, 2017, https://www.washingtonpost.com/realestate/home-inspections-can-be-valuable-but-sometimes-they-go-too-far/2017/04/24/b8019e02-2916-11e7-a616-d7c8a68c1a66_story.html.

[3] For example, the Illinois Multi-Board Residential Real Estate Contract requires buyers to complete their inspections within 5 business days of the seller's acceptance of their offer. *See* Kelly A. Anderson, *Home Inspection Requests: Do Sellers Have an Obligation to Make Repairs?*, LAVELLE LAW, LTD. (June 21, 2016), https://www.lavellelaw.com/residential-real-estate/home-inspection-requests-do-sellers-have-obligation-make-repairs.

Inspections: The Buyer's View.

Property buyers learn about the physical condition of the property through inspections. Often, they only walk through the property briefly before signing a purchase and sale contract.

As indispensable as a good inspection can prove to be, buyers ordering an inspection need to appreciate its scope and limitations.[4]

Home inspections are based on visual inspections. Sellers would balk at inspectors drilling through walls to inspect the condition of ducting and wiring or removing the tiles on a shower floor to make sure the shower pan is not leaking.

Concealed or latent defects are also excluded from the inspection. (This is one reason that sellers are required to disclose latent, material defects they know about.)

> Inspections are not designed to cover certain conditions and elements that may require specialized skill, instruments or access. Thus, often home inspectors will recommend that additional inspection and testing be done by qualified inspectors for such issues and environmental hazards as: radon or other air-quality issues; energy consumption; termites and other invasive pests or vermin; the chimney, flue and liner; well-water potability; septic tank efficiency; asbestos encapsulation; lead paint; and mold.[5]

Repairs or Price Reduction?

Sellers have no implied obligation to make repairs as long as the property is in the same condition on the closing date as when the buyer signed the purchase contract.

In the widely used California CAR form, typical of forms in other states as well, the buyer's remedy for defects revealed by the inspection is the right to cancel the contract, request the seller to make repairs or "take other action."[6]

Canceling the contract means that both the buyer and seller start from scratch with all the delays and uncertainties that come with that choice.

"Take other action" usually refers to the buyer agreeing to accept a price reduction or closing cost credit from the seller that will amply cover the estimated cost of the buyer making the repairs after the closing.

The third choice is for the seller to complete the work even if this means a delayed closing.

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[4] Nick Gromicko & Kenton Shepard, *The Limitations of a Home Inspection*, INTERNATIONAL ASSOCIATION OF CERTIFIED HOME INSPECTORS, https://www.nachi.org/limitations-home-inspection.htm (last visited Aug. 10, 2017). Inspection guidelines are often shaped by state regulatory guidelines for licensed building inspections.
[5] Harney, *supra* note 1.
[6] GEORGE LEFCOE, REAL ESTATE LAW AND BUSINESS 26, paragraph 15B (2016).

An experienced real estate broker explains why sellers should always choose to reduce the purchase price and close on time instead of undertaking the repairs themselves.

> Say the roof over your garage has hail damage that the buyer demands be fixed. You agree that repairs need to be made and offer to have them done before the closing takes place. Two things happen: First, the repairs take longer than you thought and potentially end up delaying the closing if the buyer or their attorney will not agree to an escrow hold back. Second, the roof shingles are newer, so they do not look the same as the old shingles.
>
> The buyer should understand this, but chooses not to, and demands you do something about it. Again, in the second example the buyer could attempt to delay the closing creating stress for you especially if you have bought another home and you need to close on your home in order to purchase.
>
> You probably would not be liable for any further costs in this particular situation, but you also just put yourself through weeks of anxiety and ended up with an angry buyer, all of which could have been avoided by just handing over the estimated cost of repair in cash or credit on the sale. The buyer picks his contractor and deals with the consequences while you move on.[7]

Seller's Obligation to Disclose Inspection Results to Future Prospective Buyers.

A seller who learns about a property defect will be required by statute and broker-imposed disclosure norms, to pass that information along to future prospective buyers.

Broker-prepared forms require buyers to deliver copies of inspection reports to sellers. Whether the seller actually sees the report or just hears about the defects through the buyer or the inspector, the seller's disclosure obligation is the same. Failing to make the disclosure, the seller risks crossing the line from misrepresentation into fraud or concealment.

A widely quoted real estate lawyer urges sellers not to require or accept copies of inspection reports. His advice to sellers is: say no to being given the report.

Sellers should be aware that a buyer's inspection report can be problematic for them because if the deal doesn't close, they could be obligated to tell subsequent buyers about any defects mentioned in the report. "Once they're in possession of the report, they have a duty to disclose all of those now-known defects to all future purchasers," Jacobs says.

To avoid that scenario, Jacobs says he 'strongly urges' sellers not to accept a copy of the report, and to strike any wording in the contract that says that the buyer must give the seller a copy of the inspection report. That doesn't end the seller's obligation to disclose known defects,

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[7] Bill Gassett, How to Negotiate Issues After a Home Inspection, MAXIMUM EXPOSURE REAL ESTATE (Jan. 20, 2014), http://www.maxrealestateexposure.com/negotiate-issues-home-inspection/.

but it limits new knowledge of additional defects, giving them a safeguard if the deal falls through.[8]

Bad advice, your textbook author says. What is your opinion?

III. Fixtures

Fixtures: What Kind of Property Are They? [9]
By Sharon L. Morris

The law distinguishes between real property and personal property. Most lawyers learn early in their careers that the characteristics of each are vital to their practices. A property's classification affects the property's transfer of title, insurance, estate matters, taxes, family law treatment, and more. But property does not always fit so neatly into the categories of real and personal (or immovable and movable, the corresponding terms used in Louisiana).

The law recognizes a third category, commonly referred to as fixtures, that fits somewhere in between. Often it is hard enough to determine what should be considered real or personal property in one jurisdiction, but it becomes even more complicated when a lawyer represents parties with property in multiple locations.

To understand the definition of fixtures, it is first important to comprehend the basics of classification. Almost every "thing" fits into one of two categories of property: real and personal.

Real property includes land and, typically, items that are affixed to land, such as buildings and other improvements. In some jurisdictions, the nature of the attachment is specifically described. For example, Cal. Civ. Code § 660 provides:

> A thing is deemed to be affixed to land when it is attached to it by roots, as in the case of trees, vines, or shrubs; or imbedded in it, as in the case of walls; or permanently resting upon it, as in the case of buildings; or permanently attached to what is thus permanent, as by means of cement, plaster, nails, bolts, or screws; except that for the purposes of sale, emblements, industrial growing crops and things attached to or forming part of the land, which are agreed to be severed before sale or under the contract of sale, shall be treated as goods and be governed by the provisions of the title of this code regulating the sales of goods.

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[8] Marcie Geffner, *Who Repairs Home—Buyer or Seller?*, BANKRATE (Feb. 14, 2014), http://www.bankrate.com/finance/real-estate/who-repairs-home-buyer-or-seller.aspx (Quoting Harvey S. Jacobs, a real estate attorney with Joseph, Greenwald & Laake in Rockville, Md.).
[9] Sharon L. Morris, *Fixtures: What Kind of Property Are They?*, PROBATE & PROPERTY, Sep.-Oct. 2010, at 60–63 (available at https://www.americanbar.org/content/dam/aba/publishing/probate_property_magazine/rppt_publications_magazine_2010_so_pp_SeptOct10_Morris.authcheckdam.pdf).

In California, personal property is defined as anything that is not "real." Id. § 663. Personal property includes movable things, that is, items that are not affixed to the land, such as furniture, cash, and vehicles.

Then the question becomes whether the personal property has lost its movable nature so as to become a part of the real property. The answer typically depends on the facts of each case.

Fixtures

Fixtures fall somewhere between personal property and real property, but, generally, once a fixture is attached to real estate, it is considered real property. Article 9 of the Uniform Commercial Code (Article 9) defines fixtures as goods that have become so related to a particular real property that an interest in them arises under real property law. U.C.C. § 9-102(a)(41).

Black's Law Dictionary 713 (9th ed. 2009) defines a fixture as "personal property that is attached to land or a building and that is regarded as an irremovable part of the real property, such as a fireplace built into a home."

The significant part of both definitions is the relation to real property. A fixture starts out as personal property, that is, goods, that typically become so attached to the real estate as to become a part of it while retaining a theoretically separate identity. For example, a brick, although deemed personal property, is essentially a building material that becomes such a part of the real estate that it cannot be separated without causing damage to the real estate. (Bear in mind that the level of damage is not dispositive.) But a chandelier, water heater, or the like, once incorporated into the real estate, can still be considered something separate from the real estate. It is this separate identity that often leads to confusion.

The typical scenario in which the fixture definition becomes important looks like this: Debtor owns a bakery that operates in a two-story building encumbered by a mortgage in favor of Lender A. All of Debtor's baking takes place on the bottom floor in a room with large pieces of equipment bolted to the floor and, in some cases, to the wall.

Lender B finances the purchase of a new oven for the bakery and Debtor grants Lender B a security interest in the oven. The oven, while sitting on the showroom floor, is clearly personal property. It can easily be picked up and hauled away. Debtor installs the oven in the bakery by attaching it to the wall with heavy bolts and to additional bakery equipment with conveyer belts.

If Debtor defaults in its payments to Lender B, who holds a security interest in the oven, or defaults in its payments to Lender A, who holds a mortgage on the real estate, then the classification of the oven becomes vitally important in determining who holds the superior interest.

Lender A's mortgage indicates that it covers the "real estate." If the oven is considered a part of the real property, then it is covered under Lender A's mortgage.

Note, however, that under Article 9, Lender B can preserve its priority interest by filing its fixture filing before the oven becomes a fixture or within 20 days thereafter. U.C.C. § 9-334(d)(3). Every state, except Louisiana, has adopted this "20-day rule." In Louisiana, to perfect its security interest a lender must file a fixture filing before goods become fixtures; otherwise the lender's interest is not protected. La. Rev. Stat. § 10:9-334(d)(3).

If Lender B has not perfected its fixture filing under section 9-334(d)(3) of Article 9, resolution of the scenario above depends on the law of the jurisdiction in which the property is located.

A general review of the law of most states reveals that the majority follow the same rule. For a fixture to be considered a part of the real property, the following elements must exist: "(1) annexation of the article to the land, (2) adaptation of the article to the use of the land, and (3) an intention that the article become a permanent part of the freehold." Green Tree Servicing, LLC v. Random Antics, LLC, 869 N.E.2d 464, 469 (Ind. Ct. App. 2007).

This three-part test is very fact specific. Although annexation was historically the most significant part of the test, most states now appear to focus more on intent. In a case with facts similar to the bakery scenario above, the Supreme Court of Virginia stated that the "method of the annexation to the realty receives slight consideration and then only as a circumstance from which the intention of the annexor may be deduced." Danville Holding Corp. v. Clement, 16 S.E.2d 345, 349 (Va. 1941).

The court held that certain machinery and equipment installed in the bakery after execution of a deed of trust encumbering the real property were a part of the real estate, thus covered under the deed of trust.

In a case out of Texas, the court indicated that the third criterion—the intent criterion—is preeminent, "whereas the first and second criteria constitute evidence of intention." Trenolone v. Cook Exploration Co., 166 S.W.3d 495, 499 (Tex. App. 2005).

Intent is made apparent by objective manifestations. As a general rule, intent is a question of fact to be decided by the jury. However, even testimony of intention that the chattel was not meant to become a fixture will not prevail in the face of undisputed evidence to the contrary. Where reasonable minds cannot differ, the issue is one of law rather than one of fact. Id.

Similarly, in a New York case, the court stated: "The intent which is regarded as controlling is not the initial intention at the time the [item] is acquired, nor the secret or subjective intention of the party making the attachment, but rather the intention which the law will deduce from all the circumstances." Mastrangelo v. Manning, 793 N.Y.S.2d 94, 95 (N.Y. App. Div. 2005) (quoting Midland Tr. Co. of Binghamton v. Ahern, 168 N.Y.S.2d 656, 659 (N.Y. Sup. Ct. 1939)).

Intent

Because the intent of the party annexing the property appears to be the most important test in most jurisdictions for classifying a fixture as either real or personal, it is worth considering whether or not changed intentions would lead to a different result.

For instance, if a person purchases real property at a sheriff's sale with the intent to redevelop the property for another use, does that change the nature of things attached to the real property?

The Supreme Court of Connecticut considered this issue in ATC Partnership v. Town of Windham, 845 A.2d 389 (Conn. 2004). This case involved a replevin claim in which the threshold issue was whether or not certain factory machinery and equipment could properly be classified as personal property because only personal property is covered under Connecticut's replevin statute.

In a nutshell, the plaintiff purchased property once used as a textile mill with the intent to redevelop the site for another use. Most of the machinery and equipment remaining in the mill was bolted to the building and had been used to operate the property as a textile mill.

The plaintiff sought to recover the property when the building was seized by the town of Windham through a condemnation proceeding. The plaintiff argued that the machinery and equipment were personal property not subject to the condemnation proceeding.

The trial court placed particular emphasis on the facts and circumstances present when the property was first annexed and determined that the property was not the type covered under the replevin statute. Id.

On appeal the partnership claimed that because the parties intended to redevelop the property in a manner that called for treating the items as personal property, they could no longer be considered to have retained the status of fixtures. Id.

The court disagreed. The parties agreed that the items were fixtures at the time the property was used as a textile mill, so the court considered whether or not events after the cessation of the mill operations "had the effect of severing the fixtures from the realty such that the fixtures reverted to the status of personalty." Id. at 401.

Although the evidence showed that the partnership had tried to enter into an economic redevelopment agreement with the town concerning the property, these discussions failed to lead to a final agreement. For that reason, the Supreme Court in Connecticut agreed with the trial court that the owner's mere expectation of a future use for the property was insufficient to result in a constructive severance of the property.

Consequently, the court found that the machinery and equipment at issue were fixtures and, therefore, not personal property that could be recovered under the state's replevin statute.

Careful Drafting Is Key

Once an item is deemed to be a fixture, then it is usually considered a part of the real property. That characterization means that the property at issue, depending on the jurisdiction, can be taxed, transferred, or leased as a part of the real estate. A careful drafter that understands the subtle distinctions that may lead to property being classified as a fixture, and thus part of the real estate, can then address that fact in the drafting process.

For instance, in the bakery scenario, if the new oven is considered a part of the real estate, then any transfer of the building housing the bakery would automatically include the oven. If Debtor did not want that to be the case, Debtor's lawyer could draft the sale documents to specifically exclude the transfer of the oven and any other items of personal property.

Moreover, if Debtor plans to purchase additional items that should be encumbered by Lender A's mortgage, this fact should be taken into account before executing the mortgage.

Assuming Lender A agrees, the loan documents could be prepared with a description of Lender A's collateral that excludes goods to be purchased and installed on the property after the date of the mortgage. Therefore, these goods would retain their identity as personal property.

It is for this reason that a property owner's lawyer should not use the term "fixture" in any agreement without further specifying the items that are or are not included in that term.

Transfers of Real Property

Although classification is important to lenders desiring to protect their security interests, it may be even more important to the average property owner or purchaser. Imagine first-time homebuyers that find the house of their dreams, replete with custom drapes, surround sound speakers, high-end appliances, and a six-foot security fence wrapped around the whole lot.

They are so excited that they sign a purchase agreement, provided by their real estate agent, the first time they see it. Then imagine their shock when, after the closing, they drive up to their new home and the fence is gone, the drapes are removed, and the speakers have been ripped from the walls.

This is not an unrealistic scenario. Few purchase agreements mention items like these, but so often they are exactly the kind of home improvements that become the subject of post-closing arguments.

Classification of the fence is not the simple proposition it may seem to be. The facts are always key. In an Alabama case, Groves v. Segars, 261 So. 2d 389 (Ala. 1972), the court was asked to determine ownership of a chain link fence removed from the property just before the sale. The fence stood on property that plaintiffs possessed under a lease/ sale contract. They agreed to transfer the contract and the property to the defendant but would continue to live on the property until their new residence was constructed.

At the outset, the court indicated that ordinarily "a fence composes part of the land on which it is located and passes to the vendee of the land." Id. at 391. Based on the facts of the case, however, the court determined that the plaintiffs had orally indicated their intent to reserve the fence to themselves. Therefore, the trial court correctly found that a fixture could be reserved "or the right to remove it may be obtained, by an oral agreement between the owner of the equitable title and his vendee." Id. at 393.

The case emphasizes the point that the status of property should never be presumed and that parties can, in most cases, change that status by agreement. The general rule is that fixtures follow the real property, but it is always better to be specific.

When dealing with improved real estate, it is best to use more than just the property's legal description to describe the property to be transferred. For example, it would be better to add "this sale includes all fixtures, equipment, furniture, furnishings, supplies, and personal property owned by seller and used in connection with the operation of the property" and then reference any specific exclusions.

The fixture issues that can arise in sales become even more complicated when dealing with commercial property. If the property to be sold is leased to a third party, then the third party needs to protect its interest in items that might be considered fixtures. For example, if a tenant is operating a restaurant in which the tenant purchased and installed the equipment, then the tenant should make sure that the purchase agreement and transfer documents do not include the tenant's equipment. Alternatively, if the equipment was owned and installed by the landlord, then the purchaser should make sure the equipment is specifically included in the purchase agreement's description of the property to be purchased.

If the equipment has significant value, then a bill of sale in addition to the deed would be the best way to transfer the equipment to reduce potential claims from tenants, or any other parties, later.

Again, it is important to recognize the issues and document the transaction so that any items of questionable classification are considered.

Conclusion

No bright-line rule defines fixtures. Most states generally consider fixtures to be things capable of existing separate and apart from the realty but that are annexed to the realty for a specific use related to the realty and that are intended to be a part of the realty. The facts of each case make a big difference. For that reason, a good understanding of the basic rules is imperative when drafting documents dealing with both real and personal property. Recognizing the facts that will make the difference in each situation aids the practitioner immensely when trying to protect the client's interest.

IV. REVISED QUESTIONS

Question 1: ***Inspections.***

(a) Why should buyers pay for inspections before purchasing when they will have the benefit of builders' warranties for newly-built houses and seller disclosures of defects for pre-owned homes? Anyway, buyers will have no practical recourse against inspectors who fail to disclose important defects because inspection companies usually have minimal resources and seldom carry errors and omissions coverage.

(b) Why is the seller better off with a contract allowing buyers to back out of their purchase agreements in their sole discretion following the inspection contingency time period, or should buyers be obligated to demonstrate reasonableness in backing out by pointing to "substantial defects" and giving the seller a chance to cure them?

(c) Is it a good idea for sellers to commission a physical inspection of the property's condition when the seller must share the report with potential buyers, even if it reveals horrific defects previously unknown to the seller?

Question 2: ***Seller's Post- Closing Liability for Defective Conditions.***

Buyer closes escrow on a house in August and closes in September. The seller had acquired the house five years ago from a buyer who had bought it from the original builder over a decade earlier.

The first seasonal rains pour down a week after closing; the roof leaks badly. Buyer spends $10,000 on roof repairs.

(a) Is the seller liable at common law, assuming he is not a merchant builder or developer, to deliver the house in a habitable condition?

(b) Is the seller liable in a disclosure state if he said nothing about the roof leaking in the disclosure statement because he didn't know it would leak?

(c) If the seller had known all along that the roof was leaky, and the buyer can prove it, would an "as is" clause have exonerated the seller?

(d) Would the seller be liable if he had promised the buyer he would have the roof repaired before closing, and four days before the closing the seller had paid a roofer to fix the leak, and has a receipt to prove it?

Question 3: ***Are "As Is" Clauses a Good Idea for the Seller?***

What are the main advantages and disadvantages of an "as is" clause for the seller in a jurisdiction where an "as is" clause negates any implied warranties and representations, but offers no excuse to the seller for not disclosing material, known, latent defects?

Question 4: ***Seller Disclosure of Pre- Existing Defects***

This question is about the seller's obligation to disclose that she repainted the exterior of her home because the exterior wall was cracking in various places, and it looked terrible. The house is in Los Angeles.

Melissa, the seller, would prefer not to disclose that there were various cracks in the exterior walls of the house. Everything is good now. The house was recently repainted. The cracks are no longer visible. The seller has no idea whether those cracks suggest structural instability of the house. She knows nothing about engineering or soil stability.

She is convinced that the buyer should be happy that the house has a new paint job.

(a) Should Melissa disclose the existence of those (now invisible) cracks?

Melissa decides not to disclose, and the buyer's inspector informs the buyer that it looks like there had been some cracks in the wall but nothing very serious. The buyer signs the form required by their purchase and sale agreement indicating acceptance of the condition of the property as a contingency of closing.

Six weeks after closing, the buyer notices that cracks are appearing on the concrete outside the house. A geologist explains that the house is slipping off its foundation. The problem was evidenced by the painted- over cracks. Further soil testing will be needed to determine if this is a serious problem or not. The testing will cost $10,000.

(b) Is the seller liable for: (1) the cost of testing; (2) implementing the recommendations of the geologist for shoring up the site, and/or (3) the difference between what the buyer paid and what a reasonable buyer would have paid had the cracked walls been disclosed?

(c) Is Melissa vulnerable to a claim of fraud for failure to disclose the cracks? To come up with the answer, review The California Transfer Disclosure Statute and The Elements of Fraud.

Question 5: ***Seller Disclosure of Changed Conditions Between the Contract Date and the Closing.***

The events depicted in this question take place in the same jurisdiction as the one in the previous question. At the time the buyers and sellers sign a contract of purchase and sale for a home, the neighborhood is quiet at night. During the executory period, a home across the street sells to a family with three raucous teenagers whose parents are often out of town. The kids' "all-nighters" draw scores of young party-goers so noisy and messy that the neighbors called the police three times last week to halt the disturbance.

(a) Must the sellers report this development to the prospective buyers?

(b) If they do report it, what pre-closing options are available to the buyers—restitution and rescission? Specific performance with a price abatement? Rescission and forfeiture of their down payment?

(c) If the sellers close without disclosing, what remedies, if any, would be available to the buyers against the sellers if the noise persists after the closing?

Question 6: *Home Seller Warranties*.

(a) Why have courts tended to impose implied warranties of habitability on homebuilders, but not on sellers of used housing?

(b) What types of provisions that frequently appear in homebuilder warranties should buyers recognize as severely limiting the usefulness of the warranty to the buyer?

Question 7: *Commercial Seller Representations and Warranties*.

An apartment developer is selling its newly constructed 50-unit building in a prime location. The buyer is acquiring the property for a family trust, and wants assurances that the building complies with all building and zoning codes and has no known defects. What is the seller likely to offer in response to this request, assuming it is quite satisfied with the price and other terms of the buyer's offer?

Question 8: *Buyer's After-Closing Remedies for a Faulty Representation*.

Buyer and seller conclude a sale for a 200-unit apartment house for $20,000,000. During the "due diligence" period, the chief financial officer (CFO) of the seller provided the last two years' financial statements, representing them to be true to the best of her knowledge.

After taking possession, the buyer learned from the landlord's project manager that tenants were often given three months' free rent. Many of those tenants are not renewing their one-year leases. The CFO had over-stated rent collections considerably. Had the buyer known this, it would have reduced the price by $1,000,000.

(a) What remedies would you suggest that the buyer consider for breach of the seller warranty?

(b) How do you suppose this dispute is likely to be resolved?

Question 9: *Fixtures*.

(a) The kitchen cabinetry is original and beautifully detailed. The old O'Keefe and Merritt stove is working perfectly. What facts about the stove and cabinets are relevant to whether the home buyer gets to keep the stove or the kitchen cabinets, assuming the buyer and seller leave their status unresolved in the contract?

(b) A restaurateur bought the same type of stove on credit for the kitchen in his newly opened rented space. When the lease expires, who owns the stove—the landlord, the tenant restaurateur, or the landlord's mortgage lender following the mortgage lender's foreclosure of the defaulting landlord's interest in the space?

(c) The lobby of an office building is adorned with a thirty- foot long painting by a prominent artist valued at $10,000,000 and a sculpture garden with museum quality work. These art objects add to the status of the building as the premier location for major law, accounting, and business firms in the area. They could all be removed without permanently damaging the building but the value of the property might be diminished by their removal.

A buyer contracts to purchase the property under which the seller reserves the right to remove personal property that it owns, including the furniture in the building owner's office. The contract also specifies that fixtures are to remain in place after the closing. The seller removes the painting and sculptures on the evening before closing. The purchase and sale contract has a limit of $100,000 in damages if the seller breaches any warranties and representations.

Has the buyer any meaningful recourse for the art and sculpture removals? Had they become fixtures?

Question 10: *Allocating Risk of Loss by Contract.*

A home seller, about to enter a purchase and sale contract, would not want a casualty loss to derail her scheduled closing because she has contracted to take title and possession to her new home on the same day that she sells her old one.

(a) Which of the three risk of loss default rules would best suit the seller—the majority rule, the minority rule, or the UVPRA?

(b) For the seller, what would be the ideal contract provision concerning risk of loss consistent with not penalizing the buyer for the mishap?

(c) If you were the buyer's representative asked to sign the seller-friendly risk of loss provision reprinted below in the answer to this question, what changes would you suggest to remove the most buyer-unfriendly language of that prepared form?

Question 11: ***Probing the Viability of the Buyer Possession Provision Under the UVPRA.***

A devastating fire destroys 700 houses in a California city. Several of the homes were in escrow at the time. Most of the sellers were in possession. But Seller A had agreed to allow Buyer B to take possession six days before the closing so that Buyer B's children could enroll in the local school.

They increased the purchase price to account for the seller's increased costs for mortgage payments, property taxes, insurance, and maintenance (gardener, security service, pool service). Before the closing, the house burned to the ground through no fault of the buyer or seller.

(a) Under the UVPRA would the seller have the right to specific performance, or to retain the buyer's down payment designated as liquidated damages in the purchase and sale contract? After all, the buyer was in possession during the executory period and the UVPRA clearly places the risk of loss on the buyer if the buyer has taken title or possession before closing.

(b) The buyer claims that the UVPRA only applies in the absence of a contract provision to the contrary, and the final inspection gives the buyer the right to terminate the contract since the property is not what it was when the purchase and sale contract was signed. The purchase and sale contract had a standard provision for a final walk through so that the buyer could determine whether the house was in the same condition as on the day the contract was entered. But the provision also contained in capital letters: THIS INSPECTION IS NOT A CONTINGENCY OF THE CONTRACT. Is the buyer right?

DEEDS AND THE QUALITY OF TITLE

I. An Overview of the Topics Covered in the Chapter.

This chapter is about deeds and marketable title—tangible objects and intangible concepts that are indispensable aspects of the legitimacy of real property ownership. The deed is a simple document that names the new owner, identifies the property and symbolizes the present owner's intent to transfer title. Deeds not only symbolize the transfer of ownership, but can also be used to impose long-term limitations on the use of property.

"Marketable title" refers to standards established by practicing real estate attorneys, courts and title insurers to assess whether a seller's claim of title is sufficiently free of potentially adverse claims of title. If these standards are met, a reluctant buyer can be compelled to go through with a purchase and sale contract, or a title insurer can become obliged under a title policy to compensate insured buyers or mortgage lenders for loss or damage due to claimed title defects.

II. Deed Formalities and Deed Restrictions

Formal Requirements for a Deed[1]
By Alan R. Romero

A deed is generally a pretty short and simple legal document, maybe just a couple of pages long. Sometimes deeds use exotic-sounding, or archaic-sounding, legal terminology. But the formal requirements for a valid deed are pretty simple. A deed must be in writing because the statute of frauds requires a writing for the transfer of any interest in land other than short-term interests. Additionally, a written deed must always:

- Identify the parties involved
- Identify the land being conveyed
- Express the grantor's intent to convey the land to the grantee
- Include the signature of the grantor

[1] Alan R. Romero, *Formal Requirements for a Deed*, DUMMIES, http://www.dummies.com/education/law/the-formal-requirements-for-a-deed/ (last visited June 26, 2017).

Identifying the Parties

The deed must name or otherwise sufficiently identify the grantor and the grantee. Some state statutes require the parties' addresses and marital status in addition to their names, and some courts have held that the grantor's signature (a required component of a valid deed) does not sufficiently identify the grantor.

Most courts have held that a deed in which the grantee's name is intentionally left blank, to be filled in later, is valid as soon as the grantee's name is written in. But if there is no grantee and the blank remains unfilled, the deed is void, because it can't very well transfer an interest to a nonperson.

Identifying the Land

The deed must identify the land conveyed. If the deed doesn't describe the land in a way that can be identified on the ground, it's void and doesn't convey anything. There are several ways the deed may legally describe the land.

Expressing Intent to Convey

The deed must somehow express that the grantor intends to convey the interest to the grantee by means of the deed. The words "grants" and "conveys" make it pretty clear that the grantor is conveying the named interest to the grantee.

Any word that indicates a present conveyance will do, but sometimes drafters have written that the grantor "warrants" title without ever saying the grantor actually conveys title**.** Sometimes drafters also have gotten into trouble because they used words that indicated an intent to convey in the future rather than in the present. Sometimes drafters of deeds seem to feel that there must be one magic word to use, but they aren't sure which word it is—so they use every synonym they can think of, like "grantor hereby grants, conveys, bargains, sells, transfers, sets over, and delivers" the property to the grantee. That's overkill—one word will do.

Signing the Deed

For a deed to be valid, the grantor must sign it. She can sign her name or make any other mark intended to validate the deed, and she can even have her agent sign for her. But if she doesn't sign the deed somehow, the deed is void. The grantee doesn't need to sign the deed for it to be valid; only the grantor needs to sign.

Buying, or Beefing Up a Home? Watch Out for Annoying Deed Restrictions[2]
By Lisa Gordon

The day I planned to close on an acre-lot where I hoped to build a brand-new house, my real estate agent turned up a deed restriction that limited the number of garages I could construct. I had intended to build three, but according to the deed, I could have only two.

This seems like the ultimate First World problem, I know. But it was the first deed restriction I, as a new developer, had encountered, and I didn't understand why this rule had come out of nowhere to block my progress on land I was paying good money for.

It turns out, the restriction was more than 50 years old and created by a neighborhood association that long ago ceased to exist—and therefore couldn't enforce it. I ended up closing the deal, but I had to consider all the dreamy-eyed buyers who longed to build their own home and were thwarted by rules—archaic or not.

And here's the rub: Deed restrictions affect more than would-be home builders. You can be restricted by anything from the number of bedrooms in your house to the types of vehicles in your driveway. It's best to know about deed restrictions before you buy, so let's take a look at what they're all about.

First, find out if your property has any deed restrictions

Deed restrictions, often called “restrictive covenants" (especially in the context of home owners associations), are restrictions contained in a deed that limit how a property can be used and what can be built on it. Most often, developers include restrictions not covered by local zoning regulations. The property doesn't even have to be part of a home owners association (HOA) to be limited by some rule a developer included in the deed decades ago—as I discovered.

Deed restrictions turn up during title searches and a careful reading of the current deed. They “run with the land,” which means that anyone who buys the property in future is supposed to abide by the restrictions, whether they were attached to the property 20 years ago, when the neighborhood was developed, or 100 years ago, when the land was a farm.

Deed restrictions aren't HOA rules

Don't confuse deed restrictions with regular HOA rules. An HOA can decide one day that no home in the association can string up Christmas lights. But if all the homeowners object, the HOA board can easily change its mind.

Deed restrictions, on the other hand, are difficult to change. Usually it takes a judicial ruling to invalidate them. In the worst of all worlds, a property's use can be limited by *both* deed

[2] Lisa Gordon, *Buying, or Beefing Up a Home? Watch Out for Annoying Deed Restrictions,* REALTOR.COM (Mar. 1, 2017), http://www.realtor.com/advice/buy/deed-restrictions-can-limit-home/.

and HOA restrictions.

Types of deed restrictions run the gamut

Deed restrictions aren't just about construction. Zachary D. Schorr, a Los Angeles real estate attorney, says he's seen deed restrictions that require exterior paint colors to match colors found in nature, or even restrict renting properties.

"With the rise of VRBO and Airbnb, we are even seeing restrictions on nightly rentals and the minimum rental period for a house," Schorr says.

Today, HOAs and developers create restrictions that, in theory, provide the greatest good for the greatest number of people. Some common deed restrictions can cover the following:

- Number of bedrooms (an attempt to prevent overwhelming sewer and septic capacities)
- Building height, width, and siting (to prevent obstructing views, especially in scenic and vacation areas)
- Number of vehicles allowed in the driveway or in front of the house, intended to keep the neighborhood from looking cluttered and junky
- Type of vehicles allowed in the driveway, like motor homes, boats, and motorcycles
- Type of fencing allowed (e.g., chain-link fences or very high privacy fences might be restricted)
- Type and number of trees you can remove from the property (Some restrictions protect a percentage of trees on a lot, which may have been put in place years ago by neighboring farmers and still are attached to the land.)
- Style, color, and construction materials used in a renovation (an attempt to limit architectural variations in a neighborhood)
- Pools, sheds, detached workshops, and extra garages can be forbidden or restricted
- Use of your home as a business (to prevent a lot of strangers from coming and going)
- Types of animals allowed on the property (Many deeds restrict livestock like chickens and goats; some also restrict breeds and number of pets.)

Who enforces deed restrictions?

Before World War II, property owners often wrote deed covenants that restricted the race and religion of future owners. However, in 1948, the U.S. Supreme Court ruled that covenants that impose racial or religious restriction cannot be enforced.

Today, some title companies that research deed restrictions don't even include these restrictive covenants in their reports, fearing a potential buyer might misconstrue their existence with their enforceability, leaving the title company open to discrimination charges.

Many covenants, in fact, exist in limbo because no ruling body still exists to enforce them—just like the garage covenant on the deed to my property. Your real estate agent and title company can help you determine if the ruling body still exists or is actively enforcing the rules, an important piece of information to know before you buy.

How to change a deed restriction

Modifying a restrictive covenant isn't easy, but it's not impossible, either. First, go to your county courthouse and obtain a copy of the covenant, which often contains provisions for changing it or, if you're lucky, an expiration date. Sometimes, you can seek special permission from the governing body, like your HOA. Sometimes you can violate the covenant if you obtain permission from your neighbors.

Some states maintain laws that allow property owners to modify covenants if they follow certain steps. If all else fails, you may be able to persuade a judge to invalidate a covenant if it's vague, impractical, illegal, or has been widely disregarded by neighbors.

What if you can't change the restriction?

This is why we say investigate all restrictions before buying. You may not want the hassle of begging enforcing groups or judges to allow you to build a work shed or park your boat in the driveway. It's often easier to adjust your expectations or find another property when deed restrictions prevent you from building your dream home.

Read Your Deed to Avoid Being Defrauded[3]
By Richard Gullen

Who reads their deed? No one. You close escrow, celebrate, move in, and a few weeks later an envelope arrives from the county recorder's office. You open it just long enough to recognize that it's your deed before you throw it in the filing cabinet. Like most buyers, you assume that because you also bought title insurance, you do not need to read the legalese in your deed to confirm that the seller transferred what you expected. If you ever do get around to reviewing your deed and discover that there is a discrepancy, you can always force the seller to correct that problem, right? A buyer does not need to worry about the statute of limitations until he actually discovers the problem, right?

Wrong. Although ordinarily the statute of limitations for fraud does not begin to run until a buyer discovers the fraud, according to a recent case, buyers are deemed to know the contents of their deed.

Therefore, the deadline to sue the seller for a fraud disclosed in the deed is three years from receipt of the deed, regardless of whether the buyer reads the deed and is aware of the fraud or not.

In *Alfaro v. Community Housing Improvements System & Planning Association, Inc.,*[4] the sellers were two community housing organizations that sold homes subject to a deed restriction

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[3] Richard Gullen, *Read Your Deed to Avoid Being Defrauded*, FACEBOOK (April 12, 2010), https://www.facebook.com/notes/rossi-hamerslough-reischl-chuck/read-your-deed-to-avoid-being-defrauded/384634897398.
[4] Alfaro v. Cmty. Hous. Improvement Sys. & Planning Ass'n, Inc., 171 Cal. App. 4th 1356 (2009).

requiring the homes to be sold below market in future sales so that they remained affordable to low-income buyers.

The buyers/plaintiffs were unsophisticated first-time home buyers, most of whom did not read or speak English. In lieu of a down payment, the program required the buyers to invest 8 to10 months of their "sweat equity" in the construction of the home. In their lawsuit against the sellers for fraud, the buyers claimed that they were surprised to learn of the deed restriction after investing their time and labor.

Some of the grant deeds disclosed the future sales price restriction by expressly referring to the recorded document that created the restrictions; however, some did not. The lawsuit was filed more than three years after the buyers received the deeds disclosing the restriction.

The court initially noted that deed restrictions contained in a recorded declaration, such as conditions, covenants, and restrictions (CC&Rs), run with the land and bind future buyers even if the buyers' deeds do not specifically reference the CC&Rs. The recording of a deed restriction constitutes constructive notice to a subsequent buyer, which is the equivalent of actual knowledge.

Normally, a buyer will discover a recorded deed restriction upon reviewing a preliminary title report. Buyers who receive a preliminary title report referencing a deed restriction are deemed to have actual notice of the restriction, and unless the sellers somehow prevented the buyers from reading the reports or misled them about their contents, the buyers cannot blame the sellers for their own neglect in failing to read the reports. However, in the *Alfaro* case, there was no allegation that the buyers received the preliminary reports before they invested their time and labor.

Likewise, the court observed that unless the seller misrepresented the deed or prevented the buyer from reviewing the deed before it was recorded, the buyer cannot plead ignorance of the contents of a deed.

Ultimately, in *Alfaro*, the court decided that although the buyers had constructive notice of the prior recorded restrictions and were therefore bound by them, this did not relieve the sellers of their duty to disclose their existence.

However, because the grant deeds disclosed the restriction by expressly referencing the recorded document, the court held that these grant deeds provided actual notice of the deed restriction. Therefore, this notice amounted to the buyers' discovery of the fraud, which triggered the three-year statute of limitations. As a result, the buyers who received these deeds were barred from suing for fraud.

The harsh lesson taught by this case is that the statute of limitations clock may start running against the buyer, even if he or she does not actually know that they have been defrauded, if the fraud is disclosed in their deed.

As a buyer, how can you protect yourself from this kind of nightmare? Take these steps:

1. Before escrow closes, ask to review a copy of the grant deed. Since the grant deed is signed by the seller, not the buyer, there may not be a copy of the grant deed in the documents given to the buyer at or before close of escrow.
2. After close of escrow, review the deed that was actually recorded. The original will be returned to you by the recorder's office after recording.
3. Compare the deed with your title insurance policy. Confirm that the deed transfers to you all of the parcels listed in your title insurance policy and confirm that the seller has not recorded any unexpected encumbrances against the parcels being transferred.
4. Review your deed and your title insurance policy with your agent to ensure that you understand the documents and that you received what you were expecting.

