Texas Principles of Real Estate

Texas Principles of Real Estate is a 60-hour course required by the Texas Real Estate Commission (TREC) for anyone who wishes to become a licensed real estate agent in Texas. The course provides a comprehensive overview of real estate principles.

Texas Principles of Real Estate contains the following modules:

- Texas License Law
- Real Property Ownership and Land Use
- Code of Ethics in Real Estate Practice
- Fair Housing
- Agency
- Contracts, Purchase and Sale Agreements
- Environmental Hazards
- Deeds
- Titles and Records
- Liens, Taxes and Foreclosures
- Listing Agreements
- Closing and Settlement Costs
- Real Estate Appraisal
- Real Estate Finance
- Real Estate Math

Modules begin with an introduction, learning objectives and key terms. As students work through the course, they can keep the learning objectives in mind and refer to the key terms as necessary. The modules are divided into lessons, which are followed by quizzes to test student comprehension. Modules conclude with activities and case studies that allow students to apply the knowledge they have gained to real-world situations; each module is followed by a final quiz. The introductions, lesson summaries and module summaries are all available in a printable format for reference purposes.
SUBJECT MATTER EXPERTS

Gregg Driscoll
Gregg Driscoll graduated from the University of Montana in 1997 with a Bachelor of Arts in Linguistics. He then moved to Austin, TX, where he started his professional career as a business administrator, creating training documents and standardizing customer service and sales procedures for start-up companies. After he obtained a real estate license, Driscoll created training programs for newly hired salespeople and associate brokers for several different real estate brokerages. He now joins 360training as a subject matter expert in real estate, where he ensures accuracy and relevancy of course content. His extensive experience with professional training materials has proved invaluable in 360training’s efforts to produce thoughtful, digestible courses.

John Goehrs
A native Austinite, John Goehrs has held a Bachelor of Arts in Business and a Bachelor of Arts in Political Science since 1982. He started his professional career as a real estate salesperson in 1983, before obtaining a broker’s license two years later. After working as a broker, John Goehrs decided to pursue a legal career. He attended South Texas College of Law in Houston, Texas and, in May of 1987, graduated with a Doctorate of Jurisprudence. In May of 1989 he obtained licensure from the State Bar of Texas. After graduation, Goehrs founded a solo legal and real estate company in Austin, Texas, which he subsequently relocated to Coldspring, Texas. While re-establishing his individual legal practice in real estate, contracts, and collections and assisting local appraisers, Goehrs specialized in selling resort property on Lake Livingston. In 1995, he formed Goehrs Properties, which currently encompasses two offices with six agents and is ranked in the top 150 of 1400 member firms in the Houston Association of REALTORS. In May 2003, he returned to Austin to expand his legal career and joined 360training, where he now serves as a legal consultant and subject matter expert for 360training’s suite of real estate products.

Lynn Smith
Lynn Smith began her real estate career in 1981 and achieved her broker’s license in 1984 in Houston, Texas. She has worked in residential sales, commercial sales, leasing, and new home sales. She began developing courses as a Director of Training for Coldwell Banker from 1986-1989. In 1990, she was responsible for getting the first five Mandatory Continuing Education (MCE) Courses approved in the State of Texas. As Director of Education for the Texas Association of REALTORS® she developed numerous courses in real estate finance, law, contracts and marketing. She also developed a course to teach instructors how to utilize interactive teaching methods. She believes that the secret to success in real estate is to take good care of clients and customers.
# Texas Principles of Real Estate
## Module 1: Texas License Law

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| Total Lesson Time: | 300 minutes (5 Hours) |
INTRODUCTION

This module covers the Real Estate License Act, which is Chapter 1101 of the Texas Occupations Code. This Act defines the roles of different real estate professionals, dictates licensee liability and sets professional practice and ethical standards, so it is important that all real estate licensees understand the Act in its entirety.

Learning the law can seem daunting. To help the student absorb the information more easily, this module summarizes the statutes first and then presents the actual law, accompanied by explanatory notes as needed. The first section of this module focuses on the role and legal definition of the Texas Real Estate Commission (TREC), the state Commission responsible for enforcing the Real Estate License Act. The module then defines the different types of real estate licenses and licensing procedures. The last lessons of this module cover professional practice and the ethical implications of the Real Estate License Act.

This module concludes with a real estate practice lesson, which illustrates real world applications of the information learned. Through case studies the student can implement his or her new knowledge to solve common real estate dilemmas.

Upon completion of this course, the student will be able to:

- Outline the statutes and agencies governing real estate practice.
- Describe the purpose of license law.
- State the eligibility requirements and exemptions for licenses and the types of licenses.
- Name the steps of the application process.
- Identify the educational and testing requirements for obtaining and renewing a license.
- Sketch the license law's rules regarding the issuing, denial, display and expiration of licenses.
- Describe the licensee's role in representing clients.
- Recognize the license law's disciplinary procedures and penalties.
KEY TERMS

**Association of Real Estate License Law Officials (ARELLO):** An international organization that promotes uniform standards for license law administration and enforcement.

**Broker:** One who draws contracts, deals in the sale of property and/or negotiates for another in exchange for compensation; one who may lawfully employ salespeople and own a real estate office.

**Disclosure:** (Verb) the act or process of revealing or uncovering; (Noun) something uncovered.

**Fiduciary:** (Noun) A trustee; a person who, in good faith and candor, under his or her own volition acts primarily for the benefit of another; (Adjective) relating to a trust or like a trust in nature.

**Inactive Licensee:** A broker or salesperson that may renew a license but may not engage in any real estate activities listed under the Real Estate License Act, Chapter 1101 of the Texas Occupations Code. Inactive brokers are also forbidden to sponsor salespeople or market/negotiate real estate for compensation.

**Real Estate Recovery Trust Account:** A monetary pool set aside to reimburse members of the public who have been financially injured by brokers or salespeople.

**Real Estate:** This means leasehold, as well as any other interest or estate in land, whether corporeal or incorporeal, freehold or non-freehold, in state or out of state; all land and everything permanently attached to it; realty.

**Real Estate License Act:** Chapter 1101 of the Texas Occupations Code; the state law that created and empowers TREC and requires brokers and salespeople to obtain proper licensure.

**Rule:** A section of the Texas Administrative Code (TAC) which pertains to professional ethics and practices; it is published by the Secretary of State’s Office but written and enforced by TREC.

**Salesperson:** A licensed person who may engage in the sale of real estate when sponsored by a broker.

**Sunset Act:** A common state law, which, in Texas, requires the Sunset Commission to evaluate all state agencies every twelve years with respect to their efficiency and the need for their services.
Sunset Commission: The state agency that performs evaluations required under the Sunset Act; the agency responsible for recommending whether to retain or abolish a reviewed state agency every twelve years.

Texas Administrative Code (TAC): A physical compilation published by the Secretary of State’s Office containing ethical and professional standards for both members of state agencies and those professionals licensed by state agencies.

Texas Real Estate Commission (TREC): The state Commission responsible for administering the Texas Real Estate License Act. The Commission is made up of nine people, six of which are real estate brokers and three who are members of the public.

LEARNING OBJECTIVES

Upon completion of this course, the student will be able to:

- Outline the statutes and agencies governing real estate practice.
- Describe the purpose of license law.
- State the eligibility requirements and exemptions for licenses and the types of licenses.
- Name the steps of the application process.
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- Describe the licensee’s role in representing clients.
- Recognize the license law’s disciplinary procedures and penalties.
LESSON ONE
STATUTES AND AGENCIES GOVERNING REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Associations and Structures of State Bodies
- TREC Definition and General History
- Complaints and the Reimbursement Trust Account
- The Sunset Act
- Canons of Professional Ethics and Conduct

INTRODUCTION

This lesson will introduce you to the Texas state statutes governing the real estate industry. Initially, we will examine the state agencies that create and enforce real estate laws; as a licensed real estate agent, you will need to be familiar with these organizations. We will then move on to the laws that establish your obligations, duties and capabilities as a licensee. Subsequent lessons in this course will then examine each of the relevant statues and their various components in detail.

The Real Estate License Act is a compilation of many shorter statutes and the enforcement and content of each of the various statutes can seem confusing. Upon completion of this lesson you will understand which state agencies are responsible for the various regulatory and legal activities pertinent to the practice of real estate. You will also be introduced to the general liabilities faced by a Texas real estate salesperson or broker.

ASSOCIATIONS AND STRUCTURES OF STATE BODIES

The following sections contain brief descriptions of state bodies, which we will cover in detail later in this lesson. Following the summary discussion of these bodies and how they relate to one another, you will be asked to fill in the blanks on a chart illustrating this information.

STATE BODIES THAT INFLUENCE THE REAL ESTATE INDUSTRY

There are three principal governing bodies that directly affect the real estate industry:

- The Texas State Legislature
The Texas State Legislature

The Texas State Legislature is a broad term that refers to the state Senate and the House of Representatives. The Texas Legislature is responsible for all laws in Texas, which includes those laws that directly affect the real estate industry. For additional information on the State Legislature, consider visiting their website: http://www.capitol.state.tx.us.

The Texas Real Estate Commission (TREC)

The state Legislature created The Texas Real Estate Commission, or TREC. TREC has two main functions:

- To enforce all real estate-related statues in the Texas Occupations Code
- To make and enforce new rules governing the practice of real estate, as needed

The Real Estate License Act states that TREC must enforce all the statutes contained in the Act. In addition, TREC passes new regulations, officially called “rules,” as needed. Just as real estate licensees are responsible for adhering to the Real Estate License Act, they are also responsible for adhering to all subsequently created TREC rules.

Creating and enforcing rules is not the only thing TREC does—for example, it also administers the Timeshare Act found in the Property Code. However, for the purposes of this course, we are primarily interested in TREC’s role as the developer and enforcer of Chapter 1101 of the Texas Occupations Code, the Real Estate License Act.

The Secretary of State’s Office

While the Secretary of State has many obligations, we will focus on only one: compiling, indexing and producing the Texas Administrative Code, or TAC. TAC is a physical collection of state laws published by the Secretary of State’s Office; it contains ethical and professional standards for members of state agencies and those professionals licensed by state agencies. Like the standards set by TREC, the standards set by various state agencies are all called rules and are all compiled into TAC. This means that TREC, like all state agencies, sends its various rules to the Secretary of State’s Office, where they are compiled in a kind of “supplement” to the Real Estate License Act.

Please note that while the Secretary of State’s Office publishes the physical code, it is not responsible for enforcing TAC, except as applicable to its own
rules. Each state agency must enforce its applicable rules and TREC enforces these pertaining to the real estate industry.

**MAJOR LAWS AFFECTING THE REAL ESTATE INDUSTRY**

This course is primarily concerned with the Real Estate License Act and TREC’s Canon of Professional Ethics. You should understand, however, that these two laws are actually parts of bigger statutes.

**Texas Occupations Code**

The Real Estate License Act is one section of a larger law passed by the State Legislature called the Texas Occupations Code. The Real Estate License Act is Chapter 1101 (“Real Estate Brokers and Salespersons”) of the Texas Occupations Code; Chapter 1102 of the Code pertains to property inspectors.

**Real Estate License Act**

In essence, the Real Estate License Act:

- Empowers TREC to enforce the Real Estate License Act and to make and enforce new rules.
- Requires that those persons who negotiate the sales and inspection of real estate for compensation obtain state licensure (i.e., real estate brokers, salesperson and inspectors must be licensed).

**TREC’s Canons of Professional Ethics**

TREC’s Canons of Professional Ethics are the ethical and professional standard for the real estate industry, published by the Secretary of State in the TAC. The Canons are made up of five individual rules written and enforced by TREC.

**RELATIONSHIP CHART**

The relationship between the different governing bodies and the hierarchy of statues may be confusing. To help formulate a bigger picture of real estate statues, consider the following chart illustrating the associations previously covered. Notice that some information is missing. Use the terms in the Word Bank to fill in the chart on the following page to the best of your knowledge.

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Enforce all rules it makes and the provisions of the Real Estate License Act

Which Are Submitted To

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The Canons of Professional Ethics
The Texas Principles of Real Estate

RELATIONSHIP CHART ANSWERS:

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TREC DEFINITION AND GENERAL HISTORY

Created in 1949 when the Texas legislature passed the Texas Real Estate License Act, the Texas Real Estate Commission (TREC) oversees the licensing, education requirements and ethical standards for real estate sales, marketing and inspections within the State of Texas. More specifically, it administers the following legislation, the first part of which comprises the principal concern of this module:

- Texas Occupations Code; The Real Estate License Act, Ch. 1101: Texas Occupations Code; Real Estate inspectors, Ch. 1102: formerly called, The Residential Service Company Act, Article 6573b, V.T.C.S.
- Texas Timeshare Act, Chapter 221, Texas Property Code

TREC regulates the activities of real estate brokers, salespeople, real estate inspectors and education providers who offer real estate and inspection courses. The Commission also regulates residential service companies, timeshare developers and easement or right-of-way developers.

TREC requires that all real estate brokers and salespeople meet and maintain specific education standards and obtain proper licensure before receiving compensation for negotiating real estate transactions. Brokers and salespeople must follow the provisions of Chapter 1101 (The Real Estate License Act) of the Texas Occupations Code and follow TREC’s rules (these rules make up a section of the Texas Administrative Code [TAC] which pertains to professional ethics and practices; they are written and enforced by TREC, but published by the Secretary of State’s Office). The Real Estate License Act and TREC rules require that all transactions involving public interests be dutifully completed in a competent, honest and ethical manner.

In essence, TREC acts as a public watchdog. It monitors the actions of real estate licensees, maintains educational standards and records, collects licensure fees and issues fines and penalties for breaches of TREC rules and/or the Licensing Act. In addition, the Commission also handles all consumer compliments and complaints regarding the actions of licensees.

For more information on TREC, you may visit this website: http://www.trec.state.tx.us/index.asp.

Before viewing the actual state law, please review the following list, which details a few of the key points stated in the following statutes.

- The Commission has nine members.
- Six of those members are brokers.
- Three of those members are non-brokers (usually members of the business community).
• Commission members serve staggered six-year terms.
• Three of the members’ terms expire every odd year on January 31st.

After viewing the law verbatim, you will complete a short exercise to aid in retaining information.

**AS DEFINED**

As defined by the Texas Occupations code:

Sec. 1101.051 describes the administration of the Act.

Adherence to the State License Act is enforced by the Texas Real Estate Commission, which is comprised of nine members—six brokers and three non-brokers. The three non-brokers are usually members of the state business community (and may be referred to as the newest members). This section also details the payment of fees, both those paid to the State Treasury and those paid to the Real Estate Research Center at Texas A&M University.

**SEC. 1101.151 GENERAL POWERS AND DUTIES OF COMMISSION**

(A) The commission shall:

1. Administer this chapter and Chapter 1102;
2. Adopt rules and establish standards relating to permissible forms of advertising by a license holder acting as a residential rental locator;
3. Maintain a registry of certificate holders; and
4. Design and adopt a seal.

(B) The commission may:

1. Adopt and enforce rules necessary to administer this chapter and Chapter 1102;
2. Establish standards of conduct and ethics for persons licensed under this chapter and Chapter 1102 to:
   a. Fulfill the purposes of this chapter and Chapter 1102; and
   b. Ensure compliance with this chapter and Chapter 1102; and
3. Authorize specific employees to conduct hearings and issue final decisions in contested cases.

(\textit{V.A.C.S. Art. 6573a, Secs. 5(a) (part), (h) (part), (j) (part), (t) (part), 9A(b), (d), 24(c).})
SEC. 1101.751 INJUNCTIVE ACTION BROUGHT BY COMMISSION

(A) In addition to any other action authorized by law, the commission may bring an action in its name to enjoin a violation of this chapter or a commission rule.
(B) To obtain an injunction under this section, the commission is not required to allege or prove that:
   (1) An adequate remedy at law does not exist; or
   (2) Substantial or irreparable damage would result from the continued violation.

(V.A.C.S. Art. 6573a, Sec. 5 (h) (part).)

SEC. 1101.752 ADDITIONAL INJUNCTIVE AUTHORITY

(A) In addition to any other action authorized by law, the commission, acting through the attorney general, may bring an action to abate a violation or enjoin a violation or potential violation of this chapter or a commission rule if the commission determines that a person has violated or is about to violate this chapter.

(B) The action shall be brought in the name of the state in the district court in the county in which:
   (1) The violation occurred or is about to occur; or
   (2) The defendant resides.
(C) An injunctive action may be brought to abate or temporarily or permanently enjoin an act or to enforce this chapter.
(D) The commission is not required to give a bond in an action under Subsection (a), and court costs may not be recovered from the commission.
(E) If the commission determines that a person has violated or is about to violate this chapter, the attorney general or the county attorney or district attorney in the county in which the violation has occurred or is about to occur or in the county of the defendant's residence may bring an action in the name of the state in the district court of the county to abate or temporarily or permanently enjoin the violation or to enforce this chapter. The plaintiff in an action under this subsection is not required to give a bond, and court costs may not be recovered from the plaintiff.

(V.A.C.S. Art. 6573a, Secs. 19(c), (d) (part).)

SEC. 1101.102 DIVISION OF RESPONSIBILITIES

The commission shall develop and implement policies that clearly define the respective responsibilities of the commission and the commission staff.

(V.A.C.S. Art. 6573a, Sec. 5 (s).)
SEC. 1101.055 TERMS; VACANCY

(A) Commission members serve staggered six-year terms, with the terms of three members expiring January 31 of each odd-numbered year.  
(B) If a vacancy occurs during a member's term, the governor shall appoint a person to fill the unexpired term.  

(V.A.C.S. Art. 6573a, Sec. 5 (a) (part).)

SEC. 1101.053 MEMBERSHIP AND EMPLOYEE RESTRICTIONS

(A) In this section, Texas Trade Association means a nonprofit, cooperative, and voluntarily joined statewide association of business or professional competitors in this state designed to assist its members and its industry or profession in dealing with mutual business or professional problems and in promoting their common interest.

(B) A state elected president, president-elect, vice president, or secretary-treasurer, employee, or paid consultant of a Texas trade association in the real estate industry may not be a commission member and may not be a commission employee who is exempt from the state's position classification plan or is compensated at or above the amount prescribed by the General Appropriations Act for step 1, salary group A17, of the position classification salary schedule.

(C) A person who is the spouse of an officer, manager, or paid consultant of a Texas trade association in the real estate industry may not be a commission member and may not be a commission employee who is exempt from the state's position classification plan or is compensated at or above the amount prescribed by the General Appropriations Act for step 1, salary group A17, of the position classification salary schedule.

(D) A person may not serve as a commission member or act as the general counsel to the commission if the person is required to register as a lobbyist under Chapter 305, Government Code, because of the person's activities for compensation on behalf of a profession related to the operation of the commission.  

(V.A.C.S. Art. 6573a, Secs. 5(b)(1) (part), (2).)

SEC. 1101.056 OFFICERS

(A) The governor shall designate a commission member who is a licensed broker as presiding officer. The presiding officer serves in that capacity at the pleasure of the governor.

(B) At a regular meeting in February of each year, the commission shall elect an assistant presiding officer and secretary from its membership.  

(V.A.C.S. Art. 6573a, Sec. 5 (a) (part).)
SEC. 1101.054 OFFICIAL OATH; BOND

Sec. 1101.054. Official Oath; Bond
Not later than the 15th day after the date of appointment, each appointee must:
(1) Take the constitutional oath of office; and
(2) Execute a bond payable to the governor in the amount of $10,000, conditioned on the faithful performance of the member's duties.
(V.A.C.S. Art. 6573a)

SEC. 1101.057 GROUNDS FOR REMOVAL

(A) It is a ground for removal from the commission that a member:

(1) Does not have at the time of appointment the qualifications required by Section 1101.051(a) or (b) or 1101.052
(2) Does not maintain during service on the commission the qualifications required by Section 1101.051(a) or (b) or 1101.052
(3) Violates a prohibition established by Section 1101.053
(4) Cannot, because of illness or disability, discharge the member's duties for a substantial part of the member's term; or
(5) Is absent from more than half of the regularly scheduled commission meetings that the member is eligible to attend during each calendar year, unless the absence is excused by majority vote of the commission.

(B) The validity of an action of the commission is not affected by the fact that it is taken when a ground for removal of a commission member exists.

(C) If the administrator has knowledge that a potential ground for removal of a commission member exists, the administrator shall notify the presiding officer of the commission of the ground. The presiding officer shall notify the governor that a potential ground for removal exists.

SEC. 1101.058 PER DIEM REIMBURSEMENT

A commission member is entitled to receive:

(1) $75 for each day the member performs the member's official duties; and
(2) Reimbursement for actual and necessary expenses incurred in performing the member's official duties.
(V.A.C.S. Art. 6573a, Sec. 5 (g).)
SEC. 1101.101 ADMINISTRATOR AND OTHER PERSONNEL

(A) The commission may appoint an administrator.
(B) The commission may designate a subordinate officer as assistant administrator to act for the administrator in the administrator's absence.
(C) The commission may employ other subordinate officers and employees necessary to administer and enforce this chapter and Chapter 1102, including a general counsel, attorneys, investigators, and support staff.
(D) The commission shall determine the salaries of the administrator, officers, and employees of the commission. The amounts of the salaries may not exceed the amounts specified by the General Appropriations Act.

(V.A.C.S. Art. 6573a, Secs. 5(i) (part), (t) (part).)

SEC. 1101.105 CAREER LADDER PROGRAM; PERFORMANCE EVALUATIONS

(a) The administrator or the administrator's designee shall develop an intra-agency career ladder program. The program must require intra-agency postings of all non-entry level positions on currently with any public posting.
(b) The administrator or the administrator's designee shall develop a system of annual performance evaluations. All merit pay for commission employees must be based on the system established under this subsection.

(V.A.C.S. Art. 6573a, Sec. 5(i) (part).)

SEC. 1101.206 PUBLIC PARTICIPATION

(a) The commission shall develop and implement policies that provide the public with a reasonable opportunity to appear before the commission and to speak on any issue under the commission's jurisdiction.
(b) The commission shall prepare and maintain a written plan that describes how a person who does not speak English or who has a physical, mental, or developmental disability may be provided reasonable access to the commission's programs.

(V.A.C.S. Art. 6573a, Secs. 5(p), (y).)

SEC. 1101.201 PUBLIC INTEREST INFORMATION

(a) The commission shall prepare information of public interest describing the functions of the commission and the procedures by which complaints are filed with and resolved by the commission.
(b) The commission shall make the information available to the public and appropriate state agencies.

(V.A.C.S. Art. 6573a, Sec. 5(r).)
MATCHING COMMISSION VALUES

Please use the terms given in the Word Bank to fill in the blanks. Note that some values are duplicates.

<table>
<thead>
<tr>
<th>Word Bank</th>
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<td>Three</td>
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1. There are _____ members of TREC.

2. _____ members of TREC are brokers.

3. _____ members of TREC are non-brokers.

4. All members serve staggered _____-year terms.

5. _____ terms expire on January 31\textsuperscript{st} of every odd year.

6. The _____ appoints TREC members with the _____’s approval.
MATCHING COMMISSION VALUES ANSWERS:

1. There are (Nine) members of TREC.

2. (Six) members of TREC are brokers.

3. (Three) members of TREC are non-brokers.

4. All members serve staggered (Six)-year terms.

5. (Three) terms expire on January 31st of every odd year.

6. The (Governor) appoints TREC members with the, (Senate)’s approval

COMPLAINTS AND THE REIMBURSEMENT TRUST ACCOUNT

The following material continues our examination of the laws describing TREC’s rules and responsibilities. It presents two of TREC’s key functions:

- TREC must maintain a record of all consumer complaints and respond to these complaints appropriately.
- TREC must maintain a Recovery Trust Account, from which financially aggrieved members of the public who have been harmed by licensees are reimbursed.

Please note that the Recovery Trust Account is used to reimburse financial damages, not emotional or punitive damages. There is a document describing the Recovery Trust Account that all brokers must display for their customers. This document is described under a rule, which we will discuss later in this lesson.

SEC. 1101.202 COMPLAINTS

(A) The commission by rule shall establish methods by which consumers and service recipients are notified of the name, mailing address, and telephone number of the commission for the purpose of directing a complaint to the commission. The commission may provide for that notice:

(1) on each application for a license or certificate of registration or written contract for services of a person regulated under this chapter or Chapter 1102;
(2) on a sign prominently displayed in the place of business of each person regulated under this chapter or Chapter 1102;
(3) in a bill for services provided by a person regulated under this chapter or Chapter 1102; or 
(4) in conjunction with the notice required by Section 1101.615; or 
(5) to be prominently displayed on the Internet website of a person regulated under this chapter or Chapter 1102.

(B) The commission shall provide to a person who files a complaint with the commission relating to a license holder and to the license holder against whom the complaint is filed:

(1) an explanation of the remedies that are available to the person under this chapter; and 
(2) information about appropriate state or local agencies or officials with whom the person may file a complaint.

(V.A.C.S. Art. 6573a, Secs. 5(q), 18B(a).)

SEC. 1101.203 COMPLAINT INFORMATION

(A) The commission shall maintain an information file about each complaint filed with the commission that the commission has authority to resolve.

(B) If a written complaint is filed with the commission that the commission has authority to resolve, the commission, at least quarterly and until final disposition of the complaint, shall notify the parties to the complaint of the status of the complaint unless the notice would jeopardize an undercover investigation authorized under Section 1101.204.

(V.A.C.S. Art. 6573a, Secs. 18B(b), (c).)

SEC. 1101.204 COMPLAINT INVESTIGATION AND DISPOSITION

(A) The commission may, on its own motion, investigate the actions and records of a license holder.

(B) The commission shall investigate the actions and records of a license holder if:

(1) a person submits a signed, written complaint; and 
(2) the complaint and any evidence presented with the complaint provide reasonable cause for an investigation.

(C) The commission may not conduct an investigation of a license holder in connection with a complaint submitted later than the fourth anniversary of the date of the incident that is the subject of the complaint.

(D) The commission shall promptly provide a written notice to a person licensed under this chapter or Chapter 1102 who is the subject of an investigation unless after deliberation the commission decides against notification.
(E) Notwithstanding any other provision of this chapter, an undercover or covert investigation may not be conducted unless the commission expressly authorizes the investigation after considering the circumstances and determining that the investigation is necessary to implement this chapter.

(F) An investigation or other action against a person licensed under this chapter or Chapter 1102 may not be initiated on the basis of an anonymous complaint.

(G) The commission may authorize a commission employee to file a signed, written complaint against a person licensed under this chapter or Chapter 1102 and to conduct an investigation if:

(1) a judgment against the person has been paid from the real estate recovery trust account under this chapter or the real estate inspection recovery fund under Chapter 1102;
(2) the person is convicted of a criminal offense that may constitute grounds for the suspension or revocation of the person’s license; or
(3) the person fails to honor a check issued to the commission.
(4) The person fails to complete required continuing education within the period prescribed by commission rules adopted under Section 1101.457; or
(5) The person fails to provide, within a reasonable time, information requested by the commission in connection with an application to renew a license.

(V.A.C.S. Art. 6573a, Secs. 15(a) (part), (d), 15B(a), (e).)

**SEC. 1101.601 REAL ESTATE RECOVERY TRUST ACCOUNT**

(A) The commission shall maintain a real estate recovery trust account to reimburse aggrieved persons who suffer actual damages caused by an act described by Section 1101.602 committed by:

(1) a license holder;
(2) a certificate holder; or
(3) a person who does not hold a license or certificate and who is an employee or agent of a license or certificate holder.

(B) The license or certificate holder must have held the license or certificate at the time the act was committed.

(V.A.C.S. Art. 6573a, Sec. 8(a) (part).)

**SEC. 1101.602 ENTITLEMENT TO REIMBURSEMENT**

An aggrieved person is entitled to reimbursement from the trust account if a person described by Section 1101.601 engages in conduct described by Section 1101.652(a)(3) or (b) or 1101.653(1), (2), (3), or (4).
THE SUNSET ACT

A Sunset Act is a common state law, which, in Texas, requires the Sunset Commission to evaluate all state agencies every twelve years with respect to their efficiency and the need for their services. The Texas Real Estate Commission has been reviewed three times under this Act and has received approval each time. The section below presents the law stating that TREC is subject to the Sunset Act.

SEC. 1101.006 APPLICATION OF SUNSET ACT

The Texas Real Estate Commission is subject to Chapter 325, Government Code (Texas Sunset Act). Unless continued in existence as provided by that chapter, the commission is abolished and this chapter and Chapter 1102 expire September 1, 2007.
(V.A.C.S. Art. 6573a, Sec. 5(n).)

CANONS OF PROFESSIONAL ETHICS AND CONDUCT

We mentioned earlier that one of TREC’s rules requires licensees to provide their customers with information about the state’s Recovery Trust Account. The following sections explain the use of such rules, the difference between these rules and the sections of legislation previously covered and where these rules can be found.

In addition to the Texas Occupations Code (of which the Real Estate License Act is a part), the Texas Legislature enacted the Administrative Code Act, or TAC, in 1977. TAC is a publication of ethical and professional standards for both members of state agencies and those professionals licensed by state agencies. While TREC is responsible for the writing and enforcing of all individual rules that make up the real estate-related section of TAC, the Office of the Secretary of State is responsible for indexing, compiling and producing TAC.

In essence, TAC is a collection of all state agency rules. TAC is organized in a sequence of increasingly specific categories, which starts with 16 different Titles. The Titles are categories in which we docket all the various state agencies. For example, the guidelines pertaining to real estate professionals are under Title 22, Examining Boards. Each Title is further broken down into Parts. Real estate is under Part 23, Texas Real Estate Commission—and TREC is the author of the rules contained therein. In Part 23, there are eight Chapters that apply to real estate licensees licensed under the Real Estate License Act. While most of the rules listed within these eight Chapters are found elsewhere in the Real Estate License Act, one is not: Chapter 531, Canons of Professional Ethics. Within Canons of Professional Ethics there are five individual rules: Fidelity (Rule 531.1), Integrity (Rule 531.2), Competency (Rule 531.3), Consumer Information...
(Rule 531.18) and Discriminatory Practices (Rule 531.19). It is worth noting that Titles, Chapters, Sections, and Rules are not always numbered consecutively.

The following sections present Rules 531.1-3 and Rules 531.18-19. Before continuing, please note that Rule 531.18 refers to a form that all real estate professionals must provide and display for their consumers: Consumer Information Form 1-1. Consumer Information Form 1-1 informs the public that the subject office possesses adequate licensing and declares the existence of a *Recovery Trust Account*. This recovery trust account is the monetary pool that TREC maintains under Section 1101.601 *Real Estate Recovery Trust Account* and Section 1101.602 *Entitlement to Reimbursement* (previously discussed). From this fund, TREC reimburses members of the public who have been financially harmed by its licensees.

For more information on TAC, visit: [http://www.sos.state.tx.us/tac](http://www.sos.state.tx.us/tac)

### RULE 531.1 FIDELITY

While acting as an agent for another person, a real estate broker or salesperson serves as a fiduciary. Special obligations are imposed when such fiduciary relationships are created. Fiduciary relationships require:

- That the real estate agent makes the representation of her clients’ interests her primary duty. The agent’s position, in this respect, should be clear to all concerned parties in a real estate transaction. However, in performing her duties to her clients, the agent shall treat other parties to the transaction fairly.
- That the real estate agent be faithful to and observant of the trust placed in her. Part of her responsiveness to this trust is the scrupulous and meticulous execution of her various duties as an agent.
- That the real estate agent place no personal interest above her clients’ interests.

### RULE 531.2 INTEGRITY

A real estate broker or salesperson has a special obligation to exercise integrity in the discharge of the licensee’s responsibilities, including employment of prudence and caution so as to avoid any sort of misrepresentation by acts of commission or omission.

### RULE 531.3 COMPETENCY

It is the obligation of a real estate agent to be knowledgeable as a real estate brokerage practitioner. The agent should:
(1) be informed on market conditions affecting the real estate business and pledged to continuing education in the intricacies involved in marketing real estate for others;

(2) be informed on national, state, and local issues and developments in the real estate industry; and

(3) exercise judgment and skill in the performance of the work.

**RULE 531.18 CONSUMER INFORMATION FORM 1-1**

(A) The Texas Real Estate Commission adopts by reference Consumer Information Form 1-1 approved by the Texas Real Estate Commission in 1991. This document is published by and available from the Texas Real Estate Commission, P.O. Box 12188, Austin, Texas 78711-2188.

(B) Each real estate inspector or active real estate broker licensed by the Texas Real Estate Commission shall display Consumer Information Form 1-1 in a prominent location in each place of business the broker or inspector maintains.
531.19 DISCRIMINATORY PRACTICES

No real estate licensee shall inquire about, respond to or facilitate inquiries about, or make a disclosure which indicates or is intended to indicate any preference, limitation, or discrimination based on the following: race, color, religion, sex, national origin, ancestry, familial status, or handicap of an owner, previous or current occupant, potential purchaser, lessor, or potential lessee of
real property. For the purpose of this section, handicap includes a person who had, may have had, has, or may have AIDS, HIV-related illnesses, or HIV infection as defined by the Centers for Disease Control of the United States Public Health Service.

SEC. 1101.103 CODE OF ETHICS; STANDARDS OF PRACTICE

Each member, officer, employee, and agent of the commission is subject to the code of ethics and standards of conduct imposed by Chapter 572, Government Code.
(V.A.C.S. Art. 6573a, Sec. 5(b)(1) (part).)

SUMMARY

This lesson covered TREC’s creation, its basic role, and TREC’s various regulatory duties under the Real Estate License Act; we also discussed the use of rules within the Texas Administrative Code (TAC). Of the various rules listed in TAC, this lesson focused on Chapter 531, the Canons of Professional Ethics, Rules 531.1-3 and 531.18-19.

The Texas Real Estate Commission, established in 1949 by the Real Estate License Act (Chapter 1101 of the Texas Occupations Code), administers and enforces the Texas Occupations Code, Chapters 1101 and 1102, as well as the Texas Timeshare Act (Chapter 221 of the Texas Property Code). TREC is made up of nine people, six of which are broker members and three who are non-broker members (usually members of the local business community). Each of these members serves a staggered, six-year term, three of which terminate January 31st of every odd year.

TREC is a public watchdog that enforces licensing and education requirements, establishes ethical standards, handles and files public compliments and complaints and maintains a monetary fund to reimburse members of the public who have been financially harmed by its licensees. This reimbursement fund is referred to as the Recovery Trust Account or the Real Estate Recovery Trust Account.

TREC is subject to the Sunset Act, which in Texas states that the Sunset Commission must review all state agencies every twelve years with respect to their efficiency and the need for their services. TREC has been reviewed three times under this Act, passing every time.

TREC is also responsible for writing law-like entities called “rules.” TREC’s rules make up a section of TAC that pertains to professional ethics and practices; this section is written and enforced by TREC, but published by the Secretary of State’s Office. The Texas Administrative Code, or TAC, is a publication that compiles all of the rules written by various state agencies. TAC is organized in an
increasingly specific sequence of categories, which starts with 16 different Titles. The Titles are categories in which we docket all the various state agencies. For example, the guidelines pertaining to real estate professionals are under Title 22, Examining Boards. Each Title is further broken down into Parts. Real estate is under Part 23, Texas Real Estate Commission—and TREC is the author of the rules contained therein. In Part 23, there are eight Chapters that apply to real estate licensees licensed under the Real Estate License Act. Chapter 531, the Canons of Professional Ethics, contains five rules: Fidelity (Rule 531.1), Integrity (Rule 531.2), Competency (Rule 531.3), Consumer Information (Rule 531.18) and Discriminatory Practices (Rule 531.19).

*Return to your on-line course player to take the Lesson Quiz.*
LESSON TWO
REAL ESTATE LICENSE LAW

This lesson focuses on the following topics:

- License Eligibility
- Types of Licenses
- Exemptions from Licensing Requirements

INTRODUCTION

All U.S. states (including the District of Columbia) and Canadian provinces have enacted real estate license laws to govern the activities of real estate brokers and salespeople. While some details regarding these laws vary from state-to-state, many states enact similar provisions. These provisions are based on the patterns of law recommended by the License Law Committee of the National Association of REALTORS®. The primary objectives of the Texas License Law are:

- To protect the public from incompetent brokers and salespeople
- To set minimum standards and qualifications for licensing brokers and salespeople
- To maintain high ethical and moral standards among licensees
- To protect licensed brokers and salespeople from unfair or unethical competition.

This lesson will begin by explaining licensure eligibility and prerequisites, such as age limits and education and residency requirements. It will then move on to discuss the different types of licenses available and describe the particular services permitted under a given type of license. For example, this lesson will cover the difference between broker and salesperson licenses, as well as the meaning of Subchapter K Certification.

LICENSE ELIGIBILITY

A prospective licensee must meet all requirements set by the Commission. Eligibility for licensure is described in Sec. 1101.354 of The Real Estate License Act, Ch. 1101; an applicant is required to be 18 years of age or older, a Texas resident and a citizen of the United States or a lawfully admitted alien at the time the application is filed. The Commission will judge the honesty and integrity of each individual over the course of the application process. After a person files his or her application, the Commission has 30 days to decide whether the applicant’s moral character is consistent with the Commission’s set standards. In addition, an applicant must complete the required core education courses and then pass a
written final exam to receive a real estate license. This lesson also addresses non-resident eligibility and Subchapter K Certificate eligibility.

- General Resident Eligibility: Section 1101.354
- Additional Resident Eligibility: Section 1101.355
- Subchapter K Certificate and Eligibility: Section 1101.501; 502
- Non-Residential Eligibility: Section 1101.360

SEC. 1101.354 GENERAL ELIGIBILITY

To be eligible to receive a license under this chapter, a person must:
(1) at the time of application:

(A) be at least 18 years of age;
(B) be a citizen of the United States or a lawfully admitted alien; and
(C) be a resident of this state;

(2) satisfy the commission as to the applicant's honesty, trustworthiness, and integrity;

(3) demonstrate competence based on an examination under Subchapter I;

(4) complete the required courses of study, including any required core real estate courses prescribed under this chapter; and

(5) complete at least:

(A) three classroom hours of course work on federal, state, and local laws governing housing discrimination, housing credit discrimination, and community reinvestment; or
(B) three semester hours of course work on constitutional law.

(V.A.C.S. Art. 6573a, Secs. 6(b), 7(a) (part), (j).)

SEC. 1101.355 ADDITIONAL GENERAL ELIGIBILITY REQUIREMENTS FOR CERTAIN BUSINESS ENTITIES

(A) To be eligible for a license under this chapter:

(1) a corporation must designate one of its officers as its agent for purposes of this chapter; and
(2) a limited liability company must designate one of its managers as its agent for purposes of this chapter.
(B) A corporation or limited liability company may not act as a broker unless the entity's designated agent is a licensed broker according to the commission's records.
(V.A.C.S. Art. 6573a, Sec. 6(c) (part).)

SEC. 1101.360 NON-RESIDENT ELIGIBILITY FOR CERTAIN NON-RESIDENT APPLICANTS

(A) A resident of another state who is not a licensed real estate broker and who was formerly licensed in this state as a broker or salesperson may apply for a license under this chapter not later than the first anniversary of the date of the expiration of the former license.

(B) A nonresident applicant is subject to the same license requirements as a resident. The commission may refuse to issue a license to a nonresident applicant for the same reasons that it may refuse to issue a license to a resident applicant.

(C) A nonresident applicant must submit with the application an irrevocable consent to a legal action against the applicant in the court of any county in this state in which a cause of action may arise or in which the plaintiff may reside. The action may be commenced by service of process or pleading authorized by the laws of this state or by delivery of process on the administrator or assistant administrator of the commission. The consent must:

1. stipulate that the service of process or pleading is valid and binding in all courts as if personal service had been made on the nonresident in this state;
2. be acknowledged; and
3. if made by a corporation, be authenticated by its seal.

(D) A service of process or pleading served on the commission under this section shall be by duplicate copies. One copy shall be filed in the commission's office, and the other copy shall be forwarded by registered mail to the last known principal address recorded in the commission's records for the nonresident against whom the process or pleading is directed.

(E) A default judgment in an action commenced as provided by this section may not be granted:

1. unless the commission certifies that a copy of the process or pleading was mailed to the defendant as provided by Subsection (d); and
2. until the 21st day after the date the process or pleading is mailed to the defendant.

(V.A.C.S. Art. 6573a, Secs. 14(b) (part), (c) (part).)
TYPES OF LICENSING AND CERTIFICATION

In Texas, real estate salespeople, brokers and inspectors must hold the appropriate license as specified by the statutes we are about to discuss. The first half of this section explains broker and salesperson licensure; the latter half covers certification under Subchapter K.

In essence, there are two types of real estate licenses: a broker’s license and a salesperson’s license. Salespeople work under brokers; a salesperson works as an employee or independent contractor for a broker. Consequently, the licensing processes for a broker and a salesperson are different, with a broker’s license being a bit more difficult to obtain. Salespeople may not negotiate real estate transactions without broker sponsorship. If a candidate qualifies for salesperson licensure, then TREC will mail the person’s license to his or her sponsoring broker.

A Subchapter K Certificate is required for any person wanting to sell, buy, lease, or transfer an easement or right-of-way for another for compensation or with the expectation of receiving compensation, for duties or services in connection with the sale of land or real estate for the purpose of pipeline, telecommunication, railroad or utilities. For example, a Subchapter K Certificate would be useful for someone who worked for a gas company—a person who has no need for a full real estate license, but is likely to have to perform services (for pay) involving utilities maintenance on people’s property.

Please consider the following state statutes relating to licensure.

SEC. 1101.351 LICENSE REQUIRED (BROKER/SALESPERSON)

(A) Unless a person holds a license issued under this chapter, the person may not:

(1) act as or represent that the person is a broker or salesperson; or
(2) act as a residential rental locator.

(B) An applicant for a broker or salesperson license may not act as a broker or salesperson until the person receives the license evidencing that authority.

(C) A licensed salesperson may not act or attempt to act as a broker or salesperson unless the salesperson is associated with a licensed broker and is acting for that broker.

(V.A.C.S. Art. 6573a, Secs. 1(b), 4 (part), 9(b) (part), 24(b) (part).)
SEC. 1101.554 CUSTODY OF SALESPERSON LICENSE

The commission shall deliver or mail each salesperson license to the broker with whom the salesperson is associated. The broker shall keep the license under the broker's custody and control. An applicant may not begin selling, leasing, or transferring real estate until he or she has obtained proof of licensure. The license proves that the holder has satisfactorily completed all the necessary education, paid the appropriate fees and taken the proper exams to begin receiving compensation for their real estate services.

(V.A.C.S. Art. 6573a, Sec. 9(a) (part).)

SEC. 1101.501 CERTIFICATE REQUIRED (SUBCHAPTER K)

A person may not sell, buy, lease, or transfer an Easement or Right-of-Way for another, for compensation or with the expectation of receiving compensation, for use in connection with telecommunication, utility, railroad, or pipeline service unless the person:

(1) holds a license issued under this chapter; or
(2) holds a certificate of registration issued under this subchapter.

(V.A.C.S. Art. 6573a, Secs. 4 (part), 9(b) (part), 9A(a).)

SEC. 1101.502 ELIGIBILITY REQUIREMENTS FOR SUBCHAPTER K CERTIFICATION

(A) To be eligible to receive a certificate of registration or a renewal certificate under this subchapter, a person must be:

(1) at least 18 years of age; and
(2) a citizen of the United States or a lawfully admitted alien.

(B) To be eligible to receive a certificate of registration or a renewal certificate under this subchapter, a corporation, limited liability company, partnership, limited liability partnership, or other entity must designate as its agent one of its officers, partners, or managers who is registered under this subchapter.

(V.A.C.S. Art. 6573a, Sec. 6(d).)

EXEMPTIONS FROM LICENSURE

In particular situations, certain people are exempt from licensure even if the context might otherwise seem to require a real estate license. Consider the following list, which presents a few key examples:

- Licensed attorneys
- Public officials carrying out their appointed duties
- Transactions involving one’s own property or cemetery lots
On-site apartment managers
Auctioneers auctioning real estate
Attorneys-in-fact operating under power of attorney
Owners selling their own property

Those individuals servicing telecommunications, railroads and pipelines, although possibly exempt from licensure, may require a Subchapter K Certificate. It is best not to assume exemption. If you have a question about a possible exception, contact TREC. Sec. 1101.005 of The Real Estate License Act lists all exceptions.

SEC. 1101.005 APPLICABILITY OF CHAPTER

This chapter does not apply to:
1) an attorney licensed in any state;

2) an attorney-in-fact authorized under a power of attorney to conduct a real estate transaction;

3) a public official while engaged in official duties;

4) an auctioneer licensed under Chapter 1802 while conducting the sale of real estate by auction if the auctioneer does not perform another act of a broker or salesperson;

5) a person acting under a court order or the authority of a will or written trust instrument;

6) a person employed by an owner in the sale of structures and land on which structures are located if the structures are erected by the owner in the course of the owner's business;

7) an on-site manager of an apartment complex;

8) an owner or the owner's employee who leases the owner's improved or unimproved real estate;

9) a partnership or limited liability partnership acting as a broker or salesperson through a partner who is a licensed broker; or

10) a transaction involving:

   A) the sale, lease, or transfer of a mineral or mining interest in real property;
   B) the sale, lease, or transfer of a cemetery lot; or
   C) the lease or management of a hotel or motel.
SUMMARY

This lesson covered the sections of the Real Estate License Act that pertain to license law. It explained candidacy qualification, the different types of licenses and those situations and persons exempt from licensure.

Before obtaining a license, all applicants must meet eligibility requirements. Generally, aspiring salespeople and brokers must:

- Be 18 years old or older
- Be citizens of the U.S. or lawfully admitted aliens
- Be Texas residents
- Meet the Commission’s integrity requirements
- Demonstrate competence on the state exam
- Complete the required courses of study, including three classroom hours on federal, state, and local laws governing housing discrimination, housing credit discrimination, and community reinvestment or three semester hours of course work on constitutional law.

Texas will entertain nonresident licensure, although the stipulations governing this sort of license are slightly more complicated. For a complete list of the requirements and laws regulating nonresident licensure, consult Section 1101.360 of the Real Estate License Act.

In essence, Texas recognizes two main types of licenses—salesperson and broker—and one type of certification, listed under Subchapter K, required for the sale and purchase of easements or rights-of-way. All salespeople must receive broker sponsorship to negotiate real estate transactions for compensation.

There are exceptions to the Real Estate License Act. Generally, licensed attorneys and public officials carrying out their duties are exempt from licensure requirements. Individuals selling their own homes are also exempt from licensure requirements. For a complete exemption list, consult Section 1101.005 of the Real Estate License Act.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
THE APPLICATION PROCESS

This lesson focuses on the following topics:

• The Real Estate License Act
• License Application
• Acts of a Broker or a Salesperson

INTRODUCTION

This lesson will cover the application process, the legal definitions of pertinent real estate terminology and the acts that constitute salesperson and broker services, as well as the Code of Ethics listed in the Real Estate License Act. As you complete the following lesson, keep in mind that the intent of the Real Estate License Act is to protect both licensees and members of the public from unfair and unethical business practices.

Upon completion of this lesson you will understand how to obtain licensure and for what acts you need licensure. Specifically, this lesson will outline the duties of brokers and salespeople and describe how they differ.

THE REAL ESTATE LICENSE ACT

The Texas Real Estate License Act was formerly called Vernon’s Texas Civil Statutes, Article 6573a, and is now known as Chapter 1101 of the Texas Occupations Code. The legislation governs those individuals that receive compensation or commission for their services or participation in real estate transactions. Chapter 1102 of the Texas Occupations Code covers real estate inspectors. This Act, revised in August 1967, again in May 1975 and, most recently, in September of 2003, increased the initial and continued education requirements placed on real estate brokers and licensees. It also removed surety bond provisions and established a real estate recovery trust account to reimburse members of the public who are financially damaged by the acts of licensees. Amendments were made to the Act up until 1997. During these sessions of the Texas legislature, sections of the Act were amended to establish the requirements for acquiring a real estate license, establish broker’s accountability to clients and the public for acts performed by the broker or by the salespeople the broker sponsors.

SEC. 1101.001 SHORT TITLE

This chapter may be cited as The Real Estate License Act.
(V.A.C.S. Art. 6573a, Sec. 1(a).)
REAL ESTATE LICENSE ACT DEFINITIONS

Of particular importance are the definitions of a broker and a salesperson because these specifically describe the activities that require licensure. Careful reading will reveal that the Act makes no distinction pertaining to the type of activity each is permitted to practice. The licensee’s level of accountability serves as the defining factor concerning salespeople and brokers. Both are permitted to lawfully sell, exchange, advertise and lease real estate in similar ways. However, a qualifying broker is accountable for all of the brokerage’s collective actions, while a salesperson is only liable for his or her own actions.

Sec 1101.002 Definitions

In this chapter:

(1) “Broker”:

(A) means a person who, in exchange for a commission or other valuable consideration or with the expectation of receiving a commission or other valuable consideration, performs for another person one of the following acts:

(i) sell, exchanges, purchases, or leases real estate;
(ii) offers to sell, exchange, purchase, or lease real estate;
(iii) negotiates or attempts to negotiate the listing, sale, exchange, purchase, or lease of real estate;
(iv) lists or offers, attempts, or agrees to list real estate for sale, lease, or exchange;
(v) appraises or offers, attempts, or agrees to appraise real estate;
(vi) auctions or offers, attempts, or agrees to auction real estate;
(vii) deals in options on real estate, including buying, selling, or offering to buy or sell options on real estate;
(viii) aids or offers or attempts to aid in locating or obtaining real estate for purchase or lease;
(ix) procures or assists in procuring a prospect to effect the sale, exchange, or lease of real estate; or
(x) procures or assists in procuring property to effect the sale, exchange, or lease of real estate; and

(B) includes a person who:

(i) is employed by or for an owner of real estate to sell any portion of the real estate; or
(ii) engages in the business of charging an advance fee or contracting to collect a fee under a contract that requires the person primarily to promote the sale of real estate by:
(a) listing the real estate in a publication primarily used for listing real estate; or
(b) referring information about the real estate to brokers.

(2) **Certificate holder** means a person registered under Subchapter K.
(3) **Commission** means the Texas Real Estate Commission.
(4) **License holder** means a broker or salesperson licensed under this chapter.
(5) **Real estate** means any interest in real property, including leasehold, located
in or outside this state. The term does not include any interest given as security
for the performance of an obligation.
(6) **Residential rental locator** means a person who offers for consideration to
locate a unit in an apartment complex for lease to a prospective tenant. The term
does not include an owner who offers to locate a unit in the owner's complex.
(7) **Salesperson** means a person who is associated with a licensed broker for the
purpose of performing an act described by Subdivision (1).
(8) **Subagent** means a license holder who:

(A) represents a principal through cooperation with and the consent
of a broker representing the principal; and
(B) is not sponsored by or associated with the principal's broker.

(V.A.C.S. Art. 6573a, Secs. 2(1), (2), (3), (4), (6), 15C(m)(3), (5), 24(a); New.)

**LICENSE APPLICATION**

**SEC. 1101.352 LICENSE APPLICATION**

(a) Each applicant for a broker or salesperson license must submit an application
on a form prescribed by the commission.

(b) Each applicant for a broker or salesperson license must disclose in the
license application whether the applicant has:

(1) entered a plea of guilty or nolo contendere to a felony; or
(2) been convicted of a felony and the time for appeal has elapsed or the
judgment or conviction has been affirmed on appeal.

(c) The disclosure under Subsection (b) must be provided even if an order has
granted community supervision suspending the imposition of the sentence.
(V.A.C.S. Art. 6573a, Secs. 6(a), (part), 9(e) (part).)

**SEC. 1101.353 MORAL CHARACTER DETERMINATION**

a) If before applying for a license under this chapter a person requests that the
commission determine whether the person's moral character complies with the
commission's moral character requirements for licensing under this chapter and
pays the fee prescribed by Section 1101.152, the commission shall make its
determination of the person's moral character.
(b) Not later than the 30th day after the date the commission makes its determination; the commission shall notify the person of the determination.

(c) If a person applies for a license after receiving notice of a determination, the commission may conduct a supplemental moral character determination of the person. The supplemental determination may cover only the period after the date the person requests a moral character determination under this section.

(V.A.C.S. Art. 6573a, Sec. 6A.)

**ACTS OF A BROKER OR A SALESPERSON**

**SEC. 1101.004 ACTING AS BROKER OR SALESPERSON**

A person acts as a broker or salesperson under this chapter if the person, with the expectation of receiving valuable consideration, directly or indirectly performs or offers, attempts, or agrees to perform for another person any act described by Section 1101.002(1), as a part of a transaction or as an entire transaction.

(V.A.C.S. Art. 6573a, Sec. 4 (part).)

**SEC. 1101.103 CODE OF ETHICS: STANDARDS OF CONDUCT**

Each member, officer, employee, and agent of the commission is subject to the code of ethics and standards of conduct imposed by Chapter 572, Government Code.

(V.A.C.S. Art. 6573a, Sec. 5(b)(1) (part).)

**SEC. 1101.803 GENERAL LIABILITY OF BROKER**

A licensed broker is liable to the commission, the public, and the broker's clients for any conduct engaged in under this chapter by the broker or by a salesperson associated with or acting for the broker.

(V.A.C.S. Art. 6573a, Sec. 1(c).)

**SEC. 1101.651 CERTAIN PRACTICES PROHIBITED**

(b) A salesperson may not accept compensation for a real estate transaction from a person other than the broker with whom the salesperson is associated or was associated when the salesperson earned the compensation.

(c) A salesperson may not pay a commission to a person except through the broker with whom the salesperson is associated at that time.

(V.A.C.S. Art. 6573a, Secs. 1(d), (e), 14(a), 15C(j), (k) (part).)
SEC. 1101.106 EQUAL EMPLOYMENT OPPORTUNITY POLICY; REPORT

(a) The administrator or the administrator's designee shall prepare and maintain a written policy statement to ensure implementation of an equal employment opportunity program under which all personnel transactions are made without regard to race, color, disability, sex, religion, age, or national origin. The policy statement must include:

(1) personnel policies, including policies relating to recruitment, evaluation, selection, appointment, training, and promotion of personnel;
(2) a comprehensive analysis of the commission workforce that meets federal and state guidelines;
(3) procedures by which a determination can be made of significant under use in the commission workforce of all persons for whom federal or state guidelines encourage a more equitable balance; and
(4) reasonable methods to appropriately address those areas of under use.

(b) A policy statement prepared under Subsection (a) must:

(1) cover an annual period;
(2) be updated at least annually; and
(3) be filed with the governor.

(c) The governor shall deliver a biennial report to the legislature based on the information received under Subsection (b). The report may be made separately or as a part of other biennial reports made to the legislature.

(V.A.C.S. Art. 6573a, Secs. 5(u), (v), (w).)

SEC. 1101.156 RULES RESTRICTING ADVERTISING OR COMPETITIVE BIDDING

(a) The commission may not adopt a rule restricting advertising or competitive bidding by a person regulated by the commission except to prohibit a false, misleading, or deceptive practice by the person.

(b) The commission may not include in rules to prohibit false, misleading, or deceptive practices by a person regulated by the commission a rule that:

(1) restricts the use of any advertising medium;
(2) restricts the person's personal appearance or use of the person's voice in an advertisement;
(3) relates to the size or duration of an advertisement used by the person; or
(4) restricts the person's advertisement under a trade name.
(V.A.C.S. Art. 6573a, Sec. 5(z).)

SEC. 1101.104 QUALIFICATIONS AND STANDARDS OF CONDUCT

The commission shall provide, as often as necessary, to its members and employees information regarding their:

(1) qualifications for office or employment under this chapter and Chapter 1102
(2) responsibilities under applicable laws relating to standards of conduct for state officers or employees.
(V.A.C.S. Art. 6573a, Sec. 5(x).)

SUMMARY

This lesson focused on the sections of the Real Estate License Act that apply to the license application process, differentiate between the roles of a broker and a salesperson and establish the code of ethics and standards of conduct for real estate professionals.

Before an individual can receive a broker or salesperson license he or she must fill out the proper application established by the Commission. The application requires that prospective licensees disclose if they have ever been convicted of a felony, or entered a plea of guilty or nolo contendere to a felony. In addition, the Commission reviews all applicants to ensure that they meet the ethical and moral standards required by state law. The Commission must notify the applicant within 30 days of its decision on the applicant’s moral status.

The Real Estate License Act outlines the difference between a broker’s license and salesperson’s license. A broker is responsible to his or her clients, the public and the Commission for his or her actions and the actions of his or her salespeople, while a salesperson faces more limited liability. A salesperson must receive sponsorship from a broker. The section of the Act covered in this lesson states that a salesperson may not accept compensation from any party except his or her sponsoring broker and may not disperse compensation except through his or her sponsoring broker.

All real estate licensees must adhere to the Commission’s moral and ethical standards. In particular, they must establish an equal opportunity workplace and place the interests of their clients before their own.

Return to your on-line course player to take the Lesson Quiz.
LESSON FOUR
EDUCATION AND TESTING REQUIRED TO RECEIVE OR RENEW A REAL ESTATE LICENSE OR SUBCHAPTER K CERTIFICATE

This lesson focuses on the following topics:

- Educational Requirements
- Final Exam and Testing Services
- License Application and Renewal
- Continuing Education Requirements
- Fees

INTRODUCTION

Both brokers and salespeople must meet certain requirements to obtain and maintain their active real estate licenses. First and foremost, the Commission requires that you complete state-approved pre-licensing courses; once licensed, you must take appropriate continuing education classes.

This lesson will outline the education requirements you must fulfill, the application and renewal process and the fees that you will be required to pay. You should remember that failure to meet any of these requirements can prevent you from obtaining a license, from renewing an active license and from activating an inactive license.

EDUCATIONAL REQUIREMENTS

TREC has determined that certain course material must be studied by all individuals pursuing a real estate license. This coursework establishes a minimum competency level for all new agents.

Aspiring real estate licensees must complete a required number of education hours and then pass the course’s final exam to receive credit. In certain situations, prior experience can be substituted for coursework. Each course covers a special portion of the real estate industry.

SEC. 1101.003 CORE REAL ESTATE COURSES

(a) For purposes of this chapter, core real estate courses include:

(1) agency law, which includes the following topics:

(A) the relationship between a principal and an agent;
(B) an agent’s authority;
(C) the termination of an agent’s authority;
(D) an agent’s duties, including fiduciary duties;
(E) employment law;
(F) deceptive trade practices;
(G) listing or buying representation procedures; and
(H) the disclosure of agency;

(2) contract law, which includes the following topics:

(A) elements of a contract;
(B) offer and acceptance;
(C) statute of frauds;
(D) remedies for breach, including specific performance;
(E) unauthorized practice of law;
(F) commission rules relating to use of adopted forms; and
(G) owner disclosure requirements;

(3) principles of real estate, which includes:

(A) an overview of:
   (i) licensing as a broker or salesperson;
   (ii) ethics of practice as a license holder;
   (iii) titles to and conveyance of real estate;
   (iv) legal descriptions;
   (v) deeds, encumbrances, and liens;
   (vi) distinctions between personal and real property;
   (vii) appraisal;
   (viii) finance and regulations;
   (ix) closing procedures; and
   (x) real estate mathematics; and

(B) at least three hours of classroom instruction on federal, state, and local
   laws relating to housing discrimination, housing credit discrimination, and
   community reinvestment;

(4) property management, which includes the following topics:

(A) the role of a property manager;
(B) landlord policies;
(C) operational guidelines;
(D) leases;
(E) lease negotiations;
(F) tenant relations;
(G) maintenance;
(H) reports;
(I) habitability laws; and
(J) the Fair Housing Act (42 U.S.C. Section 3601 et seq.);

(5) real estate appraisal, which includes the following topics:

(A) the central purposes and functions of an appraisal;
(B) social and economic determinants of the value of real estate;
(C) appraisal case studies;
(D) cost, market data, and income approaches to value estimates of real estate;
(E) final correlations; and
(F) reporting;

(6) real estate brokerage, which includes the following topics:

(A) agency law;
(B) planning and organization;
(C) operational policies and procedures;
(D) recruitment, selection, and training of personnel;
(E) records and control; and
(F) real estate firm analysis and expansion criteria;

(7) real estate finance, which includes the following topics:

(A) monetary systems;
(B) primary and secondary money markets;
(C) sources of mortgage loans;
(D) federal government programs;
(E) loan applications, processes, and procedures;
(F) closing costs;
(G) alternative financial instruments;
(H) equal credit opportunity laws;
(I) community reinvestment laws, including the Community Reinvestment Act of 1977 (12 U.S.C. Section 2901 et seq.); and
(J) state housing agencies, including the Texas Department of Housing and Community Affairs;

(8) real estate investment, which includes the following topics:

(A) real estate investment characteristics;
(B) techniques of investment analysis;
(C) the time value of money;
(D) discounted and non-discounted investment criteria;
(E) leverage;
(F) tax shelters depreciation; and
(G) applications to property tax;

(9) real estate law, which includes the following topics:

(A) legal concepts of real estate;
(B) land description;
(C) real property rights and estates in land;
(D) contracts;
(E) conveyances;
(F) encumbrances;
(G) foreclosures;
(H) recording procedures; and
(I) evidence of titles;

(10) real estate marketing, which includes the following topics:

(A) real estate professionalism and ethics;
(B) characteristics of successful salespersons;
(C) time management;
(D) psychology of marketing;
(E) listing procedures;
(F) advertising;
(G) negotiating and closing;
(H) financing; and
(I) Subchapter E, Chapter 17, Business & Commerce Code; and

(11) real estate mathematics, which includes the following topics:

(A) basic arithmetic skills and review of mathematical logic;
(B) percentages;
(C) interest;
(D) the time value of money;
(E) depreciation;
(F) amortization;
(G) proration; and
(H) estimation of closing statements.

(b) The commission may designate a course as an equivalent of a course listed in Subsection (a).

(c) The commission by rule may prescribe:

(1) The content of the core real estate courses listed in Subsection (a); and
(2) the title and content of additional core real estate courses.

(V.A.C.S. Art. 6573a, Secs. 7(a) (part), (b).)
SEC. 1101.356 BROKER LICENSE: EXPERIENCE AND REQUIREMENTS

To be eligible for a broker’s license, the applicant must have two years of active real estate license experience plus additional core education courses and classroom hours beyond those required for a salesperson’s license. The broker’s responsibility to his or her licensees and to the public creates a need for more extensive knowledge and experience in the real estate profession.

(a) An applicant for a broker license must provide to the commission satisfactory evidence that the applicant:

(1) has had at least two years of active experience in this state as a license holder during the 36 months preceding the date the application is filed; and
(2) has successfully completed at least 60 semester hours, or equivalent classroom hours, of postsecondary education, including:

(A) at least 18 semester hours or equivalent classroom hours of core real estate courses; and
(B) at least 42 hours of core real estate courses or related courses accepted by the commission.

(b) Subsection (a) does not apply to an applicant who, at the time of application, is licensed as a real estate broker by another state that has license requirements comparable to the requirements of this state.

(c) An applicant for a broker license who is licensed as a salesperson and is subject to the annual education requirements prescribed by Section 1101.454 must provide to the commission satisfactory evidence that the applicant has satisfied the requirements of that section. The hours completed under Section 1101.454 shall be applied to the number of hours required of the applicant under Subsection (a)(2) of this section.

SEC. 1101.357 BROKER LICENSE: ALTERNATE EXPERIENCE REQUIREMENTS FOR CERTAIN APPLICANTS

An applicant for a broker license who does not satisfy the experience requirements of Section 1101.356 must provide to the commission satisfactory evidence that:

(1) the applicant:

(A) is a licensed real estate broker in another state;
(B) has had at least two years of active experience in that state as a licensed real estate broker or salesperson during the 36 months preceding the date the application is filed; and
(C) has satisfied the educational requirements prescribed by Section 1101.356; or

(2) the applicant was licensed in this state as a broker in the year proceeding the date the application is filed.

(V.A.C.S. Art. 6573a, Secs. 7(g) (part), 14(b) (part).)

**SEC. 1101.359 ALTERNATE EDUCATION REQUIREMENTS FOR CERTAIN LICENSE HOLDERS**

An applicant for a broker license who is not subject to the education requirements of Section 1101.356(a)(2) and an applicant for a salesperson license who is not subject to the education requirements of Section 1101.358 or 1101.454 must provide to the commission satisfactory evidence that the applicant has completed the number of classroom hours of continuing education that would have been required for a timely renewal under Section 1101.455 during the two years preceding the date the application is filed.

(V.A.C.S. Art. 6573a, Sec. 7A(b).)

**SEC. 1101.358 SALESPERSON LICENSE: EDUCATION REQUIREMENTS**

Applicants must provide documentation that they have completed the necessary hours for real estate license eligibility. The student must take courses from TREC approved providers or other recognized colleges or universities.

(a) An applicant for a salesperson license must provide to the commission satisfactory evidence that the applicant has completed at least 12 semester hours, or equivalent classroom hours, of postsecondary education, including:

(1) at least four hours of core real estate courses on principles of real estate;
(2) at least two hours of each of the following core real estate courses:
   (A) agency law
   (B) contract law
(3) at least four hours of core real estate courses or related courses.

(b) The commission shall waive the education requirements of Subsection (a) if the applicant has been licensed in this state as a broker or salesperson within the year proceeding the date the application is filed.
(c) If an applicant for a salesperson license was licensed as a salesperson within the year preceding the date the application is filed and the license was issued under the conditions prescribed by Section 1101.454, the commission shall require the applicant to provide the evidence of successful completion of education requirements that would have been required if the license had been maintained without interruption during the preceding year.

**FINAL EXAM AND TESTING SERVICES**

In order to obtain licensure, an applicant must take the Texas State Real Estate exam through a testing service or center recognized by TREC. To obtain salesperson licensure, one must pass the exam with a score of 70 percent or higher. An applicant for a broker’s license must score 75 percent or higher to pass the final exam. Applicants will not be allowed to take the state exam until they have completed all pre-licensing education.

**SEC. 1101.401 EXAMINATION REQUIRED**

(a) The competency requirement prescribed under Section 1101.354(3) shall be established by an examination prepared or contracted for by the commission.

(b) The commission shall determine the time and place in the state for offering the examination.

(c) The examination must be of sufficient scope in the judgment of the commission to determine whether a person is competent to act as a broker or salesperson in a manner that will protect the public.

(d) The examination for a salesperson license must be less exacting and less stringent than the broker examination.

(e) The commission shall provide each applicant with study material and references on which the examination is based.

(f) An applicant must satisfy the examination requirement not later than six months after the date the license application is filed.

(V.A.C.S. Art. 6573a, Sec. 7(a) (part).)

**SEC. 1101.402 WAIVER OF EXAMINATION**

The commission shall waive the examination requirement for an applicant for:

1. a broker license if:
   
   (A) the applicant was previously licensed in this state as a broker; and
   
   (B) the application is filed before the first anniversary of the expiration date of that license; and
(2) a salesperson license if:
   (A) the applicant was previously licensed in this state as a broker or salesperson; and
   (B) the application is filed before the first anniversary of the expiration date of that license.

(V.A.C.S. Art. 6573a, Sec. 7(c) (part).)

SEC. 1101.362 WAIVER OF LICENSE REQUIREMENTS: PREVIOUS LICENSE

The Commission by rule may waive some or all of the requirements for a license under this chapter for an applicant who was licensed under this chapter within the six years preceding the date the application is filed.

(V.A.C.S. Art. 6573a, Sec. 7(c) (part).)

SEC. 1101.403 ADMINISTRATION OF EXAMINATION; TESTING SERVICE

(a) The commission shall administer any examination required by this chapter or Chapter 1102 unless the commission enters into an agreement with a testing service to administer the examination.

(b) The commission may accept an examination administered by a testing service if the commission retains the authority to establish the scope and type of the examination.

(c) The commission may negotiate an agreement with a testing service relating to examination development, scheduling, site arrangements, administration, grading, reporting, and analysis.

(d) The commission may require a testing service to:

   (1) correspond directly with license applicants regarding the administration of the examination;
   (2) collect fees directly from applicants for administering the examination; or
   (3) administer the examination at specific locations and specified frequencies.

(e) The commission shall adopt rules and standards as necessary to implement this section.

(V.A.C.S. Art. 6573a, Sec. 7(k).)
SEC. 1101.404 EXAMINATION RESULTS

(a) Not later than the 30th day after the date an examination is administered; the commission shall notify each examinee of the results of the examination. If an examination is graded or reviewed by a national testing service, the commission shall notify each examinee of the results of the examination not later than the 14th day after the date the commission receives the results from the testing service.

(b) If the notice of the results of an examination graded or reviewed by a national testing service will be delayed for more than 90 days after the examination date, the commission shall notify each examinee of the reason for the delay before the 90th day.

(c) If requested in writing by a person who fails an examination, the commission shall provide to the person an analysis of the person's performance on the examination.

(V.A.C.S. Art. 6573a, Sec. 7(i).)

SEC. 1101.405 RE-EXAMINATION

An applicant who fails an examination may apply for reexamination by filing a request accompanied by the proper fee.

(V.A.C.S. Art. 6573a, Sec. 7(a) (part).)

LICENSE APPLICATION AND RENEWAL

The Texas Real Estate License Act explains the pre-licensing requirements for both a broker and a salesperson. It also states that a salesperson must apply for his or her license under the sponsorship of a qualifying broker. The Commission addresses the education level, fees and examination of all perspective licensees.

SEC. 1101.352 LICENSE APPLICATION

(a) Each applicant for a broker or salesperson license must submit an application on a form prescribed by the commission.

(b) Each applicant for a broker or salesperson license must disclose in the license application whether the applicant has:

   (1) entered a plea of guilty or nolo contendere to a felony; or
   (2) been convicted of a felony and the time for appeal has elapsed or the judgment or conviction has been affirmed on appeal.

(c) The disclosure under Subsection (b) must be provided even if an order has granted community supervision suspending the imposition of the sentence.
(V.A.C.S. Art. 6573a, Secs. 6(a), (part), 9(e) (part).)

SEC. 1101.366 INACTIVE LICENSE: BROKER

(a) The commission may place on inactive status the license of a broker if the broker:

(1) is not acting as a broker;
(2) is not sponsoring a salesperson; and
(3) submits a written application to the commission before the expiration date of the broker's license.

(b) The commission may place on inactive status the license of a broker whose license has expired if the broker applies for inactive status on a form prescribed by the commission not later than the first anniversary of the expiration date of the broker's license.

(c) A broker applying for inactive status shall terminate the broker's association with each salesperson sponsored by the broker by giving written notice to each salesperson before the 30th day proceeding the date the broker applies for inactive status.

(d) A broker on inactive status:

(1) may not perform any activity regulated under this chapter; and
(2) must pay annual renewal fees.

(e) The commission shall maintain a list of each broker whose license is on inactive status.

(f) The commission shall remove a broker's license from inactive status if the broker:

(1) submits an application to the commission;
(2) pays the required fee; and
(3) submits proof of attending at least 15 classroom hours of continuing education as specified by Section 1101.455 during the two years preceding the date the application under Subdivision (1) is filed.

(V.A.C.S. Art. 6573a, Secs. 6(a) (part), 13A.)

SEC. 1101.367 INACTIVE LICENSE: SALESPERSON

(a) When the association of a salesperson with the salesperson's sponsoring broker terminates, the broker shall immediately return the salesperson license to the commission. A salesperson license returned under this subsection is inactive.
(b) The commission may remove a salesperson license from inactive status under Subsection (a) if, before the expiration date of the salesperson license, a licensed broker files a request with the commission advising the commission that the broker assumes sponsorship of the salesperson, accompanied by the appropriate fee.

(c) As a condition of returning to active status, an inactive salesperson whose license is not subject to the annual education requirements of Section 1101.454 must provide to the commission proof of attending at least 15 hours of continuing education as specified by Section 1101.455 during the two years preceding the date the application to return to active status is filed.

(V.A.C.S. Art. 6573a, Secs. 6(a) (part), 7A(c), 13.)

SEC. 1101.454 SALESPERSON LICENSE RENEWAL

(a) An applicant applying for the first renewal of a salesperson license must provide to the commission satisfactory evidence of completion of at least 14 semester hours, or equivalent classroom hours, of postsecondary education, including 10 hours of core real estate courses.

(b) An applicant applying for the second renewal of a salesperson license must provide to the commission satisfactory evidence of completion of at least 16 semester hours, or equivalent classroom hours, of postsecondary education, including 12 hours of core real estate courses.

(c) An applicant applying for the third renewal of a salesperson license must provide to the commission satisfactory evidence of completion of at least 18 semester hours, or equivalent classroom hours, of postsecondary education, including 14 hours of core real estate courses.

(d) The commission may not waive the requirements for renewal under this section.

(V.A.C.S. Art. 6573a, Secs. 7(e) (part), 9(d) (part).)

SEC. 1101.452 INFORMATION REQUIRED FOR LICENSE RENEWAL

(a) To renew an active license that is not subject to the annual education requirements of Section 1101.454, the license holder must provide to the commission proof of compliance with the continuing education requirements of Section 1101.455.

(b) Each applicant for the renewal of a license must disclose in the license application whether the applicant has:
   (1) entered a plea of guilty or nolo contendere to a felony; or
   (2) been convicted of a felony and the time for appeal has elapsed or the judgment or conviction has been affirmed on appeal.
(c) The disclosure under Subsection (b) must be provided even if an order has granted community supervision suspending the imposition of the sentence. (V.A.C.S. Art. 6573a, Secs. 7A(a) (part), 9(e) (part).)

SEC. 1101.453 ADDITIONAL RENEWAL REQUIREMENTS FOR CERTAIN BUSINESS ENTITIES

(a) To renew a license under this chapter:
   (1) a corporation must designate one of its officers as its agent for purposes of this chapter; and
   (2) a limited liability company must designate one of its managers as its agent for purposes of this chapter.

(b) A corporation or limited liability company may not act as a broker unless the entity’s designated agent is a licensed broker according to the commission’s records. (V.A.C.S. Art. 6573a, Sec. 6(c) (part).)

SEC. 1101.502 ELIGIBILITY REQUIREMENTS FOR CERTIFICATE

(a) To be eligible to receive a certificate of registration or a renewal certificate under this subchapter, a person must be:

   (1) at least 18 years of age; and
   (2) a citizen of the United States or a lawfully admitted alien.

(b) To be eligible to receive a certificate of registration or a renewal certificate under this subchapter, a corporation, limited liability company, partnership, limited liability partnership, or other entity must designate as its agent one of its officers, partners, or managers who is registered under this subchapter. (V.A.C.S. Art. 6573a, Sec. 6(d).)

CONTINUING EDUCATION REQUIREMENTS

Once a person secures his or her respective license, he or she must complete all required continuing education to maintain his or her license. The following sections outline the continuing education requirements for salesperson and brokers. In addition, those situations/parties exempted from continuing education are discussed.

SEC. 1101.455 CONTINUING EDUCATION REQUIREMENTS

a) In this section, “property tax consulting laws and legal issues” includes the Tax Code, preparation of property tax reports, the unauthorized practice of law, agency law, tax law, law relating to property tax or property assessment,
deceptive trade practices, contract forms and addendums, and other legal topics approved by the commission.

(b) A license holder who is not subject to the annual education requirements of Section 1101.454 must attend during the term of the current license at least 15 classroom hours of continuing education courses approved by the commission.

(c) The commission by rule may:

1. prescribe the title, content, and duration of continuing education courses that a license holder must attend to renew a license; and
2. approve as a substitute for the classroom attendance required by Subsection (b):
   (A) relevant educational experience; and
   (B) correspondence courses.

(d) In addition, the commission may approve supervised video instruction as a course that may be applied toward satisfaction of the classroom hours of continuing education courses required by Subsection (b).

(e) At least six of the continuing education hours required by Subsection (b) must cover the following topics:

1. commission rules;
2. fair housing laws;
3. Property Code issues, including landlord and tenant law;
4. agency law;
5. antitrust laws;
6. Subchapter E, Chapter 17, Business & Commerce Code;
7. disclosures to buyers, landlords, tenants, and sellers;
8. current contract and addendum forms;
9. unauthorized practice of law;
10. case studies involving violations of laws and regulations;
11. current Federal Housing Administration and Department of Veterans Affairs regulations;
12. tax laws;
13. property tax consulting laws and legal issues; or
14. other legal topics approved by the commission.

(f) The remaining nine hours may be devoted to other real estate-related topics approved by the commission.

(g) The commission may consider courses equivalent to those described by Subsections (e) and (f) for continuing education credit.
(h) The commission shall automatically approve as mandatory continuing education courses:
   (1) core real estate courses; and
   (2) real estate-related courses approved by the State Bar of Texas for minimum continuing legal education participatory credit.

(i) The commission may not require an examination for a course under this section unless the course is a correspondence course or a course offered by an alternative delivery system, including delivery by computer.

(j) Daily classroom course segments must be at least one hour and not more than 10 hours.
   (V.A.C.S. Art. 6573a, Sec. 7A(a).)

SEC. 1101.456 EXEMPTION FROM CONTINUING EDUCATION FOR CERTAIN BROKERS

Notwithstanding any other provision of this chapter, a broker who, before October 31, 1991, qualified under former Section 7A(f), The Real Estate License Act (Article 6573a, Vernon's Texas Civil Statutes), as added by Section 1.041, Chapter 553, Acts of the 72nd Legislature, Regular Session, 1991, for an exemption from continuing education requirements is not required to comply with the mandatory continuing education requirements of this subchapter to renew the broker's license.
   (V.A.C.S. Art. 6573a, Sec. 7A(f) (part).)

SEC. 1101.457 DEFERRAL OF CONTINUING EDUCATION REQUIREMENTS

(a) The commission by rule may establish procedures under which an applicant may have the applicant's license issued, renewed, or returned to active status before the applicant completes continuing education requirements.

(b) The commission may require an applicant under this section to:
   (1) pay an additional fee, not to exceed $200; and
   (2) complete the required continuing education not later than the 60th day after the date the license is issued, renewed, or returned to active status.
   (V.A.C.S. Art. 6573a, Sec. 7A(g).)

SEC. 1101.301 ACCREDITATION OF PROGRAMS AND COURSES OF STUDY

(a) The commission, as necessary for the administration of this chapter and Chapter 1102, may:
(1) establish standards for the accreditation of educational programs or courses of study in real estate and real estate inspection conducted in this state, excluding programs and courses offered by accredited colleges and universities;
(2) establish, by rule, reasonable criteria for the approval of real estate and real estate inspection courses; and
(3) inspect and accredit real estate and real estate inspection educational programs or courses of study.

(b) The commission shall determine whether a real estate or real estate inspection course satisfies the requirements of this chapter and Chapter 1102. (V.A.C.S. Art. 6573a, Sec. 7(f) (part).)

SEC. 1101.302 BOND REQUIRED

(a) In this section, educational institution means a school, excluding an accredited college or university, authorized by the commission under this chapter to offer a real estate or real estate inspection educational program or course of study.

(b) An educational institution shall maintain a corporate surety bond or other security acceptable to the commission that is:

1. in the amount of $10,000;
2. payable to the commission; and
3. for the benefit of a party who suffers damages caused by the failure of the institution to fulfill obligations related to the commission's approval. (V.A.C.S. Art. 6573a, Sec. 7(f) (part).)

SEC. 1101.303 APPROVAL OF CONTINUING EDUCATION PROVIDER OR COURSE OF STUDY

(a) If the commission determines that an applicant for approval as a continuing education provider satisfies the requirements of this subchapter and any rule adopted under this subchapter, the commission may authorize the applicant to offer continuing education for a two-year period.

(b) If the commission determines that an applicant for approval of a continuing education course of study satisfies the requirements of this subchapter and any rule adopted under this subchapter, the commission may authorize the applicant to offer the course of study for a two-year period. (V.A.C.S. Art. 6573a, Sec. 7A(d) (part).)
FEES

Each license carries its respective fees. For example, the initial broker’s license application costs $100.00 and a salesperson’s license application costs $75. This section of the lesson outlines the laws pertaining to fees, fee caps and the process for fee increases. In addition, it explains the fees that it disburses to the Texas Real Estate Research Center, managed by Texas A&M University.

SEC. 1101.152 FEES

(a) The commission shall charge and collect the following fees:
   (1) for filing an original application for a broker license, not more than $100;
   (2) for annual renewal of a broker license, not more than $100;
   (3) for filing an original application for a salesperson license, not more than $75;
   (4) for annual renewal of a salesperson license, not more than $50;
   (5) for annual registration, $80;
   (6) for an application for a license examination, not more than $100;
   (7) for filing a request for a branch office license, not more than $20;
   (8) for a request for a change of place of business, change of name, return to active status, or change of sponsoring broker, not more than $20;
   (9) for filing a request to replace a lost or destroyed license or certificate of registration, not more than $20;
   (10) for filing an application for approval of an education program under Subchapter G, not more than $400;
   (11) for annual operation of an education program under Subchapter G, not more than $200;
   (12) for filing an application for approval of an instructor of core real estate courses, not more than $40;
   (13) for transcript evaluation, $20;
   (14) for preparing a license or registration history, not more than $20 and
   (15) for filing an application for a moral character determination, not more than $50.

(b) The commission may set and collect reasonable fees to implement the continuing education requirements for license holders, including the following fees:
   (1) for an application for approval of a continuing education provider, not more than $400; and
   (2) for an application for approval of a continuing education course of study, not more than $100; and
   (3) for an application for approval of an instructor of continuing education courses, not more than $40.
(c) Notwithstanding Subsection (a), if the commission issues an original inactive salesperson license under Section 1101.363(b) to a salesperson who is not sponsored by a licensed broker and the salesperson is subsequently sponsored by a license broker, the commission may not charge:
   (1) the salesperson a fee for filing a request to place the salesperson license on active status; or
   (2) the broker a fee for filing a request to sponsor the salesperson.

(V.A.C.S. Art. 6573a, Secs. 7A(d) (part), 11 (part).)

SEC. 1101.153 FEE INCREASE

(a) The fee for filing an original application for an individual broker license and the fee for annual renewal of an individual broker license is the amount of the fee set by the commission under Section 1101.152 and a fee increase of $200.

(b) Of each fee increase collected under Subsection (a), $50 shall be deposited to the credit of the foundation school fund and $150 shall be deposited to the credit of the general revenue fund.

(V.A.C.S. Art. 6573a, Secs. 11A(a), (b) (part).)

SEC. 1101.154 ADDITIONAL FEE: TEXAS REAL ESTATE RESEARCH CENTER

(a) The fee for the issuance or renewal of a:
   (1) broker license is the amount of the fee set under Sections 1101.152 and 1101.153 and an additional $20 fee;
   (2) salesperson license is the amount of the fee set under Section 1101.152 and an additional $17.50 fee; and
   (3) certificate of registration is the amount of the fee set under Section 1101.152 and an additional $20 fee.

(b) The commission shall transmit quarterly the additional fees collected under Subsection (a) to Texas A&M University for deposit in a separate banking account that may be appropriated only to support, maintain, and carry out the purposes, objectives, and duties of the Texas Real Estate Research Center.

(V.A.C.S. Art. 6573a, Secs. 5(m) (part), 11 (part).)

SEC. 1101.603 PAYMENTS INTO TRUST ACCOUNT

(a) In addition to other fees required by this chapter, an applicant for an original license must pay a fee of $10.

(b) In addition to other fees required by this chapter, an applicant for an original certificate of registration or renewal certificate must pay a fee of $50.

(c) The commission shall deposit to the credit of the trust account:
(1) fees collected under Subsections (a) and (b); and
(2) an administrative penalty collected under Subchapter O for a violation by a person licensed as a broker or salesperson.

(d) an administrative penalty collected under Subchapter O for a violation by a person who is not licensed under this chapter or Chapter 1102 shall be deposited to the credit of the trust account or the real estate inspection recovery fund, as determined by the commission.

(e) On a determination by the commission at any time that the balance in the trust account is less than $1 million, each license holder at the next license renewal must pay, in addition to the renewal fee, a fee that is equal to the lesser of $10 or a pro rata share of the amount necessary to obtain a balance in the trust account of $1.7 million. The commission shall deposit the additional fee to the credit of the trust account.

(f) To ensure the availability of a sufficient amount to pay anticipated claims on the trust account, the commission by rule may provide for the collection of assessments at different times and under conditions other than those specified by this chapter.

(V.A.C.S. Art. 6573a, Secs. 8(b), (c) (part), 11 (part),19A(o) (part).)

**SUMMARY**

This lesson covered education requirements for brokers and salespeople, the final examination and testing services, the license application and renewal process, continued education requirements for license renewal and the fees associated with real estate licensure.

TREC has established a minimum level of competency and professionalism which all real estate licensees must meet in order to receive a Texas real estate license. The state ensures this competency by requiring a final examination upon completion of the core pre-licensing and continuing education courses. These minimum requirements help licensees and consumers avoid potential problems and misunderstandings during a real estate transaction. TREC-sanctioned education providers must deliver all required core courses for pre-licensure and continued education. TREC allows prospective licensees and licensees satisfying continuing education requirements to take courses by correspondence and online in addition to more conventional classroom instruction.

TREC also describes the various situations in which education and examination requirements can be waived, deferred, or replaced with an alternative. Typically, TREC will review an application to verify the individual’s educational needs and experiences and then make a determination as to whether or not the required courses and examination can be waived.
This lesson also discussed the fees one must pay and the continued education requirements one must fulfill to retain an active license. These fees help fund TREC, The Texas Real Estate Research Center and the State’s recovery trust account. TREC makes this recovery trust account available to reimburse members of the public who have been financially damaged by incompetent brokers or salespeople.

Return to your online course player to take the Lesson Quiz.
LESSON FIVE
RECEIVING THE REAL ESTATE LICENSE

This lesson focuses on the following topics:

- Issuance of License or Certificate
- Denial of License or Certificate
- Expiration
- Displaying Licenses

INTRODUCTION

Once an applicant has satisfied all necessary course requirements, passed the state-mandated final exam and submitted an application, TREC reviews the applicant’s performance and judges the applicant’s moral character. Based on their conclusions, TREC then either issues a license or denies the application. Once the applicant has been issued a license, she must monitor her renewal dates and properly display her license as part of her duties as a licensee.

This lesson covers the steps involved in issuing a license; it also describes the process of denying an application for licensure. In addition, the lesson discusses license expiration dates and the need to display the license in the sponsoring broker’s fixed office location. The lesson presents the relevant sections of The Real Estate License Act verbatim.

ISSUANCE OF LICENSE OR CERTIFICATE

SEC. 1101.363 ISSUANCE OF LICENSE

(a) The commission shall issue an appropriate license to an applicant who meets the requirements for a license.

(b) The commission may issue an inactive salesperson license to a person who applies for a salesperson license and satisfies all requirements for the license. The person may not act as a salesperson unless the person is sponsored by a licensed broker who has notified the commission as required by Section 1101.367(b). Notwithstanding Section 1101.367(b), the licensed broker is not required to pay the fee required by that subsection.

(c) A license remains in effect for the period prescribed by the commission if the license holder complies with this chapter and pays the appropriate renewal fees. (V.A.C.S. Art. 6573a, Sec. 9(a) (part).)
SEC. 1101.503 SUBCHAPTER K CERTIFICATE

(a) The commission shall issue a certificate of registration to an applicant who meets the requirements for a certificate of registration.
(b) The certificate remains in effect for the period prescribed by the commission if the certificate holder complies with this chapter and pays the appropriate renewal fees.

(V.A.C.S. Art. 6573a, Sec. 9(a) (part).)

SEC. 1101.554 CUSTODY OF SALESPERSON LICENSE

(a) The commission shall deliver or mail each salesperson license to the broker with whom the salesperson is associated.
(b) The broker shall keep the license under the broker’s custody and control.

(V.A.C.S. Art. 6573a, Sec. 9(a) (part).)

SEC. 1101.365 PROBATIONARY LICENSE

(a) The commission may issue a probationary license.
(b) The commission by rule shall adopt reasonable terms for issuing a probationary license.

(V.A.C.S. Art. 6573a, Sec. 10(c).)

DENIAL OF LICENSE OR CERTIFICATE

TREC may deny a license application providing it gives immediate written notice to the applicant. Upon receipt of TREC’s notice of denial, an applicant has 10 days to file his or her appeal. The following sections present the law pertaining to license denial and appeal.

SEC. 1101.364 DENIAL OF LICENSE

(a) The commission shall immediately give written notice to the applicant of the commission’s denial of a license.

(b) Before the applicant may appeal under Section 1101.658, the applicant must file, not later than the 10th day after the date the applicant receives the notice, an appeal requesting a time and place for a hearing before the commission. If the applicant fails to request a hearing as provided by this subsection, the commission’s decision becomes final and is not subject to judicial review.

(c) The commission shall:
   (1) set a time and place for the hearing not later than the 30th day after the date the commission receives the appeal; and
(2) give notice of the hearing to the applicant before the 10th day preceding the date of the hearing.

(d) The hearing may be continued from time to time with the consent of the applicant.

(e) After the hearing, the commission shall enter an appropriate order.

(V.A.C.S. Art. 6573a, Secs. 10(a) (part), (b).)

SEC. 1101.505 DENIAL OF CERTIFICATE

The denial of a certificate of registration is subject to the same provisions as are applicable under Section 1101.364 to the denial of a license.

(V.A.C.S. Art. 6573a, Secs. 10(a) (part), (b).)

EXPIRATION

This section of the license law covers the expiration and renewal procedures for both a salesperson’s license and a broker’s license.

SEC. 1101.451 LICENSE EXPIRATION

(a) The commission may issue or renew a license for a period not to exceed 24 months.

(b) The commission by rule may adopt a system under which licenses expire on various dates during the year. The commission shall adjust the date for payment of the renewal fees accordingly.

(c) For a year in which the license expiration date is changed, renewal fees payable shall be prorated on a monthly basis so that each license holder pays only that portion of the fee that is allocable to the number of months during which the license is valid. On renewal of the license on the new expiration date, the total renewal fee is payable.

(d) A renewal fee for a license under this chapter may not exceed, calculated on an annual basis, the amount of the sum of the fees established under Sections 1101.152, 1101.154, and 1101.603.

(V.A.C.S. Art. 6573a, Secs. 9(c) (part), (d) (part).)

SEC. 1101.504 CERTIFICATE EXPIRATION

The duration, expiration, and renewal of a certificate of registration are subject to the same provisions as are applicable under Section 1101.451 to the duration, expiration, and renewal of a license.

(V.A.C.S. Art. 6573a, Secs. 9(c) (part), (d) (part).)
DISPLAYING LICENSES

SEC. 1101.553 DISPLAY OF LICENSE

A residential rental locator shall prominently display in a place accessible to clients and prospective clients:
1. the locator's license;
2. a statement that the locator is licensed by the commission; and
3. the name, mailing address, and telephone number of the commission as provided by Section 1101.202(a).

(V.A.C.S. Art. 6573a, Secs. 12(c), (d), 24(d).)

SEC. 1101.507 DISPLAY OF CERTIFICATE

A certificate holder shall prominently display at all times the holder's certificate of registration in the holder's place of business.

(V.A.C.S. Art. 6573a, Sec. 12(e) (part).)

SEC. 1101.552 FIXED OFFICE REQUIRED; CHANGE OF ADDRESS; BRANCH OFFICES

(a) A resident broker shall maintain a fixed office in this state. The address of the office shall be designated on the broker's license.

(b) Not later than the 10th day after the date a broker moves from the address designated on the broker's license, the broker shall submit an application, accompanied by the appropriate fee, for a license that designates the new location of the broker's office. The commission shall issue a license that designates the new location if the new location complies with the requirements of this section.

(c) A broker who maintains more than one place of business in this state shall obtain a branch office license for each additional office maintained by the broker by submitting an application, accompanied by the appropriate fee.

(d) A nonresident licensed broker is not required to maintain a place of business in this state.

(V.A.C.S. Art. 6573a, Secs. 12(a), (b), 14(b) (part).)

SEC. 1101.506 CHANGE OF ADDRESS

Not later than the 10th day after the date a certificate holder moves its place of business from a previously designated address, the holder shall:
1. notify the commission of the move; and
2. obtain a new certificate of registration that reflects the address of the new place of business.
SUMMARY

This lesson covered the issuance of salesperson licenses, broker licenses and the Subchapter K Certificate. It also described what should happen if TREC denies an applicant’s request for licensure or certification as well as the basic steps involved in appealing such a denial.

If TREC denies an application, then the applicant has the opportunity to request a hearing to ask the Commission to reconsider its position. The applicant must file this request for hearing no later than the 10th day after receiving the denial notice. The Commission can, under certain circumstances, offer a license on a probationary status.

TREC has the authority to grant licenses and certificates on an inactive basis. In the event a salesperson or certificate applicant completes all necessary requirements for licensure but has no sponsoring broker, TREC issues an inactive license. Upon acquisition of a sponsoring broker, the licensee and sponsoring broker must submit a request for TREC to mail the license to the sponsoring broker. The broker maintains custody of the license during the broker/agent relationship. Once the sponsoring broker receives the agent’s license, they need to display the license at his or her fixed address in a public area. If and when that relationship ends, the broker must immediately return the license to TREC.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON SIX
REPRESENTING CLIENTS

This lesson will focus on the following topics:

- Acting as Agent
- Representation Disclosure
- Acting as Intermediary

INTRODUCTION

Once the sponsoring broker has received the salesperson’s license and has the license on display, the real estate agent can begin working with and representing owners, lessors and purchasers of real estate. This lesson covers the aspects of The Real Estate License Act concerned with agency, disclosure and intermediary relationships.

A broker is responsible for representing clients in an honest, fair and ethical manner. These general obligations require an agent to disclose any information regarding a subject property that would affect a prudent buyer’s decision to purchase. This requirement is a matter of presenting an honest picture of the property; it does not include information about your client or your client’s situation, only information about the subject property. An agent must also disclose their relationship (that is, he must clearly state which party or parties he represents) to all those who are or may become involved in the transaction. The agent must disclose this information at first contact with that party.

In any transaction facilitated by a real estate professional, both the seller side and the buyer side of the transaction require representation. A broker or licensee can represent the buyer, the seller or, in some instances, both sides of the transaction. When a broker or agent represents both parties involved, then he or she is an intermediary. This intermediary position requires the broker or agent to treat both parties equally, fairly, honestly and justly. Sections of the Real Estate License Act regarding agency, disclosure responsibility and intermediary position are presented verbatim.

ACTING AS AGENT

SEC. 1101.557 ACTING AS AGENT

A license holder who represents a party in a real estate transaction acts as that party’s agent.

(V.A.C.S. Art. 6573a, Sec. 15C(c).)
REPRESENTATION DISCLOSURE

The following sections of the law describe the details of disclosure, representation and acting as an intermediary. It is essential that all licensees understand the importance of disclosure and disclosure liability, as well as the more general standards of ethical conduct they’re required to meet.

SEC. 1101.558 REPRESENTATION DISCLOSURE

(a) In this section, “substantive dialogue” means a meeting or written communication that involves a substantive discussion relating to specific real property. The term does not include:
   (1) a meeting that occurs at a property that is held open for any prospective buyer or tenant; or
   (2) a meeting or written communication that occurs after the parties to a real estate transaction have signed a contract to sell, buy, or lease the real property concerned.

(b) A license holder who represents a party in a proposed real estate transaction shall disclose, orally or in writing, that representation at the time of the license holder's first contact with:
   (1) another party to the transaction; or
   (2) another license holder who represents another party to the transaction.

(c) A license holder shall provide to a party to a real estate transaction at the time of the first substantive dialogue with the party the written statement prescribed by Subsection (d) unless:
   (1) the proposed transaction is for a residential lease for not more than one year and a sale is not being considered; or
   (2) the license holder meets with a party who is represented by another license holder.

(d) The written statement required by Subsection (c) must be printed in a format that uses at least 10-point type and read as follows:

Before working with a real estate broker, you should know that the duties of a broker depend on whom the broker represents. If you are a prospective seller or landlord (owner) or a prospective buyer or tenant (buyer), you should know that the broker who lists the property for sale or lease is the owner's agent. A broker who acts as a subagent represents the owner in cooperation with the listing broker. A broker who acts as a buyer's agent represents the buyer. A broker may act as an intermediary between the parties if the parties consent in writing. A broker can assist you in locating a property, preparing a contract or lease, or obtaining financing without representing you. A broker is obligated by law to treat you honestly.
Broker Represents the Owner

The broker becomes the owner's agent by entering into an agreement with the owner, usually through a written listing agreement, or by agreeing to act as a subagent by accepting an offer of sub-agency from the listing broker. A subagent may work in a different real estate office. A listing broker or subagent can assist the buyer but does not represent the buyer and must place the interests of the owner first. The buyer should not tell the owner's agent anything the buyer would not want the owner to know because an owner's agent must disclose to the owner any material information known to the agent.

Broker Represents the Buyer

The broker becomes the buyer's agent by entering into an agreement to represent the buyer, usually through a written buyer representation agreement. A buyer's agent can assist the owner but does not represent the owner and must place the interests of the buyer first. The owner should not tell a buyer's agent anything the owner would not want the buyer to know because a buyer's agent must disclose to the buyer any material information known to the agent.

If the Broker Acts as an Intermediary

A broker may act as an intermediary between the parties if the broker complies with The Texas Real Estate License Act. The broker must obtain the written consent of each party to the transaction to act as an intermediary. The written consent must state who will pay the broker and, in conspicuous bold or underlined print, set forth the broker's obligations as an intermediary. The broker is required to treat each party honestly and fairly and to comply with The Texas Real Estate License Act. A broker who acts as an intermediary in a transaction:

(1) shall treat all parties honestly;

(2) may not disclose that the owner will accept a price less than the asking price unless authorized in writing to do so by the owner;

(3) may not disclose that the buyer will pay a price greater than the price submitted in a written offer unless authorized in writing to do so by the buyer; and

(4) may not disclose any confidential information or any information that a party specifically instructs the broker in writing not to disclose unless authorized in writing to disclose the information or required to do so by The Texas Real Estate License Act or a court order or if the information materially relates to the condition of the property. With the parties' consent, a broker acting as an intermediary between the parties may appoint a person who is licensed under The Texas Real Estate License...
Act and associated with the broker to communicate with and carry out instructions of one party and another person who is licensed under that Act and associated with the broker to communicate with and carry out instructions of the other party.

If you choose to have a broker represent you, you should enter into a written agreement with the broker that clearly establishes the broker's obligations and your obligations. The agreement should state how and by whom the broker will be paid. You have the right to choose the type of representation, if any, you wish to receive. Your payment of a fee to a broker does not necessarily establish that the broker represents you. If you have any questions regarding the duties and responsibilities of the broker, you should resolve those questions before proceeding.

(e) The license holder may substitute buyer for tenant and seller for landlord as appropriate in the written statement prescribed by Subsection (d).

(V.A.C.S. Art. 6573a, Secs. 15C(a), (b), (d), (e), (f), (g), (m)(1).)

**ACTING AS INTERMEDIARY**

**SEC. 1101.559 BROKER ACTING AS INTERMEDIARY**

(a) A broker may act as an intermediary between parties to a real estate transaction if:

(1) the broker obtains written consent from each party for the broker to act as an intermediary in the transaction; and
(2) the written consent of the parties states the source of any expected compensation to the broker.

(b) A written listing agreement to represent a seller or landlord or a written agreement to represent a buyer or tenant that authorizes a broker to act as an intermediary in a real estate transaction is sufficient to establish written consent of the party to the transaction if the written agreement specifies in conspicuous bold or underlined print the conduct that is prohibited under Section 1101.651(d).

(c) An intermediary shall act fairly and impartially. Appointment by a broker acting as an intermediary of an associated license holder under Section 1101.560 to communicate with, carry out the instructions of, and provide opinions and advice to the parties to whom that associated license holder is appointed is a fair and impartial act.

(V.A.C.S. Art. 6573a, Secs. 15C(h), (i), (m)(2) (part).)
SEC. 1101.560 ASSOCIATE LICENSE HOLDER ACTING AS INTERMEDIARY

(a) A broker who complies with the written consent requirements of Section 1101.559 may appoint:
   (1) a license holder associated with the broker to communicate with and carry out instructions of one party to a real estate transaction; and
   (2) another license holder associated with the broker to communicate with and carry out instructions of any other party to the transaction.

(b) A license holder may be appointed under this section only if:
   (1) the written consent of the parties under Section 1101.559 authorizes the broker to make the appointment; and
   (2) the broker provides written notice of the appointment to all parties involved in the real estate transaction.

(c) A license holder appointed under this section may provide opinions and advice during negotiations to the party to whom the license holder is appointed.

(V.A.C.S. Art. 6573a, Sec. 15C(k) (part).)

SEC. 1101.561 DUTIES OF INTERMEDIARY

The duties of a license holder acting as an intermediary under this subchapter supersede the duties of a license holder established under any other law, including common law.

(V.A.C.S. Art. 6573a, Sec. 15C(l).)

SUMMARY

This lesson covered disclosure and agency and how these responsibilities can change in intermediary transactions. An agent must provide either written or verbal disclosure to all potential buyers or sellers, explaining whom the agent represents. This disclosure must be presented at the beginning of the first substantive dialogue with the individuals interested in a particular transaction.

Prior to the formation of an agency relationship, however, brokers and salespeople must give potential principals a written statement describing the role of a real estate licensee in real estate transactions. By law, brokers and salespeople must use TREC’s written statement from section 1101.558 (d) of the Real Estate License Act to make this disclosure; for convenience they can use TREC’s form OP-K, *Information about Brokerage Services*, which provides a preprinted version of this statement.

It is important that members of the public understand the role of real estate agents and brokers in a real estate transaction. Proper disclosure is the only way to ensure that all of those involved in a transaction understand each other’s roles.
and are clear about who represents whom. That is to say, proper disclosure helps customers and clients to understand where an agent or broker’s fiduciary duties lie.

Intermediary positions pose a unique challenge. If an agent or broker acts as an intermediary, then written disclosure must be provided about what this role entails. When an agent or broker assumes this role, he or she must have both parties agree to intermediary representation and sign a promulgated intermediary disclosure form.

Return to your on-line course player to take the Lesson Quiz.
LESSON SEVEN
DISCIPLINARY ACTION

This lesson will focus on the following topics:

- Disciplinary Authority
- Administrative Penalty
- Hearings
- Suspension or Revocation of License
- Civil and Criminal Penalties

INTRODUCTION

This lesson covers TREC’s disciplinary authority and discusses the administrative penalties, hearings, license suspension or revocation and civil and criminal penalties that can arise via TREC’s disciplinary actions against those who violate the TREC rules and guidelines.

As mentioned earlier, customers and clients of real estate agents may contact TREC when they feel they have been misrepresented, financially damaged or otherwise aggrieved during a real estate transaction. TREC can use any of the state’s resources and personnel, including the attorney general, to resolve complaints.

A real estate agent who is disciplined by TREC may request a hearing to dispute the Commission’s decision and additional appeals may follow. TREC directs these appeals to a district court in the county where the administrative hearing was held. Real estate licensees found guilty of inappropriate conduct or actions may have their licenses suspended or revoked; they can also face civil and criminal prosecution.

DISCIPLINARY AUTHORITY

SEC. 1101.703 REPORT AND NOTICE OF VIOLATION AND PENALTY

(a) If, after investigation of a possible violation and the facts relating to that violation, the administrator determines that a violation has occurred, the administrator may issue a violation report stating:

(1) the facts on which the determination is based; and
(2) the administrator's recommendation on the imposition of the administrative penalty, including a recommendation on the amount of the penalty.
(b) Not later than the 14th day after the date the report is issued, the administrator shall give written notice of the report to the person charged with the violation. The notice must:
   (1) include a brief summary of the charges;
   (2) state the amount of the recommended penalty; and
   (3) inform the person of the person's right to a hearing on the occurrence of the violation, the amount of the penalty, or both.

(V.A.C.S. Art. 6573a, Secs. 19A(d) (part), (e).)

SEC. 1101.656 ADDITIONAL DISCIPLINARY AUTHORITY

(a) In addition to any other authority under this chapter, the commission may suspend or revoke a license, place on probation a person whose license has been suspended, or reprimand a license holder if the license holder violates this chapter or a commission rule.

(b) The commission may probate a suspension, revocation, or cancellation of a license under reasonable terms determined by the commission.

(c) The commission may require a license holder whose license suspension or revocation is probated to:
   (1) report regularly to the commission on matters that are the basis of the probation;
   (2) limit practice to an area prescribed by the commission; or
   (3) continue to renew professional education until the license holder attains a degree of skill satisfactory to the commission in the area that is the basis of the probation.

(V.A.C.S. Art. 6573a, Secs. 15B(b), (c), (d).)

ADMINISTRATIVE PENALTY

SEC. 1101.701 IMPOSITION OF ADMINISTRATIVE PENALTY

The commission may impose an administrative penalty on a person who violates this chapter or a rule adopted or order issued by the commission under this chapter.

(V.A.C.S. Art. 6573a, Sec. 19A(a).)

SEC. 1101.702 AMOUNT OF PENALTY

(a) The amount of an administrative penalty may not exceed $1,000 for each violation. Each day a violation continues or occurs may be considered a separate violation for purposes of imposing a penalty if the commission determines that the person charged:
   (1) engaged in an activity for which a broker or salesperson license is required without holding a license; and
(2) was not licensed by the commission as a broker or salesperson at any time in the four years preceding the date of the violation.

(b) In determining the amount of the penalty, the administrator shall consider:
  (1) the seriousness of the violation, including the nature, circumstances, extent, and gravity of the prohibited acts;
  (2) the history of previous violations;
  (3) the amount necessary to deter a future violation;
  (4) efforts to correct the violation; and
  (5) any other matter that justice may require.

(V.A.C.S. Art. 6573a, Secs. 19A(b), (c).)

SEC. 1101.706 NOTICE OF ORDER

The administrator shall give notice of the commission's order to the person. The notice must:
  (1) include the findings of fact and conclusions of law, separately stated;
  (2) state the amount of any penalty imposed;
  (3) inform the person of the person's right to judicial review of the order; and
  (4) include other information required by law.

(V.A.C.S. Art. 6573a, Sec. 19A(i).)

SEC. 1101.704 PENALTY TO BE PAID OR HEARING REQUESTED

(a) Not later than the 20th day after the date the person receives the notice under Section 1101.703, the person may:
  (1) accept the administrator’s determination, including the recommended administrative penalty; or
  (2) request in writing a hearing on the determination.

(b) If the person accepts the administrator's determination, the commission by order shall approve the determination and order payment of the recommended penalty.

(V.A.C.S. Art. 6573a, Secs. 19A(f), (g).)

SEC. 1101.707 OPTIONS FOLLOWING A DECISION: PAY OR APPEAL

(a) Not later than the 30th day after the date the commission's order becomes final, the person shall:
  (1) pay the administrative penalty; or
  (2) file a petition for judicial review with a district court in Travis County contesting the fact of the violation, the amount of the penalty, or both.
(b) Within the 30-day period, a person who acts under Subsection (a) (2) may stay enforcement of the penalty by:
   (1) paying the penalty to the administrator for placement in an escrow account;
   (2) giving the administrator a Supersedeas bond in a form approved by the administrator that:

   (A) is for the amount of the penalty; and

   (B) is effective until judicial review of the order is final; or

   (3) filing with the administrator an affidavit of the person stating that the person is financially unable to pay the penalty and is financially unable to give the Supersedeas bond.

(c) A person who fails to take action as provided by this section waives the right to judicial review of the commission's order.

(V.A.C.S. Art. 6573a, Secs. 19A(j), (k), (l) (part), (m)(part).)

HEARINGS

SEC. 1101.657 HEARING

(a) If the commission proposes to suspend or revoke a person's license or certificate of registration, the person is entitled to a hearing before the commission or a hearings officer appointed by the commission.

(b) The commission shall adopt procedures by which all decisions, to suspend or revoke a license or certificate, are made by or are appealable to the commission.

(c) Except as provided by Subsection (d), the commission shall prescribe the time and place of the hearing.

(d) This subsection applies only to a hearing relating to a proposal to suspend or revoke a person's license or certificate of registration for a violation of Section 1101.652(a)(3) or (b). The hearing shall be held, if the license holder requests, in the county in which the principal place of business of the license holder is located, or, if the license holder is not a resident, the hearing may be held in any county in this state.

(e) A hearing under this section is governed by the contested case procedures under Chapter 2001, Government Code.

(V.A.C.S. Art. 6573a, Sec. 17(a).)
SEC. 1101.705 HEARING; DECISION BY COMMISSION

(a) If the person requests a hearing or fails to timely respond to the notice, the administrator shall set a hearing and give notice of the hearing to the person.

(b) A hearings examiner designated by the administrator shall conduct the hearing. The hearings examiner shall:
   (1) make findings of fact and conclusions of law; and
   (2) promptly issue to the commission a proposal for decision regarding the occurrence of the violation and the amount of any proposed administrative penalty.

(c) Based on the findings of fact, conclusions of law, and proposal for decision of the hearings examiner, the commission by order may determine that:
   (1) a violation occurred and impose an administrative penalty; or
   (2) a violation did not occur.

(d) A proceeding under this section is subject to Chapter 2001, Government Code.

(e) The commission may authorize the hearings examiner to conduct the hearing and enter a final decision.

(V.A.C.S. Art. 6573a, Sec. 19A(h).)

SEC. 1101.157 SUBPOENA AUTHORITY

(a) The commission may request and, if necessary, compel by subpoena:
   (1) the attendance of witnesses for examination under oath; and
   (2) the production for inspection and copying of records, documents, and other evidence relevant to the investigation of an alleged violation of this chapter.

(b) A subpoena may be issued throughout the state and may be served by any person designated by the commission.

(c) If a person fails to comply with a subpoena issued under this section, the commission, acting through the attorney general, may file suit to enforce the subpoena in a district court in Travis County or in the county in which a hearing conducted by the commission may be held.

(d) The court shall order compliance with the subpoena if the court finds that good cause exists to issue the subpoena.

(V.A.C.S. Art. 6573a, Secs. 15(e), 17(b).)
SEC. 1101.709 REMITTANCE OF PENALTY AND INTEREST

(a) If after judicial review the administrative penalty is reduced or is not upheld by the court, the administrator shall:
   (1) remit the appropriate amount, plus accrued interest, to the person if the person paid the penalty; or
   (2) execute a release of the bond if the person gave a Supersedeas bond.

(b) Interest accrues under Subsection (a)(1) at the rate charged on loans to depository institutions by the New York Federal Reserve Bank. The interest shall be paid for the period beginning on the date the penalty is paid and ending on the date the penalty is remitted.
   (V.A.C.S. Art. 6573a, Sec. 17(a).)

SUSPENSION OR REVOCATION OF LICENSE

SEC. 1101.652 GROUNDS FOR SUSPENSION OR REVOCATION OF LICENSE

(a) The commission may suspend or revoke a license issued under this chapter or take other disciplinary action authorized by this chapter if the license holder:

   (1) enters a plea of guilty or nolo contendere to or is convicted of a felony in which fraud is an essential element, and the time for appeal has elapsed or the judgment or conviction has been affirmed on appeal, without regard to an order granting community supervision that suspends the imposition of the sentence;

   (2) procures or attempts to procure a license under this chapter for the license holder or a salesperson by fraud, misrepresentation, or deceit or by making a material misstatement of fact in an application for a license;

   (3) engages in misrepresentation, dishonesty, or fraud when selling, buying, trading, or leasing real property in the license holder's own name;

   (4) fails to honor, within a reasonable time, a check issued to the commission after the commission has sent by certified mail a request for payment to the license holder's last known business address according to commission records;

   (5) fails or refuses to produce on request, for inspection by the commission or a commission representative, a document, book, or record that is in the license holder's possession and relates to a real estate transaction conducted by the license holder;
(6) fails to provide, within a reasonable time, information requested by the commission that relates to a formal or informal complaint to the commission that would indicate a violation of this chapter;

(7) fails to surrender to the owner, without just cause, a document or instrument that is requested by the owner and that is in the license holder's possession;

(8) fails to use a contract form required by the commission under Section 1101.155; or

(9) disregards or violates this chapter.

(b) The commission may suspend or revoke a license issued under this chapter or take other disciplinary action authorized by this chapter if the license holder, while acting as a broker or salesperson:

(1) acts negligently or incompetently;

(2) engages in conduct that is dishonest or in bad faith or that demonstrates untrustworthiness;

(3) makes a material misrepresentation to a potential buyer concerning a significant defect, including a latent structural defect, known to the license holder that would be a significant factor to a reasonable and prudent buyer in making a decision to purchase real property;

(4) fails to disclose to a potential buyer a defect described by Subdivision (3) that is known to the license holder;

(5) makes a false promise that is likely to influence a person to enter into an agreement when the license holder is unable or does not intend to keep the promise;

(6) pursues a continued and flagrant course of misrepresentation or makes false promises through an agent or salesperson, through advertising, or otherwise;

(7) fails to make clear to all parties to a real estate transaction the party for whom the license holder is acting;

(8) receives compensation from more than one party to a real estate transaction without the full knowledge and consent of all parties to the transaction;
(9) fails within a reasonable time to properly account for or remit money that is received by the license holder and that belongs to another person;

(10) commingles money that belongs to another person with the license holder's own money;

(11) pays a commission or a fee to or divides a commission or a fee with a person other than a license holder or a real estate broker or salesperson licensed in another state for compensation for services as a real estate agent;

(12) fails to specify a definite termination date that is not subject to prior notice in a contract, other than a contract to perform property management services, in which the license holder agrees to perform services for which a license is required under this chapter;

(13) accepts, receives, or charges an undisclosed commission, rebate, or direct profit on an expenditure made for a principal;

(14) solicits, sells, or offers for sale real property by means of a lottery;

(15) solicits, sells, or offers for sale real property by means of a deceptive practice;

(16) acts in a dual capacity as broker and undisclosed principal in a real estate transaction;

(17) guarantees or authorizes or permits a person to guarantee that future profits will result from a resale of real property;

(18) places a sign on real property offering the real property for sale or lease without obtaining the written consent of the owner of the real property or the owner's authorized agent;

(19) offers to sell or lease real property without the knowledge and consent of the owner of the real property or the owner's authorized agent;

(20) offers to sell or lease real property on terms other than those authorized by the owner of the real property or the owner’s authorized agent;

(21) induces or attempts to induce a party to a contract of sale or lease to break the contract for the purpose of substituting a new contract;

(22) negotiates or attempts to negotiate the sale, exchange, or lease of real property with an owner, landlord, buyer, or tenant with knowledge that
that person is a party to an outstanding written contract that grants exclusive agency to another broker in connection with the transaction;

(23) publishes or causes to be published an advertisement, including an advertisement by newspaper, radio, television, the Internet or display, that misleads or is likely to deceive the public, tends to create a misleading impression, or fails to identify the person causing the advertisement to be published as a licensed broker or agent;

(24)-withholds from or inserts into a statement of account or invoice a statement that the license holder knows makes the statement of account or invoice inaccurate in a material way;

(25) publishes or circulateds an unjustified or unwarranted threat of a legal proceeding or other action;

(26) establishes an association by employment or otherwise with a person other than a license holder if the person is expected or required to act as a license holder;

(27) aids, abets, or conspires with another person to circumvent this chapter;

(28) fails or refuses to provide, on request, a copy of a document relating to a real estate transaction to a person who signed the document;

(29) fails to advise a buyer in writing before the closing of a real estate transaction that the buyer should:
   (A) have the abstract covering the real estate that is the subject of the contract examined by an attorney chosen by the buyer; or
   (B) be provided with or obtain a title insurance policy;

(30) fails to deposit, within a reasonable time, money the license holder receives as escrow agent in a real estate transaction:
   (A) in trust with a title company authorized to do business in this state; or
   (B) in a custodial, trust, or escrow account maintained for that purpose in a banking institution authorized to do business in this state;

(31) disburses money deposited in a custodial, trust, or escrow account, as provided in Subdivision (30), before the completion or termination of the real estate transaction;
(32) discriminates against an owner, potential buyer, landlord, or potential tenant on the basis of race, color, religion, sex, national origin, or ancestry, including directing a prospective buyer or tenant interested in equivalent properties to a different area based on the race, color, religion, sex, national origin, or ancestry of the potential owner or tenant; or

(33) disregards or violates this chapter.

Review Section 1101.653 of Chapter 1101 of the Real Estate License Act (Grounds for Suspension or Revocation of Certificate) to see the relevant details for certificate holders.

(V.A.C.S. Art. 6573a, Secs. 15(a) (part), 16(e) (part).)

SEC. 1101.654 SUSPENSION OR REVOCATION OF LICENSE OR CERTIFICATE FOR UNAUTHORIZED PRACTICE OF LAW

(a) The commission shall suspend or revoke the license or certificate of registration of a license or certificate holder who is not a licensed attorney in this state and who, for consideration, a reward, or a pecuniary benefit, present or anticipated, direct or indirect, or in connection with the person's employment, agency, or fiduciary relationship as a license or certificate holder:

   (1) drafts an instrument, other than a form described by Section 1101.155, that transfers or otherwise affects an interest in real property; or
   (2) advises a person regarding the validity or legal sufficiency of an instrument or the validity of title to real property.

(b) Notwithstanding any other law, a license or certificate holder who completes a contract form for the sale, exchange, option, or lease of an interest in real property incidental to acting as a broker is not engaged in the unauthorized or illegal practice of law in this state if the form was:

   (1) adopted by the commission for the type of transaction for which the form is used;
   (2) prepared by an attorney licensed in this state and approved by the attorney for the type of title to real property.
   (3) prepared by the property owner or by an attorney and required by the property owner.

(V.A.C.S. Art. 6573a, Secs. 16(a), (b).)

SEC. 1101.801 EFFECT OF DISCIPLINARY ACTION ON LIABILITY

Disciplinary action taken against a person under Section 1101.652 does not relieve the person from civil or criminal liability.

(V.A.C.S. Art. 6573a, Sec. 15(b).)
CIVIL AND CRIMINAL PENALTIES

SEC. 1101.753 CIVIL PENALTIES FOR CERTAIN VIOLATIONS BY BROKER, SALESPERSON, OR CERTIFICATE HOLDER

(a) In addition to injunctive relief under Sections 1101.751 and 1101.752, a person who receives a commission or other consideration as a result of acting as a broker or salesperson without holding a license or certificate of registration under this chapter is liable to the state for a civil penalty of not less than the amount of money received or more than three times the amount of money received.

(b) The commission may recover the civil penalty, court costs, and reasonable attorney's fees on behalf of the state.

(c) The commission is not required to give a bond in an action under this section, and court costs may not be recovered from the commission.

(V.A.C.S. Art. 6573a, Sec. 19(d) (part))

SEC. 1101.754 PRIVATE CAUSE OF ACTION FOR CERTAIN VIOLATIONS BY BROKER, SALESPERSON, OR CERTIFICATE HOLDER

(a) A person who receives a commission or other consideration as a result of acting as a broker or salesperson without holding a license or certificate of registration under this chapter is liable to an aggrieved person for a penalty of not less than the amount of money received or more than three times the amount of money received.

(b) The aggrieved person may file suit to recover a penalty under this section.

(V.A.C.S. Art. 6573a, Sec. 19(b).)

SEC. 1101.756 GENERAL CRIMINAL PENALTY

(a) A person commits an offense if the person willfully violates or fails to comply with this chapter or a commission order.

(b) An offense under this section is a Class A misdemeanor.

(V.A.C.S. Art. 6573a.1.)

SEC. 1101.757 CRIMINAL PENALTY FOR CERTAIN VIOLATIONS BY RESIDENTIAL RENTAL LOCATOR

(a) A person commits an offense if the person engages in business as a residential rental locator in this state without a license issued under this chapter.
Texas Principles of Real Estate

(b) An offense under this section is a Class A misdemeanor.  
(V.A.C.S. Art. 6573a, Sec. 24(f).)

SUMMARY

This lesson covered TREC’s disciplinary authority, the administration of penalties and the basic legal shape of hearings. We also discussed the various conditions that can lead to license suspension or revocation, as well as some of the civil and criminal penalties licensees can face. TREC requires real estate licensees to act in an ethical, honest and judicious manner throughout any real estate transaction. Licensees are expected to put their clients’ interests above their own. When TREC determines that a broker or salesperson has violated the law, it can fine the real estate licensee in addition to suspending or revoking his or her license.

When a client complains to TREC about a licensee, TREC determines the validity of the complaint and evaluates the extent of the violation; if needed, TREC imposes appropriate penalties. The accused licensee has the right to request a hearing from TREC, as well as a right to appeal TREC rulings in district courts in the same county where the complaint was filed. Aggrieved clients may also bring civil and criminal charges against licensees. TREC’s various disciplinary actions do not preclude or supersede suits brought forward in courts of law.

If a licensee feels uncomfortable or uncertain in a real estate transaction, then he or she should contact TREC for advice. No commission is worth placing one’s career and reputation at risk.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON EIGHT
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Field applications of the Texas Occupations Code

INTRODUCTION

This module covered many specifics of the Real Estate License Act, which is Chapter 1101 of the Texas Occupations Code. To ensure a comprehensive understanding of this material, we will now integrate the information provided in the module through a series of questions delivered in case study form. Please read each case study thoroughly and consider each situation.

FIELD APPLICATION OF THE TEXAS OCCUPATIONS CODE

CASE STUDY ONE

Broker A was advertising his brokerage services in the newspaper while his license was inactive and being renewed. Broker A has held his license for 5 years. Is Broker A violating any TREC rules by continuing to advertise his brokerage services during the inactive period?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY ONE RESPONSE:
YES. According to Section 1101.351 (b) of the Real Estate License Act, no individual may sell, lease, advertise or exchange real estate services without an active license. If the licensee is a salesperson, then he or she may only sell, lease, advertise or exchange real estate while acting under his or her sponsoring broker. If that sponsoring broker’s license status is "inactive," then all agents must stop providing real estate services until the broker renews his license.

CASE STUDY TWO
A friend of Salesperson B asked for his help when she was selling her own property. Salesperson B negotiated a contract for the sale and received compensation for the assistance. Has Salesperson B violated any portion of the Real Estate License Act?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY TWO RESPONSE:
YES. According to Section 1101.652 of the Real Estate License Act, a licensed real estate salesperson should only accept compensation through his or her sponsoring broker. Receiving funds directly from the principal, regardless of any relationship that may exist between the principal and the salesperson, is a direct violation of the law.

CASE STUDY THREE

TREC fines Agent F for representing himself as a broker when he does not hold a broker’s license. TREC received a complaint about this conduct and determined that the violation had taken place on 15 consecutive days. According to the Real Estate License Act, what is the maximum fine that TREC can administer for this violation?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY THREE RESPONSE
TREC can administer a maximum fine of $15,000 for this violation. According to Sec. 1101.702, the maximum administrative fine is $1000 per violation. For certain serious violations—including practicing real estate without a proper license—each day that the violation continues is fined as an independent violation. A serious violation that goes on for 15 days is subject to an administrative penalty of 15 times the maximum fine, or $15,000.

CASE STUDY FOUR
Broker R wants to advertise a piece of vacant land for sale. However, instead of listing the property with a standard list price, Broker R puts an advertisement in the local newspaper stating that he is selling $100 lottery tickets for the property and a drawing on New Year’s Eve will determine the winner of the property. According to the Real Estate License Act, is this a legal way to advertise property for sale?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY FOUR RESPONSE
NO. Section 1101.652 (14) of the Real Estate License Act states that it is illegal to solicit property, sell property, or offer property for sale (advertise) by means of a lottery. Doing so can result in suspension or revocation of one’s license.

CASE STUDY FIVE
Broker Q and her client had a contract accepted for purchase of a single family home. In order to expedite the inspection process, Broker Q strongly recommends an inspector she has worked with in the past and assures her client that the inspector will provide a thorough and comprehensive home inspection. Broker Q also states that the inspection would include a wood-boring pest inspection. Is this risky behavior for Broker Q?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY FIVE RESPONSE:
YES. A broker should think hard before steering her client in the direction of any particular service provider because she cannot truly guarantee the quality or effectiveness of the service. TREC’s Canons of Professional Ethics require licensees to conduct themselves with integrity and competence, as well as to make their clients’ interests their foremost concern. Because this is so, it would be prudent for Broker Q to offer a list of potential inspectors to her client and allow her client to choose for himself. Broker Q might offer general advice about choosing an inspector, but she should not make or imply any judgments about the quality of the report a specific inspector would provide.
# Texas Principles of Real Estate
## Module 2: Real Property Ownership and Land Use

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INTRODUCTION

The objective of this course is to impress the meaning of real property ownership and the difference between real estate and personal property on the student. Although these terms are commonly used interchangeably in everyday conversation, there are different rights associated with these different commodities. It is important that licensees understand the differences between them and are able to explain the distinctions to their clients and customers. This module addresses the following topics:

- Personal and Real Property Ownership
- Land Description
- Controlling Development
- Real Estate Practice Lesson

In accordance with TREC rules, Sections 535.71 and 535.72D, this module will describe how different commodities—land, real estate, and real property—transfer and are related and to one another. In addition, the student will learn about land use theory and come to understand how our federal, state, municipal and private authorities govern and plan our communities. This module covers legal descriptions as well as informal descriptions, the development of these concepts and the role they play in the real estate industry.

This module’s final lesson presents real-world dilemmas and provides opportunities to apply the information covered in the rest of the course. As the student completes this module, he or she should try to develop a broad understanding of real property use and to place this understanding within the larger context of real estate practice as a whole. This final lesson aims to help the student achieve this goal using comprehensive content questions, practice examples and case studies.
KEY TERMS

**Air Rights:** The right to use, control and occupy the space above a particular parcel of real estate, which is sometimes called an “air lot.”

**Bench Mark:** A permanent reference point attached to a durable object (such as a brass marker set into a sidewalk) that establishes a fixed location of known elevation. These are often set by a government agency (such as the U.S. Geological Survey) and are commonly used as references in the “metes and bounds” method of land location and description. Notice that this term is distinct from the more general “benchmark,” which simply indicates a general precedent or standard.

**Block:** A grouped or connected series of lots segmented from other lots by a series of streets or major thoroughfares. A group of blocks generally makes up a subdivision tract.

**Chattel:** An item of personal property which is movable, as opposed to real estate, and which is sold or exchanged via a bill of sale, rather than by a conveyance instrument such as a deed.

**Economic Fixity:** An economic characteristic of land describing the commodity’s permanence as an investment; generally referred to as “fixity.”

**Emblements:** A growing crop made up of annually cultivated plants (sometimes called *fructus industriales*). Because these plants represent an investment of labor and industry, they are considered personal property, *even prior to harvest*.

**Fixtures:** An object that was personal property but which has been bound to real estate in such a way as to become part of that real estate; for example, a bookcase that has been built into the wall of a house is considered a fixture. This binding changes the item from personal property into real property.

**Land:** An all-inclusive description of the natural environment for the purposes of legal ownership, which includes the Earth’s surface, the space below it, the space above it, and all things naturally attached to it, such as trees and water.

**Lot:** An individual parcel of land for sale or development, having a mapped perimeter and located in a tract. A group of lots makes up a block.

**Metes and Bounds:** A legal land description method that distinguishes the exact dimensions and location of a lot in reference to a fixed and permanent monument.
Non-fungible Commodity: An object that has no precise equal or substitute, such as a tract of land.

Owner's Bundle of Rights: The intangible ownership rights associated with real property rather than real estate, including the right to control the property within the framework of the law, the right of exclusion, the right of possession, the right of disposition and the right of enjoyment. These rights are what distinguish real estate from real property; the latter notion includes these rights, whereas the former includes only the land and that which is permanently attached to it.

Parcel: A piece of land or realty.

Real Estate: All land and everything permanently attached to it, including both natural and man-made objects (e.g., trees, sidewalks and buildings). This term is synonymous with “realty.”

Real Property: The tangible real estate and intangible rights associated with the ownership of real estate.

Recorded Plat: A surveyor or developer’s plat map that is recorded in the public records office of the area having jurisdiction over the development. A plat map is used for property description; it indicates individual lots, blocks, and tracts.

Severance: The act of turning real estate into personal property by disuniting some element, which then transfers by bill of sale rather than deed. Cutting down a tree to make lumber is an example of severance: as part of the land, the tree is real estate, but as lumber it becomes personal property.

Situs: An economic characteristic of land, describing some individual’s preference for one location over another.

Tract: This term can be a general description of a parcel or plot of land (in these cases it would usually refer to a comparatively large parcel or lot), but it can also refer to land bought for a specific type of grouped development, such as a subdivision or industrial complex.

Trade Fixtures: Pieces of personal property that a tenant attaches in some permanent way to leased (especially commercial) real estate as essential parts of the tenant’s trade or business practices. Tenants can remove trade fixtures before lease terms expire; these fixtures are frequently considered the tenants’ property. Trade fixtures are thus distinguished from ordinary fixtures, which are considered part of the leased real estate and not the property of the tenant.

Zoning: A legal method for controlling the use and development of land. Zoning ordinances establish various zones and aim at preventing conflicting land uses.
Zoning promotes orderly development and local governments employ it to regulate the use and development of privately owned real property.