Many buyers believe that if they buy title insurance, then any defects in their title can be corrected simply by asserting a claim under their title insurance policy. However, title insurance companies can only pay monetary damages.

Correcting the title—for example, if the seller failed to transfer certain property or recorded a deed restriction or easement without the buyer's consent—requires filing a lawsuit against the seller based upon fraud or breach of contract.

If the fraud or breach of contract is disclosed in the deed, the buyer will be stuck with the unauthorized deed restriction, easement, or other deficiency unless the buyer files suit against the seller within three years of receiving the deed (if based on fraud) or four years (if based upon breach of contract).

As the court stated in *Alfaro*, buyers who do not read their deeds have only themselves to blame if they do not discover that they have been defrauded in time.

III. <u>Types of Deeds: Grant vs Quitclaim Deeds</u>

Quitclaim and Grant Deeds[5]
By Dale Alberstone

A grant deed contains two, but only two, implied warranties: (1) The grantor did not previously convey the property or any interest therein to anyone else and (2) at the time of the conveyance, the property is not burdened by any encumbrances "done, made or suffered by the grantor."[6]

The first warranty is obvious in one respect, and confusing in others. The obvious part is that the grantor did not previously convey title to the property to someone else. What is not so

[5] Dale Alberstone, *Quitclaim and Grant Deeds*, AOA (Dec. 12, 2012), https://www.aoausa.com/magazine/?p=846.
[6] Cal. Civ. Code § 1113 (Deering, LEXIS through 2017 Sess.).

obvious is the fact that the first warranty provides that the grantor did not convey an interest, other than title, in the property to someone else.

For example, when an Apartment Owners Association (AOA) member sells an apartment building in which all of the units are leased, it would be wise for the seller to insert a provision in the grant deed that the conveyance is "subject to all leases and rental agreements entered into between the grantor and tenants at the property." Because a lease is a conveyance of an interest in the property, delivery of a grant deed which does not refer to the rented units might violate the first of the implied warranties.

The second implied warranty (i.e. free from encumbrances) also merits discussion. If the grantor had previously conveyed an easement across his property, such as for ingress and egress to and from a neighbor's property, then that easement could constitute a breach of the second implied warranty. Similarly, if the grantor allowed a lender to record a trust deed against the property during the grantor's ownership, then the grantor must remove the trust deed as of the time of the conveyance or make the grant deed "subject to" the deed of trust. Otherwise, the grantor will be in breach of the warranty implied in the grant deed. As another example, if the grantor recorded a restriction in the use of his property during the grantor's ownership (such as in "CC&Rs"), then that restriction would constitute an encumbrance against the property and violate the grant deed.

Remarkably, even if the grantor informed the grantee of the encumbrance which the grantor placed against the property, the grantee's knowledge does not negate the warranty in the grant deed. As explained in *Evans v. Faught*, 231 Cal. App. 2d 698, a grantee is entitled to rely on the implied covenant even if he had actual knowledge of the encumbrance if the encumbrance was a cloud on the title as opposed to a physical condition apparent from a view of the premises.

There are three methods by which a grantor can protect himself when using a grant deed. First, if an encumbrance is one which can be removed, the grantor should consider doing so at or prior to the close of escrow. For example, if a first trust deed loan exists against the property, the grantor can pay (usually through escrow) the balance due on the loan, in exchange for the lender's reconveyance of the deed of trust concurrently with the close of escrow.

Second, the grantor can specify in the grant deed the specific encumbrance to which the deed is subject.

Third, the grantor can include a general exception to the warranty by stating in the deed that the conveyance is "subject to all covenants, restrictions, conditions, easements, leases and other encumbrances of record existing at the time of delivery or recordation of this deed."

Grant Deeds: The Real Surprise

Returning to the opening issue I posed of whether a grantor warrants that he/she has title to the property purportedly being conveyed by a grant deed, the answer is an unequivocal and resounding "NO." Neither of the implied covenants (discussed previously) warrant the grantor actually owns the property.

This point was settled as early as 1920, when the California Court of Appeal decided in *Gaffey v. Welk* (46 Cal. App. 385). There, the grantor initially received title by a forged deed. Thereafter, he purported to convey the property by grant deed to the grantee. When the grantee later sued the grantor for defective title, the court held that the grantor was not liable because he had not previously made a conveyance. In other words, there is no implied covenant that the grantor has any title to the property that he purports to convey when delivering or recording a grant deed. He only warrants that he did not previously convey or encumber it.

Concluding Remarks

What is important to remember is that a quitclaim deed contains no warranty and conveys only the interest, if any, actually possessed by the transferor. On the other hand, a grant deed contains implied warranties concerning the title to the property, but not that the grantor owns the property he is purporting to convey.

IV. Marketable Title

A Cloud on a Home's Title Can Make It Unmarketable[7]
By Robert Bruss

You've worked hard to find the right home to buy, negotiated the sales price and terms with the seller and hassled with the mortgage lender to arrange a new home loan. The closing date has been scheduled, when you'll make the down payment, sign the papers and finally get the keys to the house.

But just a few days before the house is to become your home, you get a phone call informing you, "There's a cloud on the title which the seller will have to clear up." In other words, the seller can't deliver "marketable title." Don't panic. Most title problems can be quickly solved to make the title marketable.

There are other title problems that may cause a title to be unmarketable, even though not recorded. A frequent title problem involves encroachments, of which there are three types: (A) where a neighbor's building encroaches on the property being purchased, (B) the structure purchased encroaches on a neighbor's land, or (C) a building on the property being sold extends into the public sidewalk or street.

Although slight encroachments have been held not to make title unmarketable, especially when the cost of removing the encroachment is great compared with little or no benefit to be gained, such impairments should be taken seriously.

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[7] Robert Bruss, *A Cloud on a Home's Title Can Make It Unmarketable*, CHICAGO TRIBUNE (Feb. 14, 1987), http://articles.chicagotribune.com/1987-02-14/news/8701120459_1_title-problems-lender-clouds.

Although not a title cloud, zoning and building restrictions obviously make a specific property more or less valuable than without such limitations. Title insurance companies do not concern themselves with zoning and building limitations, nor do title insurance policies mention them, but property buyers and sellers should be aware of how these factors affect property values.

As mentioned earlier, recorded easements are a cloud on a title. Normal utility easements, such as for power and phone wires along the property edge, are title clouds but don't make the title unmarketable. However, buyers should be very careful not to sign purchase contracts that say title is to be "subject to easements of record." The buyer would then be required to complete the purchase even if an unused but recorded highway easement runs through the property.

V. REVISED QUESTIONS

Question 1: ***Community vs. Separate Property.***

You are working for a title insurance company underwriter trying to decide whether to insure the prospective grantee of a deed to property located in California that had been acquired during a marriage but conveyed to only one of the spouses. That spouse would be the grantor. The other spouse refuses to sign a release. Under what circumstances, if any, would you be comfortable recommending that the company insure the prospective grantee's title?

Question 2: ***Acquisition of Property Held by a Tenancy in Common.***[8]

Brother and sister acquire a summer home as tenants in common. They and their families enjoy its use for many years. The sister relocates abroad and decides to sell her interest in the property, hoping her brother will join in the sale. The prospective buyer contracts to acquire the sister's interest, and the sister promises to use her best efforts to persuade her brother to join in the sale. But as the closing date nears, despite her best efforts to convince her brother to sell, it becomes clear that he will not do so and intends to continue using the vacation home. In its preliminary report presented to the buyer during the due diligence period, the title insurer excepts from coverage any interest the brother may have in the co-tenancy property.

(a) Is the buyer entitled to specific performance against the sister?

(b) Under the terms of the CAR form re-printed in the first chapter, can the sister compel buyer to complete the sale if the buyer attempts to rescind during the due diligence period upon

[8] The wording of the question has been changed to make it clear that the sister used her best efforts to try to convince the brother to sell, the preliminary title report excepted from coverage any interest the borrower may have in the co-tenancy property, and a new sub-question was added, concerning the sister's right to compel the buyer to complete the contract for the sister's interest. The answer to (d) is found in chapter 4, 111-112.

discovering that the title insurer excepts from coverage any interest the brother has in the co-tenancy property?

(c) Will the buyer acquire the right to the undivided use of the property?

(d) If the buyer and the brother have difficulty sharing the house, what options are available to them to resolve their disagreements peacefully regarding the use and improvement of the property?

Question 3: ***Assuring the Buyer a Marketable Title.***

Practically, how do realty buyers in the U.S. avoid getting stuck with unacceptably defective titles?

Question 4: ***"Defects, Liens and Encumbrances."***

During the executory period, the buyer learns certain things she had not known about the commercial property she contracted to buy. Would any of the following make title legally unmarketable?

(a) To serve the site, there is a recorded easement for cable TV.

(b) The property is zoned for single family use and the buyer had hoped to construct a small house, "a grannie flat," in the spacious back yard for her grandmother. Under local zoning ordinances, "grannie flats" are allowed. But the house is located in a subdivision subject to privately recorded covenants, conditions and restrictions put in place by the original subdivider. These CC&Rs limit each lot to one dwelling unit. This restriction has never been violated in the history of the subdivision.

(c) The property is fully leased to a single tenant and the lease is set to expire one day before the scheduled closing date. But the tenant remains in possession on the date set for closing.

(d) The property is subject to a deed of trust secured by a note under which the seller still owes the beneficiary $100,000, and there is also a federal tax lien of $50,000.

Question 5: ***Modifying the Marketable Title Standard.***

(a) What objection could a mortgage lender possibly have if the seller prefers to convey an insurable title instead of a marketable title since the title policy insures "marketability" of title?

(b) How can a buyer reserve for herself the right to judge whether the seller's title is acceptable?

(c) Why do you suppose any seller would ever accept the uncertainty of closing with such an open- ended way out of the contract provided to the buyer?

Question 6: ***Reserving the Right to Rescind If the Buyer Cannot Use or Develop the Property as Hoped.***

Buyer A is acquiring a downtown parking lot where she hopes to construct a hotel. Buyer B is acquiring 20 acres of previously undeveloped land where he hopes to construct 40 townhouses for sale to homebuyers. They have both determined that their intended uses will require zone changes. Buyer B will need to record a subdivision map. Their sellers are willing to grant purchase contracts for six months but want to be compensated for having to hold title longer than that unless assured of compensation to offset their holding costs (property taxes, insurance, and maintenance). Neither A nor B want to forfeit their 10% down payment deposits as liquidated damages if they are not granted the land use approvals they require. Sellers do not want to be bound to any changes in land use rules or subdivisions of their parcels if the buyers do not complete their acquisitions.

(a) Will buyers A and B have the right to a refund of their deposits because denial of their needed land use approvals would be evidence that their sellers lacked marketable titles?

(b) What provisions would you propose on behalf of A and B to avoid your clients forfeiting their deposits if they cannot obtain the land use approvals they seek, and that would compensate the sellers adequately for extensions of the six month purchase and sale agreement if land use approvals take longer than that to process?

Question 7: ***Tenants in Possession.***

The purchaser of a neighborhood shopping center based its purchase price on the income tenants are paying to cover operating costs and produce a small profit. Instead of relying solely on the landlord's estimate of the rent roll, how might the buyer confirm that the tenants agree with the landlord's representations regarding the leases and the rents?

Question 8: ***Drafting a Valid Deed Between the Parties.***

Test your mastery of the fine points of drafting short-form deeds by preparing the most minimal document that would validly transfer your interest in the Brooklyn Bridge to a classmate.

Before putting pen to paper, consider: (a) whether to convey by warranty, grant or quitclaim deed, (b) the operative words for each type of conveyance, (c) whether the deed needs to be dated, acknowledged, and/ or recite "valuable consideration," (d) whether it needs to identify the grantor and grantee, and either or both of them need to sign it, and (e) how the subject property needs to be described.

Question 9: ***Delivery*.**

What useful purpose does the deed delivery requirement serve?

Question 10: ***Grantor Competence.***

A widower is too infirm to care for himself. He hires a nurse who moves in and takes care of him for three years. The widower grows senile. The nurse prepares a deed of the widower's house to herself and urges him to sign it just before his death, perhaps even bringing a notary public in to take the widower's acknowledgment.

Shortly after the funeral, the widower's children file a suit to show he was too senile to understand what he was doing when he signed the deed. They want the court to set it aside.

If you had been representing the nurse, and anticipated the possibility of the children filing suit, what would you have done to improve the chances of a favorable outcome for the nurse?

Question 11: ***Acknowledgments.***

(a) In a typical transfer by deed, who acknowledges what to whom, and why do they bother?

(b) A busy law firm handles dozens of closings each day. It has adopted the efficient practice of having the firm's in-house notary affix the acknowledgment form to all the deeds at the end of each day after most grantors have left, instead of taking each acknowledgment separately while the grantors are still present.

Do you see anything seriously wrong with this practice? If you had a notary license and were working as a summer intern in this law firm, would you be willing to affix the acknowledgment forms at the end of the day in the absence of the grantors? If not, how would you explain your refusal to a senior partner?

Question 12: ***Deed Covenants.***

(a) Which covenant in a warranty deed will a precocious eleven-year-old grantor have breached at closing?

(b) Which covenants, if any, in a grant deed will the grantor have breached when the grantee learns soon after closing that the grantor acquired title by a forged deed?

Question 13: ***Grant Deeds and Title Insurers.*** **[The textbook version did not separate this question into two parts.]**

(a) Why do title insurers accept grant deeds but seldom accept quitclaim deeds?

(b) What is equitable subrogation and why does it matter to title insurers?

Question 14: ***Trustees' Deeds Upon Sale.***

On January 4, 2008, the borrower signs a note and executes an accompanying deed of trust to Lender A on property at 222 Glorious Lane. On March 1, 2008, the borrower signs another note and executes an accompanying deed of trust to Lender B on the same property. On December 2, 2008, the borrower signs a third note and executes an accompanying deed of trust to Lender C secured by the Glorious Lane property. All of the deeds of trust are recorded in the order they were executed. Two years later, the borrower defaults on the note to Lender B. The beneficiary under the accompanying deed of trust instructs the trustee to foreclose. X is the winning bidder at the sale.

(a) How would the foreclosure sale proceeds be allocated?

(b) Is the trustee's deed in the nature of a quitclaim, grant, or warranty deed?

LAND DESCRIPTIONS, SURVEYS AND BOUNDARY DISPUTES

I. Land Descriptions

Most homebuyers signing a binding contract to purchase land have no idea what its true legal description is. Prospective buyers usually visit the property, often more than once. They assume that what they see is what they will own. They imagine their back-yard swimming pool is located entirely within their property boundaries, and they own all of the yard up to the fence that appears to separate their property from the neighbor's. Listing brokers and sellers tend to use street addresses, but a street address delineates no boundaries—only a formal legal description would do that. What the buyer has seen on viewing the property is not necessarily what the buyer will own at closing.

Discrepancies among land descriptions in the deeds by which one property owner transferred title to the next are a vexing source of title and boundary disputes. Unless all the owners in the property's chain of title conveyed exactly the same property when they sold, mortgaged or gifted their properties, the current owner's title has been compromised.

Anyone buying land should be able to read the land description in the seller's deed well enough to recognize whether it describes the property that the seller contracted to convey. But this task is complicated because brokers are in a hurry to see the contract signed, and since everyone knows the street address, parties rely on what can be seen on site. Buyers simply assume that what they see is what they are going to own and have no idea that the street address promises no such thing. What they own is the land described in the deed. Even if the seller knew that the street address was misleading because a portion of the site was excluded from the formal legal description, the buyer's cause of action against the seller begins to run on the date the buyer "should have discovered" the discrepancy. Courts are likely to hold that the statute of limitations begins to run on the date the seller deeded the property to the buyer. The buyer is presumed to have implied actual knowledge of the true boundaries of the property, as a survey based on the land description in the deed would have revealed.

Why Real Estate Contracts Should Have a Legal Description[1]
By Jack O. Hackett II

If you signed a contract to buy vacant property described as "adjacent to the Mardi Gras, a Daytona Beach business, that has a minimum of 50 frontage feet on the Boardwalk and that has sufficient land to build a 7500-square foot one story building," and the seller is trying to back out, do you think you can get a court to force the seller to sell the land to you?

A court will evaluate what is essential on a case-by-case basis. However, a description of the land to be conveyed is generally an essential element of an agreement to sell land.

The gold standard in drafting a contract is to use a complete legal description of the property to be conveyed matching some or all of the property owned by the seller. This can be taken from the earlier deed made to the seller, a prior survey of the subject property, or a sketch of a description prepared by a surveyor.

Often closing attorneys and title companies are presented with a contract which contains a shortened legal description, just an address, or only a property appraiser-assigned parcel identification number.

Most of these contracts get closed with the right legal description because the closing agents figure it out through online property information, prior deeds, and other title information.

Hopefully, the buyer is getting a new survey if a prior one is not available. This is recommended in all real estate purchases and typically required if financing is involved. The survey is the only document that matches what the buyers thought they wanted to buy when they walked around the property before they made their offer and all the dry documents presented at closing, especially the deed. The formal legal description needs to be precisely the same on the survey, the title insurance commitment and policy, the deed, and the mortgage.

But what happens if the parties get crosswise between contract and closing, perhaps on issues having nothing to do with the description of the property? Will the buyer be able to force the seller to close if the legal description on the contract is just an address or a tax ID number?

While there is some case law out there which permits the enforcement of such contracts in limited situations, it becomes a matter of proof as to what was intended.

The description of land is sufficient only if a surveyor using the general rules of surveying can locate that precise piece of land and establish its boundaries to the exclusion of all other pieces of property in the world. If the description is in any way ambiguous such that it could possibly describe multiple pieces of property, the court will not permit the use of outside evidence to remove that ambiguity. If the description is indefinite or facially vague, there is no meeting of the minds of the parties as to an essential element of the contract and the contract fails.

[1] Jack O. Hacket II, *Why Real Estate Contracts Should Have a Legal Description*, FARR LAW FIRM, https://farr.com/legal-description-real-estate-contracts/ (last visited June 27, 2017).

So, what about the 50 front feet on the Daytona Beach Boardwalk in the opening paragraph? If you've gotten this far, you already know the answer.

The very first sentence of Florida's Fifth District Court of Appeal opinion (*link to opinion*: http://www.5dca.org/Opinions/Opin2016 /111416/5D15-1944.op.pdf) filed November 18, 2016, that considers this question says it all: "Neither law nor equity can furnish a sufficient description of land to be conveyed where the parties have failed to do so." The contract fails; it will not be enforced; the parties go home, one happy, one not so much.

***A Land Description Challenge*: Davis v. Hinson, 67 So.3d 1107 (July 18, 2011).**

For a deed to be effective, the legal description must be included in the deed signed by the grantor. But suppose that in the deed that the grantor signed the description was incomplete or inaccurate, and the error was only first noticed years later.

How can the grantee's title be made marketable? Maybe the original grantor is still around, and willing to sign a corrective deed. In some jurisdictions, a recorded affidavit might suffice. If all else fails, the grantee could file a suit to quiet title,[2] seek a declaratory judgment, or file a *quia timet*.[3]

The following case summary shows how serious procedural glitches in the preparation and execution of deeds can invalidate what would otherwise have been perfectly good titles to land. The summary is followed by short essays suggesting various ways to rehabilitate the owner's title: corrective deeds, recorded affidavits and suits to quiet tile.

Lalisa Davis and the Hinsons were neighboring property owners. They had a falling out. In March 2010, the Hinsons brought a complaint against Lalisa Davis to quiet title and for ejectment because she "had strewn personal property over the boundary line and built a shed straddling the boundary line." The Hinsons lost their suit because they could not prove good title.

They appealed the case. The appellate court chronicled the essential facts about the history of the title:

- July 1983—Geraldine Hinsons' parents recorded a quit-claim deed conveying an undivided tract of approximately 74 acres to Geraldine, her six siblings, and several of the siblings' spouses. The deed named each recipient a tenant in common without a right of survivorship.

[2] These lawsuits are essentially declaratory judgments sanctioned by state statutes. Procedures and requirements vary from state to state. One important and often litigated issue is whether the property owner must prove good title, or just a title better than anyone else involved in the lawsuit can establish.

[3] See, e.g., the Georgia *quia timet* statute: O.C.G.A. 23-3-40 (2010) 23-3-40. Purpose of *quia timet* The proceeding *quia timet* is sustained in equity for the purpose of causing to be delivered and canceled any instrument which has answered the object of its creation or any forged or other iniquitous deed or other writing which, though not enforced at the time, either casts a cloud over the complainant's title or otherwise subjects him to future liability or present annoyance, and the cancellation of which is necessary to his perfect protection.

The co-tenants decided to subdivide the land among themselves. Recognizing that a cotenant cannot convey exclusive possessory rights to a specific portion of their property unless every cotenant agrees to the conveyance, they envisioned preparing and executing a series of separate deeds each of which would be signed by all the co-tenants and would describe the individual parcel each co-tenant was to receive.

• September 1989—The tenants in common signed a deed conveying an eleven-acre portion of the 74–acre tract to the Hinsons for their exclusive use and possession. At the time it was signed, the deed did not include a description of the exact eleven-acre parcel being conveyed.

• August 1990—The Hinsons recorded the September 1989 deed. Hoping to correct their previous omission of a land description, they attached to the deed a survey describing the exact eleven acres being conveyed.

One of the co-tenants never signed this deed, having died before the September 1989 deed was signed, leaving her interest in the property to her surviving children. One of her children—Rashunn Lewis—did not sign the deed.[2]

The court concluded that the Hinsons lacked good title. The September 1989 deed did not give the Hinsons exclusive possessory rights to the eleven-acre parcel as it was not signed by all cotenants with an interest in the land and did not include a description of the specific eleven acres being conveyed. A survey was attached to the 1990 deed but no one re-signed it. Without evidence of such mutual agreement, the fact that the survey was later attached to the deed does not correct its missing description.

The following excerpts show how the Hinsons could obtain a good title.

Correction Deed[4]

Once a deed has been recorded, it is part of the public record and cannot be changed. It is possible, however, to amend that record by adding a newly executed deed, usually called correction or corrective deed, deed of correction or, in some states, deed of confirmation. As a confirmatory instrument, it perfects an existing title by removing any defects, but it does not pass title on its own.

A correction deed confirms the covenants and warranties of the prior deed. It needs to refer to that instrument by indicating its execution and recording date, the place of recording, and the number under which the document is filed. It must also identify the error or errors by type before supplying a correction. The body of this new deed contains the same information as the original deed and thus, confirms the conveyance of title. Generally, all parties who signed the prior deed must sign the correction deed in the presence of a notary, who will acknowledge its execution.

[4] *Correction Deed*, DEEDS.COM, https://www.deeds.com/correction-deed/ (last visited June 27, 2017).

A corrective deed is most often used for minor mistakes, such as misspelled or incomplete names, missing or wrong middle initials, and omission of marital status or vesting information. It can also be used for obvious errors in the property description. For example: errors transcribing courses and distances; errors incorporating a recorded plat or deed reference; errors in listing a lot number or designation; or omitted exhibits that supply the legal description of the property. A correction deed can also amend defects in the execution or acknowledgement of the original deed.

Resolving material errors often causes confusion. A material correction constitutes an actual change in the substance of the deed, such as changing the legal description, adjusting the amount of consideration, and adding or removing names. Some states allow a corrective instrument to address these flaws, but others require an entirely new deed.

Non-material changes are generally typographical in nature and may be adjusted with a less involved correction. For example, some states accept a re-submission of the original deed with corrections, along with a cover page that contains a correction statement, error identification, and clear reference to the previously recorded deed. Depending on the error type and gravity, re-acknowledgement may not be required under such circumstances.

In some states, an affidavit of correction or a scrivener's affidavit may be recorded and serve as notification of an error in a recorded deed. It is usually reserved for minor corrections and typographical mistakes, and it can often be given by persons other than the parties of the original instrument, as long as reasons for the correction and knowledge of the facts corrected are stated and evidence of notification of the original parties or their heirs is provided. However, it does not constitute an actual correction of the original deed in the way a corrective deed does.

Changes affecting the legal description of the property are often sensitive in nature and best handled by a new corrective deed, signed by the original grantor. Some states generally recommend that both parties, that is, the grantor and grantee, sign a corrective instrument to assure valid title. For larger errors or to include/omit a name from the existing deed, a new standard conveyance, such as a warranty or quitclaim deed, may be more appropriate than a correction deed.

What is a Quiet Title Suit, and Why do I Need It?[5]
By John Frederick "Fred" Kempf, Jr.

When we are ready to sell our real estate, we typically enter into a contract, let the buyer check out the property, let the buyer obtain a "title policy commitment" showing that if they buy the property, they will not have any title issues, and set a time for closing. At that closing, we expect to deed the property to the buyer, and expect the buyer to pay us.

Nothing is more frustrating than to learn that we cannot close on the sale because there is a title defect, and until that is eliminated, no money will change hands. Then we are told that unless the problem can be cleared up immediately with proper documentation in the land records, the buyer and the title company will insist on the seller eliminating the problem with a quiet title suit, or the buyer may back out of the deal.

The reality is that in today's real estate market, if a buyer is going to buy the property, and a lender is going to loan money and obtain a mortgage against that property, they both want to know that they have "good and marketable title" to the property, and that there are no title defects that would detract from the owner's potential ownership and enjoyment of the land, or deprive the mortgage lender of a first priority mortgage against the property.

They typically get that by having a title insurance company examine the title, issue a "title insurance policy commitment" showing what the current state of title is, and which lists any title requirements to be met before closing on the sale.

That is where a title company would typically identify any "title requirements" designed to eliminate any title defects, if there are any. With the possible exceptions of prior mineral conveyances or reservations, or existing easements, most buyers want "marketable title."

Once the seller delivers a property with marketable title, the title company will issue its "title insurance policy" in favor of both the buyer and its lender, and insure that they will have good title incident to the sale.

What is a quiet title suit? It is a lawsuit filed by a party claiming ownership of property to eliminate a claim or possible claim another party has or may have against that same property.

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[5] John Frederick Kempf, Jr., *What is a Quite Title Suit, and Why Do I Need It?*, ANDREWS DAVIS, http://www.andrewsdavis.com/Websites/andrewsdavis11/images/BlogPDF/JFKBlog.QuietTitleSuit.pdf (last visited June 26, 2017).

II. SURVEYS

How Important Is a Land Surveyor for a Buyer of a Home?[6]
By Anna Assad

Land surveyors are the licensed professionals who prepare surveys for property. The survey serves as the legal graphical depiction of the property you are buying and allows you to see all of the features of the property you are going to purchase from an overhead perspective.

Function

The land surveyor will study legal documents pertaining to the property, such as deeds and land documents recorded in the local county recorder's office, when preparing the survey.

Legal Effects

Surveys are vital in solving property disputes about where your land ends and a neighbor's land begins. You, as the buyer, can use a survey to address items owned by neighbors that are interfering with your land, such as a misplaced fence. A survey is used in court as evidence for property dispute cases. The survey can be used to determine if you can legally add features to the property after purchase. A large item, such as a pool, can infringe on the neighbor's land if the size of the lot you are purchasing has uneven borders. Building structures that cross over into a neighbor's property can expose you to a potential lawsuit and additional expenses if you end up having to move the item.

Restrictions

Some areas have defined restrictions that affect the property you are buying. Zoning restrictions are rules relating to property features and use imposed by a government authority. Zoning restrictions typically cover a designated area, such as a street or an entire neighborhood. Violating zoning restrictions can lead to penalties and legal action from the imposing authority.

Surveyors are generally knowledgeable about such restrictions and mark any possible violations on the survey, giving you time to address the problems with the owner before you purchase the property.

Building restrictions are rules imposed by local authorities or the property developer about how the home and additional structures, such as a garage, can be built. The surveyor will examine land records relating to building restrictions to determine if the property you are buying is subject to building restrictions or currently is in violation.

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[6] Anna Assad, *How Important Is a Land Surveyor for a Buyer of a Home?*, SFGATE, http://homeguides.sfgate.com/important-land-surveyor-buyer-home-2506.html (last visited June 26, 2017).

Property Rights

Necessary items that are used by two neighboring properties, like a common driveway or walkway, are disclosed on the survey. The surveyor will identify how much of the shared element is located on the property you are purchasing. This disclosure allows you to evaluate the impact of the shared element on the property before you buy, such as who is responsible for the cost of maintaining the joint item and the estimated amount of your portion of such fees. The land surveyor will determine if any known easements or rights of way directly affect the property, as per the California Board for Professional Engineers and Land Surveyors. Easements and rights of way are rights to the property granted from one property owner to a neighboring owner, owners, or a business, such as a utility company. Rights of way are generally for allowing persons or entities to pass over the property. Easements are typically for land access and placement or use of a structure. The survey will allow you to determine who has these types of rights to the property you are buying and for what purpose.

Considerations

The surveyor can identify any problems with the property's current legal description, or the description of the property you are buying in words and measurements that is used for important legal documents such as the deed, according to the California Board for Professional Engineers and Land Surveyors. The deed is the legal instrument used to prove your ownership of the property. An error in the legal description can result in you receiving an inaccurate deed at the time of purchase, such as a deed that does not contain all of your property. A deed that contains errors can cause you problems later on, such as in a property dispute, and will need to be refiled to correct, for which there is generally additional filing fees. Pins or pipes, which were physically placed by previous surveyors, are occasionally used as references in legal descriptions to establish property boundaries. The current surveyor will verify the locations of the pins or pipes prior to your purchase to ensure that the items have not been moved by prior owners.

What Every Lawyer Should Know About Title Surveys[7]

By Mitchell G. Williams & Harlan J. Onsrud

The Existence of the Property

Nearly all titles to land in the United States depend on an original grant or patent and subsequent conveyance instruments. Each of these instruments contains descriptions of the land conveyed. It is a fundamental principle that for a deed to be valid it must contain a sufficient description. Whether a metes-and-bounds description or a description by reference to a parcel on a map is sufficient to transfer the property often depends upon whether a knowledgeable surveyor can interpret the description to reasonably locate the property physically on the ground.

[7] Mitchell G. Williams & Harlan J. Onsrud, *What Every Lawyer Should Know About Title Surveys*, *in* LAND SURVEYS: A GUIDE FOR LAWYERS AND OTHER PROFESSIONALS (2nd ed., 2000).

In determining whether the land description is sufficient, the surveyor determines whether the description forms a mathematically closed figure and whether the description reasonably conforms to the physical evidence on the earth's surface. The first determination is done by numeric calculation, the second by physical measurements in the field.

The Relationship of the Property to Adjoining Properties

Merely locating the lines described in a deed on the ground is not adequate to establish the physical limits of a property owner's interest. All parcels of land exist in relation to the parcels surrounding them.

At some point in the past, all adjoining land parcels were held in common by a single grantor. Over time, parcels were partitioned off or subdivided to arrive at the current ownership configuration. As a general rule, the description in a senior deed or prior conveyance controls over any discrepancy in a later one. If the drafter made an error or created an ambiguity in describing a parcel being partitioned off from a larger parcel, or made an error in a later attempt to "correct" or refine an earlier description, the legal descriptions of adjoining parcels may be inconsistent.

The two descriptions of their "common" boundary may in fact either overlap or have a gap between them. Failure to discover overlaps may leave the holder of the junior deed owning much less property than the junior deed on its face would indicate.

The presence of gaps or gores also poses problems when attempting to consolidate several adjacent parcels under a single owner for development purposes. When consolidation is attempted, one must definitively establish ownership to these leftover land strips. If a gap or gore exists along a street line or right-of-way, it has the potential of creating a landlocked parcel.

The Relationship of Occupied Lines to Record Lines

Not infrequently, the boundary lines of a parcel as physically occupied or possessed by its owner differ from the distances and direction or the monuments called for in the deed. Discrepancies between possession and the record deed lines may range from minor variations in fence line locations to substantial encroachments of multistory buildings.

A land survey should always show the occupied lines together with the deed record lines and the extent of any mismatch. Significant mismatches may suggest potential claims of ownership by senior right or adverse possession or a change in a boundary line by mutual agreement and acquiescence.

To cut off any potential rights of another to a claim of adverse possession, the property owner may want to record an appropriate document confirming his claim of ownership or seek a change in possession to match the record lines.

The Location of Physical Improvements

This reason for requiring a survey is related to the previous one, but deals with the relationship of all physical improvements on the parcel to the boundary lines of the parcel, not just those improvements near the exterior limits of the parcel. Features that surveyors are often requested to locate include fences, walls, driveways, pavements, buildings, structures, utilities, wells, and natural features such as streams and ponds.

This information is necessary to determine the presence of features that may limit the value or use of the property, and to determine conformity to setback lines contained in recorded documents and with local zoning ordinances regarding minimum building setbacks. It is also necessary to confirm that the improvements do not encroach upon easements or rights-of-way. When most attorneys and laypersons think of a survey, this is the type of information they expect to see on the surveyor's final survey map.

Unrecorded Easements and Other Facts Not of Record

There are numerous unrecorded rights that can affect title to land which may not show up in a title search but will become obvious upon an inspection of the property. The right of a neighbor to use utility lines, drainage ditches, sewer lines, and unrecorded travel easements across the property may have arisen by prescription or other methods of unwritten land transfer.

A visual inspection of the property will usually give some physical indication as to whether such adverse rights may exist; for example, the presence of manholes or vent pipes suggests underground sewers or other utilities.

Typically, only a survey in which unrecorded physical features are referenced to the property lines will induce a title insurance company to remove its exception in regard to "any state of facts an accurate survey might show."

What If Your Property Survey is Incorrect? [8]

Today let's talk about what to do when there are problems or issues with your survey. After you have looked over the survey of a property and realize there may be a problem, there are some steps you can take to get those items corrected.

First thing's first—call the survey company that conducted the survey to verify that what you're seeing as a problem is correct. On rare occasions survey companies do make mistakes. If they have indeed made a mistake, you have several options.

[8] *What If Your Property Survey is Incorrect?*, KIMBERLY HOWELL PROPERTIES (Mar. 7, 2014), http://www.kimberlyhowell.com/real-estate-in-san-antonio/property-survey-incorrect/.

1. If the lender or title company has an issue with a fence line or similar issue, they may call exception to it on the title policy. What this means is that it becomes akin to a "pre-existing condition" in health insurance (the way they used to be handled) and it won't get covered if there's ever an issue or dispute over the matter. All parties sign accepting that exception as a part of their closing documents.

2. You can contact the seller and ask for the fence or violating structure to be moved. Sometimes this is an easy fix and other times it can be very complicated. The seller may also need to contact neighbors to make the adjustment.

3. If the issue is a utility easement, you can apply for a variance. This is basically a waiving of the utility company's right to access a certain portion of the easement area. It can be time consuming, so the sooner you can begin to address these issues the better.

4. Back out of the deal. If your concerns over an improper building, property line, etc. are not something that you feel you are willing to live with or something that cannot be properly corrected, the buyer may have the right to terminate the contract. As always, we recommend consulting a legal professional before terminating a real estate contract because there could be complicating factors.

A fun story in terms of dealing with this type of issue: Our company once represented a buyer who contracted to purchase one end unit in a newer townhome complex. When they went to get a survey of the property, it was discovered that the actual walls of the townhome extended a few inches into the property line of the neighboring unit. In theory, the neighbors could tear down the wall on one side (let's say it was a living room) and there would be nothing the owner of that unit could do about it. Because it was a townhome where all of the units had shared walls, basically the whole structure had been built a few inches out of line and every single unit in that building was impacted with the same problem, right on down the row.

Eventually, with a lot of phone calls, door knocking, and paperwork, the issue was resolved. Everyone in that entire row of townhomes signed documentation giving those few inches of property back over to their neighbors in keeping with the building lines (not the property ones).

As you can imagine, a situation like this could easily turn into potential for disaster. Luckily, all the owners were able to work it out with a bit of compromise and the problem was resolved.

III. Boundary Disputes and Adverse Possession

Property owners who become entangled in boundary disputes and take no decisive action could eventually forfeit their rights under adverse possession statutes. Among the basic rights of land ownership is the right to exclude others.

Adverse Possession: When Trespassers Become Property Owners[9]
By Emily Doskow

Homeowners have the right to keep unwanted intruders off their property. People may do this with fences or with signs, or just by asking trespassers to stay away. In cases of serious, repeated annoyance or threatened harm, a land owner can call the police, who will usually warn the person to stay away and, if necessary, make an arrest.

You may be surprised to learn that under certain circumstances, a trespasser can come onto your land, occupy it, and gain legal ownership of it. The legal term for this is 'adverse possession.

Through adverse possession, a trespasser can gain ownership of just a few feet of property or hundreds of acres. And the trespasser doesn't need to intend to take the land by adverse possession. Sometimes it happens through an honest mistake—for example, a neighbor may have relied upon a faulty property description in a deed when building a fence on your property.

How Adverse Possession Claims End Up in Court

Questions about legal ownership of property may arise in various situations, such as in the sale of a house. For example, a title insurance company may refuse to issue insurance when a property is sold because the neighbor's garage is found to be standing squarely on the property.

If questions about ownership of land arise in this type of situation, and the people involved cannot work something out, then the issue may end up in court. The property owner may sue the trespasser (for example, the neighbor whose garage is encroaching), or the trespasser may bring a lawsuit to "quiet title"—a request for the court to settle who owns what.

If you are a landowner, keep an eye on your property. If you suspect that someone has a possible adverse possession claim, check property tax records to see if this person (or anyone else) has made tax payments on the property. To prevent a trespasser from gaining property ownership, you can take the following steps:

- Post "no trespassing" signs and block entrances with gates. Keep in mind that this is a good way to deter trespassers, but in many states the fact that you have signs or gates won't protect against a claim by a trespasser who takes possession of the land anyway.

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9 Emily Doskow, *Adverse Possession: When Trespassers Become Property Owners*, http://www.nolo.com/legal-encyclopedia/adverse-possession-trespassers-become-owners-46934.html (last visited 06/24/2017).

- Give written permission to someone to use your land, and get their written acknowledgement. For example, you could give someone permission to park on your land, use a shortcut across your property, or to garden or grow crops. This can not only defeat adverse possession claims, but also a claim to an easement (use permit) across your property.
- Offer to rent the property to the trespasser.
- Call the police.
- Hire a lawyer. [Trespassers have long been subject to criminal as well as civil sanctions. Owners initiating civil trespass actions need to demonstrate proof of title, even going so far as to filing suits to quiet title before commencing their trespass suits.] You may need to file a lawsuit to eject the trespasser from the land. Or you may want a court to order a structure removed from your property. You must act before the trespasser has been on your land long enough, under your state's law, to make a successful adverse possession claim."