**LEARNING OBJECTIVES**

Upon completion of this module, the student will be able to:

- Describe the difference between land, real estate and real property.
- Recognize the difference between real property and personal property.
- State the definition of a fixture.
- Explain the general character of surface, subsurface and air rights, as well as littoral and riparian rights.
- Outline the basic features of the metes and bounds survey method and the rectangular survey method.
- Distinguish the vertical method of land description from other survey methods.
- Name the basic public and private methods employed to control the use and development of land.
- Outline the “highest and best use” theory of land application.
INTRODUCTION

Before covering the definitions and details of modern real property and land use, we will first examine the development of these ideas. This module is primarily concerned with present-day land use and the various controls and ownership conditions that shape the contemporary views of property. However, to understand the modern versions of these ideas, one must understand their evolution. In this lesson, we will discuss the physical and economic characteristics that distinguish land from other commodities and also cover the distinctions between land, real estate and real property. We will also examine the rights associated with real property and learn the difference between real property and personal property. Within this exploration, we will discuss alterations to land and property and how they can affect whether something counts as personal property or real property.

HISTORY OF LAND OWNERSHIP

In medieval Europe, the average person did not own land in the way that we think of someone owning land today. Much contemporary land ownership is what we call allodial, or complete, whereas in medieval times, a kind of abbreviated land ownership was established through a system known as feudalism.

FEUDALISM

Feudalism was a system of land ownership in which the land was owned by the head of the state. The head of state would then allow a few lords to use, but not own, some of the land. The lords, in turn, would allow peasants known as vassals to live on and work the land. This was a system of land owned by the head of state and then loaned to others who worked the land and usually paid fees and allegiance to the head of state.
The lord had responsibilities to the vassal, and was obligated to provide:

- A portion of land called a “fief”. This land was considered as “loaned” to the vassal, not given or sold.
- Just protection under the law.
- Maintenance of the land.

In brief, the lord had to protect the vassal’s land interest and guarantee the vassal’s quiet occupation. If the vassal became involved in a dispute, then the lord was obligated to do right by the vassal.

In return for the use of the lord’s land and his broad protection, a vassal had responsibilities to the lord. He was generally obligated to provide certain services to the lord, including military service if the lord became involved in a military campaign. These services were the means by which the vassal gained his property rights (but not yet ownership) and the protection of those rights.

**ALLODIAL LAND OWNERSHIP**

In contrast to feudal land tenure with obligations and duties to the owner, an allodial ownership system is one in which the land is owned completely, without an obligation of services or duties to another. The land is owned absolutely and may be passed to heirs. This sort of complete ownership is commonly called an allodium estate (also called a “fee simple estate,” a concept that will be discussed further in later lessons). This contemporary concept of land ownership stands in stark contrast to the reciprocal obligations and ongoing relationships under medieval feudalism.

**CHARACTERISTICS OF REAL ESTATE AND LAND**

The following sections detail the physical and economic characteristics that set land and real estate apart from all other commodities. To help keep the physical and economic characteristics of land and real estate separate in your mind, remember this point: the most important difference between physical characteristics and economic characteristics lies in their origin. Physical characteristics occur naturally, while economic characteristics are man-made.

The physical and economic characteristics we are about to discuss are relevant to all land, real estate and real property. For now, don’t worry about how these three commodities differ from each other. Instead, focus on the features that distinguish these commodities from all other commodities and personal property. Following convention, the following information may use the terms “real estate” and “land” interchangeably; at this early stage of our discussion, this use of the terms is unproblematic, but please remember that there are important differences here that we will clarify later in this lesson.
PHYSICAL CHARACTERISTICS

The physical characteristics that make land or real estate a distinctive commodity are as follows:

- Immobility
- Durability
- Uniqueness

We will now discuss the details of these characteristics.

Immobility

While it is true that some parts of what we usually call “land” can be removed, such as soil or plants (a process of severance, which is discussed later) a parcel has a particular geographical location that will remain constant, barring erosion or slow, geological changes. The actual land itself—the tract or lot that an individual purchases is immovable. When a person buys a piece of land he cannot simply load it into his trunk and take it home. The land is immovable; this is why deeds and titles are used to convey land ownership.

Durability

“Physical durability” refers to the permanence of land. While its economic value and surface appearance may change, land itself is indestructible for all practical purposes. For example, in terms of the basic character of the surface land, much of the contemporary United States looks just as it did hundreds of years ago (and it is likely to continue to look this way for many centuries to come). Despite fluctuations in culture, value and use, the land itself tends to endure in approximately the same form over time. This durability also makes transference of land to others, such as heirs possible.

Uniqueness

The physical location of a lot or parcel is an integral feature of its identity. Because land occupies a specific site, which no other piece of land may also occupy, it is unique unto itself and not interchangeable with an exact substitute. Other commodities are not like this. For example, a fifty-pound slab of beef may be replaced or exchanged with another fifty-pound slab of beef and the exchange is indistinguishable. However, an acre of land in the desert exchanged for an acre of land in Hawaii is hardly an exact substitute, even though they are both an acre of land. If the location changes, then we are talking about a different plot of land. No two tracts of land are exactly alike because no two lots can occupy exactly the same space. Land is considered a non-fungible commodity due to its
uniqueness. That is to say, each parcel of land is an object that has no precise equal or substitute.

The fact that two tracts of land are not exactly alike does not mean that they cannot have similar properties or hold similar values. For example, a house located on 50 lakeside acres can be similarly priced to another house on the same lake, or even to a 500-acre ranch located in New Mexico. It is precisely due to the fact that comparisons between properties can be made that market-comparison and real estate appraising are performed.

**ECONOMIC CHARACTERISTICS**

The economic characteristics that distinguish land as a commodity are as follows:

- Economic scarcity
- Alteration
- Fixity
- Situs

We will now discuss the details of these characteristics.

**Economic Scarcity**

Although good, usable land may be physically scarce in the world, this is not what the term “economic scarcity” describes. Economic scarcity is created *solely* by demand for land in particular areas. Like all commodities, land is most valuable when it is in short supply and in high demand, and some land is more desirable than other land.

Another way to grasp the notion of scarcity is to think about the fact that the economic scarcity of land changes over time, even if the physical amount of available land does not change. For example, land in densely populated cities or on tropical beachfronts is scarce. However, this economic scarcity is only due to the high demand for land in *that particular* geographical region, not because some geological catastrophe destroyed large parcels of earth and made land physically scarce.

Technology can also affect the economic scarcity of land. For example, new farming techniques may make food production possible on previously unusable land. This could make the previously useless land now economically scarce, even if there is the same physical quantity of land as before.
Alteration

The economic worth of land depends heavily on how it is developed, altered and modified by building and other developments. A neighborhood that was once undesirable due to its inaccessibility or lack of amenities, but has seen improved roads, schools and hospitals built may now become more desirable and the prices for the homes increase. Conversely, if a sewage treatment plant is built next to a neighborhood, they are likely to see their home values decrease. Alteration is one reason that real estate prices may fluctuate.

Fixity

The investment permanence of land, also known as “fixity”, refers to the idea that real estate and improvements to real estate take many, many years to recoup their cost. Before anyone invests large amounts of money in any one parcel, he or she must consider whether the land will still be useful 20 or 30 years down the line when the property is finally paid off. This level of commitment on the part of the investor is not a physical characteristic of the land; we create it with economic conventions. For this reason, real estate investments are sometimes referred to as “sunk costs” because the cost has already been expended and is gone whether you sell in five years or 20 years.

Situs

The importance of location in the real estate industry is now a cultural cliché. However, the aspect behind the cliché, location preference, or situs, is an economic preference for a particular location and not a geographic one. For residential areas, the ambiance of a neighborhood is important and therefore parks and friendly neighbors constitute factors. When looking for a site to build an industrial park, ambiance is not important, whereas access to transportation and inexpensive land to build large warehouses are. Situs is an economic preference for a certain location or characteristic that affects land value. The preference is a social convention that creates part of the value of a particular tract, so we say that situs is an economic characteristic rather than a physical one.

LAND, REAL ESTATE AND REAL PROPERTY

At first glance, the terms “land,” “real estate” and “real property” appear to be interchangeable. However, the technical use of these terms in real estate practice involves subtle but important differences that licensees must understand. Each of these three terms, beginning with “land”, builds upon the previous term, while adding more characteristics. Previously, we discussed the physical and economic characteristics of the three commodities, or the traits that set them apart from personal property. Now, we must consider the characteristics of each of these commodities individually.
LAND

"Land," put simply, refers to more than a tract of earth. "Land" is defined as not only the natural resources seen on the surface of the land but the minerals below the surface and the air above the surface. When a person acquires land, it is possible to acquire all of these things as well.

REAL ESTATE (OR REALTY)

The term “real estate” encompasses everything in the definition of land, but adds permanent buildings and structures (known as improvements) to the definition; basically the land and everything attached to the land. Real estate is also referred to as “realty.”

REAL PROPERTY

Property ownership includes a set of rights, specifically the owner’s rights, which deals with the right to control the property, the right of exclusion, the right of possession, the right of disposition and the right of enjoyment. While “real estate” refers to the land and improvements on it, “real property” refers to both the real estate and the set of rights associated with it.

GENERAL CONSIDERATIONS

As a practical convention, real estate licensees do not burden a conversation with the technical distinctions between the three commodities. In everyday use, these terms are interchangeable. While in the field or otherwise discussing land, real estate or real property, it is not generally important that one differentiate between the three. In fact, we will use the three terms interchangeably in subsequent lessons. However, it is still important for the student to understand these basic technical distinctions for their own professional education and for the state-licensing exam. Land is the land and everything naturally associated with it and the air above it. Real estate is the land plus any buildings. Real property is real estate plus the rights that go along with ownership.

OWNERSHIP RIGHTS

There are four ownership rights associated with real property: subsurface rights, surface rights, air rights and water rights. We defined “real property” earlier as covering real estate plus the owner’s set of rights. It is important to understand that these four different rights may be sold separately, sometimes to different persons; thus, creating situations in which multiple people can have an ownership interest in the same piece of property. We will now discuss the details of these various rights.
SUBSURFACE RIGHTS

Subsurface rights relate to everything beneath the surface of a tract. The importance of this right lies largely in the fact that it may secure ownership of mineral deposits located under the surface of a property.

In some states, subsurface rights are sold separately from surface rights. In the event that two parties each hold an interest in a property—one holding the subsurface rights and the other holding the surface rights—the holder of subsurface rights may legally enter the property to extract the minerals he or she has rights to, but he or she must take care to not materially disturb the surface.

SURFACE RIGHTS

Surface rights are rights and interests with respect to the surface of the earth, including natural elements and the things built on or attached to it.

AIR RIGHTS

Air rights are the right to use the airspace above a property. These rights may be sold or leased independently of the tract itself.

WATER RIGHTS

When a property borders a body of water or a river, the right to enjoy the water is usually included in the bundle of rights. There are two types of rights associated with waterfront properties: riparian rights and littoral rights.

Riparian Rights

The use of flowing water, such as rivers and streams, which passes through or borders property, is governed by “riparian rights.” In accordance with riparian rights, a property owner does not own the water, but may use the water and shares those same rights and uses with other property owners whose land also borders the water body.

Littoral Rights

“Littoral rights” deal with lakefront or seafront property and usually allow the property owner to use the water bordering his or her property. However, littoral use does prohibit the property owner from artificially changing the water’s location.
It is important to note that water rights connect to surface rights in that a permanent right to enjoy a body of water surrounded by privately owned realty usually necessitates surface ownership of waterfront property.

REAL PROPERTY VS. PERSONAL PROPERTY

Property can be thought of in two different terms: either real or personal. Recall that “real estate” is the land, including everything on, under and above it. Also recall that “real property” is the definition of real estate plus the set of owner’s rights associated with it. So, simply put, “personal property” is all that which is not covered by real property’s definition. Therefore, personal property includes objects that can be moved such as couches, tables and clothing (here the student may recall the indestructibility and immobility of land, and note the way that these traits set real estate apart from personal property). Personal property is sometimes called “personalty” or “chattel”.

Another difference between real property and personal property is the way in which each transfers. Ownership to a parcel of real estate is transferred by a recordable document such as a deed or will, whereas ownership to personal property usually transfers by a bill of sale. A bill of sale is a written agreement used to sell, reassign or transfer one’s right to, or interest in, personal property. A deed, on the other hand, is a written instrument used specifically for the transfer of real property, which the owner (sometimes also called the “grantor”) uses to convey ownership in real property to the buyer (the “grantee”).

In the same way that there are subtle differences between the concepts of real estate, land and real property, there are specific technical terms used to discuss subtle differences in personal property. The term “personal property” actually refers to the theory of ownership rights in personal property (like the set of rights associated with real property). “Personalty” is effectively a synonym for “personal property” but “personalty” refers to the actual, tangible object itself, such as a chair (this distinction corresponds to the way that the terms “real estate” and “realty” denote the tangible buildings and trees associated with a parcel of land, in addition to the land itself). This technical distinction arises only rarely. However, these ideas may shed more light on the nature of real property, real estate and land, all of which are important concepts for this course.

SEVERANCE

It is possible to turn some elements of real estate into personal property. The most common way that real estate is converted to personal property is through “severance”. Severance is the act of separating some element of the real estate from the land. For example, a tree is real estate, but if the owner cuts down the tree, literally severing it from the earth, the tree is now personal property, which can be carried off.
FIXTURES

Conversely, personal property can be turned into real estate. This is accomplished by making that personal property a “fixture.” A fixture is a chattel bound to real estate and refers to an object that was once personal property but which has now been firmly attached to the land in such a way that it becomes part of the real estate. For example, a person can purchase wood, nails and paint, which are all personal property. But when the wood, nails and paint are made into a fence on the land, the former items of personal property are now real estate. The items have been transformed from movable personal property into an attached fixture on the land, i.e., real estate.

The most common way to turn personal property into real property is by permanently affixing the object(s) to real estate. Some examples of fixtures are:

- Elevators
- Central Air Conditioning Units
- Garage Door Openers

TRADE FIXTURES

When a tenant makes a physical alteration or permanent addition to the property he or she is renting, the altered or added object usually belongs to the landlord upon expiration of the lease agreement. For example, if a tenant installs new kitchen cabinets in his or her apartment, generally speaking, these cabinets are considered fixtures, and thus revert to the landlord’s possession when the lease agreement expires.

One can see how this might impose undue hardship on a tenant who is leasing commercial property because of the large amount of money that many businesspeople have invested in items that they use in the course of business and have affixed to the real estate they lease. For example, what if a tenant is leasing a commercial retail property in a shopping mall: Are all the shelving, racks and cash registers that the tenant installs automatically the landlord's property when the lease expires? Generally, they are not.

Objects affixed to the leased property that are owned by and necessary for the tenant’s trade or business are called “trade fixtures”, and they are not subject to the same rules of transfer as fixtures in general. Trade fixtures are items that the tenant owns but has attached in some permanent way to leased (especially commercial) real estate. Trade fixtures remain the tenant's property when his or her lease expires. Examples of trade fixtures include:

- Check-out stands
- Coolers
- Display shelves
- Display racks
- Counters
- Desks

Courts usually conclude that all trade fixtures are the tenant's property, regardless of the method of installation. Nevertheless, for a tenant to retain ownership of a trade fixture, the tenant must remove the fixture by the last day of the lease. That is to say, a tenant may not leave a trade fixture on a property after the lease has expired and then later request that the landlord relinquish the item.

**DETERMINING WHAT COUNTS AS A FIXTURE**

While the exact definition of a fixture varies slightly between states, there are some common attributes that allow us to make some general remarks about what sort of thing counts as a fixture. All licensees should acquaint themselves with state and local regulations that help to identify fixtures for the type(s) of property with which they work. However, when trying to determine whether something is a fixture, we can consider the following issues: annexation, adaptation and intention.

**Annexation**

One trait that separates fixtures from non-fixtures is the way the item is annexed, or attached, to the land. Usually, personal property can be removed without the aid of tools or heavy machinery; we can see this in the case of furniture, decorative items, utensils, wall hangings and the like. With a comparatively minimal amount of effort, one can easily remove, shift and replace a chattel. This is not the case with a fixture, the removal of which generally involves a great deal of effort and can require professional assistance because of its permanent nature.

Earlier, we mentioned an elevator as an example of a fixture, and it is easy to see how annexation might be used as a criterion for identifying it as such. The installation and removal of an elevator is a lengthy and often costly endeavor, which will probably require the aid of several professionals and a few days of labor. If an owner installs an elevator on his or her property, then unless it needs to be replaced he or she generally intends to leave it there indefinitely.

**Adaptation**

As real estate transactions become increasingly complex, so do our definitions of key terms like “fixture.” In the past, the definition of a fixture depended solely on the means of attachment, that is, annexation. Nowadays, it is important to consider the issue of adaptation as well. “Adaptation” refers to the use and modification of a particular item for a specific use on a property. If one can show
that an item was custom designed for a specific use on the property, then it is likely that the item would be considered a fixture rather than a chattel.

**Intention**

The most important characteristic to consider when deciding whether something is a fixture is the owner's intent for that item. Intention is inferred from the nature of the item and blends annexation and adaptation. That is to say, we can look at how the item is attached and the way in which it has been modified to suit its purpose or role within a given property. From these we can often infer whether the item was intended to be a fixture or personal property. Each case is unique and the individual parties involved in the decision must consider the method and purpose of adaptation and annexation when determining whether something is a fixture. It is often best to ask, when unsure, and write into a contract what will stay on the property and what is intended for removal.

**CHANGING CHATTELS INTO REAL ESTATE AND VICE VERSA**

Because a chattel can be converted to real estate, and vice versa, the difference between the two can be confusing. The following sections will provide a few more examples and explanations to help you better understand when a thing is real estate and when a thing is personal property.

**Trees and Crops**

Plants pose a unique challenge when we are trying to judge whether they are real estate or personal property. Are crops, which can be harvested and sold, personal property or real estate while they are still attached to the earth? What about trees and decorative flora that one could remove—are they chattels or realty?

To decide whether plants are personal property or real property, one must generally consider their use and the duration of their existence. Trees, persistent decorative plantings (such as perennial landscape plants) and uncultivated plants are referred to as *fructus naturales* and are usually considered to be realty because of their permanence. Annually cultivated crops are called *fructus industriales*, or “emblements,” and are generally considered to be personal property, even prior to harvesting.

Therefore, the broad general rules for making judgments about plants are as follows:

- Trees, bushes and grasses, or *fructus naturales* that do not require annual cultivation are real estate.
- Cultivated annual crops, or emblements, are personal property.
Minerals

When substances are still underground, they are considered real estate. But when an owner extracts things from underground and stores them topside, the item is converted from real estate into personal property.

Mobile Homes

Mobile homes are, for the most part, movable. Therefore, mobile homes fall into the personal property category. However, if a mobile home is sold in conjunction with a parcel of land or is permanently attached, then it may be considered real estate.

It is worth noting here that real estate licensees should be familiar with their local real estate laws before attempting to market mobile homes. They should also make sure they are acquainted with any clauses of their state licensing laws that apply to the sale of mobile homes, because some states impose special restrictions regarding this type of property.

SUMMARY

This lesson covered the basic definitions and characteristics of land, real estate, real property and personal property. It also examined the ways that personal property can be turned into real estate, and vice versa.

All land, real estate and real property have a few characteristics in common. These characteristics are generally broken down into physical or naturally occurring characteristics and economic or man-made characteristics. The naturally occurring characteristics that distinguish land, realty, and real property are their immobility, durability, and uniqueness. Land is a permanent, indestructible and non-fungible commodity; because land is an integral part of real estate, real estate generally shares many of these traits. The distinguishing economic characteristics of land, realty and real property are scarcity, alteration, fixity and situs.

Even though we use the terms “real estate,” “real property” and “land” interchangeably in everyday conversation, there are important differences that separate these three commodities from each other. Land is an all-inclusive description of the natural environment for the purposes of legal ownership, which includes the Earth’s surface, the space below it, the space above it and all things naturally attached to it, such as trees and water. “Realty” and “real estate” both identify the land and all items permanently attached to it, including manufactured items such as buildings, sidewalks and streets. Real property encompasses
everything captured by the term “real estate,” but also includes the intangible benefits or rights of ownership referred to as owner’s rights.

Owner’s rights include the right to control the property, the right of exclusion, the right of possession, the right of disposition and the right of enjoyment. In essence, real property refers to real estate and the rights to occupy and enjoy that real estate. Personal property is anything that is not real estate. As a general rule, knowing the method of attachment helps to determine the difference between real estate and personal property.

Real property ownership is divided into four rights—that is to say, there are four basic “aspects” of a property to which the owner has special rights. These rights are surface rights, subsurface rights, air rights and water rights, any of which may be sold or leased independently of the others. For example, one person may hold the rights to minerals located under the surface of someone else's home; similarly, a local airstrip might purchase the right to use the air space over someone's home.

It is important to note that water rights connect to surface rights in a unique way. That is to say, a permanent right to enjoy a body of water surrounded by privately owned realty usually necessitates surface ownership of waterfront property.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON TWO
LAND DESCRIPTION

This lesson focuses on the following topics:

- Informal Location References
- Metes and Bounds Survey System
- Rectangular Survey System
- Recorded Plat Method of Land Description
- Vertical Land Description
- Reference to a Previous Record

INTRODUCTION

In the last lesson, we discussed the elements that distinguish land, real estate, real property and personal property from one another. In this lesson, we will discuss how land and property are located, measured and described. This process of defining and describing land and real estate is essential, because legal ownership requires that we be able to distinguish the owned piece of land or real estate from all others—otherwise, there would be no clear way to tell what was owned by any particular individual, or what lot was described by any particular deed. The exact boundary of a property can be determined several ways; by metes and bounds, rectangular survey systems, as well as by recorded plats or, sometimes, a pre-existing document describing the property. A less exact but nevertheless common way to locate a property is informal location reference. We will begin our discussion of land description by considering informal location references.

INFORMAL LOCATION REFERENCES

For purposes of legal documents the exact size and location of a property requires precise measurements. However, for everyday commuting and travel complex legal land descriptions are unnecessary and irrelevant. This is why in everyday use we have a system of informal references that describe location by street. We can use these informal descriptions when a practical need for simplicity supersedes our need for precision.

Street numbers and place names are all informal references. For example, 1234 Main Street and 123 First Street, Apartment B, are informal references, as are districts or titles, such as “Hyde Park” or “Lazy River Ranch.” The advantage of an informal reference point is that it is easy to understand and makes it possible for the layman to locate a home or an office building without the aid of a survey team. The disadvantage, from a real estate standpoint, is that informal
references are not specific enough because they do not describe a particular property's borders.

**METES AND BOUNDS SURVEY SYSTEM**

In the past, when people wanted to record title to a particular lot they would reference its location relative to some landmark, such as a stream, road, bridge or tree. This worked well enough for a time, but as our cities grew and property disputes arose, it became necessary to establish more exact descriptions of a property's location. The drawbacks of the landmark system are evident: streams, roads, bridges, and other landmarks change and deteriorate over time. In addition, not all properties are fortunate enough to be favored with a noticeable landmark in their immediate vicinity. To solve this problem, communities developed the *metes and bounds* system of land description.

Metes and bounds is a legal method for describing land that gives the exact dimensions and location of a lot in reference to a man-made or possibly naturally fixed monument. To use the metes and bounds method, a surveyor places a monument in a corner of a parcel; the monument can be a metal pole one to two inches in diameter, or a stone or concrete fixture. He then records the parcel's distance and direction from that point by measuring the perimeter of the lot in feet, usually to tenths or hundredths of a foot. He indicates direction in degrees, minutes and seconds.

The sexagesimal system is one form of units used to describe angular measurement. In this system, there are 360 degrees (°) in a circle, 60 minutes (') in every degree, and 60 seconds (") in every minute. Therefore, the directional notation 80°50'32" reads eighty degrees, fifty minutes and thirty-two seconds. These measurements provide a way for the surveyor to describe any direction in the 360° circle around the set monument. The monument is described as the point of beginning (POB) or the point of commencement for a directional notation because we move clockwise from the monument around a parcel of land describing size in feet and direction in degrees, minutes and seconds.

**COMPASS DIRECTIONS**

The sexagesimal system of degrees coupled with measurements in feet may seem complex. To understand how surveyors use degrees, minutes, and seconds to distinguish direction, and thus location, just place the measurements on a 360° circle marked with cardinal directions, or use a compass. Imagine you are standing directly on the monument and holding the compass. From this position, you can move outward in any direction from the center of the 360° circle—forward, backwards, or to either side. Whichever way the surveyor chooses to move, surveyors describe that direction relative to two transecting lines: a north-to-south line and an east-to-west line. Their directions are relative to these lines. Consequently, metes and bounds directions indicate:
• Whether we move north or south of an east-to-west transaction through our monument.
• Whether we move east or west of a north-to-south transaction though our monument.

In essence, we give directions relative to a 90° crosshair placed dead center on top of our monument. Using this method, we can also describe complex geometric perimeters, such as arcs. In the metes and bounds survey method, a surveyor uses a compass that contains 90° quadrants—taken together, these encompass the full 360° of a circle.

**BENCH MARKS**

Metal rods and stone fixtures are ultimately no more permanent than a stream or tree, so how do we ensure that no confusion arises in the event that a parcel's monument is destroyed? To compensate for the impermanence of these monuments and ensure that lot dimensions are not lost even if the monument itself disappears, we record the monument's exact location by means of a connection line to a nearby fixed reference mark of known location and elevation as established by a government survey team. These permanent reference points are called “bench marks” and they generally consist of a marker attached to a durable object.

The marker may be a simple object, like a metal pole, or it may be an elaborate, engraved brass disc placed in cement by the U.S. Geological Survey (USGS) or the U.S. Coast and Geodetic Survey (USCGS). The locations of bench marks are extremely accurate, usually to less than an inch. Records are kept regarding the locations of all official bench marks, relative to each other. Therefore, in the event a bench mark is destroyed, it can easily be replaced because the exact locations of all bench marks are known.

**RECTANGULAR SURVEY SYSTEM**

In 1785 Congress authorized the use of the rectangular (or government) survey system as an alternative to metes and bounds. Back then, the metes and bounds system would have been extremely difficult to use, given the lack of permanent monuments and the relative difficulty of establishing precise locations. The rectangular survey system provided an easier way to describe newly acquired or surveyed land.

Whereas the metes and bounds method of survey requires a physical monument, the rectangular survey method depends upon the longitude and latitude system of mapping. Longitude lines (meridians) run north to south, segmenting the globe along the Earth's poles, while latitude lines (parallels) run
east to west, parallel to the equator. Certain longitude lines serve as principal meridians. For any given principal meridian (a “noted longitude line”), there is an intercepting, specially notated latitude line, called a “base line.”

Every 24 miles north and south of a base line, we name a correction line, or standard parallel. Conversely, every 24 miles east and west of a principal meridian, we name a guide meridian. This method allows for the Earth’s curvature. That is to say, a map might illustrate a grid of lines intersecting at 90° angles, but accurately mapping the surface of a sphere requires a slight shifting of our lines. This curved surface requires that the Earth's grid of meridians and parallels be slightly distorted; as one approaches either pole, longitude lines (meridians) get closer together. Every 24-by-24-mile area created by a guide meridian and a standard parallel is known as a “check.”

There are 36 principal meridians (with corresponding base lines) in the U.S. public land survey system. Generally, each state will utilize the one principal meridian (north-south) and corresponding base line (east-west) that run through that state as the principal point of reference. Some states, however, do not follow this rule. For example, Ohio uses rectangular plots established relative to state boundaries and rivers. Even if states don’t use the principal meridian and corresponding baseline as a general point of reference, they will create a system of ranges and townships, which create a smaller, more detailed grid relative to the larger principal meridian and base line grid.

RANGES

A “range” is a column created by drawing a parallel line every six miles east and west of a principal meridian (north-south). Ranges are numbered consecutively east and west from their respective principal meridians. In essence, these range divisions establish a series of narrower longitudinal lines, adding greater detail that allows us to locate specific parcels of land within a “check.” The rectangular survey system uses these range columns in conjunction with township lines, which are the more-detailed counterparts of latitude lines. We will now discuss this other component of the rectangular survey system.

TOWNSHIPS

Just as range columns run parallel to meridians (the north-south longitude lines), township lines run parallel to base lines, thus making the township lines run east-west. These lines intersect with range lines to create 36-square-mile parcels (six-by-six-mile squares) called townships. We number township “rows” consecutively, north and south of a base line. For example, for the first tier of townships lying north of a base line, the entire row is called “Township 1 North” (T1N) and all those comprising the first row south of the base line are dubbed “Township 1 South” (T1S). By attributing the appropriate range column to a specific township, we can identify it uniquely. For example, “T1N, R1E” identifies
a township located on the first tier north of the base line (east-west) and one range column east of the principal meridian. This six-by-six-mile square is thus differentiated from all others on the grid.

This diagram provides a visual depiction of the way that township lines and range columns intersect to form townships. It also shows the way that identifiers like “T1N, R1E” pick out a unique location in a grid of six-by-six mile squares, relative to the base line and the principal meridian.

The Dissection of Townships

Establishing the unique location of a township is, for our purposes, the most difficult part. After that, designations become a little easier. Each 36-square-mile township is divided into 36 individual square mile sections, starting in the upper right-hand corner. Each square mile contains 640 acres, and every acre has 43,560 square feet. Perhaps you have flown over farmland and seen a visible demonstration of our rectangular survey system. From a plane, much of the Midwest looks like one giant checkerboard.
CONCLUDING NOTES ON RECTANGULAR SURVEY

In terms of the surface area surveyed, more U.S. land is defined by rectangular survey than by any other method. In light of this, it is important that licensees understand a few key points about the rectangular survey method:

- Not all sections are exactly 640 acres; some are slightly smaller because of the Earth's curvature.
- It is customary to name the county and state along with any rectangular survey title.
- Some rectangular survey descriptions will include fractions; the fraction identifies a portion of a 640 acres area (for example, if you see ¼, then it means one-fourth of 640 acres, or 160 acres). A fractional designation will generally include notation indicating which half or quarter is meant; for example, “NE ¼ “picks out the upper right quadrant of the 640-acre square.

RECORDED PLAT METHOD OF LAND DESCRIPTION

Next to the informal use of addresses and districts, recorded plats are probably the simplest method of land description. They are used when parcels of land, divided up into individual lots, are ready for sale or development.

The term "plat" refers to a surveyor’s or a developer's map detailing the borders of the individual lots that he or she will develop or sell. We will discuss plats in detail in coming lessons. When a surveyor or developer records his or her plat in the public records office of the county where the land is located, then the map becomes a legal description of property for ownership. The recorded plat system of land description is also called the “lot-block-tract system” and the “recorded map method.” It utilizes the metes and bounds method of land description to locate the borders of each parcel; once a surveyor establishes a parcel's perimeter using this method, he or she records the dimensions on a plat for easy reference.

To understand how the recorded plat system works, we must understand the “pieces” that make up a plat. Specialized terminology is used to identify these “pieces”. “Parcels” are the individual lots that are combined to make a “block”, and blocks are combined to make a “tract.” The tract is the totality of the property represented on the plat.

When discussing the recorded plat system of land description, it is imperative that these terms are used in only these ways—using the terms carelessly or inconsistently will create confusion. Understand, however, that in other sections of this module and in our daily conversation, a lot or a tract is often the same as a parcel: a piece of land or real estate. This distinction between specialized
terminology and everyday conversation regarding the parts of a plat is similar to the distinction discussed earlier regarding the conventions governing the terms “real estate,” “real property” and “land.”

**RECORDING A PLAT**

While the exact recording method depends on the jurisdiction, generally, a surveyor completes the following steps to record a plat:

1. Gives each parcel a lot number.
2. Gives each block a block number.
3. Gives the tract a name or number.
4. Delivers the plat on which all property lines are described by metes and bounds, listing all relevant lot numbers, block numbers and tract numbers to the county recorder’s office in which the land is located.
5. The county recorder places it in the map books or survey books, alongside all other tracts in the area.

**VERTICAL LAND DESCRIPTION**

All of the methods we have just discussed are surface identification methods. That is to say, informal methods of land description, rectangular survey, metes and bounds, and recorded plats all distinguish pieces of land in terms of their surface location. While we commonly think of surface description when we consider land distinction, it is not the only way to describe the location and layout of a particular parcel.

Land can also be described according to vertical measurements. You may recall the different types of rights associated with real estate ownership: subsurface rights, air rights, surface rights and water rights. A vertical land description is most commonly used when air rights and subsurface rights need specific explication. Vertical land description is also used to express condominium ownership boundaries.

In essence, we create a vertical description by establishing a base point (called a “datum”), from which we move upward or downward marking standard heights or depths (we can imagine this arrangement as something like a very large ruler extending upward or downward from the datum). We reference these heights or depths to denote locations in space. In this way, we can describe land points at any elevation, the air space above a lot and the minerals below a lot. Usually the datum used is mean sea level, although some cities or other local jurisdictions utilize a different standard. From the datum, bench marks are placed at regular intervals established by a U.S. government survey team.

An “air lot” is the space above a particular parcel. To locate a particular air lot, two pieces of information are needed; the location of the parcel of land where the
air lot is believed to be and then the elevation (from the point of the datum) to where the air lot is thought to extend. One would use the same method to identify individual units in multi-story condominiums and to pinpoint the location of minerals or soil boundaries beneath a particular lot for the purposes of selling or leasing mineral rights.

**CONTOUR MAPS**

Elevation affects development. Consequently, developers need to have a clear picture of the terrain and elevation for a given parcel. A contour map (also called a “topographic map”) is a map in which curved lines (called “contour lines”) connect contiguous points of equal elevation to define the contours of the land.

A contour map shows hills, valleys, plateaus and other patterns, which may affect water drainage or runoff and other development issues. A developer uses a contour map to determine the need for leveling, grading and engineering problems that may arise—building upon a slope with a 90-degree angle, for instance, is relatively difficult.

**REFERENCE TO A PREVIOUS RECORD**

For legal purposes, such as deeds and mortgages, a parcel description must distinguish that parcel from all other parcels in the world. However, a parcel does not need a new description each time it changes hands. Instead, we can reference previously recorded descriptions for the new conveyance. Consider the following example:

Developer C sells a parcel to Owner A. Developer C has already described this parcel using a detailed metes and bounds description and filed it in a subdivision plat located at the county recorder’s office. Owner A files the deed giving her title to the property in the public record. Six years later Owner A decides to convey title to Owner B. Already on public record (in Owner A's recorded deed) is a detailed metes and bounds description of the parcel's location. Therefore, there is no need to describe the land's location again.

Rather than employ a surveyor, Owner A and Owner B simply record the new deed, using something like the following phrase: "All land described in Owner A's deed received from Developer C, recorded in (book, page, county, and state)…” A seller of real property can typically use and rely on a survey for seven years.

After seven years, lenders and title companies generally require a new survey, to ensure the land area has not been compromised by sale or purchase of the land or altered by development, infringing neighbors or natural changes in the land.
SUMMARY

A legal description must distinguish a particular parcel from all other parcels of land in the world. There are, generally, five methods used to establish this legal distinction: metes and bounds, rectangular survey, recorded plat, vertical land description and reference to a previous record. In this lesson, we discussed all five of these methods, as well as the role of informal land descriptions in identifying particular properties.

Many of these methods for identifying a parcel are extremely complex. For this reason, we developed a system of informal reference based on street addresses, districts, and titles. We use this method when our need for practical simplicity supersedes our need for precision. An informal reference point is advantageous because it is easy to understand; the main drawback of this system is that it fails to uniquely identify a location. For example, there may be multiple properties identified by the address “123 Main Street”—in fact, there could be a 123 Main Street in every city or town that has a street by that name. All of these properties are distinct, but we cannot tell that just by looking at their addresses. In addition, informal references like addresses do not describe the size or shape of the lot, which is necessary for legal purposes.

Metes and bounds is one method we might use to determine a legal land description. It distinguishes the exact dimensions and location of a lot in reference to a fixed monument, which is usually a small metal rod or a concrete or stone structure one to two inches in diameter. In the event that one of these monuments is destroyed, we record their exact location in reference to a nearby mark established by a government survey team. This ensures that no lot dimensions are lost, even if the monument itself disappears.

A developer using the metes and bounds method will describe direction in degrees, minutes and seconds using the sexagesimal system, one form of units used to describe angular measurement. In this system, there are 360 degrees (°) in a circle, 60 minutes (’) in a degree, and 60 seconds (") in every minute (thus 58°6’34” is read aloud as “fifty-eight degrees, six minutes and thirty-four seconds”). The monument is described as the point of beginning or the point of commencement for the survey description. From this point, we move clockwise from the monument around a parcel of land, describing size in feet and direction in degrees, minutes and seconds.

The rectangular survey method depends upon the longitude and latitude system of mapping. Longitude lines, or meridians, run north-to-south, while latitude lines, or parallels, run east-to-west. Certain longitude lines serve as principal meridians. For any given principal meridian (a noted longitude line), there is an intercepting, specially noted latitude line, called a base line. Every 24 miles north and south of a base line, we name a correction line (a standard parallel), which helps to ensure that our grid reflects the curvature of the Earth’s surface.
Analogously, every 24 miles east and west of a principal meridian, we name a guide meridian. This creates 24-by-24-mile squares called “checks” that we break down yet further into ranges and townships.

A range is a column created by drawing a parallel line every six miles east and west of a principal meridian; the ranges are numbered consecutively as they move out from the center axis created by the principal meridian. For example, the first range column to the right (i.e., to the east) of the principal meridian is R1E (first range east), while the first range on the left (to the west) is R1W. The second ranges are R2E and R2W, and so on.

Range columns are used in conjunction with township lines in the rectangular survey system to locate specific parcels of land. Just as ranges run parallel to meridians (longitude lines), township lines run parallel to base lines and numbers township “rows” consecutively, north and south of a base line. For example, the first tier of townships above (i.e., north of) a baseline are identified as T1N, the second tier is T2N, and so on. Township lines intersect with range lines to create a grid of 36-square-mile parcels (six-by-six-mile squares) called townships. Each 36-square-mile township is then further divided into 36 individual square-mile sections that are numbered consecutively starting in the upper right-hand corner. Each square mile contains 640 acres, and every acre has 43,560 square feet.

A recorded plat is a surveyor’s or a developer's map detailing the borders of individual lots in a particular tract. On the plat, the developer will write a lot number for each parcel, a block number for each block (a collection of parcels) and a name or number for the tract (a collection of blocks). A plat is a legal form of property description only if the developer records it in the public record. Usually, the metes and bounds method of land description is used to distinguish each individual lot.

The vertical land description method is most commonly used when the air space above a lot or the mineral or subsurface rights below a lot require specific description (most likely because they are to be leased or owned by someone other than the owner of the surface rights). To use this method, we establish a base point, or datum, which is usually mean sea level, and then define heights up or down relative to that base point.

The last method of land description relies on a pre-existing, recorded and legally distinguishing description. Although legal description must distinguish a particular parcel from all other parcels, it is not necessary to create a new legal description every time a particular parcel changes hands. Finally, a deed or mortgage could reference a parcel description in another recorded deed or mortgage using language similar to the following clause: “All land described in the deed from Person A to Person B recorded in (book, page, county, and state)...

Return to your on-line course player to take the Lesson Quiz.
LESSON THREE
CONTROLLING DEVELOPMENT

This lesson focuses on the following topics:

- Highest and Best Use
- Public Controls
- Private Controls
- Public Ownership
- Multi-State Land Controls

INTRODUCTION

When a person considers the different types of real estate and how each fits into the local, regional, state and national tapestry, he or she may wonder how each group of homes, buildings, schools, farms and parks blends together so well. “Land use” refers to the way land is developed. In order for our communities to run smoothly, safely and effectively, we must place some limits on land use. This lesson covers the ways that communities determine and enforce restrictions and controls of both public and private land development.

HIGHEST AND BEST USE

The main way in which communities determine the best use of land is by employing the principle of “highest and best use.” This principle states for a given tract of land there is a way for it to maximize its profitability and use. This “best use” should dictate a tract’s development. Criteria for determining highest and best land use include the following points:

- The plan should be financially viable.
- The plan should be physically plausible.
- The plan should maximize land usability.

Satisfying these criteria does not mean that a given plan automatically is the highest and best use of the land in question. There may, after all, be multiple plans that meet these standards, among which we must then choose based on the various benefits and burdens that are part of each plan. It is also important to note that the highest and best use of any given tract may change over time for social, political and economic reasons.
PUBLIC CONTROLS

Municipal, state, federal and private organizations all use different methods to keep our communities clean, well-ordered, safe and running smoothly. There are four main types of land use controls that state and local governments follow in order to regulate the development of real estate:

- Zoning
- Regulation of subdivisions
- Building codes
- Environmental protection laws

These four methods work together in a process called “urban planning.” Urban planning deals with the creation of a master plan for a community and its resources. Most cities operate with some grand plan like this in mind. Usually a community develops a plan after looking at population growth and needs. The planners must consider where roads, schools and housing should go and ensure necessities such as sewerage capability, water treatment and electricity are readily available. Then, through various municipal authorities, development projects and plans are decided. In this way, local governments use a reasoned approach to growth and development for their communities.

ZONING

Zoning is a set of local ordinances that regulates land and real estate within certain areas to ensure that all development follows some comprehensive plan as specified by the local government. Zoning ordinances vary from city to city and can touch on a myriad of issues such as square footage for apartments, renting rooms in a private home and building onto a house. Zoning affects land use by designating what type of development is allowed; areas can be zoned for, among other things, commercial or residential use. Zoning may also dictate building height and building material or give incentives for certain businesses to relocate in certain places.

Zoning relates to another principle of land use, conformity. Conformity protects real estate value and safeguards present and future real estate owners against unexpected developments that might harm the value or impair the use of their property. The conformity principle states that the highest property values are realized when a structure is located among structures of similar type and purpose. In short, a harmonious environment maximizes value. City planners pay special attention to this principle, as it helps to create both an aesthetically pleasing and a positive economic infrastructure.
Zoning laws are usually written to promote the highest and best use of the land within a given jurisdiction. To do this, local authorities may enact laws pertaining to:

- Permit requirements
- Lot sizes
- Structure type, height, appearance and use
- The use and extraction of natural resources
- Pollution
- Location of streets, sidewalks, parks, schools, etc.
- Architectural style

**Zoning Controversy**

Zoning can be controversial. When controversies do erupt, local businesses and neighborhood organizations may find themselves lobbying against one another. Invariably, there are differing opinions regarding the best way to use land.

The constitutional complexity of the issue muddles matters further. The U.S. Constitution states that one of the purposes of government is to promote the general welfare. However, the Fourteenth Amendment prevents the government from depriving anyone of life, liberty, or property without due process of law. It may seem difficult for local zoning authorities to uphold the public's general welfare without sometimes depriving individuals of their property rights.

To resolve this issue there are certain limitations on zoning laws. Zoning restrictions that are found to be arbitrary, destructive, unreasonable or confiscatory are usually disallowed. Although cities, towns and local municipalities adopt and write their own particular zoning ordinances, they all must comply with state and federal laws that protect citizens' rights and the natural environment. The following criteria can be used to gauge whether or not zoning laws comply with state and federal statutes:

- Ordinances must not be discriminatory.
- Ordinances must promote the general welfare.
- Ordinances must be consistent.
- Ordinances must be exercised reasonably.
- Ordinances must be clear and specific.

Federal statutes (such as the Fair Housing Act) and state statutes prevent discriminatory practices related to real estate. All zoning laws must comply with these state and federal laws—meaning, they may not discriminate. This requirement coincides with the second requirement: all ordinances must promote the general welfare of the people. No ordinance may be harmful, arbitrary or biased to benefit only one particular party.
The third requirement, that all ordinances must be consistent, means that zoning laws must be applied equally to all comparable properties. That is to say, ordinances must apply to similar properties in similar ways—in other words, they must be applied and enforced impartially. For example, a jurisdiction cannot place an ordinance on one particular property while leaving other similar properties unaffected.

The last two criteria relate to enforcing laws and the pragmatic issue of complying with them. To help citizens comply with local zoning ordinances, no ordinance may be exercised unreasonably, nor may any ordinance be unclear, vague or make compliance overly burdensome. In the spirit of the last two requirements, local legislators will usually consider granting exceptions to local zoning laws. Jurisdictions generally judge exceptional situations on a case-by-case basis. When citizens or builders want to argue for an exemption from a zoning ordinance, they may plead their cases before a zoning appeal board. This appeal board can rule to enforce the zoning law in this case, throw out the request for an exemption or make an exception to a zoning ordinance.

When zoning officials grant an exemption, they may choose to issue a conditional-use permit, a variance or enact spot zoning. A “conditional-use” permit can be granted if the business abides by special, usually very specific regulations. The business is basically being granted a permit to operate, but with conditions. If those conditions are not adhered to, the business risks losing its permit to operate in that location. For example, say a pet food store is granted a conditional-use permit to operate adjacent to a residential area as long as it does not sell pets because the noise of housing animals would disturb the residents. If the store at some point decides to ignore its conditional-use restriction, it may be required to close.

Zoning authorities may issue a variance if the existing zoning ordinance would be excessively restrictive or cumbersome for a property owner. A “variance” effectively allows the person who is granted the variance to legally be exempt from, or vary slightly from the ordinance. “Variance” should not be confused with “nonconforming use,” which occurs when an area is rezoned, thus making a building that had previously been compliant, now out of compliance with the new zone designation. The building may be allowed to continue operating as it had been (grandfathered in); but it is designated as “nonconforming use” because its use does not conform to the new zoning use.

Finally, zoning authorities may “spot zone,” which actually rezones a small, specific area within a larger zone. This creates an “island” which is zoned differently from the area around it.
As mentioned previously, zoning laws often dictate the everyday terms we use to discuss location and environment, creating three broad categories of property:

- Residential
- Industrial
- Commercial

Local jurisdictions often create numerous subcategories that cater to their planning needs. For example, a community may specify that only certain sorts of residential dwellings may be built in particular parts of an area zoned for residential development. In such case, they use zoning regulations to further subdivide the residential area under one or more of the following headings: detached, single-family dwellings, semi-detached structures containing no more than four-unit structures, walk-up apartments, high-rise apartments, etc.

Categorizing land in these ways not only maximizes value (i.e., follows the principle of conformity), it also helps to make cities livable. A city or county without zoning laws would struggle with the noise and air pollution of industrial complexes encroaching upon schools, parks, and homes.

### Zoning Enforcement

Zoning ordinances are enforced through permits. Before contractors begin building or modifying an existing structure, they must obtain permits from various authorities, depending on the location of their work and the type of development upon which they are working. These permits are granted or denied depending, in part, on whether the proposed building or modification is compatible with the zoning laws that apply to the area.

Sometimes though, zones are rezoned or zoning ordinances are passed in an area where something already exists, creating a situation in which the structure is not in compliance. In these cases, the city (or other zoning authority) will usually classify the pre-existing structure as a non-conforming use. Although this is not always the case, usually cities will allow a non-conforming use structure to remain in its present state, rather than forcing it to comply with the new zoning laws. However, if any of the following events occur, the development (and anything that replaces it) must comply with the new zoning laws:

- The use of the property changes—for example, if a property that had been used as a residence is turned into a hair salon.
- The ownership of the property changes.
- The building is destroyed.

In essence, non-conforming use buildings must be made compliant at the time the nature of the development changes. This change can include the property’s ownership, its use or the structure itself. Once the development fundamentally
changes, then for the purposes of zoning it is as though a new structure has come into existence. Current zoning laws bind all new structures, and all properties that undergo substantial change in use, ownership or structure are, for all intents and purposes, considered “new.” This is one way our counties and cities grow and modernize.

REGULATION OF SUBDIVISIONS

Local authorities, municipalities and states develop their own ordinances for the land located within their jurisdictions. Local jurisdictions may enact construction codes to set minimal standards, which usually elaborate on and exceed those set by national agencies like the American Society of Home Inspectors. The details of these local standards vary among different jurisdictions; one should consult local rules, regulations and legislation governing residential property prior to construction, to limit any possible confusion.

Purpose of Subdivision Restrictions

Most communities have special land development ordinances relating to subdivisions. Subdivisions can become expensive quickly, and this expense translates into higher taxes for residents in the subdivision and surrounding areas. To prevent excessive taxation, local authorities regulate almost every aspect of subdivision development. In addition to limiting tax increases, these ordinances state the provisions for proposing and executing subdivision plans and promote economically advantageous land use.

Subdivision Development and Common Restrictions

What follows is the general process for receiving approval to develop land. Although, there may be slight differences from city-to-city.

During the initial planning stage, before any land is purchased or any construction begins on a subdivision, a developer who has located undeveloped acreage that is for sale has the land surveyed and a plat made. The developer then creates the community on paper (indicating roads, schools, parks etc.). The proposed plan for the subdivision is then given to the city for review and approval. The city ensures that the proposal adheres to the overall urban plan and subdivision regulations of the city. If modifications or changes are needed, the developer is notified and allowed to submit changes as required.

In the next stage, sometimes referred to as the final planning stage, all the initial planning has met approval and now any loose ends are tied up, all the details are finalized and the final subdivision plat is turned over to the whichever authority has jurisdiction for final approval; possibly the Planning and Zoning Commission, the City Council or the city managers. After final approval, the subdivision plat is filed at the county records office and the developer is given a certificate from the
city. It is at this point that the developer may purchase the property (hopefully, with financing already secured).

It may sound contradictory, but the final stage is called the start-up or disposition stage. This is when actual construction starts. Infrastructure is put into place; roads are paved, and water, gas and electricity are routed to home sites. The lots are then ready to be disposed of (or sold) and are prime for the new owners to begin building their homes.

In planning a subdivision, the developer usually decides upon the size and the locations of all of the individual lots. There are usually local ordinances stipulating maximum and minimum lot sizes for which the developer must allow. For example, many zoning authorities enact zoning standards governing density. A density zoning standard establishes the maximum number of homes that a subdivider may build per acre of land.

Compliance with a density standard is a matter of assessing the development as a whole, and does not depend on each individual lot. Usually, the average density for the entire subdivision (often called the “gross density”) is measured for compliance purposes. That is to say, if the maximum number of houses per acre is set at four, a legally-compliant subdivision could have three houses on one acre and five on another provided that the average number of houses per acre overall is equal to, or less than, four. While developing the plan for a subdivision, a prudent developer will study the land to exploit any natural drainage and land contours as he or she develops easements for water mains, sewer mains and other utilities.

**Plats and Approval Requirements**

After the developer creates his or her plan for the subdivision, he or she draws up a plat—a detailed map that notes the property lines dividing individual lots. This map also illustrates blocks (collections of lots) and marks sections, streets, monuments and any other relevant public amenity or structure. The particularities of a plat may vary among different developers; for example, some developers may include engineering data or restrictive covenants as part of their plats. The layout of a housing community, as established in a plat, influences the accessibility of recreational space as well as the general functionality and aesthetic appeal of the development. For example, a developer can create more space for parks and other amenities by varying the street patterns and clustering houses.

Developers commonly use one of two patterns for their plat: gridiron or curvilinear. The gridiron pattern evolved from the government's rectangular survey system; it features large lots, wide streets, and some limited-use service alleys. Sidewalks usually run parallel to the street, possibly separated from the road by a small, grassy area. While the gridiron system makes a subdivision
easy to navigate, its drawbacks include most homes being located on or near busy streets and a lack of open space.

The curvilinear pattern integrates major feeder roads with smaller streets and cul-de-sacs. While the varied road patterns in a curvilinear system prevent monotony and increase open space, this approach generally minimizes service alleys and the more complex road patterns can be difficult to navigate. Overall, however, the curvilinear plat system provides for quieter and safer neighborhoods.

After the plat is complete, the developer must submit it to the proper authorities for approval. In addition, some jurisdictions require an environmental impact report stating the effect(s) that the development will have on the surrounding areas.

**BUILDING CODES**

City authorities require builders to follow building codes, which are sets of regulations pertaining to building design, materials, safety, sanitation and structure. These codes concern a building’s structural soundness and its basic cleanliness—not its aesthetics or appearance.

If someone wants to materially alter an existing development or construct a new building, then he or she must obtain a *building permit*. Just as was the case regarding zoning laws, part of being awarded a building permit is demonstrating that your proposed project complies with building codes. The permit-application process keeps city officials up-to-date on new construction and property modifications and more importantly allows the city to enforce and check for compliance with local zoning laws and building codes. Once construction begins, inspectors from the area that has jurisdiction over the building site will periodically examine progress. Upon completion of construction, an inspector checks the building one last time and if it is found to be compliant, the inspector issues a *certificate of occupancy* or an *occupancy permit*.

**ENVIRONMENTAL PROTECTION LAWS**

The federal and state laws that protect the environment and natural resources are usually one of a contractor's principal concerns. Many cities have their own additional set of local environmental standards that protect public places, water supplies and other natural areas. These laws limit developments that may produce excess drainage, waste or other pollutants harmful to persons, plants and animals. In addition, the environmental protection laws may prohibit development altogether in environmentally sensitive areas and habitats, such as wetlands.
PRIVATE CONTROLS

The most common way private land use can be regulated is through deed restrictions. Deed restrictions are limitations that control the land’s use. Most commonly, deed restrictions are put into place by the developer in order to fulfill the aspects of the master plan and are disclosed to parcel buyers in the sales contract. Like zoning ordinances these restrictions:

- Must not be discriminatory.
- Must promote the general welfare.
- Must be consistent.
- Must be exercised reasonably.
- Must be clear and specific.

Private parties can regulate land use through deed restrictions and other restrictive covenants.

DEED RESTRICTIONS

Various civil authorities and courts enforce deed restrictions. Depending on the type of restriction and the governmental structure of the city or state in which the deed is issued, a deed restriction may override a zoning ordinance. For example, a city could zone a property for some use, but if the deed prohibits that use, the deed restriction will supersede the city’s zoning ordinance.

Deed restrictions are independent of and separate from municipal codes and ordinances. Therefore, construction on or alterations to private property must comply with any deed restrictions in addition to whatever state, local and municipal regulations and legislation may apply. For example, if a building has been completed but is found to be in violation of a deed restriction, having a valid building permit will not void or otherwise invalidate that restriction. This is because a building permit only proves that a structure complies with municipal regulation, not that a building project is in compliance with any deed restrictions.

Similarly, specific communities in cultural, artistic or historic districts may have aesthetic ordinances designed to help those communities maintain a certain appearance. In this case, individuals wishing to remodel property or build new structures in these areas may need to receive multiple permits, showing that their projects are in line with municipal legislation and the regulations specific to the special area.

A deed restriction does not influence how title is transferred; it just sets limits on how the property may be used by the owner. For instance, one common deed restriction applies to land bought within an established subdivision. It is usually stated in the deed that such property may not be developed for commercial or industrial uses—that is, the deed limits development to projects that are roughly
the same as that found in the surrounding residential properties. If a property owner bound by this kind of deed restriction were to run any type of large business out of his or her home, then he or she would probably be violating the deed restriction.

Just as property owners can request exceptions to zoning ordinances, they may also seek exceptions to deed restrictions. A property owner can try to secure a waiver of a deed restriction by petitioning the entire affected community, all the mortgage lenders and the original developer. This requires a great deal of work and is often difficult as it involves securing permission from each property owner. The other way to get around a deed restriction is through judicial means. Oddly, suing is the most efficient way. By suing, the property owner is asking the court to strike down a restriction. If he or she wins, then that restriction is invalidated for everyone in the area, not just for the person that sued.

Restrictions are meant to protect property value and public interest; they are enforced in court when a lot owner applies for an injunction against another lot owner who is believed to be disobeying a deed restriction. If upheld, the injunction would order the party who is in violation to cease and desist or remove the violation (for example, a construction project or a completed structure). If the violator fails to comply, the court may hold him or her in contempt of court and punish the violator with fines or citations.

However, if lot owners fail to seek injunctions against a violator in a timely matter, then the restriction may ultimately be overturned. The lack of a timely response from surrounding property owners can be seen as an indication that the deed restriction is unnecessary or outdated. In such a case, the court may decide that the right to whatever was ensured by the deed restriction is lost through the doctrine of laches, in which unreasonable delay or negligence in asserting or defending one's rights can create a legal bar to equitable relief.

Additionally, some deed restrictions are valid only for a set number of years. That is, they may expire or “sunset” after a given period, of 25 years for example. However, property owners may exercise the option to vote to keep the restrictions if they so wish.

PUBLIC OWNERSHIP

Public ownership of land is necessary so that there is land available not only for schools, government buildings, roads and military bases, but for more enjoyable public spaces such as local parks and national forests. Locally elected officials in each municipal, state, or federal jurisdiction has direct authority over the development and use of public property. This approach attempts to ensure that everyone in the community has some say in deciding how to best to use, develop and preserve our public facilities, community institutions, natural resources and cultural treasures.
MULTI-STATE LAND CONTROLS

All of the land use controls we have discussed thus far pertain to selling and using land within a particular, local jurisdiction. Land use legislation becomes slightly more complicated when one considers multi-state sales, because there are strict state and federal laws governing interstate real estate transactions. The following topics cover a few of the significant laws pertaining to the sale of land carried out between residents of different states.

INTERSTATE LAND SALES FULL DISCLOSURE ACT

The Interstate Land Sales Full Disclosure Act is Title XIV of the Housing and Community Development Act of 1968. The Interstate Land Sales Full Disclosure Act is a federal law pertaining to sales and leases of property executed between parties who do not reside in the same state. The Secretary of the Department of Housing and Urban Development (HUD) administers the Act through the Office of Interstate Land Sales Registration. In essence, the law aims to prohibit fraudulent real estate marketing in circumstances where distance makes out-of-state buyers and lessees especially vulnerable to deception regarding property they either cannot, or are unlikely to, inspect themselves.

This Act requires that sellers who deal in the interstate sale or lease of 25 or more properties file a statement of record with HUD supplying accurate, material facts about the development project and the property. This statement of record must be filed before offering property in interstate commerce conducted by telephone, mail or any other means of communication. The Act describes the information that sellers must disclose to prospective buyers and lessees prior to closing a transaction. In addition, the Act requires sellers to present prospective buyers and lessees with a detailed, written property report including much of the same information included in the statement of record.

LEARN MORE

If you would like to view the Interstate Land Sales Full Disclosure Act in its entirety, HUD makes it available online at http://www.hud.gov/offices/hsg/sfh/ils/ilsstat.cfm.

Facts about which sellers and what kind of developments are bound by the provisions of this Act may be found in Section 1403; there are notable exceptions to the Act with which real estate professionals should be familiar. Specifics regarding the information required in a statement of record can be found in Section 1406. Section 1408 details the information that belongs in a property report.
HUD provides additional information about interstate land sales online at http://www.hud.gov/offices/hsg/sfh/ils/ilshome.cfm.

If a seller bound by the Act fails to provide this property report to prospective purchasers and lessees prior to their signing the contract, then the purchaser or lessee has the right to back out of the contract before midnight of the seventh day following the signing of the contract. HUD recommends that anyone wishing to void a contract covered under the Act notify the seller in writing of his or her decision. If the developer refuses to honor the request, then the consumer should contact HUD.

Buyers also have recourse if, when a seller is marketing a property, the property is materially misrepresented. Purchasing property based on false or misleading information is remedied in federal court, where the buyer can sue the seller for civil damages. The three-year statute of limitations for violations of this type begins once the fraud is discovered, not when the contract for the property is signed.

Consumers and real estate licensees can contact the main office for the Interstate Land Sales Full Disclosure Act at the following address:

Office of RESPA and Interstate Land Sales
Room 9154
Department of Housing and Urban Development
451 7th Street SW
Washington, DC 20410

STATE SUBDIVIDED-LAND SALES LAW

In the spirit of the federal Interstate Land Sales Full Disclosure Act, many states enact their own land sales laws. These state laws, like the federal Act, require that properties be registered with particular state offices or authorities prior to sale or lease and require that developers issue a disclosure statement to all purchasers prior to signing a purchase agreement. These laws are usually more stringent than the federal Act and permit fewer exceptions.

SUMMARY

This lesson defined the various conventions regulating land use and development and discussed the ways that communities try to ensure optimal land development. The principle of highest and best use guides most communities’ decisions when developing land. In an effort to make this ideal a reality, communities generally utilize three different regulatory mechanisms: public controls, private controls and public ownership.
The principle of highest and best use states that there is an optimal use for a given tract of land—that is, one use that is most beneficial and least wasteful. Some people believe that the highest and best use is the course of action that generates the most income. However, there are numerous kinds of value apart from economic—for example, many people would argue that development decisions in wilderness areas and historic districts should not be made solely on the basis of economic criteria and although open park space generally does not turn a profit, it does add lifestyle value to those who enjoy its use.

There will usually be at least some disagreement about which strategy best fits with the principle of highest and best use. In an effort to minimize disagreement, there are some general criteria we can use to identify courses of action that at least might be within the highest and best use of a given piece of property:

- The proposed project should be financially viable.
- The proposed project should be physically plausible.
- The proposed project should maximize land usability.

Satisfying these criteria does not mean that a proposed project automatically is of the highest and best use. Instead, these criteria help us sort out possible good choices from significantly poorer ones. Remember that what counts as the highest and best use of any given tract may change over time for social, political or economic reasons.

Communities uphold and enforce the highest and best use principle in various ways, using public controls, private controls and public ownership. There are four broad types of public controls: zoning laws, regulation of subdivisions, environmental protection laws and building codes; these controls are a part of the urban planning process. The most common way for communities to regulate private land use is through deed restrictions, which are clauses written into deeds that constrain the way(s) in which the land may be used. All ordinances regulating land use (whether they are private or public controls) must adhere to all relevant state and federal statutes. Specifically, they may not be discriminatory, they must promote the general welfare, they must be consistent, they must be exercised reasonably and they must be clear and specific.

Public ownership of land is another way to regulate land use. Schools, parks, libraries and government buildings are for the use of or benefit of everyone who lives in a community. The elected officials in each municipal, state, or federal jurisdiction have authority over the development and use of public property. This approach attempts to ensure that everyone in the community has some say in deciding how to best to use, develop and preserve our public facilities, community institutions, natural resources and cultural treasures.

There are no national zoning ordinances. However, there are numerous federal environmental laws that affect land use and development. In addition, the
federal Interstate Sales Full Disclosure Act (enacted in 1968) imposes requirements on developers in an effort to prevent fraudulent real estate transactions involving out-of-state buyers and lessees. In the spirit of this law, many states have enacted their own laws governing the sale of subdivided land. While these laws are usually more stringent than the federal Act, they generally require developers to register a property with the proper state office or authority prior to offering it for lease or sale. In addition, they obligate developers to present prospective purchasers with a written report detailing the condition and location of the property prior to the signing any sales agreement.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FOUR
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Describing Land Using Metes and Bounds
- Field Applications of Real Property and Land Use Material

INTRODUCTION

This module has covered a lot of specific information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided in this module, using a series of exercises and case studies. The first half of this lesson uses a fill-in worksheet to illustrate the metes and bounds method of legal land description. The second half presents case studies that examine the principles and ideas presented in this module. Upon completion, the student will have a better understanding of the real-world applications of the information he or she has been studying in this module.

DESCRIBING LAND USING METES AND BOUNDS

Earlier in the course, we discussed metes and bounds as a legal method of land description. With this method, the surveyor uses both feet and cardinal compass directions to indicate the location and perimeter of a particular parcel of land. The following exercise will help you understand how feet, degrees and minutes and seconds are used to indicate measurement dimensions.

Imagine that you looking down at a level a compass. If there is no other magnetic interference, then the direction needle should point due North, towards the planet’s magnetic pole. You may notice that there is not a full 180° on either side of the crosshairs (on either side of the north-to-south line or the east-to-west line); this is because each quadrant only goes up to 90°. All quadrants are sections of 0° to 90°. This helps distinguish direction.

Now take a moment to complete the following exercise.

METES AND BOUNDS EXERCISE:

1. Which angle bisects each of the four 90° segments?

2. If you are standing directly on a monument and facing north, then where, in general terms (behind, in front, left, right) is S 15° W?
METES AND BOUNDS EXERCISE ANSWERS:

1. Which angle bisects each of the four 90° segments?
   45°*

2. If you are standing directly on a monument and facing north, then where, in general terms (behind, in front, left, right) is S 15° W?
   Behind you and to the left*

FIELD APPLICATIONS OF LAND USE AND REAL PROPERTY CONCEPTS

Please consider the following case studies. After reading the details of each situation, use the information you have learned in this course to decide how someone could resolve the dilemma or complication. Keep in mind that land use legislation aims to protect the general welfare, so your response to any given case should take into consideration the interests of both the individuals involved and the larger community.