IV. REVISED QUESTIONS

Question 1: ***Understanding Legal Descriptions.***

(a) *Informal Descriptions.* What is wrong with using the postal street address as the land description in a deed? If it's good enough for MapQuest,™ why isn't it good enough for a deed?

What is wrong with using property tax assessors' parcel numbers as formal land descriptions?

(b) *Metes and Bounds.* Draw this description: "Beginning at an iron stake where Old Oak Tree Road intersects Plum Avenue, then continuing south 15 degrees west for a distance of fifty feet to an iron stake, then south 20 degrees east 105 feet to a maple tree, then north 89 degrees west for a distance of 167 feet to stone monument, then north 45 degrees east 200 feet." Does the description form a fully enclosed area?

(c) *Government Survey.* What is the approximate acreage of this site: N 1/ 2 SE 1/ 4, SW 1/ 4, S24, T32N, and R18E?

(d) What could a grantee learn by studying the details of a subdivision map that was incorporated into the legal description of her deed?

Question 2: ***Types of Survey Language in Realty Sales Agreements.***

(a) What type of survey condition should a homebuyer place in her purchase and sale agreement if she wants to be sure her swimming pool does not encroach on the neighbor's land?

(i) "Subject to any state of facts a survey would reveal."

(ii) "Buyer may disapprove title based on the survey."
(iii) "Buyer's approval of survey is a condition of buyer's obligation to buy."

(b) Which of the above conditions would the seller prefer?

Question 3: *Ordering the Right Survey.*

An institutional lender, as a condition to funding a real estate investor's acquisition of a downtown office tower, insists upon the investor commissioning a survey.

(a) What questions need to be answered in the investor's contract with the surveyor?

(b) What type of survey will the lender probably require of the investor?

(c) Why won't a boundary survey suffice?

Question 4: *Liability for Faulty Surveys.*

How can the purchaser of a lot in a new subdivision make sure she doesn't become liable to her buyer years from now for a survey error made by the original subdivider?

Question 5: *Resolving Boundary Disputes.*

(a) An attorney observes in a blog: Every year, I get calls from clients who need help resolving boundary disputes with their neighbors. One such dispute involved an adjacent neighbor who built a wall on the client's property. Another involved a neighbor who built a barn partially over the client's property line. And another involved a client who owned property on which a neighbor constructed storage sheds. What questions would you ask each of these clients before deciding whether to take the case?

(b) This question appeared in a "Real Estate: Questions and Answers" column in the Los Angeles Times: We bought our home about 25 years ago. Last year, the house next door was sold. The nice young couple who bought it had a survey made. It says my garage is located about one foot on their side of the property line. This garage was built almost 35 years ago when our house was constructed. The new neighbor is a lawyer and he said I will have to move my garage off "his" property because he doesn't want me to acquire title by adverse possession. What should I do? Consult a lawyer, you say, but if you are the lawyer, what advice should you give?

Question 6: ***Preventing the Casual Location of a Fence from Changing the Boundary.***

(a) When your neighbor asks whether it's OK to construct a fence between your yard and hers, are you potentially forfeiting title to property that belongs to you if the fence is built on your side of the boundary?

(b) How can you avoid inadvertently surrendering title to any of your land and still allow the neighbor to build her fence without incurring the cost of a survey?

Question 7: ***Preventing Hikers from Becoming Easement Holders*****.**

What advice would you offer to the owner of a pristine open space, enjoyed by hikers, who welcomes sharing the terrain but would like someday to develop it, free of adverse possession or prescriptive easement claims?

RECORDING LAWS AND PUBLIC LAND RECORDS

I. The Chain of Title, Recording Laws, and Title Insurance

A chain of title is the history of ownership of a particular parcel of land. In a real estate setting, "Chain of Title" means the overall history of the passing of title from the present owner of a piece of real property, going back long enough to satisfy prevailing norms regarding marketable title—typically 20 to 40 years.

The chain of title is typically maintained and preserved through the use of formal, written documents since most transfers of real estate are subject to the Statute of Frauds and must be in writing.

Local governments maintain copies of these documents. Such documents are usually submitted to a registry office or the county "recorder of deeds." These offices keep copies of documents that establish the chain of title for the property in question.

In the US, before a real property buyer pays the full purchase price, a closing attorney, title insurer or escrow agent will have checked to be sure there were no prior adverse claims recorded against the property.

Recording laws protect owners against the past. Had the seller previously mortgaged, deeded or leased the property, the new owner's title would be subject to those claims.

Recording laws also protect owners against the future. Suppose after deeding the property to A, the seller (the prior owner) deeds or mortgages the same property to B. Once A's deed is executed and recorded, A's title will be superior to B's, and to any other competing adverse interests in the A-B chain of title.

Thus, the public sector has hugely supported private ownership by creating a depository for documents affecting private chains of title, and made its use virtually indispensable by the lien priority rules emanating from state recording statutes.

Two features of the public system create the conditions for private title insurance to flourish.

First, in most jurisdictions, the public land records are extremely difficult to use. The indexing systems are archaic, and copies of the recorded documents are kept in unwieldy books, microfilm or microfiche. In many cities, title companies have duplicated these public records, used better indexing systems and made documents easily retrievable. In jurisdictions where public recording systems are indexed digitally and documents are available online, buyers and mortgage lenders can access them efficiently—though often for a subscription fee. Private title insurers have made their systems available to subscribers as well.

Second, the public recorder makes no determination about the validity of the documents presented for record except for minimal formalities—such as a quick determination that the document presented for recordation concerns an interest in real property, that the recording fee has been paid, and in the case of property sales, the document indicates where future property tax bills should be sent.

II. REVISED QUESTIONS

Question 1: ***Consequences of Not Recording a Purchase and Sale Contract.***

The purchaser is unable to record a realty purchase and sale agreement because the vendor refuses to acknowledge it. What legitimate reason could the vendor have for preventing the purchaser from recording the purchase and sale contract?

Question 2: ***Consequence of Not Recording a Lease.***

A family-owned "Dry Bar" leases space in a neighborhood shopping center for a term of five years, and spends $500,000 on improvements to the interior. The family would not want to risk the landlord selling to a subsequent purchaser who could possibly evict them, claiming no knowledge of their lease terms. Do you see any reason for the family to incur the cost of recording its lease? As a practical matter, could the family record it without the landlord's consent?

Question 3: ***Marketable Title Acts.***

(a) What is the purpose of marketable title acts, and how does it affect the length of a title search?

(b) Under a Marketable Title Act, what does the holder of a non-possessory interest accomplish by recording a notice of intent to preserve?

Question 4: ***Title Insurance and Recording Acts.***

(a) How does title insurance fill the gaps of recording systems and public land records?

(b) What aspects of a land registration system obviate the need for title insurance?

Question 5: ***The Language of the Statutes.***

(a) Is this Florida statute a race, race-notice, or notice statute? [1]

> Fla. Stat. Ann. § 695.01 (2013): Conveyances to be Recorded.
> No conveyance, transfer or mortgage of real property, or of any interest therein, nor any lease for a term of 1 year or longer, shall be good and effectual in law or equity against creditors or subsequent purchasers for a valuable consideration and without notice, unless the same be recorded according to law; nor shall any such instrument made or executed by virtue of any power of attorney be good or effectual in law or in equity against creditors or subsequent purchasers for a valuable consideration and without notice unless the power of attorney be recorded before the accruing of the right of such creditor or subsequent purchaser.

(b) Is the California statute a race-notice or notice statute?

> Cal. Civ. Code § 1214 (West 2014):
> Unrecorded Conveyance Void as to Subsequent Purchaser or Mortgagee.
> Every conveyance of real property or an estate for years therein, other than a lease for a term not exceeding one year, is void as against any subsequent purchaser or mortgagee of the same property, or any part thereof, in good faith and for a valuable consideration, whose conveyance is first duly recorded, and as against any judgment affecting the title, unless the conveyance shall have been duly recorded prior to the record of notice of action.

(c) Is the Delaware statute a race, race- notice or notice statute?

> 25 Del. Code Ann. § 153 (West 2014):
> Priority of deed concerning lands or tenements.
> A deed concerning lands or tenements shall have priority from the time that it is recorded in the proper office without respect to the time that it was signed, sealed and delivered.

Question 6: ***Donees' Rights Under Recording Acts.***

(a) In a race-notice state, O donates land to a private university and then mortgages it to M. The University records before M makes its mortgage loan to O. Who has priority to the realty, The University[2] or M?

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[1] The Florida statute is dissected in RICHARD R. POWELL, POWELL ON REAL PROPERTY 82-24 (1992). Distinguishing notice from race-notice statutes can be hard work. *See* Charles G. Rogers, *The Colorado Recording Act: Race-Notice or Pure Notice?*, 51 DENV. U. L. REV. 115 (1974).

(b) In a race-notice state, O mortgages land to M and subsequently donates the land to a private university without informing the University of M's prior mortgage. M neglects to record until after the University records its deed from O. Who has priority to the realty, the University or M?

Question 7: ***The Doctrine of Shelter*.**

Suppose O, the record owner of a vacant parcel of land known as Blackacre, deeds the property first to A and then to B. Both pay valuable consideration to O. B knows nothing of A's claim, and pays the full purchase price before A records. But A records before B. Then, A sells to C and soon thereafter, B sells to D. C records before D.

(a) In a race- notice state, who has the superior claim to Blackacre, C or D?

(b) In a notice state, who has the superior claim to Blackacre, C or D?

Question 8: ***Lien Priorities, Recordation and Equitable Subrogation.***

In 2008, Seller S closed a sale of her 10-unit apartment house to Buyer B for a purchase price of $1,500,000. Buyer B agreed to take subject to Seller S's existing $1,000,000 mortgage loan from a local bank that Seller S had obtained when she acquired the property two years earlier. The term of the loan was 15 years, interest at 6%, fully amortized.

To facilitate the sale, Seller S took back a $400,000 loan secured by a deed of trust on the apartment house, interest only at 10%, all of the principal to be repaid in a lump sum in ten years. The deed of trust was recorded on the closing date along with the deed from S to B. Buyer B paid $100,000 in cash at closing.

In 2011, Buyer B arranged a refinancing of the balance due on Seller S's original purchase money loan from a private lending consortium. By that time, Seller S's loan balance had been reduced to $900,000. The new loan was for $1,400,000. All the terms were the same as those of the mortgage being repaid. The new loan was written so that it became due on the same date as the re-financed loan would have become due. The re-financed deed of trust was promptly recorded. The trustee on the repaid loan executed a reconveyance of title, which was recorded. Buyer B retained the $500,000 cash difference between the old and new loan.

Due to increased competition from newer buildings, Buyer B had to reduce rents to a point that she could no longer make payments on her two mortgage loans. The lending consortium initiated foreclosure, which would eliminate Seller S's lien. She hired an attorney who sought a court order that Seller S had first priority to the foreclosure sale proceeds to the

[2] The text mistakenly asks whether O or M has the better title, instead of asking whether The University or M has better title.

extent of the unpaid balance on her loan because as against the consortium's deed of trust, under the state's race-notice recording statute, her lien was "first duly recorded."

(a) Was Seller S correct?

(b) How would the consortium justify its having a first lien priority?

(c) What would be the correct outcome according to existing applicable legal norms?

TITLE INSURANCE

I. An Overview

Questions About Title Insurance[1]
By Jack M. Guttentag

What Is Title Insurance?

Title insurance is protection against loss arising from problems connected to the title to your property.

Before you purchased your home, it may have gone through several ownership changes, and the land on which it stands went through many more. There may be a weak link at any point in that chain that could emerge to cause trouble. For example, someone along the way may have forged a signature in transferring title. Or there may be unpaid real estate taxes or other liens. Title insurance covers the insured party for any claims and legal fees that arise out of such problems.

Is Purchasing Title Insurance Obligatory?

It is if you need a mortgage, because all mortgage lenders require such protection for an amount equal to the loan. It lasts until the loan is repaid. As with mortgage insurance, it protects the lender but you pay the premium, which is a single-payment made upfront.

Does Title Insurance Do Anything for Me?

The required insurance protects the lender up to the amount of the mortgage, but it doesn't protect your equity in the property. For that you need an owner's title policy for the full value of the home. In many areas, sellers pay for owner policies as part of their obligation to deliver good title to the buyer. In other areas, borrowers must buy it as an add-on to the lender policy. It is advisable to do this because the additional cost above the cost of the lender policy is relatively small.

Doesn't the Lender Policy Indirectly Protect Me?

No, title policies are indemnity policies, they protect against loss, and a lender policy would only cover the lender's loss. Of course, the fact that the insurer issued a policy to the

[1] Jack M. Guttentag, *Questions about Title Insurance*, MORTGAGE PROFESSOR, https://www.mtgprofessor.com/A%20-%20Title%20Insurance/Questions%20About%20Title%20Insurance.htm (last modified Jan. 17, 2012).

lender indicates that the title has been searched and nothing amiss has been found, but no search is 100% dependable. That is why an insurance policy is issued.

When Does Title Insurance Protection Begin and End?

With the exception noted later, title insurance only protects against losses from claims that arose prior to the date of the policy. Coverage ends on the day the policy is issued and extends backward in time for an indefinite period. This is in marked contrast to property or life insurance, which protect against losses resulting from events that occur after the policy is issued, for a specified period into the future.

For How Long Is the Property Owner Purchasing Title Insurance Covered?

Indefinitely. The owner's protection lasts as long as the owner or any heirs have an interest in or any obligation with regard to the property. When they sell, however, the lender will require the purchaser to obtain a new policy. That protects the lender against any liens or other claims against the property that may have arisen since the date of the previous policy.

For example, if the contractor you failed to pay for remodeling your kitchen places a lien on your home, you are not protected by your title policy; the lien was placed after the date of the policy. You will probably be required to get the lien removed before you can sell the property. But in the event the lien hasn't been removed and a search has failed to uncover it, the new lender will be protected by a new policy.

Will Title Insurance Protect Me Against False Claims That Arose After I Purchased the Property?

The standard policy does not, which is a weakness. Many events beyond your control can reduce the value of your house after you buy it. If it is a newly-constructed house, sub-contractors claiming they had not been paid by the builder may place a lien on the house. Identity theft can result in a new mortgage you know nothing about. A neighbor could build on your land without your knowledge, thereby adversely possessing and possibly eventually taking your land. Or you may suddenly be told that you must correct a zoning violation of the previous owner.

To deal with these issues, a new policy with expanded coverage has been developed. I am told it is virtually standard in California and is available in many other states, perhaps at a small price increase. It is usually referred to as the ALTA Homeowner's Policy.

Does Title Insurance Coverage Rise with Increases in the Value of My Property?

No, but coverage under the ALTA policy referred to above increases by 10% a year for the first 5 years after issuance, to 150% of the initial amount. You can buy additional coverage as a rider to the policy.

If your policy does not have such a rider and your property has appreciated sharply in value, you may be able to purchase additional coverage on the same policy by paying an incremental fee. The fee should be modest because no new title search is involved. The coverage will only apply to title defects that existed prior to the original date of the policy. To extend the coverage to events that may have clouded the title since the original policy, you would need to take out a new policy with a new search and pay the full rate.

Why Do I Need to Purchase a New Policy When I Refinance?

You don't need a new owner's policy, but the lender will require you to purchase a new lender policy. Even if you refinance with the same lender, the existing lender's policy terminates when you pay off the mortgage. Furthermore, the lender is concerned about title issues that may have arisen since you purchased the property, such as the lien mentioned in an earlier question. A new title search will uncover the lien, and you will have to pay it off as a condition for the refinance.

Subject to state law, insurers generally offer to extend the existing policies of borrowers who refinance at a discount from the standard premiums. The periods for which the discounts are available vary by state, ranging up to 15 years in Massachusetts. BE SURE TO ASK FOR THE DISCOUNT, IT MAY NOT BE OFFERED IF YOU DON'T.

Does the Fact That Title Insurance Companies Pay Out Very Little in Claims Indicate That It Is Overpriced?

No, it may be overpriced, but not for that reason. Because title insurance protects against what may have happened in the past, most of the expense incurred by title companies or their agents is in loss reduction. They look to reduce losses by finding and fixing defects before the policy is issued, in much the same way as firms providing elevator or boiler insurance. These types of insurance are very different from life, property or mortgage insurance, which protect against losses from future events over which the insurers have no control.

Are Title Insurance Premiums Fair to Low-Income Borrowers?

Probably they are more than fair. Most title insurance costs arise in preventing loss rather than paying claims, and prevention costs are not much different for a small policy than for a large one. Despite this, premiums are scaled to the amount of the mortgage or the value of the property, which suggests that smaller policies may be underpriced and larger policies overpriced.

Does Title Insurance Guarantee Me That I Will Be Able to Sell My Property If an Unforeseen Claim Arises?

No. Title insurance does not prevent loss of marketability due to a title claim, any more than fire insurance prevents fire. If a claim arises, you probably won't be able to sell your property until the claim is settled by the title insurer. The interest of the owner and the insurer may clash in such cases. The owner usually wants settlement immediately, whereas the insurer wants to minimize the cost of settlement, which may require time-consuming negotiations with the claimant.

Why Are There Such Large Variations in the Cost of Title Insurance in Different Parts of the Country?

One major reason is that the services covered by the title insurance premium vary in different parts of the country. In some areas, the premium covers not only protection against loss but also the costs of search and examination, as well as closing services. In other areas, the premium covers protection only, and borrowers pay for the other related services separately.

To complicate it further, in some states, the charges for title-related services are paid to title insurance companies, which perform the functions but charge separately for them. In other states, borrowers may pay attorneys or independent companies called abstractors or escrow companies.

Of course, what matters to the borrower is the sum total of all title-related charges. These also differ from one area to another in response to a variety of factors. The 50 states have 50 different regulatory regimes, which affect charges: so do local costs, competition in local markets, and other factors. This is a largely unstudied segment of the economy that would make a nice PhD dissertation for a student in economics!

Does a Borrower Have the Right to Purchase Title Insurance on Her Own?

Yes, although few exercise it. Most leave it up to one of the professionals with whom they deal—real estate agent, lender or attorney—to select the carrier. This means that competition among title insurers is largely directed toward these professionals who can direct business rather than toward borrowers.

However, this has begun to change with the development of the internet, and one new insurer has emerged to market directly to borrowers.[2] Borrowers who seek a mortgage on this web site from a Certified Network Lender can also price and buy title insurance from Boston National.[3]

If a Borrower Does Shop for Title Insurance, Would It Pay?

Perhaps. It is difficult to generalize because market conditions vary state by state, and sometimes within states.

I would certainly shop in states that do not regulate title insurance rates: Alabama, District of Columbia, Georgia, Hawaii, Illinois, Indiana, Massachusetts, Oklahoma, and West Virginia.

You would be wasting your time shopping in Texas and New Mexico because these

[2] *See* Jake M. Guttentag, *Buying Title Insurance on the Web: Entitle Direct*, MORTGAGE PROFESSOR (Sep. 22, 2008), https://www.mtgprofessor.com/A%20-%20Title%20Insurance/selling_title_insurance_directly_to_borrowers.htm.
[3] *See* Jake M. Guttentag, *Why Shop Here: Shop for Third Party Services*, MORTGAGE PROFESSOR, https://www.mtgpro fessor.com/ShoppingReasons/AvailableProducts.html (last visited June 28, 2017).

states set the prices for all carriers. Florida also sets title insurance premiums but not other title-related charges, which can vary.

In the remaining states, the situation is murky and it may or may not pay to shop. Insurance premiums are the same for all carriers in “rating bureau states”: Pennsylvania, New York, New Jersey, Ohio and Delaware. These states authorize title insurers to file for approval of a single rate schedule for all carriers through a cooperative entity. Yet in some there may be flexibility in title-related charges. More promising are “file and use” states—all those not mentioned above—which permit premiums to vary between insurers.

The question is further complicated by the fact that title agencies, which actually write the policies and receive most of the premium as commission income, may share their commission with borrowers in some states. The fact that all the insurers in a state charge the same premium doesn't necessarily mean that all the borrowers in the state pay the same premium.

It is a good idea to ask an informed but disinterested local whether it pays to shop in the area where the property is located. Just keep in mind that those likely to be the best informed are also likely to have an interest in directing your business in the direction that is most advantageous to them.

Are Title Insurance Premiums Deductible?

Under existing rules, they are not. If the tax code was logically consistent, however, premiums paid by borrowers on lender policies—those that protect only the lender—would be deductible. The same is true of mortgage insurance.[4]

II. <u>REVISED QUESTIONS</u>

Question 1: ***Shopping for Title Insurance.***

(a) Most homebuyers negotiate the purchase price but do not shop for the best price for title insurance. What could explain this apparent anomaly?

(b) How can a homebuyer be sure that the title insurer offering them a bargain rate has adequate financial resources to make good on its policies if the title is defective?

[4] *See* Jake M. Guttentag, *Are Mortgage Insurance Premiums Deductible?*, MORTGAGE PROFESSOR, https://www.mtgprofessor.com/A%20-%20PMI/are_PMI_premiums_deductible.htm (Last modified Mar. 25, 2011).

Question 2*: Preliminary Title Report.*

(a) Why is it necessary for a buyer to study the preliminary report or title commitment closely even in jurisdictions where the title insurers have no liability for errors and omissions in the preliminary report?

(b) What are the most compelling competing arguments concerning whether realty buyers and mortgage lenders should be entitled to rely on the description of title in a preliminary report or commitment, and hold the title insurer accountable for a negligent title search?

(c) When a prospective buyer contracts for an inspection of the physical condition of the house she has contracted to purchase, she can usually count on the inspector being willing to discuss any and all of the issues raised by its inspection report. But when a prospective homebuyer has questions about the exceptions and exclusions in a preliminary title report or title commitment, title company lawyers and title searchers are going to be far less forthcoming in answering such questions. What could account for this?

Question 3: *Scope of Coverage. Off-Record Risks.*

Title insurance covers the insured against defects appearing in the public records. Give examples of the three potentially costly off-record risks that as a prospective homebuyer you would personally be most relieved to know are also covered?

Question 4: *Negotiating Coverage.*

The buyer of a restaurant strongly objects to an exception in the preliminary title report for a covenant barring the sale of alcoholic beverages, which was imposed eighty years ago and never enforced. What might a title insurer require of the seller as a condition to removing the exception?

Question 5: *Changing Ownership Without Losing Title Coverage.*[5]

Ally Artist purchases an empty warehouse as an art gallery and wine bar. She obtained a title policy at the time of her acquisition. Now that the business has grown, she is worried about potential liability, having heard some horror stories of drunk patrons suing bar owners for their mishaps.

(a) Will she continue to be covered by her title policy if she transfers title of the real estate to a Limited Liability Company?

(b) Suppose she had taken title in a limited partnership, assuming unlimited liability as the general partner, while her investor became the limited partner because he wanted to avoid

[5] This question has been added; it does not appear in the textbook.

personal liability for partnership debts. Could she transfer her general partnership interest into a specially formed limited liability company without losing the benefit of her title insurance coverage?

(c) Ali decides to make a major capital improvement now that the wine bar and art gallery have become a huge success. Her money partner will become a member of the LLC that owns the warehouse, or perhaps a new LLC that she and her money partner will form. Recalling that title coverage is subject to flaws "created, assumed, suffered or known" by the insured, what type of endorsement would the money partner be well advised to obtain from the title insurer? (Recall the concept of "imputed notice" described in the title insurance chapter.)

Question 6: ***Gap Coverage.***

(a) What is gap coverage?

(b) Why is it important to a real estate buyer or mortgagee?

Question 7: ***Defects Known to or Assumed by the Insured.***

(a) The homebuyer agrees to purchase subject to the seller's mortgage. Though the mortgage was properly recorded at the time the seller purchased the home many years ago, the buyer's title insurer had not exempted that mortgage from coverage. What policy language will the title insurer probably cite to justify denying liability to the buyer?

(b) A motorcycle gang has been hanging out for several years on vacant acreage that the owner has now sold to a buyer who purchased a title policy. Because the buyer observed the gang in action on the site, he insisted upon the seller paying extra for an extended coverage policy, insuring against loss by reason of any facts, rights, interests, or claims which are not shown by public record but which could be ascertained by an inspection of the land or by making inquiry of persons in possession thereof. The title insurer issued the policy with no exclusion for the gang's activities at the site. The buyer never mentioned to the title insurer his concerns about the gang. After closing, the buyer asked the gang to stop using the property. They are claiming a prescriptive easement or adverse possession. Is the title insurer liable for the costs of quieting or defending the buyer's title?

Question 8: ***Donee's Rights Under a Title Policy.***

Since title policies exclude liability for losses that would not have occurred had the insured paid value, is there any point in Cousin Miguel obtaining a title policy for the condo Aunt Teresa conveyed to him as a gift?

Question 9: ***The Title Insurer's Options for Discharging Its Liability Under the Policy.***

(a) A buyer discovers that her title is subject to a lien for twice the amount of her purchase price, a properly recorded lien that the title insurer simply overlooked. Does she have the right to insist upon the insurer paying off the lien instead of just handing the insured a check for the policy amount?

(b) If there is room to dispute the legal validity of the lien, will the insurer be obligated to litigate, or can the insurer elect to pay the policy amount and not defend the title?

(c) The title insurer denies the claim for no particularly good reason, forcing the buyer to file suit. After a lengthy and distressing lawsuit in which the insurer defends its position vigorously and ultimately loses, would the insured[6] be limited in its recovery to the insured amount under the policy? If not, describe the sources and extent of the title insurer's potential exposure to liability.

Question 10: ***Title Insurance Regulation, Fees and Expenses.***

In a 10-28-2006 article in Forbes magazine, Scott Woolley contended that title insurance was an oligopoly protected by state laws. Insurance regulators barred most general insurers from entering the title business. Title insurers routinely offered kickbacks to brokers for referrals with scant enforcement of federal and state statutes prohibiting such practices, and local governments were slow to transform their records into digital formats and make them available online. This enabled title insurers to extract excess profits. As proof of excess profits, he noted that policy premiums were rising steeply even as title insurer payouts on claims were steadily declining. *(Google: Scott Woolley, Title insurance).*

How could the title industry justify charging higher premiums for title coverage even as their pay-outs on claims were falling?

Question 11: ***Defects an Inspection Would Reveal; Coverage Against Encroachments and Trespass.***

(a) The insured's concrete driveway is being damaged by the roots from honey lotus trees intruding from the neighboring property. Anyone familiar with this type of tree would know that it has extensive root systems that would be likely to compromise the driveway.

The insured has a premium homeowner's policy, which insures against title defects that an inspection would reveal, and covers loss or damage from encroachments of the owner's property into neighboring terrain and any neighbor's encroachment into the insured's property. Is the driveway owner's title insurer liable?

[6] It was “the insurer” in the textbook, which is wrong, it should be “the insured.”

(b) The insured acquired a house on a golf course. Their title policy covered defects an inspection would reveal.

After taking possession, they discovered that golf balls often landed in their yard, sometimes dented their garden wall and once even broke a second-floor bedroom window.

The title was subject to recorded covenants, conditions, and restrictions, which included an "easement for errant golf balls."

Neither the title commitment nor the title policy noted these CC&Rs as exceptions or exclusions to coverage. Is the title insurer liable to the homeowners for loss or damage caused by the stray golf balls?

REAL ESTATE ESCROWS AND CLOSINGS

I. Introduction to Escrows

This chapter is about how intermediaries assist real estate buyers and sellers to fulfill the conditions of their purchase and sale contracts. The escrows highlighted in this chapter handle real estate transactions for buyers, sellers, and their lenders in purchase and sale transactions.

Depending on local custom and practice, the escrow function can be performed by a title insurance company, a bank, a real estate attorney, a real estate brokerage firm or an independent escrow agent. Each of these is licensed and regulated separately at the state level. In northern California, title companies are typically used to handle escrows. In southern California, independent escrow agents predominate.[1]

What's an Escrow?[2]
By John Reilly

Some real estate agents toss around the word "escrow" not realizing that to many sellers and buyers the concept of a deal being in escrow is a mystery. Just what is this strange place called escrow and what happens there? I recall a broker telling me about a rookie agent who put together a sale in her first week, something almost unheard of. The broker heartedly congratulated the new agent and told her to put the signed contract into escrow.

A few days later the broker asked the agent how it was going. Fine came the response—"it's in escrow."

A week later, the broker called the escrow company who acted surprised. They hadn't seen any paperwork on that deal. The broker called the agent and asked again where was the contract, to which the agent responded that she put it in escrow.

[1] *See* Sandy Gadow, *State by State Closing Guide*, SANDYGADOW, http://sandygadow.com/state-by-state-closing-guide/ (last visited July 18, 2017).
[2] John Reilly, *What's an Escrow?*, THE DATA ADVOCATE (July 29, 2015), http://www.thedataadvocate.com/whats-an-escrow/ (last visited June 30, 2017).

The broker said "show me." The agent went over to the filing cabinet and opened the drawer marked "escrow"—in the section marked "In Escrow," lo and behold, there was the signed contract between buyer and seller.

So, just to be clear about what is this mysterious place called escrow, here's a discussion from my book, The Language of Real Estate, Dearborn Publishing:

ESCROW**:** the process by which money and/or documents are held by a disinterested third person (a stakeholder) until satisfaction of the terms and conditions of the escrow instructions (as prepared by the parties to the escrow) has been achieved.

Once these terms have been satisfied, delivery and transfer of the escrowed funds and documents takes place. Although in some states a real estate broker is authorized to handle escrow functions, the common practice is to employ the services of a licensed escrow company, title company or lending institution. In some states, it is called a settlement service.

Escrow can generally be used to close the following types of real estate transactions: sales, mortgages and exchanges; sales by means of a contract for deed; and leases of real estate. In all cases, the escrow holder acts as a fiduciary and retains documents and entrusted assets until specified conditions are fulfilled.

The holder is the special and impartial agent for both parties and acts in accordance with the escrow instructions given by both.

The sales contract usually serves as the basis for escrow instructions for both seller and buyer because it contains (or should contain) the agreement of the parties concerning who must pay the various expenses, the proration date and the like. This importance of the sales contract underscores the critical role of the real estate salesperson or broker whose responsibility is to advise the parties and properly complete the sales contract form (and advise the parties to seek legal counsel if appropriate).

If the contract has been unprofessionally prepared, the escrow company may be delayed or even prevented from closing the transaction. It is important to remember that an escrow agent does not prepare or review the legal documents—escrow merely takes directions from the parties to the contract and acts on them in a confidential manner. Thus, the parties should not rely on the escrow agent to discover defects in the transaction. If an established escrow company is not involved in the transaction, an attorney should be consulted about the preparation of proper escrow instructions.

Because of the escrow's limited duties of disclosure and the confidentiality of the escrow in general, facts known to the escrow holder are normally not imputed or implied to the other party. Escrow is a limited agent for both parties, but once the conditions to the escrow transaction have been performed, the nature of the dual agency changes—escrow then becomes the agent for the seller for the money, and the buyer for the deed. Escrow acts as the "clearinghouse" for the details of the transaction.

Escrow cannot be unilaterally revoked, and in the event of disagreement the escrow can only be amended, changed or revoked by mutual agreement.

In closing a real estate transaction, the escrow company may perform such duties as paying liens, computing pro-rations, ordering title evidence, having new documents prepared, drawing up closing statements, obtaining necessary signatures, recording documents and receiving and disbursing funds. After payment of their respective closing costs, the buyer is thus assured of receiving a clear title and the seller is assured of receiving the appropriate funds. Typically, escrow fees are split equally between buyer and seller.

Some special situations to which an escrow arrangement is most appropriate are closing of sale and immediate resale or purchase; closing when several lenders are involved either in new mortgages or releases of prior encumbrances; closing an entire condominium project when purchasers' funds must be escrowed under state law; closing a VA or an FHA loan (an FHA and VA requirement).

Once a valid escrow has been set up and a binding and enforceable contract of sale has been deposited with the escrow holder along with a fully executed deed, the death or incapacity of one of the parties to the escrow will not terminate the escrow. Upon performance of the decedent's part of the contract, the other party is entitled to have escrow concluded according to the terms of the contract.

An escrow is usually not opened until major contingencies in the contract of sale have been met. Such major contingencies might be the arrangement of new financing or the approval of a loan assumption, building permit, zoning change or the like. Among the contingencies that can be taken care of after the start of escrow are the appliance check, the termite inspection, and the signing of bylaws or house rules.

Escrows and Contracts for Deed[3]

A related term— "holding escrow" is an arrangement whereby an escrow agent holds the final title documents to a contract for deed. Holding escrows are often suggested as the solution for the problems that arise when the buyer is ready to pay off the balance owed on the contract, but the seller either cannot be found or is not cooperative about executing the deed.

[3] A contract for deed is a written contract between a potential seller and buyer agreeing to a future conveyance of property once terms and conditions of the contract have been met. A contract for deed is often referred to as an installment sale agreement, land contract or owner financing. Unlike a typical real estate purchase agreement, the buyer usually takes possession of the property upon execution of the contract and makes payments until the agreed-upon price has been paid in full, at which time the property is usually deeded to the purchaser.

Marie Murdock, *Contracts for Deed Pros &* Cons, LEGALZOOM, http://info.legalzoom.com/contract-deed-pros-cons 23932.html (last visited July 18, 2017).

Under a holding escrow, the seller, at the time the contract for deed is signed, deposits with the escrow agent an executed deed or assignment of lease and instructs the escrow agent to deliver the conveyance to the buyer when full payment is made under the contract.

Many escrow companies are reluctant to handle holding escrows, even when they are indemnified against loss, because of the following possible complications:

- It may be difficult for the holding escrow to ascertain whether there has been a full payoff, whether the amount deposited in escrow is the correct amount and whether the buyer is in default under any other terms of the contract for deed.
- Difficulties may arise if the seller dies, particularly in terms of determining the rights of his or her heirs. Other problems may arise if the seller remarries, and new dower, courtesy or marital rights must be considered.
- If the buyer has resold the property still under contract and used a different escrow agent, the seller will be requested to draft new documents conveying title directly to the new buyer. Thus, sometimes there are added costs.

While the holding escrow practice is good in theory, these practical problems may prevent its effective use.

A good alternative is to establish a collection account with the lending institution where the seller has an existing mortgage. The collecting agent will know how to contact the seller if the buyer wants to quickly pay off the outstanding balance and receive a deed to the property. Also, the buyer can thus be assured that the seller's mortgage payments are being made as long as the buyer makes his contract for deed payments and vice versa. The seller can be notified if the buyer is in default in making payments. This situation is sometimes called a true escrow.

Other Types of Escrows

Real estate escrows should not be confused with two other types of escrows—those involved in administering the mortgage payments of borrowers, and online escrow facilitators.

Mortgage Escrow Accounts. Home mortgage loans require borrowers to insure the security property against casualty losses for the benefit of their lenders, and to pay local property taxes. To assure that borrowers are complying with these requirements, mortgage lenders sometimes require borrowers to remit, along with their monthly mortgage payments, an additional sum of money each month sufficient to cover insurance premiums and property tax payments as they become due.

As Wells Fargo explains to home loan borrowers:

> It's an easy way to manage property taxes and insurance premiums for your home. You don't have to save for them separately because you make one monthly payment where part goes toward your mortgage to pay your principal and interest. The other part goes into your escrow account for property taxes and insurance premiums (like homeowners' insurance, mortgage insurance, or flood insurance). When those bills are due, we use the funds in your escrow account to pay them.[4]

Online Escrow Facilitators. Another common type of escrow is used to process online transactions between buyers and sellers.[5] This is done primarily with personal property and online goods, and similar to real estate, the escrow will act as the middleman between buyer and seller to ensure the transfer of funds for the product or service. Online escrows have increased in popularity due to the trend of online transactions using PayPal or even Bitcoin. Unsurprisingly, with the facilitation of online transactions, there have been many instances of fraudulent behavior by parties acting as legitimate escrow holders.[6]

II. REVISED QUESTIONS

Question 1: *Duties of an Escrow Agent.*

(a) In a particular transaction, the buyers and seller sign a purchase and sale contract but only the seller signs the escrow instructions. Soon after the buyers deposit $15,000 as a down payment with their escrow agent, they suffer buyers' remorse, decide to back out of the deal, and ask the escrow agent to refund their $15,000. Under the law of agency, what should the escrow agent do?

(b) What should an escrow agent tell the seller in the above situation when he asks whether to sue or just cancel the deal?

(c) In another transaction, the buyer and seller each sign separate escrow instructions. The buyer adds an instruction that immediately following the closing, the escrow agent is to deed the property from the buyer to the listing broker. Later, the seller learns that the ostensible buyer was just acting as an intermediary for the listing broker who didn't want to risk having to reduce or waive her commission by disclosing that she was the buyer. Did the escrow agent owe a duty to disclose this instruction to the seller?

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[4] *Escrow Accounts*, WELLS FARGO, PERSONAL, HOME MORTGAGE LOANS, INFORMATION FOR CUSTOMERS, https://www.wellsfargo.com/mortgage/manage-account/escrow/ (last visited July 18, 2017).
[5] *See, e.g.*, ESCROW.COM, HTTPS://WWW.ESCROW.COM/ (LAST VISITED JULY 2018) ("Escrow.com Removes the Risk from Online Transactions Complete protection for buyers & sellers with our licensed and audited escrow service.").
[6] Fake online escrow scams abound. *See*, Bob Sullivan, *Fake Escrow Site Scam Widens*, MSNBC.COM (Dec. 17, 2002), http://www.nbcnews.com/id/3078510/ns/technology_and_science-tech_and_gadgets/t/fake-escrow-site-scam-widens/.

(d) In a third transaction, the escrow instructions call for the buyer to receive title free and clear of all liens and encumbrances except for one specifically identified lien—a new purchase money mortgage loan. Acting under a purchase and sale contract provision calling for buyer approval of the preliminary title report within five days of receipt, buyer tenders timely written approval to the escrow agent. The agent notices that Schedule B excludes from coverage a recorded lien for which the parties appear to have made no specific arrangement. The purchase price does not appear to have been reduced by the amount of the lien. Nothing in the contract obligates the buyer to assume or take subject to that lien. The agent finds it puzzling that the buyer never mentioned the lien. The seller tells the escrow agent not to worry about that lien if the buyer approves the preliminary title report without objecting to it. Does the escrow agent have an obligation to call the lien to the buyer's attention or just let sleeping dogs lie?

Question 2: ***Allocating the Risk of Escrow Agent Malfeasance.***

Occasionally, escrow agents or closing attorneys abscond with funds buyers or lenders deposited with them to facilitate sale or loan closings. Under which of the following situations would the seller bear that loss if the escrow agent was uninsured and can't be found?