CASE STUDY ONE

Homeowner A wishes to open a daycare business in a residential section of town. She is on good terms with her neighbors and has casually mentioned her idea to several of them. No one seems opposed to the idea. In fact, a few favor it because they could benefit from a business offering after-school care so close to their homes. However, Homeowner A's deed states that she may not use her property for commercial purposes. In addition, she knows that local zoning laws prohibit the business. Homeowner A comes to you for real estate advice. What should you tell her?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY ONE RESPONSE:

Homeowner A must address the zoning ordinance and the restrictions on her deed independently, since a legal remedy for one of these issues will not serve as a remedy to the other as well. Initially, a real estate professional would probably address ways to deal with the city ordinance (because its scope is broader) and then figure out how to handle the deed restriction.

Homeowner A has several options with respect to the zoning ordinance, all of which start with her presenting her case to the zoning appeal board. Because Homeowner A wants to use her property in a way prohibited by the zoning ordinance, she needs to seek an exception to the ordinance. When zoning officials grant an exception they issue either a conditional-use permit or a variance; they can also enact spot zoning, though this is done only rarely. A conditional-use permit may be granted if the non-compliant use is in the public’s best interest. Zoning authorities may issue a variance if the existing zoning ordinance creates a hardship for a property owner, but this does not really describe Homeowner A’s situation, so her best chance for receiving an exception is to appeal for a conditional-use permit. She may need to talk to more of her neighbors about the proposed project and the details of what it would involve. Depending on her neighbor’s response to her plan, it may be easy to convince the board that opening a daycare facility in this residential area is in the public’s best interest.

Once Homeowner A has presented her zoning appeal, she must address the restrictions on her deed. Homeowner A could try to secure a waiver or judicial alteration of the deed restriction, either by petitioning the affected community or by suing for the right to alter the deed. In Homeowner A’s case, she should probably try to secure her waiver by petition. Since she is on good terms with her neighbors and has (so far) not received any negative reaction to her plan, there is reason to believe that all property owners in the community would sign a petition agreeing with her request to waive or alter the deed.
CASE STUDY TWO

Purchaser A wishes to buy a home. He contracts Licensee B to represent him. After speaking with Purchaser A, Licensee B finds a home he feels may suit Purchaser A's needs. When Licensee B and Purchaser A view the home, it still contains appliances, furniture and electronics. Purchaser A is a first-time homebuyer and is uncertain about which, if any, of these items are part of the property he is considering. He asks Licensee B what items the owners will remove and what items will most likely be left. What is Licensee B likely to say to Purchaser A?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY TWO RESPONSE: In response to Purchaser A's question, Licensee B is likely to explain the definition of a fixture, that is, a chattel bound to real estate. Licensee B should explain to Purchaser A the difference between personal property and real estate. For example, the term "real estate" refers to the land and everything attached to it, such as the plot and the house that Purchaser A and Licensee B are viewing. Everything else not permanently affixed to the real estate is personal property, including all movable chattels such as chairs, televisions and refrigerators. Personal property purchased through a bill of sale, such as a garage door opener, may become real property if it is considered so permanently affixed to real estate that it becomes part of the property.

Please note that Licensee B's explanation is only an educated prediction and that Licensee B should make sure that Purchaser A is aware that the prediction guarantees nothing. Usually, the deed for a particular property identifies any fixtures associated with it. Any personal property to remain with the home after purchase must have an independent bill of sale. To be absolutely certain about what, if any, of the personal property in the house is planned as part of the sale, Purchaser A and Licensee B would have to consult the seller or the seller's representative, and obtain a copy of the seller's disclosure.
CASE STUDY THREE

A city recently changed its zoning ordinances governing a particular section of land directly outside of town. Even though this area is currently home to a small manufacturing plant, the municipal authority decides it would better serve the community if the land were zoned for agricultural use. Does the owner of the manufacturing plant have reason for concern regarding this zoning change? What action is the city likely to take regarding pre-existing developments such as the plant?

Write your answer in the space provided and then check the answer on the next page.

CASE STUDY THREE RESPONSE ONE: The owner of the plant should consult the local zoning board to find out exactly what implications this change might have for her facility. However, it is likely that the city (or other zoning authority) will not require that the plant conform to zoning laws that were enacted after it was built; instead they will probably classify the development as non-conforming use. Although this is not always the case, cities will often allow a non-conforming development to continue in its present form.

Please take this case study one step further. Imagine that the plant owner decides to sell her property to someone else after the new zoning laws have been enacted. Will the new owner be likely to receive the same treatment from the city or other zoning authority?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY THREE RESPONSE TWO:

If the plant is sold to a new owner after the new zoning laws have been enacted, it is unlikely that the plant will still qualify as a non-conforming use. Non-conforming use buildings must be made compliant if the nature of the development changes; new ownership is generally considered the kind of change that requires compliance with the zoning laws in effect at the time of sale, as does major construction and renovation.
CASE STUDY FOUR

Developer A establishes the size and shape of each residential lot in her plat using the metes and bounds method of land description. After she gives each lot a lot number, each block a block number and the tract itself a name, she wants to begin selling the lots to potential homeowners. How might her choice of land description method make the conveyance process easier for both herself and potential purchasers?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY FOUR RESPONSE: Every deed requires a legal land description. Rather than record the extended metes and bounds description of each lot every time one is sold, Developer A could record the plat itself with the proper local authorities and then refer to the tract, block and lot number of each parcel in its individual deed. To record her plat, Developer A must take the finished map, with the metes and bounds descriptions labeled, to her county records office. This office will record her plat as a unit among the other plats in the area. The recorded plat method is probably the simplest method of legal land description, although it is not as commonly used as the rectangular plat.

Note: It is not legal in Texas to refer to a tract by lot and block until the subdivision plat has been approved and recorded with the county recorder’s office.
CASE STUDY FIVE

Consumer A walks into a real estate office where she meets Licensee B, a salesperson. She explains to Licensee B that she is looking for a lot on which to build a commercial plant. Licensee B pulls up a list of potential areas and shows them to Consumer A. Consumer A chooses one of the lots and submits an offer to purchase the property. The seller accepts her offer, which puts the property under contract. As she applies for her building permits, Consumer A discovers that her business plan does not conform to local zoning ordinances. Understandably upset, Consumer A takes up the issue with Licensee B. Licensee B explains that he is unfamiliar with the local zoning laws and apologizes. Is Licensee B responsible for the complication? How could the two remedy their situation?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY FIVE RESPONSE: Members of the general public are not expected to understand the many complex facets of real estate—after all, this is the very reason they hire real estate professionals. It is therefore reasonable for licensees to assume that their customers and clients may not know about zoning laws or other local ordinances that govern various properties. Consequently, Licensee B is responsible for the problem and should have foreseen this complication. As a real estate professional, Licensee B must always look out for his client’s best interests. It is up to real estate professionals to educate themselves and to make recommendations as their clients evaluate various properties and carry out their plans.

The remedy for such an error will probably be complex and may require a third party. Buyers have successfully sued real estate professionals in such cases. Knowledge of real property ownership and land use will help licensees avoid this sort of situation.
CASE STUDY SIX

Tenant A plants tomatoes on the property he is renting. They ripen just as his lease agreement is about to terminate. Landlord B states that Tenant A must leave the tomatoes, as they are part of the real estate. Tenant A feels that he may remove them, because he planted and cared for the tomatoes. Given the information in this module, how do you think the two might best resolve the issue?

Write your answer in the space provided and then check the answer on the next page. CASE STUDY SIX RESPONSE:
The tomatoes are considered emblements because they require cultivation. Emblements are generally considered to be personal property, despite the fact that they are attached in some significant way to the land. In considering this case study, you may have recalled the distinction between personal property and real estate as it pertains to plant life:

- Trees, bushes and grasses and other fructus naturales that do not require annual cultivation are considered to be realty.
- Cultivated annual crops, or emblements, are considered to be personal property.

All the decorative plants on the property Tenant A leases (e.g., the grass, the trees and the flowers) are real estate, and belong to Landlord B when the lease agreement expires. However, since Tenant A planted and cared for the tomatoes, which require cultivation and are generally eaten or cultivated as produce, they are Tenant A’s personal property. Because the tomatoes qualify as emblements, Landlord B should allow Tenant A to remove the tomatoes, as long as he finishes the task prior to the lease termination date. As with other improvements, Tenant A cannot expect to leave the tomatoes after his lease terminates and then ask Landlord B to allow him to remove the tomatoes later.
CASE STUDY SEVEN

Homeowner A lives next door to Neighbor B on a lot in a residential neighborhood. Neighbor B, over the course of about three weeks, constructs a large, obtrusive façade one story taller than the roof of his home, right on the main thoroughfare. Homeowner A’s deed specifically addresses the construction of large, obstructive improvements and he believes that Neighbor B’s deed may contain a similar clause. In addition, neighborhood development restrictions prohibit all improvements over the height of the home itself. Homeowner A is also worried that his property value may be negatively affected by Neighbor B’s construction. Homeowner A wants to contact the proper courts, but he is extremely busy. Two weeks after the façade’s completion (which itself took three weeks), Homeowner A finally finds the time to contact authorities. What steps must Homeowner A take? What are two possible outcomes?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY SEVEN RESPONSE:

Homeowner A must file for a court injunction. If the court finds that Neighbor B’s deed did indeed have a restriction concerning the construction of large, obstructive improvements and grants the injunction, it would require Neighbor B to remove the offending construction from his property. If the court does not grant the injunction, it is likely because Neighbor B claims that Homeowner A’s right to take action against the violation was lost through the doctrine of laches.

Although Neighbor B’s construction is a violation, Homeowner A waited a rather long time before filing a grievance with the proper authorities. The structure took three weeks to build and Homeowner A waited another two weeks before contacting the courts. The doctrine of laches allows unreasonable delay or negligence in asserting or defending one’s rights to create a legal bar to equitable relief—that is, this doctrine may mean that Homeowner A cannot seek legal action against the violation because he failed to assert his rights in a timely fashion.
CASE STUDY EIGHT

Purchaser A, represented by Licensee C, receives land from Seller B. Purchaser A is looking at the parcel’s description in the deed; it is identified as “Section 1 of T4S, R2E Niceville, TX.” This description leaves Purchaser A a little confused. What general information could Licensee C offer Purchaser A that would ease his client's confusion?

Write your answer in the space provided and then check the answer on the next page.

CASE STUDY EIGHT RESPONSE:
Assuming there are no further specifications regarding the property, Licensee C should be prepared to answer the following questions:

• **What kind of land description does the deed use?** Given the nature of the description, we know that the deed uses the rectangular survey method of land description. This method employs a grid system that relies on longitude and latitude.

• **To what does the term “section” refer?** “Section” refers to a one-square-mile unit within a township. This number identifies the location of the lot as one of the 36 one-square-mile sections that make up a township. The section numbers begin in the top right corner of the 36-square-mile block, so we know that section one is the unit in the uppermost right.

• **To what does the term “T4S” refer?** “T4S” identifies the location of the township on a north-south continuum. “T4S” informs us that the township is in the fourth row of townships if we go south from the base line, which helps to define the 24-by-24 mile area that contains this township along with many others. There will be four township lines between the baseline and this township, running east-to-west, occurring every six miles.

• **To what does the term “R2E” refer?** “R2E” identifies the range in which the township is located. Ranges are a north-to-south analogue of township lines, creating vertical columns every six miles running outward from a principal, meridian. Taken together, the ranges and township lines create a grid of six-by-six mile squares, i.e., a grid that marks the various townships in a check.

• **Using cardinal directions and basic “left/right” terminology, where is Purchaser A’s land located relative to the principal meridian, the base line and within the township?** Purchaser A’s lot is located four townships south of the base line (a specially-noted latitude line), two ranges east of the principal meridian (a specially-noted longitude line) and in the rightmost top corner of the township.

• **How big is Purchaser A’s parcel?** Since there are no further restrictions in the description (such as might suggest that Purchaser A’s lot is only a fraction of section one), we can conclude that Purchaser A’s lot includes the entirety of section one, which is one square mile or 640 acres.
An actual land description by rectangular survey in a deed will usually be more complex than the description given here, as most parcels do not consist of a single, whole section; this may mean that the survey description will exceed a licensee’s knowledge on the subject. However, a more detailed explanation of the rectangular survey method is probably a bit much to offer the average consumer. Nevertheless, one can see how knowledge of this terminology can set a licensee apart from a less knowledgeable real estate professional; these distinctions are becoming increasingly important as the industry continues to grow. If Licensee C is able to convey at least some accurate and helpful information about survey descriptions, then he is likely to stand out among his peers, fostering a loyal clientele base and good recommendations, as well as creating an image of dependability and reliability.
CASE STUDY NINE

Buyer A contracts Licensee B to locate a suitable property near a river. Licensee B locates several local parcels she feels will satisfy Buyer A’s needs, and Buyer A and Licensee B examine a few of the locations. Buyer A informs Licensee B that he likes one of the parcels and wants to look into purchasing it. During a discussion about the purchase, Buyer A states that he likes this particular location because he is interested in building ponds in his backyard; he believes that the river will allow him to do this easily and cheaply, compared to pumping all the water from the city water mains. Licensee B tells Buyer A that he might not be permitted to do this, even if the river flows extremely close to the property. Is Licensee B correct in her concern? Why or why not?

Write your answer in the space provided and then check the answer on the next page. CASE STUDY NINE RESPONSE:
Licensee B is correct to be concerned about her client’s plans because of the nature of riparian rights, i.e., the rights that property owners have regarding the use of and access to the rivers and streams that cross or border their properties. Generally speaking, these property owners must use the river or stream water in conjunction with the other owners along the same waterway. No one owner has complete ownership of the river or stream, so everyone must use the water that flows along or through their properties in a reasonable and equitable way. If a particular owner’s use greatly affects the natural course or content of the waterway, then he or she is probably violating the riparian rights of other owners who share the stream or river.

It may be that Buyer A’s plans for his backyard ponds will not affect nearby property owners’ riparian rights. However, it is good that Licensee B brings this issue to her client’s attention as it may affect Buyer A’s decision to purchase that particular parcel. Buyer A may need to check with several other professionals, such as an attorney or an environmental expert, before attempting to carry out his project.
CASE STUDY TEN

Licensee A represents Commercial Buyer B. Currently, Licensee A is trying to find a suitable location for Commercial Buyer B to open a small coffee shop. This is Commercial Buyer B's first business and he is a little nervous. There are several undeveloped parcels that could meet Commercial Buyer B's needs. However, Licensee A notices a good-sized, reasonably priced lot for sale that is currently the site of a small grocery. In light of the information given here, what advice or standards could Licensee A offer to Commercial Buyer B that might help him choose a location?

Write your answer in the space provided and then check the answer on the next page.
CASE STUDY TEN RESPONSE:

Licensee A could recommend that Commercial Buyer B carry out a highest and best use analysis. Just as cities employ the principle of highest and best use to determine zoning laws, consumers can use this principle for investment and development purposes. Although running a feasibility test is clearly outside Licensee’s A role in the transaction, she can supply information about the principle of highest and best use that could help Commercial Buyer B make a good decision as a new commercial real estate owner.

Licensee A could explain to Commercial Buyer B the role of the highest and best use principle in the real estate industry and the general criteria for deciding whether a particular project might qualify as the highest and best use. In brief, these standards are (whether or not):

- The project is financially viable.
- The project is physically plausible.
- The project maximizes land usability.

Remember that what counts as the highest and best use changes over time. This means that Commercial Purchaser B might consider a previously developed lot, such as the grocery store; even if a grocery store was once the highest and best use of that property, various changes (such a shift in traffic patterns or a change in neighborhood demographics) might mean that a coffee shop would now be a more economically productive use of the property. A highest and best use analysis of the grocery store location may show that it suits Commercial Buyer B’s needs at a fraction of the cost of building a new structure.
## Module 3: Code of Ethics

### Introduction
- Learning Objectives
- Key Terms
  - 15 minutes

### Lesson 1: Definitions of Ethics and Morals
- Ethics Defined
- Morals Defined
- Morals vs. Ethics
  - 10 minutes

### Lesson 2: The Four Approaches to Ethical Decisions
- Ethics End-Result
- Ethics Rules and Laws
- Ethics of Social Contract
- Ethics of the Individual Conscience
- Ethical Decision-Making Model
  - 40 minutes

### Lesson 3: Articles in the Code of Ethics
- Preamble
- Articles of the Code of Ethics
  - 140 minutes

### Lesson 4: Using the Model for Ethical Decision-Making
- Ethical Decision-Making Model
- Decision-Making Model Case Studies
  - 70 minutes

### Lesson 5: Basics of Professional Standards Enforcement Process through the Local REALTOR® Board of Association
- Ethics Complaints
- Arbitration
- Mediation
  - 10 minutes

### Lesson 6: More Risk Management in Action to Improve Business
- Unethical Conduct
- Antitrust Laws and Violations
- Ethical and Professional Business Practices
- Ethics Summary
  - 40 minutes

### Lesson 7: Real Estate Practice
- Activity
- Insight into the Code of Ethics
- Field Applications of the Code of Ethics
  - 35 minutes
INTRODUCTION

This module covers the standards of conduct and ethical judgment by addressing the different concepts that contribute to ethical business practices. This module will introduce the student to ethics and morals by defining both terms in order to distinguish differences between the two. The student will also learn the four approaches to ethical decision-making; therefore, after learning the Articles and Standard Practices of the NAR® Code of Ethics, the student will be able to use the model to identify any violations of the Code.

This module will include seven lessons. Lesson One will introduce the concept of ethics and morals. Lesson Two will introduce four approaches to making ethical business decisions and a model for ethical decision-making. Lesson Three will present an overview of the NAR® Code of Ethics including the concept of aspirations within the Preamble and the Articles and Standard Practices in the NAR® Code of Ethics. In Lesson Four, participants will use case studies to apply the model for making ethical decisions, which includes using the four approaches to business ethics while using the NAR® Code of Ethics. Lesson Five focuses on ethics complaints, arbitration and mediation. Lesson Six will conclude the course with a discussion of unethical conduct, antitrust laws and violations of antitrust laws and professional and ethical business practices.

Lesson Seven will conclude the module with a presentation of real world situations and applications of the information presented. As the student completes this module, he or she should endeavor to realize the big picture of the code of ethics, which the module will address with comprehensive content questions, practices, and case studies.
KEY TERMS

**Broker:** A real estate agent acting in a legally recognized non-agency capacity by bringing parties together for specific purposes.

**Client:** The person(s) or entity(ies) with whom a real estate broker or a real estate broker’s firm has an agency or legally recognized non-agency relationship.

**Customer:** A party to a real estate transaction who receives information, services, or benefits but has no contractual relationship with the real estate professional or the real estate professional’s firm.

**Ethics:** The study of standards of conduct and moral judgment, which includes the system or code of morals of a particular person, religion, group, professional, etc. It is also the required conduct (to act otherwise would be unlawful) of real estate professionals as outlined in the National Association of REALTORS® Code of Ethics.

**National Association of REALTORS® (NAR®):** Brokers, salespeople, appraisers and other real estate professionals are the residential and commercial REALTORS® that comprise NAR®. NAR® requires its members to adhere to a strict code of ethics, which forces its members to operate at a higher standard.

**NAR® Code of Ethics:** A code designed to establish a public and professional consensus against which the practice and conduct of REALTORS® and REALTOR-ASSOCIATES® may be judged.

**REALTOR®:** A real estate professional who subscribes to the NAR® Code of Ethics as a member of the local and state boards. This is the professional designation for a member of the National Association of REALTORS® or its affiliated local groups.

**Standard of Practice:** Interpretations of various Articles of the Code of Ethics. They are not part of the Code itself but are meant to compliment and supplement its meaning. This is a professional code of behavior for real estate professionals promulgated by the National Association of REALTORS®.
LEARNING OBJECTIVES

Upon completion of this course, the student will be able to:

- Define *ethics* as used in this course.
- Describe the four business ethics approaches used in this course.
- List major categories of the Articles of the NAR® Code of Ethics.
- Describe the structure of the NAR® Code of Ethics and its supporting materials.
- Identify at least two aspirational concepts in the Preamble to the NAR® Code of Ethics, describe the concept of general business ethics and identify how the Code of Ethics compares and contrasts with the concept of general business ethics.
- Describe the concepts of at least two of the following Articles of the Code of Ethics: Articles 1, 2, 3, 9, 11, 12, 16, and 17.
- Identify possible violations of the NAR® Code of Ethics given interactive learning methods such as case studies, quizzes, role playing and group discussion of fact scenarios.
- Describe the professional standards enforcement process of a local board or association.
- Differentiate between intentional fraud, negligent misrepresentation and negligence.
- Explain the three violations of antitrust laws: price fixing, group boycotts and market allocations.
- Describe how the existence of and adherence to the NAR® Code of Ethics is good for the real estate profession.
LESSON ONE
DEFINITIONS OF ETHICS AND MORALS

This lesson focuses on the following topics:

- Ethics Defined
- Morals Defined
- Morals vs. Ethics

In this lesson, we will discuss the definitions of morals and ethics while distinguishing the differences between the two concepts. We will begin with definitions of ethics and morals for use in this course.

**ETHICS DEFINED**

From the *Second College Edition of the American Heritage Dictionary*, copyright 1982 by Houghton Mifflin Company, Boston, Massachusetts:

- **ethics** 3. The study of the general nature of morals and of specific moral choices to be made by the individual in his relationship with others. 4. The rules or standards governing the conduct of members of a profession. (page 467)

**MORALS DEFINED**

From the *Second College Edition of The American Heritage Dictionary*, copyright 1982 by Houghton Mifflin Company, Boston, Massachusetts:

- **moral** 1. Of or concerned with the judgment principles of right and wrong in relation to human action and character. Synonym: Ethical - approaches behavior from a philosophical standpoint; it stresses more objectively defined, but essentially idealistic, standards of right and wrong such as those applicable to the practices of lawyers, doctors, and businessmen. (pages 813-814)

**MORALS VS. ETHICS**

Ethics are morals that society has converted into laws and principles, whereas morals are the ideas of right and wrong seemingly inherent in each individual. The two terms are oftentimes used interchangeably, but they do not mean the same thing.
No one is perfect and all of us are faced with difficult choices every day. The study of ethics would be easy if there was always a clear “right” and “wrong” answer in every situation. However, in many situations it just isn’t that easy, and there seems to be one version of “right” contrasted with another version of “right.”

**Case Study**

A broker with ABC Real Estate goes out on a listing appointment. During the course of her discussion with the sellers, the broker discovers that the sellers are selling their home because they just cannot live next door to their neighbors any longer. According to the sellers, although the neighbors maintain their yard, they have very loud arguments at all hours of the night. The neighbors are known to abuse alcohol, which contributes to the arguments. The sellers are tired of being awakened by the arguments of their neighbors and the occasional visits from police. Is the noise from the neighbors something that should be disclosed to potential buyers? Perhaps only to buyers that the broker thinks would be bothered by the noise? Should the broker keep quiet because she owes her fiduciary duty to the sellers and knowledge about the neighbors might lower the price that the sellers would receive for the house? Is there another solution?

Due to difficult situations like these, there needs to be a system that helps make ethical decisions. The Code of Ethics plays a large role in setting guidelines for agents to follow; it is up to the agent to follow the Code as he or she deems morally appropriate. Of course when there is legislation, court precedents and/or common law pertaining to specific situations, then the decision may be much easier. On the other hand, there are situations where two laws are involved, and legal counsel is needed to determine how to proceed since following one law may appear to violate the second law. (Recall that this course is not intended as a substitute for legal counsel.)

**SUMMARY**

This lesson defined ethics as “the rules governing the conduct of members of a profession” or “an individual’s moral conduct pertaining to other individuals” and morals as “the judgment principles of right and wrong in relation to human action and character.” Essentially, both ethics and morals should be used when dealing with real estate transactions to ensure fairness to all the parties involved.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON TWO
THE FOUR APPROACHES TO ETHICAL DECISIONS

This lesson focuses on the following topics:

- Ethics End-Result
- Ethics Rules and Laws
- Ethics of Social Contract
- Ethics of the Individual Conscience
- Ethical Decision-Making Model

INTRODUCTION

In this lesson, we will discuss four approaches to making ethical decisions and the model for applying these approaches. The student will be asked to apply these approaches and the model for ethical decision making in Lesson Four. The four approaches are similar to those in a book written by Deborah H. Long entitled, Doing the Right Thing: A Real Estate Practitioner’s Guide to Ethical Decision Making, Second Edition. The four approaches we will use in this course will be based on End-Result Ethics, Rules and Laws Ethics, Social Contract Ethics and Individual Conscience Ethics.

ETHICS END-RESULT

A person who approaches an ethical decision using End-Result Ethics may draw up a list of advantages and disadvantages of a potential decision; whichever list has the most items determines if the proposed decision is appropriate. This is a pragmatic approach and has appeal in the real estate industry since agents are very concerned with public opinion, making people happy and closing transactions.

A downside of this approach is that obeying the law is only one item on the list, and there are consequences such as lawsuits, potential loss of real estate licensure and potential loss of NAR® membership for disobeying the law. Essentially this approach tries to find the solution that makes the most people happy.

In some cases, there are no laws involved, only personal feelings and preferences. What causes one person to be happy may cause another person pain. The following is a paraphrased case study from Doing the Right Thing (DRT, p. 28) to illustrate how this approach may be applied:
Case Study A

A real estate office is considering a ban on smoking within the office based on health concerns. Perhaps 80% of the office does not smoke, but the 20% who do smoke bring up concerns about potential decreased sales because without cigarettes the smokers become irritable and unproductive. The agents are also concerned about clients that smoke and whether or not smoking clients may go to a competitor who allows them to smoke in the office. A no smoking policy has the potential to make 80% of the office happy, but at the expense of making 20% of the office unhappy in addition to a potential loss of clients.

An advantage of the End-Result approach to ethics is that it is a common sense approach that considers all the stakeholders within the decision process. A disadvantage is that this approach fails to define “happiness” in a consistent manner and cannot be applied to every situation. Therefore, other approaches may be necessary to reach the best potential decision.

ETHICS RULES AND LAWS

Those opting to use the Rules and Laws approach believe that rules and laws are necessary in society because they are based on “fundamental moral truths” (DRT, p. 31), and all laws and rules should apply to everyone equally. Those who favor this approach believe that lawmakers are motivated for the good of society and are not influenced by personal interests.

However, the motivations of lawmakers are not always purely motivated. With this approach, another challenge is that not everyone agrees on what constitutes a fundamental moral truth. Throughout history, there have been examples of wars being fought and persons being killed in the name of a fundamental moral truth.

The other challenge to the Rules and Laws approach to ethics is that even when a law or rule is well conceived, there is always an exception. Consider the case below paraphrased from Doing the Right Thing (p.33).

Case Study B

You are a commissioner from a state regulatory board that must decide on appropriate action in the case of the mishandling of escrow funds.

It is the first time that this licensee has been the recipient of a complaint. She is 24 years old and has only 8 months more than the required experience to obtain her broker’s license. She comes from a real estate family and her parents asked her to take over the brokerage business due to their failing health. While the daughter was in the process of obtaining her real estate education and
experience to become a broker, her parents hired an interim broker to run the brokerage business. The interim broker stole $25,000 from the escrow account. The embezzlement was not discovered until several months after the young woman took over the business and at that time she and her family made complete monetary restitution to all of the clients. However, one of the clients filed a complaint to the state regulatory board.

The young broker expressed her regret that she did not have the accounts audited before she took over the managing broker position and she is willing to accept any penalties that the state might impose. She does make one request. She asks that her name not be published in the state regulatory newsletter. She is a student at a prominent university and is being considered for a scholarship. She believes that if her name is not published, she will remain eligible for the scholarship.

The policy of the regulatory body is, as a deterrent for violating the state real estate license law or regulatory body rules, the names of all persons found guilty of violations shall be published in the state regulatory newsletter.

Do you believe that this young broker’s name should be published in the newsletter? Why or why not?

The Rules and Laws Ethics approach is very useful, but perhaps not the most useful in every situation. Therefore, let us consider the approach entitled Social Contract Ethics by Deborah Long of Doing the Right Thing.

ETHICS OF SOCIAL CONTRACT

According to Deborah Long in Doing the Right Thing (p. 32), “In contrast to rule thinkers who consider the legalities of an issue first, individuals that consider their community’s best interest when making an ethical decision are using social contract ethics.” Such individuals believe in abiding by their real estate company’s policies and procedure manual since such manuals are designed to prevent conflict and promote better working relationships between the agents of the company.

An example of a social contract is the National Association of REALTOR® (NAR®) Code of Ethics. All members of the National Association of REALTORS® (NAR®) agree to abide by this Code as a condition of their membership. In complying with the Code, the members agree to hold themselves to a higher standard than the law. The social contract thinkers who agree to abide by this Code, or any similar code, “believe in helping others and working for the common good” (DRT, p. 33). In Doing the Right Thing (DRT, p. 34), the following is a paraphrased case study to illustrate how this approach may be applied:
Case Study C

A married couple requests assistance from a broker in making an offer to purchase a home. The Broker learns that the couple had been working with a broker from another company who first showed them the home. The Broker asks why the couple did not go to the other broker for assistance in writing the offer. The buyers inform the Broker that they no longer want to work with the current broker because he made an off-color remark when showing the house. In order to prevent a procuring cause battle, the broker asks whether or not the couple sought assistance from the broker/manager of the other company to get assistance from another broker (since their buyer agency agreement would be with the broker of the other company). The buyers state that the broker who showed them the home was the broker/manager of the company, and they no longer wanted to be associated with that broker or her company in any way.

What should the Broker do?

Many states do not have laws that address procuring cause. Therefore, most brokers rely on community standards, customs and/or arbitration by the Professional Standard Hearing Panel of their local board or association of REALTORS® in order to resolve such issues.

Also note that REALTORS® are required by Article 17 of the NAR® Code of Ethics to arbitrate rather than litigate matters that involve disputes between REALTORS® of different firms (that arise in the course of their relationship as REALTORS®) regarding matters that are either contractual or non-contractual in nature. However, if all parties to the dispute advise the local board in writing that they choose not to arbitrate before the board, they may not have to arbitrate.

A weakness to the social contract approach is that sometimes change is difficult because of an established community belief system. For example, buyer brokers may attempt to establish themselves in a market, but in many cases, the established real estate community will try not to cooperate with them. The established real estate community believes in the traditional way of doing business; therefore, they will be fearful and skeptical of new practices presented by buyer brokers.

Another potentially large disadvantage to the social contract way of thinking is that some people who adopt this theory believe that the supreme authority is the state. If the state or community adopts an approach that is immoral, then all persons in the state could be at risk.
ETHICS OF THE INDIVIDUAL CONSCIENCE

Individual Conscience Ethics use individual and personal beliefs in order to establish a standard for decision-making. Most other philosophies are primarily concerned with focusing on the outer world such as laws and societal consequences for guidance and action. Individual Conscience Ethics “focuses on what lies within each person: conscience. A conscience can be defined as the “voice within” (DRT, p. 35). Martin Luther King, Jr. and Mahatma Gandhi are persons who practiced this approach even though it involved great personal risk.

A limitation to Individual Conscience Ethics is that it is of course individualized; therefore, it is hard to apply this approach when managing an office where each individual in the office has his/her own “personal ethical code” and, on some issues, those codes may clash (DTRT, p. 36). In Doing the Right Thing (DRT, p. 37), the following is a paraphrased case study to illustrate how this approach may be applied:

Case Study D

You are the listing broker of a home in a well-kept neighborhood of medium priced homes. The home you are listing is not near high-voltage power lines, but there is an elementary school in the neighborhood that is located on land purchased from the power company with a close proximity to a power substation and high-voltage lines. When the school was being constructed, there were protests from parents who cited several studies that showed that children who were constantly exposed to electromagnetic fields (EMFs) developed childhood leukemia and other diseases. As a result of the parental concerns, the school board agreed to periodically test the EMF levels throughout the year, and no significant results were discovered. However, the school board voted to allow parents to move their children to another school within the district if they were still concerned about the potential effects of EMFs.

The owners of your listing have asked you not to mention anything about the EMF issue. You have read the results from several studies on the effects of EMFs and the results seemed conflicting and confusing. In your state, there is no law compelling you to disclose the EMF issue. You have seen evidence that the homes located alongside the power lines sell for less than comparable neighborhood homes without close proximity. If you disclose that children who attend the neighborhood elementary school may be exposed to a potential environmental risk, your listing will probably sell for less.

How would you handle this situation?
ETHICAL DECISION-MAKING MODEL

Consider the following decision making model.

**Defining the Problem**
Determine:
- Facts
- Assumptions
- Affected persons
- Resources

**Applying an Ethical System**
- End results approach
- Rules and laws approach
- Social contract approach
- Individual conscience approach

**Making a Trial Decision for testing**

**Making a Final Decision**

**Evaluating a Final Decision**

In order to use this model, it is helpful to define facts, assumptions, persons affected, resources, trial decisions and final decisions.

**DEFINING THE PROBLEM**

**Facts**

*Fact: a statement or assertion of verified information about something that is the case or has happened*

**Examples** of facts in Case Study D:
- The sellers would like to sell their home (the subject property).
- Their home is not close to the high voltage power lines.
• The neighborhood elementary school is located in close proximity to a power substation and high voltage lines.
• Some parents are concerned about potential long-term affects to children who are chronically exposed to electromagnetic fields (EMF), and those parents protested the construction of the school on the site purchased from the power company.
• The school board has agreed that parents who are concerned about EMFs may move their children to another school within the district.
• The EMF readings at the school have been periodically tested and none of the readings have been reported as significant thus far.
• Homes located along high voltage power lines have sold for less than comparable homes that are not near power lines.
• The sellers have requested that the listing broker not mention the EMF issue while marketing the home.

Assumptions

Assumption: According to the person facing the decision, anything related to the situation that is assumed to be true and from which a conclusion can be drawn

Examples of assumptions in Case Study D:
• There is not a clear scientific conclusion that EMFs are harmful.
• Since homes next to high voltage lines have sold for less than other comparable homes and there has been a lot of publicity over the EMF issue in relation to the construction of the elementary school, it is possible that the subject property may sell for less than it would be valued otherwise.

Persons Affected

Persons affected: All persons that will probably be affected by whatever decision is reached

Examples of affected persons in Case Study D:
• The Broker does not want to disobey the seller because of the fiduciary duties involved in agency law. However, the Broker is concerned that not disclosing the EMF controversy may be dishonest. If a buyer’s child were to come down with a disease believed to be caused by EMFs, the Broker would feel guilty, and the buyer might sue.
• Sellers may receive less for their home due to the controversy over the EMFs and the elementary school. The Buyer might sue on down the line if the buyer felt that he or she were coerced into buying due to the Seller’s withholding of the EMF information.
• **Potential Buyers** may not be familiar with the controversy. If they have children and purchase the home, they may discover the controversy after their purchase. As a result of owning the home, they may worry about health effects from EMFs if they allow their children to attend the elementary school. If they decide not to risk the possibility of EMF health risks by having their children attend another school, the buyer may be inconvenienced daily during the school year in arranging to transport their child to an elementary school that is farther away. They also may believe that they paid too much for the home considering the situation and may be concerned that they will not be able to sell the home because of the EMF controversy.

• **The Broker** of the firm may not want the listing because of the controversy associated with the neighborhood and the potential for a lawsuit. The broker may decide to accept the listing either with or without a disclosure regarding the EMF controversy.

• **Associates in the Firm** may not be comfortable recommending the listing to persons who call in on ads for the subject property.

• **Peers** may refuse to show the listing because they are familiar with the controversy and feel that other neighborhoods would be less risky for buyers in terms of stability of investment and safety of children.

• **The Neighborhood** may be hurt if all of their homes lose value because buyers are not comfortable buying due to the EMF controversy.

### Resources

**Resources:** All persons, periodicals and books that offer information on how other people have handled identical or similar situations. This may include laws, professional standards published by a regulatory body, and/or the NAR® Code of Ethics.

### Examples of potential resources for Case Study D:

• The broker of the office may have handled similar situations in the past and can advise the agent from his or her experience.

• Periodicals published by the REALTOR® board or association as well as other real estate industry sources may have helpful advice on the EMF or related issues.

• An attorney may offer valuable insight and advice.

• The NAR® Code of Ethics may be reviewed for its insights.

• Professional Standards or Rules published by the state real estate regulatory body may be reviewed.
APPLYING AN ETHICAL SYSTEM

Note: All four approaches to ethical decision-making can be applied to Case Study D and then weighed for their applicability to this situation.

TRIAL DECISION

Trial decision: A possible decision that must be more closely considered before becoming a final decision.

FINAL DECISION

Final decision: The decision that is reached after careful consideration of all facts, assumptions, affects on various people and groups, available resources (both verbal and written) and the results of applying the four approaches to ethical decision-making.

SUMMARY

The four ethical systems applied to decision-making are End-Result Ethics, Rules and Laws Ethics, Social Contract Ethics and Individual Conscience Ethics. End-result ethics uses a list of pros and cons; a pragmatic decision is then made concerning the ethical dilemma at hand depending on outcomes of the lists. The Rules and Laws approach bases resolutions on the laws set forth by the government and other lawmaking entities. In contrast, when individuals use social contract ethics, they make decisions that place the community’s interest first and tend to follow company procedures and guidelines. On the other hand, Individual Conscience Ethics formulates decisions and choices based upon personal beliefs. Following the model for decision-making and using the ethical approaches can help determine the best decision; this decision, then, considers all facts, assumptions, affected parties, available resources and results from applying the four approaches to ethical decision-making.

Return to your on-line course player to take the Lesson Quiz.
LESSON THREE
ARTICLES IN THE CODE OF ETHICS

This lesson focuses on the following topics:

- Preamble
- Articles of the Code of Ethics

INTRODUCTION

REALTORS® are different from other practitioners because the National Association of REALTORS® (NAR®) Code of Ethics requires a higher standard than the law requires. The Code of Ethics consists of a Preamble and 17 Articles: the first 9 Articles are "Duties to Clients and Customers," Articles 10 through 14 are "Duties to the Public" and Articles 15, 16, 17 are "Duties to REALTORS®." Some of the Articles are further clarified by Standards of Practice. A Standard of Practice gives an example of how a particular Article has been applied. In order to file a complaint with the local REALTOR® association or board, one must cite an Article that the complainant believes has been violated. A Standard of Practice may only be cited as support for the argument that an Article of the Code has been violated.

The NAR® Code of Ethics establishes a basis for professionalism. Seeking financial success without accepting the responsibility of choosing the moral and ethical pathway will lead to failure. Remember success is measured by the respect that clients and peers have for agents.

The National Association of REALTORS® Code of Ethics was adopted in 1913 to establish a widely held code for conducting business in a proper fashion. Over time, the Code of Ethics has evolved to keep pace with practices and business concepts that may have changed or developed throughout the Code’s lifespan; it must change with the legal issues and practices of the time to remain relevant and maintain its place as the industry standard. The following information presented in this course was taken from the Code of Ethics and Standards of Practice of the National Association of REALTORS®, Effective January 1, 2003.

Two disclosures, which precede the body of the NAR® Code of Ethics, follow.

"Where the word REALTORS® is used in this Code and Preamble, it shall be deemed to include REALTOR-ASSOCIATE®s.

While the Code of Ethics establishes obligations that may be higher than those mandated by law, in any instance where the Code of Ethics and the law conflict, the obligations of the law must take precedence."
The following is the Preamble of the NAR® Code of Ethics. The Preamble contains concepts which all REALTORS® are expected to aspire to.

After reading the Preamble, you will be asked to identify aspirational concepts of the Preamble.

PREAMBLE

“Under all is the land. Upon its wise utilization and widely allocated ownership depend the survival and growth of free institutions and of our civilization. REALTORS® should recognize that the interests of the nation and its citizens require the highest and best use of land and the widest distribution of land ownership. They require the creation of adequate housing, the building of functioning cities, the development of productive industries and farms, and the preservation of a healthful environment.

Such interests impose obligations beyond those of ordinary commerce. They impose grave social responsibility and a patriotic duty to which REALTORS® should dedicate themselves and for which they should be diligent in preparing themselves. REALTORS®, therefore, are zealous to maintain and improve the standards of their calling and share with their fellow REALTORS® a common responsibility for [maintaining] its integrity and honor.

In recognition and appreciation of their obligations to clients, customers, the public, and each other, REALTORS® continuously strive to become and remain informed on issues affecting real estate, and as knowledgeable professionals, they willingly share the fruit of their experience and study with others. They identify and take steps, through the enforcement of this Code of Ethics and by assisting appropriate regulatory bodies, to eliminate practices which may damage the public or which might discredit or bring dishonor to the real estate profession. REALTORS® having direct personal knowledge of conduct that may violate the Code of Ethics involving misappropriation of client or customer funds or property, willful discrimination, or fraud resulting in substantial economic harm, bring such matters to the attention of the appropriate Board or Association of REALTORS® (Amended 1-00).

Realizing that cooperation with other real estate professionals promotes the best interests of those who utilize their services, REALTORS® urge exclusive representation of clients; they do not attempt to gain any unfair advantage over their competitors, and they refrain from making unsolicited comments about other practitioners. In instances where their opinion is sought, or where REALTORS® believe that commentary is necessary, their opinion is offered in an objective, professional manner, uninfluenced by any personal motivation or potential advantage or gain.
The term REALTOR® has come to connote competency, fairness, and high integrity resulting from adherence to a lofty ideal of moral conduct in business relations. No inducement of profit and no instruction from clients can justify departure from this ideal.

In the interpretation of this obligation, REALTORS® can take no safer guide than that which has been handed down through the centuries, which is embodied in the Golden Rule, "Whatsoever ye would that others should do to you, do ye even so to them."

Accepting this standard as their own, REALTORS® pledge to observe its spirit in all of their activities and to conduct their business in accordance with the tenets set forth below.

Before reading the actual Articles of the NAR® Code of Ethics, please identify aspirational concepts contained in the Preamble from the concepts listed below.

Identify the aspirational concepts contained in the Preamble of the NAR® Code of Ethics.

1. Always remember that to best serve the interests of our nation, land should be utilized for its highest and best use and there should be a wide distribution of land ownership.
2. In order to keep property values high and fulfill our fiduciary duties to the seller, an agent should always avoid disclosing to a buyer any information that is not mandated by law.
3. REALTORS® should always perform their duties with integrity and honor.
4. Always stay informed of current events and current issues that affect real estate and be ready and willing to share with others the knowledge and experience that you have gained.
5. Any REALTOR® having personal knowledge of conduct that violates the NAR code of Ethics should bring this matter to the attention of the local REALTOR® board or association.
6. When asked by the public or when you so desire, share your opinions of other real estate professionals with the public in order to identify and root out the “bad apples.”
7. Treat others as you would like to be treated.
Preamble Answers appear in BOLD:

1. **Always remember that to best serve the interests of our nation, land should be utilized for its highest and best use and there should be a wide distribution of land ownership.**
2. In order to keep property values high and fulfill our fiduciary duties to the seller, an agent should always avoid disclosing to a buyer any information that is not mandated by law.
3. **REALTORS® should always perform their duties with integrity and honor.**
4. **Always stay informed of current events and current issues that affect real estate and be ready and willing to share with others the knowledge and experience that you have gained.**
5. **Any REALTOR® having personal knowledge of conduct that violates the NAR code of Ethics should bring this matter to the attention of the local REALTOR® board or association.**
6. When asked by the public or when you so desire, share your opinions of other real estate professionals with the public in order to identify and root out the “bad apples.”
7. **Treat others as you would like to be treated.**

**ARTICLES OF THE CODE OF ETHICS**

There are three major categories of Articles in the NAR® Code of Ethics. The first nine Articles of the NAR® Code of Ethics deal with “Duties to Clients and Customers.” Articles 10 through 14 apply to “Duties to the Public” and the last three Articles consider “Duties to REALTORS®.” Application of the Articles of the NAR® Code of Ethics will be applied in the next lesson. Some of the Articles are followed by one or more Standards of Practice. A Standard of Practice illustrates how an Article has been applied to specific circumstances in the past. The purpose of a Standard of Practice is to clarify circumstances in which particular Articles have been applied in actual cases. Review of the Articles and the Standards of Practice will be useful in working on the case studies in the next lesson.

After selected Articles, you will be asked to summarize the basic concept of that Article.

**DUTIES TO CLIENTS AND CUSTOMERS**

**Article 1**

When representing a buyer, seller, landlord, tenant, or other client as an agent, REALTORS® pledge themselves to protect and promote the interests of their client. This obligation to the client is primary, but it does not relieve REALTORS® of their obligation to treat all parties honestly. When serving a buyer, seller,
landlord, tenant or other party in a non-agency capacity, REALTORS® remain obligated to treat all parties honestly. (Amended 1/01)

What does Article 1 mean?
The primary duty of a REALTOR® is to conduct his business in the best interest of the person(s) they represent. This includes performing fair, honest, and selfless business practices, as covered under the Code of Ethics.

The temptation to rationalize or justify errors in judgment cannot be tolerated within ourselves or in those with whom we practice our profession. Article 1 establishes an equal obligation to clients and customers.

By entering into a contractual agreement to act as agents, REALTORS® are both legally and ethically obligated to the client to use their best efforts to accomplish the client's objective, be it the sale, purchase, or lease of real property, or managing, counseling, syndicating, or other real estate related services. REALTORS® must be completely faithful to the client they have committed to serve. At the same time, a REALTOR® must also be honest with all parties to the transaction. Even if a REALTOR® is the agent of a seller, the REALTOR® still must be honest with buyers and all cooperating brokers. If the REALTOR® is the agent of a prospective purchaser, then the REALTOR® must be honest with sellers and their agents by making his relationship with the buyer clearly known to all. If a REALTOR® leases property as the agent of the owner or landlord, then the REALTOR® must be honest with the lessee and any other brokers involved in the transaction. Even when a REALTOR® is not acting as an agent, the REALTOR® remains obligated to treat all parties honestly. This has particular significance to REALTORS® engaging in appraising, counseling, facilitating, and other activities where a principal-agent relationship is not involved.

How would you summarize the basic concept(s) of Article 1?
A REALTOR® shall be faithful to their agency responsibilities to their principal in a transaction by putting the principal's interests above their own. In addition, an agent shall treat all parties in a transaction honestly.

Standard of Practice 1-1
REALTORS®, when acting as principals in a real estate transaction, remain obligated by the duties imposed by the Code of Ethics. (Amended 1/93)

Standard of Practice 1-2
The duties the Code of Ethics imposes are applicable whether REALTORS® are acting as agents or in legally recognized non-agency capacities except that any duty imposed exclusively on agents by law or regulation shall not be imposed by this Code of Ethics on REALTORS® acting in non-agency capacities.

As used in this Code of Ethics, “client” means the person(s) or entity(ies) with whom a REALTOR® or a REALTOR®’s firm has an agency or legally recognized non-agency relationship; “customer” means a party to a real estate transaction
who receives information, services, or benefits but has no contractual relationship with the REALTOR® or the REALTOR®’s firm; “prospect” means a purchaser, seller, tenant, or landlord who is not subject to a representation relationship with the REALTOR® or REALTOR®’s firm; “agent” means a real estate licensee (including brokers and sales associates) acting in an agency relationship as defined by state law or regulation; and “broker” means a real estate licensee (including brokers and sales associates) acting as an agent or in a legally recognized non-agency capacity. (Adopted 1/95, Amended 1/04)

Standard of Practice 1-3
REALTORS®, in attempting to secure a listing, shall not deliberately mislead the owner as to the market value.

Standard of Practice 1-4
REALTORS®, when seeking to become a buyer/tenant representative, shall not mislead buyers or tenants as to savings or other benefits that might be realized through use of the REALTOR®’s services. (Amended 1/93)

Standard of Practice 1-5
REALTORS® may represent the seller/landlord and buyer/tenant in the same transaction only after full disclosure to and with informed consent of both parties. (Adopted 1/93)

Standard of Practice 1-6
REALTORS® shall submit offers and counter-offers objectively and quickly as possible. (Adopted 1/93, Amended 1/95)

Standard of Practice 1-7
When acting as listing brokers, REALTORS® shall continue to submit to the seller/landlord all offers and counter-offers until closing or the execution of a lease unless the seller/landlord has waived this obligation in writing. REALTORS® shall not be obligated to continue to market the property after an offer has been accepted by the seller/landlord. REALTORS® shall recommend that sellers/landlords obtain the advice of legal counsel prior to acceptance of a subsequent offer except where the acceptance is contingent on the termination of the pre-existing purchase contract or lease. (Amended 1/93)

Standard of Practice 1-8
REALTORS® acting as agents or brokers of buyers/tenants shall submit to buyers/tenants all offers and counter-offers until acceptance but have no obligation to continue to show properties to their clients after an offer has been accepted unless otherwise agreed in writing. REALTORS® acting as agents or brokers of buyers/tenants shall recommend that buyers/tenants obtain the advice of legal counsel if there is a question as to whether a pre-existing contract has been terminated. (Adopted 1/93, Amended 1/99)
Standard of Practice 1-9
The obligation of REALTORS® to preserve confidential information (as defined by state law) provided by their clients in the course of any agency relationship or non-agency relationship recognized by law continues after termination of agency relationships or any non-agency relationships recognized by law. REALTORS® shall not knowingly, during or following the termination of professional relationships with their clients:

1. Reveal confidential information of clients.
2. Use confidential information of clients to the disadvantage of clients.
3. Use confidential information of clients for the REALTOR® advantage or the advantage of third parties unless:
   a) Clients consent after full disclosure.
   b) REALTORS® are required by court order.
   c) It is the intention of a client to commit a crime and the information is necessary to prevent the crime.
   d) It is necessary to defend a REALTOR® or the REALTOR® employees or Associates against an accusation of wrongful conduct.

Information concerning latent material defects is not considered confidential information under this Code of Ethics. (Adopted 1/93, Amended 1/01)

Standard of Practice 1-10
REALTORS® shall, consistent with the terms and conditions of their real estate license and their property management agreement, competently manage the property of clients with due regard for the rights, safety and health of tenants and others lawfully on the premises. (Adopted 1/95, Amended 1/00)

Standard of Practice 1-11
REALTORS® who are employed to maintain or manage a client’s property shall exercise due diligence and make reasonable efforts to protect it against reasonably foreseeable contingencies and losses. (Adopted 1/95)

Standard of Practice 1-12
When entering into listing contracts, REALTORS® must advise sellers/landlords of:

- The REALTOR®’s company policies regarding cooperation and the amount(s) of any compensation that will be offered to subagents, buyer/tenant agents, and/or brokers acting in legally recognized non-agency capacities;
- The fact that buyer/tenant agents or brokers, even if compensated by listing brokers, or by sellers/landlords may represent the interests of buyers/tenants; and
• Any potential for listing brokers to act as disclosed dual agents, e.g. buyer/tenant agents. (Adopted 1/93, Renumbered 1/98, Amended 1/03)

**Standard of Practice 1-13**
When entering into buyer/tenant agreements, REALTORS® must advise potential clients of:

• The REALTOR®’s company policies regarding cooperation;
• The amount of compensation to be paid by the client;
• The potential for additional or offsetting compensation from other brokers, from the seller or landlord, or from other parties;
• Any potential for the buyer/tenant representative to act as a disclosed dual agent, e.g. listing broker, subagent, landlord’s agent, etc., and
• The possibility that sellers or sellers’ representatives may not treat the existence, terms, or conditions of offers as confidential unless confidentiality is required by law, regulation, or by any confidentiality agreement between the parties. (Adopted 1/93, Renumbered 1/98, Amended 1/06)

**Standard of Practice 1-14**
Fees for preparing appraisals or other valuations shall not be contingent upon the amount of the appraisal or valuation. (Adopted 1/02)

**Standard of Practice 1-15**
REALTORS®, in response to inquiries from buyers or cooperating brokers shall, with the sellers’ approval, disclose the existence of offers on the property. Where disclosure is authorized, REALTORS® shall also disclose whether offers were obtained by the listing licensee, another licensee in the listing firm, or by a cooperating broker. (Adopted 1/03, Amended 1/06)

**Article 2**

REALTORS® shall avoid exaggeration, misrepresentation, or concealment of pertinent facts relating to the property or the transaction. REALTORS® shall not, however, be obligated to discover latent defects in the property, to advise on matters outside the scope of their real estate license, or to disclose facts which are confidential under the scope of agency or non-agency relationships as defined by state law (Amended 1/00).

**What does this mean?** Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 2:
An elaboration of Article 1, Article 2 reiterates that REALTORS® must be open and honest when dealing with the buyer and/or seller, shall neither conceal information that is readily available, nor should they divulge information that is to remain confidential.

Article 2 guarantees faithful service to both clients and customers as consumers of real estate services. Article 2 protects the consumer by ensuring that the REALTOR® provides accurate, factual information without exaggeration. The REALTOR® must communicate truthfully and cannot misrepresent the facts, and the REALTOR® cannot remain silent concerning pertinent facts including adverse factors affecting the property. As a real estate professional, the REALTOR® is obligated to discover and disclose adverse factors apparent to someone with the REALTOR®’s level of expertise, but the REALTOR® is not required to discover and disclose latent (hidden) defects in property or to advise clients or customers on matters requiring specialized knowledge and training not required by the state licensing authority or in the REALTOR®’s area of expertise. The REALTOR® is neither expected to possess knowledge or skills generally attributable to specialists in other fields such as architects, structural engineers, soil experts, etc., nor is the REALTOR® obligated to disclose facts which are confidential under the scope of agency or non-agency relationships as defined by state law. The necessity to safeguard the confidence of clients must be respected unless there is some superseding ethical obligation or legal duty.

How would you summarize the basic concept(s) of Article 2? Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 2:
A REALTOR® should avoid misrepresentation, fully disclose the property condition, restrict advice to matters that are within the agent’s expertise and keep confidential matters confidential, such as matters related to a client’s reason for selling (if it is not related to property condition), but which might adversely affect the principal’s negotiating position.

Standard of Practice 2-1
REALTORS® shall only be obligated to discover and disclose adverse factors reasonably apparent to someone with expertise in those areas required by their real estate licensing authority. Article 2 does not impose upon the REALTOR® the obligation of expertise in other professional or technical disciplines. (Amended 1/96)

Standard of Practice 2-2
(Renumbered as Standard of Practice 1-12 1/98)

Standard of Practice 2-3
(Renumbered as Standard of Practice 1-13 1/98)

Standard of Practice 2-4
REALTORS® shall not be parties to the naming of a false consideration in any document, unless it is the naming of an obviously nominal consideration.

Standard of Practice 2-5
Factors defined as “non-material” by law or which are expressly referenced in law or regulation as not being subject to disclosure are considered not “pertinent” for purposes of Article 2. (Adopted 1/93)

Article 3
REALTORS® shall cooperate with other brokers except when cooperation is not in the client’s best interest. The obligation to cooperate does not include the obligation to share commissions, fees, or to otherwise compensate another broker. (Amended 1/95)

What does this mean? Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 3:
Article 3 forces REALTORS® to cooperate with their competitors on mutually agreed upon terms when it is in the best interest of the client. This obligation promotes harmonious teamwork by competitors to the benefit of buyers/tenants and sellers/lessors. The real estate market is best served when individuals with a variety of skills and resources work together. Cooperation optimizes the benefits available to clients and customers, as well as agents and their subagents, and it ensures sellers and lessors of the broadest possible market exposure. By cooperating with one another, brokers are able to enhance the market exposure of listed property and their own ability to serve the needs of prospective purchasers and tenants.

How would you summarize the basic concept(s) of Article 3?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 3:
Unless contrary to the best interests of their principal, a REALTOR® shall cooperate with other brokers.

Standard of Practice 3-1
REALTORS®, acting as exclusive agents or brokers of sellers/landlords, establish the terms and conditions of offers to cooperate. Unless expressly indicated in offers to cooperate, cooperating brokers may not assume that the offer of cooperation includes an offer of compensation. Terms of compensation, if any, shall be ascertained by cooperating brokers before beginning efforts to accept the offer of cooperation. (Amended 1/99)

Standard of Practice 3-2
REALTORS® shall, with respect to offers of compensation to another REALTOR®, timely communicate any change of compensation for cooperative services to the other REALTOR® prior to the time such REALTOR® produces an offer to purchase/lease the property. (Amended 1/94)

Standard of Practice 3-3
Standard of Practice 3-2 does not preclude the listing broker and cooperating broker from entering into an agreement to change cooperative compensation. (Adopted 1/94)

Standard of Practice 3-4
REALTORS®, acting as listing brokers, have an affirmative obligation to disclose the existence of dual or variable rate commission arrangements (i.e., listings where one amount of commission is payable if the listing broker’s firm is the procuring cause of sale/lease and a different amount of commission is payable if the sale/lease results through the efforts of the seller/landlord or a cooperating broker). The listing broker shall, as soon as practical, disclose the existence of such arrangements to potential cooperating brokers and shall, in response to inquiries from cooperating brokers, disclose the differential that would result in a cooperative transaction or in a sale/lease that results through the efforts of the seller/landlord. If the cooperating broker is a buyer/tenant representative, the buyer/tenant representative must disclose such information to their client before the client makes an offer to purchase or lease. (Amended 1/02)

Standard of Practice 3-5
It is the obligation of subagents to promptly disclose all pertinent facts to the principal’s agent prior to as well as after a purchase or lease agreement is executed. (Amended 1/93)
Standard of Practice 3-6
REALTORS® shall disclose the existence of accepted offers, including offers with unresolved contingencies, to any broker seeking cooperation. (Adopted 5/86, Amended 1/04)

Standard of Practice 3-7
When seeking information from another REALTOR® concerning property under a management or listing agreement, REALTORS® shall disclose their REALTOR® status and whether their interest is personal or on behalf of a client and, if on behalf of a client, their representational status. (Amended 1/95)

Standard of Practice 3-8
REALTORS® shall not misrepresent the availability of access to show or inspect a listed property. (Amended 11/87)

Article 4
REALTORS® shall not acquire an interest in or buy or present offers from themselves, any member of their immediate families, their firms or any member thereof, or any entities in which they have any ownership interest, any real property without making their true position known to the owner’s agent or broker. In selling property they own, or in which they have any interest, REALTORS® shall reveal ownership or interest in writing to the purchaser or purchaser’s representative. (Amended 1/00)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 4:
Article 4 prohibits the REALTOR® from buying or presenting offers or selling property owned by the REALTOR®, or in which the REALTOR® has any interest, without making full disclosure of the ownership or interest to the buyer or seller or his agent or representative.

This prohibition applies not only to buying and selling by the REALTOR® but also any member of the REALTOR®’s immediate family, firm, or any entity in which the REALTOR® has any ownership interest.

"Immediate family" includes "in-laws" because in some instances, the transaction may benefit the REALTOR® in the future. A purchase or sale for the REALTOR®’s firm or any member thereof must be disclosed because it can be reasonably presumed that an individual will tend to favor the interests of business colleagues over the interests of strangers. Any entity in which the REALTOR® has any ownership interest is included to ensure that the buyer or seller or respective agents will be fully informed in advance of the REALTOR®’s position and interest in the transaction.

Article 4 protects the public by ensuring their full awareness of any direct or indirect personal interest of the REALTOR® in a real estate transaction involving property owned by the REALTOR® or property the REALTOR® is interested in acquiring. If the seller or buyer initially knows of the REALTOR®’s interest in a real estate transaction, he or she can make knowledgeable decisions, secure competent assistance, if necessary, and deal with the REALTOR® in an arm's length transaction.

How would you summarize the basic concept(s) of Article 4?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 4:
In order to protect clients from unfair treatment, the REALTOR® must disclose, in writing, any interest he or she has in a property; this includes disclosing whether the REALTOR® is listing the property, has interest in the property or has family members linked to the property.

Standard of Practice 4-1
For the protection of all parties, the disclosures required by Article 4 shall be in writing and provided by REALTORS® prior to the signing of any contract.
(Adopted 2/86)

Article 5

REALTORS® shall not undertake to provide professional services concerning a property or its value where they have a present or contemplated interest unless such interest is specifically disclosed to all affected parties.

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 5:
Article 5 protects the public by requiring REALTORS® to disclose any present or contemplated interest they may have in a property for which they are undertaking to provide professional services. These services include buying, selling, leasing, appraising, managing, counseling, and other real estate related services. Article 5 prevents REALTORS® from using their professional knowledge to gain an unfair advantage in a real estate transaction.

REALTORS® should remain aware that even indirect interests may obscure their objectivity and jeopardize the quality of their service. Such indirect interests could include interest in adjoining property, or could relate to transactions involving relatives or business associates. REALTORS® must be alert and utilize care in any real estate transaction that could be seen as benefiting them either directly or indirectly.

How would you summarize the basic concept(s) of Article 5?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 5:
REALTORS® should not use their expertise of the field in order to gain an unfair advantage over buyers or sellers in order to promote professional services. Any interest REALTORS® have in a property must be fully disclosed to all involved parties.

Article 6
REALTORS® shall not accept any commission, rebate, or profit on expenditures made for their client, without the client’s knowledge and consent.

When recommending real estate products or services (e.g., homeowner’s insurance, warranty programs, mortgage financing, title insurance, etc.) REALTORS® shall disclose to the client or customer to whom the recommendation is made any financial benefits or fees, other than real estate referral fees, the REALTORS® or the real estate agent’s firm may receive as a direct result of such recommendation. (Amended 1/99)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 6:
Article 6 protects clients and customers from conflicts of interest by the REALTOR® by requiring advance disclosure of the REALTOR®’s connection or interest in any organization or business entity before the REALTOR® recommends such services or products.

Many REALTORS® have interests in service firms, including contracting, roofing, brickwork, plumbing, electrical, air conditioning, title insurance, home owner's insurance, pest control, moving, etc. The REALTOR® is not precluded from offering such services, and it should be noted that such services may be among the best available. But, to recommend such services without first disclosing the REALTOR®’s interest, making it clear that the clients and customers are free to obtain these services elsewhere, can raise suspicion and create the appearance of impropriety.

Article 6 also prevents the REALTOR® from benefiting directly or indirectly from the providers of such goods or services without the client’s prior knowledge and consent. An agent must disclose when he or she or his or her firm will receive any fee or will benefit directly from recommending a real estate service or product to a client or customer.

How would you summarize the basic concept(s) of Article 6?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 6:
Since REALTORS® oftentimes have access to home-related services and products, REALTORS® must not mislead the buyer or seller into believing that the use of these services or products will in any way benefit them beyond its regular scope. Although the REALTOR® is free to promote these services and products, he or she must also reveal any benefits he or she will receive from the buyer’s or seller’s use of these services or products.

Standard of Practice 6-1
REALTORS® shall not recommend or suggest to a client or a customer the use of services of another organization or business entity in which they have a direct interest without disclosing such interest at the time of the recommendation or suggestion. (Amended 5/88)

Article 7
In a transaction, REALTORS® shall not accept compensation from more than one party, even if permitted by law, without disclosure to all parties and the informed consent of the real estate agent’s client or clients. (Amended 1/93)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
**Meaning of Article 7:**
Article 7 imposes an ethical obligation that may go beyond the requirements of state law. A REALTOR® may never accept compensation from more than one party without the informed consent of all parties. Only through adequate prior disclosure can the parties be fully aware of any potential conflicts of interest that may affect their ability or willingness to rely on the objectivity of the REALTOR®’s advice and counsel.

**How would you summarize the basic concept(s) of Article 7?**
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 7:
Any compensation that a REALTOR® receives from another party must be revealed to the other parties involved in the transaction.

Article 8

REALTORS® shall keep in a special account in an appropriate financial institution, separated from their own funds, monies coming into their possession in trust for other persons, such as escrows, trust funds, clients' monies, and other like items.

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 8:
REALTORS®, as fiduciaries, are in positions of trust. They must keep monies coming into their possession in trust funds, separate from their own funds. Stated simply, REALTORS® must not commingle their firm's monies or their personal monies with money accepted in trust for others. Such money must be placed in a separate account to safeguard against unauthorized use.

How would you summarize the basic concept(s) of Article 8?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 8:
All monies that a REALTOR® handles must be kept separate from his or her own funds.

Article 9

REALTORS®, for the protection of all parties, shall assure whenever possible that all agreements related to real estate transactions including, but not limited to, listing and representation agreements, purchase contracts, and leases are in writing in clear and understandable language expressing the specific terms, conditions, obligations and commitments of the parties. A copy of each agreement shall be furnished to each party to such agreements upon their signing or initialing. (Amended 1/04)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 9:
A REALTOR® should make sure everything is in writing to avoid complications or disagreements regarding terms of the listing. (Some states have laws requiring real estate agreements to be in writing.)

To avoid any misunderstanding and to prevent future controversy, all contractual agreements should be in writing and should set forth, in detail, the understanding of each of the parties. This can substantially reduce questions relating to the terms of the listing agreements, offers to purchase, financing instruments, and other agreements and commitments.