(a) The embezzlement of loan funds occurs after all other conditions of escrow have been met, although the agent has yet to remit the final payment due to the seller.

(b) The embezzlement occurs during a 30-day delay in the closing, which the buyer agreed to give the seller because she needed additional time to fund the pay-off of a judgment creditor's lien.

(c) The seller had agreed to complete some remedial termite repairs by closing but her contractor needed another week after closing to complete the work. The seller had agreed to leave $10,000 in escrow until the buyer certifies that he is satisfied with the work. Any savings is to be remitted to the seller. The parties sign a one-week extension of the purchase and sale agreement. The escrow agent absconds with the $10,000 during that one-week extension period. Who bears the loss—buyer or seller?

Question 3. ***Responsibilities of Closing Agent*****s**

Buyer and seller request that the escrow agent modify the escrow instructions by charging the seller for $10,000 in closing costs and pro-rations of various kinds that the buyer had previously agreed to pay. They request that this re-allocation be made by the escrow agent outside of escrow after the closing. Is there any reason the escrow agent needs to disclose this modification to the buyer's mortgage lender?

Question 4: ***Drafting Post- Closing Escrow Instructions*****.**

Seller agrees to make certain repairs after closing. To secure the seller's promised repairs, the escrow agent is required to withhold $75,000 of the purchase price until the buyers sign a release that they are satisfied with the repairs. The seller worries that the buyers may refuse to sign the release and force the seller to make further concessions or give up a portion of the cash to the buyers.

Is there a way to word the instruction that does a better job of protecting a seller who makes the repairs in good faith and wants to be reimbursed fairly and promptly for having paid for the work without resorting to mediation, arbitration, or litigation?

Question 5: ***Kickbacks Under RESPA.***

(a) In California, every home seller is required to deliver a Natural Hazard Disclosure Statement to the buyer before closing. Independent firms prepare these forms though title insurers are eager to enter the business. Would RESPA bar title insurers from giving any insurance policy purchaser a discount on the title policy for purchasing a Natural Hazard Disclosure Statement from the title insurer or an affiliated firm?

(b) Would title insurers be violating RESPA if an affiliated Natural Hazard Disclosure preparer sold individual Natural Hazard Disclosure Statements for half the usual price to brokers who customarily utilized the title insurer's policies?

TERMINATING FAILED REAL ESTATE CONTRACTS

I. When Contracts for the Purchase and Sale of Real Estate Go Sideways

Seller's Remedies When Buyer Defaults[1]
By Benny L. Kass

Q:

I thought I had sold my house last month. There was a signed contract with the buyer, and settlement was to take place toward the end of this month. The buyers removed all contingencies and arranged for a title attorney to handle the closing. However, I have just been advised that the buyers are being transferred out of the area and they cannot purchase my house. What rights do I have?

A:

Hopefully, the contract which you entered into with your buyers will give you guidance. Most standard form contracts contain provisions relating to defaults—both by the buyer as well as the seller.

First, we have to define "default." When a real estate contract is entered into, it often contains certain contingencies—such as obtaining a satisfactory home inspection, or getting a firm loan commitment, or even selling the purchaser's home. These contingencies should include time limitations, whereby if the contingency is not removed within a certain time frame, the contract will either become null and void or will become a valid and binding contract. The specific contingency will usually spell out the consequences of not meeting the time deadlines.

Where there is a contingency in a sales contract, a buyer will not be in default should the contingency not pan out. For example, the buyer signs a contract to purchase your house, and the contract is contingent on the buyer obtaining financing. So long as the buyer promptly makes application for a mortgage loan, if the buyer is unable to obtain the necessary financing within the time spelled out in the contract—and advises the seller in writing of this fact—the contract will usually become null and void. Under these circumstances, the earnest money deposit will be returned to the buyer and there is no default.

Thus, whether you are a buyer or a seller, you want to make sure that any contingencies which are contained in the sales contract are well-drafted. You also want to keep a calendar so that any time limits are not missed.

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[1] Benny L. Kass, *Seller's Remedies When Buyer Defaults*, REALTY TIMES (Aug. 16, 2004), http://realtytimes.com/consumeradvice/sellersadvice/item/11888-20040816_buyerdefault.

Once all contingencies have been removed, both the seller and the buyer have the legal obligation to go to settlement. Usually, the sales contract will contain a specific date when settlement must take place. The seller may want to add language in the contract that all time limits contained in the contract are "time of the essence." This generally means that if the deadline passes, there will be a default.

The legal dictionary defines "default" as "an omission or failure to perform a legal duty." But no definition can do justice to the facts of each case. There can be no universal definition; each case must be determined on its own facts—and on the language of the sales contract.

Buyer Default

If the buyer defaults, generally the seller has three alternative remedies:

> **(1) Keep the earnest money deposit**. A potential buyer who signs a real estate contract generally gives the title attorney or the real estate agent between 5 and 10 percent of the purchase price. This is referred to as the "earnest money deposit." It is a show of good faith on the part of the buyer that they are serious in wanting to purchase the property in question. A seller would like 100 percent of the purchase price as this deposit, while a buyer would only like to sign a promissory note and shake hands with the seller. However, the general practice is that the buyer will put up some agreed upon percentage of the sales price as this deposit.
>
> In the event of a default, the seller has the right to keep this deposit, and put the house back on the market and resell it.
>
> [In some states (e.g., California) the deposit has to qualify as a valid liquidated damage provision under state law. The reserved sum must have been actually deposited by the buyer. The amount must bear a reasonable relationship to the seller's anticipated loss when the contract was entered, and not greatly exceed the seller's actual loss as measured by a resale within a period of time after the breach. In many other states including New York, New Jersey, and Florida, courts enforce "forfeiture of deposit" provisions not exceeding customary limits, typically 10%.]
>
> Usually, the person holding this deposit is called the "escrow agent." This agent does not have the unilateral right to release the deposit—to either buyer or seller—unless there is a written statement from both buyer and seller authorizing the release or, if the matter has to go to Court, a court settlement agreement or a Court order.
>
> **(2) Sue for specific performance**. There is a legal right for the seller to file suit against the buyer, asking the Judge to order that the buyer actually go to closing. This is known as an action for specific performance. Legal actions take time and are expensive. But if the buyer is financially able—and for example if the property values has declined—this is a possible alternative for the seller to consider.

(3) Bring a lawsuit for damages. Let us assume that the sales contract called for a $500,000 purchase price. After the buyer defaulted, the seller was only able to sell the property for $400,000. The seller has the right to file a lawsuit against the buyer for this $100,000 loss. Damages would also include any carrying costs, which the seller had to absorb until the property was in fact sold to someone else.

> [It is common for sellers to desire the breaching buyer to pay for expenses incidental to ownership pending resale.
>
> Expenses incidental to ownership include, but are not limited to, mortgage payments, insurance, taxes, maintenance, homeowner association dues, and utilities. "To allow the recovery of such expenses would be analogous to allowing a car owner to recoup from a defaulting buyer the costs of maintenance, gasoline, and automobile club membership dues until the vehicle is sold. Such a result, in our view, goes far beyond the reach of recoverable contract damages." *See, Peterman v. Dimoski*, 2002-Ohio-7337, ¶11.
>
> The issue of foreseeability of damages is a logical approach for a seller seeking damages from a breaching buyer, however it is not successful. Consequential or special damages in contract have been limited to those that are certain, foreseeable, and within the contemplation of the parties at the time the contract was entered into.
>
> The one item that a few Ohio courts have carved out as a recoverable expense is real estate broker commissions. The scenario is that the first sale involves either a "for sale by owner" or a discount broker and then a full commission broker is subsequently employed to sell the property after the breach. The use of a full commission broker is foreseeable as a reasonable effort to get the property sold as quickly as possible. The courts in *Peterman v. Dimoski* and *Saylor v. Eno*, *2007-Ohio-351* both awarded to the seller the additional real estate broker commission the seller had to pay.
>
> Recently, I had lunch with my opposing counsel the day after I won on a summary judgment in the defense of a buyer breach case. He commented that it just did not seem right that his client should not be able to recover expenses incidental to ownership. After all, my client breached the contract by not closing within the stated time. The seller had promptly resold the property for $5,000 more than my client was going to pay, but he had to hold it for 65 days beyond the scheduled closing with my client.
>
> It was a million-dollar home with alleged significant per diem expenses. The court found the seller had no damages that were recoverable under Ohio law. As we discussed it further, he reluctantly acknowledged the problems that would

> be incurred if there were not such a bright line rule limiting recoverable damages to the difference between the contract price and the value of the property at the time of the breach. While in our case it was a matter of only 65 days, what if it had not sold so quickly? Where do you draw the line? Of course, the litigation would be endless.][2]

Once again, litigation is time consuming and unpredictable.

These are the basic remedies that a seller has on a default by the buyer. Smart buyers will generally want to limit their exposure by spelling out in the sales contract that the seller can only keep the deposit, and not be able to assert any of the other two options.

Smart sellers, on the other hand, will want to keep all options open, and try to get as high an earnest money deposit as possible.

Seller Defaults

Should the seller default, the buyer should have the absolute right to sue for specific performance and damages. Generally, when sellers default, it is because they think they can get a higher price for the property. It would be manifestly unfair to the buyer to allow that to take place, and accordingly the law gives the buyer the right to file a suit for specific performance. And in most jurisdictions, such a suit (often accompanied by documents recorded against the property in the land records) puts a cloud on the seller's title. This is known in the law as "*lis pendens*."[3] It puts the world on notice that there is a lawsuit involving the property. No third-party buyer would dare to even consider buying the property while that lawsuit is pending in the courts.

> [The reality is that pursuing specific performance may not actually work. Last year I had a case where the seller came to the closing and refused to pay a judgment lien to convey the property free and clear of all liens as required in the contract. The deal did not close. The buyer promptly filed a complaint for specific performance and a notice of *lis pendens*. The seller had stopped making the mortgage payments some months before going in contract with my client. Consequently, the bank had started foreclosure against the property, and it was sold at the sheriff's auction shortly after the filing of the complaint for specific performance.][4]

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[2] James A. Zitesman, *Breach of Contract in Real Estate Cases,* AMERICAN BAR ASSOCIATION SECTION OF LITITGATION, https://www.americanbar.org/groups/litigation/committees/realestate/news_analysis/articles_2013/0509-breach-of-contract-real-estate.html (last visited July 2, 2017).

[3] *Lis pendens* is an easy-to-file notice placed in the public land records to deter the seller from trying to sell or refinance the property until the underlying lawsuit is resolved. In United States law, a ***lis pendens*** is a written notice that a lawsuit has been filed concerning real estate, involving either the title to the property or a claimed ownership interest in it. The notice is usually filed in the county land records office. Recording a *lis pendens* against a piece of property alerts a potential purchaser or lender that the property's title is in question, which makes the property less attractive to a buyer or lender.

[4] James A. Zitesman, *supra* note 3.

Default—whether by buyer or seller—should not be taken lightly. Nor should it be asserted without giving the defaulting party an opportunity to cure the default. Regardless of the merits, litigation is both time consuming and expensive.

Seller Backing Out (MA). Has Anyone Here Sued for Specific Performance[5]
Submissions on Reddit Real Estate by Natsunohana

My husband and I are first-time home buyers with a signed offer to purchase agreement. After we put down money for a home inspection and attorney retainer fees, the sellers decided they no longer want to move. Since we have a legally binding contract, our real estate lawyer told us we could sue for specific performance. My questions . . . has anyone here actually sued for specific performance before? What was your experience like? Any advice for buyers on negotiating the release agreement?

Reposting a previous comment I've made:

I see a few people throwing out the "just sue for specific performance" angle. As someone who went through a very similar experience, I wanted to give you a taste of my experience.

> 1) This was an open and shut case, where the seller added an addendum to the contract AFTER everything was signed and agreed to, asking for a ridiculous easement/access for everyone in the neighborhood to our driveway.
>
> 2) We wanted the house but were willing to walk for a very moderate price to cover our costs/time ($2K)
>
> 3) We offered to "sell" access via our driveway, seller said they would not pay a cent.
>
> 4) We were told to just sue for specific performance, you have an easy case and will be in and out in 6 months.

Two years later, we got the house, the judge dismissed the case "with prejudice" meaning it was dismissed permanently (and in our favor). In those two years, we spent $40K on lawyers and had to put much of that up front (this was Los Angeles, but still, it was a $250K house). We lived with the constant worry that we would lose our money and the house, even though everyone including our lawyers said not to worry.

The judge awarded us attorney's fees, but knocked them down to $30K so we were out of pocket significantly.

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[55] Natsunohana, *Seller Backing Out (MA): Has Anyone Here Sued for Specific Performance?*, REDDIT REALESTATE, https://www.reddit.com/r/RealEstate/comments/3y1b4t/seller_backing_out_ma_has_anyone_here_sued_for/ (July 2, 2017).

In the meantime, we had moved 300 miles away, but had spent so much time/money on attorneys we didn't want to walk away. Would I do it all over again? NO. Our pride in knowing we were "in the right" and love for the house got the better of us.

While others may have gone through this process and have a different take, I do think that a lot of people who urge others to sue have not been there/done that (at least in the specific performance realm). Think rationally and clearly as to whether suing is worth the time/stress/money before you take that advice.

Please do not get the impression that I think you are in the wrong in any way, just be aware of the issues with some of the advice you have been given.

Specific Performance of Real Estate Contracts: Legal Blackmail[6]
By Gerald F. Richman & Mark A. Romance

Beware real property owners: The mere filing of a suit for specific performance (regardless of its ultimate success or the merits) can potentially tie up your property for several years, with or without the existence of a *lis pendens*. The reason is simple. It is virtually impossible to obtain title insurance necessary to convey title while an action for specific performance is pending. In effect, this can be a form of "legal blackmail."

The unsophisticated owner of an attractive residence on Palm Island on Miami Beach entered into what effectively was a lease/option to purchase contract with a tenant, but had 48 hours to have the contract reviewed by an attorney.

Within the allotted time period, the owner elected not to proceed in what was an ambiguous contract coupled with a bad bargain. However, the buyer took the position that the seller had not properly terminated the contract, refused to leave the premises, and the owner was forced to sue for eviction. The tenant responded with a counterclaim for specific performance that tied up the property for over a year even after a settlement agreement was reached requiring the tenant to leave the premises.

On the eve of the agreed-upon scheduled departure the tenant filed for bankruptcy, which deprived the state court of jurisdiction to enforce the settlement and evict the tenant.

By the time the stay was lifted, the tenant was evicted, and the specific performance claim tried and determined adversely to the tenant, the tenant had occupied the property for a year and a half rent free and tax free.

[6] Gerald F. Richman & Mark A. Romance, *Specific Performance of Real Estate Contracts: Legal Balckmail*, RICHMAN GREER (Nov. 2, 1998), http://www.richmangreer.com/1998/11/02/specific-performance-of-real-estate-contracts-legal-blackmail/.

The seller again faced the prospect of a drastic downturn in the market, had lost a year and a half of rent, and had to absorb the real estate taxes and utility bills.

The law as it exists today affords an unable buyer the power to force the unwary seller to settle a frivolous claim. This conduct can be characterized as "legal blackmail."

It is a common misconception that title to property is not clouded by the filing of a lawsuit unless it is accompanied by a *lis pendens*. The fiction is that a *lis pendens* is necessary to give notice to the world of the existence of a suit. Many serious legal battles involve trying to dissolve a *lis pendens* or to force the party filing the *lis pendens* to post a substantial bond.

At first blush, it would seem that a seller who has had a *lis pendens* dissolved while a specific performance suit is pending should simply be able to seek out an uninformed buyer and close the transaction without revealing to the buyer or the buyer's attorney the pendency of the lawsuit for specific performance. No title defect would appear of record, so the seller should then be able to find a buyer without knowledge of the pending specific performance claim.

Aside from the possibility of a suit for fraudulent inducement by virtue of the alleged failure to disclose a material fact, and aside from issues as to whether caveat emptor applies, a more practical barrier exists: the duty of the seller's attorney who is ethically obligated to inform both the buyer's attorney and the title company of the pendency of the suit.

In today's day and age, the marketability of any parcel of property depends on the buyer's ability to obtain title insurance. Although a title insurance company theoretically could issue a policy with an exception for an unrecorded interest in property of which it is aware, such as the existence of a specific performance lawsuit involving the property, such a practice is prohibited by most title insurance companies because they might then become involved in the practice of "buying a lawsuit."

Potential Solutions

What can sellers reasonably do to protect themselves? One solution lies in the freedom to contract, where the seller could insert a clause in the sale contract that as a condition precedent to filing a suit for specific performance, the buyer would be required to deposit in an interest-bearing escrow account the full amount of the purchase price, plus a reasonable sum to reimburse the seller for attorneys' fees and costs in the event the seller prevails.

Alternatively, the buyer could be required to post a bond or letter of credit payable to the seller in the event the seller prevails, in a sum equivalent to the purchase price of the property plus a reasonable amount for attorneys' fees and costs.

An alternative contract solution would be for the seller to specifically exclude the remedy of specific performance. In so doing, the seller must provide an alternative remedy for the buyer in the event of a default, such as a mechanism to determine the amount of damages if a court determines that seller breached the contract.

II. REVISED QUESTIONS

Question 1: ***To Sign the Arbitration Clause or Not?***[7]

Standard form purchase and sale contracts prepared by real estate brokers invariably contain an arbitration clause. The California Association of Realtors' form has these provisions regarding dispute resolution.

> MEDIATION: The Parties agree to mediate any dispute or claim arising between them out of this Agreement, or any resulting transaction, before resorting to arbitration or court action through the C.A.R. Consumer Mediation Center or through any other mediation provider or service mutually agreed to by the Parties."
>
> "The Parties also agree to mediate any disputes or claims with Broker(s), who, in writing, agree to such mediation prior to, or within a reasonable time after, the dispute or claim is presented to the Broker. Mediation fees, if any, shall be divided equally among the Parties involved. If, for any dispute or claim to which this paragraph applies, any Party (i) commences an action without first attempting to resolve the matter through mediation, or (ii) before commencement of an action, refuses to mediate after a request has been made, then <u>that Party shall not be entitled to recover attorney fees, even if they would otherwise be available to that Party in any such action.</u> (Emphasis added). THIS MEDIATION PROVISION APPLIES WHETHER OR NOT THE ARBITRATION PROVISION IS INITIALED.
>
> "The Parties agree that any dispute or claim in Law or equity arising between them out of this Agreement or any resulting transaction, which is not settled through mediation, shall be decided by neutral, binding arbitration. The Parties also agree to arbitrate any disputes or claims with Broker(s), who, in writing, agree to such arbitration prior to, or within a reasonable time after, the dispute or claim is presented to the Broker. The arbitrator shall be a retired judge or justice, or an attorney with at least 5 years of residential real estate law experience, unless the parties mutually agree to a different arbitrator."

(a) A home owner is about to sign a form purchase and sale agreement that contains provisions like those quoted above concerning mediation and arbitration. The home owner is not sure how to compare the various available dispute resolution alternatives. Bring the home owner up to speed on the differences among litigation, arbitration and mediation.

(b) How do you suppose real estate brokers obtaining listing agreements from sellers would explain why it is the best interest of the seller to initial the arbitration clause in the form purchase and sale agreement as it appears in the above text?

[7] Question 1 differs significantly from the version in the textbook.

Question 2: ***Specific Performance: Strategic Choices.***

(a) Why do you guess home sellers so rarely seek specific performance from breaching buyers?

(b) Would you advise a developer-client to seek specific performance for vacant land the seller[8] was refusing to sell just a few days before the scheduled closing date?

(c) Real estate brokerage forms usually contain liquidated damage provisions capping the liability of breaching buyers but not of breaching sellers. What reasoning do you imagine supports this asymmetry in brokers' minds?

Question 3: ***Pre-Closing Release of Escrowed Funds and "No Recordation" Clause.***

The seller owns a 200-acre citrus grove in a rapidly subdividing area. The buyer is a land developer. They enter a purchase and sale agreement contingent on the buyer being able to obtain certain government approvals for a new subdivision. The buyer deposits 10% of the purchase price of $500,000 with an escrow agent when the contract is signed.

The contract specifies that the buyer has six months from the date on which both parties signed the contract to deposit an additional $100,000 with the balance due at closing, ten months after the contract was first signed.

Alternately, the buyer can provide the seller with notice of the buyer's intent to terminate the contract any time before six months from the date that both parties signed the contract, and obtain a refund of the $50,000 initial deposit.

At the seller's request, the following "No Recordation" provision was included in the contract: "In no event shall this Agreement or any document or other memorandum related to the subject matter of this Agreement be recorded without the consent of Seller."

According to the terms of the contract, if the buyer fails to make the final payment, time is of the essence. The seller is entitled to retain $150,000 denominated as liquidated damages. This provision of the purchase and sale contract was initialed by the buyer and seller.

(a) The seller wants a provision to be included in the contract and the accompanying escrow instructions, that once the buyer deposits the full $150,000, these funds should be remitted to the seller, either to be applied to the purchase price at closing, or as liquidated damages if the buyer fails to come up with the balance of the purchase price on or before the contract closing date. Can you imagine any reasonable basis for the buyer to object to such a provision?

(b) The buyer had advanced the $150,000 but had some difficulty raising the balance of the purchase price on time. At the end of six months from the initial contract date, the seller sent

[8] The text incoherently identifies the recalcitrant party as the buyer.

a notice to the buyer declaring that she would regard the contract as terminated if the buyer failed to come up with the balance of the purchase price within two weeks.

Four weeks after the seller sent that notice, the buyer tendered a cashier's check for $350,000 which the seller refused to accept, claiming that the contract had ended, and the seller was retaining $150,000 as liquidated damages. Do you see any reasonable basis for the buyer to obtain specific performance or a return of the $150,000?

(c) The buyer files a suit for specific performance and records a *lis pendens*. The seller files suit to expunge the *lis pendens* on the basis of the "No Recordation" provision. If you were the trial judge, how would you decide the seller's expungement motion, and why?

Question 4: ***Lis pendens - Strategic Factors.***

(a) Suppose in a market in which house prices are rising rapidly, a seller refuses to honor a purchase and sale contract for her residence because she comes to believe she will garner a much higher price by putting the property back on the market. What strategic advantage could the buyer obtain by filing a suit for specific performance and recording a *lis pendens*?

(b) Why would the owner of a $400,000,000 office building be well advised to limit a potential buyer's purchase and sale contract remedies to liquidated damages and specifically to bar specific performance?

Question 5: ***The Case for Liquidated Damages.***

(a) What are the advantages of liquidated damages to a breaching homebuyer over potential liability to the seller for specific performance or actual damages?

(b) Why are home sellers not usually better off reserving the right to actual damages from breaching buyers?

Question 6: ***The Interplay of Specific Performance and Liquidated Damages.***

O enters a non-binding letter of intent to sell three office buildings to P, as a portfolio sale of all three of O's buildings. For each of the three properties, O and P sign separate purchase and sale agreements. None of the agreements mentions that the three properties are being sold together. Each of the three purchase and sale agreements gives the buyer the right to specific performance. Each contract also liquidates any damage claims either party may have against the other to the amount of P's down payments—$250,000 per property.

Two of the buildings appreciate in value and are easy to purchase because the buyer can assume the seller's existing and highly favorable financing. The third building must be financed anew. Since the time when the purchase and sale contract was first entered, financing office building acquisitions has become far more costly and challenging. Also, the third building has lost its main tenant, and this loss has greatly reduced the building's value.

The purchase price of the two “good” buildings was $12,000,000 and $23,000,000. Each of those buildings is now worth a million dollars more ($13,000,000 and $24,000,000) due partly to the favorable financing and partly to some new tenancies. The contract price of the third building was $17,000,000. Presently, it would sell for $14,000,000 to an all cash buyer or $15,000,000 if the buyer could find a loan of no less than $12,000,000 at 7% for ten years.

P is about to close escrow with O on the first two buildings. P's contract with O for the third building has a financing contingency that won't expire until several weeks after the scheduled closings on the two buildings. O wants P to waive the financing contingency on the third building as a condition to closing on the first two. O contends that P was obligated to buy all three buildings or none of them. P wants to close on the two, and walk away from the third by invoking the financing contingency.

(a) If the court finds that P has the right to acquire two of the buildings without buying the third since the parties entered three separate agreements, is P better off seeking specific performance or liquidated damages for the first two?

(b) If you had drafted the purchase and sale agreement for P, would you have limited P's damages for O's breach to $250,000 for each property?

(c) If P convinces a trial court judge that O has repudiated the third contract, should P be entitled to $250,000 in liquidated damages? After all, O's breach will have saved P from a huge loss.

(d) If you had drafted the purchase and sale agreement for O, what provision would you have made—in hindsight—regarding specific performance and damages in each of the three separate contracts?

AN INTRODUCTION TO MORTGAGE LENDING

Chapter 12 of the textbook is about permanent residential and commercial mortgage lending.

This supplement introduces three other types of loans: construction, acquisition and development, and bridge lending. After defining these terms, we include a detailed "how they do it" explanation of what land developers do and how land development is financed.

The concluding section in this supplement features an introduction to mortgage loan commitments, concluding with borrower-initiated litigation when real estate mortgage lenders balk at funding their loan commitments.

I. Underwriting Home Mortgage Loans

Through underwriting, the introductory topic in chapter 12, lenders assess the ability and willingness of the borrower to repay the loan.

(Anyone curious to check out the sorts of data that underwriters compile in processing home mortgage loan applications to come up with a Debt to Income ratio for each borrower, see APPENDIX A following the REVISED QUESTIONS.)

The most widely used loan documents in residential mortgage lending come from the dominant issuers of residential mortgage backed securities. They are Freddie Mac (The Federal Home Loan Mortgage Corporation—FHLMC) and Fannie Mae (The Federal National Mortgage Association-FNMA) (aka GSEs—"government sponsored enterprises" or "Enterprises").

Fannie Mae and Freddie Mac buy mortgages from lenders and either hold these mortgages in their portfolios or package the loans into mortgage-backed securities (MBS) that may be sold.

Lenders use the cash raised by selling mortgages to the Enterprises to engage in further lending. The Enterprises' purchases help [to] ensure that individuals and families that buy homes and investors who purchase apartment buildings and other multifamily dwellings have a continuous, stable supply of mortgage money.[1]

By packaging the purchased mortgages into MBS and guaranteeing the timely payment of principal and interest on the underlying mortgages, Fannie Mae and Freddie Mac attract to the secondary mortgage market investors who might not otherwise invest in mortgages, thereby expanding the pool of funds available for housing. That makes the secondary mortgage market more liquid and helps lower the interest rates paid by homeowners and other mortgage borrowers.

Even those lenders who expect to retain in their own portfolios the loans they originate cautiously preserve the option of selling some of the loans at a later date by using FNMA and FHLMC mortgage forms and conforming to FNMA and FHLMC underwriting guidelines for at least some of their loans.[2]

II. Construction Loans

Some would-be home owners buy land on which they plan to construct homes for themselves. The following article describes how they would go about obtaining a construction loan, comparing construction to conventional residential mortgage loans. The basics of construction loan financing are pretty much the same for an owner-initiated single family residence as it is for a 200-unit apartment house or a high-rise office building.

Construction Loans[3]

Unless you are paying cash for your project, you will need a construction loan to pay for the materials and labor, and you can use it to buy the land as well. Construction loans are a bit more complicated than conventional mortgage loans because you are borrowing money for a

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1 *Fannie Mae and Freddie Mac, About Fannie Mae & Freddie Mac*, FEDERAL HOUSING FINANCE AGENCY, https://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/About-Fannie-Mae---Freddie-Mac.aspx (last visited July 5, 2017).

2 See, e.g., *Mortgage Products, Type*, FEDDIEMAC SINGLE FAMILY BUSINESS, http://www.freddiemac.com/singlefamily/mortgages/ (last visited July 5, 2017) (listing various guidelines for underwriting a mortgage loan); *Originating & Underwriting*, FANNIE MAE, https://www.fanniemae.com/singlefamily/originating-underwriting (last visited July 5, 2017) (same); *FHA Loan Requirements: Important FHA Guidelines for Borrowers*, FHA.COM, https://www.fha.com/fha_loan_requirements (last visited July 5, 2017) (same). The GSEs also have $4.6 trillion of mortgage-backed securities outstanding, which is close to 25% of the nation's gross domestic product. *See* Ben Lane, *Moody's: Privatizing Fannie Mae, Freddie Mac Would Cost "Hundreds of Billions"*, HOUSINGWIRE (Dec. 8, 2016), https://www.housingwire.com/articles/38715-moodys-privatizing-fannie-mae-freddie-mac-would-cost-hundreds-of-billions.

3 *Construction Loans*, BUILDINGADVISOR.COM, http://buildingadvisor.com/project-management/finance/construction-loans/ (last visited July 5, 2017).

short term for a building that doesn't yet exist. They are essentially a line of credit, like a credit card, but with the bank controlling when money is borrowed and released to the contractor.

Both you and your contractor must be approved for the loan. The bank wants to know that you can afford the loan with enough cash left over to complete the house, and that the contractor has the financial strength and skills to get the house built on time and on budget.

If you are converting the construction loan to a mortgage when the building is completed, the bank also wants to know that the finished building plus land will have a high enough appraised value to support the mortgage. Because the lender needs to know the story behind the project, and believe that you can make it happen, construction loans are sometimes referred to as "story loans."

There are many variations on these types of loans from lender to lender, and they change frequently, so you should talk to a few different lenders to see what plan is best for you.

Construction loans are harder to find than conventional mortgages. Start with your local bank where you already have a relationship. Also, speak with other local banks including community banks, credit unions, and cooperative banks that are more likely to make these types of loans.

Owner-builders face additional obstacles since you will need to convince the bank that you have the necessary knowledge and skills to get the job done on time and on budget.

Two Types of Construction Loans

The two basic types of construction loans used by homeowners are one-time-close loans, and two-time-close loans. In all construction loans, money is disbursed by the lender based on a pre-established draw schedule,[4] so much money upon completion of the foundation, so much upon completion of the rough frame, and so on. The goal is to only pay for what has been completed, minus retainage, typically 10% of the cost of the project, which is held back until everything is completed properly and the owner is issued a certificate of occupancy (CO).

During the construction phase, payments are interest-only and start out small as you only pay on funds that have been disbursed. When construction is complete, you pay a large balloon payment for the full amount owed. On some loans, no payments are due until the house is completed. Fees on construction loans are typically higher than on mortgages because the risks are greater and banks need to do more work managing the disbursement of funds as work progresses. The faster the work is completed, the less you will pay in interest.

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[4] "A draw schedule is a detailed payment plan for a construction project. If a bank is financing the project, the draw schedule determines when the bank will disburse funds to you and the contractor." *Draw Schedules*, BUILDINGADVISOR.COM, http://buildingadvisor.com/project-management/finance/draw-schedules/ (last visited July 18, 2017).

One-Time-Close Construction Loans

These are the most popular type of construction loan for consumers, but are now difficult to find in some areas. Also called "all-in-one loans" or "construction-to-permanent loans", these wrap the construction loan and the mortgage on the completed project into a single loan. These loans are best when you have a clear handle on the design, costs, and schedule as the terms are not easy to modify.

The loan has one approval process, and one closing, simplifying the process and reducing the closing costs. Within this basic structure, there are several variations. Many charge a higher rate for the construction loan than the permanent financing. Typically, the borrower can choose from the portfolio of mortgages offered by the lender such as 30-year-fixed, or various ARM's (adjustable rate mortgages). Some banks will let you lock in a fixed rate with a "float-down" option allowing you to get a lower rate if rates have fallen, for a fee of course. There may be penalties if the construction phase of the loan exceeds 12 months.

Paying a slightly higher rate on the construction phase of the loan is usually not significant, since the loan is short-term. For example, paying an extra 0.5 percent on a $200,000 construction loan over six months, would only add no more than $250 to your borrowing costs.

Construction loans are typically interest-only and you will pay only on the money that has been disbursed. So, your loan payments grow as progress is made and more money is released. When the home is completed, the total amount borrowed during the construction loan automatically converts to a permanent mortgage. If you locked in a fixed mortgage rate at closing, but rates have since fallen, you can lower your mortgage rate by paying a fee—if your loan has a float-down option, a feature you will probably want on a fixed rate loan. If you had chosen a variable rate, pegged to the prime or another benchmark, then you will have to pay the current rate at the time the mortgage converts.

If interest rates are stable or rising, locking in the rate at closing makes sense. If rates are falling, a floating rate would be better—at least in the short run. If you have no idea which way rates are headed, a locked rate with a float-down provision may be your best bet.

Pros of one-time-close construction loans:

- You pay just one set of closing costs.
- You are approved at the same time for both construction and permanent financing.
- Multiple options for permanent financing give you flexibility.

Cons of one-time-close construction loans:

- If you spend more than the construction mortgage, you may need to take out a second loan, and pay additional closing costs.
- Permanent rates may be a little higher than with a two-time-close loan.

Two-Time-Close Construction Loans

A two-time-close loan is actually two separate loans—a short-term loan for the construction phase, and then a separate permanent mortgage loan on the completed project. Essentially, you are refinancing when the building is complete and need to get approved and pay closing costs all over again. During the construction phase, you will pay only interest on the money that has been paid out, so your payments will be small, but increase as more money is disbursed. There may be a maximum duration for the loan, such as 12-month, after which penalties kick in.

The bank will typically add a 5-10% contingency amount for cost overruns, an all-too-common occurrence on home construction projects. In any event, it's best to qualify for the highest amount possible. Think of it as a line of credit that is nice to have in place in case you need it.

Because of two loan settlements, closing costs will be greater for this type of loan. However, you may get a better rate on the permanent mortgage as you will be working with mortgage refinance rates, which are typically more competitive than the rates offered in one-time-close loans. While it is easiest to stick with the same lender for the permanent financing, in most cases you will be free to shop around to make sure you are getting the best rate and terms. Also, you will not be locked into a fixed loan amount, and will be able to borrow more if you have added upgrades to the project and increased its value (assuming you qualify for the larger loan).

Pros of a two-time-close loan

- Greater flexibility to modify the plans and increase loan amount during project.
- Mortgage rates are often lower than in one-time-close loans.
- You are usually free to shop around for permanent financing.

Cons of a two-time-close loan

- You need to be approved twice and pay closing costs twice.
- You face risks if your financial circumstances change when you apply for permanent financing.
- If you don't get approved for permanent financing, you could face foreclosure.

Construction Loan Details

Construction loans are essentially a short-term line of credit extended to you to get your house built. If you don't use all the money, you only pay interest for the money borrowed. If you'll be taking out a construction loan, your total loan expense needs to cover both hard and soft costs. A typical breakdown is shown below:

Typical Construction Loan Breakdown	
Land cost	$100,000

Hard Construction Costs	$250,000
Soft Costs: Plans, permits, fees	$20,000
Closing Costs: Loan fees, title, escrow, inspections, appraisal, etc.	$4,500
Contingency Reserve (5% of hard costs)	$12,500
Interest Reserve	$8,000
Total Project Cost	$395,000
Appraised Value (completed project)	$475,000
Down payment	$55,000
Loan Amount	$340,000

Owner's equity. With construction loans, banks want the borrower to have some "skin in the game" in the form of owner's equity. If you are borrowing on the land as well as the construction, you will need to make a substantial down payment of 20% to 25% of the completed value of the land and building. The land is typically assumed to account for 25% to 33% of the value of the completed project. If you already own the land, you will have an easier time getting a construction loan. The land will count as equity in the project, and you may be able to borrow up to 100% of the construction cost.

Land and Construction Loans. These are harder to obtain than construction-only loans, especially for vacant land vs. a developed lot in a subdivision. Construction loans are also complicated if you are buying the land from one person and contracting with another to build the house. Unless you have detailed plans and a contractor ready to go, you will need time to finalize your plans and line up a builder.

To protect yourself, it's best to make any offer to buy land contingent on getting your construction financing approved. Also, build enough time into your offer to apply for a construction loan and get approved. The more planning you do ahead of time, the better.

Some land and construction loans allow you to wait months or years before building. In the meantime, you will make monthly principal-plus-interest payments on the land portion of the loan. Check with your loan office to see what options are available.

Contingency provision. Since many projects exceed the loan amount, loans often have a built-in contingency of 5% to 10% over the estimated cost. To access this money, you may need documentation in the form of a change order, describing the additional work or more expensive materials chosen and the resulting upcharge. Some banks, however, will not pay for changes with or without a change order.

Interest Reserve. Another peculiarity of construction loans is that most people make no payments at all during the construction phase. Assuming that you don't have extra cash in your pocket during construction, most loans include an "interest reserve," which is money lent to you to make the interest payments. The money is stored in an escrow account and paid back to the bank as interest. The interest is considered part of the cost of construction by your contractor, or by you as an owner-builder. The benefit is that you don't have to come up with additional cash during the construction phase. The downside is that you are borrowing additional money.

Draw Schedule. In general, the lender does not want to disburse more money than the value of the completed work. Nor do you, if you are hiring a general contractor. If the contractor has completed $50,000 worth of work and has been paid $75,000, neither you or the bank are likely to recoup the difference if the builder leaves town, goes bankrupt, or does not complete the job for whatever reason. For that reason, you and the bank will need to establish a draw schedule based on the value of each phase of the work, called a schedule of values.

If the loan is paying for both the land and construction, then the first draw will be to pay off the land and closing costs. It may also cover costs such as house design, permitting, site development.

If you are not borrowing money, you will still need to establish a draw schedule with your contractor so that you don't get ahead of the work completed. It's not your job to play banker and provide your contractor with working capital or extra spending money. However, it's reasonable for the contractor to ask for money to cover the deposit on special-order items. If you are putting up a lot of money, it's best to put the material orders in your name. If anything goes wrong along the way, at least you'll own the 20 high-end windows you've paid for.

Insurance. Your construction loan will also require that you or your contractor carry General Liability Insurance, covering any harm to people (non-workers) or property caused during the construction process, and Builders Risk insurance, which covers damage to the unfinished building.

The loan—and the law—will also require that your contractor carry Worker's Comp Insurance if he has any employees. If the contractor does not carry the proper insurance, then you, the owner, can be sued by an injured employee or neighbor whose child is hurt while playing in the unfinished home. You should also ask the contractor to list you and your family as "additional insured" on his liability policy.

Typically, the homeowner buys the Builder's Risk policy, which may convert to homeowner's insurance when the building is complete. In a renovation, your homeowner's policy may already include this coverage, or it can be added as a rider.

If your builder does not carry liability insurance, you will need to purchase this on your own before closing on a loan. Don't hesitate to ask the contractor why he does not carry full insurance, and reconsider whether this is the person you want to build or remodel your home. You may find it easier to get a loan (and sleep at night) with a fully insured contractor. Talk to your insurance agent about your potential liability and how to protect yourself before getting too far along.