How would you summarize the basic concept of Article 9?
Write your answer in the space provided and then check the answer on the next page.
Summarize the basic concept of Article 9:
A REALTOR® shall endeavor to get all agreements in writing and get agreements expressed in clear and specific language in order to avoid confusion or misunderstandings. In addition, whenever a party signs and/or initial a contract, that party should be furnished with a copy of what he or she signed or initialed.

Standard of Practice 9-1
For the protection of all parties, REALTORS® shall use reasonable care to ensure that documents pertaining to the purchase, sale, or lease of real estate are kept current through the use of written extensions or amendments.  
(Amended 1/93)

DUTIES TO THE PUBLIC

Articles 10 though 14 are labeled as “Duties To The Public.”

Article 10

REALTORS® shall not deny equal professional service to any person for the reason of race, color, religion, sex, handicap, familial status, or national origin. REALTORS® shall not be parties to any plan or agreement to discriminate against a person or persons on the basis of race, color, religion, sex, handicap, familial status, or national origin.  
(Amended 1/90)

REALTORS®, in their real estate employment practices, shall not discriminate against any person or persons on the basis of race, color, religion, sex, handicap, familial status, or national origin.  
(Amended 1/00)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 10:
The law prohibits discrimination in housing on the basis of race, color, religion, sex, handicap, familial status, or national origin. Article 10 illustrates the REALTOR®’s commitment to fair housing. A charge alleging that a REALTOR® has violated a fair housing law may also form the basis of a charge alleging a violation of Article 10. The REALTOR® can have nothing to do with any plan or agreement to discriminate on the basis of race, color, religion, sex, handicap, familial status, or national origin with respect to any real estate transaction.

To ensure strict compliance with fair housing laws, Boards of REALTORS® are authorized to require training in fair housing as a condition of continued membership and REALTORS® are encouraged to establish ongoing equal opportunity educational training programs for individuals in their firms. Article 10 also calls on REALTORS® to refrain from discrimination in selecting and retaining employees and independent contractors who provide real estate-related services, and the administrative and clerical staff who support them.

How would you summarize the basic concept(s) of Article 10?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 10:
A REALTOR® should be committed to the cause of fair housing; this means that there should be no discrimination based on race, color, sex, familial status, national origin, religion or handicap.

Standard of Practice 10-1
When involved in the sale or lease of a residence, REALTORS® shall not volunteer information regarding the racial, religious or ethnic composition of any neighborhood nor shall they engage in any activity which may result in panic selling, however, REALTORS® may provide other demographic information. (Adopted 1/94, Amended 1/06)

Standard of Practice 10-2
When not involved in the sale or lease of a residence, REALTORS® may provide demographic information related to a property, transaction or professional assignment to a party if such demographic information is (a) deemed by the REALTOR® to be needed to assist with or complete, in a manner consistent with Article 10, a real estate transaction or professional assignment and (b) is obtained or derived from a recognized, reliable, independent, and impartial source. The source of such information and any additions, deletions, modifications, interpretations, or other changes shall be disclosed in reasonable detail. (Adopted 1/05, Renumbered 1/06)

Standard of Practice 10-3
REALTORS® shall not print, display or circulate any statement or advertisement with respect to selling or renting of a property that indicates any preference, limitations or discrimination based on race, color, religion, sex, handicap, familial status, or national origin. (Adopted 1/94, Renumbered 1/05 and 1/06)

Standard of Practice 10-4
As used in Article 10 “real estate employment practices” relates to employees and independent contractors providing real estate-related services and the administrative and clerical staff directly supporting those individuals. (Adopted 1/00, Renumbered 1/05)

Article 11
The services which the REALTORS® provide their clients and customers shall conform to the standards of practice and competence which are reasonably expected in the specific real estate disciplines in which they engage; specifically, residential real estate brokerage, real property management, commercial and industrial real estate brokerage, real estate appraisal, real estate counseling, real estate syndication, real estate auction, and international real estate.
REALTORS® shall not undertake to provide specialized professional services concerning a type of property or service that is outside their field of competence unless they engage the assistance of one who is competent on such types of property or service, or unless the facts are fully disclosed to the client. Any persons engaged to provide such assistance shall be so identified to the client, and their contribution to the assignment should be set forth. *Amended 1/95*

**What does this mean?**
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 11:
Article 11 explicitly describes a REALTOR®’s obligation to provide only those services which he or she can deliver competently.

For example, if a REALTOR® acting as a residential broker with no commercial experience was asked to market a complex business property, the REALTOR® would be obligated to disclose to the client that he or she does not possess the experience and expertise to provide the requested service. In certain instances, a prospective client may value the general abilities and integrity of a particular REALTOR® and may insist on engaging in the REALTOR®’s services despite the REALTOR®’s lack of experience and competency needed to undertake the assignment. In such a case, the REALTOR® may undertake the assignment only after fully disclosing his/her lack of experience, and the REALTOR® obtains assistance from someone competent in the field. The REALTOR® must fully inform the client as to whose assistance was utilized and the degree to which that person contributed to the assignment.

How would you summarize the basic concept(s) of Article 11?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 11:
A REALTOR® shall be competent in the services they perform and shall not attempt to provide services outside their scope of expertise without getting assistance from a person who is competent in the area where the REALTOR® is lacking.

Standard of Practice 11-1
When REALTORS® prepare opinions of real property value or price, other than in pursuit of a listing or to assist a potential purchaser in formulating a purchase offer, such opinions shall include the:

- Identification of the subject property
- Date prepared
- Defined value or price
- Limiting conditions, including statements of purpose(s) and intended user(s)
- Any present or contemplated interest, including the possibility of representing the seller/landlord or buyers/tenants
- Basis for the opinion, including applicable market data
- If the opinion is not an appraisal, a statement to that effect. (Amended 1/01)

Standard of Practice 11-2
The obligations of the Code of Ethics in respect of real estate disciplines other than appraisal shall be interpreted and applied in accordance with the standard of competence and practice which clients and the public reasonably require to protect their rights and interests considering the complexity of the transaction, the availability of expert assistance, and, where the REALTOR® is an agent or subagent, the obligation of a fiduciary. (Adopted 1/95)

Standard of Practice 11-3
When REALTORS® provide consultative services to clients which involve advice counsel for a fee (not a commission), such advice shall be rendered in an objective manner and the fee shall not be contingent on the substance of the advice or counsel given. If brokerage or transaction services are to be provided in addition to consultative services, a separate compensation may be paid with prior agreement between the client and REALTORS®. (Adopted 1/96)

Standard of Practice 11-4
The competency required by Article 11 relates to services contracted for between REALTORS® and their clients or customers; the duties expressly imposed by the Code of Ethics; and the duties imposed by law or regulation. (Adopted 1/02)
Article 12

REALTORS® shall be careful at all times to present a true picture in their advertising and representations to the public. REALTORS® shall also ensure that their professional status (e.g., broker, appraiser, property manager, etc.) or status as REALTORS® is clearly identifiable in any such advertising. (Amended 1/93)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 12:
To avoid any confusion or miscommunication, REALTORS® should make an extra effort to ensure that the advertisements that promote a listing do not give the wrong impression to potential buyers, who may purchase the listing expecting one thing, only to be disappointed.

In marketing properties, REALTORS® use advertising to inform the public about listings and to induce interest in them. REALTORS® are obligated to present a “true picture” in their advertising and in all representations to the public. A “true picture” is truthful, accurate advertising and nothing less. Descriptions that go beyond “puffing” may mislead the public. Statistics indicating a REALTOR®’s sales volume and comparisons with other firms can be impressive, but if they are inaccurate, untrue, or misleading, their use injures the public and violates Article 12.

REALTORS® must always disclose their status as real estate professionals in their advertisements. This may be accomplished by including the terms “REALTOR®, “REALTORS®” or “REALTOR-ASSOCIATE®,” or by disclosing their status as a licensed broker, appraiser, property manager or other real estate professional.

In advertising listed property, REALTORS® must also disclose the name of their firm so that the public will be aware that they are dealing with the property owner’s agent. Further, the REALTOR® must ensure that all brokers and salespeople affiliated with the firm include the firm’s name in their advertisements of listed properties.

When advertising unlisted property in which the REALTOR® has any ownership interest, the advertisement must disclose the interest and the existence of Board membership or real estate licensure.

How would you summarize the basic concept(s) of Article 12?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 12:
A REALTOR® shall be honest in advertising and identify his or her professional status in each ad.

Standard of Practice 12-1
REALTORS® shall offer a service described as “free” and in similar terms in their advertising and in other representations provided that all terms governing availability of the offered product or service are clearly disclosed at the same time. (Amended 1/97)

Standard of Practice 12-2
REALTORS® may represent their services as “free” or without cost if they expect to receive compensation from a source other than their client provided that the potential for the REALTOR® to obtain a benefit from a third party is clearly disclosed at the same time. (Amended 1/97)

Standard of Practice 12-3
The offering of premiums, prizes, merchandise discounts or other inducements to list, sell, purchase, or lease is not, in itself, unethical even if receipt of the benefit is contingent on listing, selling, purchasing, or leasing through the REALTOR® making the offer. However, REALTORS® must exercise care and candor in any such advertising or other public or private representations so that any party interested in receiving or otherwise benefiting from the real estate agent’s offer will have clear, thorough, advance understanding of all the terms and conditions of the offer. The offering of any inducements to do business is subject to the limitations and restrictions of state law and the ethical obligations established by any applicable Standard of Practice. (Amended 1/95)

Standard of Practice 12-4
REALTORS® shall not offer for sale/lease or advertise property without authority. When acting as listing broker or as subagent, REALTORS® shall not quote a price different from that agreed upon with the seller/landlord. (Amended 1/93)

Standard of Practice 12-5
REALTORS® shall not advertise nor permit any person employed by or affiliated with them to advertise listed property without disclosing the name of the firm. (Adopted 11/86)

Standard of Practice 12-6
REALTORS®, when advertising unlisted property for sale/lease, in which they have an ownership interest, shall disclose their status as both owner/landlords and as REALTORS® or real estate agents. (Amended 1/93)
Standard of Practice 12-7
Only REALTORS® who participated in the transaction as the listing broker or cooperating broker (selling broker) may claim to have “sold” the property. Prior to the closing a cooperating broker may post a “sold” sign only with the consent of the listing broker. (Amended 1/96)

Article 13

REALTORS® shall not engage in activities that constitute the unauthorized practice of law and shall recommend that legal counsel be obtained when the interest of any party to the transaction requires it.

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 13:
The REALTOR® is prohibited by the law and by the Code from engaging in the unauthorized practice of law. The REALTOR® has an affirmative obligation to recommend the use of legal counsel to clients and customers when their interests require it.

If the REALTOR® is also an attorney, then Article 13 would not preclude the offering of legal services in a manner consistent with the standards of the Bar Association. However, REALTORS® must be mindful of their agency relationship and the duties owed to clients and to customers and must avoid all conflicts of interest.

Article 13 encourages respect for the law and protects clients and customers from well intended but potentially misguided "legal advice" from those unqualified to provide it.

How would you summarize the basic concept(s) of Article 13?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 13:
REALTORS® should not practice law if they are not authorized to do so; therefore, REALTORS® should recommend that the buyer or seller obtain qualified legal counsel in order to resolve any disputes.

Article 14
If charged with unethical practice or asked to present evidence or to cooperate in any other way, in any professional standards proceeding or investigation, REALTORS® shall place all pertinent facts before the proper tribunals of the Member Board or affiliated institute, society, or council in which membership is held and shall take no action to disrupt or obstruct such processes. (Amended 1/99)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 14:
The Code of Ethics is meaningful because it is respected and enforced. Article 14 establishes an absolute obligation to cooperate with the Board when charged with unethical practice, or when asked to present evidence in any professional standards proceeding or investigation. In either event the REALTOR® must place all pertinent facts before a proper tribunal.

REALTORS® are required to take an active part in Code enforcement. If this were not so, then the Code would lose its relevance and influence in promoting and enforcing high standards of professional conduct.

Boards must provide due process in professional standards proceedings, as well as in the enforcement of the Board's bylaws, and other rules and regulations. Due process requires as much factual support as can be reasonably ascertained to substantiate violations of the Code or arbitration awards or failure to abide by other membership obligations. With fairness established in the Board's procedures, and with the facts in hand, the Board can respect and protect the rights of all its members while strictly enforcing the Code.

If, in connection with a professional standards proceeding or an investigation, a REALTOR® is requested by the Board to answer a charge or to appear as a witness, then the REALTOR® must do so, and must take no action to disrupt or obstruct such processes.

How would you summarize the basic concept(s) of Article 14?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 14:
When a REALTOR® gets charged with unethical practices, he or she must appear before the appropriate boards where he or she will have the opportunity to disclose facts pertaining to the case to the board.

Standard of Practice 14-1
REALTORS® shall not be subject to disciplinary proceedings in more than one Board of REALTORS® or affiliated institute, society or council in which they hold membership with respect to alleged violations of the Code of Ethics relating to the same transaction or event. *(Amended 1/95)*

Standard of Practice 14-2
REALTORS® shall not make any unauthorized disclosure or dissemination of the allegations, findings, or decision developed in connection with an ethics hearing or appeal or in connection with an arbitration hearing or procedural review. *(Amended 1/92)*

Standard of Practice 14-3
REALTORS® shall not obstruct the Board’s investigation or professional standards proceedings by instituting or threatening to institute actions for libel, slander or defamation against any party to a professional standards proceeding or their witnesses based on the filing of an arbitration request, an ethics compliant, or testimony given before any tribunal. *(Adopted 11/87, Amended 1/99)*

Standard of Practice 14-4
REALTORS® shall not intentionally impede the Board’s investigation or disciplinary proceedings by filing multiple ethics complaints based on the same event or transaction. *(Adopted 11/88)*

DUTIES TO REALTORS®

Articles 15 through 17 are labeled as “Duties To REALTORS®”

**Article 15**

REALTORS® shall not knowingly or recklessly make false or misleading statements about competitors, their businesses, or their business practices. *(Amended 1/92)*

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 15:
Article 15 logically flows from the REALTOR®'s duty established in Article 12 "to present a true picture in . . . representations." This includes comparisons with competitors and comments or opinions offered about other real estate professionals.

Article 15 is not intended to limit or inhibit the free flow of commercial information valued by potential users regarding the many and varied services that REALTORS® provide. Article 15 requires that REALTORS® make good faith efforts to ensure that statements and representations they make, including those made in their advertising, are truthful and accurate.

REALTORS® should consider that while truthfulness is the ultimate measuring stick of Article 15, little is gained, and often much is lost, through negative, non-constructive criticism which can impair the cooperative efforts that make the service provided by REALTORS® so valuable to the public.

How would you summarize the basic concept(s) of Article 15?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 15:
REALTORS® should be truthful in all representations and statements they make about their competitors. Unless the REALTOR® is absolutely certain of a competitor's business or business practice, the REALTOR® should not disclose any uncertain information to a buyer or seller.

Standard of Practice 15-1
REALTORS® shall not knowingly or recklessly file false or unfounded ethics complaints. *(Adopted 1/00)*

**Article 16**

REALTORS® shall not engage in any practice or take any action inconsistent with exclusive representation or exclusive brokerage relationship agreements that other REALTORS® have with clients. *(Amended 1/04)*

**What does this mean?**
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 16:
A REALTOR® should not interfere with the business relationships of others. Contact with other agents or sellers without authorization may be illegal under certain circumstances, so REALTORS® should ensure that all business communication is allowed under the Code.

Competition among brokers to provide appraising, brokerage, managing, leasing, syndicating or counseling services is extremely intense until the prospective client enters into a binding agreement for such services. When an exclusive relationship is created, the competition shifts to searching for buyers or to fulfilling the agreement. At this point, Article 16 comes into play.

Once clients have selected a particular broker to serve their interests, the competition that prevailed earlier ceases and cooperation takes its place. Cooperation between REALTORS® is the general practice that is considered when it is in the best interest of the client. Generally, cooperation exists in great measure, since it benefits the clients and customers in virtually every case. REALTORS® must carefully avoid taking any action that is inconsistent with the exclusive relationship between the seller and the listing broker and avoid any action that could be construed to induce a breach of the contractual agreement made with the client. Once the client has made a decision, he or she is entitled to the benefit of his or her bargain. This includes relief for the duration of the relationship from direct overtures of other REALTORS® seeking to interest the seller or lessor in the services they provide. This limited protection from direct solicitation does not preclude general advertising efforts by other REALTORS®, but it does prohibit efforts to induce the breach of an existing contract so that another REALTOR® can substitute himself in the place of the current listing broker.

In order to respect the exclusivity of the listing broker's relationship in an exclusive listing, other REALTORS® must be able to determine with certainty that an exclusive listing exists. If the listing broker refuses to disclose the nature (type) and duration of a listing, Article 16 recognizes the REALTOR®'s right to contact the seller or lessor directly to obtain this essential information. Under these circumstances, the REALTOR® may also discuss the terms of a future listing on the property or may enter into a listing to become effective upon the expiration of the current listing.

Article 16 also acknowledges the right of property owners whose properties are listed exclusively to contact other REALTORS® if they are not satisfied with the listing broker's performance. A REALTOR® is free to discuss the terms of a future listing on the property and may enter into a listing to become effective upon the expiration of the current listing if the discussion and contact were initiated by the property owners.

Actions inconsistent with the exclusive relationship of the listing broker can occur
when a REALTOR® provides unauthorized information to a prospective purchaser or tenant. It can occur when a cooperating broker fails to obtain permission to show the property from the listing broker, but contacts the owner directly. It can occur when a cooperating broker takes an offer directly to the client without the knowledge and consent of the listing broker. It can occur when a cooperating broker uses the showing of a property as an opportunity to make unsolicited, derogatory and false remarks about the listing broker. REALTORS® are obligated to respect the agency, or other exclusive relationships recognized by law, of other REALTORS® and to work through them as long as the exclusive relationship remains in effect. Professionalism, integrity, and courtesy require it and buyers/tenants and sellers/lessors benefit from it.

How would you summarize the basic concept(s) of Article 16?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 16: REALTORS® should not solicit a seller that is already bound by a listing contract with another REALTOR® or a buyer that is already bound by a buyer representation agreement with another REALTOR® or an owner that has an existing property management with another REALTOR®, etc.

Standard of Practice 16-1
Article 16 is not intended to prohibit aggressive or innovative business practices which are otherwise ethical and does not prohibit disagreements with other REALTORS® involving commission, fees, compensation or other forms of payment or expenses. (Adopted 1/93, Amended 1/95)

- Standard of Practice 16-2
Article 16 does not preclude REALTORS® from making general announcements to prospects describing their services and the terms of their availability even though some recipients may have entered into agency agreements or other exclusive relationships with another REALTOR®. A general telephone canvass, general mailing or distribution addressed to all prospects in a given geographical area or in a given profession, business, club, or organization, or other classification or group is deemed “general” for purposes of this standard. (Amended 1/04)

Article 16 is intended to recognize as unethical two basic types of solicitations:

First, telephone or personal solicitations of property owners who have been identified by a real estate sign, multiple listing compilation, or other information service as having exclusively listed their property with another REALTOR®, and

Second, mail or other forms of written solicitations of prospects whose properties are exclusively listed with another REALTOR® when such solicitations are not part of a general mailing but are directed specifically to property owners identified through compilations of current listings, “for sale” or “for rent” signs, or other sources of information required by Article 3 and Multiple Listing Service rules to be made available to other REALTORS® under offers of subagency or cooperation. (Amended 1/04)

Standard of Practice 16-3
Article 16 does not preclude REALTORS® from contacting the client of another broker for the purpose of offering to provide, or entering into a contract to provide, a different type of real estate service unrelated to the type of service currently being provided (e.g., property management as opposed to brokerage) or from offering the same type of service for property not subject to other brokers’ exclusive agreements. However, information received through a Multiple Listing Service or any other offer of cooperation may not be used to target clients of
other REALTORS® to whom such offers to provide services may be made.  
*Amended 1/04*

**Standard of Practice 16-4**  
REALTORS® shall not solicit a listing which is currently listed exclusively with another broker. However, if the listing broker, when asked by REALTOR®, refuses to disclose the expiration date and nature of such listing; i.e., an exclusive right to sell, an exclusive agency, open listing, or other form of contractual agreement between the listing broker and the client, the REALTOR® may contact the owner to secure such information and may discuss the terms upon which the REALTOR® might take a future listing or, alternatively, may take a listing to become effective upon expiration of any existing exclusive listing.  
*Adopted 1/94, Amended 1/98*

**Standard of Practice 16-5**  
REALTORS® shall not solicit buyer/tenant agency agreement from buyers/tenants who are subject to exclusive buyer/tenant agency agreements. However, if asked by a REALTOR®, the broker refuses to disclose the expiration date of the exclusive buyer/tenant agency agreement, the REALTOR® may contact the buyer/tenant to secure such information and may discuss the terms upon which the REALTOR® might enter into a future buyer/tenant agency agreement or, alternatively, may enter into a buyer/tenant agency agreement to become effective upon expiration of any existing buyer/tenant agency agreement.  
*Adopted 1/94, Amended 1/98*

**Standard of Practice 16-6**  
When REALTORS® are contacted by the client of another REALTOR® regarding the creation of an exclusive relationship to provide the same type of service, and REALTORS® have not directly or indirectly initiated such discussions, they may discuss the terms upon which they might enter into a future agency agreement or, alternatively, may enter into an agency agreement which becomes effective upon expiration of any existing exclusive agreement.  
*Amended 1/98*

**Standard of Practice 16-7**  
The fact that a prospect has retained a REALTOR® as an exclusive representative or exclusive broker in one or more past transactions does not preclude other REALTORS® from seeking such prospect’s future business.  
*Amended 1/04*

**Standard of Practice 16-8**  
The fact that an exclusive agreement has been entered into with a REALTOR® shall not preclude or inhibit any other REALTOR® from entering into a similar agreement after the expiration of the prior agreement.  
*Amended 1/98*

**Standard of Practice 16-9**
REALTORS®, prior to entering into a representation agreement, have an affirmative obligation to make reasonable efforts to determine whether the prospect is subject to a current, valid exclusive agreement to provide the same type of real estate service. (*Amended 1/04*)

**Standard of Practice 16-10**
REALTORS®, acting as buyer or tenant representatives or brokers, shall disclose that relationship to the seller/landlord’s representative or broker at first contact and shall provide written confirmation of that disclosure to the seller/landlord’s representative or broker not later than execution of a purchase agreement or lease. (*Amended 1/04*)

**Standard of Practice 16-11**
On unlisted property, REALTORS® acting as buyer/tenant representatives or brokers shall disclose that relationship to the seller/landlord at first contact for that buyer/tenant and shall provide written confirmation of such disclosure to the seller/landlord not later than execution of any purchase or lease agreement. (*Amended 1/04*)

REALTORS® shall make any request for anticipated compensation from the seller/landlord at first contact. (*Amended 1/98*)

**Standard of Practice 16-12**
REALTORS®, acting as representatives or brokers of sellers/landlords or as subagents of listing brokers, shall disclose that relationship to buyers/tenants as soon as practicable and shall provide written confirmation of such disclosure to buyers/tenants not later than execution of any purchase or lease agreement. (*Amended 1/04*)

**Standard of Practice 16-13**
All dealings concerning property exclusively listed, or with buyer/tenants who are subject to an exclusive agreement shall be carried on with the client’s representative or broker, and not with the client, except with the consent of the client’s representative or broker or except where such dealings are initiated by the client.

Before providing substantive services (such as writing a purchase offer or presenting a CMA) to prospects, REALTORS® shall ask prospects whether they are a party to any exclusive representation agreement. REALTORS® shall not knowingly provide substantive services concerning a prospective transaction to prospects who are parties to exclusive representation agreements, except with the consent of the prospects’ exclusive representatives or at the direction of prospects. (*Adopted 1/93, Amended 1/04*)

**Standard of Practice 16-14**
REALTORS® are free to enter into contractual relationships or to negotiate with sellers/landlords, buyers/tenants or others who are not subject to an exclusive agreement but shall not knowingly obligate them to pay more than one commission except with their informed consent. (Amended 1/98)

**Standard of Practice 16-15**
In cooperative transactions, REALTORS® shall compensate cooperating REALTORS® (principal brokers) and shall not compensate nor offer to compensate, directly or indirectly, any of the sales agents employed by or affiliated with other REALTORS® without the prior expressed knowledge and consent of the cooperating broker.

**Standard of Practice 16-16**
REALTORS®, acting as subagents or buyer/tenant representatives or brokers, shall not use the terms of an offer to purchase/lease to attempt to modify the listing broker's offer of compensation to subagents or buyer/tenant representatives or brokers nor make the submission of an executed offer to purchase/lease contingent on the listing broker's agreement to modify the offer of compensation. (Amended 1/04)

**Standard of Practice 16-17**
REALTORS®, acting as subagents or as buyer/tenant representatives or brokers, shall not attempt to extend a listing broker's offer of cooperation and/or compensation to other brokers without the consent of the listing broker. (Amended 1/04)

**Standard of Practice 16-18**
REALTORS® shall not use information obtained from listing brokers through offers to cooperate made through multiple listing services or through other offers of cooperation to refer listing brokers' clients to other brokers or to create buyer/tenant relationships with listing brokers' clients, unless such use is authorized by listing brokers. (Amended 1/02)

**Standard of Practice 16-19**
Signs giving notice of property for sale, rent, lease, or exchange shall not be placed on property without consent of the seller/landlord. (Amended 1/93)

**Standard of Practice 16-20**
REALTORS®, prior to or after terminating their relationship with their current firm, shall not induce clients of their current firm to cancel exclusive contractual agreements between the client and that firm. This does not preclude REALTORS® (principals) from establishing agreements with their associated agents governing assignability of exclusive agreements. (Adopted 1/98)
Article 17

In the event of contractual disputes or specific non-contractual disputes as defined in Standard of Practice 17-4 between REALTORS® (principals) associated with different firms, arising out of their relationship as REALTORS®, the REALTORS® shall submit the dispute to arbitration in accordance with the regulations of their Board or Boards rather than litigate the matter.

In the event clients of REALTORS® wish to arbitrate contractual disputes arising out of real estate transactions, REALTORS® shall arbitrate those disputes in accordance with the regulations of their Board, provided the clients agree to be bound by the decision.

The obligation to participate in arbitration contemplated by this Article includes the obligation of REALTORS® (principals) to cause their firms to arbitrate and be bound by any award. (Amended 1/01)

What does this mean?
Write your answer in the space provided and then check the answer on the next page.
Meaning of Article 17:
Generally, arbitration is used to settle disputes between REALTOR® principals of two different real estate firms concerning entitlement to a commission or to a cooperating brokers’ compensation. Entitlement is determined on the basis of determining the "procuring cause." In most instances, the decision awards the disputed amount to one party or the other. In certain cases, if not precluded by state law, the disputed amount may be divided between the parties if the arbitrators determine that both parties contributed, without interruption, to the transaction.

Article 17 also requires a REALTOR® to arbitrate disputes with clients, if the client requests the arbitration and agrees to be bound by the decision. The Code of Ethics and Arbitration Manual advises Boards and State Associations to determine whether:

- State law authorizes prior agreements to arbitrate future disputes in advance of a dispute or only after the dispute occurs.
- State law recognizes binding arbitration at all. In the latter case, Boards can only offer arbitration and cannot require REALTORS® and REALTOR-ASSOCIATE®s to participate in it.

The Code of Ethics and Arbitration Manual also specifies three circumstances under which REALTORS® must submit to arbitration:

- Arbitration of a dispute between REALTOR® principals of different firms.
- Arbitration between REALTORS® (other than principals) or REALTOR-ASSOCIATE®s in different firms, provided the REALTOR® principals join in the arbitration.
- Arbitration between REALTOR® principals and their clients when the client or REALTOR® invokes the arbitration and the client agrees to be bound by the decision.

The Manual also specifies three circumstances under which the REALTOR®s participation in arbitration is voluntary:

- Arbitration between REALTOR® principals and REALTORS® and REALTOR-ASSOCIATE®s (non-principals) who are or were affiliated with the same firm, provided each party voluntarily agrees to the arbitration in writing. This applies to disputes arising when the parties are, or were, affiliated with the same firm, irrespective of the time the request is made for such arbitration.
- Arbitration between a REALTOR® principal with a non-member broker, provided each party agrees in writing to be bound by the decision. However, it is the member's choice whether the member will submit to
arbitration with a non-member broker who is not an MLS Participant. A non-member broker, who is not an MLS Participant, is not entitled to invoke the arbitration facilities of a Board of REALTORS®.

- Arbitration between a REALTOR® principal and a customer if a written contractual relationship has been created by the REALTOR® principal between a customer and a client, and provided all parties to the dispute (i.e., the customer and the REALTOR®) agree in writing to arbitrate the dispute.
- REALTORS® and REALTOR-ASSOCIATE®s who participate in the Board's MLS or otherwise access MLS information through any Board in which they do not hold membership, have the same rights and responsibilities as any Board member relative to the Code of Ethics.

How would you summarize the basic concept(s) of Article 17?
Write your answer in the space provided and then check the answer on the next page.
Summarizing the basic concept(s) of Article 17:
REALTORS® must arbitrate rather than litigate matters that involve disputes between REALTORS® of different firms that arise in the course of their relationship as REALTORS® regarding matters that are either contractual or non-contractual in nature.

Standard of Practice 17-1
The filing of litigation and refusal to withdraw from it by REALTORS® in an arbitrary matter constitutes a refusal to arbitrate. *(Adopted 2/86)*

Standard of Practice 17-2
Article 17 does not require REALTORS® to arbitrate in those circumstances when all parties to the dispute advise the Board in writing they choose not to arbitrate before the Board. *(Amended 1/93)*

Standard of Practice 17-3
REALTORS®, when acting solely as principals in a real estate transaction, are not obligated to arbitrate disputes with other REALTORS® absent a specific written agreement to the contrary. *(Adopted 1/96)*

Standard of Practice 17-4
Specific non-contractual disputes that are subject to arbitration pursuant to Article 17 are:

- Where a listing broker has compensated a cooperating broker and another cooperating broker subsequently claims to be the procuring cause of the sale or lease. In such cases the complainant may name the first cooperating broker as respondent and arbitration may proceed without the listing broker being named as a respondent. Alternatively, if the complaint is brought against the listing broker, the listing broker may name the first cooperating broker as a third-party respondent. In either instance the decision of the hearing panel as to procuring cause shall be conclusive with respect to all current or subsequent claims of the parties for compensation arising out of the underlying cooperative transaction. *(Adopted 1/97)*

- Where a buyer or tenant representative is compensated by the seller or landlord, and not by the listing broker, and the listing broker, as a result, reduces the commission owed by the seller or landlord and, subsequent to such actions, another cooperating broker claims to be the procuring cause of sale or lease. In such cases the complainant may name the first cooperating broker as respondent and arbitration may proceed without the listing broker being named as a respondent. Alternatively, if the complaint is brought against the listing broker, the listing broker may name the first cooperating broker as a third-party respondent. In either instance the
decision of the hearing panel as to procuring cause shall be conclusive with respect to all current or subsequent claims of the parties for compensation arising out of the underlying cooperative transaction. (Adopted 1/97)

- Where a buyer or tenant representative is compensated by the buyer or tenant and, as a result, the listing broker reduces the commission owed by the seller or landlord and, subsequent to such actions, another cooperating broker claims to be the procuring cause of sale or lease. In such cases the complainant may name the first cooperating broker as respondent and arbitration may proceed without the listing broker being named as a respondent. Alternatively, if the complaint is brought against the listing broker, the listing broker may name the first cooperating broker as a third-party respondent. In either instance the decision of the hearing panel as to procuring cause shall be conclusive with respect to all current or subsequent claims of the parties for compensation arising out of the underlying cooperative transaction. (Adopted 1/97)

- Where two or more listing brokers claim entitlement to compensation pursuant to open listings with a seller or landlord who agrees to participate in arbitration (or who requests arbitration) and who agrees to be bound by the decision. In cases where one of the listing brokers has been compensated by the seller or landlord, the other listing broker, as complainant, may name the first listing broker as respondent and arbitration may proceed between the brokers. (Adopted 1/97)

- Where a buyer or tenant representative is compensated by the seller or landlord, and not by the listing broker, and the listing broker, as a result, reduces the commission owed by the seller or landlord and, subsequent to such actions, claims to be the procuring cause of sale or lease. In such cases arbitration shall be between the listing broker and the buyer or tenant representative and the amount in dispute is limited to the amount of the reduction of commission to which the listing broker agreed. (Adopted 1/05)


**Explanatory Notes**

The reader should be aware of the following policies which have been approved by the Board of Directors of the National Association:

In filing a charge of an alleged violation of the Code of Ethics by a REALTOR®, the charge must read as an alleged violation of one or more Articles of the Code. Standards of Practice may be cited in support of the charge.

The Standards of Practice serve to clarify the ethical obligations imposed by the
various Articles and supplement, and do not substitute for, the Case Interpretations in Interpretations of the Code of Ethics.

Modifications to existing Standards of Practice and additional new Standards of Practice are approved from time to time. Readers are cautioned to ensure that the most recent publications are utilized.

**SUMMARY**

This lesson covers the Code of Ethics by discussing the Preamble and the various Articles and Standard Practices that are applied. The Preamble addresses aspirational concepts that include serving the best interests of our nation, utilizing the land for its highest and best use, performing duties with honor and integrity, staying current and informed on current real estate related events and issues and the Golden Rule.

Essentially, it is vital that the agent act responsibly, ethically and fairly by disclosing all relevant information concerning property conditions and the agent’s interest and involvement in the property; this works towards the best interest of the client. The agent not only needs to treat all clients fairly and honestly, but must also treat their competitors in the same manner. The agent needs to make truthful and valid representations in all facets concerning a property, sales transaction, competitor, agent involvement, compensation, etc. The Code of Ethics helps to set requirements expected by NAR® in order to regulate equal and fair treatment of all people involved in the real estate industry. Below is a brief overview of each Article in the Code of Ethics:

Article 1 requires REALTORS® to be faithful to their clients by treating them honestly and by placing their client’s interests above their own.

Article 2 requires REALTORS® to fully disclose the condition of a property; they must avoid misrepresentation, restrict advice on matters that are not in their expertise and respect a client’s confidentiality (so long as it does not violate any laws).

Article 3 requires REALTORS® to cooperate with other brokers unless it is not in the best interest of the client to do so.

Article 4 protects clients from unfair treatment by ensuring that REALTORS® disclose any interest (in writing) that they may have in a property prior to making any agreements.

Article 5 states that REALTORS® should not use their expertise of the field to gain unfair advantage over their clients. Any interest that REALTORS® have in a property must be fully disclosed to the client.
Article 6 discusses the REALTORS®’ responsibility to fully inform a buyer or seller of the true nature of a product or service he or she is promoting. This means that the REALTOR® may not mislead the buyer into thinking that purchasing these services or products will in any way benefit them beyond their regular scope.

Article 7 requires that REALTORS® reveal to all parties involved in the transaction any compensation that they may receive from another party.

Article 8 requires that REALTORS® must keep their personal funds separate from any monies he or she handles in transactions.

Article 9 asserts that REALTORS® should get all agreements in writing, and these agreements must be written in clear and concise language and all appropriate signatures or initials must be in place.

Article 10 stipulates that REALTORS® must adhere to the Fair Housing Laws.

Article 11 states that REALTORS® should not offer services that are beyond their range of expertise, without attaining assistance from a more competent person in that particular field.

Article 12 requires REALTORS® to be honest in advertising; meaning, they must state their professional status in every ad.

Article 13 asserts that REALTORS® should not practice law unless they are authorized to do so. REALTORS® should recommend that buyers or sellers obtain qualified legal counsel to settle disputes.

Article 14 requires REALTORS® to appear before the appropriate boards when charged with unethical practices.

Article 15 entails REALTORS® to be truthful in all comments and depictions they make about their competitors.

Article 16 disallows the solicitation of sellers or buyers who are bound to an agreement with another REALTOR®.

Article 17 states REALTORS® should dispute cases in arbitration.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FOUR
USING THE MODEL FOR ETHICAL DECISION MAKING

This lesson focuses on the following topics:

- Ethical Decision-Making Model
- Decision-Making Model Case Studies

The Decision-Making Model will be used in order break down the different steps that need to be taken in order to arrive at a decision. By examining each case study, the student will be able to define the problem by explaining the facts, assumptions, affected persons and resources associated with each case. Then, after each of the ethical systems is applied to the case, the student should have a grasp of the different possible decisions that can be discerned and be able to decide which ethical approach best fits each situation.

**ETHICAL DECISION-MAKING MODEL**

Defining the Problem
Determine:
- Facts
- Assumptions
- Affected persons
- Resources

Applying an Ethical System
- End results approach
- Rules and laws approach
- Social contract approach
- Individual conscience approach

Making a Final Decision

Evaluating a Final Decision

Making a Trial Decision for testing
DECISION-MAKING MODEL CASE STUDIES

Using the model for ethical decision making from Lesson 2, analyze Case Study 4-1. For the purpose of this course, use the NAR® Code of Ethics for the Social Contract approach.

CASE STUDY 4-1

As a favor, a broker listed his friend’s home despite the fact that it was a residential property, and his expertise was in commercial real estate. The friend’s home was located in an area of town that the Broker was unfamiliar with; therefore, the Broker had apprehensions about the listing. As a precaution, the Broker insisted that the Seller have the house appraised, but the Seller insisted that he was in good hands and encouraged the Broker to list the house at $150,000, a price that the Seller believed to be fair market value for the area. The Broker reluctantly listed the house at that price, and a young couple quickly snatched up the house.

Not more than 6 months later, the Broker received a call from the slightly perturbed Seller. The Seller told the Broker that he had run into the young couple at a restaurant, and they had mentioned that they were in the process of transferring to another town and had received an offer for the house, of $175,000, but refused because they had been told that they could do much better. This upset the Seller because he felt that the Broker did not do all he could to get the most for his property.

Work through the following questions.

1. What facts are presented in this case study?
Write your answer in the space provided and then check the answer on the next page.
Facts presented in case study 4-1:

- The Broker’s expertise was in commercial real estate.
- The Seller said that he wanted the Broker to list his home even though the Broker informed the Seller that residential real estate was outside his expertise and that he was unfamiliar with the area of town where the home was located.
- The Broker insisted that the Seller have the house appraised.
- The Seller insisted that he felt confident in the Broker’s abilities.
- The Seller said that he believed $150,000 to be an appropriate fair market value at which to list his home.
- The Broker listed the home for sale at $150,000.
- A young couple purchased the home soon after it went on the market.
- Less than 6 months later, the young couple told the seller that they were selling the home because of a job transfer and that they had already received an offer for $175,000 but had turned it down because they thought “they could do much better.”
- The Broker’s friend (the Seller) is now upset with him.

2. What assumptions apply to this case study?
Write your answer in the space provided and then check the answer on the next page.
Assumptions that apply to case study 4-1:

- The seller did not want to listen to the Broker’s disclaimers because the seller thought both he and the Broker knew what they were doing.
- Perhaps since the Seller was a friend, the Broker agreed to a lower commission than the Seller would have been asked to pay by real estate professionals more knowledgeable in residential real estate and who were familiar with the neighborhood where the house was located.
- If the Seller was getting a bargain in the commission, perhaps the Broker should not have made (or perhaps agreed to) that offer but should have referred his friend to a more appropriate agent.
- The young couple could have made significant improvements to the house in six months.
- The market could have improved dramatically in six months.

3. Name the persons and/or groups affected by a decision made on this case?
Write your answer in the space provided and then check the answer on the next page.
Persons and/or groups affected by the decisions made in case study 4-1:

- The **Broker** probably does not want to lose his friendship, but neither would he want any trouble because he tried to do a friend a favor.
- The **Seller** probably received less for his house than he could have if there had been an appraisal or an agent who was competent in residential real estate and familiar with the neighborhood where the house was located.
- Peers may be hurt if the firm suffers because of the expense and stigma of a lawsuit.
- The **Neighborhood** may be hurt by the sale that was probably below market value and may count against the value of the home if it is deemed comparable by an appraiser. At this point, there may be no course of action that will help the neighborhood.

4. What resources (persons or written documents) may be useful in reaching a decision on this case?
Write your answer in the space provided and then check the answer on the next page.
Resources that may prove useful in reaching a meaningful decision about this case:

- NAR® Code of Ethics
- The real estate firm’s attorney
- The local board or association
- Real Estate publications that may contain comments on similar cases
- An appraiser

5. Applying the *end results approach* to this case, what decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
By applying the *end results approach* to this case, you may reach the following decision:

With this approach, the goal is to make as many people happy as possible. If there is a reason to believe that the home was worth significantly less when the Broker listed it than it was 6 months after the sale, then the Broker could hire an appraiser to perform an appraisal as though the “clock was turned back” and give a value for the home at the time of the listing. Then the Broker could offer to pay the Seller the difference of the appraisal and the list price less the cost of closing costs and the cost of the appraisal that the Broker wanted the Seller to pay for in the first place. This could potentially pacify the Seller. Another possibility is to offer to refund (to the Seller) the Broker’s portion of the commission. Yet another possibility is to write the Seller a letter outlining the facts, including the Broker’s efforts to make a full disclosure by insisting that the Seller get an appraisal. In any event, perhaps the Seller would cool off after he revisited the facts.

6. Applying the *rules and law approach*, what decision might you reach? Write your answer in the space provided and then check the answer on the next page.
By applying the rules and law approach, you might reach the following decision:

The decision resulting from the rules and law approach would depend on the laws of each state. For example, if the license law presumes that if you take the required education and pass the exam, you are competent to practice all types of real estate, then perhaps the Broker has violated a law in taking a listing outside of his expertise. In this instance, the Broker was honest with the seller in accepting the listing and fully informed the seller of his lack of knowledge about residential real estate as well as his unfamiliarity with the neighborhood. Additionally, the seller turned down the idea of securing expert advice from an appraiser to determine the value of home. (The seller himself set the list price.) However, if there is an affirmative duty in the real estate license law of the Broker’s state to always inform the seller of the market value of a property before listing it, then the Broker is guilty of failing to determine the market value prior to listing the property. This failure could result in a disciplinary action from the state regulatory agency and/or a possible lawsuit.

7. Applying the Social Contract Approach and using the NAR® Code of Ethics for your “social contract,” what Article(s) have been violated, if any? What decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
Articles have not been violated:

An appropriate conclusion under this approach is that the Broker did not violate the NAR® Code of Ethics. The Broker’s obligation under Article 1 is to protect and promote the interests of the client. He had made known his lack of knowledge about the area, the market value of the property, and insisted that the seller have the property appraised. Because of these disclosures and recommendations, the Broker is not in violation of Article 1. In addition, the Broker did exactly what was required under the second paragraph of Article 11 in advising the seller that residential real estate was not his area of expertise and that the Seller should hire an appraiser to assist in pricing the property.

8. Applying the Personal Conscience Approach, what might be the resulting decision?
Write your answer in the space provided and then check the answer on the next page.
By applying the *Personal Conscience Approach*, the resulting decision would vary:

One possible result of this approach is that the Broker might regret that he did not do one of the following: 1) refuse to take the listing; 2) decide to take the listing, but pay for the appraisal himself; or 3) explain to the Seller that he could refer the listing to an experienced and knowledgeable agent in residential real estate who was familiar with the neighborhood and then work closely with that agent to make sure that the Seller got good service. If the Broker felt that he had let the Seller down, he might offer to refund his share of the commission and/or order an appraisal for a value at the time the listing was taken and then compensate the Seller for the untapped value of the home.

9. From your application of the four approaches, what approach should be weighed most heavily in this case?
Write your answer in the space provided and then check the answer on the next page.
The approach that should be weighed most heavily in this case may also vary:

This depends on each person who uses this model, the office in which they work, the laws of the state in which they are licensed, the social contract under which they work and their own conscience. If the Broker violated any laws in his state, conscience may advise him to do what is necessary to make the Seller happy and keep him from bringing legal action through a lawsuit and/or filing a complaint with the regulatory board.

10. What might be an appropriate decision for this case study? Is the Broker at fault? Is the Seller?
Write your answer in the space provided and then check the answer on the next page.
Who is at fault?

Obviously it would have been better if the Broker had not taken the listing. The only good news here is that the Broker does not appear to have violated the NAR® Code of Ethics which is often a standard more stringent than the law. Probably both the Seller and the Broker are at fault. The Seller is at fault for insisting that the Broker list the home given the Broker’s disclosure of inexperience in the residential area. The Broker is at fault for neither refusing the listing nor turning it into a referral and for taking the listing only after paying for the appraisal himself. Mediation is a dispute resolution process that strives for a “win-win” solution to preserve relationships. Potential sources of mediators are the local board, alternative dispute resolution centers, and attorneys trained in mediation. Perhaps the best solution would be for the Broker to suggest that he and the Seller enter mediation to settle the dispute. Mediation through the local board is discussed further in Lesson 5.

CASE STUDY 4-2

Last year, a Seller received word that her uncle had passed away and had bequeathed his property to her. The Seller suddenly had this beautiful stretch of land practically fall into her lap—a massive house in the middle of a dozen acres of land bordered by the Pacific Ocean. Unfortunately for the Seller, the property is in southern California, and because the Seller lives in Louisiana, she has never had an opportunity to take full advantage of the land.

Torn between doing the sensible thing and having this great stretch of land, the Seller finally decides to sell the property and make full use of the monetary value. The Seller calls around and is referred to REALTOR® Rex. The Seller asks the REALTOR® to look at the land and suggest a listing price, which he does and comes back with a price of $180,000, which seems far below what the Seller had expected, but she reluctantly agrees to the price.

Within a month the REALTOR® has called with an offer. He intends to buy the property for the price listed, less his commission. The Seller senses that she is being taken advantage of and suggests that he have the property appraised; in response, Rex demands his commission for a job well done.

1. What facts are presented in this case study?
Write your answer in the space provided and then check the answer on the next page.
Facts presented in case study 4-2:

- The Seller inherited a piece of property in California with a large house and a dozen acres bordering the Pacific Ocean.
- The Seller lives in Louisiana and does not want to move to California.
- The Seller decides to sell the property she inherited.
- The Seller selects the REALTOR® to list the property after calling around.
- The list price that the REALTOR® suggests is $180,000.
- The Seller reluctantly agrees to the list price.
- Within a month of when he listed the property, the REALTOR® offers to buy the property for $180,000 less his commission.
- The Seller then suggests that the property be appraised.
- The REALTOR® rejects the idea of an appraisal and demands his commission since he’s produced a ready, willing, and able buyer who is willing to purchase the property at list price.

2. What assumptions apply to this case study?
Write your answer in the space provided and then check the answer on the next page.
Assumptions that apply to case study 4-2:

- After the REALTOR® saw the property, he wanted to buy it so he suggested a below market list price that he could afford.
- The REALTOR® suggested a list price that was below market value.
- After the REALTOR® made the offer to purchase the property, the REALTOR® was upset when the Seller suggested that he get an appraisal.
- The REALTOR® may have made no effort to market the property.
- If the REALTOR® had marketed the property at the $180,000 list price to the public, it probably would have sold within days to someone other than the REALTOR®.

3. Name the persons and/or groups affected by the decision made in this case?
Write your answer in the space provided and then check the answer on the next page.
Persons and/or groups affected by the decisions made in case study 4-2:

- **The REALTOR®** would be affected because his reputation may suffer if he is found to have put his own interests above those of his client. Also, if found guilty of failing to protect the interests of his client, Rex may suffer disciplinary action from the local Board, and he may lose his license.
- If the REALTOR® is found guilty, then **the REALTOR®’s Broker** will probably be dragged into court with the REALTOR® and his reputation may also suffer in the community.
- **The Seller** will suffer because of the inconvenience and expense of definitively determining whether or not the REALTOR® was trying to take advantage of her. This factual determination is necessary to protect the Seller against the REALTOR®’s demand for a commission. The facts will also aid the Seller in taking other legal actions against Rex if she deems it necessary to do so.
- **The REALTOR®’s Peers** may be hurt by bad publicity towards the firm.
- **The Real Estate Industry** may suffer because the REALTOR®’s actions were unprofessional and reflect poorly on the industry in general.

4. What resources (persons or written) may be useful in reaching a decision on this case?

Write your answer in the space provided and then check the answer on the next page.
Resources that may prove useful in reaching a meaningful decision about this case:

- An appraiser
- California real estate laws
- The NAR® Code of Ethics
- An attorney in California
- Real Estate publications that may contain comments on similar cases.

5. Applying the *end results approach* to this case, what decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
By applying the *end results approach* to this case, you might reach the following decision:

In order to make the most people happy in this situation and after consulting with his broker, the REALTOR® may decide to withdraw his demand for a commission and offer, at no charge (no referral commission), to refer the Seller to a reputable firm to handle the sale of the oceanfront property. This would save the Seller the expense and inconvenience of having to hire an attorney in California and should result in a sale at fair market value. If the Seller agrees to this solution, then the REALTOR® may not have to face a lawsuit, a complaint to the state regulatory board and a complaint to the local association.

6. Applying the *rules and law approach*, what decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
By applying the rules and law approach, you might reach the following decision:

Since it appears that Rex attempted to place his interests above those of his client, he would be in violation of the principles of agency law by breaching his fiduciary duty of loyalty to the client. The consequence for such a breach varies from state to state, according to state law. The Seller would have the right to pursue appropriate penalties under the agency laws and/or real estate license laws of California. The REALTOR® would also be in violation of any state law that may require that the agent inform a seller of fair market value before listing a property and/or making an offer on a property.

7. Applying the social contract approach and using the NAR® Code of Ethics for your “social contract,” what Article(s) have been violated, if any? What decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
What Article(s) have been violated?

The REALTOR® violated Article 1 of the NAR® Code of Ethics. The REALTOR®'s obligation was to protect and promote the interests of his client. When he became a principal in the transaction, he was pursuing his own interest, possibly at the expense of the client. He could not continue to act as the Seller's agent, except with full disclosure to the Seller and with the Seller's knowledgeable consent. The REALTOR®'s comment that the Seller had no choice but to view the REALTOR® as her agent and to compensate him, even though the REALTOR® had become a principal, was not accurate. The REALTOR®'s demand was not only unprofessional but acted as a clue to the Seller that there was a lack of disclosure.

8. Applying the personal conscience approach, what might be the resulting decision? Write your answer in the space provided and then check the answer on the next page.
By applying the personal conscience approach, the resulting decision could vary:

This approach depends on the REALTOR®’s conscience. The REALTOR® may feel that he did the right thing by offering to purchase the Seller’s property promptly. The REALTOR® knew that he had the capacity to purchase the property and there would be no impediments to a swift closing. A swift and hassle-free closing would be beneficial to the Seller. However, the REALTOR®, upon more reflection, might decide that it was wrong to try to purchase the property for less than market value, and he might make an offer to give the Seller the amount of the commission as an apology for his actions in addition to giving the Seller the names of three reputable area REALTORS® whom the Seller could interview by phone and from which the Seller could select an agent that would do a good job for her in selling the property.

9. From your application of the four approaches, what approach should be weighed most heavily in this case?
Write your answer in the space provided and then check the answer on the next page.
In this case the approach that should be weighed most heavily will vary:

The Seller was probably very angry with the REALTOR®'s reaction to the suggestion of an appraisal. Therefore, it might be a good idea for the REALTOR®'s broker to try to contact the Seller and negotiate with her for a private settlement and/or suggest mediation as a way to remedy the dispute. This would save everyone the expense and inconvenience of going to court.

CASE STUDY 4-3

A broker always made a point of following her checklist when filling out property data sheets, as she did when evaluating the Seller’s house. As she studied each room in the house meticulously, she noticed that there were hardwood floors in the game room where every other room had carpeting. When the Broker asked the Seller if there was hardwood flooring under the wall-to-wall carpeting throughout the house, the Seller hesitated before finally answering yes. The Broker made note of this and included “hardwood flooring” on the property data form.

Weeks later she received a call from the new owner. He told the Broker that he had bought the house under the impression that there were hardwood floors throughout, yet when he removed the carpeting in the bedrooms and living room all he found was plywood sub-flooring. Despite her disappointment, the Broker realized that the new owner had every right to be angry.

1. What facts are presented in this case study?
Write your answer in the space provided and then check the answer on the next page.
Facts presented in case study 4-3:

- The Broker followed her standard listing procedure of filling out a property data sheet on the home she listed.
- The Broker was observant that the room without carpet had hardwood floors.
- The Broker asked the Seller if there were hardwood floors under the carpeted floors in the other rooms.
- The Seller hesitated before answering the Broker’s question affirmatively about hardwood floors.
- The new owner purchased the home.
- The new owner discovered that there was not hardwood flooring under the carpet.
- The new owner was angry when he discovered that the carpeted rooms had plywood sub-flooring rather than hardwood flooring under the carpet.

2. What assumptions apply to this case study?
Write your answer in the space provided and then check the answer on the next page.
Assumptions that apply to case study 4-3:

- The Broker assumed the Seller was being truthful.
- The Buyer assumed that the property condition disclosure was accurate.
- Possibly, the Seller assumed that it was okay to embellish the truth.
- Possibly, the Seller did not know what was under the carpet and hardwood flooring sounded reasonable; therefore, she confirmed that there was hardwood flooring underneath the carpet.
- The Seller might have hesitated in trying to recall what was in fact under the carpet, and then, innocently, failed to remember what type of flooring under the carpet actually was.

3. Name the persons and/or groups affected by a decision made on this case?
Write your answer in the space provided and then check the answer on the next page.
Persons and/or groups affected by the decisions made in case study 4-3:

- The **Broker** could be affected because her reputation could suffer if she was found guilty of any wrongdoing. Also, if found guilty of violating the NAR® Code of Ethics, she could suffer disciplinary action from the Professional Standards Hearing Panel of the local board. Additionally, if found guilty of violating the license law of her state, she could lose her license or suffer other penalties.
- The **Buyer** could suffer monetarily if he has to pay for new flooring rather than the cost of refinishing the existing hardwood flooring that the house was represented to have.
- The **Seller** may suffer for the cost of new hardwood flooring and any attorney’s fees and/or court costs associated with a claim in this case.
- The **Real Estate Industry** could be affected if the Buyer remains uncompensated and tells all of his friends and associates about his bad experience.

4. What resources (persons or written) may be useful in reaching a decision on this case?

Write your answer in the space provided and then check the answer on the next page.
Resources that may prove useful in reaching a decision in this case:

- NAR® Code of Ethics
- The real estate firm’s attorney
- State law on property disclosure
- Real Estate publications containing comments on similar cases

5. Applying the end-results approach to this case, what decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
By applying the *end-results approach* to this case, you might reach the following decision:

If the Seller made a good profit on the sale of the house, and if the Seller has not reinvested the money in another home, then the Seller is a source of money for the misrepresentation made regarding the hardwood flooring. If the Seller is feeling guilty, it might be possible to talk her into reimbursing the Buyer for the difference between the cost of refinishing the (nonexistent) hardwood flooring, which the Buyer seemed willing to expend, and the cost of installing new hardwood floors in the rooms that had carpeting. This would make everyone, but the Seller, happy.

6. **Applying the rules and law approach, what decision might you reach?**
Write your answer in the space provided and then check the answer on the next page.
By applying the rules and law approach, you might reach the following decision:

The answer to this would depend on state law, common law, and court precedents in terms of the legal interpretation of responsibility for property condition foreclosure. A factor against the Broker is that she completed the property data sheet that detailed the property condition. If the Seller, in her own handwriting, had completed a Seller’s Disclosure Form that included a notation of hardwood floors under the carpeting, then the responsibility might be more clearly linked to her, unless the Broker “coached” the Seller on the form. It is possible that some state law requires that the broker verify and/or substantiate the information given by the seller. State law may not allow a buyer’s agent to rely on a seller’s or seller’s agent’s information and require that the buyer’s agent verify and/or substantiate the information.

7. Applying the social contract approach and using the NAR® Code of Ethics for your “social contract,” what Article(s) have been violated, if any? What decision might you reach?
Write your answer in the space provided and then check the answer on the next page.
What Article(s) have been violated?

One might review Article 2 of the NAR® Code of Ethics, but it appears that neither Article 2 nor any other Article was violated. The Broker accurately conveyed to the buyer information given to her by the Seller. There was no reason to believe that hardwood floors were not present, according to what the Seller had stated. This case makes clear that the REALTOR® has a right to rely on the representations of the Seller unless there is reason to believe that the Seller’s information is inaccurate. The Seller’s hesitation in answering the hardwood-flooring question is probably not enough, in and of itself, to cause the Broker to believe the Seller’s statement to be false.

8. Applying the personal conscience approach, what might be the resulting decision?
Write your answer in the space provided and then check the answer on the next page.
By applying the *personal conscience approach*, the resulting decision might be the following:

The Broker may feel personally responsible since she noticed the Seller’s hesitation in answering the question regarding the hardwood flooring and because the Broker did not ask further questions to discover the reason for the Seller’s hesitation. The Broker also did not pull back the carpeting in a corner, as she could have done, to verify the type of flooring beneath the carpet. If the Broker felt that she was responsible in some way, she might offer to split with the Seller the cost of installing hardwood flooring for the Buyer.

9. From your application of the four approaches, what approach should be weighed most heavily in this case? 
Write your answer in the space provided and then check the answer on the next page.
The approach that should be weighed most heavily in this case would vary:

Of course the answer to this question will vary from person to person and from state to state depending on the property disclosure laws of the state. A critical issue is whether or not the Seller was intentionally misrepresenting the flooring material. It is important that all sellers are encouraged to disclose all property condition accurately to avoid these types of disputes. If there is an undisclosed problem with a property condition, in all probability the buyer will discover it either before or after the transaction closes, and there will be consequences to the seller and possibly to the broker for failing to disclose the property condition known by the seller.

10. What might be an appropriate decision for this case study? Is the Seller at fault? Is the Broker?
Write your answer in the space provided and then check the answer on the next page.
Given the circumstances, who is likely at fault in this instance?

The selection of an appropriate decision will vary from person to person and state to state and would probably somewhat depend on the Seller's situation. If it could be determined that the Seller knowingly lied about the flooring, then the Seller is probably responsible to the Buyer for all the monetary damages suffered by the Buyer concerning the flooring. If the Seller did not make any profit on the sale of the property, recovering monetary damages from the Seller might be difficult. If the Seller did not intentionally lie, but simply thought she was telling the truth by agreeing with the “knowledgeable” Broker about the flooring, then the Broker and the Seller may share the burden of responsibility. In any case, mediation may be the first step in resolving this situation.

CASE STUDY 4-4

A Seller is unhappy with his present experience in trying to sell his house. REALTOR® Able doesn’t seem to be working very hard to represent his needs; since agreeing to a 90 day exclusive contract with the REALTOR®, the property has only been shown four times during the preceding two and a half months. With the Seller ready to move into a new house, he certainly does not need this headache on his hands. With REALTOR® Able’s time almost up, the Seller wants to find another REALTOR® who will better serve his needs.

The Seller is told about REALTOR® Bene and gives her a call. He tells Bene about REALTOR® Able’s ineptitude, prompting her to inquire about when his listing expires. She decides to contact Able herself, which results in many phone messages and e-mails before he finally responds with a curt and unprofessional response, still refusing to discuss the terms of his business relationship with the Seller. REALTOR® Bene informs him that she can easily get the information from the Seller, but REALTOR® Able still does not budge.

After meeting with the Seller, REALTOR® Bene happily agrees to assume the role of agent when Able’s listing expires. Consequently, some four weeks later, the house is sold.

1. What facts are presented in this case study?
Write your answer in the space provided and then check the answer on the next page.
Facts presented in case study 4-4:

- The Seller signed a 90-day listing agreement with REALTOR® Able to sell his home.
- During the listing agreement with REALTOR® Able, the home was only shown four times, and there are only two weeks left in the listing term.
- The Seller is not happy with his current REALTOR®.
- The Seller has purchased another home and wants to be rid of the headache of additionally owning his current home.
- The Seller wants a REALTOR® who will be more responsive to his needs.
- The Seller contacts REALTOR® Bene and tells her about his experience with REALTOR® Able.
- REALTOR® Bene is finally successful in contacting REALTOR® Albe and asks about his business relationship with the Seller.
- REALTOR® Able refuses to answer any questions about the listing agreement.
- REALTOR® Bene informs REALTOR® Able that she can easily get the information from the Seller.
- REALTOR® Bene meets with the Seller and agrees to list the property as soon as his current listing with REALTOR® Able expires.
- REALTOR® Bene lists the property right after the Seller’s agreement with REALTOR® Able expires.
- Four weeks after REALTOR® Bene lists the property the house is sold.

2. What assumptions apply to this case study?
Write your answer in the space provided and then check the answer on the next page.
Facts presented in case study 4-4:
- REALTOR® Able was not communicating well with the Seller regarding his efforts to sell the property.
- Perhaps REALTOR® Able had not made much effort to market the Seller's property.
- REALTOR® Bene did not initiate the contact with the Seller. Rather, the Seller contacted her because he was unhappy with Able’s performance.

3. Name the persons and/or groups affected by the decision made in this case?
Facts presented in case study 4-4:
- The **Seller**, who wants good service from a listing broker, may be affected by any decision because he initiated contact with REALTOR® Bene while having an existing listing agreement with REALTOR® Able.
- REALTOR® Able is affected because he might have been able to sell the property if he had been asked to renew the listing agreement.
- REALTOR® Bene is affected and receives a commission for actually selling the property.
- The **General Public** may suffer if individuals had no right to contact another agent when unhappy with a current broker.
- The **Real Estate Industry** would be adversely affected if the public felt they had no recourse against a lazy broker.

4. What resources (persons or written) may be useful in reaching a decision on this case?
Facts presented in case study 4-4:
- NAR® Code of Ethics
- REALTOR® Bene’s broker
- REALTOR® Able’s broker
- State law on agency and/or state law regarding contact with a seller while under an existing employment contract with another broker
- Real Estate publications that may contain comments on similar cases

5. Applying the *end results approach* to this case, what decision might you reach?
Facts presented in case study 4-4:
REALTOR® Able is the only person unhappy with REALTOR® Bene getting the listing and selling the house. Therefore, using this approach, there should be no action taken against the Seller or REALTOR® Bene.

6. Applying the *rules and law approach*, what decision might you reach?
Facts presented in case study 4-4:
There may be some states that have laws that do not allow the type of seller contact and/or discussion that REALTOR® Bene conducted. Please check state law before conducting the activities described in this case study.

7. Applying the social contract approach and using the NAR® Code of Ethics for your “social contract,” what Article(s) have been violated, if any? What decision might you reach?
Facts presented in case study 4-4:
Article 16 is the article that applies to this case. The key Standard of Practice is Article 16-4. This Standard of Practice sets out the correct procedure in this situation and shows REALTOR® Bene not in violation of the Code. She followed the exact procedure required by Standard of Practice 16-4. She first contacted REALTOR® Able to determine the nature and expiration date of the listing. When he refused to give her the information, she then contacted the Seller to secure it. REALTOR® Bene’s obligation was to first contact REALTOR® Able to secure information about the nature and expiration date of the listing. She fulfilled that obligation in this case.

REALTOR® Able did not violate the Code. He had a choice; he could disclose or not disclose the information concerning the listing to REALTOR® Bene. Once REALTOR® Able chose not to disclose the information, REALTOR® Bene was free to go directly to the Seller, obtain the information and discuss the terms of a future listing as well as enter into an agreement that would become effective upon expiration of the current listing. REALTOR® Able had no obligation to disclose the information; however, the consequence of not disclosing the information is that REALTOR® Bene had a right to contact the Seller directly to secure it.

Questions may arise regarding the ability to discuss a listing if the client contacts the REALTOR® directly. This is covered by Standard of Practice 16-6, which allows the REALTOR® to discuss listing a property currently listed with another broker if the client initiates the discussion, and the REALTOR® has not directly or indirectly initiated such discussion.

8. Applying the personal conscience approach, what might be the resulting decision?
Facts presented in case study 4-4:
Since this approach is an individual one, it is hard to determine a definitive answer. However, since most people agree that the responsibility of an agent is to serve the public in matters related to real estate, it is hard to fault REALTOR® Bene. She did not initiate contact with the Seller. If the Seller had perceived that REALTOR® Able was doing a good job, he would probably have renewed his listing agreement with him. However, since he did not believe that Able was doing a good job of serving his interests, he contacted REALTOR® Bene who successfully sold his home. Therefore, most people would conclude that Bene acted appropriately.

9. From your application of the four approaches, what approach should be weighed most heavily in this case?
Facts presented in case study 4-4:
Unless there is a state law preventing the actions by REALTOR® Bene, all approaches seem to indicate that she acted appropriately.

10. What might be an appropriate decision for this case study? Did REALTOR® Bene behave appropriately?
Facts presented in case study 4-4:
Yes, she did act appropriately, unless she otherwise violated a law within her state.