Finding the Right Lender

Most construction loans are issue by banks, not mortgage companies, as the loans are typically held by the bank until the building is complete. Since construction loans are more complicated and variable than mortgages, you will want to work with a lender experienced in these loans. And given that not all banks offer all types of construction loans, you should talk to at least a few different banks to see what is available in your community.

You can learn a lot by listening to the lenders' policies on draw schedules, inspection and payment procedures, and qualification rules, which will vary from bank to bank. Also, banks can be a big help in creating a realistic budget for your project—the biggest challenge for most homeowners (as well as many contractors). Following the bank's budgeting format can help you with cost control and can also help you obtain a loan from that bank.

Some banks use loan officers employed by the bank, while others work primarily with independent loan officers. In either case, you want a loan officer experienced in construction loans and one who will walk you through the process and protect your best interests.

In most cases, the loan officers get paid on commission when they release funds. So, there is a potential conflict of interest if the loan officer wants to release funds at the end of project and you want the funds withheld until problems are corrected. Even though payments are generally based on physical inspections of the work done, the inspectors are simply looking to see if the work has been completed, not at its quality.

Also, different lenders have different policies around construction loans. For example, if you have a mortgage on your current home that you are selling, some lenders will not count that against your borrowing limits. Otherwise you may need to sell your first house before you can obtain a construction mortgage to build your new home.

Different lenders will also offer different rates. Naturally you will also want the best rates and terms available. If the bank you have dealt with for many years is a little higher than a bank you have less confidence in, tell your local bank you'd like to work with them—but can they do a little better on the rate to match their competitor. Since all banks borrow their money at the same rate, they can all lend at the same rate.

Getting Pre-Approved or Pre-Qualified

Before getting too far ahead with your plans to buy land and build, or to undertake a major remodeling project, it makes sense to find out how much you can borrow. Conversely, once you know your borrowing limits, you can tailor your design to your budget realities. You can meet with a loan officer to just gather information, or to get pre-approved if you plan to start the project soon. Pre-approvals typically last for 30 to 90 days, depending on the lender.

Pre-Approval requires a full loan application and is generally valid as long as the property appraises properly and you haven't lost your job before the loan closes. A quicker process is called *pre-qualification*. This is generally free and quick (1-3 days) and relies primarily on unconfirmed information you provide about your finances. Although it is not a guarantee that you will be approved, pre-qualification can help you come up with a realistic budget for your project.

Otherwise, you can waste a lot of time and money designing your dream project, only to find that it is not even in the ball park of what you can afford. And once you are in the ballpark, you will still need to make a number of trade-offs during the design process to keep within the budget (9-ft. ceilings vs. better windows, jetted tub vs. tile floor; etc.). Knowing what you can afford will help you make better decisions. You may decide that you want to add inexpensive unfinished space now, such as attic or basement, that you can finish later when you're a little more flush.

The specific requirements to obtain a loan change from time to time and vary among lenders. But all lenders look at the same three factors: your credit score (FICO), your income-to-debt ratio, and how much equity you will be putting into the project. The higher your credit score and down payment the better your chances are for approval. If you already own the land, you are in pretty good shape given the high cost of land these days relative to construction costs.

Income-to-Debt Ratio. The income-to-debt ratio limits how much of your monthly income you can use to pay off debts. Banks look at two numbers: the "front ratio" is the percentage of your monthly gross income (pre-tax) used to pay your monthly debts. The "back ratio" is the same thing but includes your consumer debt. This is expressed as 33/38, typical bank requirements for the front and back ratios. FHA accepts up to 29/41 for front and back ratios, while the VA accepts a 41 back ratio, but has no guideline for the front ratio.

Equity. Except in the bad old days of the nothing-down, "no-doc" mortgages that helped spawn the financial collapse of 2008, lenders want the borrower to have some "skin in the game." The more money you have in a project, the less likely you are to default or not complete the project. On construction loans, most lenders today will only loan you 75% of the appraised value of the home, based on the plans and specs. This is called the "Subject to Completion Appraisal," done by the bank. If you already own the land, you will probably have no problem with this equity contribution, since land costs have risen much faster than construction costs in most areas and usually account for a large share of the total project cost.

Applying for a Construction Loan

If you've been pre-approved, the building appraises within the lending limits, and you show up with full documentation and a reputable contractor, you should have no problem obtaining the loan. If you are an owner-builder, you will have the additional task of convincing the lender that you can get the project completed on time and on budget. The more cost documentation you bring the better since cost overruns (or underestimates) are the number-one problem with inexperienced builders. Hiring a construction manager may help you put together a credible package and secure the loan

To apply for a loan, you'll need the following, in addition to the standard financial information required for any bank loan:

- Building lot details: a deed or offer to purchase, documentation of protective covenants and other deed restrictions
- A clear description of responsibilities of the architect (if any), and the general contractor, construction manager, or yourself if you are an owner-builder.
- The builder's resume, insurance certificates, and credit and banking references
- Complete set of blueprints and specifications
- Material's list in the bank's format
- Line-item budget (schedule of values) in the bank's format
- A draw schedule (payment schedule) consistent with the lender's disbursement procedures.
- A signed construction contract, including start and completion dates, and provisions for change orders

Financing for Owner-Builders

It is often difficult for owner builders to get construction loans. Since you are being loaned money for something that does not yet exist, you need to convince the bank that can get the job done on time and on budget. They key to this is approaching the bank the same way a contractor would—with professional plans and specs, a detailed estimate, and a proposed construction schedule. You may consider hiring a construction manager, estimator, or other building consultant to help put your package together.

An accurate estimate is essential, since the bank will assign an appraiser to determine the value of your project. If it looks like your estimate is overly optimistic and the bank does not think you can really get the project built for the loan amount, you will either need to borrow more (if you qualify), add more cash to the deal, or scale back elements of the design.

Many building projects come in over budget, and it's the rare job that comes in under. An owner-builder's (or inexperienced contractor's) lack of experience can often lead to important items being overlooked in the estimate. Or the project may incur extra costs through design or construction errors, inefficiency, hidden problems, or changes to the plans or specs during the project.

A bank wants protection against these uncertainties, so they may want more of your cash in the project as well as evidence that you are well-organized and have done thorough planning in the plans, specs, and budgets. Of course, you don't want to be surprised any more than the bank does, so make sure you do your homework. Have the house completely designed, built, and paid for on paper before you start borrowing and digging.

III. Financing Land Development

A. The Three Phases of Development Financing: Acquisition and Development, Construction, And Permanent

Investors and lenders willing to put money into development ventures tend to specialize based on the three phases of development. Each of these presents a different level of risk for the suppliers of capital and calls for different kinds of information to underwrite loans.

(1) Acquisition and development financing (A&D) is for site acquisition, the preparation of engineering and design plans, local government approvals and site work (grading, utilities and roads). This type of financing is sometimes called a land development loan. In this stage of development, raw or vacant land is transformed into finished lots–parcels fully readied for construction.

(2) Construction loans pay the costs of building the project. Construction lenders put a floor on their exposure to loss by only lending on the security of finished lots. In the worst case, at least the foreclosing lender will have buildable parcels to sell. Sometimes, the land developer contracts with other firms to build some or all of the projects on the site. A land developer's sale agreement might apportion between itself and the homebuilder the burdens of constructing roads and other infrastructure. Typically, the developer builds the main connector roads, and the builder constructs the roads within its subdivision. Lenders financing homebuilders tend to divide their loans into separate A&D and construction phases. Generally, for commercial projects (shopping centers, office buildings, warehouses, industrial buildings), often the same developer buys the land, secures the entitlements and contracts for construction. In these situations, a single lender makes a combined acquisition, development and construction loan–an ADC loan.

(3) The permanent loan provides the home buyer's or developer's long-term mortgage financing. Funds from the permanent loan repay ('take-out') the construction loan; hence, the term take-out financing. Until the construction lender is paid in full and releases its lien of record, the permanent lender won't be entitled to a first lien on the project. So, the permanent lender makes the construction lender's repayment and lien release a condition precedent to funding its take-out loan commitment.

B. Land Development

1. The Developer

Every successful real estate development project requires: (1) land, (2) construction labor and building materials, (3) capital (usually consisting of some combination of debt and equity financing), (4) end users—buyers or tenants, and (5) a real estate developer, an entrepreneur who blends these separate elements into a completed project.

The seeds of development grow in the fertile imagination of developers, perpetual optimists convinced their efforts can improve the landscape, whether the developer happens to be a physician who purchased a vacant lot for the construction of her dream house, a determined entrepreneur putting up a sparkling downtown entertainment center, or a blue-chip U.S. based building contractor creating high quality office space in prime Central European locations.

Real estate developers "are not necessarily architects or contractors, engineers or financiers, but their skill lies in bringing these specialties together to satisfy the demands of those who need space to carry on their businesses. They do not draw up blueprints or erect steel or pour concrete, but they cause these things to happen." No matter how diverse, all successful developers possess an intangible called 'vision,' what one author described as a "peculiar entrepreneurial solipsism . . . at the root of capitalism's greatest achievements, and greatest disasters."

States impose no licensing, certification or educational requirements upon developers. A handful of university graduate programs award degrees in real estate development. But most of today's developers come from trades (plumbers, electricians and carpenters) or professions (architects, accountants, engineers and lawyers).

2. The Tasks Required of Land Developers

Developers find sites for new construction in all kinds of places. Infill projects are those constructed within already built-up cores of inner cities or the inner suburbs that developed along the linear routes of street car lines in the late 19th and early 20th centuries. Brownfield projects are those that arise, typically, on sites formerly occupied by failed industries or shuttered military bases. Greenfield development usually refers to projects built in the outer suburbs on land previously used for agriculture or recreation. Many of these projects were built after World War II. Outer suburbs now house a majority of Americans.

Ask a seasoned developer to differentiate among these three settings for development and you will probably hear that, by definition, greenfield sites usually consist of raw land, land not ready for immediate development. It lacks roads and utilities, and its owners have yet to be awarded the right to build under the terms of local land use controls. Greenfield sites require massive investments in new roads, schools, utilities, shopping centers and other urban infrastructure and amenities.

Brownfield sites often require expensive remedial work to clean up polluted soils and water courses before being put to productive re-use.

Infill sites are usually served by a full panoply of urban improvements in already well functioning real estate markets. But infill projects challenge developers in other ways—higher land prices, inadequate public infrastructure from overburdened roads to troubled schools, and political obstacles to new development raised by the numerous stake holders surrounding infill sites who join together to protest. Developers often seek regulatory approval from local governments to build at higher than prevailing densities to compensate for the escalated land prices they have had to pay, sometimes provoking a political 'pushback' from residents determined to defend their neighborhoods against proposed projects they deem intrusive.

Though much of what follows in this chapter would apply equally well to infill, brownfield or greenfield projects, the next few pages were written mainly with greenfield development in mind.

A land developer shapes raw land, or previously developed but derelict or underutilized sites, into a useful product much like a manufacturer might mold plastic or carve wood into furniture. Developers (1) locate and 'tie up' suitable sites; (2) determine the soil conditions, land form and character of the site; (3) come up with a concept for the use of the site and refine it into a feasible program for development; (4) design a site plan showing the configuration of lots, location of roads, utilities and structures; (5) obtain all the necessary approvals from governments entitling the developer to proceed with the project; (6) construct the improvements; and (7) use, sell or lease the finished product.

In tackling the first of the five tasks listed above, finding suitable land, developers contact real estate brokers specializing in raw land sales, local government planning officials for the sites they regard as ripe for development, banks holding mortgages on failed subdivisions, and family and personal friends with real estate connections.

Before committing to purchase a site, the developer studies government land use regulations, site physical characteristics such as natural amenities (views, water frontage), dimensions, size, soil conditions and slope, water and utility availability, wastewater disposal options, important off-site conditions impacting development approval such as neighboring land uses. They meet with public relations consultants, area residents, and local city planners capable of assessing the political feasibility of the proposed project and determine the adequacy of support services—transportation networks, fire and police, hospitals, schools, employment and shopping facilities. Along the way, they assess the interest of potential tenants or buyers, and discuss funding with interested lenders and equity investors.

The Finished Lot. A finished lot is a saleable parcel in full compliance with all applicable land use controls and subdivision laws. It has roads, a reliable water supply, a safe system for sewage disposal and access to utilities. A finished lot is one for which the owner could obtain a building permit by simply preparing and submitting detailed construction plans and specifications drafted to comply with the local building code.

Land developers sell finished lots, either retail to individual consumers or wholesale to homebuilding firms or commercial developers. Homebuilders tend to avoid purchasing raw, unentitled land—especially homebuilding companies that are publicly traded on the national stock exchanges. Publicly traded home building firms purchase finished lots from land developers and subdividers because their shareholders grow impatient waiting for investments that take years to ripen, and the transformation of raw land into finished lots can take a long time in some jurisdictions with the requisite approvals by no means guaranteed.

By contrast, some privately funded real estate developers purchase raw land expecting eventually to sell it to builders, hoping to profit by first obtaining the requisite local government approvals entitling the land's full development. Such firms can earn far more money from obtaining the requisite government approvals for new development, a process called 'entitling' raw land, than from building it out with new projects—but only when there is vibrant demand for new development. In times of slack demand for real estate projects, land speculators face years of steady cash flow losses as they pay property taxes and other holding costs while waiting for better times ahead. In deep housing market downturns, raw land can have negative value in the near term. This occurs, for instance, when the actual construction cost of building new homes exceeds what buyers will pay for those houses.

A second factor strongly determines the profitability of the business of acquiring unentitled land, entitling it and then selling to builders. Profits tend to be greatest where local politicians and planners take their sweet time making land use decisions, impose hefty development fees, and favor 'insiders' processing land use applications. Conversely, in cities that put out a big welcome mat for new development and grant entitlements readily, competition tends to drive down the profit margins that can be earned from entitling raw land.

3. How Developers Determine What They Can Afford to Pay for Land

How do developers decide what they can afford to pay for land? The process is relatively simple for a cost-conscious homeowner in quest of her dream house. She starts by scrutinizing the market of potentially acceptable houses for sale and compares their prices to construction cost estimates for the home she would prefer to construct. She could add a premium for a house built to her special needs, offset by a sum sufficient to account for the risks, delays and worries of construction. The difference between the price she would pay for an existing house and the cost of building a new one is what she can sensibly pay for a vacant lot. Whether she knows it or not, a homeowner who figures out this way what she can afford to pay for land is utilizing a variant of what real estate appraisers call the land residual method of appraisal, described in chapter 27.

For professional developers, the process of estimating how much to pay for land is a bit more complicated. Starting with an assumption about the ultimate sales price that their finished product would bring, they work backwards, subtracting development costs to come up with the residual value of the site. For instance, suppose an apartment developer narrows his land search for a 100-unit apartment project to two sites, A and B. At either site, construction costs would be the same since labor and materials are fairly mobile, $100,000 per unit, or $10,000,000.

Figuring tenants would pay more for a comparable apartment at site B, she could sell the project upon completion at the B site for $18,000,000 and at the A site for $15,000,000. Suppose the developer wouldn't undertake the venture for less than $2,000,000 to cover profit and overhead costs. Adding her profit and overhead fee to the cost of construction, the project cost is $12,000,000 at either site. Since the developer believes that site A would sell for $3,000,000 less than site B, she could pay up to $6,000,000 for site B and $3,000,000 for site A.

This doesn't mean site B is necessarily worth more than site A for any use other than apartments. Maybe site A's value for apartments is lessened because it abuts a noisy, heavily trafficked thoroughfare, more suitable for retail than housing. In analyzing potential sites, developers try to assess the most profitable use of the land—what appraisers call the "highest and best use," gauging demand from demographic trends, the economic base and competing projects.

Estimating Costs. The developer of a finished lot incurs five types of costs: (1) the price of the raw land; (2) indirect soft costs for acquisition and development financing, attorney's fees, and office overhead; (3)fees imposed by local governments, school districts and other public agencies, levied as conditions to the issuance of development or subdivision approvals; (4) infrastructure—the cost of roads, sewer lines, water service and grading necessary to make the site buildable; and (5)marketing costs including real estate brokerage commissions.

Estimating Revenues. Developers feed the information from their location analyses into an estimate of projected revenues based on the product. For a land developer or subdivider, crucial factors include the total number of lots into which the local government will allow the site to be subdivided and the anticipated selling price per lot. The timing of lot sales, as measured by the 'absorption rate,' is another important factor in estimating revenues. The absorption rate reflects the number of lots that are sold in a given market over a specified time. All else being equal, the higher the absorption rate, the greater the present value of the project.

A tract homebuilder usually considers more than one possible site plan configuration—and takes into account zoning and environmental constraints. Often, they compare plans with fewer units at higher prices against plans with a greater number of more affordable lots or units. The developer also weighs the relative costs of each configuration against estimated revenues, including the timing of expenditures and revenues. A developer may choose to build affordable units with a lower profit margin but higher absorption rate, over more expensive units with a high profit margin but a slower rate of sale.

Developers can obtain control of development sites by various means. They can lease the land from the owner, persuade the owner to contribute the land to the enterprise by becoming a joint venturer, and enter a purchase and sale agreement or option the land.

4. An Overview: A Homebuilders' Analysis on Acquiring and Financing Development Land

Here is a comprehensive and clear analysis of the land development process prepared as a guide for anyone considering becoming a land developer.

Land Acquisition and Development Finance[5]
By Rich Guerard

Tying Up Land

Once you've identified a parcel of land and completed the preliminary investigation, you'll need to tie up the land until you are ready to acquire it. Tying up the land allows you to gain control of the property with minimal risk while you complete a formal due diligence. The method of tying up land prior to the actual purchase depends on the seller's requirements coupled with the developer's ability to pay. Often the seller wants cash. In other situations, the seller may prefer payments over time for tax planning purposes or to allow participation in the future profits of the developer.

There are many options that you can use to tie up land. The three most common methods are:

- Letters of intent
- Option agreements
- Purchase contracts.

Letters of Intent. A letter of intent is a document used to describe your interest in a parcel of property and the terms and conditions under which you will purchase it from a seller. While typically not a binding contract, it can be used as an outline or framework from which a more binding contract could be drafted. At a minimum, it usually contains a clause allowing price to be determined by mutual agreement in the future, a timeline for you to perform due diligence on the property, an acknowledgment that it is the seller's intent to sell the property to you and the seller's agreement not to market the property in the interim.

Option Agreements. An option agreement is a contract between you and the seller that allows you to have the right to purchase the property once certain contingencies have been met. As a buyer, an option contract gives you a secure agreement, subject to events or timing that neither seller nor you can control or predict. This is why it is imperative that the agreement specifies the conditions of the sale very clearly. In general, you purchase the option rights at a price, much like making a nonrefundable down payment on the property that may be deducted from the purchase price if you opt to complete the purchase.

Some examples of options that are widely used include:

The Straight Option. Using a straight option, you have the opportunity within a specified period of time to purchase a given piece of land for a certain price. For the privilege, you pay the seller a certain amount of money. If you ultimately proceed with the purchase, this money can be deducted from the purchase price at settlement. If instead you do not close on the property, then the seller keeps the option amount. The straight option is the most common form used by sellers and purchasers of property.

[5] Rich Guerard, *Land Acquisition and Development Finance Part 3*, PROFESSIONAL BUILDER (Oct. 1, 2005), https://www.probuilder.com/land-acquisition-and-development-finance-part-3.

The Letter of Credit Option. Using this type of agreement, a letter of credit is issued from your bank to the seller in the amount of the option price. There is a charge for the letter of credit and the bank typically requires some type of security. If the option is exercised, in other words, if the purchase has proceeded to closing, the letter of credit is voided. If the option is not exercised, in other words the contemplated purchase does not close, then the seller collects the value of the letter of credit from your bank. This form of option eliminates money up front, however the additional required paperwork involving your lender makes it more complex.

The Interest Option. In this form of option agreement, you agree to pay the seller the amount of interest that he or she would have earned on the purchase price or appraised value of the parcel during the period of due diligence. If you do not exercise the option to purchase the property, then at least the seller has received compensation while the property was unavailable for sale. This form of option is more commonly used when the seller is only willingly to tie up their property if the buyer is willing to pay the true "loss of use" cost between the time of sale and time of closing.

The Rolling Option. The rolling option is used when you and the seller divide a larger parcel into smaller parcels and the selling price for each is predetermined from the onset of the option agreement. When you take the option on the entire parcel, you both agree to treat each smaller parcel as an individual contract within a larger contract. A predetermined event typically triggers closing on each smaller parcel. Developers use this option to gain control of a large piece of property as it is needed for development. This is ideal for the small developer who discovers the "perfect" parcel for a project, but it is too large for the immediate development plans.

The Purchase and Sale Contract

A purchase and sale contract is a document that outlines the terms and condition under which you will purchase and a landowner will sell their property. It becomes the roadmap to the planned closing on a parcel of property. If drafted properly, it will also allow you some "outs" should the property fail to meet all of the requirements during the due diligence process. Only experienced developers should consider drafting the purchase and sale contract language. Competent legal advice prior to executing this contract is also advisable. Besides the obvious items of purchase price and closing date, several important issues should be addressed in any purchase contract, including the following:

Contingencies. The contract should specify any terms and conditions, called contingencies, set forth by you and/or seller that must be met prior to purchase. In a contract with contingencies, parties are not bound to the purchase until the specified terms and conditions set forth by you and/or the seller are met. Establish reasonable contingencies to protect yourself in the event that the property is unable to support planned development activities. Contingencies help you avoid entering into a purchase and sale contract to then learn that the property is unsuitable for your intended use.

The following terms are often contingencies within most purchase and sale contracts:

- A brief explanation of your development plan to include a condition that the purchase is only possible if the site is economically feasible.
- An adequate timeframe set by you to obtain the necessary approvals, to determine the project's feasibility, and to complete the appeals period or any subsequent litigation.
- A statement that you will be the sole determiner of the feasibility of the development project on the property specified for purchase.

Timeframes. It is imperative that a purchase and sale contract provide ample time for you to perform reasonable due diligence on the property and to seek necessary approvals in order to develop the property. This timeframe varies by region and municipality. It may be necessary to include reasonable extension times in the contract to anticipate unforeseen delays during the due diligence period.

Right to Cure. The contract should include an automatic extension, or right to cure, on the feasibility period for approvals that are pending when the agreement expires. Similar to timeframe extensions pertaining to the activities during the due diligence period, this right ensures that you will not have to close or lose out on the property if your contingencies have not been satisfied due to lagging third party activities for which you have little or no control. Some developers attempt to negotiate extensions for the "free-look" period by offering to hand over all due diligence materials obtained, if the deal does not go through.

Assignment. A statement should be included in the contract which allows you to assign the ability to close on the purchase of the property to another individual or entity without amending the original terms and conditions of the contract.

Due Diligence

In the formal due diligence phase, you complete a more thorough investigation of the parcel. It builds on information gained during your preliminary investigation to clarify and address any issues or concerns that should be clarified and addressed. Your objective is to clearly define any land development issues and determine whether to proceed with the purchase of the land and construction of the development. If you have tied up the land in a formal agreement, it would likely have a provision for a period of formal due diligence in which you are allowed to perform these investigative activities. If the parcel gains a positive evaluation, then you would complete the land purchase transaction. However, if the due diligence raises costly land development issues, then the contract should allow you to walk away from the deal with no fines or penalties.

Formal due diligence often requires a financial investment to hire professionals and specialists who perform land evaluation services that provide the definitive information you need about land usability for the planned development. Civil engineers or land planners are essential in this process and can aid in determining a budget for the tests and studies that may need to be performed. In addition, they can provide an estimate or a contract for the services they may be required to perform. If they are not able to answer your questions, they can identify other experts who have expertise in specialized fields of study to add to the development team.

As in the preliminary investigation, formal due diligence requires exploration of the same land characteristics, except with more depth of consideration. You take additional steps and involve expert resources to arrive at a final conclusion or decision including the following:

Wetlands Study. Developing land that contains wetlands is highly regulated at federal, state and local levels and many municipalities have different rules that may apply to development within flood plain areas. Wetlands are "those areas that are inundated or saturated by surface or ground water at a frequency and duration sufficient to support, and that under normal circumstances do support, a prevalence of vegetation typically adapted for life in saturated soil conditions. Wetlands generally include swamps, marshes, bogs and similar areas." (EPA Guidelines, Section 404)

Tree Survey and Appraisal. Trees are valuable resources on parcels. Tree surveys locate and identify the number and type and provide valuable information to use in the concept creation.

Flood Plain Analysis. If the property has any areas along creeks or drainage ways, your civil engineer should survey the property to verify if it lies within the flood plain. The survey helps you avoid creating any lots within a flood plain. You'll also need this verification to assure most jurisdictions, insurance companies and title companies that your development does not lie within a flood plain—areas that have a high probability of flooding within a 100-year time period and thus are susceptible to property and home devastation. These entities will not always rely exclusively on the maps created by Federal Emergency Management Agency (FEMA) because they don't always accurately depict elevation.

Soil Testing. Your civil engineer can survey to determine if soil testing is necessary and direct you to a firm that performs the tests. In general, if anticipated road cuts in grading or trenches for utility lines are to be less than five feet in depth, then soil testing may not be necessary. The primary concern of testing lies with two soil types: rock formations and unstable or expansive soils. Either can be dealt with using cost effective alternatives but only if they are identified in advance.

Topography Mapping. For areas where improvements are to be made for roadways and other improvements, such as detention areas and underground utilities, have your civil engineer create more accurate on-site topography maps. The USGS maps you referenced during the preliminary investigation only provide a general sense of the topography. New global positioning technologies make this task less costly than it has been in the past.

Utility Assessment. Confirm any preliminary findings with regard to availability and location of utilities. In addition, if using public utilities for water and wastewater, confirm any tap fees associated with the development. Using a conceptual drawing of the development, you can obtain accurate estimates for the installation of water and sewer lines. For all utilities, verify the cost of extending service and determine whether any easements are going to be required from adjoining properties.

Endangered Species Study. The types of creatures on the endangered species list are diverse, from warm or cold-blooded to furry or feathered. It may also include plant life. Many activist groups are trying to stop development at all costs to protect them. Your task is to identify if any of them exist on your parcel. If the possibility exists for a habitat of an endangered species on the property, it is better to discover this prior to completing the land purchase instead of spending 10 years in court to fight activists opposed to your development.

Archeological or Historical Study. Finding archeological ruins or burial grounds while constructing a road are two common reasons for identifying the historical significance of the land under consideration. Many times, family burial grounds have little to no markings or the archeological or historical significance of a structure is not self-apparent.

Environmental Analysis. Preliminary investigations sometimes uncover potential environmental concerns. In these situations, most lenders require further investigation during the due diligence period. Certified engineers conduct a formal environmental analysis, called a Phase I audit. The audit provides definitive answers regarding those concerns—good information for both you and the lender. The formal environmental analysis may involve as many as three phases.

The Phase I environmental audit usually addresses most concerns except for hazardous materials. Engineers certified to do the audit perform it. Depending on the availability of those certified in your area, it might take three to four weeks to have this completed.

The Phase II environmental audit is completed if Phase I produces negative results. The Phase II goes further with actual tests performed in the area where any environmental hazards are suspected. It includes recommendations for clean-up.

The Phase III environmental audit focuses on the actual clean-up and legal disposal of contaminated material.

Costs for the audits increase with each phase. Typical costs for a Phase I for a 20-acre site might range between $1,500 to $3,000 with Phase II and III costs varying with the nature of the issues involved. [Ed. Note: This article was published in 2005].

Political Analysis. During due diligence, formalize your involvement in the government approval process. This means gaining a very complete understanding of the process, achieving a common understanding with municipal staff, and establishing a timeline. If you have not already done so, obtain a checklist from the governing municipality.

Community Relations. At this point, coordinate meetings with the concerned citizen groups identified in your preliminary investigation, as well as any regulatory groups affected by the development. This can include school, fire, and special utility districts. The purpose of the meetings is to give information, allow time for feedback, and ultimately secure support for your project.

Financial Analysis. In the preliminary investigation, you prepared a thumbnail estimate to make an initial determination of financial feasibility. Once due diligence is completed, you can update your lot analysis based on the additional and more thorough information you have gained. Add in the option cost, if applicable, and the costs for completing the due diligence. These costs can range from $25,000 to $70,000 and you should count on spending it. Most important, regardless of this investment in the property, you have to be able to walk away from the deal if your due diligence determines development is not feasible for any reason. Other important financial factors should be considered at this point, including slow profits, the timing of tax liability and the impact of velocity on financial feasibility.

Development Financing

Financing your land development projects is a key component of running a business. In recent years this task has become one of the more challenging and complex aspects of land acquisition and development. Traditionally, your first source of funds to purchase land is personal equity invested in the company and retained earnings. Much of the day-to-day operations of the building or development are funded by your personal equity investments and the short-term credit of the vendors. However, when embarking on a land development project, the construction of developments requires more money than your own resources.

Land acquisition and development financing typically comes from any of the following three sources:

- Debt financing
- Private financing
- Public financing

Lender Financing

With more than 15,000 institutions in the United States, commercial banks handle a significant portion of real estate lending. They buy a wide variety of assets, ranging from short-term government securities, to long-term business loans and home mortgages.

Depending on its business focus, a bank may offer debt financing to support any or all of the land acquisition and development process. There are three financing phases in the process, each financed separately. They are:

- Land acquisition debt financing used to secure the purchase of raw land
- Land development debt financing used to build the subdivision improvements, earthwork, sewer, water, streets, etc.
- Construction debt financing used for construction of models and homes for sale

Despite the fact that financial institutions have become more specialized, major lenders often finance more than one phase of complex projects and one lender can finance all three phases of development. Land acquisition and development financing are often combined. Regardless, each phase presents unique challenges and risks.

Land Acquisition Debt Financing. The land development business is risky because it tends to generate little cash. Raw land may also be difficult to resell if a project fails because it may reduce its value as collateral. As a result, there are few major lending institutions that are involved in land acquisition financing and most of it comprises a combination of bank financing and developer equity. The institutions that finance raw land purchases typically rely heavily on your credit worthiness for assurance of payment. They often approve them only for their strongest customers or for those who have entitlements to develop the land and alternative sources, other than sale or development of the land, to repay the loan. The proportion of their real estate loan portfolio that can be used for land acquisition is restricted. They also provide no more than a 50 to 60 percent loan-to-value ratio funding.

Additionally, because your ability to repay a development loan is dependent on the successful sale of the lots, a lender must be satisfied that you will be able to sell enough lots fast enough to pay off the loan. Toward this point, appraisals can have a critical impact to securing financing. The federal government stipulates standards that appraisers must use. These standards require discounting the appraised value to adjust it to a present value. The discount, usually around 15 to 25 percent, results in a land value equivalent to a "bulk sale" purchase. A bulk sale is a price a single purchaser would pay to purchase the land for cash. This price allows for your overhead and profit earned by selling the lots at a retail price. After discounting the land and factoring a time value and velocity for a sale, the appraisal may be discounted up to 75 to 80 percent of the retail value. If the lender only lends 70 to 80 percent of that discounted appraised value, the amount the lender can actually lend in a transaction is severely restricted.

Addressing this issue early avoids undesirable project financing surprises. It is important that the appraiser understands the market, velocities, and appropriate discount rates for the local market that is being appraised. While federal regulations require banks to order the appraisal, you can ask the lender who it uses and work to educate the selected appraiser. Supply the most accurate and favorable information about your project in your loan package, including market information, costs, projections, comparable sales, and your retail house product pricing. You don't want the appraiser to have to work any harder than necessary to find this information and fairly appraise your project.

Land Development Debt Financing. Once land has been acquired for a project, you obtain land development financing. This financing covers the following activities:

- Site preparation
- Installation of infrastructure
- Engineering and consultants
- Architect fees
- Zoning
- Other soft costs

Most land development loans are a first lien on the property and are short-term. Rates are generally one to two points above prime rate. Check around and try to get the lowest rate. Again, lenders take high risks when financing raw land development. If the project falls through, the forecasted increase in land value will not be realized. Therefore, the lender carefully scrutinizes the credit worthiness and project potential and takes specific steps to minimize risk. Lending by parcel, developer backing, and repayment procedures are three common risk management examples in lender land development financing.

Parcel Lending. If you subdivide the raw land, lenders may approve loans for each sub parcel separately. This is true because land loans are riskier than construction loans since repayment of the development loan is contingent on the sale of the building sites.

Developer Backing. Construction loans are generally backed by a commitment from the developer to assume the loan if the product does not sell. Often this is in the form of a personal guaranty of performance provided by the principals of the developer's company.

Repayment Procedure. Repayment of land development loans is conducted via a "release price" procedure. Lenders specify a loan payoff amount required before the land can be cleared of mortgage liens, a prerequisite for you to sell the lot free and clear. The release price per lot is calculated based on the proportion of the project's total financing cost, represented by the lot price plus 10 to 20 percent. The use of 110 to 120 percent of the proportional share is required by lenders to minimize the risk associated with the development. It allows the lender to recapture the bulk of the loan before project closeout, which provides the lender with further assurance. In turn, you receive profit from the sale of the lots at the end of the development period.

Construction Debt Financing. A construction loan is used to finance improvements to the property, primarily the grading, drainage, streets, and utilities. Generally, this type of loan requires collateral, usually the land itself assuming that you have sufficient equity value in the land. The lender will disburse funds according to completion of the improvements as the project is developed. Commercial banks make the preponderance of construction loans, leaving life insurance companies, syndicators and mortgage banks to pick up the rest.

While land development financing is sometimes considered risky, construction financing is popular among lenders because of its characteristics. The appealing characteristics can include:

High Interest Rates. Risk and ongoing administrative burden generate the high interest rates and substantial loan commitment fees of construction loans.

High Loan-to-Value Ratio. Construction loans generally equal 100 percent of the total construction cost if you can provide adequate security.

Short Term. These loans cover the expected period of construction, usually from six months to three years. Payment in full is expected at the end of the construction period.

Timed Funds Disbursal. Funding is released as construction progresses, in a predetermined sequence. You pay interest on the funds disbursed and the lender's risk is reduced since the outstanding loan is matched closely to the value of the construction.

Repayment at Maturity. During the construction period there is no cash flow and no amortization on the loan. Repayment is made possible from the proceeds of long-term financing or from the sale of the residential units.

Construction lending and land development lending share a unique set of risks associated with the real estate market. First, loans must be based on estimates, projections, and judgments rather than facts. Lenders must assess the project's marketability, the accuracy of construction cost estimates, and the developer's competence—none of which is a known fact when making the loan decision. In addition, construction projects are subject to many external factors that can dramatically affect their success. These can include:

- Weather delays
- Unavailability of scheduled land
- Material shortages
- Environmental and regulatory barriers
- Changes in market demand
- Changes in interest rates

Lenders attempt to minimize these inherent risks in various ways, such as the nature and value of collateral, the method of funding of loan proceeds, and the method of repayment. Once the loan is made, the lender and developer must follow a very strict loan disbursement process. Funds are made available as work progresses. In addition, payouts are frequently authorized by the general contractor, but go directly to the subcontractor to assure receipt of funds.

Pension Funds. Pension funds are another viable source of debt financing for established developers. Pension funds have expressed an interest in real estate investments and they are becoming an increasingly popular option for large projects.

Small Business Administration. The Small Business Administration is a governmental agency that insures a percentage of the loan that is made by a local lender. These loans can be made on a real property for business use. These loans have many restrictions and usually take a long time to process. The interest rate is often lower than the current market because the government is guaranteeing a portion of the loan. You can find a description of the programs available and their requirements on the SBA website, www.sba.gov.

Private Financing

Private financing falls into the following to categories:

Seller Financing. Within the seller financing category, there are several options available for land acquisition. The most common purchase arrangement is 20–25 percent down payment with the balance financed through a land loan. The seller-financed loans most commonly include: subordinated mortgages, installment contracts, option agreements and the partnering seller.

Subordinated Mortgage or Purchase Money Mortgage. With a purchaser money mortgage, also called a purchase money trust deed, you purchase all or a part of the land by giving the seller a mortgage at transaction closing for a portion of the purchase price. The Seller becomes the lender in the transaction. Typically, you make a down payment of 10 to 20 percent of the purchase price to the seller. At closing, you sign a note, secured by a mortgage lien, on the purchased property, for the balance of the purchase price. The mortgage term is generally short. Terms include balloon payments that are often used when monthly payments are set on a 20 to 30-year schedule.

Subordination is a key feature with this type of financing. Sometimes, the seller agrees to subordinate the first mortgage on the land to a subsequent construction financing lender and the lender typically demands a first lien.

In subordination agreements, the Seller's interest in the unpaid balance of the purchase, whether as a contract balance or mortgage position, becomes a second interest behind a lender who takes a first position. If the lender in not paid and chooses to foreclose on the property, the Seller must pay off the first position of the lender or risk losing the unpaid balance of the purchase price.

Other times, a seller will not agree to subordinate his interest to a construction mortgage because the seller's position is high risk and his or her interest becomes the equivalent of risk equity. However, in circumstances where there is a high degree of trust and credibility between you and the Seller, it can be an effective method of financing.

Essentially, the purchase money mortgage offers financing with no amortization or with the amortization delayed. It provides immediate financing and an investment for the seller secured by his or her property. This seller's position is high risk and his or her interest becomes equivalent to risk equity. In return for the financing opportunity, the seller receives a higher return from the buyer. However, it is in your best interest to prepay the purchase money mortgage as soon as conventional financing is available. This lowers the interest rate thus creating a greater leveraged return.

Installment Contracts. In a land installment contract, also known as a land contract, the owner retains title (and possibly possession and use) of the land until the purchase price is fully paid; however, you gain immediate possession of the property. You can also use these contracts to arrange a phased release of land portions, with 20 percent of the land held by the seller until full payment of a three or four-year contract. If the seller retains possession, other present uses may continue. This gives the seller security and enables you to obtain release of at least a majority of the land.

In the installment sale, you make periodic payments to the seller with interest on the unpaid portion of the purchase price. This continues until you pay the entire purchase price and obtain the deed. This is a nonrecourse contract meaning that, in the case of default, the seller normally cannot force you to buy the remainder of the land. If problems with local municipalities and utility officials arise, these contracts usually offer an abatement of periodic payments on the land contract as an option. Also, common, you can retain the right to pay off the outstanding balance at any time to facilitate land development plans.

According to the IRS regulations under a qualified installment sale, the seller can realize a tax benefit by spreading out the tax consequences of a sale over a period of time. The seller is taxed only on sales proceeds in the year they are received. The purchase price must be paid over two or more tax years.