CASE STUDY 4-5

A Listing Broker, Hedge, published an offer of cooperation and compensation in the MLS for one of her listings, with a list price of $200,000 and an offer of compensation at X%. Broker Apt, struck by the X% compensation for such a high-priced property, showed the property and assisted a Buyer in writing an offer on the property. However, when Broker Apt delivered the offer to the Listing Broker, she informed him that in order to keep the Seller happy, she had to reduce the commission, which in turn lowered the value of Broker Apt’s co-op fee by 1%. Needless to say, he was not pleased.

1. What facts are presented in this case study?
Facts presented in case study 4-5:
- The Listing Broker published a commission offer to cooperating brokers in the MLS.
- The list price of the property was $200,000.
- Broker Apt showed the property to the Buyer.
- When Broker Apt brought the Listing Broker the offer from the Buyer, Hedge informed Apt that the overall commission had been lowered and consequently the commission that would be paid to him had been lowered by 1%.

2. What assumptions apply to this case study?
Facts presented in case study 4-5:

- Agent Apt appears to have been attracted to showing the listing because of the commission being offered through the Listing Broker’s company.
- The intent of the Listing Agent advertising an attractive commission in the MLS was to attract more brokers to show the property.
- The Listing Agent could have changed the commission to the cooperating broker in the MLS computer as soon as the change of the total commission had occurred.
- It seems doubtful that the Listing Agent changed the commission in the MLS computer as soon as the change in commission occurred.
- Usually during the preparation of an offer, there is communication between the listing broker and the broker working with the buyer. If this communication did occur, the Listing Broker could have communicated the change in commission prior to Broker Apt’s presenting an offer.
- If Broker Apt is representing the Buyer, he should be placing the Buyer’s interests above his personal interests, and the amount of commission being paid to Broker Apt should not be a deciding factor in what he decides to show the Buyer.
- If Broker Apt is a cooperating broker, then the commission paid to him should not in any way jeopardize this transaction and the dispute should be taken up with the Listing Broker and her company as an issue separate from the Seller being able to sell the home to the Buyer.
- If Broker Apt works exclusively with the Buyer, then the commission paid him should not in any way jeopardize this transaction, and the dispute should be taken up with the Listing Agent and her company as an issue separate from the Buyer being able to purchase the home that she wants.
- Although the transaction itself could give Broker Apt leverage to collect the commission that the Listing Broker advertised, his agency duties to either the Buyer or the Seller prevent him from jeopardizing the transaction to assure that he collects his commission.

3. Name the persons and/or groups affected by the decision made in this case?
Facts presented in case study 4-5:

- The **Listing Broker** could have to give up some of her personal commission if she did not change the commission offer to cooperating brokers in a timely manner.
- **Broker Apt** might lose 1% of the commission as advertised for the cooperating broker.
- If Broker Apt uses the transaction as leverage to collect the full commission that the Listing Broker advertised, the **Buyer** might lose the opportunity to purchase the home.
- If Broker Apt uses the transaction as leverage to collect the full commission that the Listing Broker advertised, the **Seller** may suffer if the transaction does not close because of the controversy.
- The **Real Estate Industry** may suffer. If brokers begin spending their energy worrying whether or not they will get compensated as advertised in the MLS, it might take away from energy that they could spend concentrating on their duties to buyers and sellers.

4. What resources (persons or written) may be useful in reaching a decision in this case?
Facts presented in case study 4-5:
- NAR® Code of Ethics
- The Listing Broker’s Broker
- Broker Apt’s broker
- State law, if any, regarding representation of and communication of compensation by one broker to a cooperating broker and/or false advertising
- Real estate publications that may contain comments on similar cases

5. Applying the *End-Results Approach* to this case, what decision might you reach?
Facts presented in case study 4-5:
The end result goal is to close the transaction and make sure that brokers are paid appropriately. In order to accomplish this goal, Broker Apt should not do anything to jeopardize the closing of the transaction and should take action against the Listing Broker and her company as a separate issue from closing the transaction.

6. Applying the *Rules and Law approach*, what decision might you reach?
Facts presented in case study 4-5:
As long as the agency duties are fulfilled, there may not be any state law that addresses the issue of how brokers compensate cooperating brokers. However, the Listing Broker could be accused of false advertising and that is illegal in many states; each state’s laws concerning this issue should be checked.

7. Applying the Social Contract Approach and using the NAR® Code of Ethics for your “social contract,” what Article(s) have been violated, if any? What decision might you reach?
Facts presented in case study 4-5:
The analysis of this case is based on Article 3; however, it should be noted that it is further explained in Standard of Practice 3-2, which requires the timely communication of any change in an offer of compensation before an offer to purchase is produced by the other REALTOR®.

The Listing Broker is in violation of Article 3 as interpreted by Standard of Practice 3-2, but bear in mind that the violation is of the Article and not of the Standard of Practice. The Listing Broker should have communicated the change to the offer of compensation before Broker Apt produced the offer to purchase. If this were an MLS listing, the Listing Broker could have changed the offer of compensation in the MLS computer before Apt produced the offer to purchase.

If Apt files an arbitration claim against Hedge for the 1% difference, the arbitration panel will likely rule in Apt's favor provided that he can prove that the offer of compensation in the MLS was X% on the day the offer to purchase was produced. To prove the offer of compensation was X%, he should print a copy of the MLS data sheet on the day the offer to purchase was produced.

8. Applying the Personal Conscience Approach, what might be the resulting decision?
Facts presented in case study 4-5:
It is difficult to know how the personal conscience of the Listing Broker or Broker Apt might contribute to this analysis, but here are some possibilities. The Listing Broker may feel as though she should have communicated the change in commission in a timely manner and may offer to pay Apt the 1% out of her own commission or get her broker to help her pay him the 1%. On the other hand, Hedge may believe that Apt is too greedy and that he should be happy with the reduced commission.

Broker Apt may believe that he deserves the commission as advertised because he showed the home in good faith at the advertised commission and because the change in commission was not communicated in a timely manner. On the other hand, he may not feel that it is worth the hassle of pursuing the matter and that he could use his energies more productively by working with other buyers and sellers.

9. From your application of the four approaches, what approach should be weighed most heavily in this case?
Facts presented in case study 4-5:
The Social Contract Approach would probably be most appropriate in this case. With this approach, the transaction would close as scheduled, making the buyer and seller happy. If Broker Apt is a REALTOR®, he is required to arbitrate commission disputes first. He should file a request for arbitration with the local board or Association of REALTORS®. The arbitration request will be reviewed by the Grievance Committee, and if found to have merit, the matter will be arbitrated by the Professional Standards Hearing Panel. Hedge might learn a lesson, and Apt may get the rest of his commission.

10. What might be an appropriate decision for this case study?
Facts presented in case study 4-5:
An appropriate decision may be for Broker Apt to file a request for arbitration with the local board or Association of REALTORS®.

SUMMARY

This lesson uses the model for ethical decision-making to help the student better understand the steps required in formulating an ethical resolution to a problem. Given these case studies, this lesson illustrates, step-by-step, the process of breaking down each scenario according to the decision-making model. First, the problem must be identified; the problem includes facts, assumptions, affected persons and resources. Second, each ethical approach must be applied, which leads to making a final decision and evaluating that decision. This model shows resolutions from each ethical approach, thus allowing the student to become more informed as to various possible outcomes and decisions that may be made as well as showing the student how to use the model effectively.

Return to your on-line course player to take the Lesson Quiz.
LESSON FIVE
BASICS OF PROFESSIONAL STANDARDS
ENFORCEMENT PROCESS THROUGH THE
LOCAL REALTOR® BOARD OR ASSOCIATION

This lesson focuses on the following topics:

- Ethics Complaints
- Arbitration
- Mediation

INTRODUCTION

There are two basic types of cases that may be heard through the local board or association. Since local boards and associations have a duty to enforce the NAR® Code of Ethics, the first type of case deals with issues of ethics in relation to possible violations to the NAR® Code. The second type of case is a request for arbitration related to a money dispute between two REALTORS® usually from different firms.

ETHICS COMPLAINTS

Anyone may file an ethics complaint. In other words, a buyer, seller, REALTOR® (member of NAR®) or a member of the general public may contact the board or association and complete the required paperwork to file an ethics complaint. The first issue to be decided is whether or not there is a possible violation of the Code. The Grievance Committee, which acts as a screening committee for complaints, makes this decision. The members of the Grievance Committee are appointed, and it is their duty to decide whether or not there has been a possible violation of the NAR® Code of Ethics assuming initially that the allegations given in the complaint are true as stated. If the Grievance Committee agrees that there may have been a violation of the NAR® Code, then they recommend the case to the Professional Standards Hearing Panel.

The Professional Standards Hearing Panel is comprised of members of the Professional Standards Committee, and their function is to provide “due process” by hearing sworn testimony, witnesses, and evidence. After conducting the hearing, the Panel decides if clear, strong, and convincing evidence has been presented to prove the allegation of a violation of the NAR® Code. If they agree that the Code of Ethics has been violated, then it is the Hearing Panels duty to impose a sanction on the violator (respondent). The Panel’s authority is limited to selecting penalties from the list of disciplinary actions. The last item on the list may only be imposed if it is imposed on all cases where a violation is found.
The potential disciplinary actions are:

- Letter of Warning
- Letter of Reprimand
- Education
- Fine not to Exceed $2,500
- Probation for one year or less
- Suspension from board membership for not less than 30 days nor for more than a year
- Expulsion from board membership for a period of one to three years
- Suspension or termination of MLS privileges.
- Administrative processing fee (if found in violation) not to exceed $500 ("Court Costs")

**ARBITRATION**

The Arbitration Process begins with a request for arbitration that is reviewed by the Grievance Committee to determine whether or not the matter is arbitrable. In other words, the Grievance Committee screens arbitration requests and decides if there is some basis for which a money award could be granted if the allegation in the arbitration request is found true.

Using Article 17 of the Code of Ethics and the state arbitration statute (if any), arbitration is conducted by the Professional Standards Hearing Panel (consists of members of the Professional Standard Committee). If a money award is awarded to a party in the dispute and the money is not paid voluntarily, the arbitration award can be taken to court and enforced through judicial processes.

Another approach is for the Board to adopt a procedure whereby the potential monetary award (usually the amount of the commission) would be collected prior to the beginning of the arbitration process. The money would be deposited and held by the Board during the arbitration hearing and possible legal challenges that may follow the arbitration hearing.

**MEDIATION**

As of January 1, 2002, mediation is a voluntary dispute resolution process that is to be offered by local boards and associations. In this type of mediation, the local board or association appoints a mediator who assists the disputing parties to come to a mutually acceptable resolution of the dispute. This process is an alternative to having the Arbitration Hearing Panel impose a decision to resolve the dispute. The local board or association establishes a policy as to when mediation can occur, but it generally occurs prior to or after the Grievance
Committee reviews the allegations. In order to resolve a dispute using mediation, the parties must come to an agreement, spell out the agreement in writing and then the parties must sign the agreement. If the dispute is settled by mediation, then no arbitration hearing will be held.

**SUMMARY**

Local real estate boards and associations handle two specific types of cases, those concerning violations of the NAR® Code of Ethics and those dealing with arbitration (related to money disputes). If an agent feels that another agent is in violation of the Code, then he or she must address this violation in front of the Grievance Committee, who then decides if an infringement has occurred. Arbitration also begins with the Grievance Committee, who then decides if there is a basis for a monetary award. On the other hand, mediation acts as an alternative to arbitration; this is a voluntary dispute resolution process where a mediator is appointed in order to help the disputing parties come to an acceptable resolution.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON SIX
MORE RISK MANAGEMENT IN ACTION TO IMPROVE BUSINESS

This lesson focuses on the following topics:

- Unethical Conduct
- Antitrust Laws and Violations
- Ethical and Professional Business Practices
- Ethics Summary

INTRODUCTION

Despite the standards and guidelines that the NAR® Code of Ethics sets for REALTORS® to adhere to, there are still possible situations where a REALTOR® or firm acts unethically. This lesson covers the different types of unethical conduct, which includes intentional fraud, negligent misrepresentation and negligence. Firms can act unethically by violating antitrust laws by participating in group boycotts, price fixing and market allocation. REALTORS® must at all times adhere to a strict code of ethics, which instructs them to be knowledgeable and well-informed concerning the laws and procedures governing the real estate industry in order to provide the best service possible to their clients and customers.

UNETHICAL CONDUCT

Here are some examples of unethical conduct in real estate:

- Intentional fraud
- Negligent misrepresentation
- Negligence

INTENTIONAL FRAUD

*Intentional fraud* generally includes both affirmative misrepresentations and affirmative concealment, when the person making the misrepresentation is aware of the true facts. A real estate agent, who willfully deceives another person with intent to induce him to alter his position to his injury or risk, is liable for any damages that he thereby suffers.

Any of the following points constitutes intentional fraud:

- The suggestion that something is a fact, when it is not true, by someone who does not believe it is true.
The assertion that is something is a fact, when it is not true, by someone who has grounds to believe that it is untrue.

The suppression of a fact, by one who is bound to disclose it, or who gives information of other facts which are likely to mislead for want of communication of the fact.

A promise made without any intent of performing it.

**Elrich v. Menezes (Cal. 1999)**

The Elrich family purchased a home from the builder, Mr. Menezes. The home was to be the Elrich family “dream” home, but instead became a nightmare. After moving in, the Elrich family discovered numerous defects and serious structural errors that Mr. Menezes did not inform them about. None of the 20 load-bearing walls were installed correctly, within months the roof had begun to collapse, three decks were in danger of "catastrophic collapse," and a foundation required to support 12,000 pounds could only support about 2,000 pounds. In addition, the house leaked from “every conceivable location.” The Elrich family was able to successfully sue for fraud and misrepresentation.

**NEGLIGENT MISREPRESENTATION**

_Negligent misrepresentation_ generally means an affirmative statement that is not true is made by a person who did not know that the statement was false, but who either had no reasonable basis for believing its truth, or who should have known of its falsity, due to some other duty to investigate.

**Easton v. Strassburger (Cal. 1984)**

Easton, the plaintiff, purchased a single-family residence from Strassburger for $170,000 in 1976. Valley Realty (hereafter, Valley) was the listing broker in the transaction. Three years prior to the sale to Easton, there had been two landslides on the property. Strassburger had taken corrective action to prevent further subsidence of the soil but did not inform Valley of the soil problems nor of the corrective action taken. Valley's agents inspected the property several times during the listing period, and according to the appellate court, there was evidence that Valley's agents "were aware of certain 'red flags' which should have indicated to them that there were soils problems." Earth movements and landslides that occurred soon after Easton occupied the property virtually destroyed the property value. Easton filed suit against Strassburger, Valley and others. He successfully found Valley guilty of negligent misrepresentation.

**NEGLIGENCE**

_Negligence_ generally means failing to perform some duty that a person is required to perform under the law, or failing to perform such a duty in accordance with industry standards.
Padgett v. Pharett (Cal. 1997)

In 1991, the Padgett family entered into a real estate contract with Stone Point development for $207,500. The standard real estate contract specified the sellers were to provide copies of the governing documents of the development and its homeowners' association, the Stone Point-Sweetwater Homeowners' Association, to the buyers. These documents included the covenants, conditions and restrictions (CC&R's), bylaws, and financial data. Sellers were also required to disclose, in writing, any known pending litigation affecting the property. Despite this, the buyers’ and sellers’ real estate agents and brokers failed to disclose to the defendants that there was a pending lawsuit between the development’s homeowners’ association and the developer concerning alleged construction defects in the common areas of the property. Thus, the Padgetts were able to successfully sue for negligence against their real estate brokers and the sellers’ real estate brokers.

ANTITRUST LAWS AND VIOLATIONS

Antitrust laws preserve free enterprise by making private conspiracies to minimize competition illegal. In antitrust law, it is important to distinguish between a single firm and a group of competitors; an otherwise legal activity may be illegal if other competing firms join the activity. Even though many sales agents operate as independent contractors under their broker, for purposes of the antitrust laws, a real estate brokerage firm is usually considered one entity. Price fixing, boycotting, market allocation and tying arrangements are common violations of antitrust laws.

PRICE FIXING

*Price fixing* is a typical example of the individual versus group distinction. An individual firm may certainly set the prices it charges its clients. However, once that same firm agrees with a competing firm to set the same prices, the activity becomes illegal under antitrust laws.

Price agreements between brokers are another issue. An agreement between competing real estate brokers to fix the prices each will charge a third party violates state and federal antitrust laws; the prohibition is not limited to the commission to be charged sellers. Depending on the circumstances, it could include splits to be offered to cooperating brokers or it could include referral fees to be paid. Pricing decisions should be made individually or within the firm.

GROUP BOYCOTTS

An illegal group boycott may occur when competitors collectively exert pressure for the purpose of eliminating competition by refusing to deal with or by
withholding services from another firm. Again, there is a distinction between
group and individual action. The antitrust laws prohibit the collective action.
Although each individual office has a legal right to choose its clients and
business associates, decisions not to buy from or sell to individuals should not be
made lightly. Aside from concerns about discrimination or other improper
motives, real estate firms must also take into account their fiduciary
responsibilities to clients. Is refusing to deal with a competing firm in the best
interest of the client? Has this been discussed with the client? In almost every
case, the brokers will find that dealing with all brokerage firms on an equal basis
will benefit their clients.

Antitrust laws, for instance, prohibit a group of brokers from collectively deciding
not to deal with a third party to eliminate competition. This is especially true if the
group of boycotting brokers is attempting to put competitive pressure on a broker
to increase prices or curtail an aggressive marketing plan.

**MARKET ALLOCATION**

Antitrust laws prohibit competing firms from dividing their markets to insulate
themselves from each other's competition. For example, one real estate firm
may not agree with another real estate firm's decision not to list or sell property in
each other's areas; such agreements restrict open competition. Firms should be
free to list and sell real property in any area they so wish; therefore, brokers
should sell their services on their own merits rather than on the basis of a
pre-determined agreement with competing firms.

Many offices are familiar with the term *farming*, whereby an office assigns
different sales associates to intensively market in certain areas. Typical farming
practices are acceptable as long as the division is made within a firm and not
between two different firms. Since the real estate firm is really one entity for
purposes of the antitrust laws, it may devise methods to cover a certain territory
for more effective marketing.

*Market allocation* is a little different when customers are divided among
competitors; it is illegal for competitors to divide or allocate the customers to
whom they sell. One firm should never agree with another firm to abstain from
servicing the other real estate firm's former client if approached by the client.

If a seller has an exclusive listing agreement with another broker, then such an
agreement should be respected. This means that no agent should interfere with
the existing contract or agency relationship by requesting the client to breach his
existing contract. Of course, agents should follow applicable MLS Rules or Code
of Ethics provisions when contacting a current client of another agent. However,
competing agents are not required to agree to "leave the client alone" after a
listing has expired and there is no legal obligation to any broker.
TYING ARRANGEMENTS

Under certain circumstances, it may be illegal to refuse to sell a product or service unless the customer decides to purchase another product or attain another service. The analysis of a tying arrangement may involve difficult factual questions such as whether the product is actually two (products) or packaged as one. Additionally, illegal tying arrangements involve a seller of the tying product (usually the more desired product or service), who has substantial or dominant market power in the tying product. This determination may involve a complicated economic analysis.

This means the buyer cannot receive the product he or she wants (the tying product) without first purchasing a different product (known as a positive tie) or by promising to not buy the tying product from another seller (known as a negative tie). In order for the tying arrangement to be illegal, the seller must have adequate economic power relating to the tying product in order to affect free competition for the tied product.

In the real estate industry, some courts have applied tying law to "list backs" where a sale of property is conditioned upon the agent obtaining the listing for a future sale.

Although it may appear that one could apply tying laws to many transactions where the seller insists on certain companies (such as title or escrow companies or specific lenders), this is not necessarily the case. As mentioned before, the seller has to have "market dominance," and therefore, this area would seem to be limited to larger developers. However, each case is subject to a rather difficult analysis as it pertains to this question.

ETHICAL AND PROFESSIONAL BUSINESS PRACTICES

REALTORS®’ DUTIES

The amount of information a REALTOR® may have varies at different states of the REALTOR®’s professional life. The REALTOR® should strive to:

- Become informed as rapidly and thoroughly as possible about laws, proposed legislation, government regulations, public policies, and current market conditions.
- Seek reliable information on matters that depend, in whole or in part, upon information or knowledge the REALTOR® may provide to clients and customers.
REALTORS® will find it difficult to advise clients and customers properly if they do not know the requirements and limitations imposed by laws upon a property or its owner. REALTORS® must provide accurate information, but they must refrain from the unauthorized practice of law. REALTORS® should avoid engaging in activities where they lack sufficient knowledge or when the activity is beyond the scope of their licensure.

It is important to admit the lack of pertinent knowledge and recommend that information be sought from those who are adequately informed. REALTORS® cannot be fully informed on all matters at all times, but must always be honest and forthright and should constantly increase their knowledge and expertise consistent with the reasonable expectations of clients and customers.

With so many issues affecting the practice of real estate and the rights of property owners, it is recommended that REALTORS® be informed and contribute responsibly to debate and decision as best they can.

**CRITICISM**

A REALTOR® is not precluded from responding to a request for an opinion as to a competitor's general business practices or a particular real estate transaction. If it is appropriate to respond, the REALTOR® should provide the opinion with strict professional integrity and courtesy (i.e., provide objective, reliable information in a professional manner). This requires careful language and analytical approach based on facts. REALTORS® can always refrain from comment if they so choose.

Uninvited criticism is counterproductive, impairs cooperative efforts, and diminishes the public's appreciation for the valuable services provided by REALTORS®.

Stress the value and merit of your own work rather than criticizing or making derogatory comments about the efforts of other REALTORS®.

**PARTICIPATION IN LAW ENFORCEMENT, REGULATIONS AND CODE OF ETHICS**

If the REALTOR® becomes aware of any damaging practice to the public that would discredit the real estate profession, the Preamble encourages the REALTOR® to bring such actions to the attention of the State Real Estate Commission.

Such reports should not be prompted by personal whim, preference or spite but should be a manifestation of respect for the law and the Code of Ethics. Reports should never be made for the purpose of stunting a competitor who provides new or different services. Any challenge to a competitor's practice must
be based solely upon an unbiased and disinterested analysis of the practice or service itself and whether it damages the public or brings discredit upon the real estate profession.

REALTORS® should be aware that they must arbitrate certain business disputes with other members rather than resorting to litigation. However, the obligation to arbitrate does not necessitate the need to report any potential violations of the law to the governmental agency charged with regulating the practices of brokers and salespeople in the state.

REALTORS® who have direct personal knowledge of conduct that may violate the Code of Ethics, involving misappropriation of client or customer funds or property, willful discrimination or fraud resulting in substantial economic harm, should bring such matters to the attention of the appropriate Board or Association of REALTORS®.

EXCLUSIVE REPRESENTATION

REALTORS® should urge the exclusive listing of property unless it is contrary to the best interest of the owner. This prevents dissension and misunderstanding, therefore assuring better service to owners and lessors.

The exclusive listing includes both exclusive right to sell and exclusive agency agreements, which benefit sellers and lessors since they establish a clear line of responsibility on the part of the seller or lessor and the listing broker. Listing brokers know they will not be paid unless they meet the specific terms and conditions of the listing; they realize that payment will be received if they perform accordingly. Sellers and lessors know they will incur an obligation to pay only one commission and are assured that property will be shown only to bona-fide, pre-qualified prospective buyers or tenants. Such certainties, established by the exclusive listing agreement, minimize dissension and misunderstanding and sellers and lessors are assured of the best efforts of listing brokers and cooperating brokers.

SHARING KNOWLEDGE AND EXPERIENCE

This concept encourages a high standard rarely established by business and professional groups. As a general rule, business competitors do not share the lessons of their experience with each other for the benefit of the public. Rather, such experience is zealously guarded lest it fall into the hands of competitors. But REALTORS®, although intensely competitive with each other, cooperate with each other in the best interest of clients and customers. In cooperative transactions, it is desirable that the combined professional abilities and talents (as well as the shared commitment to high standards of conduct) prevail. This cooperation benefits clients and customers.
Programs offered by the Boards provide opportunities to share information on: public policy, politics, and legislation affecting private ownership of real property and the practice of real estate technology to improve service and maintain competency, methods of financing real estate transactions, and the standards of professional conduct. They also provide opportunities to share information on better methods of selling, buying, leasing, managing, counseling, appraising, developing, and syndicating.

REALTORS® should share their knowledge and expertise with other REALTORS® for the benefit of their clients and customers.

If disagreements did not arise between members, then there would be little need for ethics or arbitration hearings. REALTORS® should strive to minimize the likelihood of disagreements through professional practice by adhering to the Code of Ethics, understanding and respecting the law and practicing general competence in all transactions undertaken. A REALTOR® cannot guarantee that disagreements will never arise, but should always seek to avoid even the appearance of impropriety.

Unfair advantage can be avoided through efforts of caring, consideration and communication. REALTORS® who care for the interests of every individual involved in a real estate transaction, and consider all points of view, are not apt to take any unfair advantage. Good relationships and good results in real estate matters are commensurate with good communication between principals, agents, and cooperating brokers.

The phrase "unfair advantage" is not intended to discourage aggressive competition. Rather, it is intended to discourage the misrepresentation of law or fact, misleading clients and customers with respect to the competence, honesty, or loyalty of other REALTORS®, resorting to technicalities to justify questionable actions and attempts to induce a breach of contract. Ultimately, unfairness works to the disadvantage of clients and customers since it limits their power of choice, exposes them to possible litigation and deprives them of the full benefits of an open and cooperative relationship.

**ADVANTAGES OF ADHERING TO THE NAR® CODE OF ETHICS**

The NAR® Code of Ethics is a code designed to establish a public and professional consensus against which the practice and conduct of REALTORS® and REALTOR-ASSOCIATE®S may be judged. It is designed to protect the public and also helps protect fellow agents from practices that are considered harmful to the industry.

There are many reasons why a real estate agent may want to be familiar with the professional conduct required by the NAR® Code of Ethics. Not only does adherence to a high level of professional conduct avoid legal exposure and
liability, it also increases the public’s awareness of real estate agents as professionals and results in better service to the real estate agent’s clients and customers. Decreasing legal liability exposure while increasing the level of professionalism and services offered to clients can result in a successful business for the real estate agent.

**ETHICS SUMMARY**

To be ethical is a daily struggle because there are many hard choices that each person faces in their professional and personal lives. This course has presented four approaches to ethics, a model for ethical decision-making, and introduced the NAR® Code of Ethics as the real estate industry’s ethical code. Hopefully, these tools will help you make good and well-reasoned choices in your business. Being ethical is an important part of a business plan. When clients and customers are treated in a professional and ethical manner, those clients and customers are much more likely to respond positively to your request for referral. In addition to referrals, your percentage of repeat business should be substantial if you follow up on past sales and if your clients believe that you treated them in an ethical and professional manner. Good ethics are the key to a long and successful real estate career.

**SUMMARY**

There are multiple forms of unethical conduct; however, some major ones include: intentional fraud, negligent misrepresentation and negligence. An agent has committed intentional fraud when he or she knowingly misrepresents or misinforms a client with information that the agent blatantly knows is untrue. Negligent misrepresentation occurs when an agent discloses information that he or she suspects is untrue but does not take the time to verify. An agent acts negligently when he or she fails to perform a duty that he or she is required to conduct under law.

Antitrust laws help protect the public from any unfair practices by entities conspiring to minimize competition. Price fixing, boycotting and market allocation are among the most common violations of antitrust laws.

In order for an agent to be successful in the real estate industry, he or she must be aware of the actions that need to be taken to ensure success. Agents need to be informed of the laws and guidelines that apply to the industry, as well as aligning closely to the Code of Ethics. Whenever possible, the agent should urge the client into an exclusive representation agreement because this establishes a fiduciary relationship between the client and agent, which without question identifies the responsibilities necessary of both parties.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON SEVEN
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Activity
- Insight into the Code of Ethics
- Field Applications of the Code of Ethics

INTRODUCTION

This module has covered many specifics over a relatively short period. To ensure a comprehensive understanding, we will integrate the information provided in the module through a series of comprehension questions and case studies. The first half of this lesson presents an activity and comprehensive questions and dilemmas. The second half presents brief case studies that illustrate principles and ideas presented in the module.

ACTIVITY

The following activity will test your comprehension of the material covered in this module by asking you to apply your knowledge of the information presented. Please identify which Article of the Code of Ethics is being violated in each scenario. Check your answers on the next page.

Imagine the following scenes to complete the activity.

1 A REALTOR® is seen pocketing money given him by a client, which in and of itself is not a violation of the Code of Ethics, unless the REALTOR® then makes the money his own by depositing it in his personal account. Which article would be violated in this case?

2 A REALTOR® is overheard denying services to a customer. He specifically states that he does not offer services to the handicapped. In this instance, what article has been violated?

3 Suppose a REALTOR® bad mouths a REALTOR® of another firm by making questionable and false accusations. What article has she violated?
INSIGHT INTO THE CODE OF ETHICS

Q: Why are antitrust laws important?

A: Antitrust laws protect free enterprise; they make price fixing, boycotting, market allocations and tying arrangements illegal in order to promote free and fair competition between firms. This serves to not only protect firms from illegal actions but also to protect consumers from corrupt firms. Antitrust laws make private conspiracies to minimize competition illegal.

Q: When does a tying arrangement become illegal?

A: A tying arrangement occurs when a buyer cannot receive the product that he or she wishes to buy without first buying a different product. This activity becomes illegal when the seller has substantial economic power relating to the tying product, which affects free competition for that product.

Q: Why should REALTORS® be informed on the current events and issues in their industry?

A: REALTORS® will find it hard to help clients and customers if they are not acquainted with the most current information, requirements and limitations imposed by their industry or by law. It is essential that REALTORS® be able to provide accurate and substantial information to clients. A lack of knowledge will hinder a REALTOR®’s relationship with his or her clients, and an exaggeration of the facts will expose the licensee to potential lawsuits.

Q: How is an exclusive listing agreement beneficial?

A: The REALTOR®, the seller and the buyer all benefit from the exclusive listing agreement, in that, it sets forth the terms and conditions of their relationships; any future complications arising may then be solved simply by referring back to the contract. This allows all parties to know their role in the relationship and eliminates any confusion as to compensation, deadlines, etc.

Q: How does knowing how to apply the various methods of ethical decision help a decision maker?
A: By understanding the different methods of ethical decision making, a decision maker can evaluate a decision from various points of view and pick a decision that will best benefit the parties involved in each case. The decision-maker can use the model to identify the facts, the assumptions and the resources involved in each case as well as to see how each decision affects each and every aspect of the model. The decision-maker can then make the appropriate decision, depending on which method yields the best outcome.

Q: Is a REALTOR® allowed to disclose confidential information given him by a client?

A: According to Standard Practice 1-9, a REALTOR® can withhold confidential information so long as this action does not violate any laws. However, a REALTOR® must disclose all information if the client gives consent of the disclosure, if there is a court order requiring the disclosure, if the information prevents a crime or if the information is needed to defend a REALTOR® or any associates accused of wrongful conduct.

FIELD APPLICATIONS OF THE CODE OF ETHICS

CASE STUDY ONE

REALTOR® A shows a property to three different buyers: Buyer A, Buyer B and Buyer C. All three prospective buyers like the property; however, Buyer A could not afford the listing price, Buyer B desires a home closer to an elementary school and Buyer C wants a home nearer his work. Upon hearing this, REALTOR® A discloses to each buyer that if he or she purchases the property from him and some additional services through him, he can reduce the price of the home. What Articles of the Code of Ethics does REALTOR® A violate in doing this, and how?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY ONE RESPONSE:
REALTORS® should never promise prospective buyers that purchasing a property or acquiring their services will, in any way, affect the sale of a property. Article 1, Standard Practice 1-4 specifically states, “REALTORS®, when seeking to become a buyer/tenant representative, shall not mislead buyers or tenants as to savings or other benefits that might be realized through use of the REALTOR®’s services.” This means that REALTORS® shouldn’t mislead a buyer into thinking that using his or her services will benefit the buyer beyond the normal scope.

According to Article 6 of the Code, REALTORS® must disclose any compensation or benefits they will receive as a result of the buyer’s purchase or usage of specific products or services. A REALTOR® can recommend these services, however, he or she cannot delude the customer into thinking that using these services or product will, in any way, affect the price of the sale or the services rendered by the REALTOR®.

CASE STUDY TWO

College Student Adam is looking for a one bedroom apartment and approaches REALTOR® A to help him find one that fits his needs. He explains to REALTOR® A that since he is a college student, he cannot afford to spend a lot for an apartment; however, the apartment needs to be close to campus. REALTOR® A thinks about Adam’s request and later explains to him that she does not render services to college students. Outraged at hearing this, Adam cites Article 10 of the Code of Ethics and accuses REALTOR® A of violating it. What is Article 10, and is Adam correct?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY TWO RESPONSE:

Article 10 of the Code addresses fair housing; a violation of fair housing laws also constitutes a violation of the Code of Ethics. According to Article 10, “REALTORS®, in their real estate employment practices, shall not discriminate against any person or persons on the basis of race, color, religion, sex, handicap, familial status, or national origin.” This means that REALTORS® cannot discriminate against a protected class, which includes color, religion, sex (gender), handicap, familial status or national origin; College Student Adam is incorrect because college students are not a protected class. However, if REALTOR® A were to say that she would not render services due to Adam’s marital status, then that would be violation of the Code because familial status is a protected class.

CASE STUDY THREE

For the last two years, REALTOR® Achilles has been aware of REALTOR® Bane’s unethical conduct. REALTOR® Bane has consistently violated multiple articles of the Code of Ethics, primarily Articles 1, 6, 11 and 16. Although, Achilles always meant to report the violations, he also felt that Bane deserved time to show improvement. The crux of the situation comes when, REALTOR® Crow files an ethics complaint against Bane after he violates Article 16 by trying to solicit Crow’s client (with whom she has a written, exclusive listing agreement). When called to appear in front of the board, Achilles claims that he can offer no material evidence of this, or former, violations. REALTOR® Crow explains to him that he does not have to have material evidence, but rather, could provide testimonials about Bane’s unethical conduct. Who is correct?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY THREE RESPONSE:
Article 14 of the Code of Ethics requires REALTORS® to cooperate with the board by disclosing all pertinent information and presenting relevant information before the board. By not cooperating, REALTORS® are disrupting the board’s investigation, which results in a violation of the Code. Although Achilles was not directly involved with Bane’s actions, he had witnessed the unethical conduct; therefore, he would serve as an appropriate witness to such actions and could provide a solid testimony. REALTORS® should always report violations of the Code to uphold the high standards of professionalism associated with NAR®.

CASE STUDY FOUR

Seller Axelroy decides to sell his home and lists it on the open market. REALTOR® Abelard and REALTOR® Brutus both want to attain an exclusive right-to-sell agreement with Axelroy, in order to assure themselves commissions. Abelard approaches Seller Axelroy and explains to him the benefits of having an exclusive right-to-sell agreement. Having an exclusive right-to-sell listing agreement will guarantee the seller extensive exposure of his property to other real estate professionals; therefore, under this type of agreement, although only one broker is actively listing the property, multiple brokers and salespeople are working for the seller. Seller Axelroy, upon hearing the advantages of an exclusive right-to-sell listing, agrees to contract with REALTOR® Abelard for 90 days. Two weeks later, REALTOR® Brutus contacts Axelroy and discovers that Abelard has already established an exclusive listing agreement with Axelroy. Brutus tries to persuade Axelroy to terminate his contract with Abelard because he believes that Abelard is incompetent and inexperienced. Seller Axelroy explains to Brutus that he cannot break his contract and contacts Abelard to describe to him Brutus’s unethical behavior. What should REALTOR® Abelard do?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY FOUR RESPONSE:
In this case, REALTOR® Brutus violated both Articles 15 and 16. Article 15 disallows REALTORS® from making false statements and assumptions about other REALTORS®, and Article 16 stresses the importance of not interfering with the relationships other REALTORS® have with their clients. Since REALTOR® Brutus is in violation of these Articles, REALTOR® Abelard should file an ethics complaint. If the Panel finds Brutus in violation of the Code, a number of actions can be taken against him. He could receive a letter of warning or reprimand, a fine, be suspended, placed on probation or lose his MLS privileges. REALTOR® Abelard was correct in filing an ethics complaint; by so doing, he is upholding the standards of the NAR® Code of Ethics.

CASE STUDY FIVE

Seller Azure contacts REALTOR® Ace and explains that he has a property in New Mexico that he needs to sell. He asks REALTOR® Ace if he can list the property for him and quote him a reasonable price for listing the property. REALTOR® Ace says that he will call Azure back as soon as he takes a look at the property to evaluate its value. After inspecting the property, Ace calls Azure back and says that he thinks $80,000 is a fair price for the 20 acres of land. Uninformed about land value and trusting of the REALTOR®’s opinion, Seller Azure agrees to the price. One week later, REALTOR® Ace contacts Azure and explains to him that he would like to purchase the property himself. Now, suddenly suspicious of REALTOR® Ace’s intention, what should Seller Azure do?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY FIVE RESPONSE:
Seller Azure cannot be sure that REALTOR® Ace didn’t quote him a low price just so he himself could later purchase the property. Most likely, Azure would have to get an appraiser to evaluate the value of the property. In this case, however, he can cite a violation of Article 4 of the NAR® Code of Ethics because REALTOR® Ace never initially disclosed his interest in the property until after he listed it at the price that he quoted. If Seller Ace has the property appraised, and the value is exceptionally more than REALTOR® Ace’s estimate, Azure should consider finding new representation, even if he has entered an exclusive listing agreement. REALTOR® Ace will most likely agree to terminate the relationship if it is discovered that his intentions were not in the best interest of the client, which is a violation of Article 1 of the Code. Ace will most likely try to avoid any litigation or ethics complaints by upholding the client’s wishes.

CASE STUDY SIX
REALTOR® Anvil and REALTOR® Byron both show Buyer Peach the same listing. REALTOR® Anvil showed Peach the property in March 2003, and REALTOR® Byron showed Peach the property a month later. After REALTOR® Byron showed the property, Peach decided to place an offer on the home. The seller quickly accepted the offer and sold the house to Peach. A few weeks later, REALTOR® Anvil discovers that a customer he had shown a property to decided to buy the property after a showing with REALTOR® Byron. REALTOR® Anvil asserts that because he is the procuring cause of the sale, and since he originally showed the listing, he has rights to the commission, not Byron. What action, if any, can REALTOR® Anvil take?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY SIX RESPONSE:
REALTOR® Anvil should NOT litigate this case. According to the Code of Ethics, a REALTOR® should submit the dispute to arbitration where the local board will review the case or settle the dispute through mediation. If either party has an exclusive listing agreement with the Seller, then whoever has the listing agreement will receive the bulk of the commission. However, if it was an open listing, then most likely, REALTOR® Byron will receive the commission because he will be seen as the cause of the sale. Although REALTOR® Anvil showed the property the first time, Buyer Peach declined to purchase the property at the time of his showing. Only after REALTOR® Byron showed Buyer A the property did the Buyer decide to place an offer on it. Thus, the board will review the facts of the case and examine evidence before making an informed decision concerning the outcome of the case.

CASE STUDY SEVEN
Seller Xavier contacts his friend, REALTOR® Yates and asks him to list a commercial property for him. REALTOR® Yates explains to Seller Xavier that his expertise is residential real estate, and he cannot adequately provide services to Xavier. Xavier is, however, adamant about REALTOR® Yates listing the property because he thinks Yates will do a good job. After getting the property evaluated by an appraiser, REALTOR® Yates lists the property at $250,000, and it sells within a week. REALTOR® Yates calls Seller Xavier with the good news, but Xavier does not sound too happy about the listing price. REALTOR® Yates explains to him that he had an appraiser look at the property and evaluate the property’s worth. After hearing the listing price for the property, Seller Xavier gets upset because he feels his property is worth more than that. Using the various methods of ethical decision-making, which decision will best benefit both parties in this case?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY SEVEN RESPONSE:
The end-results method lists each and every advantage and disadvantage to a decision and opts to make the most number of people happy. In this case, perhaps the best decision in the end would have been for REALTOR® Yates to pass the listing on to a commercial REALTOR® who would have been better equipped and experienced to handle such a listing; therefore, REALTOR® Yates will have been “happy” because he would not have exposed himself to any possible liabilities or lawsuits, and Seller Xavier would have had the quality of expertise that he so desired. However, since this did not happen, Seller Xavier will most likely have to mediate this issue with REALTOR® Yates in order to come to an agreeable resolution. However, since Yates did seek the help of a professional (a commercial property appraiser), he did not violate the Code of Ethics and did inform Xavier of all the facts before listing the property. Most likely, REALTOR® Yates will not be held accountable in this case.

The social contract method will require an evaluation of the Code of Ethics to see if any violations of the Code have occurred. Most likely, Seller Xavier will try to charge REALTOR® Yates with violating Article 11 of the Code of Ethics, which states that a REALTOR® should not offer services outside his range of expertise without first acquiring the aid of an expert in the field. Since REALTOR® Yates did not violate this Article, a decision using this method will be in the favor of the REALTOR®.

The decision resulting from the rules and law approach would depend on the laws of each state. For example, if the license law presumes that if you take the required education and pass the exam, you are competent to practice all types of real estate, then perhaps the REALTOR® has violated a law in taking a listing outside his expertise. The REALTOR® was honest with the seller in taking this listing, and the REALTOR® fully informed the seller of his lack of knowledge of commercial real estate and the Seller still insisted that the REALTOR® list the property. If there is an affirmative duty in the real estate license law of the Broker’s state to always inform the seller of the market value of a property before listing it, then the Broker is guilty of failing to determine the market value prior to listing the property. This failure could result in a disciplinary action from the state regulatory agency and/or a possible lawsuit.

Using the personal conscience approach, REALTOR® Yates may feel guilty about rendering services of which he was not capable of fully giving; therefore, REALTOR® Yates may offer to give Seller Xavier a portion of, or the entire commission in order to appease Xavier. REALTOR® Yates may also feel that he adequately provided services and may offer to give Seller Xavier nothing. This depends on the conscience and personal beliefs of the decision-maker.
CASE STUDY EIGHT

Buyer Aft becomes interested in Seller Prospero’s property—a two bedroom, one bathroom house in a seemingly quiet neighborhood. Seller Prospero knew Buyer Aft liked the home due to the quiet surroundings; however, he also knew that at night, the neighbors liked to play loud music and argue noisily. When Aft asked about the noise level, Prospero assured him that the neighborhood was always peaceful and quiet. Knowing that he would lose the sale if Aft discovered this information, Prospero lowered the price of the home so that Buyer Aft would immediately place an offer and purchase the home. After moving into the home, Aft discovers that the seemingly quiet neighborhood only appeared to be so during the day, but at night, it was extremely loud and unbearable. What rights does Aft have?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY EIGHT RESPONSE:
Intentional fraud is a prime example of unethical conduct. Seller Prospero withheld adverse information he knew would affect Buyer Aft’s decision concerning the property. Prospero is required to disclose any pertinent information to the Buyer; by lying to the Buyer, he is blatantly swindling him. At this point, Buyer Aft can file a case against Prospero to recoup his damages, or Prospero can offer to void all contracts and refund Aft’s money in order to avoid potential lawsuits.

CASE STUDY NINE
REALTOR® Guise showed Buyer Ingénue a home located in an upper middle class neighborhood; the area is clean and relatively new. REALTOR® Guise notices that there is a cracked wall along the backside of the house, but he does not disclose this information to the Buyer because he figures because it is not a latent defect, he does not have the responsibility to disclose the information. The buyer can discover the crack on her own; however, Ingénue purchases the house without discovering the crack. Two weeks after moving into the home, the Buyer discovers the crack in the wall and calls Guise to complain about the defect. He tells her that it was her responsibility to discover any defects. Is REALTOR® Guise correct?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY NINE RESPONSE:
According to Article 2 of the Code of Ethics, REALTORS® should not conceal any information that is readily available. By not disclosing the crack in the wall to the Buyer Ingénue, REALTOR® Guise is acting negligently. A REALTOR® is not responsible for latent defects that are beyond the scope of his expertise; however, Guise knowingly withheld adverse information from the buyer, even though he knew it was his responsibility to disclose it.

CASE STUDY TEN
Broker Emeritus listed a property on the MLS, offering a compensation of X%. Two weeks later, Emeritus decided to change the amount of compensation he was offering but did not post the change on the MLS until three days later. Prior to the change on the MLS, Broker Blythe presented the Seller with a willing and able buyer, and the seller sold the property to Broker Blythe’s client. Broker Blythe contacted Emeritus and demanded the amount listed on the MLS, but Emeritus stated that he had made the change on the MLS and would only compensate him for that amount. What can Broker Blythe do?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY TEN RESPONSE:
In this case, if Broker Blythe has proof that he presented the client on the day that the MLS still stated the original X% as compensation, then he is entitled to that amount. An example of evidence would be a printout of the listing with the X% commission. Broker Emeritus has the burden of proving that he made the change in a timely manner and acted according to Standard Practice 3-1.

According to Article 3 of the Code, brokers have a responsibility to cooperate with each other in order to best serve the client. In this case, Broker Blythe can dispute the commission with Broker Emeritus in arbitration or mediation, or just accept the commission given because his primary interest should be that of the client and not the commission in and of itself.
# Texas Principles of Real Estate

## Module 4: Fair Housing

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- Learning Objectives
- Key Terms

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INTRODUCTION

All Americans have the right to attempt to purchase, rent, or finance housing for themselves in the location of their choosing, regardless of their gender, religion, handicap, color, race, national origin or familial status. To help ensure that no one is deprived of this right, Congress passed the federal Fair Housing Act in 1968. This Act prohibits unethical discrimination by those who rent, sell and finance residential real estate. This module discusses the federal Fair Housing Act, as well as other anti-discrimination laws that directly affect the real estate industry and the financing of real estate. Upon completion of this course, you will understand the legislation, its purpose, and importance. You will also be familiar with the penalties for violating such statutes and have a better understanding of how you can avoid unethical discrimination in your everyday conduct.

Initially, this module will introduce the federal Fair Housing Act, explaining the groups of people whom it covers and the various wrongs against which the law is meant to protect. In addition, we will discuss the meaning of discrimination and the existence of certain exemptions to the law. After detailing the Fair Housing Act, this course will move on to other relevant statutes, such as the federal Equal Credit Opportunity Act and the Americans with Disabilities Act.

This module concludes with a real estate practice lesson that will present you with various case studies. Using the information you have gained from this course, this final lesson provides you with an opportunity to decide how to handle the common predicaments that often face those providing brokerage services.
KEY TERMS

**Americans with Disabilities Act (ADA):** This Act prohibits discrimination against individuals with disabilities. Specifically, it guarantees them access to employment, public services, telecommunications, public accommodations and commercial facilities.

**Blockbusting:** This is the practice of inducing the panic selling of homes at below market value, generally by raising fears that an influx of individuals belonging to a particular minority group will decrease property values in a neighborhood and otherwise affect the area negatively.

**Civil Rights Acts of 1866 and 1870:** These Acts stipulate that all persons, regardless of their race, color or previous position of servitude, have the same legal right to make and enforce contracts. Similarly, these Acts entitle all people to the full and equal benefit of laws and proceedings for the security of persons and property.

**Civil Rights Act of 1964:** A federal Act that includes a prohibition against discrimination by housing programs that receive any federal funding.

**Civil Rights Act of 1968:** This federal Act prohibits discrimination in the sale or rental of property on the basis of race, color, religion or national origin. Later amendments added prohibitions against discrimination on the bases of sex, handicap and familial status.

**Disability:** The federal government defines a disabled individual as a person who has a physical or mental impairment that substantially limits one or more of that individual’s major life activities. This legal definition also includes any individual who has a record of having suffered from such impairment.

**Discrimination:** Unfavorable or unfair treatment of a person or class of persons based on race, sex, color, religion, national origin, familial status or disability. The relative favorability or fairness of treatment is judged by comparing it to the way the individual or institution accused of discrimination interacts with people who are not members of the class.

**Dwelling:** The Fair Housing Act defines a dwelling as any building, structure or portion of a building that is occupied as—or designed or intended for occupancy as—a residence by one or more families. This definition also includes any vacant land offered for sale or lease for the construction of a building, structure, or portion of a building that is intended for occupancy as a residence.

**Equal Credit Opportunity Act (ECOA):** A federal Act prohibiting discrimination in lending on the basis of race, color, religion, national origin, sex, marital status,
age (provided the applicant is of legal age) or on the basis of the applicant’s receipt of income from a public assistance program.

**Fair Housing Act:** A federal law prohibiting discrimination in the sale or rental of housing on the basis of race, color, religion, sex, handicap, familial status or national origin. This Act makes up Title VIII of the Civil Rights Act of 1968.

**Familial Status:** “Familial status” is a term meant to capture the idea of having a family with minor-aged children. An act or practice is considered discrimination on the basis of familial status if it is unfavorable or unfair to anyone who is pregnant or planning to adopt, or to families with children under the age of 18 who reside with a parent or other legal custodian.

**Housing for Older Persons:** Senior citizen or adult communities that are exempt from the federal laws prohibiting discrimination against families with children.

**Redlining:** A refusal to finance housing for people living in a certain area, or a restriction on the number of loans granted in a certain area. Redlining is illegal under fair housing laws when the refusal or restriction is based on an individual’s sex, marital status, age, race, national origin, or the fact that the individual receives public assistance income. Some state or local ordinances may prohibit redlining altogether, regardless of the motivation for the practice.

**Seven Protected Classes:** The federal Fair Housing Act establishes seven protected classes or categories: race, religion, sex, national origin, color, disability and familial status. Individual states often expand the number of protected classes.

**Steering:** This term describes a real estate licensee’s efforts to discourage someone from considering a particular location, home or apartment and to encourage them to consider another property because of that person’s race, color, sex, religion, national origin, family status or disability.

**Title VIII:** The part of the Civil Rights Act of 1968 that is also known as the federal Fair Housing Act.
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

• Explain the purpose of the federal Fair Housing Laws and be able to identify the protected classes covered by the Fair Housing Act.
• Name the seven activities considered illegal as a result of the Fair Housing Laws.
• Identify the five exemptions from the federal Fair Housing Laws for property owners.
• Recognize discrimination in real estate practice.
• Recognize the purpose of the federal Equal Credit Opportunity Act (ECOA) and know the classes it protects.
• Describe the purpose of the Americans with Disabilities Act (ADA).
• Outline how the ADA affects real estate practice.
• Describe how fair housing complaints are handled.
• List the penalties for non-compliance with Fair Housing Laws.
• Sketch various ways a broker might incorporate business practices designed to prevent discriminatory practices.
• Explain the purpose of the HUD/NAR Partnership and why it is important.
• State the basic principle that should guide licensees in following HUD’s Advertising Guidelines.
• Identify acceptable and unacceptable words and phrases for use in advertisements.
• Describe how to apply the practices that help a licensee show that he or she does not discriminate.
LESSON ONE
INTRODUCTION TO FAIR HOUSING

This lesson focuses on the following topics:

- Federal Fair Housing Laws
- Protected Classes Established by the Federal Fair Housing Act
- Conduct Prohibited by the Federal Fair Housing Act
- Transactions Not Covered by the Federal Fair Housing Act
- Fair Housing Trends

INTRODUCTION

The U.S. Constitution guarantees everyone certain, basic rights and freedoms. For example, no person may be deprived of property without due process. Fair housing laws were conceived as an extension of this idea. When people are denied housing because of their membership in a particular minority group, they are, in essence, denied property without due process. So unfair discrimination in the letting and sale of residential real estate is not just unethical, it also undermines the U.S. Constitution.

This lesson will introduce the student to the federal Fair Housing Act. Our discussion will cover the seven protected classes, the conduct prohibited by the law and the few exemptions from the law. Once you have completed this lesson, you should know the legalities of the Act; in addition, you should understand its importance and intent. Finally, you should have a better sense of your role, as a real estate professional, in implementing this law.

FEDERAL FAIR HOUSING LAWS

Congress passed the Civil Rights Act of 1866 on April 9th, over the veto of President Andrew Johnson. It granted all citizens of the United States—without exception—a set of basic rights regardless of their race, color or previous condition of servitude. Among the rights granted by this Act are the rights to “make and enforce contracts, to sue, be parties, and give evidence, to inherit, purchase, lease, sell, hold, and convey real and personal property.” The right to make and enforce contracts is the foundation of property ownership and, according to the Civil Rights Act of 1866, fair access to property ownership includes equality in making, fulfilling, modifying and terminating contracts, as well as equal enjoyment of the benefits, terms and conditions of the contractual relationship.

In the more than 100 years that elapsed between the passage of the Civil Rights Act of 1866 and the passage of the Fair Housing Act, there were only two serious attempts to legislate fair housing practices. Both of these efforts dealt with
federally funded housing. In 1962, John F. Kennedy issued Executive Order 11063, which prohibits discrimination in the selling or leasing of property owned or funded by the federal government, including those properties that rely upon Veterans Administration (VA) and Federal Housing Administration (FHA) loans. The Civil Rights Act of 1964 included a prohibition against discrimination on the basis of race, color and national origin in any program or service funded by the federal government.

Shortly after the assassination of Dr. Martin Luther King Jr., Congress passed the Civil Rights Act of 1968. Title VIII of this Act, also known as the Fair Housing Act, prohibits discrimination in real estate practices. The Department of Housing and Urban Development, commonly referred to as HUD, enforces the Act. The law applies to most, if not all, activities in which real estate licensees may engage, including selling, appraising, managing and renting real property. Real estate licensees are in violation of the law if their actions or words are discriminatory, even if they have no intention to discriminate.

**PROTECTED CLASSES ESTABLISHED BY THE FEDERAL FAIR HOUSING ACT**

Under the federal Fair Housing Act, there are seven protected classes. It is illegal to discriminate against someone because of his or her:

- Race
- Color
- National Origin
- Gender
- Familial Status
- Religion
- Disability

It is a violation of federal law to discriminate against someone in the sale or letting of residential real estate on the basis of his or her membership in one of these seven protected classes. Some individual states and local jurisdictions, such as counties and cities, have introduced legislation to protect additional classes. It is, therefore, necessary for licensees to review state laws and local ordinances regarding housing discrimination to ensure that their conduct satisfies any additional requirements.

The Civil Rights Act of 1968 established all of the protected classes (listed earlier), except for sex, familial status and disability. In 1974, the Housing and Community Development Act added sex as a protected class. A 1988 amendment to the federal Fair Housing Act itself added familial status and handicap. Then, in 2005, the state of Hawaii added Sexual Orientation and
Gender Identity or Expression to the list of classes protected under Fair Housing law.

While some of these classes may seem self-explanatory, the definitions of “disability” and “familial status” may be a little less clear. For example, a disability does not necessarily mean a physical disability. The next few sections will further define the terms “disability” and “familial status.”

DEFINITION OF DISABILITY

The law states that a disability is any physical or mental impairment that limits one or more of a person’s major life activities, such as walking, talking, hearing, seeing, breathing, learning, performing manual tasks and caring for oneself. This definition thus includes a variety of conditions, such as being infected with HIV or having AIDS, being an alcoholic and having a learning disability. It is worth noting here that while alcoholism is considered a disability, being addicted to illegal drugs is not.

A disability can be actual or perceived. This means that if a real estate professional believes that a prospect may have a disability of any kind, and, as a result, refuses to rent, offer services, show housing, etc., then that professional has violated the federal Fair Housing Act. This is true regardless of whether or not the person is actually disabled.

Real estate professionals and lessors must make reasonable accommodations for people with disabilities. A landlord or real estate professional must make any accommodation that helps a disabled person acquire and enjoy his or her dwelling, though the parties providing accommodation(s) are not required to suffer undue hardship in doing so. For brokerages, this could mean providing Braille versions of pamphlets and handouts. For a lessor, this could mean allowing a person with an assistive animal to keep his or her animal indoors, even if tenants are generally forbidden to keep pets.

Although you may not discriminate against people because of a disability, it is not illegal to refuse housing to prospective tenants, or to evict current tenants, who have a physical or mental impairment that poses a direct threat to other tenants. For example, it would not be illegal to refuse to rent an apartment to an unmedicated schizophrenic with a history of violence against others, even though the person has a documented mental impairment.

In cases like these, it is important that real estate professionals, landlords, prospective sellers and other people bound by the Fair Housing Act show that an actual and direct threat exists. For example, a tenant with Tourette’s syndrome who cannot help making loud noises throughout the night may pose an indirect threat to other tenants through the long-term effects of sleep loss, but does not pose any immediate, direct threat. The courts have ruled that a landlord must
also show that no reasonable accommodation could eliminate the direct threat posed by a tenant.

DEFINITION OF FAMILIAL STATUS

The federal Fair Housing Act also protects families with children under the age of 18 living with one or more parent or guardian, as well as pregnant women and those planning to adopt. In general, no one may deny housing to an individual simply because that person has or may soon have children.

There is one exception to this prohibition: what the Fair Housing Act calls "housing for older persons." A dwelling is exempt from the requirement to accommodate families if:

- That dwelling is provided under any state or federal program that the Secretary of Housing and Urban Development determines is designed and operated to provide assistance to the elderly.
- That dwelling is intended for and occupied solely by people who are 62 years of age or older.
- At least 80 percent of all occupied units in that dwelling house at least one person over the age of 55 and the landlord generally adheres to a policy with the demonstrable intent of housing persons over 55.

In some cases, imposing limitations on the number of occupants allowed in a dwelling may constitute discrimination on the basis of familial status. To ensure that fair housing lawsuits regarding this issue remain reasonable, Congress passed the Quality Housing and Work Responsibility Act of 1998. This Act required HUD to set reasonable limitations on the number of occupants allowed in a dwelling. HUD concluded that a "two occupants per bedroom" rule—taking other factors into consideration—constitutes a good basic model.

The law does not prohibit local regulations regarding the maximum number of persons allowed to occupy a dwelling. However, in 1991, HUD’s then-General Counsel Frank Keating issued a memo that provided a guideline: "... the Department believes that an occupancy policy of two persons in a bedroom, as a general rule, is reasonable under the Fair Housing Act.... However, the reasonableness of any occupancy policy is rebuttable..." and nothing "implies that the department will determine compliance with the Fair Housing Act based solely on the number of people permitted in each bedroom."
CONDUCT PROHIBITED BY THE FEDERAL FAIR HOUSING ACT

The federal Fair Housing Act describes a number of illegal practices. We will cover these in greater detail during Lesson Two, but we can examine them briefly here. They include the following actions, when these are based on an individual’s membership in a protected class:

- Refusals to sell or rent
- Discrimination in terms, conditions, or privileges of sale
- Discrimination in advertising
- Denying availability
- Blockbusting and steering
- Denying availability
- Lending discrimination and redlining

STEERING AND BLOCKBUSTING

Two discriminatory practices on this list are not part of everyday language and thus require special explanation: steering and blockbusting. As previously stated, both of these activities violate the federal Fair Housing Act, and people guilty of such activities—regardless of whether they intended the act or its effects—are held liable. The following sections define these terms.

Steering

Steering is the practice of providing real estate advice or other real estate services in a manner that perpetuates segregated housing. All of the following actions constitute steering:

- Using an individual’s race, gender or membership in any other protected class as the basis for one’s suggestion that a person live in a specific section of town.
- Using an individual’s membership in a protected class as the basis of one’s refusal to show housing in another section of town.
- Focusing one’s marketing effort in a narrow way that perpetuates the segregation of protected classes.

Consider the following example: a Vietnamese family comes into Real Estate Licensee X’s office looking for a home. X knows of a good neighborhood with a substantial number of Vietnamese residents, one he thinks the family would enjoy. He shows them only properties in that neighborhood. This is considered steering because he is directing the family away from other, less racially segregated neighborhoods and the licensee thereby works to perpetuate segregation. Notice that the licensee does not have any malicious intent here—
he is not trying to deprive the family of anything nor does he hold any negative beliefs about them. He may actually think he is being helpful. However, it is still wrong for X to take this choice out of the family's hands. They should be allowed to choose for themselves among the various properties he has available, regardless of location.

A real estate licensee should not let a client's membership in a protected class influence the properties she shows that client—not even if the client specifically asks that she do so. For example, if a prospective buyer expresses a wish to live in a Hispanic community, it is recommended that the real estate professional tell the client that he cannot take such factors into consideration, and respond by showing the client a range of listings meeting the client’s other, property-related specifications. The client is free to choose a Hispanic community if he or she so desires, but the real estate licensee can play no role in helping the client to identify or acquire segregated housing.

**Blockbusting**

*Blockbusting* refers to the practice of encouraging the panic selling of homes below market value, generally by raising fears that an influx of individuals belonging to a particular minority group will decrease property values in a neighborhood and affect the area negatively. Because it requires this kind of special effort, licensees are unlikely to engage in blockbusting accidentally and without malicious intent; nonetheless, they should remember that intent is not required for their acts to be a violation of the Fair Housing Act.

Blockbusting may also be referred to simply as *panic selling*. Those wishing to foster this panic selling often cite effects like a decline in the quality of education and an increased crime rate, even though there is no justification for making these claims. At its core, though, blockbusting is a profit-seeking practice that relies upon mistaken and discriminatory ideas about various protected classes, and uses these to induce people to engage in real estate transactions that are not in their best interests. As such, it violates the Fair Housing Act and encourages people in keeping their discriminatory beliefs. Real estate licensees have an obligation not to let their work or services be influenced by confused and harmful notions about members of the seven protected classes. Engaging in this kind of activity for profit is unethical and is expressly forbidden by the Fair Housing Act.

**TRANSACTIONS NOT COVERED BY THE FEDERAL FAIR HOUSING ACT**

The Fair Housing Act defines a dwelling as any building, structure or portion of a building that is occupied as—or designed or intended for occupancy as—a residence by one or more families. The definition also includes any vacant land offered for sale or lease for the construction of a building, structure, or portion of
a building that is intended for occupancy as a residence. This definition is important because the Fair Housing Act does not cover buildings other than those defined as dwellings. Therefore, the Fair Housing Laws do not apply to commercial transactions unless those transactions include property that would be properly defined as a dwelling.

The federal Fair Housing Act is primarily intended to prohibit discrimination in the sale, rental and advertisement of dwellings. Although commercial property transactions are not normally included under the Act, other laws—such as the Americans with Disabilities Act—are covered.

Even in the case of dwellings, however, the federal Fair Housing Act does not cover all transactions. There are four general circumstances under which a dwelling is exempt from the federal Fair Housing Act. Licensees should remember that even though federal law allows for these exemptions, the laws of a particular state might not. In most states, these exemptions do not apply if a real estate licensee is involved in the transaction, so licensees should also be aware that their participation in the process could negate the exemption.

**SINGLE-FAMILY RESIDENCES SOLD BY OWNER**

The sale or rental of a single-family residence is not bound by the Act, provided that:

- The property owner does not own, or own any interest in, more than three single-family residences at one time.
- The owner is not the most recent resident of the property being sold, and that owner is only granted one exempt sale in any 24-month period.
- The owner does not use the facilities or services of a real estate licensee, broker, salesperson or anyone else engaged in the business of selling or renting dwellings.
- The owner does not use any discriminatory advertising.

For this exemption to apply, it is important that the person making the sale or arranging the rental not be in the business of selling or renting dwellings. This exemption applies only to those individuals who are incidentally selling their own property, not to people who are professional real estate dealers or investors. The Fair Housing Act judges a person to be in the business of selling or renting if:

- That person has, within the preceding twelve months, participated as principal in three or more transactions involving the sale or rental of any dwelling or any interest therein.
- That person has, within the preceding twelve months, participated as agent, other than in the sale of his own personal residence in providing sales or rental facilities or sales or rental services in two or more
transactions involving the sale or rental of any dwelling or any interest therein.

- That person is the owner of any dwelling designed or intended for occupancy by, or occupied by, five or more families.

**RENTAL OF ROOMS OR UNITS IN OWNER-OCCUPIED PROPERTY**

This law does not apply to the rental of rooms or units in a dwelling containing living quarters occupied or intended to be occupied by no more than four families living independently of each other, if the owner actually occupies one of the living units as his residence.

**DWELLINGS BELONGING TO RELIGIOUS ORGANIZATIONS OR PRIVATE CLUBS**

Nothing in the law prohibits a religious organization or private club from limiting the sale, rental, or occupancy of a dwelling that it owns or operates for other than commercial purposes to persons of the same religion or club. Private clubs may show preference to club members under similar circumstances.

**HOUSING FOR OLDER PERSONS**

Housing for older persons is also exempt from the requirements of the Fair Housing Act if one or more of the following three conditions apply:

- The housing is occupied only by persons who are 62 years of age or older.
- 80% of the housing units have at least one occupant who is 55 years old or older.
- The housing is provided under any state or federal program that the Secretary of Housing and Urban Development determines is designed and operated to provide assistance to the elderly.