Seller as Partner. You can also become a partner with the landowner to finance the land purchase. For example, the landowner can put up the land, while you put up the skill of platting the site and obtaining all the necessary approvals. After the plat has been approved and all appeal periods have expired, then the exchange of money can occur. The price for the land can be fixed or adjusted up or down for such provisions as the length of the closing date, the number of lots achieved or the actual costs of development.

IV. Bridge Loans [6]

What is the Purpose of a Bridge Loan?

Bridge loans have nothing to do with bridges. A bridge loan is a short-term real estate loan that temporarily closes a gap in the borrower's finances, enabling the borrower to complete an acquisition, improve or re-position a property to enhance its fully stabilized value.

How Much Do Bridge Loans Cost?

Bridge loans typically do not come cheap to borrowers because it is a highly attractive market. On average, bridge loans typically run about two percentage points more than the interest rate charged for a 30-year, fixed-rate mortgage. Additionally, a lender may charge higher fees and prepayment charges.

Bridge Loan Costs: An Example

To illustrate the potential costs, have a look at an example. Robert, who lives in Idaho, buys a new home while still in the process of selling his existing home. He gets a bridge loan to continue making his mortgage payments on time. Assume that the interest rate for a bridge loan in Idaho is 8.5%. The terms provide no payments for four months and interest that accrues throughout the loan, which is due upon the sale of Robert's old house. Here's an example of typical fees associated with bridge loans that Robert finds included in his loan:

[6] Emily Peterson, *What You Need to Know About Bridge* Loans, HUNT MORTGAGE GROUP Feb. 7, 2017), http://www.huntmortgagegroup.com/blog/what-you-need-to-know-about-bridge-loans/.

Administration fees: $850
Appraisal fee: $475
Escrow fee: $450
Title: $450+
Notary fees: $40
Wiring fees: $75
Loan origination fee: 1%+ of the loan amount

As this example demonstrates, although Robert needs the extra funding, the money comes at a high cost. Before taking his loan, Robert researched all of his options and was aware of all the associated fees, and he still decided that this was the right choice. The lender used Robert's old home as collateral to secure the bridge loan.[7]

"Bridge loans typically have repayment terms of between 6 months and 3 years, after which the property is either sold or refinanced with permanent financing."[8]

"Commercial bridge loans can be used for the purchase or refinance of office buildings, hotels, retail property, multifamily housing including apartment complexes, and even for raw land that will be developed for commercial purposes."[9]

"They feature quick closings and the loan amounts are based on the fully improved value of the property, rather than its 'as-is' value. In this way, commercial mortgage bridge loans provide the capital that a real estate investor needs in order to close on opportunities quickly, complete necessary renovations (if needed), and either sell or refinance into permanent financing with affordable monthly payments."[10]

V. Mortgage Loan Commitments

A. Loan Commitments: Recent Trends

REAL ESTATE INVESTOR'S DESKBOOK[11]
By Alvin Arnold & Myron Kove

Mortgage loan commitments play the same role in the financing of real estate as do contracts of sale in the selling of real estate. However, whereas the courts over centuries have developed well-understood rules as to when a contract of sale is binding and when it is not, the same is not true of loan commitments, which have a much more recent history.

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[7] Caryn Anderson, *What Is a Bridge Loan & How Does It Work?* CREDIT SESAME (Aug. 11, 2016), https://www.creditsesame.com/blog/loans/what-is-bridge-loan-how-does-it-work/.
[8] Kevin Mercadante, *What Are Commercial Bridge Loans and How Do They Work?*, FITSMALLBUSINESS.COM (Feb. 25, 2017), http://fitsmallbusiness.com/commercial-bridge-loans/.
[9] Id
[10] Id.
[11] ALVIN L. ARNOLD & MYRON KOVE, REAL ESTATE INVESTOR'S DESKBOOK, § 4:34 (2017).

Nevertheless, until the past 20 years or so, relatively little litigation occurred over loan commitments. Lenders and real estate professionals generally had long-standing business relationships and would settle any disagreements over the terms of a loan commitment without resorting to the courts.

This has changed in recent years, for several reasons. First, larger and more complex real estate projects call for much more detailed loan agreements and involve very large loan amounts, making both borrowers and lenders more willing to resort to the courts when disputes arise.

Second, relatively rapid changes in interest rates at certain times can make it very expensive for a borrower to close a loan commitment after interest rates have dropped, making substantial savings possible by obtaining the loan elsewhere. As a result, loan commitments are now negotiated with the same care to detail and draftsmanship as are the loan documents themselves.

The usual form of a commitment letter for a permanent mortgage loan contains numerous conditions and satisfaction clauses intended to assure the lender that when the loan is funded (closed), the condition of the property is as represented, leases have been executed and contain specified clauses, insurance policies have been obtained, and that overall, the real estate constitutes a sound and legal security for the loan.

Finally, commitment letters normally provide that the form and substance of all documents required to be provided by the borrower must be satisfactory to the lender and its counsel.

If, at or prior to the loan closing, either lender or borrower indicates it will not go through with the transaction, two issues arise: (1) is the loan commitment a binding contract, enforceable against the defaulting party; and if so, (2) what remedies are available for the innocent party?

In a 1988 case, Runnemede Owners, Inc. v. Crest Mortg. Corp., 861 F.2d 1053, 12 Fed. R. Serv. 3d 787 (7th Cir. 1988), a lender issued a "conditional commitment letter" for a $5.5 million loan. The commitment was subject to the lender's approval of the borrower's finances, and provided that the lender could cancel the commitment prior to the closing if the income or expenses of the project, or market conditions in the area, changed adversely. The lender canceled because it did not believe the project would produce sufficient cash flow to service the loan. The borrower sued for breach of contract. The Court held that the commitment "was nothing more than an agreement to consider extending a loan, not an unqualified promise [.]"

Sometimes, a binding commitment can be found to exist even though no formal commitment letter is written. In 999 v. C.I.T. Corp., 776 F.2d 866, 3 Fed. R. Serv. 3d 923 (9th Cir. 1985), a 1985 case applying California law, the Ninth Circuit Court of Appeals held that a binding commitment existed when a letter from a lender asking the borrower to submit a loan application and a $25,000 deposit contained a handwritten note, at the request of the borrower, consisting of the words "proposed financing." When the borrower signed the letter, the lender was held bound.

From the perspective of the mortgage lender, the loan application, commitment letter, or application-commitment should include all the major terms and conditions (e.g., agreement to lend a specified amount, identity of the security and the borrower, interest rate, prepayment terms, amortization schedule, and method of payment) and specify them with reasonable precision. Otherwise, the agreement may be unenforceable for want of certainty in its terms, and vague language will be construed against the party who drafted the agreement (usually the lender).

Finally, both lender and borrower should recognize that most jurisdictions impose on them the obligation to exercise good faith in dealing with one another in negotiating the terms of the commitment letter, and during the commitment period prior to the closing of the loan. This obligation also applies to the manner in which the lender administers the loan once the loan is closed.

B. Loan Commitment Litigation: Some Key Issues

The Writing Requirement. The Statute of Frauds has no provision requiring loan commitments to be in writing unless they fall under the provision concerning contracts not to be performed within one year. So, a borrower could successfully contend that he or she was orally promised a loan or other financing consideration by a lender unless the oral agreement could not be performed within a year.

"In response to the surge in lender-liability claims against mortgage lenders commencing in the mid-1980s—especially in connection with affirmative claims or defenses of borrowers based on breach of an alleged oral agreement to lend; to extend, modify or refinance an existing loan; or to forbear from exercising contractual remedies, many states enacted laws specifically requiring a written agreement between the lender and borrower as a prerequisite for any legal action against the lender. These statutes typically apply to any 'credit agreement.'"[12]

Some Courts Systematically Uphold Lender Preconditions to Funding. Other Courts Require Lenders to Prove "Good faith" When Exercising Their Rights Strictly Under the Terms of Their Loans. Compare the following two situations.

(1) In Brighton Development Corp. v. Barnett Bank of South Florida, N.A., 513 So.2d 1103 (Fla. 2d DCA 1987), the borrower was required to complete loan documents within a 60-day period. When the borrower was unable to complete its performance, it requested an extension. The request came one day after the expiration of the 60-day period under the loan agreement. The lender refused to grant an extension. The lender not only declined to fund the loan but refused to refund the borrower's commitment fee. The trial court dismissed the

[12] Jack Murray, *Credit-Agreement Statutes: Are Equitable Defenses Permitted?*, FIRST AMERICAN TITLE (July 26, 2016), http://blog.firstam.com/commercial/credit-agreement-statutes-are-equitable-defenses-permitted. This article contains a state-by-state list of credit agreement statutes.

borrower's complaint with prejudice and the district court affirmed, rejecting the breach of contract claim as well as the claim that the bank acted in bad faith.[13]

(2) Many commercial mortgage loans contain an "insecurity" clause. An insecurity clause allows the lender to demand payment or to foreclose if the lender feels insecure about receiving repayment from the borrower. Suppose a lender has no doubt that the borrower possesses the ability to repay the loan, but interest rates are rising rapidly, and the lender would like to rid itself of loans now bearing below-market interest rates in order to re-invest the proceeds in the higher current market rate.

Under the insecurity clause, the lender would have the right to declare the entire loan due and payable if it had a reasonable basis for doubting the borrower's ability to fulfill its obligations under the loan. The lender's burden of proof is eased when the borrower is already in default. But the lender will need to show the court more than a worried frown who is anxiously trying to declare the entire loan due and payable because of deteriorating market conditions. Courts recognize that if the lender declares the entire loan due and payable, unless the borrower is flush with cash, the borrower stands to forfeit the property through foreclosure.

In some states, if the borrower challenges the lender's right to invoke the insecurity clause, the lender would be required to show an objectively verifiable reason for doubting the borrower's continued ability to perform. This is particularly true when there is reason to suspect that the lender is using the insecurity clause as a subterfuge for trying to terminate a loan because the loan turned out to be a money loser for the lender because market rates of interest are much higher than they were when the original contract rate of interest was set.[14]

The customary remedy against the lender breaching its obligations under a loan commitment is money damages, not specific performance. "If a lender fails to provide funding required by a construction loan agreement, an action for breach of contract may be commenced. In determining the appropriate remedy, various avenues are possible. Specific performance of a contract to lend money is, however, rarely available."[15] Money damages are presumed adequate. "The principle against applying specific performance in these situations is founded on the law's assumption that funds are available in the financial markets at the lawful interest rate." [16] The borrower just finds a new loan. The borrower's damages would be measured by the difference between what the breached construction loan would have cost and what the borrower had to pay for the replacement loan.

When lenders walk away from their loan commitments, the borrower's lost profits (provable, not speculative) are included as an element of the monetary recovery. The following excerpt demonstrates this.

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[13]Kendall Coffey and Ava J. Borrasso, *Lender Liability Issues Arising from Construction Loan Agreements*, *in* FLORIDA REAL PROPERTY LITIGATION, 8B-1 (2013).
[14] Michael Guisto, Note, *Mortgage Foreclosure for Secondary Breaches: A Practitioner's Guide To Defining "Security Impairment"*, 26 Cardozo L. Rev. 2563 (2005).
[15] Kendall Coffey and Ava J. Borrasso, *supra* note 14, at §8.32.
[16] Id.

Lender's Breach of a Construction Loan Results in Awarding of Economic Damages to Builder[17]
By Kent Lang

Great Western Bank vs JLC Dev., LLC[18]

The financial distresses of the Great Recession led to a wide variety of conflicts between construction lenders and builders. In many cases, the lender had the upper hand, with few options for builders who lost their financing in mid-project. But in at least one case, a lender's arbitrary termination of a construction loan agreement backfired.

In early 2007, a predecessor of Great Western Bank[19] made an acquisition and development (A&D) loan to a builder-developer, Cedar Ridge Investments, to purchase Flagstaff-area real estate and develop it as a residential subdivision. Separately, the bank entered into an agreement with Cedar Ridge to make construction loans, on a case-by-case basis, for the homes to be built in the subdivision. Both loans were guaranteed by Cedar Ridge's parent company and its principals.

Loan Termination

In July 2008, as development of the project was nearing completion and Cedar Ridge was preparing to obtain building permits for the homes, Great Western Bank decided to stop making construction loans in Arizona and told Cedar Ridge that it was pulling out of their agreement.
[Ed. Note: Arizona had one of the highest rates of home foreclosures in the nation during the Great Recession of 2007-2009, falling house prices and growing inventories of unsold homes in new housing tracts. Banking regulators were severely sanctioning banks that continued to make land acquisition, development and construction loans.]

Cedar Ridge was unable to get alternate financing, could not build and sell homes and, thus, could not generate cash to service its A&D loan. Great Western foreclosed, sold the property to another developer, and sued the guarantors for the remaining $2.6 million loan balance.

At trial, the guarantors argued that the unpaid loan balance should be offset by lost profits caused by Great Western's breach of their loan agreement, which they further argued constituted "anticipatory repudiation" and breach of the implied covenant of good faith and fair dealing.

[17] Kent Lang, *Lender's Breach of a Construction Loan Results in Awarding of Economic Damages to Builder*, LANG & KLAIN, P.C., http://www.lang-klain.com/publications/constructionadvisor/great-western-v-ljc.htm (last visited July 5, 2017).

[18] Great Western Bank vs JLC Dev., LLC 238 Ariz. 470 (Ct. App. 2015).

[19] The original loans were made by TierOne Bank, which, after being closed by the federal government during the Great Recession, was purchased by Great Western Bank.

Great Western claimed that the construction loan agreement was just a "guidance line," under which the bank could choose to make—or not make—loans to build the homes at Cedar Ridge.

Win for the Builder

In the end, the trial court rejected the bank's "guidance line" argument, noting that the agreement (titled "Loan Agreement") obligated the bank to "make the Loans to Borrower" and required Cedar Ridge to "accept such Loans." Also, the agreement allowed the bank to withdraw only if the borrower defaulted—a moot point, as the bank never made a loan on which Cedar Ridge could default.

The trial court concluded that:

- Great Western breached the loan agreement;
- Great Western's breach prevented Cedar Ridge from building and selling homes and using the proceeds to retire the A&D loan; and
- Great Western had no valid reason for terminating the loan agreement, as Cedar Ridge was not in default and was prepared to begin construction.

Further, the trial court found that, if the bank had not breached the agreement, Cedar Ridge would have made a profit of between \$2.8 million and \$3.5 million. As that figure exceeded the outstanding balance on the A&D loan, the guarantors' liability under the guaranty would have been reduced to zero.

Great Western Bank appealed, unsuccessfully. The Arizona Court of Appeals upheld the trial court's ruling in all respects, sending a harsh warning to lenders and providing good news to borrowers who find themselves in a comparable situation:
A lender's breach of a loan agreement can result in lost profits and other economic damages to the borrower.

Lost profits can be used to offset a loan deficiency and a guarantor's liability.

[Ed. Note: Here is how the court addressed the issue of the declining housing market:]

Great Western first argues the award of lost profits was inappropriate because, it contends, the loss was more likely caused by a declining economy rather than breach of the Agreement.

Although this is a possible explanation, it is one which the trial court rejected in favor of evidence from Great Western's own appraiser that home sales in Flagstaff remained largely consistent through 2009.

The record also reflects that demand for housing in Flagstaff was significant given the limited availability of land in the area and the lower-cost housing proposed_ for Cedar Ridge would fill an underserved niche in the community even in the down economy.

Great Western's appraiser also concluded that Borrower would have been able to sell at least one home per month in 2009 which would have been sufficient to service the loans with Great Western. And, even if Great Western had decided not to extend the Agreement beyond its expiration in December 2008, Borrower would have been able to build several model homes in the meantime and enhance its chances of obtaining alternate financing, thereby mitigating its damages.[20]

VI. REVISED QUESTIONS

Question 1: ***Direct Mortgage Lender, Mortgage Broker, or Mortgage Banker.***

Suppose you or a friend are looking for a home mortgage loan. You could approach a direct mortgage lender, mortgage broker, or mortgage banker in person or online. The text describes the differences. Do you see any reason to prefer one type over another or would you canvass a variety of loan sources regardless of whether they were direct lenders, mortgage bankers or mortgage brokers?

Question 2***: The Three Cs of Mortgage Loan Underwriting.***

(a) What information is required for each of the three Cs of home mortgage loan underwriting—capacity, credit reputation, and collateral?

(b) If you were personally making a home mortgage loan to an individual you did not know, would you rely equally on each of the three Cs, or would you regard one or another of them as the most probative?

(c) As a borrower, how would you determine how much of a home mortgage loan you could afford? Would you mostly rely on the two ratios—housing and total debt to income?

(d) Between two borrowers with low down payments (for instance 10% of the purchase price), the one with the higher credit score is significantly less likely to default. How would you explain that?

(e) If you were advising a mortgage lender, would you advise the lender to organize its underwriting criteria to accommodate the data that borrowers with higher credit scores and lower down payments appear less risky than borrowers with somewhat lower scores and higher down payments? How would the lender implement your advice?

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[20] Great W. Bank v. LJC Dev., LLC, 238 Ariz. 470, 481(Ct. App. 2015).

Question 3: ***Underwriting, Default Rates, and House Prices.***

One of the lessons of the mortgage default and foreclosure crisis of 2008 seems to be that house price trends matter much more than individual or property characteristics as predictors of defaults and losses for lenders. Why does this finding not completely undermine CFPB efforts to stiffen "ability-to-repay" underwriting and the avoidance of any but "qualified mortgages?"

Question 4: ***Amortization.***

(a) What is the difference between full, partial, no, and negative amortization?

(b) What is a balloon payment?

(c) What is the maturity date and the amortization period of a loan "20 due in 10?"

(d) Why would a borrower ever find such a loan advantageous?

(e) What could attract a lender to fund a loan partially amortized or "interest only?"

(f) A first-time homebuyer is looking for an affordable "starter" home, hoping in time to trade up with rising personal income and, hopefully, rising property values. What would be the advantages and disadvantages of an interest only loan to this homebuyer?

(g) Describe briefly the ideal potential borrower for an FHA Graduated Payment Mortgage or a Reverse Mortgage (an FHA Home Equity Conversion Mortgage). Why is negative or no amortization sensible in these situations?

Question 5. ***Adjustable or Fixed-Rate Loans?***

(a) Why would any price-conscious homebuyer ever have chosen an adjustable-rate loan at a time when fixed-rate 30-year mortgage loans were available at historically low interest rates?

(b) To a borrower who worries about whether she will be able to afford an adjustable-rate loan if interest rates go up, why is the life-of-loan cap more important than periodic annual caps?

Question 6. ***Rate Locks.***

(a) What is a rate lock?[21]

(b) Why would the listing real estate broker care about whether the buyer obtained a rate lock? Is it prudent for the buyer to purchase the rate lock? [22]

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[21] This question has been changed from "When would a borrower be well advised to purchase a rate lock and when would such a purchase be a waste of money?" in the text book to "What is a rate lock?"

(c) Is there any good reason for a loan applicant to spend good money buying a rate lock on an adjustable-rate loan? After all, the rate itself moves with market conditions.

Question 7: ***Commercial Loan Underwriting. LTV (Loan to Value), Debt Yield, and DSCR (Debt Service Coverage Ratio).***

(a) What is the difference between Debt Yield and DSCR?

(b) Why do commercial lenders resort to three metrics in deciding whether to make their loans: loan-to-value ratios, debt service coverage ratios, and debt yield ratios? What does each one measure that the other two do not, and why would a commercial mortgage lender care?

Question 8***: Notes and Mortgages.***

(a) What is the difference in content between a note and a mortgage, also known as a deed of trust?

(b) Following payment in full or foreclosure of a previously recorded mortgage or deed of trust, what recorded document should a subsequent purchaser expect to see if the security instrument was a mortgage? A deed of trust?

Question 9: ***The Mortgagor's Obligation to Repair Defects.***

What rationale could possibly support the Restatement (Third) of Property (Mortgages) position that mortgagors have no responsibility for repairing defects that existed at the time the mortgage was entered into, even though the mortgagor knew about the defects, the mortgagee did not, and the defects were latent?

Question 10: ***Waste, Demolition, and Redevelopment.***[23]

A real estate developer, investing personal funds and equity money from family and friends, he paid $500,000 to acquire a large two-story space that was in bad condition and long overdue for major a major renovation. Despite the poor condition of the space, and the fact that it was 50% vacant, it was generating a net operating income of $100,000 a year from the struggling retail tenants located there.

The developer saw potential because the site was located on a street with significant consumer foot traffic in a thriving commercial area. Having worked as a leasing agent for a

[22] This question is not in the text book. It was added to help emphasize the presence of rate locks in real estate transactions.
[23] The wording of this question, though not the substance, differs from the version in the textbook.

particular national retailer, a major chain discount clothier, he knew the retailer was seeking locations just like the one he had acquired.

As soon as the developer entered a binding purchase and sale contract for the space, and even before taking title, he entered an agreement to lease the space to the retailer for a term of 15 years. The retailer was a national discount clothing chain with excellent credit at the time the lease was signed. The lease payments would easily have amortized the $4,000,000 loan that the developer would need to meet an obligation in the lease that he would renovate and upgrade the space to the retailer's specifications.

To fund the renovation, the developer borrowed $4,000,000 from a bridge lender for a term of three years at an interest rate of 9%. At the time, prime commercial mortgage lending rates were 5%. The bridge lender’s higher interest rate reflected the riskiness of the venture; the loan would only be repaid after the building was cleared of tenants and demolished, the renovation was complete, and the retailer moved in and began paying rent.

The loan was non-recourse; the developer strongly resisted putting his personal assets at risk in this venture. To avoid personal liability on the mortgage, the developer did not hold title to the space in his own name. Instead, he arranged for the seller to deed the property to a newly formed Limited Liability Company which had no assets except for the acquired two-story space.

The members of the LLC were the developer and a money partner. The LLC signed the bridge loan and deed of trust, not the developer personally. But the developer personally signed a non-recourse carve-out guaranty agreeing to be personally liable for certain “bad” acts, including fraud and waste.

The developer managed to clear the building of tenants and demolished the structure. He drew plans and was about to apply for building permits when the retailer filed bankruptcy. This disrupted the bridge lender’s assessment of risk when it made the loan. The bridge lender had been relying on the cash flow from the retailer’s rent payments to attract a permanent lender willing to provide the funds the developer would require to pay off the bridge loan when it became due in three years.

The specially formed LLC will default on the bridge loan. Is the developer going to be held personally liable on the “bad boy” carve out for waste? Was it waste for the developer to have demolished the building that had been producing $100,000 a year in net operating income?

Question 11: ***How Mortgage Lenders Limit Liability Under CERCLA.***

(a) What CERCLA risks do mortgage lenders take when they finance real estate developers building new projects on previously developed industrial sites that might have been subject to hazardous or toxic waste?

(b) How can mortgage lenders reduce those risks?

Question 12: ***Mortgagees and the Drug Forfeiture Laws.***

A wealthy Brazilian national who lives in Uruguay, through her second cousin who is a Los Angeles real estate broker, acquires a run-down motel on Sunset Boulevard with a purchase money mortgage loan from Chase.

She hires a young man, who was one of her son's friends at a Swiss boarding school, to manage the motel. The purchaser rarely visits Los Angeles and never saw the motel. If she had observed the clientele coming and going from the motel for a while, she might have realized why it has a reputation in the neighborhood as a place of prostitution and drug sales.

The DEA seizes the motel in a sting operation. The young man who managed the hotel was earning $10,000 a month leasing space to several gang members who have been indicted for selling drugs, money laundering, and other felonies.

The Chase mortgage prohibited illegal acts. Chase initiates a non-judicial foreclosure. The DEA claims the property through the drug forfeiture laws. Is Chase likely to free the motel from the DEA's forfeiture by contending that it is an innocent lender? Would the DEA be able to enjoin Chase from foreclosing non-judicially?

Question 13. ***Securitization Issues.***

(a) Why would a commercial bank ever sell its safest and highest yielding home mortgage loans to an aggregator for eventual securitization?

(b) A bond investor fears that interest rates are going to rise soon. Would that investor be attracted to IO or PO mortgage-backed bonds?

(c) A commercial developer is a major mortgage borrower who appreciates the lower rates achievable on mortgage loans originated for eventual securitization. Her mortgage lender reserves the right of prior approval of major leases. Once the loans have been securitized, approval delays by her loan servicer have occasionally caused her to lose a prime tenant because it took so long for her loan servicer to secure the lease approval. What provision should she negotiate to include the next time she borrows money from her mortgage lender of choice?

APPENDIX A

Underwriting Guidelines for the Home Mortgage Loan[24]

Income

Income is one of the most important variables a lender will examine because it is used to repay the loan. Income is reviewed for the type of work, length of employment, educational training required, and opportunity for advancement. An underwriter will look at the source of income and the likelihood of its continuance to arrive at a gross monthly figure.

Salary and Hourly Wages—Calculated on a gross monthly basis, prior to income tax deductions.

Part-time and Second Job Income—Not usually considered unless it is in place for 12 to 24 straight months. Lenders view part-time income as a strong compensating factor.

Commission, Bonus and Overtime Income—Can only be used if received for two previous years. Further, an employer must verify that it is likely to continue. A 24-month average figure is used.

Retirement and Social Security Income—Must continue for at least three years into the future to be considered. If it is tax free, it can be grossed up to an equivalent gross monthly figure. Multiply the net amount by 1.20 percent.

Alimony and Child Support Income—Must be received for the 12 previous months and continue for the next 36 months. Lenders will require a divorce decree and a court printout to verify on-time payments.

Notes Receivable, Interest, Dividend and Trust Income—Proof of receiving funds for 12 previous months is required. Documentation showing income due for 3 more years is also necessary.

Rental Income—*Cannot* come from a Primary Residence roommate. The only acceptable source is from an investment property. A lender will use 75 percent of the monthly rent and subtract ownership expenses. The Schedule E of a tax return is used to verify the figures. If a home rented recently, a copy of a current month-to-month lease is acceptable.

Automobile Allowance and Expense Account Reimbursements—Verified with 2 years' tax returns and reduced by actual expenses listed on the income tax return Schedule C.

Education Expense Reimbursements—Not considered income. Only viewed as slight compensating factor.

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[24] *Underwriting Guidelines for Mortgage Loans – Loan Requirements, Credit Review, Quality for Loan,* CREDIT INFOCENTER, http://www.creditinfocenter.com/mortgage/guidelines.shtml (last updated Mar. 15, 2016).

Self-Employment Income—Lenders are very careful in reviewing self-employed borrowers. Two years' minimum ownership is necessary because two years is considered a representative sample. Lenders use a 2-year average monthly income figure from the **Adjusted**

Gross Income on the tax returns. A lender may also add back additional income for depreciation and one-time capital expenses. Self-employed borrowers often have difficulty qualifying for a mortgage due to large expense write offs. A good solution to this challenge used to be the ***No Income Verification Loan***, but there are very few of these available any more given the tightened lending standards in the current economy. NIV loan programs can be studied in the Mortgage Program section of the library.

Debt and Liabilities

An applicant's liabilities are reviewed for cash flow. Lenders need to make sure there is enough income for the proposed mortgage payment, after other revolving and installment debts are paid.

- All **loans, leases, and credit cards** are factored into the debt calculation. Utilities, insurance, food, clothing, schooling, etc. are not.
- If a loan has **less than 10 months remaining**, a lender will usually disregard it.
- The minimum monthly payment listed on a credit card bill is the figure used, not the payment made.
- An applicant who co-borrowed for a friend or relative is accountable for the payment. If the applicant can show 12 months of on-time cancelled checks from the co-borrower, the debt will not count.
- Loans can be paid off to qualify for a mortgage, but credit cards sometimes cannot (varies by lender). The reasoning is that if the credit card is paid off, the credit line still exists and the borrower can run up debt after the loan is closed.
- A borrower with fewer liabilities is thought to demonstrate superior cash management skills.

Credit History

Most lenders require a residential merged credit report (RMCR) from the 3 main credit bureaus: **Trans Union**, **Equifax**, and **Experian**. They will order one report which is a blending of all three credit bureaus and is easier to read than the individual reports. This "blended" credit report also searches public records for liens, judgments, bankruptcies and foreclosures. See our credit report index.

Credit report in hand, an underwriter studies the applicant's credit to determine the likelihood of receiving an on-time mortgage payment. Many studies have shown that past performance is a reflection of future expectations. Hence, most lenders now use a national credit scoring system, typically the FICO score, to evaluate credit risk.

- 12 plus months of positive credit will usually get you into an "A paper" loan program, depending on the overall credit. FHA loans usually follow this guideline more often than conventional loans.

- Unpaid collections, judgments and charge offs must be paid prior to closing an A paper loan. The only exception is if the debt was due to the death of a primary wage earner, or the bill was a medical expense.
- If a borrower has negotiated an acceptable payment plan, and has made on time payments for 6 to 12 months, a lender may not require a debt to be paid off prior to closing.
- Credit items usually are reported for **7 years**. Bankruptcies expire after 10 years.
- Foreclosure - 5 years from the completion date. From the fifth to seventh year following the foreclosure completion date, the purchase of a principal residence is permitted with a minimum 10 percent down and 680 FICO score. The purchase of a second or investment property is not permitted for 7 years. Limited cash out refinances are permitted for all occupancy types.
- Chapter 7 Bankruptcy—A borrower is eligible for an A paper loan program 4 years after discharge or dismissal, provided they have reestablished credit and have maintained perfect credit after the bankruptcy.
- Chapter 13 Bankruptcy—2 years from the discharge date or 4 years from the dismissal date.
- Multiple Bankruptcies—5 years from the most recent dismissal or discharge date for borrowers with more than one filing in the past 7 years.
- The good credit of a **co-borrower** does not offset the bad credit of a borrower.
- Credit scores usually range from 400 to 800. Changes to lending standards are occurring on a daily basis as a result of tightening lending standards, and can vary from lender-to-lender, so this information should be considered simply a guideline. For conforming loans, most lenders will lend down to a **FICO of 620**, with additional rate hits for the lower-end credit scores and loan-to-values.
- A credit score below 600 may require an Alternative Credit mortgage program.

Savings and Checking Accounts

Lenders evaluate checking and savings accounts for three reasons.

1. The more money a borrower has after closing, the greater the probability of on-time payments.
2. Most loan programs require a minimum borrower contribution.
3. Lenders want to know that people have invested their own into the house, making it less likely that they will walk away from their life's savings. They analyze savings documents to insure the applicant did not borrow the funds or receive a gift.

Lenders look at the following types of accounts and assets for down payment funds:

- **Checking and Savings**—60 days seasoning in a bank account is required for these funds.
- **Gifts and Grants**—After a borrower's minimum contribution, a gifts or grant is permitted.
- **Sale of Assets**—Personal property can be sold for the required contribution. The property should be appraised and a bill of sale is required. Also, a copy of the received check and a deposit slip are needed.
- **Secured Loans**—A loan secured by property is also an acceptable source of closing funds.

- **IRA, 401K, Keogh & SEP**—Any amount that can be accessed is an acceptable source of funds.
- **Sweat Equity and Cash On Hand**—Generally not acceptable. FHA programs allow it in special circumstances.
- **Sale Of Previous Home**—Must close prior to new home for the funds to be used. A lender will ask for a listing contract, sales contract, or HUD 1 closing statement.

Debt vs Income Ratio

The percentage of one's debt to income is one of the most important factors when underwriting a loan. Lenders have determined that a house payment should not exceed approximately 30 percent of Gross Monthly Income. Gross Monthly Income is income *before* taxes are taken out. Furthermore, a house payment plus minimum monthly revolving and installment debt should be less than 40 percent of Gross Monthly Income.

Example
An applicant has $4,500 gross monthly income.
The maximum mortgage payment is:
$4,500 X .30 = $1,350

Their total debts come to:

$500	Car
$20	Visa
$30	Sears
$75	MasterCard

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$625 per month

Remember, their total debts (mortgage plus other debts) must be less than or equal to 40 percent of their gross monthly income.
$4,500 X .40 = $1,800
$1,800 is the maximum debt the borrower can have, debts and mortgage payments combined. Can the borrower keep all their debts and have the maximum mortgage payment allowed? **NO!**

In this case, the borrower, since they have high debts, must adjust the maximum mortgage payment downward, because:

$625	debts
$1350	mortgage

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$1,975 - which is more than the $1,800 (40% of gross income) we calculated above.

The maximum mortgage payment is therefore:
$1,800 - $625 (monthly debt) = $1,175

PREPAYMENT OF MORTGAGE LOANS

I. Why Prepayment Matters to Home Buyers

Should You Pre-Pay Your Mortgage?[1]

Prepaying Your Mortgage

Prepaying your mortgage—which simply means that you pay all or part of the money owed on your mortgage before it's officially due—offers an alluring proposition: By paying what you owe early, you can cut down the amount of interest you owe to the lender, which can save you thousands of dollars in the long term. But before you prepay your mortgage, it's important to understand these things:

How Do Most People Prepay Their Mortgage?

People prepay their mortgages in a variety of ways, but one of the more popular methods is to pay a little extra on your loan each month, which over the life of the loan could save you thousands or even tens of thousands of dollars.

Let's say you owe $100,000 on your 30-year loan at a 4 percent interest rate. If you paid the loan as scheduled, you'd end up paying the bank roughly $71,000 in interest. If, however, you added just $75 a month to your monthly payments, you would save more than $17,000 in interest and repay the loan more than 5 years faster.

Some people also make bi-weekly mortgage payments, which effectively leads to you making 13 months of mortgage payments in a year, compared with the traditional 12. Before you decide which method to choose, do the math to see which is most financially effective and which you think you can actually stick to. Use our mortgage calculator to help determine your monthly mortgage costs.

Are There Restrictions on Prepaying Your Mortgage?

While the terms of some mortgages allow you to prepay the loan without restrictions, other mortgages have stricter terms. More specifically, some lenders require borrowers to pay a penalty for prepaying the mortgage—sometimes the amount of this penalty is based on a sliding scale depending on how long you've held the mortgage (for

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[1] *Should You Pre-Pay Your Mortgage?*, ZILLOW, https://www.zillow.com/mortgage-learning/prepaying-your-mortgage/#definition (last visited July 10, 2017).

example, if you prepay after one year, you might have to pay a fee worth 4 percent of the total loan amount, compared to a penalty of 3 percent after two years) and sometimes a one-time fixed amount.

Often, lenders demand a prepayment penalty if you prepay the mortgage before a certain amount of time, usually five years, to deter borrowers from quickly refinancing their loans, which would drastically cut into the lenders' profits. There are other variables to these penalties, including the fact that some lenders don't consider a sale of a home a "prepayment" and others allow you to pay up to a certain amount before the penalty kicks in.

The terms of the prepayment penalty vary significantly, so it's important to read through your mortgage paperwork. Typically, you will see terms such as "prepayment penalty disclosure" or "prepayment disclosure," after which the specifics of the prepayment penalty are usually listed.

Should You Prepay Your Mortgage?[2]
By Ilyce Glink

If you have the means, is prepaying your mortgage a good idea?

Most of the time, it is. You will save a substantial amount of money in interest, shorten the length of the loan term, increase the equity you have in your home, and own it outright sooner. But before you start writing checks to your mortgage company, there are a few things to consider to ensure that your money wouldn't be better used elsewhere: Do you have any debt? Is your retirement plan on track? Do you have an emergency savings account?

If you do have debt, aren't maxing out your retirement account contributions or don't have between six months to a year's salary in your emergency fund, then prepaying your mortgage isn't something to consider just yet. But if you're in good shape financially, consider this.

The Pros

By making just one extra mortgage payment per year, you could substantially reduce the total cost of your loan. For example, if you borrowed $100,000 on a 30-year loan at 4 percent, your monthly payment would be $477. If you make 13 payments a year instead of 12, you would save over $10,000 in interest over the life of the loan and reduce your total loan term by four years. (You can use the calculator at Bankrate to see how it would affect your loan). And if you double your mortgage payment, you could pay off that same 30-year loan in only 11 years.

[2] Ilyce Glink, *Should You Prepay Your Mortgage?*, DAILYWORTH (Jan. 1, 2014), https://www.dailyworth.com/posts/2359-should-you-prepay-your-mortgage.

When you're writing a check to the bank for the extra payment, it's important to mark on it that you want it to be applied to the principal. If you don't, the bank might apply the extra payment to interest, and paying interest in advance does not earn you any more equity in your home. But do your homework. Prepayment penalties—which can be owed to a lender for prepaying a mortgage within a specified time period—are much less common than they were before the Great Recession, but do still apply in some cases (although typically just during the first two to four years of a loan).

The Cons

Remember that prepaying a mortgage isn't the best option for everyone. And in addition to making sure that your other higher-interest, non-deductible debts are paid first and your retirement and emergency savings accounts are in order, there are a few other reasons why you might not choose to prepay your mortgage:

Your interest rate is extremely low. If you were lucky enough to refinance into a 30-year fixed-rate loan at 4 percent or below, that's a historic interest rate. You might want to keep that rate and use your free cash for something else, like…

> You've found other investments with a higher rate of return. You might decide to invest your savings in the stock market or another investment that has a higher rate of return over time.
>
> Or, you might decide to buy investment property.

But if neither of these scenarios apply to you, go ahead and apply a few extra payments to your principal this year. The less time it takes you to pay off your loan, the more money you'll save in the long run.

II. Defeasance: Advantages for the Commercial Mortgage Loan Borrower

Defeasance Reduces Commercial Real Estate Fees[3]
By Robert Stammers

Commercial real estate investors who favor fixed-rate debt financing occasionally find themselves having to pay prepayment penalties when they settle their debt in advance of the maturity dates of their loans. Of the different prepayment options, defeasance is one that provides the greatest flexibility and potential financial gains when market interest rates rise. Read on to learn more about how defeasance can provide straightforward solutions in complex

[3] Robert Stammers, *Defeasance Reduces Commercial Real Estate Fees*, INVESTOPEDIA, http://www.investopedia.com/articles/mortgages-real-estate/08/defeasance.asp?lgl=myfinance-layout-no-ads (last visited July 10, 2017).

lending scenarios.[4]

What's Defeasance?

Defeasance, as its name suggests, is a method for reducing the fees required when a borrower decides to prepay a fixed-rate commercial real estate loan. Instead of paying cash to the lender, the defeasance option allows the borrower to exchange another cash flowing asset for the original collateral for the loan.

The new collateral (normally Treasury securities) is usually much less risky than the original commercial real estate assets. In this scenario, the lender is far better off because it receives the same cash flow and a much better, risk-adjusted investment. Although the benefit of defeasance for the lender is obvious, borrowers can also benefit significantly. If interest rates on loans rise to a rate greater than those of the mortgage, borrowers can create value and put cash in their pockets at prepayment. Because defeasance is an option offered during the negotiation of a commercial real estate loan, borrowers should consider it in order to preserve the possibility of creating value with their financing.