**GENERAL CONSIDERATIONS**

Unlike the federal Fair Housing Act, there are NO EXCEPTIONS to the Civil Rights Act of 1866. This means that you may NEVER turn away a qualified tenant or purchaser because of his or her race or color; neither may you publish an advertisement that discriminates against someone on this basis. For example, in the U.S. Supreme Court case *Jones v. Mayer Co.* (392 U.S. 409 [1968]), the refusal to sell a home because of the prospective buyer’s race was found to be a violation of the law. The court decided that the defendant had violated the Thirteenth Amendment as well as 42 U.S. Code 1982, which provides that all citizens "shall have the same right, in every State and Territory,
as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property."

It is often difficult to determine whether a specific property or transaction is exempt under the Fair Housing Act, as well as whether it is exempt from state and local legislation addressing similar issues. Because these cases are complex, any time someone thinks that a property or transaction might be exempt, it is very important that he or she seek legal counsel.

FAIR HOUSING TRENDS

In 2005, the National Fair Housing Alliance released the Fair Housing Trends Report, based on complaint data from 2004.

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The report found that the majority of complaints concerning discrimination in housing were from African Americans, the disabled and families with children under eighteen. The report also found that the number of complaints involving discrimination on the basis of national origin had increased, possibly due to the events of September 11, 2001.

SUMMARY

The Fair Housing Act was passed in 1968 to prohibit unethical discrimination in real estate practices. Under the federal Fair Housing Act, there are seven protected classes: race, color, national origin, sex, familial status, religion and handicap. To discriminate against someone in the sale or letting of residential real estate because of his or her membership in one of these seven protected classes violates federal law. Sometimes individual states and local jurisdictions, such as counties and cities, have legislation that establishes additional protected classes. It is, therefore, necessary for all licensees to review state laws and local ordinances regarding housing discrimination.

The federal Fair Housing Act prohibits more than just the refusal to sell or rent to an individual because of membership in a protected class. In addition, it forbids:

- Any discrimination in the terms, conditions or privileges of a sale or rental agreement
- Discrimination in advertising
- Denying availability
- Blockbusting (inducing panic selling) and steering (perpetuating segregated housing)
• Refusing to make reasonable accommodations for the disabled
• Discrimination in financing.

Federal Fair Housing law does not cover all real estate transactions. Exemptions include an owner’s sale of his own home, the rental of rooms or units in an owner-occupied dwelling and housing for older persons. These exemptions do not apply if the owner uses a broker to manage real estate transactions involving the property, and there are never any permissible exemptions regarding the protected classes of race, and color, which were established by the Civil Rights Act of 1866.

Return to your on-line course player to take the Lesson Quiz.
LESSON TWO
DISCRIMINATION

This lesson focuses on the following topics:

- Defining Discrimination
- Discriminatory Conduct Prohibited by the Federal Fair Housing Act

INTRODUCTION

Fair Housing laws define discrimination as unfavorable or unfair treatment of a person or class because of race, sex, color, religion, national origin, familial status or disability. The relative unfairness or otherwise detrimental character of discriminatory treatment is judged by comparing the treatment of a given group or individual with the treatment of others who are not members of that same group. Note that this definition does not mention intent. This means that a real estate professional can be guilty of discriminatory practices even if he or she did not mean to discriminate.

This lesson will examine the meaning of discrimination. We will begin by exploring what actions constitute discrimination. We will then outline the specific actions outlawed by the federal Fair Housing Act.

DEFINING DISCRIMINATION

Discrimination is the unfavorable or unfair treatment of a person or class of persons because of race, sex, color, religion, national origin, familial status or disability. The relative unfairness or otherwise detrimental character of discriminatory treatment is judged by comparing the treatment of a given group or individual at issue with the treatment of others who are not members of that same group. This definition does not concern itself with whether a real estate professional meant to be discriminatory—the only issue is whether the licensee’s conduct had negative effects on access to fair housing that are plausibly explained in terms of a client’s or a prospect’s membership in a protected class.

Consider the following example: A real estate professional shows families with young children only properties in a certain area of town that’s near youth centers, schools and hospitals. This licensee would effectively be discriminating against those families on the basis of familial status because the licensee limits the properties he or she is willing to show due to the clients’ membership in a protected class. This is true despite the fact that the licensee had no discriminatory intent and most likely believed that she or he was looking out for her clients’ best interests. Because the result is discriminatory—that is, because the clients are not presented with a full range of information that allows them to
make their own choices and are thus essentially prevented from considering properties in other locations—the licensee’s conduct violates the federal Fair Housing Act. The real estate professional engaged in a practice called “steering,” even if he or she did not mean to intentionally discriminate.

Interestingly, demonstrable discriminatory intent is not sufficient to legally establish discrimination. For example, suppose a city council must decide whether or not to pass a referendum permitting the construction of low-income housing. One city council member opposes the referendum for discriminatory reasons (perhaps his beliefs about the race or national origin of the prospective residents), but the council passes the referendum regardless. Since no discriminatory result came of the councilman’s intent, the council itself has not violated the federal Fair Housing Act. Thus, when thinking about discrimination, one should remember that the action and its results are what truly matter. The intent behind the action is, at best, of secondary importance.

However, this does not mean that any discriminatory result is necessarily a violation of the law. In the case Phillips v. Hunter Trails Community Association, the Seventh Circuit Court of Appeals identified the following criteria for evaluating a case of alleged discrimination:

- The strength of the plaintiff’s statistical showing—that is, the degree to which a practice or policy can be shown to have a statistically disparate impact on members of a protected class
- The legitimacy of the defendant’s interest in taking the action or maintaining the practice that is the object of the complaint—i.e., the extent to which the defendant can offer a plausible, non-discriminatory justification for the action or practice
- Some indication, which might be suggestive rather than conclusive, of discriminatory intent on the part of the defendant
- The extent to which relief could be obtained by limiting or prohibiting the defendant’s current practice, rather than requiring positive remedial measures of the defendant.

DISCRIMINATORY CONDUCT PROHIBITED BY THE FAIR HOUSING ACT

In addition to the more general definition already given, federal Fair Housing laws describe specific behaviors and practices that violate the Act. They include:

- The refusal to sell or rent available properties
- Discriminating in terms, conditions or privileges connected with a sale or rental
- Discriminating in advertising
- Denying availability
• Failing to make reasonable accommodations for a tenant or prospective tenant’s disability
• Redlining, blockbusting and steering

The following sections will go over these behaviors and practices in detail.

REFUSALS TO SELL OR RENT

When a dwelling has genuinely been offered for sale—for example, through advertising or the posting of notices—it is illegal to refuse to negotiate the sale or rental of the dwelling, or otherwise make it unavailable to a person, because of that person’s membership in a protected class.

DISCRIMINATION IN TERMS

Changing the terms, conditions or privileges of a sale or rental because of a person’s membership in a protected class constitutes a violation of federal law. It is similarly illegal to use membership in a protected class to determine what services or facilities will be made available to the individual in connection with the sale or rental of a dwelling. For example, a landlord cannot legally charge an individual higher rent or require a larger deposit because of a tenant’s membership in a protected class, nor can he demonstrate inequity in maintenance activities. Similarly, it is illegal for an owner to respond to a purchase offer differently simply because of the prospective buyer’s membership in a protected class.

DISCRIMINATION IN ADVERTISING

Discriminatory advertising uses words, phrases, symbols, visual aids or media in the advertising of real estate that may indicate the advertiser’s preference for or prejudice against members of a protected class. This type of advertising may result in discriminatory practices and is illegal. Because it is not always clear whether a symbol, phrase or choice of media indicates a discriminatory preference, the Department of Housing and Urban Development (HUD) has developed advertising guidelines to help real estate professionals avoid advertising that could be considered discriminatory. These guidelines will be discussed in a later lesson.

If a discriminatory advertisement is published, however, then both the writer and the publisher can be held liable. For example, if Broker X writes a discriminatory advertisement that is published by Newspaper Y, then HUD can file a suit against both Broker X and Newspaper Y.
DENYING AVAILABILITY

It is unlawful for a real estate professional to willfully misrepresent a dwelling as unavailable for inspection, sale or rental to a person because of that person’s membership in a protected class. That is, if a dwelling is in fact available, it is illegal for a licensee to knowingly say that it is not, simply because of a client or prospect’s membership in a protected class.

REASONABLE ACCOMMODATIONS

Under Fair Housing laws, the landlord must allow a disabled tenant to make reasonable accommodations at the tenant’s own expense. A reasonable accommodation is a modification that allows a handicapped person to enjoy his or her dwelling more fully, and which does not impose an undue financial or administrative burden on the landlord. As discussed previously, a person is considered disabled if she or he has a physical or mental impairment that substantially limits one or more of the major life activities of that individual, has a record of such an impairment, or is regarded as having such an impairment. Major life activities include walking, breathing, seeing, hearing, and caring for one’s self. People who were previously addicted to illegal drugs, people who are present or former alcoholics and people with AIDS can all be considered disabled if they have serious physical or mental impairments arising from these conditions.

A landlord cannot charge a higher security deposit for disabled tenants. However, if the tenant elects to modify the apartment in a way that renders it less usable for non-disabled tenants (for example, if the tenant chooses to lower the kitchen counters), then the landlord may require that the disabled tenant deposit funds in an escrow account which are adequate to pay for returning the property to its original condition when the tenant moves out. The tenant will collect the interest from the fund he or she arranges to have this work done satisfactorily, but the landlord will receive the interest if he or she has to pay to have this work done.

Reasonable accommodations can include modification of rules against pets (if the tenant has an assistive pet), designated handicapped parking (if parking is not normally assigned) and specially printed rental applications and other materials if the tenant has difficulty reading small type. The basic criteria for reasonable accommodations claims are:

- The tenant has a disability, a history of disability, or is perceived to have a disability.
- The tenant has made a reasonable effort to alert the landlord of his or her disabled status and desire for accommodations.
- The proposed accommodations would not constitute an undue burden on the landlord or lead to a fundamental alteration of the dwelling.
Defining what may count as a “reasonable accommodation” must be done on a case-by-case basis. HUD has published guidelines providing technical assistance to homebuilders and landlords in this regard. These will be discussed in a later lesson.

**REDLINING, BLOCKBUSTING AND STEERING**

Previously, we’ve discussed “steering” and “blockbusting” — two discriminatory acts that violate the federal Fair Housing Act. As you may recall from Lesson One:

- **Steering** is the practice of directing a person seeking to buy or rent a dwelling in a manner that perpetuates segregated housing.
- **Blockbusting** is the practice of encouraging the panic selling of homes below market value by raising fears that an influx of individuals who are members of a protected class will decrease property values and negatively affect the area.

In addition to steering and blockbusting, federal fair housing legislation also prohibits unethical discrimination in lending. Specifically, the statutes outlaw certain practices that are called “redlining.”

Some lending institutions limit the number of loans or the loan-to-value ratio in certain areas of a community or city. This is redlining. If an institution practices redlining because of an individual or group’s membership in a protected class, then it violates both the federal Fair Housing Act and the Community Reinvestment Act.

The Fair Housing Act prohibits making race, color, national origin, religion, sex, familial status or disability a condition of one’s willingness to engage in any of the following practices:

- Making a mortgage loan
- Providing information regarding loans
- Setting the terms or conditions of a loan, such as interest rates, points, or fees
- Appraising property
- Purchasing a loan or setting the terms or conditions for purchasing a loan

It is similarly illegal to make the outcomes of any of these practices contingent upon an individual’s race, color, national origin, religion, sex, familial status or disability. Some state or local ordinances may prohibit redlining altogether, regardless of the motivation for the practice.

As the name of the Community Reinvestment Act might suggest, redlining legislation aims not only at preventing unethical discrimination, but also at
reversing the abandonment and decay of residential property. The Community Reinvestment Act, passed in 1977, requires lenders to assist their local communities by participating in community development projects. The Act also requires that lenders submit an annual statement including public comments about their attempts to help low-income communities.

Unfortunately, enforcing the prohibition against redlining can be difficult. To help prevent discrimination in lending, Congress passed the Home Mortgage Disclosure Act in 1975. The Home Mortgage Disclosure Act requires lenders to disclose specific lending information, which HUD then uses to map lending patterns. In essence, lenders must now disclose how many loans they offer to specific communities, as well as the types of loans and the terms of those loans. This allows HUD to spot problematic lending patterns and helps support lawsuits or other disciplinary measures that HUD deems necessary.

In addition to HUD’s efforts to promote fairness in lending, the Office of Thrift Supervision (a bureau of the U.S. Treasury) also passed a regulation banning redlining. It states that lenders may not limit or refuse loans simply because of the age of a home or the average income in the area in which the person is purchasing. The practices prohibited by this regulation are effectively discriminatory because members of protected classes are statistically more likely to purchase older homes or homes located in lower-income areas.

**SUMMARY**

Fair housing law defines discrimination as the unfavorable or unfair treatment of a person or class of persons because of race, sex, color, religion, national origin, familial status and/or physical/mental disability. The relative unfairness or otherwise detrimental character of this treatment is judged by comparing it to the treatment of others who are not members of that class. The federal fair housing laws prohibit the following specific activities as discriminatory:

- The refusal to sell or rent, when this decision is based on a prospect’s membership in a protected class
- Inequity in the terms, conditions, or privileges of sale when these are based on a prospect’s membership in a protected class
- Advertising that implicitly or explicitly expresses a preference for or a prejudice against a protected class
- Denying availability, when this decision is based on a prospect’s membership in a protected class
- Blockbusting, steering and redlining
- The failure to make or permit reasonable accommodations for someone’s disability
- Inequity in lending practices
Under federal law, you may not change the terms of a real estate agreement or your claims about the existence of available housing because of a prospective buyer or lessee’s membership in a protected class. And, in the case of a disability, landlords must make reasonable accommodations so that disabled persons can enjoy their properties. Accommodations may require legal, case-by-case consideration, but in general, an accommodation is reasonable if it does not cause undue financial or administrative burden on the landlord.

Some lending institutions limit the number of loans or the loan-to-value ratio in certain areas of a community or city. This is redlining. Redlining can be illegal when its effect is unfavorable to at least one of the seven protected classes. If an institution makes redlining decisions on the basis of membership in a protected class, then it violates both the federal Fair Housing Act and the Community Reinvestment Act. In addition to HUD’s efforts to promote fairness in lending, the Office of Thrift Supervision (a bureau of the U.S. Treasury) also passed a regulation banning redlining. It states that lenders may not limit or refuse loans simply because of the age of a home or the average income in the area in which the person is purchasing.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
ADDITIONAL LEGAL PROTECTIONS TO PREVENT DISCRIMINATION

This lesson focuses on the following topics:

- Federal Equal Credit Opportunity Act (ECOA)
- Federal Americans with Disabilities Act

INTRODUCTION

Aside from the Fair Housing Act, there are two other important federal Acts that protect individuals from discrimination in their efforts to procure housing: the federal Equal Credit Opportunity Act (ECOA) and the Americans with Disabilities Act (ADA).

This lesson will discuss these Acts, which are important pieces of non-discrimination legislation that licensees must understand. This lesson will begin by outlining the ECOA, covering both its scope and intent. It will then move on to cover the ADA. It is important to note that (unlike the federal Fair Housing Act) these Acts do not speak specifically to housing or residential properties. The ECOA also introduces different protected classes—for example, under this act, no lender may discriminate against a potential borrower because of the borrower's age or the fact that the borrower receives money from public assistance programs. In addition, the ECOA protects against discrimination on the basis of marital status. This definition of marital status differs in important ways from the definition of familial status as established under the federal Fair Housing Act.

FEDERAL EQUAL CREDIT OPPORTUNITY ACT (ECOA)

The federal Equal Credit Opportunity Act (ECOA) guards against discrimination by granting individuals seeking housing additional protection. The ECOA is Title VII of the Consumer Protection Act. It prohibits lenders from discriminating against credit applicants on the basis of:

- Race
- Color
- Religion
- National origin
- Sex
- Marital status
- Age
 Dependence on public assistance programs

The definition of “marital status” set out in the ECOA differs in important ways from the definition of “familial status” established by the federal Fair Housing Act. Under the ECOA, lenders may not deny a loan to an individual merely because that person is divorced or widowed. Whereas the federal Fair Housing Act’s “familial status” protection focuses on the presence of children (dependants under the age of 18), the “marital status” protection afforded by the ECOA aims to prevent discrimination against people without spouses.

Lenders do, however, need to ask certain questions to ascertain whether or not a loan has a good chance of being repaid as agreed. Lenders are therefore entitled to ask questions concerning the type(s) and stability of the income submitted to support the loan application, as well as questions regarding the individual’s debts and on-going obligations, the quality of his or her credit history, and the source and amount of cash that the individual is investing in purchasing the home.

A lender may ask only questions that are relevant to an individual's financial standing. This means that while asking if someone is divorced is inappropriate, asking if someone must pay alimony is acceptable. To get a better sense of the types of questions that are acceptable, please consider the following list:

- A lender may not ask if an applicant is divorced or widowed, but may ask if a borrower is married, unmarried or separated.
- The lender may not ask about the receipt of alimony or child support unless the borrower intends to use that money to qualify for the loan, but may ask if a borrower must pay alimony or child support.
- A lender may not ask about a borrower’s birth control or intentions for childbearing.
- A lender may not ask about a borrower’s spouse unless that person will be involved in the contract.
- A lender may not discount or exclude any income because of the source of that income.
- A lender must report credit information on married couples separately in the name of each spouse.
- A lender may not ask about the applicant’s race or national origin.

Take a moment to work through the following case study. Specifically, you will be asked to answer the question: Which of these situations is legal?

**CASE STUDY**

The ECOA may seem a little more complicated than the federal Fair Housing Act. To get a better sense of its implications, we will examine a case study. You will
be presented with two different situations. Given what we have covered here, try to pick out the situation that is in conformity with the requirements of the ECOA.

Which of these situations is LEGAL?
Write your answer in the space provided and check your answer on the next page.

**Situation 1:** A lender asks a loan applicant how much child support she, the applicant, is receiving, although she has stated that she doesn’t intend to use the money to qualify for the loan.

**Situation 2:** A lender asks about the credit of a loan applicant’s husband when the husband is a party to the loan application.
CASE STUDY RESPONSE:
Situation 1: Incorrect. Under the ECOA, a lender may only ask about child support if the applicant intends to use that money to qualify for the loan. This means that the borrower would have to mention that she receives child support and would like it to be considered. If she doesn’t, then this information about her personal life is not relevant to the loan application process.

Situation 2: Correct. If an applicant’s spouse is named as a party to the loan application, the lender may ask about him or her. However, the lender is still required to submit any credit reporting information in the name of each individual. For example, if the loan is granted and later paid in full, that fact must be reflected on each spouse’s credit report.

FEDERAL AMERICANS WITH DISABILITIES ACT

In addition to protection under the federal Fair Housing Act, individuals with disabilities are protected under the Americans with Disabilities Act (ADA). The ADA is a federal law that serves to protect the civil rights of individuals with disabilities. While it is true that the ADA does not speak directly to housing issues, it does apply to the operation of most real estate offices and most commercial establishments.

A disability is defined as:

- A physical or mental impairment that substantially limits one or more of an individual’s major life activities
- A record of having such an impairment
- Being regarded as having such an impairment

The ADA addresses discrimination in four general areas.

- Employment
- Public Transportation
- Public Accommodations and Commercial Facilities
- Telecommunications

EMPLOYMENT

Employers are required to provide reasonable accommodation to individuals with disabilities, and they may not discriminate against an individual with a disability when they are making decisions about hiring or promotions. Employers may ask about a potential hire’s ability to perform a job, but cannot ask whether he or she has a disability, or about the extent of that person’s disability.
PUBLIC SERVICES

Buses and trains, as well as their stations, must be accessible to disabled persons.

PUBLIC ACCOMMODATIONS

Reasonable modifications must be made to policies, practices and procedures to avoid discrimination against the disabled in public areas. This means that physical barriers that interfere with the activities of disabled persons must be removed. All new construction and alterations of facilities must be compatible with making those facilities accessible to the disabled.

TELECOMMUNICATIONS

Companies offering telephone service must offer telephone relay services to allow communications access for people with speech and hearing impairments.

BUSINESSES AND OTHER ESTABLISHMENTS AFFECTED BY THE AMERICANS WITH DISABILITIES ACT

The ADA affects a wide array of businesses and establishments, both public and private. The following list enumerates businesses and establishments affected by the ADA:

- Businesses with 15 or more employees
- Any facilities or offices affiliated with state or local government
- Public and private schools
- Hospitals and dental offices
- Restaurants
- Hotels and motels
- Grocery and retail stores
- Shopping malls
- Libraries and museums
- Banks
- Theaters
- Amusement and recreation parks

LEARN MORE:
The Access Board (also known as the Architectural and Transportation Barriers Compliance Board) is a federal organization that issues guidelines to ensure that buildings, facilities and transit vehicles are accessible and usable by people with disabilities. You can find guidelines online at: http://www.access-board.gov/.
Additionally, you may learn more about the scope of the ADA from the U.S. Department of Labor online at: http://www.dol.gov/dol/topic/disability/ada.htm.

**HOW THE AMERICANS WITH DISABILITIES ACT AFFECTS THE REAL ESTATE INDUSTRY**

The following sections will outline the ways that the ADA most directly affects the real estate industry. Its most noticeable effects are on the operations and construction of real estate brokerages and on broker representation in transactions involving commercial property.

**Compliance with the ADA in Brokerage Offices**

Many brokerages fall within the scope of the ADA, either because of their location (perhaps in a mall or other retail facility, which is bound to follow the requirements of the ADA) or because the brokerage has 15 or more employees. This means that, while every brokerage should work to protect and honor the rights of disabled Americans, brokerages in locations that fall under ADA guidelines and brokerages with at least 15 employees must be especially certain to fulfill the legal obligations that the ADA imposes upon them. Such brokerages will need to make any physical modifications necessary for the office to be accessible to persons with disabilities. In addition, the brokerage may need to make other reasonable accommodations, such as providing note takers, Braille documents, assistive listening devices or interpreters.

It is important to remember, however, that even if the ADA does not apply to a specific brokerage, the licensees who work there are still bound by the Fair Housing Act. This means that even licensees working at brokerages with fewer than 15 employees must make every effort to provide fair housing access for potential clients and customers with disabilities. Any brokerage with questions about its office’s accessibility or general compliance should seek legal counsel.

**Informing Commercial Clients about the ADA as It Applies to Prospective Purchases**

Any commercial real estate that a licensee shows to a potential buyer, customer or buyer-client will most likely fall within the scope of the ADA’s requirements. This means that the licensee should inform the client or customer that these ADA requirements apply to the property. If the space does not already comply with ADA accessibility requirements, then the finish-out (i.e., the adaptation of a space for owner’s or tenant’s use) must include any alterations necessary to ensure that the space is accessible and complies with ADA standards.
FAIR HOUSING ACCESSIBILITY GUIDELINES

The Americans with Disabilities Act prohibits discrimination against the disabled, and Title VIII of the Civil Rights Act of 1968 protects the disabled from unfair housing practices. The Department of Housing and Urban Development recognized the need for clear and measurable standards to determine compliance with these Acts. Consequently, it adopted the Fair Housing Accessibility Guidelines. These guidelines provide technical directions for satisfying specific accessibility requirements.

Establishing a specific definition for the term "reasonable" in the phrase "reasonable accommodations" did lead to a degree of controversy. In an effort to equitably resolve this disagreement, HUD enlisted the help of certain organizations and the public at large. HUD sought assistance from:

- The Southern Building Code Congress International
- The National Association of Home Builders
- The National Coordinating Council on Spinal Cord Injuries

These organizations developed a series of proposals defining the phrase "reasonable accommodation." Their different proposals were subsequently published in June of 1990 for public comment. The public seemed to favor one proposal in particular, which is now commonly referred to as Option One.

Option One became the basis for HUD’s final accessibility guidelines. Compliance with HUD’s Fair Housing Accessibility Guidelines is not mandatory. It is, however, a way to help ensure the equitable treatment of all potential clients and customers; compliance can also provide evidence of non-discrimination in the event of a lawsuit.

Details of the Accessibility Guidelines

The Accessibility Guidelines only apply to covered multifamily dwellings, which are defined by the Fair Housing Act as “buildings consisting of four or more dwelling units if such buildings have one or more elevators, and ground floor dwelling units in other buildings consisting of four or more units.” The guidelines ask landlords to ensure that:

- Public use and common use portions of the dwellings are readily accessible to and usable by persons with handicaps
- All doors within such dwellings that are designed to allow passage into and within the premises are sufficiently wide to allow passage by persons in wheelchairs
- All premises within such dwellings include the following features of adaptive design:
  a) An accessible route into and through the dwelling
b) Light switches, electrical outlets, thermostats, and other environmental controls in accessible locations

c) Reinforcements in bathroom walls to allow later installation of grab bars

d) Usable kitchens and bathrooms that can be navigated by an individual in a wheelchair

**LEARN MORE**

You can learn more about these Accessibility Guidelines from the federal Access Board (also known as the Architectural and Transportation Barriers Compliance Board), which can be found online here: [http://www.access-board.gov/](http://www.access-board.gov/).

As mentioned previously, compliance with these guidelines is not mandatory. Builders and developers may choose to depart from the Guidelines, and seek alternate ways to meet the legal requirements of the ADA while maintaining the spirit of the Act and other anti-discrimination legislation.

**SUMMARY**

Aside from the Fair Housing Act, there are two other important federal Acts that protect individuals from discrimination in their efforts to procure housing: the federal Equal Credit Opportunity Act (ECOA) and the Americans with Disabilities Act (ADA).

The ECOA is Title VII of the Consumer Protection Act; it prohibits lenders from discriminating against credit applicants on the basis of their race, color, religion, national origin, sex, marital status, age or dependence on public assistance programs. Under the ECOA, a lender:

- May not ask if an applicant is divorced or widowed, but may ask if a borrower is married, unmarried or separated
- May not ask about the receipt of alimony or child support unless the borrower intends to use that money to qualify for the loan, but may ask if a borrower must pay alimony or child support
- May not ask about a borrower's birth control or intentions for child-bearing
- May not ask about a borrower’s spouse unless that person will be involved in the contract
- May not discount or exclude any income because of the source of that income
- Must report credit information on married couples separately in the name of each spouse
- May not ask about the applicant’s race or national origin.

The ADA is a federal law that serves to protect the civil rights of individuals with disabilities. The ADA addresses discrimination in employment, public services,
public accommodations and commercial facilities and telecommunications. Under the ADA, most commercial real estate, as well as all government offices and facilities must be assessable to disabled persons.

Specifically, the ADA requires that all of the following be made readily accessible to disabled persons:

- Businesses with 15 or more employees
- State and local government offices
- Public and private schools
- Hospitals and dental offices
- Restaurants, hotels and motels
- Grocery and retail stores
- Shopping malls
- Libraries and museums
- Banks, theaters and amusement and recreation parks

These broad requirements mean that if a real estate licensee is assisting or otherwise representing a commercial buyer, buyer-client or customer, then the licensee should tell the customer that the finish-out (i.e., the adaptation of a space for owner or tenant’s use) must include any alterations necessary to ensure that the space is accessible and otherwise in compliance with ADA regulations. To assist homebuilders and landlords in constructing accessible dwellings and updating older dwellings, HUD has published Accessibility Guidelines.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FOUR
ENFORCEMENT OF FAIR HOUSING LAWS

This lesson focuses on the following topics:

- Fair Housing Complaints
- Complaint Investigation and Conciliation
- Penalties
- Civil Proceedings

INTRODUCTION

Members of the public who feel that they have been or are being discriminated against may file suit with HUD. Within 100 days of receiving a complaint, HUD must notify the complainant as to whether it intends to act on the complaint. There are a variety of ways that HUD can handle a particular dispute, including informal negotiations and legal proceedings. The penalties arising from a lawsuit can be extremely stiff. This lesson will outline the specific ways that HUD handles complaints, as well as the use and significance of informal negotiations, or conciliation, as well as the penalties for non-compliance.

Both the person who files a complaint and the individual who is charged with the violation have the right to ask that the matter be resolved by a civil action, rather than through an administrative proceeding. The last section of this lesson will outline the role of civil proceedings in fair housing complaints as well as the role of the Attorney General.

FAIR HOUSING COMPLAINTS

The Secretary of the Department of Housing and Urban Development is in charge of enforcing fair housing law. HUD can initiate action against licensees who violate fair housing law even if a member of the public does not make a complaint. Any person who believes that he or she has been injured by the discriminatory practices of a real estate licensee, or who believes that he or she is being or will be injured, may file a complaint with HUD. Complaints must be in writing and must contain the specific information that HUD requires, such as the date of the incident, its location, the name(s) of the party or parties involved and other pertinent details. All complaints must be filed with HUD within one year of the date that the alleged act of discrimination took place.

HUD investigates some complaints by using what they call “testers.” These are sets of people who are members of various groups—some legally protected, some not—who employ the services of a business. The goal here is to determine whether that business treats the members of different groups in a fair and approximately equal way. For example, suppose someone files a fair
housing complaint alleging religious discrimination: a Jewish family has complained that a real estate licensee only showed them properties near synagogues, even though they had expressed no interest in living near a synagogue. When asking to see properties in other areas, they allegedly were told that the properties they were being shown were those that best fit their needs. The tester in this situation would likely be a non-Jewish family whose housing requirements and qualifications match those of the Jewish family. The testers would then be sent to the same real estate office. If the non-Jewish family were shown properties not near synagogues, the results of the testing would incriminate the real estate office.

**SELF-TESTING**

In the 1997 Omnibus Appropriations Act, Congress established “a privilege for lender-initiated self-tests of residential real estate related to lending transactions” as part of their efforts to ensure fair lending practices. In essence, this privilege allows lenders to conduct self-tests to evaluate their lending practices. If they find discriminatory practices in their business, then they are allowed to remedy these without federal lawsuits. This Act encourages lenders to be critical about their lending practices and to engage in self-testing, which will, ideally, lead to more equitable lending practices.

**COMPLAINTS REQUIRING IMMEDIATE ACTION**

Sometimes, when discriminatory action requires an immediate solution HUD will attempt to establish a temporary solution to the complaint while it works on completing a full investigation. HUD may also ask the Attorney General to handle the suit in court, to obtain temporary or preliminary relief. A fair housing complaint that requires immediate action meets the following conditions:

- Irreparable harm will more than likely result without immediate action.
- Substantial, compelling evidence exists that indicates a violation of the fair housing laws.

Given the potential for serious harm and clear indication of illegal activity, you can see why these cases would merit immediate action. Consider the following example:

A tenant is scheduled to move out of her current apartment and into a new one. She has submitted her application paperwork electronically and has not yet met the landlord in person, although she has been approved for the apartment. One day she stops by the apartment building with a friend and meets the landlord of the building. The landlord decides that this new tenant looks to be of Middle Eastern descent and feels that he would prefer that there were no Middle Eastern individuals living in his building. He revokes the tenant’s lease contract. The tenant’s old lease is up, and she must vacate her previous apartment. If the
landlord does not allow her to move in, then the tenant may be without a residence.

In this situation, time is of the essence. Consequently, HUD might pass the case on to the Attorney General for immediate attention while it files a complete investigatory report.

**COMPLAINT REFERRALS**

Depending on state and local laws, there may be other venues—in addition to HUD—in which fair housing cases can be filed; in some cases, multiple venues may have jurisdiction over one case. In other words, a real estate licensee may be subject to more than one legal action for any one act of alleged discrimination.

If HUD determines that a state or local agency in the area of the complainant is “substantially equivalent” in powers to HUD, then it will refer the case to the agency for investigation, and notify the complainant of the referral. If the agency does not take action within a thirty-day period, then HUD may take back the case.

**COMPLAINT INVESTIGATION AND CONCILIATION**

Within 100 days of receiving any complaint, HUD must notify a complainant as to whether it intends to act on the complaint. In addition to full legal proceedings, HUD may also use informal conferences to resolve complaints as well as issues that arise over the course of an investigation.

**CONCILIATION**

Sometimes complaints may be the result of a simple misunderstanding, or an investigation may reveal issues that require additional clarification. If HUD believes this is the case, then it can hold an informal meeting to help resolve the issue. In the federal Fair Housing Act this type of informal conference is referred to as conciliation.

*Conciliation* is an attempt to resolve the issues raised by a complaint or an investigation though informal negotiations between the aggrieved person, the respondent and the HUD Secretary. With the exception of actual, written agreements that may result from conciliation, nothing said during the course of informal conferences may be made public or used as evidence in subsequent proceedings without the written consent of all parties concerned.

The respondent and the complainant can reach agreement during conciliation. For any such conciliation agreement to be binding both parties must accept it; the agreement may also be subject to the HUD Secretary’s approval. Agreements
must be made public, unless there is an alternative that is acceptable to both the respondent and the complainant.

If a complainant feels that his or her complaint has not been handled properly, then he or she may seek civil proceedings to resolve the issue. The complainant has this option following conciliation as well. For example, if a conciliation process leads HUD to conclude that dismissal is the best way to handle a case, but the complainant still feels that discrimination has occurred, then he or she may take the issue to the civil courts.

**PENALTIES**

If HUD determines that a discriminatory practice has occurred, or is in the process of occurring, then an administrative hearing on the charges may be in order. If an administrative hearing takes place and concludes that there has been a violation of fair housing law, then the person or group who violated the law can be ordered to:

- Compensate the complainant for actual damages, including humiliation, pain and suffering.
- Provide injunctive or other equitable relief, for example, making the housing available to the complainant.
- Pay the Federal Government a civil penalty. The maximum penalties are $10,000 for a first violation and $50,000 for a third violation within seven years.
- Pay reasonable attorney's fees and costs.

In addition if the person charged with the violation is licensed, the licensing agency must be notified of the decision.

**CIVIL PROCEEDINGS**

Both the complainant and the individual charged with the violation have the right to resolve the matter by a civil action, rather than an administrative proceeding. If the person being charged elects to have the matter resolved by a civil action, then HUD will request that the lawsuit be filed by the Attorney General. The court in such a civil action has the authority to assess sizeable financial penalties, which may also include reparations and relief, court costs and attorney’s fees.

In any civil action, the burden of proof is on the person making the complaint. In order to have a legal basis for a case, a complainant must show that:

- He or she is a member of a protected class.
- He or she applied for and was qualified to rent or purchase the property
but was rejected.
- The property remained available after the rejection—i.e., the property was rented or sold to someone else after it was denied to the qualified person making the complaint.

**SUMMARY**

The Secretary of the Department of Housing and Urban Development (HUD) is charged with enforcing fair housing laws. Any person who believes that he or she has been or is being injured by a real estate licensee’s discriminatory practice may file a complaint with HUD.

Within 100 days of receiving a complaint, HUD must notify a complainant as to whether it intends to act on the complaint. HUD has the power to order administrative hearings and penalties if it determines that a discriminatory practice has occurred or is in the process of occurring. The maximum civil penalties that can be imposed are $10,000 for a first violation and $50,000 for a third violation within seven years.

Both the party making the accusation of discrimination and the accused have the right to resolve the matter in a civil proceeding if either so chooses. In a civil action, the burden of proof rests with the complainant. If the person being charged elects to have the matter resolved by a civil action, then HUD will request that the lawsuit be filed by the Attorney General.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FIVE
AVOIDING DISCRIMINATORY PRACTICES

This lesson focuses on the following topics:

- General Recommendations
- The HUD/NAR Partnership
- HUD Advertising Guidelines
- Demonstrating a Commitment to Fairness

INTRODUCTION

This lesson will outline ways that real estate licensees can adhere to both the letter and spirit of federal fair housing legislation. Initially, it will discuss general practices that can help licensees to provide their services in a fair and effective manner. The lesson also covers one professional organization that real estate licensees can join, the National Association of REALTORS®, which works for equity in real estate practices. The lesson will go on to address common advertising concerns, detailing specifically the types of words and phrases that real estate licensees must avoid in their marketing materials.

In addition to discussing these more specific issues, the last sections of this lesson will go over ways that licensees can publicize their dedication to fair housing and their active commitment to HUD’s various programs and recommendations.

GENERAL RECOMMENDATIONS

In order to avoid violating federal fair housing guidelines, it is important that real estate professionals familiarize themselves with the law. A licensee should:

- Be sure that he or she discusses potential sources of conflict with the parties involved—for example, if a seller client wants his house shown only to members of a particular group, the licensee should inform this seller that she cannot help him to do this nor can she do it for him.
- Never conduct business with individuals who are unwilling to comply with the law.
- Be careful to treat all parties involved in a transaction equally.
- Develop a system of working with buyers (or tenants) that delivers equal professional service to all buyers (or tenants)—that is, the licensee should develop a general approach that he uses with everyone and tailor his services only to individuals' particular housing needs, not to their class membership.
- Develop a system of working with sellers (or landlords) that will assure...
equal professional service to all sellers (or landlords)—as before, the objective here is a general approach that guarantees everyone the same treatment regardless of their class membership.

- Never use protected classes as a basis for advising a prospect, in a positive or negative way, about renting or buying a property.
- Take fair housing courses annually to ensure awareness of all current and new laws.
- Be positive! The licensee should not merely comply with the law and HUD guidelines—he or she should go beyond this and figure out new and different ways to make the most comprehensive housing opportunities available to the greatest number of people.

Being positive and actively helping all kinds of people is the best practice. For example, if a licensee lives in an area that features a wide variety of nationalities and various spoken languages, he or she might contact local organizations, churches and government services to find translators and interpreters to aid in assisting prospective tenants who are non-English speakers. This would be a proactive approach that demonstrates a licensee’s desire to provide housing to a wide range of people regardless of their class membership.

It is also important that all licensees develop a reasonably uniform system for assisting buyers/lessees and sellers/lessors that treats everyone fairly. The next section covers what such a system might entail, first with buyers and lessees, and then with sellers and lessors.

DEVELOPING A GENERAL SYSTEM FOR ASSISTING BUYERS AND TENANTS

A system that aims to provide equitable professional service when working with buyers or tenants may include:

- A standard way of welcoming buyers and tenants to the office—perhaps by offering each person a cup of coffee or glass of water.
- A standard way of discussing the agency relationship and the agency options available to buyers and tenants.
- A standard set of questions to discover what services a buyer or tenant is looking for from a representative.
- A standard set of questions used to discover a buyer or tenant’s housing wants and needs, as well as his or her ability to purchase or rent.
- A standard way of selling the services available through the real estate professional and his or her company.
- A standard way of asking whether a buyer or tenant will allow the licensee to represent him or her.
- A standard procedure for selecting appropriate properties to show.
- A standard procedure for showing property.
• A standard procedure for closing the sale.
• A standard procedure for following up with buyers and tenants during the escrow process.
• A standard procedure for following up after the sale and asking for referrals.

DEVELOPING A GENERAL SYSTEM FOR ASSISTING SELLERS AND LANDLORDS

A system that aims to provide equitable professional service when working with sellers and landlords may include:

• A standard way of welcoming sellers and landlords to the office, perhaps by offering each person a cup of coffee or glass of water. Or, if meeting a seller or landlord at a home or property, an equitable general system should include a standard way to greet the person and express the desire to discuss his or her real estate needs.
• A standard way of discussing the agency relationship and the agency options available to sellers and landlords.
• A standard set of questions posed to each seller or landlord to discover his or her motivation for selling or leasing a property.
• A standard set of questions used to discover what services the seller or landlord seeks from an agency.
• A standard way of tailoring services to the seller or landlord’s expressed desires and goals, provided that those desires and goals are lawful and within the scope of the company’s services.
• A standard way of presenting the services that the real estate licensee and company can offer to the seller or landlord in response to his or her express wishes.
• A standard way to present the Market Analysis and the seller or landlord’s net sheet.
• A standard way to ask for the listing.
• A standard way to follow up on the marketing plan presented in the listing presentation.
• A standard way of communicating activity to the seller or landlord.
• A standard way of preparing to present offers in a timely manner.
• A standard way of following up on transaction details when properties are in escrow.
• A standard way of following up with sellers or landlords.
• A standard way of asking for referrals.

THE BROAD IMPORTANCE OF A GENERAL SYSTEM

The point here is not that compliance with fair housing laws requires all licensees to adopt a contrived script that they use in a mechanical way in every market and
with every client. Any system of equitable professional service will be unique to its market and will reflect the services offered by the real estate licensee and her company. The guiding principle in any non-discrimination measure enacted by a real estate business should be: treat everyone similarly.

The important thing is to have a system that gives equitable service to all people regardless of race, color, religion, national origin, sex, familial status or disability. This type of system will keep a real estate professional from overlooking important details. Perhaps more importantly, it will also prevent the licensee from making assumptions about what clients want, what they can understand, or what they can afford. These assumptions, even when well intentioned, prevent a licensee from truly understanding what clients are seeking, and thus prevent real estate professionals from providing the best possible service. In addition, these assumptions can also lay the groundwork for discrimination lawsuits.

THE HUD/NAR PARTNERSHIP

One way that real estate licensees can help to ensure non-discrimination is by joining a professional organization that supports equality and fair housing practices in the real estate industry. One such professional organization is the National Association of REALTORS®, or NAR.

The National Association of REALTORS® and the U.S. Department of Housing and Urban Development (HUD) have entered into a partnership to show that both entities are committed to fair housing principles and will use their collective resources to ensure that this commitment is demonstrated in practice. This partnership is important because it allows the two organizations to benefit from one another’s areas of expertise.

There are four specific goals that guide this partnership. They are:

- Sharing the responsibility for fair housing compliance
- Identifying fair housing issues and concerns
- Developing strategies for addressing fair housing issues and concerns
- Evaluating the success of attempts to resolve fair housing issues and concerns

HUD ADVERTISING GUIDELINES

To assist real estate licensees in their efforts to comply with fair housing laws, HUD has established certain advertising guidelines. In real estate advertising, the selective use of words, phrases, symbols, visual aids and particular media may indicate (or appear to indicate) an advertiser’s preference for or prejudice against members of various protected classes, and may thus result in discriminatory advertising. For example, if a broker’s advertisements contain words in that could reasonably be construed as discriminating against the
members of a protected class, this advertisement is likely to lead to charges of violating the law. Under the Fair Housing Act, those who publish discriminatory advertising, such as newspapers, can also be held legally liable and potentially be charged with violations of law.

The fundamental principle that should guide real estate licensees when advertising is: Describe the property, not the people.

For example, a licensee may be thinking about publishing the following ad:

1 BR/ 1BA Non-smoking white couples preferred. Contact Al 555-7349.

The underlying problem with this ad is that it describes the type of people to whom the landlord wishes to rent rather than the property itself. “Couples preferred” discriminates on the basis of familial status, and “white” discriminates on the basis of race. This is not only wrong, but is also prohibited by the Civil Rights Act of 1968.

Avoiding unethical discrimination in advertising will not only thwart many a lawsuit, but is also helpful in selling housing. Notice that the problematic advertisement in fact mentions very few of the property’s actual features and none of its distinctive qualities; thus, giving the reader little reason for wanting to view it.

Now consider a revised version of the same advertisement:

1 BR/ 1 BA Cozy, wood flooring. AC/ heat. New windows. Contact Al 555-7349.

This revision both avoids unethical discrimination and provides a much more effective description of the property. Thereby giving the reader reasons to want to view, and perhaps even rent, the property.

**LIABILITY FOR DISCRIMINATORY ADVERTISEMENTS**

HUD has taken the position that newspapers incur liability for publishing advertisements that violate the Fair Housing Act. As a result, many newspapers across the country have created lists specifying acceptable and unacceptable language for advertisements.

In 1995, Roberta Achtenberg (then the Assistant Secretary for Fair Housing and Equal Opportunity) wrote a memorandum that provides specific guidelines for housing advertisements. This document gives specific details about what kind of language should be used to ensure non-discrimination against all seven protected classes.
LEARN MORE
The rest of this section outlines Achtenberg’s memo, but if you would like to view that memo in its entirety, the National Fair Housing Advocate makes it available online at:

The lists of acceptable and unacceptable language provided below are intended merely as examples. Newspapers in your area may have adopted language standards of their own.

ACCEPTABLE WORDS AND PHRASES

Bachelor apartment
Close to downtown
Den
Family room
Near
No smoking
Sober
Fourth-floor walk-up
Walk to bus stop
Wheelchair ramp
Number of bedrooms
Master bedroom
Mother-in-law apartment
School district
Schools
Play area
One apartment
Privacy
Secluded
Security provided
Seniors (if certified by HUD as senior housing)
Square feet
Townhouse
Traditional (style of home)—for example, “traditional Victorian”

UNACCEPTABLE WORDS AND PHRASES

Adults only
Black
Blind
Catholic Church
Christian
Couple (including “couple preferred,” “couples only,” and similar phrases)
Ethnic landmarks
Family (including the phrase “great for families”)
Handicap limitations/not suitable for handicapped
Jewish
Male
Man
Mentally handicapped
Mentally ill
Mentally retarded
Mormon Temple
No members of group X—for example, the phrase “No Irish need apply”
No children
No wheelchairs
One child
Oriental
Private
Race
White family home

In addition, advertisements should avoid words like “private,” “exclusive” and “integrated,” which may indicate the advertiser’s preferences and imply certain things about the community’s economic or ethnic make-up. It is also important to avoid referencing racial, cultural, religious or ethnic monuments, museums or landmarks, because these references can be taken to imply that only certain
people are welcome in that location. For example, an advertisement mentioning a specific religious venue might be taken to suggest that only those who participate in that religion should contact the advertiser, or to indicate that the advertiser has a preference for those who are involved in that religion.

Colloquialisms and regional phrases that may convey discriminatory preferences do not generally lend themselves to statewide or nationwide lists. Consequently, brokers should familiarize themselves with local and emerging terminology that might be interpreted as discriminatory and avoid such language in their advertising.

OTHER ADVERTISING CONSIDERATIONS

Even if the language used in real estate advertising does not convey a discriminatory preference, the selective use of particular media or models still can. For example, if the cast of an advertisement lacks diversity or the advertisement uses different models depending on the community in which the advertisement is to be displayed, these practices can be discriminatory. Consider the following example:

Broker X runs two ads in two different sections of town, Y-ville and Z-burg. In Y-ville, his advertisement uses models of various ethnic backgrounds; in Z-burg, his advertisement uses a racially homogenous cast.

The discrepancies between X’s advertisements are suspect. The advertisement without diverse models may illustrate a preference for the class of persons represented, effectively discriminating against all others. Even if this is not Broker X’s intent, his advertisement may still be interpreted in this way, by both the law and his potential clients. When planning an advertising campaign featuring pictures of buyers and sellers, it is important to consider the diversity of the people shown in the campaign and to commit to using diverse casts consistently.

There are numerous other ways that advertisements can discriminate. For example, some advertisements discriminate against people because of a broker’s practice of making listings accessible in only one language. Consider the following example:

Broker X works in an area where English is not the primary language of many residents. Although several bilingual publications are printed in the area, the broker advertises his listings only in publications that are printed in English.

Because Broker X works in an area that has a large non-English-speaking population but advertises his listings only in English-language publications, Broker X may be (or may be viewed as) favoring English-speaking applicants, effectively discriminating against all non-English speaking individuals.
One way that licensees can indicate their dedication to fair housing practices is by including the Equal Housing Opportunity logo on everything they distribute. According to one recent study, however, only 16% of real estate licensees display the Equal Housing Opportunity logo on their business cards.

**DEMONSTRATING A COMMITMENT TO FAIRNESS**

HUD’s fair housing regulations require real estate licensees who market dwellings to display a fair housing poster in the broker’s place of business. Brokers can get these posters from any HUD office. The poster describes the basic fair housing practices and tells people how to register a complaint if they feel they have been discriminated against. The fair housing poster must be prominently displayed so that it may be easily seen by any person seeking to engage a broker’s services.

**LEARN MORE:**

Although the law requires brokers to display this poster, there is no specific penalty simply for failing to do so. However, the legislation does note that failure to display the poster is taken to be presumptive evidence of discriminatory housing practices, so it is truly important that brokers comply with this law. A broker who features the Equal Housing Opportunity logo prominently in all publications and displays this poster is in a better position to defend against discrimination lawsuits than one who does not.

**SUMMARY**

This lesson outlined ways that real estate licensees can adhere to both the letter and spirit of federal fair housing legislation. In particular, it focused on ways that licensees can avoid discriminatory advertisements and demonstrate their dedication to fair housing to their potential clients and customers.
In general, developing a standard way of addressing, meeting and greeting all potential clients and customers—both in person and on the phone—will help you avoid accidental discrimination. Similarly, it is important to develop a standard battery of questions that are then asked of all buyers and lessors (or all sellers and landlords) to help identify their needs and goals. This is a good idea because it will help ensure that the licensee’s assumptions are not mistaken for facts about the client and that these assumptions do not lead the licensee into accidental discrimination. In addition, a generalized approach helps a licensee to provide the same degree and quality of customer service to all clients.

One way that a real estate licensee can evidence non-discrimination is by joining a professional organization that works to promote fair housing. One such organization is the National Association of REALTORS®. In fact, the National Association of REALTORS® and the U.S. Department of Housing and Urban Development (HUD) have entered into a partnership, with the goal of making fair housing more accessible. Together, HUD and NAR hope to share the responsibilities associated with fair housing compliance, to identify fair housing issues and concerns, to develop strategies for addressing these issues and concerns and to evaluate the success of these endeavors.

Brokers must be especially careful in their advertisements. In addition to discriminatory statements, HUD will also prosecute those persons who exploit language barriers, models or particular media to illustrate an unethical and unfair preference. If a discriminatory ad is published, then both the writer and the publisher (for example, the newspaper or magazine) can be held responsible. Avoiding discriminatory advertising is essential. Just remember: Describe the property, not the people.

Return to your on-line course player to take the Lesson Quiz.
LESSON SIX
REAL WORLD PRACTICE

This lesson focuses on the following topics:

- Real World Practice
- Case Studies

INTRODUCTION

This module has covered a lot of detailed information in a relatively short time. To help ensure your comprehensive understanding of the material presented in this module, the content has been integrated into a series of broad questions and case studies to which you will be asked to respond. Please consider your response carefully.

REAL WORLD PRACTICE

In the following exercise you will be presented with two situations. Before continuing, decide which situation seems to be the most appropriate answer to the question. Write your answer in the space provided and check your answer on the next page.

1. Which of the following situations is ILLEGAL under the federal Fair Housing Act?

Situation 1: Landlord A is the owner of a large apartment complex. Before he rents to any person, he requires proof of employment and a credit check.

Situation 2: Landlord B also owns a large apartment complex. Concerned for her own health, she refuses to rent her apartments to individuals who are HIV positive.
ANSWER:
1
Which of the following situations is ILLEGAL under the federal Fair Housing Act?

Situation 1 is incorrect:
It is legally acceptable to require prospective tenants to agree to a credit check and offer proof of employment. This is because (unlike sex, religion, familial status, color, race, national origin or disability) credit history and employment status provide evidence of a person’s financial standing, which is directly relevant to the process of renting an apartment.

Situation 2 is correct:
HIV can affect a person’s major life activities. Consequently, HIV positive persons are considered disabled and, thus, a protected class under the federal Fair Housing Act. Please continue.

2
Which of the following situations is ILLEGAL under the federal Fair Housing Act? Write your answer in the space provided and check your answer on the next page.

Situation 1: Tenant A lost the use of her leg in a car accident. She lives on the second floor of an apartment building that does not have an elevator. In an effort to make reasonable accommodations that allow her the full use and enjoyment of the apartment, her landlord has allowed her to install a stair lift. However, he is requiring her to pay an extra security deposit to ensure that he can restore the building to its prior condition when she moves out.

Situation 2: A family with one child wants to look at an apartment complex. The landlord tells them that she cannot rent to them because of the child, explaining that the complex is HUD-certified housing for older persons.
ANSWER:
2
Which of the following situations is ILLEGAL under the federal Fair Housing Act?

Situation 1 is correct:
It is illegal under federal law to discriminate in the terms, conditions, or privileges of the rental of a dwelling, so a landlord may not charge a disabled tenant a higher security deposit. However, if the tenant elects to modify the apartment in a way that renders it less usable for non-disabled tenants (for example, if the tenant chooses to lower the kitchen counters), then the landlord may legally require that the disabled tenant deposit funds in an escrow account which are adequate to pay for returning the property to its original condition when the tenant moves out. The tenant will collect the interest from the fund he or she arranges to have this work done satisfactorily, but the landlord will receive the interest if he or she has to pay to have this work done.

Situation 2 is incorrect:
Even though the federal Fair Housing Act makes it illegal to discriminate against families that contain at least one child under the age of eighteen, the law provides an exemption covering housing for older people. Housing qualifies for this exemption if one or more of the following three conditions applies: (a) all residents are over the age of 62, (b) 80% of the units are occupied by residents over the age of 55, and the landlord adheres to a policy of housing persons over 55, or (c) it is under any state or federal program that the Secretary of Housing and Urban Development determines is designed and operated to provide assistance to the elderly.

3
Which of the following situations is ILLEGAL under the federal Fair Housing Act? Write your answer in the space provided and check your answer on the next page.

Situation 1: A landlord owns an apartment complex that does not allow pets. A blind person with an assistive animal asks to be shown a unit in that complex. He refuses, saying that he does not mean to discriminate but he cannot rent to someone who has a pet.

Situation 2: A church owns a few dwellings on its properties that are generally used to house church officials and members of the congregation. One of these properties becomes vacant and a person who does not subscribe to their religious beliefs or attend the church wants to view the dwelling. A church official refuses, stating that the dwellings are reserved for church officials and members of the congregation.
Which of the following situations is ILLEGAL under the federal Fair Housing Act?

**Situation 1** is correct:
Refusing to show or rent a dwelling to someone simply because that individual has an assistive animal constitutes discrimination on the basis of disability. The landlord in this situation must make a reasonable accommodation for this prospective tenant—that is to say, he must make an exception to his usual “no pets” policy. Even if the landlord explicitly states that he is not trying to discriminate (as is the case in the example), he is still doing so and, therefore, is violating the federal Fair Housing Act.

**Situation 2** is incorrect:
Although it is generally true that you cannot deny someone access to housing simply because that person is not a member of a particular church or affiliated with a certain religion, the fair housing laws make exceptions for dwellings owned by religious organizations when these dwellings are not used for commercial purposes. Although all organizations should check with local, state and federal authorities before assuming they are exempt from fair housing requirements, the dwelling described in this situation would qualify for an exemption.

Which of the following situations is ILLEGAL under the Equal Credit Opportunity Act?
Write your answer in the space provided and check your answer on the next page.

**Situation 1**: Lender A is evaluating applicant B for a loan. A asks B whether or not B has any obligations to pay alimony or child support.

**Situation 2**: Lender C is evaluating applicant D for a loan. C asks D whether or not D is divorced.
ANSWER:
4
Which of the following situations is ILLEGAL under the Equal Credit Opportunity Act?

Situation 1 is incorrect:
It is legal for a lender to ask a prospective borrower about any obligations to pay alimony or child support because these obligations affect the prospective borrower’s financial standing and ability to repay the loan. However, it is illegal for a lender to ask whether a prospective borrower RECEIVES alimony or child support unless the prospective borrower has stated an intention to use that money to qualify for the loan.

Situation 2 is correct:
The lender may ask if the borrower is married, unmarried or separated, but may not ask if the applicant is divorced or widowed. Please continue.

5
As discussed earlier in the lesson, HUD often uses “testers” to investigate fair housing complaints. A “tester” is an individual posing as someone seeking a dwelling in an effort to help HUD establish whether a given situation involves discriminatory housing practices. Choose the following “tester” situation that provides evidence of ILLEGAL discriminatory practices.
Write your answer in the space provided and check your answer on the next page.

Situation 1: HUD receives a complaint of racial discrimination from a client of a real estate business. In response, HUD sends eight testers to visit the business, four of them African-American and four of them Caucasian. All of them have similar financial qualifications and housing requirements. The business manager tells the four African-American testers that they have no listings that meet their needs, but shows the four Caucasian testers available properties.

Situation 2: HUD receives a complaint stating that an apartment complex discriminated against a person because of the person’s disability. HUD sends four testers to view the complex, all of whom have similar qualifications and requirements. Three of the testers have physical disabilities that the landlord will likely notice, the other does not. The landlord shows all four testers the same available units.
ANSWER:
5
As discussed earlier in the lesson, HUD often uses “testers” to investigate fair housing complaints. Choose the following “tester” situation that provides evidence of ILLEGAL discriminatory practices.

Situation 1 is correct:
Because persons of one ethnicity/color are turned away while persons of a different ethnicity/color are not, HUD’s testing process has provided strong evidence that discrimination is occurring.

Situation 2 is incorrect:
Because the landlord showed all of the testers the same units regardless of whether the person was visibly disabled, it is unlikely that the landlord is discriminating based on disability. However, if HUD believes that further investigation is necessary, a representative may continue looking into the matter—that is, the fact that the landlord “passed” this test does not mean that HUD’s investigation of the complaint is over.

6
Which one of the following advertisements is UNACCEPTABLE?
Write your answer in the space provided and check your answer on the next page.

Advertisement 1: 2br/1ba apt /Berber carpet/ close to downtown/ no smoking

Advertisement 2: 5br/3.5ba townhouse/no smoking, drinking/near Catholic church
ANSWER:

6

Which one of the following advertisements is UNACCEPTABLE?

Advertisement 1 is incorrect:
All of the words and phrases used in the advertisement are acceptable under HUD advertising guidelines.

Advertisement 2 is correct:
Under HUD advertising guidelines, to specify that the home is near a Catholic church is unacceptable. Please continue.

7

Choose the advertisement that is UNACCEPTABLE under HUD advertising guidelines.
Write your answer in the space provided and check your answer on the next page.

Advertisement 1: 3br/1ba house downtown. Tranquil setting.

Advertisement 2: 2br/2ba cottage near cape. Couples only. Non-smoking/drinking.
ANSWER:
7
Choose the advertisement that is UNACCEPTABLE under HUD advertising guidelines.

Advertisement 1 is incorrect:
All of the words and phrases used in the advertisement are acceptable under HUD advertising guidelines.

Advertisement 2 is correct:
Under HUD advertising guidelines, to specify “for couples only” is unacceptable because it discriminates on the basis of familial status. Please continue.

CASE STUDIES

The following sections present five case studies that highlight some of the fair housing issues we have covered in this course. The first three are presentations of actual court cases; the last two are hypothetical situations offered for your consideration. As you read, try to anticipate the outcome of the case or the appropriate response to the hypothetical situation.

The case studies will cover each of the following topics in the order listed below:

- Disability
- Non-Discrimination
- HUD
- Discrimination Depends on the Act, Not the Intent
- Placing an Advertisement

CASE STUDY ONE

Disability

In *Gittleman v. Woodhaven Condominium Association, Inc.*, the Woodhaven Condominium Association refused to grant an exclusive parking space to a disabled unit owner because the Master Deed stated that parking spaces were to be nonexclusive, common elements owned by all unit owners as tenants in common.

Given this statement in the Master Deed, the Woodhaven Condominium Association claimed that it was unable to take any action which would diminish the undivided interest in the common elements held by each unit owner and further asserted that the only way to grant a particular parking space to an individual owner would be by a two-thirds affirmative vote of the unit owners.
Such a vote was taken, but the disabled unit owner did not receive the required number of votes and subsequently filed suit for relief under the Fair Housing Amendments Act, which makes it unlawful to discriminate against any person in the provision of services or facilities in his or her dwelling because of that person’s disability.

As stated in this course, federal fair housing legislation requires that a landlord or property management association make reasonable accommodations in the rules, policies and services that are necessary to afford a disabled person the equal opportunity to use and enjoy a dwelling; the refusal to do so is tantamount to discrimination. Whether the disabled person was discriminated against or not in this case depends upon whether or not the parking space request constitutes a “reasonable accommodation.”

Given the information in this course, how do you think the Court settled the matter?

Write your answer in the space provided and check your answer on the next page.
Court’s Decision in Case Study One:

The U.S. District Court agreed that, under the Master Deed, the parking spaces were nonexclusive and that two-thirds approval from the rest of the unit owners would usually be required for such policy changes. However, it maintained that the association was legally able and, in fact, required by the federal fair housing legislation to grant an exclusive parking space as it constituted a reasonable accommodation.

The court held that the Master Deed and bylaws of the condominium gave power to the Association to regulate use of the common elements. But, furthermore, and perhaps most importantly for our purposes, the Court stated that any provisions of the Master Deed that violated federal fair housing legislation were unlawful and, consequently, could not be legally enforced. In essence, the Court decided that providing a parking space to a disabled person constitutes a reasonable accommodation and, therefore, not providing such a space violated the federal Fair Housing Act.

Because enforcing the provision of the Master Deed at issue in this case would violate the Fair Housing Amendments Act, the Court refused to grant the Association’s motion for summary judgment. The Court also cited case law and the legislative history of the Fair Housing Amendments Act prohibiting discrimination based on the enforcement of private agreements, such as a master deed.

CASE STUDY TWO

Non-Discrimination

Fenner v. Coldwell Banker. The plaintiffs in this case were two Chicago police officers, Fenner and Jones, who were interested in purchasing a new home. Their real estate agent was an A. Richard; notably both Fenner and Richard were African-American.

The property that Fenner and Jones wished to purchase was listed for sale by Coldwell Banker through a listing broker, Nugent, for $124,500. A first offer of $123,000 was tendered by a family named McGuire and accepted by the owners. Fenner subsequently submitted another smaller offer of $120,000 while the first contract was pending. The owners counter-offered $123,500 subject to the pending McGuire contract; importantly, Jones and Fenner never responded to the counteroffer.

The problems in this case began prior to the offer-counteroffer process; while Fenner and Jones were viewing the home, the neighbor shouted racist statements at them. Nugent, the listing broker, told the neighbor that he was going to continue to show the property while the McGuire contract was pending.
Ultimately, Jones and Fenner’s offer was not accepted, but they were never contacted. Feeling as though race played a role in the issue, they filed suit under the federal Fair Housing Act.

The Plaintiffs (including Richard, their real estate agent) complained that Nugent never intended to follow up with Richard after the incident, allegedly discriminating against the prospective buyers on the basis of race. The Plaintiffs alleged that Nugent had a duty to contact them regarding the status of the offer, although they did not respond to the owner’s counteroffer of $123,500.

Given the information in this course, how do you think the Court settled the matter?

Write your answer in the space provided and check your answer on the next page.
Court’s Decision in Case Study Two:

The Court ruled against the Plaintiffs, giving several reasons for its decision that this was not a case of discrimination.

Initially, the Plaintiffs acknowledged that the Defendants, Nugent and Coldwell Banker, continued to show the property and never refused to conduct business. The Plaintiffs’ complaint was simply that they weren’t subsequently contacted about the status of their offer and felt that this act, in and of itself, constituted discrimination. The Court did not find sufficient evidence for this, citing—among other reasons—the fact that the Jones and Fenner offer was the lowest offer received as well as Jones and Fenner’s failure to respond to the seller’s counteroffer.

The Court stated that the unfortunate event might have had something to do with Jones and Fenner’s representation. Richard, as a real estate professional, should have known that the seller has no obligation to respond to all offers and that, when both sides have professional representation; furthermore, real estate licensees are ethically prevented from contacting the buyers or sellers directly. Because this practice is standard conduct in the field of real estate, ethical real estate practices would have forbidden Nugent or Coldwell Banker to contact either Jones or Fenner directly.

The Court also noted that, although unfortunate and discouraging, neither Coldwell Banker nor Nugent could be held responsible for the distasteful and unethical comments made by the neighbor.

CASE STUDY THREE

HUD

In Pfaff v. U.S. Dept. of Housing and Urban Development, landlords sought to enforce occupancy limits, regardless of the occupants’ ages. The landlords in this case, the Pfaffs, had a very small two-bedroom house for rent. One of the bedrooms was 10’x10’. There was a “den” consisting of an alcove opening into the living room. There was “very little yard,” no basement, and an “undersized garage.” The house had 1,200 total square feet. The landlords instructed their rental agent to restrict rentals in this house to no more than four persons. They had other rental properties that they offered to larger groups, including families with children and families with nontraditional arrangements. They concluded that this particular house, however, would suffer significant deterioration—and thus that they would be economically affected in a negative way—if it were occupied by more than four residents.
The agent nevertheless showed the house to a family of five, with three young children. When the landlords told the agent that the four-occupant limit was firm, the real estate agent argued that their policy violated the Fair Housing Act. The landlords fired the agent, and the tenants were forced to look elsewhere.

The tenants then filed suit, stating that they suffered considerable inconvenience in identifying substitute housing, that this experience led to the breakup of their marriage and that they felt “demeaned” as a result of the imposition of the occupancy limits upon them.