Rationale for Defeasance

Variable-rate commercial real estate loan is an appropriate method of financing short-term needs such as construction or bridge financing, which is capital loaned to real estate owners in the lease-up phase; it is repaid when the property eventually has cash flow.

Although the interest rate risk is high and there is no limit to the financial downside, some borrowers will take on long-term, variable-rate financing. This often happens when there is a high probability that a property with cash flow will be sold before the loan matures.

Borrowers use variable-rate financing for many reasons. One significant reason is to circumvent the prepayment penalties that lenders require when prepaying fixed-rate debt. On variable-rate financing, lenders do not incur reinvestment risk because the loan rates “float” with the market and, when repaid, can then be lent again at the same market rates.[5]

Risks for Lenders

Fixed-rate financing has the potential for creating financial losses or the reduction of a lender's yield when capital is repaid and then lent out at lower market rates. Due to the potential for reinvestment risk, lenders usually require some sort of prepayment penalty from those who borrow fixed-rate debt. Originally, lenders required “yield maintenance,” which dictated that borrowers pay the rate differential (between the loan rate and the prevailing market rate) on the

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[4] For background reading, see Andrew Beattie, *Find Fortune in Commercial Real Estate*, INVESTOPEDIA, http://www.investopedia.com/articles/pf/07/commercial_real_estate.asp?lgl=myfinance-layout-no-ads (last visited July 10, 2017).

[5] To learn more about these loan structures, see James E. McWhinney, *Mortgages: Fixed-Rate Versus Adjustable-Rate*, INVESTOPEDIA (May 24, 2016), http://www.investopedia.com/articles/mortgages-real-estate/08/defeasance.asp?lgl=myfinance-layout-no-ads.

prepaid capital for the period remaining to loan maturity. Because there is opportunity and financial cost associated with originating new mortgage assets, defeasance was designed as a way to eliminate reinvestment risk and the need to relend prepaid capital.

Defeasance allows borrowers to replace the collateral of their loans with assets that provide the same cash flows as the original loan. This asset exchange allows lenders to continue to receive their expected yield throughout the loan term without having to find new lending opportunities to replace the prepaid capital. As previously mentioned, the exchange of a less risky asset (U.S. Treasuries in the place of a commercial real estate property) reduces the overall risk of the lender's investment. This is an even greater benefit for institutions that securitize these mortgages. By elevating the probability that the investors will receive all the contracted payments of interest and principal, defeasance greatly increases the value of mortgage-backed securities and profits for the lenders.[6]

Benefits and Issues for Borrowers

Defeasance, unlike yield maintenance, offers upside potential for borrowers when market rates rise above the contracted loan rate. Yield maintenance is referred to as a penalty because borrowers are subject to some type of payment regardless of which direction market rates move. It is usually structured as the greater of the yield maintenance calculation or a percentage of the amount prepaid. Because defeasance requires the purchase of Treasury bonds, the movement of rates directly impacts the costs of these assets and impacts whether defeasance will be a cost or a windfall at prepayment.

In most cases, defeasance involves the purchase of Treasury bonds with maturities equal to the remaining term of the loan, with coupon rates that provide the necessary income to offset the contracted periodic interest and principal payments. These bonds are then assigned to a defeasance trust that passes the periodic cash flows to the lender until the bonds mature. Depending on the difference between the rates of the bonds necessary to defease the loans and market rates, the Treasury bonds will trade for a discount or a premium.

When rates rise, Treasury bonds (or any fixed-income investment) lose value and become cheaper. When this happens, borrowers are able to purchase the required bonds for less than what is required to prepay the loan, resulting in additional cash in their pockets. In the reverse situation, when rates fall, fixed-income investments become more expensive. This requires the borrower to pay an amount greater than the loan balance at prepayment. On the downside, the yield maintenance calculation will result in the exact same amount of additional capital necessary to defease the loan. This does not take into consideration any transaction costs that would be incurred to purchase the bonds necessary to defease the loan. These costs vary depending on the bid-ask spread or the forces of supply and demand for the bonds. On the upside, defeasance is beneficial while yield maintenance will still require some penalty to be paid.

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[6] For background reading, see Chris Gallant, *What Is Securitization*, INVESTOPEDIA (May 4, 2017—6:58 PM EDT), http://www.investopedia.com/ask/answers/07/securitization.asp?lgl=myfinance-layout-no-ads.

The defeasance option provides fixed-rate borrowers with advantages over those who choose yield maintenance or long-term, variable-rate financing. It is a good tactical decision for borrowers who feel that they have the skill to predict interest rate movements. It is also a good choice for real estate investors who know that they will be required to sell their properties in the short term, but are worried about the potential increases in debt service if they choose to use variable rate debt.

Borrowers using portfolio level debt (one loan that is collateralized by multiple commercial properties) find that lenders will sometimes require borrowers to repay a greater percentage of a loan than an asset's value contribution to the portfolio. This situation results when the lender believes that a borrower is selling an asset that is less risky than the remaining assets in the portfolio. Because the portfolio becomes riskier with the reduction of the less risky asset, lenders will require a prepayment amount that will compensate them for the greater risk being borne, effectively deleveraging the remaining portfolio and reducing the investor's leveraged return.

Because defeasance results in a less risky asset than the original collateral, borrowers can keep the same percentage of debt in the portfolio after the sale of an asset. With the agreement of the lender, it may be possible to increase the percentage of debt on the remaining assets when the defeasance is executed.

Another benefit to borrowers is that lenders don't usually require any type of payment, either upfront or by increasing loan rates, in order to receive the defeasance option. If rates rise, there is value creation potential for the borrower; therefore, it is conceivable that lenders could ask for compensation for selling the option.

Conclusion

Borrowers need to be aware of their prepayment options so that they make the correct asset management decisions. For example, in periods of significant interest rate increases, it may be preferable to sell a suboptimal commercial asset because of the value created by defeasing the loan. On the downside, it may make sense to hold on to an asset even after value optimization. The time left on the loan at prepayment directly influences the prepayment costs. All things being equal, prepayment penalties dissipate over time.

When negotiating loan terms of a commercial real estate loan, borrowers should ask for the ability to defease their fixed-rate loans even if they have no intention of prepaying the obligation before maturity. The distinct advantage that defeasance provides over other prepayment options is significant due to its ability to create an income-generating event when market interest rates rise. It is conceivable that during periods of rising interest rates, real estate owners that prefer fixed-rate financing can produce capital gains on their debt obligations that can more than offset the decreases in real estate values. Real estate investors who use financial leverage to purchase real estate investment opportunities that are to be fixed then sold should consider fixed-rate financing with the defeasance option as an attractive alternative over short-term, variable rate financing.

III. REVISED QUESTIONS

Question 1: ***Prepayment: Borrower and Lender Perspectives.***

(a) Why do borrowers ever prepay?

(b) When do mortgage lenders welcome prepayment, and when do they resist it?

Question 2: ***Practical Economics of Prepayment Prohibitions*.**

(a) Which bondholders in a securitized mortgage loan portfolio welcome prepayment when bonds are divided into interest-only and principal-only strips?

(b) Which bondholders of an interest in a securitized mortgage loan portfolio are adversely impacted by unanticipated levels of prepayment in the securitized loan portfolio?

(c) Why would a borrower ever want to prepay a long-term fixed rate loan bearing an interest rate of 4% when the borrower would have to pay an interest rate of 7% currently on a comparable loan?

Question 3: ***Prepayment Fees, Hard and Soft*.**

What is the difference between a hard and soft prepayment fee or lock-out?

Question 4: ***The Simple Math of Fixed Fees***.

(a) When is a prepaid lender likely to be undercompensated by a fixed fee formula?

(b) When is a prepaid lender likely to be overcompensated by a fixed fee formula?

Question 5: ***Comparing Defeasance to Yield Maintenance.***

(a) Explain and compare the difference between yield maintenance and defeasance.

(b) For the investor in commercial mortgage-backed bonds seeking to match its bond income with its obligations, which is preferable—defeasance or yield maintenance?

(c) For the mortgage loan borrower, which is usually preferable—defeasance or yield maintenance?

Question 6: ***Prepayment Default Rule*.**

A homebuyer eager to prepay, in order to take advantage of falling interest rates, reads through her note and mortgage carefully and finds no mention of prepayment. Assuming no applicable statutes confer prepayment rights, does this mean that she has the right to prepay even without the lender's consent or that she has no right to prepay?

Question 7: ***Enforceability of Prepayment Penalties.***

How can courts justify upholding a yield maintenance or defeasance provision as a reasonable estimate of the lender's actual or anticipated loss as a result of the borrower prepaying?

Question 8: ***A Bridge Lender's Prepayment Penalty.***

A lender that engages in making short-term, risky loans agrees to lend a developer $15,000,000–$5,000,000 to close escrow on a failing neighborhood shopping center and $10,000,000 to refurbish the abandoned grocery store that was the most important tenant in the center before it failed. The developer is well known for these kinds of "turn around" deals. The loan would be non-recourse and for a term of ten months. The developer would have the option to extend the term for an additional six months. The interest rate is $150,000 per month.

There is a prepayment provision that allows the borrower to prepay the loan at any time by paying exactly the interest that the lender would have earned if the loan had been outstanding for ten months plus an exit fee of one month's interest. The note states that this provision is not a penalty; it is a material inducement to the lender to make the loan and represents a fair and equitable allocation of risk of loss between the parties. Is the prepayment provision likely to be overturned as an unenforceable penalty disguised as a liquidated damage clause?

THE MORTGAGE LENDER'S RIGHT TO CALL THE LOAN UPON SALE OF THE MORTGAGED POPERTY: THE DUE-ON-SALE CLAUSE

I. Transferring Title to Mortgaged Property

Transferring Mortgaged Property[1]
By Alan R. Romero

The owner of mortgaged property can transfer her property just like any other owner. But she can't change the rights of the mortgagee. Because a mortgage is an interest in land, it stays with the land even if the mortgagor transfers the property to someone else, just as a running covenant or appurtenant easement would stay with the land.

And, of course, that means the property isn't worth as much as if there weren't any mortgage encumbering the property.

Restricting Transfer

Even though the right to transfer is a fundamental attribute of property ownership, mortgagees may have good reasons to be concerned about transfers of the mortgaged property. After the mortgagor transfers the property, the new owner is expected to make the payments on the mortgage loan, and the original mortgagor no longer has the same incentive to make sure the payments are made, because she doesn't own the mortgaged property anymore.

The new owner may not be as creditworthy and reliable as the original mortgagor, and therefore a transfer may increase the risk of default. The new owner also may not take good care of the property, and the property therefore will decline in value, reducing the mortgagee's security.

Mortgages therefore often include clauses restricting transfer, typically a due-on-sale clause that says the mortgagee may accelerate the debt and foreclose if the mortgagor transfers the property without the mortgagee's prior written consent. Some states have held that such clauses are invalid restraints on alienation.

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[1] Alan R. Romero, *Transferring Mortgaged Property*, DUMMIES, http://www.dummies.com/education/law/transferring-mortgaged-property/ (last visited July 13, 2017).

However, a 1982 federal statute preempts state law and makes such due-on-sale clauses enforceable except in certain situations. In most cases, if a mortgagor wants to transfer mortgaged property without paying off the loan, she must first get the lender's written consent if there is a due-on-sale clause. Otherwise, the lender may exercise its right to demand immediate payment of the remaining debt.

Assuming Mortgage Debt

If the mortgagor transfers the mortgaged property and doesn't pay off the mortgage loan in the process, the property is still subject to the mortgage, assuming it's recorded or the new owner of the property otherwise has notice of the existing mortgage.

The original mortgagor no longer owns the property and thus will not continue making mortgage payments. Instead, the new owner will have to make the payments, or else the mortgagee can foreclose and sell the property.

However, the new owner isn't personally liable for the unpaid debt simply because she bought property that was subject to a mortgage. If there is a default on the loan, the mortgagee can foreclose, but cannot sue the new owner for a deficiency on the loan itself.

When she buys the property from the mortgagor, she can expressly agree to be personally liable on the debt. Such an agreement is called *assuming* the loan. In that case, the mortgagee is a third-party beneficiary of the buyer's promise to the mortgagor and can directly sue the new owner for breach of the obligation to pay the debt.

Enforcing a Mortgage Against the Transferor

The mortgagor remains liable on her contract to repay the mortgage loan even if she transfers the property to another, and even if that buyer assumes the loan. Her agreement with her buyer can't change the rights of the mortgagee, which has a contract with the mortgagor requiring her to pay the debt.

Even if the mortgagee consents to the transfer, the mortgagor remains liable for performance of the loan obligation. However, the mortgagee can expressly *release* the mortgagor from the debt, after which the mortgagor is no longer liable.

The mortgagor is also released from the debt if the mortgagee and the new owner modify the loan in some way that increases the risk of default and liability without the mortgagor's consent.

For example, if the mortgagee and the new owner agree to extend the term for repayment or to increase the interest rate, such changes would increase the risk of liability on the debt and would release the mortgagor from the obligation if she hadn't consented to such changes.

If the buyer assumes the mortgage but the mortgagor isn't released and remains liable on the debt, the buyer is said to have the principal obligation and the mortgagor is a surety for the buyer's performance. That means that the buyer is primarily liable and the mortgagor is secondarily liable.

In the event of default, the mortgagee can sue either or both of them. But if the mortgagor pays the debt, she can recover that payment from the assuming buyer who is primarily liable to repay the debt. If she pays off the debt, she steps into the shoes of the mortgagee and can even foreclose on the property to recover the amount she paid to the mortgagee.

II. Transferring Mortgaged Property Title or Personal Mortgages to an LLC

Question:

I am a new real estate investor and I currently own 2 homes that generate a nice monthly cash flow of about $800/month. The problem is that the titles and mortgages are in my personal name and I want to get them transferred to my LLC. I've contacted the lenders that I have my mortgages through and they said that I have to refinance under the LLC in order to get the titles/mortgages transferred. I would like to use 30 year fixed mortgages but I can't seem to find any banks that have those lending terms for businesses.[2]

Answer:

Should You Transfer the Title of Your Investment Property into Your LLC?[3]
By Matthew Engel

In a perfect world, banks and/or lenders would lend money to new LLC's with no income or credit history, thus allowing you to purchase your investment property in the name of your limited liability company (LLC).

Should you transfer the title of your investment property into your LLC? You could probably ask 10 different people for their position on this issue, and receive 10 different answers. My position is that I do not like to transfer title from the individual to the LLC—for a couple of reasons. First, transferring the title when the mortgage is still in your name triggers a due-on-sale clause within the mortgage/note. Second, if you ever go to refinance, you will have to transfer title out of your LLC back to your individual name, creating a strange series of transactions for your lender and/or title company to sort through. Finally, if you ever need to file

[2] Tumblinablue, *How Can I Transfer My Mortgages to My LLC?*, Comment to Credit & Lending, Discussions, BANK OF AMERICA: SMALL BUSINESS COMMUNITY (Mar. 29, 2008 2:50 PM), https://smallbusinessonlinecommunity.bankofamerica .com/thread/4332.
[3] Mathew A. Engel, *Should You Transfer the Title of Your Investment Property into Your LLC?*, ENGEL (July 31, 2012), http://theengellawfirm.com/2012/07/31/should-you-transfer-the-title-of-your-investment-property-into-your-llc/.

for bankruptcy, it may prove difficult to discharge a note if the title to the property is not in the filer's name.

My position rests on the assumption that you have properly formed your LLC, complying with all of the statutory corporate formalities. In addition, all of your business dealings are done in the name of the LLC—your lease with the tenant will be between the tenant and the LLC, the tenant should pay the LLC, and the LLC has a separate bank account and accounting records.

From a legal standpoint, the tenant's contract is with the LLC, not with the investor as an individual. If something goes wrong, they should sue the LLC, not the individual (this is called privity of contract). That is not to say that someone couldn't try suing the individual—it is not uncommon for a litigious person to throw everything against the wall to see what sticks.

Even if your strategy was to transfer title from your personal name to the LLC in order to "tie" the property to the LLC, the mortgage and note would still be in your name anyway, thus leaving the same issue for that litigious person to throw against the wall.

In addition, if you completed all of the other steps to adequately form and operate your LLC, the argument to be made is that it would be bad policy if a court ruled that in order to receive liability protection from your LLC, that you should have violated the due-on-sale clause in your mortgage/note.

Again, every new business must start the ball rolling somewhere. Every new business is started with the capital or credit of the owner. Eventually when you have built your portfolio, built your LLC's credit history and property equity, you will no longer need to purchase properties with your own credit and in your individual name. Your goal will be to get loans through the LLC and thus title of the property in the name of the LLC.

Remember, most banks do not make loans to brand new LLC's, therefore you must start the ball rolling by purchasing your property personally. Perhaps the bank/lender will allow the LLC to purchase the property with the individual's personal guarantee or co-signature on the note. If the bank will not accept the personal guarantee, there are several other options to consider.

Some strategies could include the individual leasing the property to the LLC, which would then lease the property to the tenant. Alternatively, there could be a written agreement between the individual and his LLC whereby the individual pledges and confers upon the LLC the right to possession of the investment property.

I also place language in the annual minutes of my business entity clients that recognizes that the owner has granted consent to his LLC to possess and use the property for business and rental purposes.

All of these alternatives should be documented through company minutes of the LLC that acknowledge and authorize the LLC's use of the investment property.

Having these added formalities can only strengthen the liability shield created by the LLC.

How Can I Transfer My Mortgages to My LLC?[4]
By Terry Masters

What Can You Transfer into Your LLC?

A limited liability company, or LLC, is an independent legal entity. Once a business files articles of organization and is recognized by a state as an LLC, it begins an existence that is separate from its owners. The LLC can enter contracts in its own name, sue and be sued, and own property. The law treats the LLC as a legal person. An LLC can hold title to property, just like an individual, and has standing to enter into any sort of financing contract, including a mortgage of property.

Step 1
Determine if your mortgage instrument allows another party to assume the mortgage. A lender is not required to release you from your obligation by substituting another entity as the responsible party, unless there is a provision in the mortgage instrument that specifically allows you to assign the mortgage.

Call the lender and explain that you want to transfer ownership of the property to a business entity. Even without a specific provision, a lender could agree to allow an assumption, under certain circumstances.

Step 2
Assign the mortgage to the LLC. The lender will have a list of due diligence items that will have to be completed before the assumption becomes effective. Ultimately, you will have to execute a new mortgage agreement that releases you from liability and substitutes the LLC as the mortgagee.

Some lenders might insist you remain on the mortgage in your individual capacity as a co-borrower or guarantor in addition to the LLC to ensure payment. This would likely defeat the benefits of transferring the obligations to the LLC, however.

[4] Terry Masters, *How Can I Transfer My Mortgages to My LLC?*, LEGALZOOM, http://info.legalzoom.com/can-transfer-mortgages-llc-4391.html (last visited July 13, 2017).

Step 3

Prepare a quitclaim deed from you to the LLC and record the new mortgage instrument and the deed with the county recorder of deeds where the property is located. A quitclaim deed is the simplest deed to prepare and is suitable for this type of private transaction that does not need a warranty of sale. A quitclaim deed template form can be downloaded from the Internet or purchased from any office supply or stationery store.

Step 4

Obtain a mortgage in the name of the LLC if your lender will not allow you to assign the mortgage. An LLC can take out a mortgage in its own name. It would be subject to the same sort of application process and creditworthiness check as an individual.

Step 5

Sell the property to the LLC. Use the new mortgage proceeds to satisfy the existing mortgage on the property. With a new mortgage, you will have to go to closing and accomplish all the steps required of any mortgage.

III. REVISED QUESTIONS

Question 1: ***Why Buyers of Mortgaged Property Ever Want to Assume the Seller's Loan.***

Most realty purchasers arrange their own acquisition financing. Why are some buyers eager to keep the seller's financing in place while other purchasers prefer to start from scratch obtaining their own loans?

Question 2: ***Factors that Buyers and Sellers Consider in Deciding Whether the Buyer Should Assume the Seller's Mortgage.***

In March, 2014, Seller acquired a condo for $240,000, paying $40,000 down and obtaining a $200,000 mortgage loan, fixed rate interest, fully amortized, 30-year maturity at 3.95%. Four years later, February, 2018, the buyer and seller entered a purchase and sale contract for $300,000. Prevailing mortgage interest rates on fixed rate, fully amortized loans had risen to 7.6%.

(a) Would it be a good idea for the buyer to assume the seller's loan?

(b) If so, would the buyer be well advised to learn whether the seller's note and mortgage had a due-on-sale clause?

(c) Would it be good or bad news for the buyer if there were no due-on-sale clause in the seller's note and deed of trust?

(d) What would the lender probably require before granting consent for the buyer to assume the seller's loan under a due-on-sale clause?

Question 3: ***Mortgage Lenders and Assuming Grantees.***

(a) Why do most mortgage lenders balk at the prospect of their borrowers being free to sell the security property without their consent?

(b) What rationale could there be for the common law default rule that buyers have the right to sell the security property subject to the mortgage without the lender's prior consent?

Question 4: ***The Lender's Remedy Under a Due-on-Sale Clause.***

(a) What remedy does the lender typically reserve under a due-on-sale clause if the borrower transfers an interest in the security property without the lender's prior consent?

(b) If a lender agrees to be "reasonable" in denying consent to a loan assumption request, what specific items should the lender include in the drafted due-on-sale clause to be sure it can properly underwrite the loan, modify the loan terms to current norms, and levy fees sufficient to recoup its costs?

Question 5: ***The Implication for the Buyer of Assuming the Seller's Debt.***

B buys a house from A for $250,000, and assumes A's loan. A's loan balance on the date of sale is $175,000. Two years later, B sells to C who also assumes the unpaid balance on A's loan, now $171,000. C loses his job and defaults on the loan. A's lender forecloses. The balance of the debt is $170,000 at the date of foreclosure. At the foreclosure sale, the highest bid is:
(1) $190,000
(2) $150,000

(a) In which of these situations will C be worse off for having 'assumed' instead of taken 'subject to' the debt?

(b) Does A have any exposure here, and, if so, is there anything A can do about it?

(c) Suppose that C had assumed A's note though B had taken title 'subject to' it. Would C be personally liable on the A note even though B had not been?

Question 6: ***LLCs and the Due-on-Sale Clause.***

(a) If title to a mortgaged warehouse was held by a specially formed single member LLC, would a typical FNMA/FHLMC form due-on-sale clause in the mortgage, read literally, prevent an LLC member from selling its membership interest in the LLC without the mortgagee's prior written consent?

(b) A blogger recently wrote: "I have 4 rental properties financed through 3 different mortgage companies. 2 of the 3 told me today that they would call the mortgage due if I transfer the property to an LLC." What advice would you offer the blogger based on your reading of the standard due-on-sale clause?

Question 7: ***Federal Regulatory Limitations on the Use of Due-on-Sale Provisions.***

(a) A faculty member on sabbatical leases his house for a year. Does the federal statute allow the lender to enforce a due-on-sale clause and declare the entire debt due and payable because of the one-year lease?

(b) What if the lease came with an option to buy at the end of the year?

(c) Parents get a divorce. Mom gets title to the house. Dad, retired, gets title to what had been their vacation house. Lender learns dad is no longer on title to the primary residence, and demands Mom pay the full loan balance. Can the lender lawfully do this?

(d) Husband dies and leaves his share of the security property, a 10-unit apartment house, to his wife. Is she subject to a due-on-sale acceleration?

(e) Homeowner takes out a home equity loan. May the mortgagee holding a first mortgage on her house exercise a due-on-sale acceleration?

(f) The owner of a 30-unit apartment house takes out a loan secured by a second mortgage. Can the owner's first mortgagee invoke a due-on-sale clause and accelerate?

(g) An investor in distress properties convinces a defaulting homeowner to avoid the credit-impairment and embarrassment of an imminent foreclosure by conveying legal title to the investor in trust for the benefit of the borrower, so that the investor can attempt to market the property before the borrower's interest is lost through foreclosure. Is this transaction protected from due-on-sale acceleration?

Question 8: ***Due-on-Encumbrance Clauses.***

(a) What three little words could be inserted into a standard due-on-sale clause to make clear that the clause would apply if the debtor further encumbered the already mortgaged property?

(b) Why do you suppose Congress freed homeowners to obtain junior lien financing without the consent of their senior lienors and did not extend the same privilege to commercial realty borrowers?

(c) What objections could a senior lienor of commercial rental realty ever have to one of its successful owner retail operators obtaining junior lien financing?

(d) An investor buys AAA rated residential mortgage backed bonds. The underlying assets are 300 mortgages each secured by first liens on houses worth $1,000,000 or more, with initial loan-to-value ratios no greater than 70%. Why would the bond investors or the credit rating agency that had conferred the AAA rating care if one or more of the borrowers obtained second mortgages?

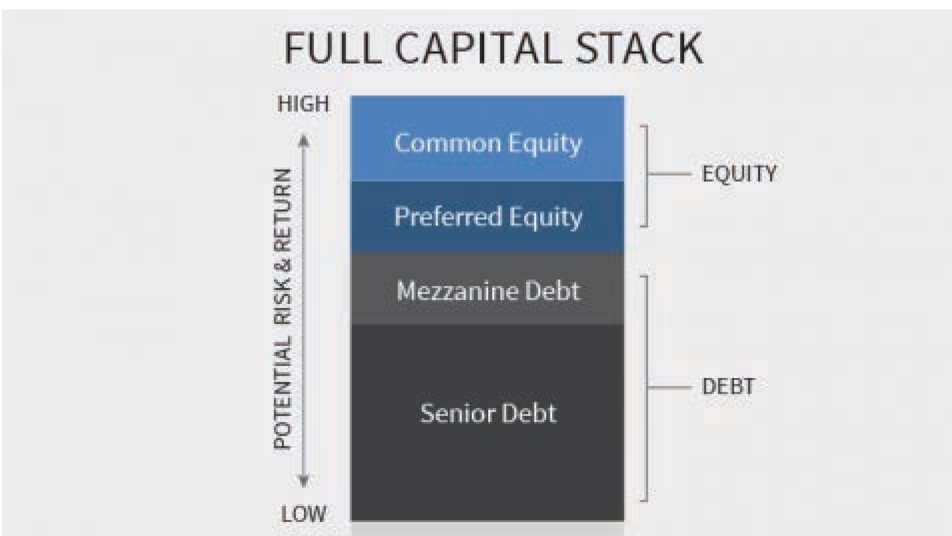
MORTGAGE FORECLOSURE

I. The Capital Stack in Commercial Real Estate, Secured Debt, and Foreclosure

The Commercial Real Estate Capital Stack: How It Works[1]

Intro

Every homeowner understands the difference between their mortgage and the equity they have in their home, but when it comes to commercial real estate transactions, the difference between equity, preferred equity, mezzanine debt and senior debt can confuse even savvy investors. The simplest deals will be just equity and senior debt, while the most complicated may have multiple tranches of mezzanine debt or senior debt that is later syndicated out into multiple notes. For now, let's focus on the four categories you're most likely to encounter when investing in real estate going from the **least** to **most** risky: senior debt, mezzanine debt, preferred equity, and common equity.



Senior Debt…

…is secured by a mortgage or deed of trust on the property itself, so if the borrower fails to pay the debt, the lender can take title to the property. This greatly reduces risk on the principal invested because, at worst, the lender owns the property and will look to maximize value by

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[1] *The Commercial Real Estate Capital Stack: How It Works*, EQUITYMULTIPLE (Feb. 1, 2017), https://www.equitymultiple.com/blog/cap-stack-commercial-real-estate-works/.

selling the property or selling the non-performing loan. The "cost" of this lower level of risk is a lower yield on the money invested. To properly understand the risk involved, look at the loan-to-value ("LTV") ratio of the loan—if the loan has a 60% LTV there is a lot more margin for error than an 85% LTV loan. It's a simple analysis: in the worst-case scenario, as the lender, you'd much rather end up owning the property at 60% of its value than 85%.

Mezzanine Debt…

Becoming involved with a distressed asset is like deciding to read "War and Peace", but discovering that your copy of the book starts on page 400. It takes a lot of catching up. Getting to know the asset's history and stakeholders, and the stakeholders' motivations and legal positions, is critical. It can make the difference between a successful investment and a protracted struggle with multiple creditors.

Investing in an asset that is subject to complex financing structures requires careful evaluation. In an earlier era, a large commercial real estate project might have been primarily financed by first-priority and possibly second-priority mortgage debt, together with a substantial equity investment by the project owner's principals. By contrast, at the height of the boom several years ago, financing on a comparable project may well have included, in addition to a mortgage loan, one or more levels of mezzanine debt, loan participation arrangements, and various derivative transactions such as loan securitization.

Even for those familiar with the rights and collateral positions of mortgage lenders in a distress setting, the peculiarities of mezzanine lending can be surprising. This column will focus on considerations to bear in mind when evaluating a proposed distressed investment with a mezzanine-financing element.

What is a mezzanine loan?[2]

A mezzanine loan is fundamentally different from a mortgage loan because its collateral is equity, not real estate. With a standard mortgage loan, the lender lends money to the owner of a real estate project. The mortgage lender's primary security for the loan is a lien on the project. If the borrower defaults, the mortgage lender can foreclose on the mortgage. Whoever purchases the project at a mortgage foreclosure sale —most often the mortgage lender itself — becomes the new project owner.

By contrast, a mezzanine loan is made not to the owner of the project, but to the parent of the project owner. The "parent" is a holding company set up for the purpose of owning stock or other equity interests in the project owner. The parent, in turn, is owned by the primary investors or principals behind the real estate project. The mezzanine lender's primary security for the mezzanine loan is a lien on the parent's equity interests in the project owner.

When a mezzanine loan default occurs, the mezzanine lender can foreclose on the parent's equity interests in the project owner. The foreclosure will not cause any change at the real estate level. Title to the project stays in the name of the same project owner company as

[2] Kate Lewis, Mezzanine Debt: A Primer for Distressed Asset Buyers (Jan. 26, 2010), National Real Estate Advisor. http://www.nreionline.com/distress/mezzanine-debt-primer-distressed-asset-buyers

before, and mortgages and other real estate documents remain in place. However, the impact at the equity level is profound. The purchaser of the equity interests at the mezzanine foreclosure sale — most often the mezzanine lender itself — gets the right to own and control the company that owns the project, the next best thing to holding title to the project itself.

Mezzanine debt sits below the senior debt in order of payment priority. Mezzanine debt typically has a higher rate of return than senior debt but lower than equity.

Once the developer pays operating expenses and the senior debt, all income must go to pay the fixed coupon of the mezzanine debt. If the developer is unable to pay (assuming they aren't also in default under the senior debt), the lender typically has the ability to quickly take control of the property. The senior debt and mezzanine lenders will usually enter into an agreement, called an intercreditor agreement, where they spell out how their rights interact (i.e., what happens if a developer stops paying both of them).

[Intercreditor terms vary widely. Sometimes, the mezz lender has the right to cure the mortgage borrower's default on the first mortgage, and to acquire the defaulted mortgage loan for the balance due.

The intercreditor agreement also answers questions about what happens when the entity that is the mortgage borrower defaults on both the mortgage loan and the mezz debt. Must the mezz lender wait until the mortgage lender forecloses? Is the mezz lender immediately entitled to initiate a UCC foreclosure of the mezz borrower's interest in the property-owning entity, taking over the ownership of that entity, and, in effect, controlling the real estate pledged as security for the mortgage loan?]

Preferred Equity…

…is perhaps the hardest portion of the capital stack to speak about generally because, for better and worse, it's very flexible. It gets its name because preferred equity holders have a preferred right to payments over regular equity holders. In terms of other characteristics, they will range from "**hard" preferred equity**, which can be very similar to mezzanine debt and include a fixed coupon and maturity date to "**soft" preferred equity**, which is more likely to include some of the financial upside if the project performs well. While hard preferred equity holders may have the ability to make some decisions or kick out the developer if they fail to make payments, soft preferred equity holders typically have more limited rights. As you'd imagine, the rate of return for hard preferred equity is similar (or slightly better) than mezzanine debt, while soft preferred equity returns can be substantially better.

Common Equity…

…is the riskiest and most profitable portion of a real estate deal. Typically, the developer (often called the sponsor) will be required—by the lender and/or by other equity investors—to invest their own money as some portion of the equity to have skin in the game. As an investor in equity your risk is the greatest because every other tranche of capital is entitled to get paid before you. However, if the property does well equity investors usually have no cap on their potential returns. In real estate, equity is typically structured so that all investors earn a preferred return until they hit a certain annual return hurdle (i.e., 8%). After that, the developer will earn a disproportionate share of the profits (i.e., 40% of all the remaining profit), while investors receive the rest of what's left pro rata.

Understanding these different investment structures and how they impact both risk and return is a key step in making real estate part of your investment portfolio. Much like investing in stocks and bonds, how you allocate between equity and debt real estate investments should depend on your investment goals and strategy, including your risk tolerance. For example, for risk-tolerant investors, heavier exposure to real estate equity may be more appealing. While studies repeatedly show that "timing the market" is next to impossible, even for experienced investors, timing considerations can also help guide portfolio strategy. After many years of a bull market, finding good value equity investment opportunities becomes more difficult, leading some investors to weight their portfolios towards debt, saving their equity investment dollars for situations where they have greater conviction. For most investors, a diversified approach makes sense both for the real estate portion of their portfolio and the portfolio as a whole.

II. The Foreclosure Experience Described

I Foreclose Houses for Banks: 5 Awful Realities[3]
By Ryan Menezes, interviewing a bank foreclosure officer

About a decade ago, home prices exploded to bizarro levels, then millions of families got behind on their mortgage payments. A financial crisis spiraled out from there, almost destroying the world. Things have improved a bit since then, but it still sucks for lots of people. If you can't make your payments, the bank squares the debt by seizing your home, and you're left out in the cold. In the modern world, it's one of the worst things that can happen to you that doesn't involve a somber doctor asking you to please sit down.

That's where Evelyn comes in. As part of her real estate job, she works with banks to handle foreclosures, evictions, and lockouts. We asked her what it's like watching this tragedy unfold again and again. And yeah, it's a nightmare.

1. We Chuck All Your Stuff

Let's say the bank forecloses on a home, but couldn't get the (former) homeowner to voluntarily move out. Here's how that's going to play out:

> We knock, the contractor drills open the lock, and in we go. We remove everything from the home and move it to the front yard. And I do mean everything…Everything but food, which is trashed, and weapons or drugs, which go to

[3] Ryan Menezes, *I Foreclose Houses for Banks: 5 Awful Realities*, CRACKED (Sep. 06, 2015), http://www.cracked.com/personal-experiences-1838-banks-cover-up-meth-labs-5-lessons-from-foreclosing-homes.html.

the police. Then, after 24 hours, I return and dump it all *back into* the house. That's because companies will bid competitively over who gets to handle the final trash-out.

That whole process is the "lockout." If the occupant *has* left and taken their stuff with them, then we poke through what they left behind. And what do we do with that stuff? It all goes to the dump.

Sometimes, we see things that make me question my job and how such horrible people can exist in the world. One family left their dog behind, locked in a room for a month with a huge bag of food but no water. The dog had ripped the room apart and soiled everywhere, but he couldn't get out. Animal Care took the dog, and the owner was charged with animal endangerment. I went home and loved my dog a little extra that night.

2. Some Homes Are Meth Labs, and the Banks Cover It Up

And this is worse than, say, covering up that someone died in a house, because ghosts are benevolent 90 percent of the time. When people (like this family) unknowingly buy foreclosed homes that were meth labs, they're liable to get breathing problems, nosebleeds, and mouth sores from the chemical residue. One family only identified the problem after five years and numerous emergency room visits, and then they learned that cleaning out the house would cost $30,000. One study found that 11 percent of foreclosed multifamily units are tainted with meth.

3. Owners Will Trash Their Homes Out of Spite

A lot of people take the attitude that if they can't keep their home, then they'll make sure that no one else can enjoy it either. And when they don't go all the way and try blowing the whole place up, this means leaving the place as unusable as possible.

Most commonly, they pour cement down toilets and sinks, forcing us to redo all the plumbing. One guy removed sections of pipes so that the bathroom would flood once the sinks were turned on. Another couple opened every electrical outlet and yanked out the wiring.

We see a lot of places where wall-mounted TVs were straight ripped out of the walls, taking the drywall with them. (Wouldn't that make transporting a TV harder?) People will remove entire kitchens, including counter tops and floorboards. Sometimes, this is to resell the items, but mostly, it's because they spent a great deal of money on a remodel and can't stand the idea of the bank profiting off of that. Plus, don't act like you've never fantasized about trashing a kitchen.

Then there's the food in the fridge. It sometimes takes years before someone actually gets assigned to manage a foreclosure. That means years of no electricity, no air conditioning—just food reveling in decay. It rots in the refrigerator until mold grows so much that it pushes open the door and you can smell it from outside. In that case, we keep kicking the fridge closed until it's time for trash-out, and then duct tape it shut, put it on the curb, and let the city handle it.

And once again, you'll see people's entire tragic downfall spelled out right in front of you. I found one home filled with graffiti, and at first figured that neighborhood kids had broken in. But then I realized that the homeowner himself had left a bizarre, painted message about his recent divorce, punctuated with anchors and hearts. This was after his wife had taken all the furniture, leaving him with a pallet of blankets and sheets on the living room floor. He even spray-painted a TV on the wall, complete with “Play” and “Pause” buttons. Yeah, this job is mostly about finding people at the absolute lowest points in their lives.

4. *The Banks Could Have Worked with Them ... or Even Paid Them to Move Out*

The movies say that if you approach a bank rep and ask about modifying your loan to lower your payment, they'll smugly laugh in your face.

Understand: The bank *doesn't want your house*. Banks are in the loan business, not the real estate business—they'd much rather leave you in your home and collect the payments that will earn them double what the house is worth. The bank doesn't give you the loan hoping your life will fall apart. Foreclosing means that the bank is abandoning years of missed payments, paying an attorney to do the foreclosure, paying for the repairs I mentioned above, paying fees and maintenance, sometimes tens of thousands of dollars in homeowners' association back dues, etc. Holding a house without making money on it screws their books, and it all probably ends with auctioning the house off at a reduced price. This means that the bank has all sorts of motivation to work with you.

If the bank insists on foreclosing (and you can't argue because you really are broke and can't make any payments at all), you still shouldn't leave immediately. That's because if you wait, they'll likely pay you to leave through a program dubbed “Cash for Keys.” Often, they'll give one percent of the home's value. Wells Fargo sometimes offers 10 percent (say, $5,000 on a cheap $50,000 home).

Banks say that the payments help with moving expenses and aim to “help the housing crisis.” (And the big payments, like the $30,000 ones, get them good PR.) But what they don't tell you is that it is also to keep you from getting so pissed that you tear the house apart. The payment comes with specific instructions—you have to leave all appliances, you have to clean the house thoroughly, and you can't go nuts and break stuff—because the goal is to get the house in a salable state as soon as you leave.

Yet, you'd be shocked at how many people don't take such a deal, or refuse to even listen. I used to visit homes directly to present Cash for Keys offers. But people who have hunkered down hate foreclosure reps, and view us as another arm of the bank that's trying to wreck their lives. One homeowner said that she'd shoot if I ever returned, and when I continued talking about Cash for Keys while standing in the street, she said, “I'm going inside to get my gun, and we'll finish this once and for all.” We send those offers by mail now.

When I said earlier that this job is about seeing people at their lowest, I meant it.

5. Lots of People Facing Foreclosure Kill Themselves

When I break open a lock and enter a home, a police officer always accompanies me. This has nothing to do with making the break-in or lockout more legitimate; it's so the officer can search the place for bodies (and illegal activity, but mostly bodies). That's how common suicides are in foreclosed homes.

At least our search makes sure that the body's out before the house is sold. Sometimes, a house gets auctioned off to other investors first and never gets into the bank's hands, so we never get a chance at it. So you get the occasional odd case like this guy, who bought a foreclosed home and found the previous owner's dead body stretched out in the bedroom. It was so decayed that he couldn't tell if it had been a man or a woman.

People look at their home as their only material asset, and foreclosures stay on your credit report for seven years. That's a long time to have people look at you sideways when you apply for credit or a rental. And the logistics are daunting. *Where do I go? Will anyone lease to me? What do I do with all my stuff? Where do I come up with a security deposit and the first and last months' rent when I can't even pay my mortgage?* People get so overwhelmed that they simply can't handle it.

Lots of others in the same position do manage to move on with their lives, so to be clear, getting foreclosed on *is not a good reason to kill yourself*. But whether people shoot themselves in their kitchen, cry when they come home to a newly-locked door, or accept a payment from the bank and make the best of the situation, foreclosure's a personal tragedy. These are people's homes. People picked this place out, moved in, fixed it up, lived in it, learned in it. They did the best they could. And it wasn't enough.

III. Mortgage Servicing Then and Now

Who's to Blame for the Mortgage Mess? Banks, Not Homeowners[4]
Abigail Field

As the home foreclosure protests the foreclosure crisis has escalated over the past several months, one overarching debate has been about who bears the most blame: homeowners or banks?

After everything I've learned and written about the foreclosure mess, my verdict is: The banks are responsible for 90% of the problem, troubled homeowners 10%.

[4] Abigail Field, *Who's to Blame for the Mortgage Mess? Banks, Not Homeowners*, AOL.COM (Jan 20, 2011), https://www.aol.com/2011/01/20/whos-to-blame-for-the-mortgage-mess-banks-not-homeowners/

Yes, every foreclosure involves a homeowner not paying his mortgage. But every foreclosure also involves a bank that made the loan. And usually another bank, or several more, that profited from securitizing the loan. And still another bank, or several, that profited from servicing the loan. Together, those banks have done three things that created the massive glut of foreclosures choking America's legal systems and laying waste to its real estate markets:

They knowingly made millions of loans doomed for foreclosure as soon as the check was written. They deliberately and/or incompetently failed to modify many salvageable mortgages. They were so careless with their paperwork and processes that they've undermined the rule of law, clouded the title to untold numbers of properties and complicated the processing of the massive backlog of foreclosures that hurts the economically crucial real estate market.

Let's take a closer look at each factor.

What Happened to Underwriting?

Getting a mortgage isn't supposed to be as easy as getting cash from an ATM. Banks are supposed to make applicants prove they can repay loans before giving them. The process is called underwriting, and it's one of the most basic in banking.

Yet during the housing bubble, banks largely stopped underwriting in any reasonable way. Indeed, if the banks had been underwriting throughout, the bubble could never have inflated so much.

If you want to get a vivid and entertaining overview of the dynamics that eliminated underwriting, listen to Planet Money's interviews of people at every stage of the process, from making the home loan through its ultimate securitization.

The mortgages made without underwriting have lots of names: Low-doc loans (the borrower stated her income without proof, but proved the assets she claimed to own, or vice versa), no-doc loans (borrower stated both income and assets without proving either), NINJA loans (no proof of income, job or assets). They're all known as liar's loans. According to a recent Forbes article, in 2006 and 2007 liar's loans accounted for 40% of new mortgages, and more than 50% of new subprime mortgages.

The Banks Knew Mortgage Applications Were Fraudulent

Now here's the thing: No one forced the banks to make those loans, even if the applicants were lying about their ability to repay.

People shouldn't be sympathetic to banks that effectively say: "Hey, we knew the applicants were lying and wouldn't be able to repay the loans. We didn't care because we didn't hold onto the loans. We offloaded the risk to investors through the securitization process. But so what? Blame the deadbeat borrowers for the volume of foreclosures today."

Why is it fair to say the banks knew they were being lied to? Well, beyond the obvious -- everybody in the business used the term liar's loan -- the FBI warned about mortgage fraud back in 2004. And take a look at this 2006 fact sheet from the Mortgage Brokers Association for Responsible Lending that analyzed data from 2004 and 2005. By doing a quick check, the group found that 90 out of 100 stated-income loans exaggerated the applicant's income, and 54 of those loans inflated it by more than 50%.

Or consider this Chase loan officer's email acknowledging that he had made up an inflated income amount to make a borrower's debt-to-income ratio "work."

By 2007, the FBI reported that industry insiders -- loan officers, mortgage brokers, real estate agents, appraisers and lawyers -- not wannabe homeowners -- were involved in some 80% of mortgage fraud. The FBI calls that "fraud for profit" as opposed to "fraud for housing," which is when a homeowner lies to get a house he can't afford. As Calculated Risk's Tanta showed in 2007, that distinction started breaking down as the absence of underwriting by the banks enabled both types of fraudsters to join forces.

Tanta also explained that in addition to being directly complicit in mortgage fraud, lenders engaged in massive cost-cutting efforts that gutted their ability to underwrite loans:

So many of the business practices that help fraud succeed -- thinning backoffice staff, hiring untrained temps to replace retiring (and pricey) veterans, speeding up review processes, cutting back on due diligence sampling, accepting more and more copies, faxes, and phone calls instead of original ink-signed documents -- threw off so much money that no one wanted to believe that the eventual cost of the fraud would eat it all up, and possibly more.

Beyond the idea that the banks knew, in real time, that they were making loans that couldn't be repaid, evidence shows that banks went a step further and tried to conceal that information from others.

Banks Hid Fraud by Shopping for AAA Ratings

Banks weren't the only entities to stop evaluating risk. Their key allies were the big three ratings agencies, Moody's, Standard & Poor's and Fitch. The ratings agencies put AAA ratings on securities that didn't come close to deserving that golden grade, in part by using outdated risk models that their own analysts complained inflated ratings. But why weren't the agencies worried about their professional reputations?

In 2009, professor and former financial regulator William K. Black used a paper from S&P to discuss how the banks and the raters chose not to look at the documents used to make the loans they were securitizing. Then Black cited a 2007 paper from Fitch to show why it mattered that no one was looking at the loan files, why it was at minimum willful blindness. (Willful blindness is trying hard to not know that the law holds you accountable for knowing.)

What was going on? According to 2010 testimony from former ratings agency executives and their emails, the agencies capitulated to demands from banks for AAA ratings on mortgage-backed securities even though they knew those ratings weren't deserved.

The banks had the leverage to get the AAA ratings they wanted because rating "structured finance products" -- mortgage backed securities and the like -- had become really profitable for the ratings agencies, and compared to other types of rated securities, very few clients issued them. So if those clients -- the big banks -- weren't pleased, they could simply "ratings shop" -- that is, go from one agency to another until they got the desired rating.

In short, a large proportion of the foreclosures drowning the courts and the real estate market are a direct consequence of the banks' failure to effectively underwrite loans during the bubble. Those borrowers should have had -- and today would have had -- their loan applications rejected.

Servicers Get Paid to Foreclose, Not Modify

But wait, you might point out, it's not just the dodgy liar's loans going bust. Foreclosures have spread widely throughout the "prime" mortgage market as well. Surely, the Great Recession, not the banks, is to blame for many of those foreclosures.

You'd be only partly right.

What's generating many recession-induced foreclosures is the relatively new model of mortgage servicing. Prior to the mass securitization of mortgages, the bank that made a mortgage was the same bank that serviced it. As a result, the servicing bank made its money from the mortgage interest, and the long-term repayment of the mortgage was key to its profit.

So, a bank was typically willing to work out a mortgage modification with the homeowner to keep that income stream intact.

Of course, sometimes the homeowner was in such trouble that foreclosure made more sense. Foreclosures do happen even in real estate markets filled only with solidly underwritten loans serviced by the bank that made the loan. That's because bad things do happen to prevent a once-creditworthy borrower from repaying.

But what's happening now is that modifications that do make sense aren't being done. That's mainly because the servicers of securitized mortgages make more money by doing foreclosures than modifications. But incompetence is to blame, too, due to banks' efforts to do everything on the cheap. As a result, they've lacked the staff and processes to do modifications well. They can't even keep their numbers straight, despite their insistence that their loan files are accurate.

How many forecloses result from financial incentive and how many from incompetence isn't clear, but it's also irrelevant. The point is that a good chunk of foreclosures shouldn't happen because modifications make more money for the people the mortgage is owed to (usually, the investors in the mortgage-backed securities).

Simply put, if the banks had kept up normal underwriting and had modified mortgages (or approved more short sales) every time it made sense to do so, we wouldn't have the foreclosure volume, and thus delays, that we currently face.

The "Paperwork" Problems Aren't Meaningless

Now you might ask, in addition to volume-related delays, with so many foreclosures in the system, aren't defaulted homeowners to blame for gumming up the process? Aren't they just citing meaningless problems with the banks' paperwork so that they can stay in their homes for free, hurting everyone else in the process?

No.

While it's true that foreclosure defense attorneys want to slow the process to give their clients more time to relocate, that doesn't mean the "paperwork" problems they're raising are meaningless.

For example, the banks' carelessness with the securitization of Massachusetts mortgages has clouded the title to thousands of properties. Foreclosure attorneys' use of non-lawyers in Pennsylvania may have clouded the title to thousands more. The use of a private, electronic database (called MERS) to track mortgages instead of recording them in government land records may have clouded yet millions more. And in any case, MERS is a legally problematic cost-savings strategy that has created only more confusion and delay.

Even homeowners who are capable of curing their default sometimes can't because banks' inaccurate record-keeping about how much the homeowners owe precludes the possibility. More outlandish problems have surfaced too: from multiple banks trying to foreclose on the same property, to banks foreclosing on homes bought with cash, to banks breaking into homes they haven't foreclosed on, to a bank ignoring its court-approved agreement to foreclose and demanding the money instead.

What Revelations Are Still to Come?

These cases are probably just the leading edge of a paperwork-problem tsunami. Even though these issues have been in the news for months, the official investigations and litigation are still in relatively early stages. Millions of foreclosures in nonjudicial states haven't gotten the scrutiny they deserve (except presumably as part of the 50-state attorneys general investigation), so who knows what will yet surface?

As major judiciaries force a closer look at bank documents, what will they find? The fact that all the major law firms advising on "typical" securitization deals didn't know that "assignments in blank" violated Massachusetts law is chilling. How many other states' laws were broken by the "typical" deal?

Moreover, everything we're seeing suggests the banks' papers for securitized loans are in total disarray. The note is in one place (theoretically), the record of payments on the loan (inaccurate as it may be) is in another, and the ownership of both the note and the mortgage may or may not be the same. When asked to produce securitization documents, banks frequently submit drafts and contracts without attachments. The attorneys doing the foreclosures are buried in volume, cutting corners themselves, and are unable to meaningfully communicate with their bank clients. Indeed, it may not even be attorneys doing the foreclosures.

Signs of this chaos abound, whether it's dead financial firms signing documents, banks changing their minds about who owns the loan in the middle of court proceedings, or attorneys unable to certify that the information in foreclosure complaints is true.

And What's the Fate of Mortgage-Backed Securities?

The banks also have a different type of mortgage "paperwork problem" relating to mortgage-backed securities. Will the banks discover that millions of mortgages they thought they had securitized instead stayed with them because they screwed up the paperwork to transfer the mortgages?

Massachusetts will be a leading indicator on that question because the "assignment in blank" problem may have prevented most of those Massachusetts mortgages from being securitized. Or if the securitizations technically succeeded, will investors still win suits against the banks or force them to buy back large volumes of securities because the papers the banks used to sell the securities were fraudulent?

The foreclosure paperwork problem damage the banks somewhat and the broader economy even more so, but the paperwork problem with mortgage-backed securities has the potential to trigger Bank Bailout II.

No One Is Above the Law

But imagine for a second a world that doesn't exist -- one in which the banks' foreclosure documents were all accurate, and their problems were simply a failure to abide by the rules that apply to everybody else? Shouldn't we blame the deadbeats for gumming up the system then? Many readers make comments to that effect on some of my reporting.

Let's flip the question: Why is it OK for the banks to ignore the rules? The rich and powerful and the ordinary Joe are all supposed to play by the same rules. No one is supposed to be above the law.

No matter whether it's America's real estate market getting crushed by millions of foreclosures that didn't need to be, or our real property records getting shredded through clouded titles, or citizens' tax dollars being used to bail out banks again, we're all paying for the banks "paperwork" problems.

And remember: We don't know yet just how big that bill is ultimately going to be.

The Changing Dynamics of the Mortgage Servicing Landscape: A Review of the Mortgage Servicing Market's Recent History and the Way Forward[5]

Overview

The objective of this paper is to describe the role that servicers play in the mortgage banking industry, provide a summary of the regulatory framework that applies to both bank and non-bank servicers, and provide perspective on two of the areas that have recently generated regulatory interest: mortgage servicing transfers and servicer net worth, capital, and liquidity requirements.

Executive Summary of Findings and Perspectives

The mortgage servicing industry has experienced significant changes over the last decade. The 2008 financial crisis not only caused an increase in the number of delinquent borrowers that required assistance but also heightened the expectations that regulators, investors, and consumers have of mortgage servicers. Along with new regulatory standards at both the state and federal levels and enhancements to operational, capital, and liquidity requirements from investors, there have been recent calls for additional regulation.

In response to the increased scrutiny, servicers have bolstered processes, quality assurance, and customer-facing practices in order to remain compliant and those changes have manifested into rising servicing costs based on industry averages. The cost to service a performing loan has increased from $59 to $156 per loan per year from 2008 to 2013, while the non-performing cost to service has risen from $482 to $2,357 per loan per year over the same time period.1 While some servicers have attempted to mitigate these cost-to-service increases through technological innovation, many remain challenged by legacy platforms that require time-consuming and costly changes to accommodate the latest requirements and servicing standards. While the servicing business model (especially when servicing is retained) and origination business model are frequently viewed as having natural offsets, managing the economics of servicing has become more challenging for servicers.

During the financial crisis, mortgage servicing market share also began to shift with a reduction in concentration among the top servicers. Market share has not only undergone a general reduction in concentration, but there has also been a shift in servicing market share to non-banks as they continue to take advantage of opportunities to meet market demand. However, non-bank mortgage servicers in the top rankings are not a new phenomenon. In the late 1980s

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[5] The Changing Dynamics of the Mortgage Servicing Landscape: A Review of the Mortgage Servicing Market's Recent History and the Way Forward, PWC.COM, https://www.pwc.com/us/en/consumer-finance/publications/mortgage-servicing-landscape-dynamics.html (Aug. 2015)

and early 1990s, non-depository mortgage bankers were major players in the servicing market. Today, while banks still hold the majority of the mortgage servicing assets in the country, the 5 largest non-bank servicers saw their market share grow by between 30 and 350 percent between 2001 and 2014.2 In our view, the primary drivers of non-bank servicing growth include:

- Servicing volume that has transferred from bank to non-bank servicers as a result of large servicers moving delinquent portfolios, portfolios being transferred from distressed entities, portfolios being transferred from institutions exiting the mortgage business, and GSE-mandated / GSE-arranged transfers;
- Banking institutions returning to a focus on their core banking / retail customer;
- Balancing of guarantee fees among Government-Sponsored Enterprise (GSE) sellers;
- Emergence of firms that are structured to invest capital in Mortgage Servicing Rights (MSRs) and / or mortgage servicing companies,3 and;
- An increase in the number of banks that are using non-bank subservicers.

While banks and non-banks have differences in how they finance operations and whether they hold deposits, all mortgage entities are fundamentally originators and servicers subject to the same consumer-related regulatory requirements with differing prudential requirements. Regulation and scrutiny have increased across the board, and this paper will highlight two specific areas. First, as the market for MSRs has been active with the frequency and size of transfers increasing, regulators have been holding servicers to high expectations as it relates to the execution of servicing transfers to ensure borrower impact is minimized. Second, investors have imposed new capital, liquidity, and net worth requirements designed to mitigate servicer failures.

Change has become the new normal from a market composition and participant perspective. Regulators and guarantors with different oversight responsibilities have been enhancing prudential and other rules to protect borrowers and taxpayers. The impacts of these changes are not limited to servicers. Consumers are also impacted by servicing due to the interplay between servicing costs and upfront loan pricing. In a rising cost environment, the value of servicing / MSRs declines due to decreased profitability and one method that originators use to boost prices and preserve production margins is to increase rates and / or upfront origination costs.

In order for the mortgage servicing market to continue to function in an open, liquid, and efficient fashion, prudential standards should be harmonized across regulatory entities to maintain consistency while reducing the cost of compliance, and restrictions on transfers should be limited to allow servicers the ability to adapt their portfolios to manage their balance sheets and strategic objectives.

Family Makes Their Mortgage Payments But Gets Foreclosed On Anyway[6]
By Steve Rhode

How ridiculous would it be if you made all your mortgage payments in full and on time for years and your mortgage lender foreclosed on you anyway? Surely that could never happen. Unfortunately, that's exactly what happened to Henry and Elizabeth Manfrediz, a lovely married couple with four kids and a cute dog, who live in Florida.

Henry and Elizabeth took out their mortgage in 2008 with JP Morgan Chase, who later transferred the loan to Fannie Mae, as often happens with many lenders who originate mortgages to sell them on.

In this case, the loan servicers for Chase and Fannie Mae appear to have so totally botched the handling of the mortgage that this family has incurred legal fees and other charges, like having to pay for a lender initiated homeowner's insurance policy they never needed. The only thing they did wrong was make their mortgage payments on-time, every single month, and continue to do so even today.

In 2010 the loan was being serviced by Chase who told the family they owed nearly $4,000 more for an insurance policy that Chase needlessly purchased to protect the property. Chase then sold off the loan to Fannie Mae and the loan got a new servicer who continued collection of the errant insurance premium. This very expensive insurance policy was forced on the homeowners despite there being no lapse in insurance and after receiving accurate and timely payments for more than two years into the loan. This insurance policy should never have been required if the servicer had not so totally botched the accounting of this loan.

When the mortgage was taken out, the Manfrediz family had met the lender requirements of not needing mandatory lender escrow because they had made a large 20% down payment. They gladly accepted the responsibility of making their timely taxes and insurance payments without the mortgage company's escrow service.

The taxes and insurance payments were received by the insurance company and tax authority as they were due. Their payments were never delinquent so the couple never needed an additional insurance policy. Regardless, that $4,000 policy was forced on them by the loan servicer even though they were covered by insurance and in good standing.

Month-after-month, year-after-year, mortgage payments to the loan servicer were refused and returned, even today, though the family has done nothing wrong. The family did not idly stand by, they took action. In fact they made repeated telephone calls and sent detailed letters pointing out the error and trying to the get loan servicer to fix their mistakes.

Henry Manfrediz is rightfully upset by all of this mess. He said, "I never thought it would ever be possible to face the loss of my home to foreclosure when I made my mortgage payments

[6] Steve Rhode, *Family Makes Their Mortgage Payments But Gets Foreclosed On Anyway*, HUFFINGTON POST (last updated June 2, 2015), http://www.huffingtonpost.com/steve-rhode/family-makes-their-mortga_b_6994004.html

as required each month but that's exactly what has happened. If it can happen to me, it can happen to anyone."

The issue even went through mediation with the lender who would not budge to fix the situation to adequately repair the mess created. Until the court action, handled by Chad Van Horn, Esq., managing partner of the Van Horn Law Group, there was no movement towards a positive resolution.

According to court documents, the loan servicer says this is not the first time they've had to deal with similar situations. It's a problem that happens time-and-time again from many loan servicers. Seterus certainly isn't the only loan servicer that has to fix mistakes that have harmed good customers.

While the loan servicer Seterus describes themselves by saying they are, "one of the nation's leading specialty loan servicing companies" and a "loan servicing company consisting of experienced, skilled professionals using leading technology. Customer service is our top priority in all interactions that we have with the borrowers we serve." But in this case, while Seterus has now admitted the errors, they are steadfastly refusing to facilitate making the innocent homeowners whole again, according to court records.

In court documents, Seterus also admits they received payment every month from Henry and Elizabeth and rejected the payments.

At this time the couple is leaning on attorney Chad Van Horn to help make this situation right. The couple is just trying to get their mortgage corrected to show the payments they've attempted to make for years, get their credit report corrected, and receive reimbursement for all the legal fees they've had to incur to get this mortgage debacle fixed.

Attorney Van Horn said, "People face injustice every day but this case is especially egregious since this well organized and intelligent couple has tried to do everything in their power to get their mortgage servicer to properly account for the mortgage payments they've sent for years. Instead the mortgage payments were refused and the couple faced the loss of their home. My firm and I are proud to help Henry and Elizabeth and other couples facing these type of situations to get their mortgage companies to correct the mistakes they've made."

To add insult to injury, the loan Servicer for Fannie Mae, Seterus, is continuing to report the mortgage as late to the credit bureaus, month-after-month.

The damaged credit report has cost the Manfrediz family dearly. Due to their erroneously damaged credit report resulting from this mortgage debacle, they've had to pay more for subsequent purchases and have been unable to refinance their home and rental property. They've also had to face numerous collection calls for an account that should have never been considered delinquent in the first place.

Henry says, "It's very frustrating to have UPS make daily stops at your house (including Christmas Eve!) for over a year, delivering default letters, demand letters, and other foreclosure documents. The neighbors all want to know what's going on. The kids know what's going on and are scared of the uncertainty. Every Realtor, property investor, and foreclosure specialist in the county has contacted us by phone, mail, or knocked on the door. I would have refinanced a long time ago if they hadn't marked up my credit from the beginning and trapped me in this loan. Our finances are in disarray. We do not deserve to be in this situation"

Henry added, "Thankfully Mr. Van Horn and the Van Horn Law Group have been fighting hard for us. I teach my kids to always do the right thing, and I think that's what Chad is doing for us. He and his team have been great and we're hopeful this will be rightfully resolved." If there is any good news to be found in the situation at least Fannie Mae has since dismissed their errant foreclosure efforts while the counter-claims for damages are still in process.

Also, Henry took excellent action along the way. He kept a log of communications with the loan servicer, documented all the actions he took, sent detailed letters to correct the errors and sent them by traceable means. Henry and Elizabeth also continue to send their mortgage payments every month, trying to pay their mortgage. Henry created a clear paper trail that he's tried hard to get this unfortunate situation created by the lender and servicer, corrected. These are good lessons any other family facing a similar situation should adopt.

IV. REVISED QUESTIONS

Question 1: ***Secured and Unsecured Debt.***

(a) What is the difference between a creditor holding a secured and an unsecured debt?

(b) How does a creditor convert an unsecured debt into a secured one?

(c) Why is it important for a judgment creditor to record evidence of its security interest, which usually takes the form of an abstract of judgment?

(d) Why are debtors obligated to repay unrecorded debts?

Question 2: ***Deficiency Judgments.***

(a) What is the practical significance to home mortgage borrowers and lenders of the following statute?

Arizona Revised Statutes § 33-729A provides: "[If a mortgage has been given on property used as a single family or two-family home on a parcel of up to 2 acres and] the proceeds of the mortgaged real property sold [in the foreclosure process] are insufficient to satisfy the judgment [for the amount due on the mortgage loan], the judgment may not otherwise be satisfied out of other property of the judgment debtor, notwithstanding any agreement to the contrary."

(b) Do you believe anti-deficiency laws are, on the whole, a good or bad idea?

Question 3: ***The Foreclosure Process.***

(a) Explain briefly the differences between judicial and nonjudicial foreclosure, as you would to a friend who was in business school, lost her job, and cannot meet her monthly home mortgage payments.

(b) What does each of these documents accomplish for the borrower and the lender: (1) notice of default; (2) notice of sale; and (3) notice of acceleration?

(c) What advice would you give a friend thinking of a 'strategic default' on an 'underwater' house who could rent a comparable house at half the price?

(d) Do you regard a 'strategic default' as morally defensible?

(e) What are the practical consequences, pro and con, of a strategic default?

(f) Clearly, strategic defaults could be avoided if lenders were willing to grant principal reductions to preserve the lender's loan to value ratio—but not to exceed current market value levels. Why are lenders so unwilling to modify loans in default by granting principal reductions, even though it could save them the enormous costs of foreclosures?

(g) Why are the purchasers of non-performing loans at steep discounts more inclined to grant loan modifications by reducing the loan balance due to current market value?

Question 4: ***The Special Purpose Entity***

(a) Why are commercial real estate lenders often insistent on the mortgaged property being held by a special purpose entity that has no other assets or liabilities?

(b) The consequence is that the "borrower" is likely to be an LLC whose members have no liability for the entity's debts. How does the mortgage lender benefit from releasing from personal liability the very individuals responsible for the success or failure of the venture that the lender has made possible with its loan?

(c) Li owns three shopping centers. All three shopping centers are located in neighborhoods with large Asian-American populations. Two are anchored by grocery stores specializing in serving an Asian consumer base. A poorly performing grocery store that had anchored the third center is closing. Mr. Li needs a short-term loan to re-position that third center along the lines of his two successful ones. For Mr. Li's re-positioning loan, who should sign the note and deed of trust as the ‘borrower'? Would Mr. Li and his lender prefer ‘the borrower' to be:

(1) Mr. Li personally?

(2) A separately formed LLC holding title to the third center (the one needing renovation)?

(3) The existing LLC that holds title to all three of the centers

(d) The mortgage lender might want “cross collateralization,” a provision added to the mortgages on the two thriving locations, that these centers are additional security for the mortgage loan on the third center. Would this be pretty much the same, or not much different, from having the existing LLC hold title to all three of the centers

Question 5: ***Why Are Commercial Entrepreneurs Forgiven for Failed Projects?***

The past financial calamities of commercial real estate entrepreneurs who know how to create large-scale projects are often quickly forgotten. An example of this was evident in the real estate roller coaster career of former attorney turned developer Ian Bruce Eichner. In the 1990s, he developed and lost several NYC signature high-rise office projects: Cityspire to the Bank of Nova Scotia and 1540 Broadway to bankruptcy. Then, in 2008, Eichner's $4 billion Cosmopolitan hotel-condo project in Las Vegas could not be refinanced upon completion, and construction lender Deutsche Bank foreclosed and eventually sold it to Blackstone at a huge loss, for less than $2 billion.

Despite all these setbacks his commercial real estate lenders and partners experienced, Eichner is currently developing a 64-story condo tower in mid-town Manhattan and a 32-story condo tower in Harlem.[7] Commercial developers with the talent and capacity to construct complex projects are not held personally accountable for the ups and downs of real estate market values.

Why do you suppose sophisticated commercial real estate lenders continue to finance promoters of spectacularly disastrous projects when a defaulting homeowner will not be eligible for another home mortgage loan for years?

Question 6: ***Monetary and Non-Monetary Defaults.***

The basic purpose of mortgage law is to make sure the mortgagee does not cheat the mortgagor out of more than the amount due on the loan. Clearly, monetary defaults relate to the mortgage lender's financial stake. But non-monetary defaults are more elusive to appraise. Also, they could result in a precipitous foreclosure even though the value of the security property exceeded the debt, and the default caused no direct monetary loss to the lender.

Would you be sympathetic to a mortgagor seeking a court injunction to prevent foreclosure for a non-monetary default? One example could be a borrower experiencing a

[7] *Ian Bruce Eichner*, WIKIPEDIA, https://en.wikipedia.org/wiki/Ian_Bruce_Eichner (last visited July 12, 2017).

material adverse change in its financial situation due to eroding market conditions at other locations. Another could be the failure of the borrower to maintain a Debt Service Coverage Ratio of 1:2 at the security property because a major tenant went bankrupt and the space is presently vacant and on the rental market.

Question 7: ***Reinstatement, Equitable Redemption, and Statutory Redemption.***

In a notice of intent to accelerate, a mortgage lender informs a defaulting borrower she has 30 days to make up her last three monthly mortgage payments, all past due, totaling $3,150, including allowable costs. She owes $100,000 on the mortgage loan. At foreclosure, the winning bidder pays $85,000.

(a) What is the price of reinstatement?

(b) What will it cost the borrower to exercise her right of equitable redemption?

(c) What will the borrower or a junior lienor have to pay for statutory redemption?

Question 8: ***Why Not Strict Foreclosure?***

(a) If you were to compare the amounts due on foreclosed mortgages with the winning bids at foreclosure sales, you would discover that only rarely does the winning bid exceed the foreclosed debt. Most of the time, the only bidder is the mortgage lender bidding exactly the amount due on the debt. Yet, foreclosure sales add hugely to the losses that lenders incur when they foreclose. Typically, losses equal 30% of the amount due. Then why do you suppose more states have not embraced "strict foreclosure," a process that allows lenders to petition the court for title to the security property without a foreclosure sale?

(b) An imaginative mortgage expert has an idea for offering property owners the equivalent of mortgage financing at a much lower price. Instead of a note and deed of trust, the borrower deeds the property to the lender and the lender leases the property back to the borrower with an option to buy at the end of thirty years. The lease payments are calibrated to be the same as mortgage payments would have been. The lease and the option terminate if the borrower misses a payment. The lender's yield is lower than what a typical interest payment would have been on a mortgage—reduced by the difference between what a foreclosure by sale would have cost a lender, and the costs of a summary eviction if the tenant defaults. The borrower defaults at the end of the second year. The lender initiates a summary eviction. Does the borrower/lessee have a good defense to the eviction?

Question 9: ***The Validity of a Mortgagee's Lien Subject to a Purchase Option.***

When Uncle Sal sold his vacation beach house to Niece Laura for $500,000, they both knew the property was worth much more than that. So she had no problem acceding to Uncle

Sal's request that she give Nephew Ricardo an option to buy the house for $200,000 if she decided to sell any time in the ensuing decade.

Uncle Sal was a title insurance underwriter, and insisted that the option be duly recorded.

A year after Sal deeded the house to Laura, she borrowed $850,000 to invest in a tech start-up that she was sure would become a “unicorn.”[8] She secured the loan by granting the lender a deed of trust on the house. The mortgage lender's title insurance policy never excepted Ricardo's option from title coverage.

The unicorn filed for bankruptcy, disappointing its investors, as tech ventures so often do. Laura's investment became worthless after draining all her personal savings. She had no way to avoid defaulting on her mortgage loan obligations.

Her lender has initiated foreclosure.

Laura has kept Ricardo up to date on her calamitous financial situation.

Ricardo and Laura believe this might be a good time for Ricardo to exercise his option.

After consulting with Uncle Sal, Ricardo has tendered Laura a written notice of his intent to exercise the option.

To complete his side of the transaction, Ricardo has placed $200,000 in an escrow account. He has signed escrow instructions authorizing the escrow agent to transfer the $200,000 to Laura in exchange for a deed from her, along with a policy of title insurance confirming his ownership of the beach house, free of the mortgage. Laura has signed escrow instructions authorizing the agent to transfer the $200,000 to the foreclosing mortgage lender, conditioned on the lender executing a recordable reconveyance of its deed of trust, and a release protecting Laura against any personal liability on the note and deed of trust.

If the escrow agent is unable to procure the requested title policy for Ricardo, or a reconveyance and release signed from the mortgage lender, Ricardo has authorized the agent to interplead the mortgage lender, Laura, and Ricardo so that a court can ascertain and declare their respective rights and priorities based on the current situation.

What are the rights of Laura, Ricardo and the mortgage lender to the property and the $200,000?

[8] “They're called ‘unicorns’—private companies valued at $1 billion or more. The billion-dollar technology startup was once the stuff of myth. Today they're seemingly everywhere, backed by a bull market and a new generation of disruptive technology.” *The Unicorn List 2016*, FORTUNE, http://fortune.com/unicorns/(Last visited July 12, 2017).

Question 10: ***A Junior Lienor's Options.***

A second trust deed investor made a loan of $150,000 secured by a deed of trust on a fourplex. Each unit is about 1100 square feet. The property was subject to a first deed of trust for $400,000 made by an individual investor. That loan is coming due in three months. The property was built in 1954 and needs updating—electrical, plumbing, and roofing. It is renting for $1.50 per square foot where newly built units rent for $2.50 per square foot. The owner was going to use the second trust deed money to improve the property but became ill, has been unable to work, and has missed two consecutive months of payments on both mortgages.

(a) What options are available to the holder of the second deed of trust?
(b) What advice would you offer on what she should do once the first trust deed holder sends out a Notice of Default, which is imminent?

Question 11: ***Rights of An Omitted Junior Lienor.***

(a) You have a friend who occasionally purchases second deeds of trust on houses owned by individuals who rent them out. What options are available to her if she receives a notice of default from the holder of a first mortgage that it will soon foreclose?

(b) She recently learned that one of her properties was foreclosed by a senior lienor who never notified her of the foreclosure sale. What questions would you ask before offering an opinion about whether she should do anything about it?

Question 12: ***Tenants' Status Following Foreclosure: Hotel Franchise and Hotel Management Agreements (HMA).***

Mortgage lenders financing hotels often require that the hotel developer enter a franchise agreement with a name hotel brand and a hotel management agreement (HMA) with a firm that specializes in managing hotels.[9]

Commercial mortgage lenders typically anticipate their loans being repaid from the rents that office, retail, or apartment tenants will be paying. They also realize that defaults are possible so they implement measures to get their hands on the cash flow, sometimes through 'lock box' arrangements or assignments of rents. They also enter subordination, non-disturbance and attornment agreements (SNDA) with major tenants anticipating the possibility that the lender will have to displace the owner in default scenarios.

[9] A hotel franchise is a licensing agreement by which a hotel is operated under a particular brand, or 'flag.' Brands establish recognizable identities by establishing uniform operating standards and recognizable physical characteristics for all the properties bearing their 'flag.' They also operate reservation systems. Most brands also operate hotel management companies. However, there are independent hotel management companies unaffiliated with any national brand.

Hotel owners and their mortgage lenders are not relying on cash flow from long-term leases; they are dependent on revenues from hotel guests who are transient. The success or failure of most hotels depends significantly on a hotel brand based on a franchise agreement between the brand operator and the hotel owner, and hotel management agreements (HMA), since very few hotel owners actually manage their own properties. As long as the franchisor and hotel manager are receiving their promised compensation, the hotel revenues not being sufficient to pay the mortgage secured by the hotel is not their problem. But the unpaid mortgage lender could decide that the best way to staunch IRS losses would be to foreclose and find a new hotel owner, a different brand, a new hotel management company—or some combination of these, maybe displacing the hotel owner while retaining the brand.

Which of the following best confers upon the foreclosing mortgage lender its choice of either ending or continuing the brand and management company?

(A) If the mortgage had been recorded *before* the franchise agreement, upon the mortgage lender's foreclosure, the franchise agreement or hotel management agreement would be terminated. The mortgage lender would then have the option of entering new agreements with the same brand or operator if it chose.

(B) If the franchise agreement or the hotel management contract were recorded *before* the mortgage, the mortgagee's foreclosure would not disturb these arrangements and the purchaser at the foreclosure sale would replace the owner under those agreements.

(C) The hotel mortgage lender usually enters a SNDA agreement with major brand franchisors. The franchisor and hotel management company subordinate their interests to the mortgage lender, and promise to attorn to the mortgage lender or its assignee, on the condition that the foreclosure sale purchaser agree to a non-disturbance promise following foreclosure.

(D) The mortgage lender would accomplish its goal if the franchisor or hotel management company subordinated their interests to the mortgage, they agreed to attorn to the mortgage lender or its successor, and the mortgage lender promised not to disturb those agreements as long as the franchisor or the management company was not in default under them.

Question 13. ***Alternatives to Foreclosure.***

(a) Which of the alternatives to foreclosure keep a defaulting home owner in the house?

(b) Which of the alternatives best suits a borrower who can afford the mortgage payments and would like to retain ownership but is considering defaulting because the mortgage balance exceeds the present market value of the house?

(c) Why do mortgage lenders generally prefer short sales to loan modifications reducing the loan balance to the current market value of the security property?

Question 14. ***Mortgage Modification Provisions.***

A mortgagor had acquired her home with a purchase money mortgage loan for 80% of her $300,000 purchase price, $240,000. Her interest rate at the time was 7%, interest only for three years, a fixed rate for 30 years with amortization to commence at the end of year three sufficient to repay the debt at the end of the original loan term of 30 years.

Exactly two years later, she borrowed $50,000 to invest in a media-tech start-up. This loan was secured by a deed of trust at a fixed interest rate of 9%, interest only, due and payable in three years.

Meanwhile, she quit her salaried position as a special assistant to a bank vice president in order to work in the start-up full time. The start-up is not generating enough money for her to meet her mortgage obligations. She has defaulted on both her loans. The house is presently worth $250,000.

Her senior mortgagee is willing to modify her loan by reducing the interest rate to 4.5% but only if it can reduce the loan term to five years while maintaining the 30-year amortization schedule. The mortgagor will owe a balloon payment when the modified loan becomes due and payable at the end of five years.

(a) The second trust deed lender seeks to establish its priority as a first lien because the modification materially increases its risk. Is this true?

(b) Does it make any difference that the senior mortgage has no provision in it that the mortgagor and her successors are deemed to consent to any future modifications, extensions, amendments or alterations of the senior mortgage?

Question 15: ***Buying Distress Property.***

From the perspective of an investor seeking to profit from the purchase of distressed realty, compare: (1) buying from a defaulting owner before foreclosure either before or after recordation of a notice of default, (2) purchasing at the mortgagee's foreclosure sale, or (3) buying from the mortgagee after the lender acquires title at its own foreclosure and listing the property for sale with either (a) a real estate broker or (b) a public auction house.