Given the information in this course, how do you think the Court settled the matter?

Write your answer in the space provided and check your answer on the next page.
Court’s Decision in Case Study Three:

Ultimately, and regardless of whether the landlords intentionally discriminated against certain families, a HUD hearing officer found that the Fair Housing Act imposed liability for more flexible occupancy limitations if firmer limits would have the effect of making housing inaccessible to families with children. HUD statistics showed that—in the area where this case occurred—households of five were overwhelmingly made up of families with children. This means that even if the Pfaffs really were trying to protect their investment, their actions had violated the Fair Housing Act.

The Pfaffs were found guilty of refusal to rent on a discriminatory basis and of making discriminatory statements in the course of business. After the investigation, the officer ordered damages, an injunction and a civil penalty, assessing the Pfaffs $20,000 in damages for emotional distress, an $8,000 civil penalty and $4,212.61 in compensatory damages.

CASE STUDY FOUR

Discrimination Depends on the Act, Not the Intent

Real Estate Licensee A is an apartment locator in a major metropolitan city with a population of three million. She has pre-qualified prospective tenant B over the phone. B has given A the following information.

- B and her husband work downtown and have very demanding jobs.
- They are expecting their first baby in two months.
- B plans to resume working after she has been home with the baby for six weeks.
- B’s husband makes enough money for them to qualify for $2,500 per month in rent without B’s income, but B enjoys working.
- They both want a good view, perhaps in a high-rise apartment building.
- They would like two bedrooms and a study.
- Since their jobs are demanding, they want to keep their commute to work as short as possible.
- B has provided her last name, which Licensee A believes is Hispanic.

Licensee A is a mother of four who believes that she knows how to raise children. She believes that B is in for a surprise in terms of the changes coming in her life with the arrival of a new baby. A realizes that B and her husband want a good view, but there is no way that A could sleep at night if she leased a high-rise apartment to a mother with a new baby. Licensee A believes that babies need fresh air and a yard to explore. In addition, she thinks that it would be too
strenuous for a family to carry all of the baby’s things up the stairs or in and out of the elevator everyday.

Licensee A knows of a lovely patio home for lease in a very nice Hispanic community, not too far from downtown. There is a wonderful nursery program in the neighborhood in which she thinks B and her family might be interested. She thinks that the patio home would be perfect for B and her husband, but she is also willing to show them some first floor apartments.

Incidentally, Licensee A also has access to several listings offering very nice high-rise apartments that are just five-minute commutes from B and her husband’s offices. However, Licensee A does not want to show these high-rises to B because of A’s belief that high-rises are not suitable for children. Besides, A is sure that B and her husband would enjoy either the patio home or the first-floor apartments and that once they have seen these options they will forget all about their high-rise idea.

Given what we have covered in this course, is there a violation of fair housing legislation taking place here?

Write your answer in the space provided and check your answer on the next page.
Case Study Four Response:

There are several problematic issues in this case study. First, Licensee A plans on steering B and her husband into a Hispanic neighborhood based on her own beliefs about the sound of their surname. The federal Fair Housing Act prohibits steering and discrimination on the basis of race and religion.

Second, Licensee A is discriminating against B and her family on the basis of their familial status by refusing to show them high-rise apartments. The fact that Licensee A has no prejudicial bias or discriminatory intent is not enough to absolve her of discrimination charges if a fair housing complaint is filed. As we discussed in this course, it’s the result of the licensee’s actions not her intention that matters.

CASE STUDY FIVE

Placing an Advertisement

Landlord Z owns four single-family dwellings. He has not made an exempt fair housing sale or rental in the past, and he has never lived on the property that is the subject of this case study. Z is very conventional in his views and lives a very conservative lifestyle. He has located a real estate professional whom he believes shares these conservative beliefs and whom he believes he can trust to find suitable tenants for his properties. Z has written an advertisement, which the licensee publishes in the local paper. It reads as follows:

2-1 duplex on quiet street. Suitable tenant will be non-smoking; straight, male preferred; no pets.

Landlord Z is now waiting for responses to the advertisement and for his real estate representative to produce prospective tenants.

Has the landlord or the real estate licensee representing him done anything that violates the federal Fair Housing Act? Write your answer in the space provided and check your answer on the next page.
Case Study Five Response:

This is a complex example, the nuances of which require professional legal interpretation. However, on the surface, we can identify a number of problematic issues. It is likely the case that Z and the real estate licensee (as well as the publishing entity, i.e., the local paper) have violated federal fair housing laws, and perhaps, even state and local fair housing laws as well.

As you may recall, the exemption to the federal Fair Housing Act reads that a sale or rental of a single family residence is exempt, provided that the owner:

- Does not own, or own an interest in, more than three single-family residences.
- Was the previous occupant of the dwelling being sold, or—if the owner was not the most recent resident—has not made another sale or rental exempt from fair housing laws in the past 24 months.
- Does not use the facilities or services of a real estate licensee, broker or salesperson.
- Does not use any discriminatory advertising.

The first problem here is that Z owns more than three dwellings. He is not the most recent resident of the property, but neither has he made any exempt sales or rentals in the last 24 months. If he owned three or fewer dwellings, this fact might help him qualify for an exemption, but since he owns more than three properties, this fact is not relevant to whether this transaction is exempt.

In addition, as soon as Landlord Z hired a real estate professional and published the discriminatory advertisement, he created further problems for himself by failing to satisfy the last two requirements for an exempt transaction. Federal housing law sees this advertisement as discriminatory because Landlord Z’s request for a male tenant indicates a preference based on gender. While sexual preference is not currently a protected class under the federal Fair Housing Act, it is in many state and local jurisdictions. That is to say, many states, cities and counties have more stringent laws, which would make the author of this advertisement guilty of other sorts of discrimination as well. Sexual orientation, gender identity and age are among the common groupings that local and state jurisdictions protect. It is possible (depending on where Landlord Z lives) that he violated other statutes, in addition to the federal Fair Housing Act.

It is worth noting that the newspaper that published the ad may be held liable as well. As you will recall from earlier lessons, HUD decided that publications incur liability for discriminatory advertisements.

Remember: fair housing laws protect all of us from unethical, unwarranted and inappropriate discrimination. Financially, it is a poor business practice to turn away qualified prospects, or to run advertisements that focus on eliminating
potential tenants rather than simply describing the property. Lost prospects may not translate into financial hardship, but discriminatory practices are not a good way to build up clientele, earn referrals or develop a respectable reputation. Ethically, one should strive to prevent unfair treatment and do one’s best to treat others fairly and respectfully, thereby upholding both the letter and the spirit of fair housing legislation.
LESSON SEVEN
TEXAS STATE LAWS AND REGULATIONS FOR FAIR HOUSING

This lesson will focus on:

- The Texas Fair Housing Act
- Filing Fair Housing Complaints in Texas
- Texas Real Estate Commission Code of Ethics

THE TEXAS FAIR HOUSING ACT

In 1989, the Texas Congress passed the Texas Fair Housing Act. It created a body known as the Texas Commission on Human Rights. The Texas Fair Housing Act and the Texas Commission on Human Rights are analogues of the Federal Fair Housing Act and HUD, respectively.

FILING FAIR HOUSING COMPLAINTS IN TEXAS

Fair housing complaints may be filed with the U.S. Department of Housing and Urban Development (HUD); but, since Texas has a fair housing program that has been judged “substantially equivalent” to that of HUD, complaints may also be filed with the Texas Commission on Human Rights. Complaints filed with HUD will be referred to the Commission.

Complaint resolution under the Fair Housing plan of the Texas Commission is similar to complaint resolution with HUD. Complaints must be filed within one year of the offending incident, and the Commission has 100 days to investigate the complaint. If the Commission determines that a violation of state or federal fair housing laws has occurred, the complaint may be resolved informally or given to an administrative law judge. An administrative judge may assess those same penalties that HUD has the power to assess, including monetary penalties between $25,000 and $50,000. The complaint filer may choose to take the matter to court to be resolved by a civil action, and in such an event the Commission will request that the Texas Attorney General file a lawsuit.

TX REAL ESTATE COMMISSION CODE OF ETHICS

Every applicant for a broker’s or a salesperson’s license in Texas is required to pledge to comply with the Canons of Professional Ethics and Conduct. This document outlines what the TX Real Estate Commission considers a discriminatory practice and prohibits real estate licensees from engaging in such practices. It states:
“No real estate licensee shall inquire about, respond to or facilitate inquiries about, or make a disclosure which indicates or is intended to indicate any preference, limitation or discrimination based on the following: race, color, religion, sex, national origin, ancestry, familial status, or handicap of an owner, previous or current occupant, potential purchaser, lessor or potential lessee of real property.”

“Lessor” and “lessee” here refer to landlords and tenants, respectively. Note that the Code of Ethics prohibits discrimination on the basis of ancestry, as well as the other federally protected classes.

**SUMMARY**

Texas law has in effect the Texas Fair Housing Act, which closely parallels the Federal Fair Housing Act. The former created the Texas Commission on Human Rights. It is the job of this commission to handle fair housing complaints in a timely manner. Real estate professionals in Texas are required to pledge to uphold a set of ethical standards defined in the Texas Real Estate Commission Code of Ethics, including prohibitions on discriminatory practices. The Code of Ethics protects ancestry as a class in addition to the seven federally protected classes.

*Return to your on-line course player to take the Lesson Quiz.*
# Texas Principles of Real Estate

## Module 5: Texas Law of Agency

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INTRODUCTION

Agency relationships are central to real estate transactions. In most transactions, the broker or licensee will represent either the buyer or the seller. In addition, it is also possible that the broker will act as a subagent for one party or that the broker will act as an intermediary between parties. Each of these relationships has its own set of guidelines, as well as its own ethical issues. Licensees who understand both the basic concepts involved in the agency relationship and Texas’s specific agency laws will be able to serve their clients to the best of their abilities and avoid litigation.

In accordance with TREC rules Sections 535.71 and 535.72D, this module discusses the basics of agency law, identifying the parties involved in an agency relationship, the methods of forming agency relationships and the type and scope of authority that various agents can have. In addition, the student will learn the rules for agency disclosure, the duties required of agents, the different types of agency agreements, the guidelines for terminating agency relationships and the employment laws in Texas that are relevant to agency relationships. The final lesson in this module discusses the laws that regulate trade practices to prohibit deceptive real estate activities.

As the student completes this module, he or she should attempt to fit this new information into his or her larger picture of the real estate profession. The final lesson of the module will assist in this process by presenting real world practice, broad comprehension questions and case studies for the student’s consideration.
KEY TERMS

**Actual Authority**: The express or implied authority that a principal gives an agent in an agency relationship.

**Agency Relationship**: A relationship created when one party designates another to represent his or her interests in dealings with a third party.

**Agent**: An individual authorized by a principal to make decisions on behalf of that principal and represent his or her interests.

**Apparent Authority**: The authority created when the principal falsely represents an agent to a third party, suggesting that the agent has significant authority when he or she has no actual authority.

**Double Exposure**: When an agent breaches fiduciary duties to one or both parties due to conflicting obligations created by pre-existing agency relationships with either party.

**Dual Agency**: The relationship created when an agent represents both the principal and the third party in a transaction.

**Estoppel**: A legal doctrine which forbids asserting rights or facts which are inconsistent with one’s previous position or any representation one has made by one’s action, conduct or silence.

**Express Actual Authority**: Authority that a principal grants to an agent directly, either orally or in writing.

**Express Agreement**: A method of creating an agency relationship in which the principal specifically appoints or hires an individual to serve as his or her agent, and the person appointed or hired accepts the position. This can be an oral or a written agreement.

**Fiduciary**: A person who has been entrusted to act for another person’s benefit or accepts responsibility for looking after another person’s interests. A fiduciary thus stands in a special relationship of trust with the person for whom he or she acts, and often has the authority to make decisions for that person.

**General Agent**: A type of agent who has broad authority in limited areas of the principal’s affairs. For example, a property manager is this sort of agent in relation to a property owner; the manager has broad authority to make decisions regarding the property, but not in any other area of the owner’s life.
**Gratuitous Agency:** An agency relationship in which the agent has waived any compensation. However, even when he or she is not compensated, the agent must still fulfill all the obligations of the agency relationship.

**Implied Actual Authority:** Power granted to an agent that has not been expressly conveyed by a principal (i.e., power which the principal has not granted orally or in writing), but which is necessary to carry out acts which the principal has expressly requested of the agent.

**Implied Agency:** This type of agency relationship is created when a licensee allows an individual to believe that he or she is representing that person. This kind of agency can be highly problematic because people can come to believe that a licensee is their agent when in fact the licensee represents another party. It is best to be very clear from the outset (with all parties) about whom is represented in any transaction.

**Intermediary:** In Texas real estate law, this term describes a real estate broker who represents both the buyer and the seller. A salesperson or affiliated licensee cannot act as an intermediary; only a broker may hold this position.

**Latent Defect:** Hidden defects in a property that might not be identified in an ordinary inspection but which could alter a prudent customer’s decision regarding the property.

**Listing Agent:** The agent who lists a seller’s property, also called a listing broker.

**Material Fact:** Information that affects the value of the property or the ability of a party to act in a transaction, i.e., a fact that is significant or essential to a given real estate transaction, or information that could reasonably be expected to influence a prudent person’s decisions regarding a transaction.

**Principal:** The individual who authorizes another party (the agent) to act on his or her behalf.

**Procuring Cause:** An effort that brings about a desired result, such as the action or actions that start a process leading to a sale.

**Puffing:** Exaggerated statements about a property that are not made as misrepresentations of fact, and which are not usually considered misrepresentative; thus, cannot usually be grounds for a lawsuit. For example, a broker or salesperson might say that a property on a small lot has a lovely yard; this statement would not be misrepresentative as long as any potential buyers are given the opportunity to assess the yard for themselves.
**Ratification:** One of the methods for creating an agency relationship or granting authority. When a non-agent acts as an agent (or when an agent acts outside the scope of his or her authority) and the principal subsequently agrees to or accepts the action, then agency is created by ratification. In essence, an agency relationship is created by ratification when an individual learns of someone acting as his or her agent, or of an established agent overreaching the scope of his or her authority, and the individual does not later deny the validity or authority of the agent’s act. His or her consent retroactively creates an agency agreement or contract.

**Salesperson:** A person who is associated with a licensed broker for the purpose of performing various real estate activities.

**Selling Agent:** An agent who procures a buyer for the property in a transaction.

**Special Agent:** An agent who has very limited authority in a specific transaction. Real estate agents are special agents.

**Subagent:** A license holder who represents a principal through the principal’s agent but who is not affiliated with the agent.

**Substantive Dialogue:** A meeting, conversation, or written communication that involves a meaningful, constructive discussion about a real estate transaction—that is to say, a substantive dialogue requires more than just passing remarks or general questions.

**Third Party:** The party who negotiates with the principal through the agent, often called the customer.

**Tort:** An action that is an intentional or negligent wrongdoing, or a breach of duty. An individual who is injured (financially or otherwise) by the wrongdoing or breach of duty can sue the party who committed the tort for damages.

**Warranty of Authority:** This is a kind of guarantee that an agent (or someone who represents herself as an agent) gives (explicitly or implicitly) to a third party. It is meant to establish that the agent has the authority to bind a principal—i.e., that the agent has the authority to make contracts, agreements, and enter into similar arrangements on the principal’s behalf. However, the agent cannot be held responsible if the principal does not or cannot follow through on the agreements the agent makes on the principal’s behalf. The warranty of authority concerns only the agent’s authority to act on the principal’s behalf, not his or her authority to ensure that the principal *himself* acts in a certain way.
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Identify the ways agency relationships are formed.
- Describe the role of the agent, the principal and the third party in the agency relationship.
- Name the different types of authority.
- Outline the differences between the general and the special agent.
- State the rules of agency disclosure.
- Describe the duties that an agent owes the principal.
- Recognize the Texas rules governing compensation of agents.
- Outline the idea of tort liability.
- Identify the circumstances under which a licensee may be held professionally liable.
- Describe how the licensee’s duties apply to the four different agency positions.
- Compare and contrast the different forms of listing agreements.
- Interpret buyer representation agreements.
- State the distinctive features of an intermediary relationship.
- Describe how an agency relationship can be terminated.
- Name the laws that prohibit deceptive trade practices.
LESSON ONE
FUNDAMENTALS OF AGENCY LAW

This lesson focuses on the following topics:

- The Agent, the Principal and the Third Party
- Forming an Agency Relationship
- Scope of Authority

INTRODUCTION

Agency relationships are central to real estate transactions. A seller typically hires a broker to list and find a buyer for his or her property. Buyers often visit a broker's office when shopping for real estate, and sometimes a buyer expressly hires a broker to help him or her find a property and negotiate the transaction.

An agency relationship is created when an individual authorizes another party to represent him or her and act in his or her interest. This module will discuss the rules, guidelines and ethical issues involved in agency relationships. First, let's look at some basic definitions.

THE AGENT, THE PRINCIPAL AND THE THIRD PARTY

THE AGENT

An agent is any individual acting as a representative for another individual in dealings with a third party. The agent is authorized by the person he or she represents to act on behalf of that person. In the context of real estate transactions, the agent is a licensed representative of the seller, buyer, landlord or tenant and facilitates the sale, purchase, exchange or lease of real property for others.

In the real estate industry, salespeople are often generically referred to as agents (as in the phrase “real estate agent”) and indeed often act as agents for their clients. One should remember, though, that there is a distinction between this generic term and the legal concept of agency: only certain individuals may legally act as agents in a real estate transaction. Brokers are the only Texas real estate professionals who can officially enter into an agency relationship with a buyer or seller. Any salesperson involved in a transaction then represents the broker—the salesperson cannot act as an agent. This is further explained in later lessons.
THE PRINCIPAL

As stated previously, the agent derives his or her power and authority from another individual—the transfer of this authority is what allows him or her to take on the role of agent. The **principal** is the individual who authorizes another person to act on his or her behalf. This person may also be referred to as the **client**.

In real estate, the principal engages the professional advice and other services of his or her agent to aid in the sale, purchase, exchange or lease of real property. The principal may be a seller, a prospective buyer, an owner wanting to lease his or her property to another person or an individual seeking property to rent.

THE THIRD PARTY

The **third party** is the final variable to consider when an agency relationship is formed. The third party is the individual with whom the agent and principal enter into real estate negotiations. The third party is also sometimes referred to as the **customer**. This individual may be a prospective seller, buyer, landlord or tenant—anyone who expresses real interest in completing a contract toward the sale, purchase or rental of real property and is both ready and able to do so.

THE AGENCY RELATIONSHIP

The agent works *for* the principal and works *with*, but not for, the third party.

![Diagram: Principal → Agent → Third Party]

The third party negotiates with the principal through the agent. In these negotiations, the agent is obligated to represent the principal’s interests; it is not the agent’s task to look out for or act on behalf of the third party. The third party should have an agent of his or her own, whose job it is to act in the third party’s best interest.

For example, a seller’s primary interest might be to get the full purchase price for his or her property. A broker representing that seller should attempt to get all prospective buyers to agree to the full price, without concern for what price is best or most reasonable for those prospective buyers. The seller’s agent thus cannot do things such as helping a prospective buyer find a way to pay less than the price the seller wants. In doing so, the agent would not be acting in his or her client’s interests.

Of course, an agent cannot *completely* disregard all of the third party’s concerns. He or she has certain ethical and legal obligations to the third party, such as the obligation not to misrepresent a property; these are covered later in the module.
The definition of agency is inherent in the basic definitions of agent, principal and third party. Ultimately, agency is the *fiduciary relationship* between one individual (the principal) and another (the agent). In this relationship, the agent acts on behalf of the principal to negotiate with a third individual (the third party), subject to the principal’s control and consent.

This relationship is *fiduciary* because it is based on the principal’s trust and confidence that the agent will act dutifully and responsibly as his or her representative. A fiduciary relationship is based on the law of agency that dictates the duties owed to the principal and to the third party by the agent. A more in-depth discussion of the moral and ethical guidelines for fiduciary relationships appears in Lesson Two.

**FORMING AN AGENCY RELATIONSHIP**

Most agency relationships are formed with little formality and based only on the consent of both parties. It is a simple matter for the principal to select someone to act as his or her agent and for the agent to agree to the arrangement. However, the real estate professional needs to be aware of the other ways that these relationships are formed so that he or she can avoid unintentional agency relationships. Given the legal and professional obligations that come with acting as someone’s agent, this is not a relationship one wants to enter into by accident.

**EXPRESS AGREEMENT**

Most agency relationships are formed by *express agreement*, in which a principal expressly appoints an agent to act on his or her behalf and the agent accepts this role.

This agreement does not have to be written to be valid; agency relationships that are established by oral agreements are held to the same rules and standards that govern those established by written agreements. However, written agreements are generally considered the clearest and most explicit way to outline the expectations and obligations of the parties involved. Written agreements also provide a greater degree of security for all parties. In the event that problems arise over the course of an agency relationship, a written agreement acts as a record of the defined contractual terms and the expressed intentions of the agent and principal.

In the real estate profession, the listing agreement between the seller and the listing broker is the written instrument most commonly used to create an express agency relationship. The written agreement that establishes an agency relationship between a broker and a buyer is often called the *buyer representation agreement*. 
NOTE:
A broker cannot sue for commission or other compensation if the agency agreement is not in writing.

IMPLIRED AGREEMENT

An implied agency relationship is created when both parties assume consent to the relationship based solely upon inferences formed from their communication and interaction with each other. We must be careful that our words and actions do not create an implied agency relationship with someone whom one does not or cannot represent.

In real estate transactions, implied agency relationships are often created when a prospective buyer approaches a licensee, and the actions of the parties are taken to indicate that they have mutually consented to the agency. Although the actual terms and conditions of their relationship have not been explicitly laid out, the actions of the agent and principal are understood to support the idea that an agency relationship exists. This will clearly be problematic if the licensee actually represents the seller, and thus cannot act as the buyer’s agent without first obtaining the seller’s consent to do so.

EXAMPLE:
A property is listed through Broker A’s office. A sign is placed on the property, which results in a call from Buyer X. The buyer soon discovers that the property, for whatever reason, is not well suited to her needs. At that point, Broker A asks the buyer what type of property she is seeking and how much she can afford to spend. This conversation gradually evolves into a discussion of her opinions regarding specific property listings. Broker A assures Buyer X that she will be able to help her find a property that is suitable for her.

In this example, the circumstances of the conversation and the conduct of both parties led the prospective buyer to conclude that Broker A is acting as an agent on her behalf and in her best interest. In effect, Buyer X assumed that Broker A was her agent, and it was thus implied that she was Buyer X’s client.

Unless Broker A dispels the buyer’s assumption that he is her representative, Broker A could be held to the duties of this implied agency relationship.

RATIFICATION

In most cases it is considered illegal for a person to represent a principal without any authorization; it is also generally against the law for an agent to act outside of the scope of his or her authority. However, an agency relationship can be created by ratification when an individual learns of someone acting as his or her
agent, or of an established agent overreaching the scope of his or her authority, and the individual does not later deny the validity or authority of the agent’s act. His or her consent retroactively creates an agency agreement or contract—it can either create an agency relationship where none existed before, or it can extend the scope of an existing agency relationship.

Although agency and extended authority can be created by ratification, remember that the person for whom the agent is acting is under no obligation to ratify or otherwise accept the agent’s actions. For this reason, developing an agency relationship by ratification is not recommended; it is both extremely risky and unreliable.

DISCLOSURE

Because it is relatively easy for people outside of the real estate industry to become confused about when and whether a licensee is their agent, all agents are legally required to present all parties with a statement of agency disclosure. This statement reveals whether the broker is representing the buyer, the seller, both parties, or neither party. The disclosure process will be discussed in greater detail in the next lesson.

SCOPE OF AUTHORITY

TYPES OF AGENTS

A general agent usually has a great deal of authority to represent the principal in multiple affairs. As an example of a general agent, we might think of a business manager who is allowed to make business decisions and to enter into contracts on behalf of a company. Property managers are also usually general agents. In addition, the relationship between brokers and their affiliated licensees is usually a general agency relationship.

In purchase and sales transactions, on the other hand, the agent is usually what is called a “special agent.” This means that he or she has limited authority in the realm of a specific duty or transaction. Most of the time, agents in real estate transactions do not have the authority to sign contracts for clients or to make other major decisions on their clients’ behalf.
TYPES OF AUTHORITY

Just as agents’ authority can differ in extent, their authority can also differ in type, as outlined in the following diagram:

Express agreements and some implied agreements grant *actual authority* to the agent. Some actions within the scope of the agent’s authority are permitted by *express actual authority*: this authority supports those acts that the principal explicitly tells the agent to carry out. Others fall under *implied actual authority*, which is the authority legitimating action(s) that must be completed in the process of carrying out the duties that the principal has expressly requested. While the principal did not explicitly authorize these other acts, the fact that the principal approved acts that depend on these other actions implies that the principal has consented to these other acts as well.

**EXAMPLE:**
Buyer Q has hired Broker D to help her find a house. Therefore, Broker D has the express actual authority to find a house for Buyer Q. Broker D employs several salespeople who generally help the broker in finding houses for clients. So, although Buyer Q did not specifically authorize this, Broker D has the implied actual authority to delegate some of the tasks involved in finding a suitable house (for her) to these salespeople.

Sometimes, the actions or words of a principal can convince a third party that the agent has authority when the agent actually has no authority. In such a situation, the person who acts as an agent has *apparent authority*.
AGENCY RELATIONSHIP TERMINOLOGY

Below is a list of statements that use terminology covered in this lesson. You may not need to use all of the words and phrases in the word bank, while some sentences may need more than word or phrase. Please select all appropriate answers before continuing.

WORD BANK

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<thead>
<tr>
<th>Actual Authority</th>
<th>Landlord</th>
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<tr>
<td>Apparent Authority</td>
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<td>Agent</td>
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<td>Special Agent</td>
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<td>Express Agreement</td>
<td>Tenant</td>
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<td>For</td>
<td>Third Party</td>
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<tr>
<td>General Agent</td>
<td>Implied Agreement</td>
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1. A broker who is authorized to represent the interests of a buyer or seller is a(n) _________.

2. A real estate agent is usually a(n) _________, which means that he or she has limited authority in a specific transaction.

3. In the context of real estate, an agent may represent the ________, ________, ________, or _________.

4. The agent works _________ the third party to negotiate on behalf of the principal.

5. An agency relationship may be created by _________, ________________ or ________________.
ANSWERS:

1 A broker who is authorized to represent the interests of a buyer or seller is an agent.

2 A real estate agent is usually a special agent, which means that he or she has limited authority in a specific transaction.

3 In the context of real estate, an agent may represent the seller, buyer, landlord or tenant.

4 The agent works with the third party to negotiate on behalf of the principal.

5 An agency relationship may be created by express agreement, implied agreement or ratification.

SUMMARY

Agency relationships, which are central to most real estate transactions, are formed when one party, the principal, authorizes another party, the agent, to act as his or her representative. Third parties negotiate transactions with the principal through the agent, and the agent’s task is to represent the principal’s best interests.

Agency relationships are usually formed through express agreements, in which the principal expressly designates an individual to act as his or her agent. A verbal agreement may create a valid agency relationship, but a written agreement provides a clearer explanation of both party’s interests and intentions. In addition, if the agency agreement is not in writing, a broker cannot sue for commission. An implied agency agreement may also be created by the actions and words of either party. To prevent confusion about representation, agents must present all parties with a statement of agency disclosure revealing whether the broker is representing the buyer, the seller, both parties, or neither party.

Sometimes an individual acts as an agent when not authorized to do so, or an established agent acts outside of the scope of his or her authority. In most cases it is considered illegal for a person to represent a principal without any authorization; it is also generally against the law for an agent to act outside of the scope of his or her authority. However, an agency relationship can be created by ratification when an individual learns of someone acting as his or her agent, or of
an established agent overreaching the scope of his or her authority, wherein individual does not later deny the validity or authority of the agent’s action. His or her consent retroactively creates an agency agreement or contract, although this is a risky and unreliable way of establishing agency.

An agent’s authority can vary in its extent. General agents, such as business managers, usually have a great deal of power in one or two limited areas. However, most real estate professionals act as something called a “special agent.” This means that they have a limited amount of power in one specific transaction.

Return to your on-line course player to take the Lesson Quiz.
LESSON TWO
DUTIES OF AGENCY RELATIONSHIPS

This lesson focuses on the following topics:

- Agency Disclosure
- The Agent’s Duties to the Principal
- The Principal’s Duties to the Agent
- The Agent’s Duties to the Third Party
- Compensation
- The Agent’s Liability

INTRODUCTION

As mentioned in the previous lesson, agency relationships are considered to be fiduciary relationships, which means that the principal entrusts certain powers or authority to the agent with the understanding that the agent will act competently on the principal’s behalf. Because of the trust and confidence placed in the agent in a fiduciary relationship, the law has established that agent has certain obligations to the principal; these obligations are called “fiduciary duties.” In addition, the principal has duties to the agent that are, in effect, obligations to behave in a way that makes it easier for the agent to provide competent service.

Although an agent’s primary obligations are to the principal, an agent also has duties to the third party. These will be discussed later in the lesson.

AGENCY DISCLOSURE

Licensees have the general duty to disclose agency relationships to all parties involved in a transaction.

TEXAS DISCLOSURE GUIDELINES

Once substantive dialogue occurs between an agent and a potential client or a third party, the agent must give the person a written statement that outlines Texas agency law.

Sec. 1101.558(a) of the Texas License Law defines substantive dialogue as follows:

A meeting or written communication that involves a substantive discussion relating to specific real property.

Substantive dialogue does not include meetings that occur at open houses. In addition, this term does not cover meetings or communications that occur after
the parties have signed a contract to sell, buy or lease the property that is the subject of the meeting or communication.

So once an agent has engaged in this kind of discussion with a client or potential client—outside the context of an open house and before the signing of a final contract—that agent is obligated to provide that person with a statement clarifying Texas agency law. However, there are situations in which the agent need not supply the client with this statement. According to Sec. 1101.558(c) of the Texas License Law, the agent does not need to provide an agency disclosure statement if:

- The proposed transaction is for a residential lease for not more than one year and a sale is not being considered; or
- The license holder meets with a party who is represented by another license holder.

If the licensee is acting as someone’s agent, then the licensee must disclose that relationship to the third party (or to the third party’s agent) upon initial contact. Oral disclosure is acceptable at initial contact, but once substantive dialogue occurs, written disclosure is required.

**STATEMENT OF AGENCY LAW**

We provide here a sample statement of agency disclosure created by the Texas Real Estate Commission (TREC). TREC does not require that licensees print and use this specific form. However, any alternative form must use the same wording; the only alterations the licensee may make to this language are the substitution of the term “buyer” for “tenant” and “seller” for “landlord,” as appropriate. This statement must be printed in no smaller than 10-point type; though not legally obligatory, a font larger than 10-point will make the statement easier for people to read.

The client, potential client or third party must sign this document to show that he or she has read and understands it; signing the statement does not in any way bind the party to the agent.

The following form has been provided for educational purposes only.
Before working with a real estate broker, you should know that the duties of a broker depend on whom the broker represents. If you are a prospective seller or landlord (owner) or a prospective buyer or tenant (buyer), you should know that the broker who lists the property for sale or lease is the owner's agent. A broker who acts as a subagent represents the owner in cooperation with the listing broker. A broker who acts as a buyer's agent represents the buyer. A broker may act as an intermediary between the parties if the parties consent in writing. A broker can assist you in locating a property, preparing a contract or lease, or obtaining financing without representing you. A broker is obligated by law to treat you honestly.

IF THE BROKER REPRESENTS THE OWNER:
The broker becomes the owner's agent by entering into an agreement with the owner, usually through a written - listing agreement, or by agreeing to act as a subagent by accepting an offer of subagency from the listing broker. A subagent may work in a different real estate office. A listing broker or subagent can assist the buyer but does not represent the buyer and must place the interests of the owner first. The buyer should not tell the owner's agent anything the buyer would not want the owner to know because an owner's agent must disclose to the owner any material information known to the agent.

IF THE BROKER REPRESENTS THE BUYER:
The broker becomes the buyer's agent by entering into an agreement to represent the buyer, usually through a written buyer representation agreement. A buyer's agent can assist the buyer but does not represent the owner and must place the interests of the buyer first. The owner should not tell a buyer's agent anything the owner would not want the buyer to know because a buyer's agent must disclose to the buyer any material information known to the agent.

IF THE BROKER ACTS AS AN INTERMEDIARY:
A broker may act as an intermediary between the parties if the broker complies with the Texas Real Estate License Act. The broker must obtain the written consent of each party to the transaction to act as an intermediary. The written consent must state who will pay the broker and, in conspicuous bold or underlined print, set forth the broker's obligations as an intermediary. The broker is required to treat each party honestly and fairly and to comply with the Texas Real Estate License Act. A broker who acts as an intermediary in a transaction:

1. shall treat all parties honestly;
2. may not disclose that the owner will accept a price less than the asking price unless authorized in writing to do so by the owner;
3. may not disclose that the buyer will pay a price greater than the price submitted in a written offer unless authorized in writing to do so by the buyer; and
4. may not disclose any confidential information or any information that a party specifically instructs the broker in writing not to disclose unless authorized in writing to disclose the information or required to do so by the Texas Real Estate License Act or a court order or if the information materially relates to the condition of the property.

With the parties' consent, a broker acting as an intermediary between the parties may appoint a person who is licensed under the Texas Real Estate License Act and associated with the broker to communicate with and carry out instructions of one party and another person who is licensed under that Act and associated with the broker to communicate with and carry out instructions of the other party.

If you choose to have a broker represent you, you should enter into a written agreement with the broker that clearly establishes the broker's obligations and your obligations. The agreement should state how and by whom the broker will be paid. You have the right to choose the type of representation, if any, you wish to receive. Your payment of a fee to a broker does not necessarily establish that the broker represents you. If you have any questions regarding the duties and responsibilities of the broker, you should resolve those questions before proceeding.

Real estate licensees ask that you acknowledge receipt of this information about brokerage services for the licensee's records.

Buyer, Seller, Landlord or Tenant Date

Texas Real Estate Brokers and Salespersons are licensed and regulated by the Texas Real Estate Commission (TREC). If you have a question or concern regarding a real estate licensee, you should contact TREC at P.O. Box 12988, Austin, Texas 78711-2988 or 512-465-5065.

01A TREC No. 01-P-K

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THE AGENT’S DUTIES TO THE PRINCIPAL

We mentioned earlier that the agent owes certain fiduciary duties to his or her principal (the client). Fiduciary duties are not just ethical or moral obligations; they are required under the law of agency and there can be serious penalties for failing to carry them out. The agent owes the principal the following five duties:

- The duty of fidelity
- The duty of care
- The duty of obedience
- The duty of accounting
- The duty to disclose facts

THE DUTY OF FIDELITY

Perhaps an agent’s most important duty is that of fidelity.

Chapter 531 (Rule 531.1, “Fidelity”) of the Rules of the Texas Real Estate Commission (TREC) describes an agent’s duty of fidelity as follows:

A real estate broker or salesperson, while acting as an agent for another, is a fiduciary. Special obligations are imposed when such fiduciary relationships are created. They demand:

(1) that the primary duty of the real estate agent is to represent the interests of the agent’s client, and the agent’s position, in this respect, should be clear to all parties concerned in a real estate transaction; that, however, the agent, in performing duties to the client, shall treat other parties to a transaction fairly;
(2) that the real estate agent be faithful and observant to trust placed in the agent, and be scrupulous and meticulous in performing the agent’s functions;
3) that the real estate agent place no personal interest above that of the agent’s client. (531.1)

As laid out in TREC’s rules, the agent’s duty of fidelity stipulates that the agent must place the principal’s interests above those of all other parties, including the agent’s own interests. A key element of this duty is confidentiality, which is the agent’s obligation to keep careful watch over the information he or she receives from a client and to ensure that private information is not shared without the client’s consent.

Additionally, an agent cannot act on confidential information to obtain an unfair advantage over a principal. An agent could not, for example, inform a prospective buyer that the agent owned property that was similar to the
principal’s property but was priced at less than the asking price of the principal’s property.

Texas law also prohibits an agent from buying or selling any piece of property in which he or she has a personal interest unless first disclosing this information and confirming the consent of the principal to follow through with the real estate transaction.

THE DUTY OF CARE

A licensee must conduct real estate transactions with care and diligence, ensuring that he or she represents the principal to the best of his or her abilities while acting in the principal’s best interests. With this understanding in place, the agent can be held professionally liable for any loss the principal suffers as a result of the agent’s negligence.

Chapter 531 (Rule 531.2, “Integrity”) of TREC’s Rules describes this duty as follows:

A real estate broker or salesperson has a special obligation to exercise integrity in the discharge of the licensee’s responsibilities, including employment of prudence and caution so as to avoid misrepresentation, in any wise, by acts of commission or omission. (531.2)

THE DUTY OF OBEDIENCE

A fiduciary relationship requires that the agent act in good faith at all times, making a conscious effort to obey the principal’s instructions as set forth in the contract. This duty does not apply, however, if the principal’s instructions are illegal or unethical in any way. For example, if an owner tells his or her broker that he or she will only sell the property to a third party of a particular race, the agent has no duty to obey this instruction. She should instead explain that to carry out this request is a violation fair housing legislation.

This example is not a matter of deciding whether breaking the law is in the client’s interest. It is not the agent’s task to determine a client’s interests for the client; that is a decision that the principal must make on his or her own. An agent might provide information that aids a client in choosing his or her goals, or an agent might try to persuade a principal that a certain course of action is an unwise choice. However, it is never up to the broker to determine independently what a client’s interests actually are. If an agent makes this kind of determination and acts on it without consulting the client, that agent runs the risk of acting against what the client believes to be in his or her best interest.
THE DUTY OF ACCOUNTING

If an agent holds any funds for the principal or the third party, then the status of these funds must be available to those parties at all times. The details of any financial transactions should be accurately recorded; proof of any deposits or exchanges of funds should be issued to the parties involved.

In Texas, most licensees prefer to have an independent entity, usually the title company, hold such funds in an escrow account. However, if a licensee elects to hold this money in trust for others, then he or she must set up a separate account for this purpose. Texas License Law forbids commingling (i.e., mixing) these funds with other funds in the licensee's personal or business accounts. Furthermore, Texas License Law requires these funds to be deposited into the escrow or separate account within a reasonable time. Agents (and any salespeople acting on their behalf) cannot wait any longer than the close of the second business day after the signing of a contract to make these deposits. The money will then be held in the escrow or separate account until closing, at which time the agent must release the funds to the appropriate party. In the event that the transaction does not close, the money can only be released with the written consent of all parties involved.

THE DUTY TO DISCLOSE FACTS

The duty to disclose factual information is central to an agent’s role in a fiduciary relationship. Just as it is an agent’s duty to keep a principal’s personal information confidential, an agent must also disclose any information about the property or customer that may affect a principal’s decisions regarding the outcome of the real estate transaction. The agent’s duty of disclosure differs slightly depending upon whether the agent is acting on behalf of the buyer or on behalf of the seller; these differences will be discussed later in the module.

Providing proper factual disclosure is one of the most important tasks of the real estate licensee. Because of its ambiguous nature, disclosure often involves conflicting opinions. One individual may consider a particular fact to be nonessential information concerning a property, while another person may believe that fact to be extremely important. For this reason, the Texas legislature periodically revisits disclosure issues, striving to clarify agency obligations.

THE PRINCIPAL’S DUTIES TO THE AGENT

Just as the agent in a fiduciary relationship has certain obligations to the principal, the principal must also conduct himself or herself in a way that facilitates the agent’s task as a representative. The principal’s duties include the following:

- The duty to compensate the agent
• The duty to provide information
• The duty of indemnification
• The duty of availability

THE DUTY TO COMPENSATE THE AGENT

The principal has a duty to compensate the agent for his or her expertise, as laid out in the terms of the contract. The principal must pay the agreed-upon commission to the agent when the agent completes his or her specified duties, unless all parties agree to another arrangement.

In the real estate industry, any party may pay the agent’s commission or fees, as long as full disclosure is made to all parties—that is, it is not the case that the principal is the only party permitted to pay the agent. However, if there is no other arrangement, compensation is the principal’s duty. This point will be discussed in detail later in the lesson.

An agent can agree to work for no compensation, and in these cases, the principal has no duty to compensate the agent. This kind of agency agreement creates a relationship called gratuitous agency. Even though no payment changes hands, the agent must still honor all of the duties of an agency relationship and the principal must honor his or her duties as well.

THE DUTY TO PROVIDE INFORMATION

The principal has a duty to provide accurate responses to the agent’s requests for information; he or she must ensure that the agent and third party can rely upon his or her precision and truthfulness. The agent is usually not held responsible for any false statements made by the principal unless the agent had reason to suspect that the statements were false.

THE DUTY OF INDEMNIFICATION

In addition to providing compensation, the principal has a responsibility to reimburse the agent for any financial losses incurred while carrying out the real estate transaction (beyond the cost of promotional efforts, which are the agent’s responsibility). This is considered a “hold harmless” clause, releasing the agent from all damages except those resulting from the agent’s own negligence or fraud.

THE DUTY OF AVAILABILITY

The principal must make an effort to be available for all activities related to the real estate transaction, assuming requests for his or her presence are reasonable and made in a timely fashion. This includes being available to show
or view a property, being available to consider offers and notices within a realistic amount of time and in a reasonable place and manner.

THE AGENT’S DUTIES TO THE THIRD PARTY

Although the agent’s primary responsibility is to the principal, both professional ethics and the law require the agent to treat third parties fairly. Most importantly, agents have the obligation to disclose the relationship of agency. Beyond that, agents also have a duty to exercise reasonable care and skill, a duty to disclose of all material facts and a duty to deal honestly and fairly with third parties.

THE DUTY TO EXERCISE REASONABLE CARE AND SKILL

Every licensee is considered to have knowledge of and expertise in real estate matters that exceeds that of the layperson. Licensees’ education and experience in their field place them at an advantage in real estate transactions, and both professional ethics and the law require them to act as competent real estate professionals.

Chapter 531 (Rule 531.3, “Competency”) of TREC’s Rules defines professional competency as follows:

> It is the obligation of a real estate agent to be knowledgeable as a real estate brokerage practitioner. The agent should:

1. be informed on market conditions affecting the real estate business and pledged to continuing education in the intricacies involved in marketing real estate for others;
2. be informed on national, state and local issues and developments in the real estate industry; and
3. exercise judgment and skill in the performance of the work. (531.3)

Because they represent themselves as competent, skilled professionals, brokers and other real estate licensees can be held liable for harm caused by their negligence or incompetence.

Licensees are NOT expected to have expert knowledge in fields other than real estate. Unless they are also licensed or certified to practice in these other fields, real estate professionals should not attempt to give advice on law, accounting, inspection, engineering or other subjects in which they are not licensed or certified professionals. They should also be aware that dispensing such advice to a paying client is a violation of both professional ethics and the law. Everyone in a transaction is better served if brokers and other licensees recommend that individuals who need advice in these other fields seek the counsel of qualified professionals.
THE DUTY TO DISCLOSE OF MATERIAL FACTS

The agent must inform the third party of any material facts that he or she knows about the property. A material fact in a real estate transaction is any fact that is significant or essential to the transaction—that is, any piece of information that could reasonably be expected to influence a prudent individual’s decisions regarding the transaction. This duty requires the agent to disclose latent, or hidden, defects in the property that may not be identified in an ordinary inspection, but which could alter the customer’s decision regarding the property.

EXAMPLE:
If the seller is aware that the fence surrounding his listed property extends beyond the designated property boundaries and that this may lead to problems with the owners of the adjoining property, then he needs to inform potential buyers of this, as it would probably be difficult for a buyer to discover the extension on his or her own. The agent must disclose this information to the prospective buyer; otherwise, the agent is intentionally concealing important information that could very likely impact the third party’s decision.

However, Texas Real Estate License Law identifies particular pieces of information that are not properly considered material facts. Under this law, a licensee is not required to inquire about, disclose or release information relating to whether:

(1) a previous or current occupant of real property had, may have had, has or may have AIDS, an HIV-related illness, or an HIV infection as defined by the Centers for Disease Control and Prevention of the United States Public Health Service; or
(2) a death occurred on a property by natural causes, suicide, or accident unrelated to the condition of the property. (Sec. 1101.556)

THE DUTY OF HONESTY AND FAIR DEALING

All parties have the right to honesty and good faith in their interactions with licensees, regardless of whom that licensee represents. Licensees can, therefore, be held liable for any dishonest or fraudulent statements made to third parties. To avoid this liability, agents must strive to acquire and convey accurate information. Unintentional misstatements about a property are called misrepresentation, while intentional misstatements are considered fraud. Both types of conduct are extremely unprofessional and may create serious legal difficulties for an agent.

EXAMPLE:
Salesperson A does not know that a home she has listed was formerly the site of illegal drug activity. Therefore, Salesperson A does not disclose
this information to a prospective buyer. After closing, the buyer discovers this fact and states that she would not have purchased the home if she had known about this information earlier.

Would this be considered a case of fraud or misrepresentation? Write your answer in the space provided and check your answer on the next page.
EXAMPLE RESPONSE:
Misrepresentation

Salesperson A’s omission was unintentional. Thus, this is considered a case of misrepresentation, because she unintentionally concealed information from the buyer. In this situation, Salesperson A would generally not be held liable. However, the seller of the property may face liability if it is found that she or he knew about the crime on the property. If the seller told Salesperson A the truth regarding the property’s history, and Salesperson A had then lied to buyers, Salesperson A could then be held liable for fraud (i.e., for intentionally concealing relevant facts).

However, misrepresentation may at times slant common sales techniques. Many salespeople rely upon exaggeration, opinions and predictions that are not firmly based on factual evidence. For example, a listing agent might describe a home as having “cozy charm,” but a prospective buyer may see the property as merely small, dark and damp. Similarly, a salesperson might tell another buyer, “This is the best home on the market.” Are these kinds of statements worthy to be interpreted as facts and, thus, subject to the criteria of accurate representation?

Consider this situation:

Broker A tells a customer that a particular property is one of the “most charming ranch houses she has ever seen.” When the customer goes out to view the property, however, the customer finds it old and run-down.

Broker A’s statement that the house was “charming” was merely the broker’s opinion. So, this type of statement would not generally be considered a misrepresentation of material fact.

Now consider the next situation:

Broker B shows a customer a home of which the broker knows to have a leaky roof. The customer asks if there is anything wrong with the home, and Broker B replies by saying, “You might need to do some cosmetic repairs, but nothing major.”

Broker B’s statement is fraudulent. Not only does the broker neglect to disclose the information about the roof, but also knowingly lies to the customer about the type of repairs that will be necessary. In the former situation, Broker A’s statement is considered mere “puffing”; it is an exaggeration, but not at odds with the known material facts regarding the property. Thus, this type of statement is not considered to be misrepresentation.

Despite the fact that “puffing” statements are permissible under Texas agency law, a consumer could still claim that an agent violated the Deceptive Trade
Practices Act by misleading with puffing, opinions or predictions. We will learn more about this act later in the module.

**COMPENSATION**

Under the common law governing agency relationships, the principal is generally responsible for compensating the agent. However, depending upon the written arrangement among the parties, it is often possible for any individual involved in a transaction to take over this duty.

Compensation can be in the form of a service fee, a commission, or a brokerage fee that is a percentage of the total money involved in the transaction. Whatever form it takes, the broker generally receives compensation when the terms of the agency relationship have been fulfilled.

In common law agency relationships, the principal is required to reimburse the agent for expenses incurred while representing the principal. In the real estate profession, however, clients usually just pay a commission or fee, and licensees pay their own expenses out of the commission.

**ELIGIBILITY FOR COMPENSATION**

To be eligible for compensation the person receiving the compensation must be licensed, and must have been licensed when the work was performed and possess a written agreement that states the terms of compensation, signed by the party who will pay the compensation.

In addition, the licensee must have informed the buyer in writing, before closing, that he or she should obtain a title insurance policy or an abstract of title (i.e., a summary of the property’s history, including any liens or encumbrances on the property), which should be examined by the buyer’s attorney. TREC provides a “Notice to Prospective Buyer” form for agents to use in this process.
NOTICE TO PROSPECTIVE BUYER

As required by law, I advise you to have the abstract covering the property known as ___________________________ (Address) examined by an attorney of your own selection OR you should be furnished with or obtain a policy of title insurance.

If the property is situated in a Utility District, Chapter 49 of the Texas Water Code requires you to sign and acknowledge the statutory notice from the seller of the property relating to the tax rate, bonded indebtedness or standby fee of the District.

DATED: ____________________________, ____________.

Brokerage Company Name

Broker or Sales Associate

I have received a copy of this NOTICE TO PROSPECTIVE BUYER.

Prospective Buyer

Prospective Buyer

This form has been approved by the Texas Real Estate Commission (TREC) for use when a contract of sale has not been promulgated by TREC. The form should be presented before an offer to purchase is signed by the prospective buyer. Texas Real Estate Commission, P.O. Box 12188, Austin, Texas 78711-2188, 1-800-252-8732 or (512) 459-5544 (http://www.trec.state.tx.us), TREC Notice to Prospective Buyer (12/59) OP-C replaces MA-C.
THE AGENT’S LIABILITY

Real estate licensees can be held liable for intentional or negligent wrongdoings as well as for breaches of duty. This sort of liability is called tort, and agents are not exempt from it.

TORT LIABILITY

Under tort liability, the injured party can sue the licensee for damages. For example, if a broker fails to fulfill his or her duty to disclose a latent defect to a third party, then the third party can sue the broker. Similarly, if a salesperson violates a duty to the principal, perhaps by breaking confidentiality, then that principal would be able to sue the salesperson.

POSSIBLE OUTCOMES OF NEGLIGENCE OR WRONGDOINGS

There are four basic outcomes that generally result from torts.

- Professional sanctions
- Rescission
- Avoidance
- Legal recourse

**Professional sanctions:** The licensee is subject to disciplinary action, which can include fines and the suspension or revocation of his or her real estate license.

**Rescission:** The principal may rescind the purchase and sales agreement.

**Avoidance:** The principal may legally avoid the obligation to pay commission.

**Legal recourse:** The injured party or parties may be able to take legal action thereby seeking compensation for any damages suffered as a result of the agent’s conduct.

AGENT’S LIABILITY FOR PRINCIPAL’S ACTIONS

Generally, an agent will not be held liable for a principal’s actions. If, for example, a principal makes false statements and the agent passes these on to the third party, the agent has no liability unless he or she suspected the information was false. Even when an agent has doubts about the information provided by a principal, he or she has no duty to inspect property or verify statements.

The “warranty of authority” is a kind of guarantee that an agent (or someone who represents herself as an agent) gives to a third party, either implicitly or explicitly. It is meant to establish that the agent has the authority to bind a principal—i.e., the authority to make contracts, agreements, and enter into similar arrangements on the principal’s behalf. However, the agent cannot be held responsible if the
principal does not or cannot follow through on the agreements the agent makes on the principal’s behalf. The warranty of authority only concerns the agent’s authority to act on the principal’s behalf, not his or her authority to ensure that the principal himself acts in a certain way.

**EXAMPLE:**
Seller E does not actually own the property he is trying to sell, meaning (in this instance), he has a counterfeit title. Broker A is not aware of this fact and has no reason to suspect the title false. At closing, the truth is discovered. The buyer can sue the seller for this, but Broker A has no liability.

**AVOIDING LITIGATION AND DISCIPLINARY ACTION**

To protect themselves from litigation and disciplinary action, agents should always incorporate the seller’s statements about the property into the listing agreement. This action firmly establishes that all information about the property comes from the seller, not from the agent. If information turns out to be false, it is clear that any misrepresentation or fraudulent statements are the seller’s responsibility.

In addition, the agent can take the following four steps to avoid litigation or disciplinary action:

- Perform according to the terms and conditions set out in the agency agreement.
- Promote the best interests of the client.
- Maintain confidentiality unless instructed in writing to do otherwise.
- Disclose all material facts regarding the real estate transaction.

**SUMMARY**

Licensees’ first duty in agency relationships is the duty of disclosure. Licensees acting as agents are required to provide all parties to a transaction with a written statement that outlines Texas agency law. Agents are also required to disclose relevant agency relationships to third parties upon first contact. Oral disclosure is acceptable at initial contact, but written disclosure is required once substantive dialogue occurs.

Because of the fiduciary nature of agency relationships, the broker who serves as an agent owes five duties to his or her clients. Most importantly, the agent must comply with the duty of fidelity, which means that the agent must always place the principal’s interests above those of anyone else involved in the transaction, including the agent. The other four duties require the agent to:

- Act with care and competence regarding the principal’s affairs.
• Obey the principal’s instructions (as long as these are within the law).
• Account for monies and property given to and received from the principal.
• Disclose all known material facts about the property and transaction.

Just as the agent in a fiduciary relationship has certain obligations to the principal and third party, the principal must also honor his or her obligations to the agent. The principal’s primary duties are as follows:

• The principal generally has the duty to compensate the agent, unless another arrangement has been agreed upon in writing.
• The principal, upon entering into the agency relationship, is obligated to provide the agent with all necessary information. The principal is responsible for ensuring that this information is accurate and complete.
• The principal is obligated to reimburse the agent for any financial losses incurred while carrying out the real estate transaction (beyond promotional costs).
• The principal is obligated to make him or herself available for all activities related to the real estate transaction, assuming requests for his or her presence are made in a reasonable and timely fashion.

Although the agent’s primary responsibility is to the principal, the agent is also required to treat third parties (customers) fairly. This broad requirement of fairness imposes several additional duties on agents. As always, they have an obligation to disclose the relationship of agency. Beyond that, agents also have a duty to exercise reasonable care and skill in their professional work, a duty to disclose material facts and a duty to deal honestly with third parties (i.e., a duty to avoid misrepresentation and fraud).

The principal is generally responsible for compensating the agent. This compensation can take the form of a service fee, a commission or a brokerage fee. Whatever its form, the broker generally receives compensation when the terms of the agency relationship have been fulfilled. However, in order for a broker to receive compensation, several conditions must be met:

• The broker must have been licensed when the work was performed.
• A written agreement must exist which states the terms of compensation. The party paying the commission must sign this statement.
• Before closing, the licensee must have informed the buyer in writing that he or she should obtain a title insurance policy or that an abstract of title should be examined by the buyer’s attorney.

Real estate professionals can be held liable for intentional wrongdoings, negligence and breaches of duty, collectively called torts. If an agent commits a tort, then one or more of the following outcomes are possible:

• The agent could be subject to disciplinary action.
• The principal could rescind the purchase and sales agreement.
• The principal could be legally released from the obligation to pay commission.
• The injured party could sue for damages.

An agent is generally not held liable for his or her clients’ actions or false statements, unless the agent suspected the statements were indeed false. However, to protect themselves from litigation and disciplinary action, agents should always incorporate a client’s statements into written agreements (like the listing agreement) and clearly show that all information about the property comes from the client, not from the agent. To further protect themselves, agents should always:

• Perform according to the terms and conditions set out in the agency agreement.
• Promote the best interests of the client.
• Maintain confidentiality.
• Disclose all material facts that may affect the real estate transaction.

Return to your on-line course player to take the Lesson Quiz.
LESSON THREE
AGENCY POSITIONS

This lesson focuses on the following topics:

- The Seller’s Agent
- The Buyer’s Agent
- Subagency
- Intermediaries
- Brokerage Relationships and Employment Laws
- Agency Relationship Scenarios

INTRODUCTION

Agency relationships can only be created through the supervising broker of a brokerage. Salespeople and other affiliated licensees can act in an agent capacity, but their activities are performed in the name of the supervising broker, who in turn is liable for these actions. A salesperson has no authority to make contracts or receive a commission directly from the principal, and he or she receives compensation only with the full knowledge and consent of the broker. Later in the lesson, we will discuss the relationship between the supervising broker and his or her affiliated licensees.

There are four positions a broker might hold in an agency relationship. A broker can act as:

- The seller’s agent
- The buyer’s agent
- A subagent
- An intermediary

A licensee or salesperson may not act as an intermediary, but may act in an agent capacity (representing the broker) in any of the other positions.

THE SELLER’S AGENT

Most of the time, the seller’s agent will be the listing agent (also called the listing broker). Typically, sellers enter into agency relationships with brokers through a listing agreement, in which the seller expressly hires a broker to list and find a buyer for his or her property.

THE AGENT’S DUTIES TO THE SELLER
As discussed in the previous lesson, the agent owes five fiduciary duties to the principal. All of those duties remain in effect when an agent is representing a seller. In an agency relationship with a seller, the agent must place the seller’s interests above the agent’s own interests and above the interests of the buyer. The agent must also maintain confidentiality for the seller.

**EXAMPLE:**
Seller A tells her agent, Broker B, that she would be willing to accept a lower price than that currently listed for the property. Broker B is working with a potential buyer, Buyer C, who asks the agent how low the seller is willing to go. Because this information is confidential, and because revealing this information would hurt the seller’s chances of getting the highest purchase price, Broker B cannot reveal it.

Suppose, on the other hand, that Buyer C submits an offer that is too low for the seller, and she rejects it. Then, in a conversation with the broker, Buyer C mentions that he would be willing to pay more than originally offered. Broker B, being the seller’s agent and not the buyer’s agent, has no duty of confidentiality or fidelity to the buyer, and the agent has an obligation to the principal to share this information with her.

In addition, the seller’s agent also has a duty to disclose to the seller all relevant facts that may affect the sale of the property, including the following:

- Appropriate asking price for the property based on typical market values
- Offers received on the property which are within the scope of the principal’s consideration
- Ability and willingness of prospective buyers to pay more than the asking price for the property
- Identity of prospective buyers if the agent or someone related to the agent is interested in purchasing the property
- Any interest the agent holds in the property or agent’s plans to form a relationship with a prospective buyer following the sale of the property (such as undertaking the role of the new owner’s property manager or as the new owner’s agent in the resell of the property for a profit)

In addition to the duties of fidelity and disclosure, the seller’s agent also owes the fiduciary duties of care, obedience and accounting.

**PROVIDING SERVICES FOR THE CLIENT**

A seller’s agent would probably provide the following services for the seller:

- Preparing a market analysis of the property
- Creating marketing strategies
- Helping the seller decide on a listing price
• Presenting all written offers
• Giving advice about which price to accept
• Negotiating for the seller, not the buyer
• Giving market updates to the seller
• Preparing the closing costs estimate
• Helping the seller through the closing process
• Attending the closing with the seller

PROVIDING SERVICES FOR THE THIRD PARTY

Sometimes, the seller’s agent will provide helpful services to third parties. As long as these actions aim at achieving the seller’s goals, there is no breach of fidelity or conflict of interest. For example, an agent may help a prospective buyer with the process of obtaining financing because that furthers the client’s goal of selling the property. However, if an agent were to advise a prospective buyer on price negotiation, this would undercut the client’s goal of obtaining the best possible price. Providing this kind of help is at odds with acting as the client’s agent.

Remember that agents have duties to the third parties in agency relationships as well as to the principal. Seller’s agents must treat prospective buyers fairly; beyond this general duty of fairness, it is fine to provide third parties with services that help to achieve the principal’s goals. However, the seller’s agent’s loyalties lie with the seller, not with the buyer, and all services provided should reflect this fact.

THE BUYER’S AGENT

As discussed in previous lessons, an agency relationship can be created between a buyer and a broker by oral or written agreement, as well as through words or conduct that imply authorization. However, the buyer representation agreement is the most common method of forming an agency relationship between a buyer and a broker. This agreement will be discussed in detail in the following lesson.

THE AGENT’S DUTIES TO THE BUYER

We have seen how the five fiduciary duties of agency relationships apply to relationships with sellers. Now let’s see how these duties apply to relationships with buyers.

A seller’s agent maintains confidentiality about all matters that the agent is not legally required to disclose to the third party. The seller’s agent, for example, should not volunteer to tell a prospective buyer about the quality of the school
districts or local traffic if these facts might negatively affect the prospective buyer’s decision.

The buyer’s agent, on the other hand, must seek out this sort of information. The buyer’s agent should amass as much helpful information about the property as possible, even the information that the seller’s agent is not required to disclose. The buyer’s agent should try to obtain information on all of the following subjects:

- Condition of the property and any property defects
- Characteristics of the neighborhood and surrounding areas
- Age of the property
- Length of time the property has been listed on the market
- Reasons the owner is selling the property
- Reasons other prospective buyers, if any, refused the purchase of the property
- Appropriate amount to pay for the property, regardless of the actual listing price
- Contractual terms that are not in the buyer’s best interest

In addition, the buyer’s agent is required to maintain confidentiality for the buyer. For example, if the buyer is willing to pay more than his or her initial offer, the buyer’s agent cannot disclose this to the seller or the seller’s agent.

**PROVIDING SERVICES FOR THE CLIENT**

A buyer’s agent would probably provide the following services for the buyer:

- Showing the buyer suitable properties
- Finding information about properties, school districts, zoning, traffic problems, taxes, communities and utilities
- Preparing a market analysis of the properties being considered
- Giving advice to the buyer about offers
- Negotiating for the buyer, not the seller
- Maintaining confidentiality
- Helping the buyer apply for a loan
- Helping the buyer through the closing process
- Attending the closing with the buyer

**PAYMENT OF AGENT’S COMMISSION**

The buyer’s agent is frequently entitled to the selling agent’s (or selling broker’s) commission. To receive this commission, the buyer’s agent must be able to prove that he or she was the procuring cause of the sale, that is, the buyer’s agent must be able to prove that his or her actions resulted in the sale.
SUBAGENCY

In Section 1101.002 (8) of the Texas License Law, a subagent is defined as a license holder who:

(A) represents a principal through cooperation with and the consent of a broker representing the principal; and
(B) is not sponsored by or associated with the principal’s broker.

In the real estate profession, subagency occurs most frequently when the seller authorizes the listing broker to engage someone other than the listing broker to facilitate the real estate transaction. The cooperating agent is then a subagent of the listing broker and is an agent for the principal, meaning he or she is responsible for both parties.

Agents have implied actual authority to delegate authority to a subagent in any of the following cases:

- When the act is purely mechanical
- When the agent cannot perform an act which the subagent can lawfully perform
- When it is appropriate to delegate such powers
- When the principal specially authorizes delegation

NOTE:
If a primary agent employs a subagent without the principal’s authorization to do so, then the principal has no obligations to that subagent.

To accept the offer of subagency, the broker interested in cooperating with the prime agent and principal must take action. Accepting a subagency offer can involve any or all of the following steps:

- Inquiring about the property
- Showing the property
- Writing an offer on the property
- Presenting an offer on the property

In the event that a subagent intentionally misrepresents a material fact or conceals critical information in a real estate transaction, Texas License Law protects the primary agent and principal from liability unless these parties had knowledge of the misrepresentation and did not disclose this information.
MULTIPLE LISTING SERVICES

A multiple listing service (MLS) is a sizeable inventory of properties located in a specified area that is maintained by the real estate brokerage industry and can be viewed by all members of the multiple-listing organization.

Some brokers view the service as a unilateral offer of subagency, allowing brokers to share their listings with other brokers in exchange for a portion of the commission generated from any resulting transactions. However, many brokers in Texas choose to not compensate the subagents who cooperate in the transaction.

The MLS is an excellent resource for agents when they are putting together a detailed comparative market analysis (CMA), because it is a comprehensive list of properties in a particular area that is updated regularly. Consequently, it allows an agent to analyze a variety of properties currently on the market to determine appropriate prices for similar listings. The MLS can also help an agent identify characteristics shared among competing listings that may influence the terms of a property’s listing agreement. Finally, because the MLS organization reaches a large number of real estate professionals, sellers benefit from many individuals having access to their property listing, just as buyers benefit from the large selection of properties available to them.

INTERMEDIARIES

When a broker represents only the buyer or the seller, he or she is in a relationship of single agency. An intermediary is an agent who represents both the buyer and the seller and is, therefore, in a position of dual agency. A salesperson is NOT allowed to act as an intermediary; only a broker may act in this capacity.

DISCLOSURE

A broker in a position of dual agency must disclose the relationship to both sides of the transaction and obtain written consent to this relationship from all parties. Section 1101.559 (a) of Texas License Law establishes the requirements that must be met before an agent can act as an intermediary:

A broker may act as an intermediary between parties to a real estate transaction if:

1. the broker obtains written consent from each party for the broker to act as an intermediary in the transaction; and
2. the written consent of the parties states the source of any expected compensation to the broker.
THE DUTIES OF AN INTERMEDIARY BROKER

It is difficult, if not impossible, for an intermediary to represent the interests of two parties fully. After all, the seller is generally interested in getting the highest possible price for a property, while the buyer wants to pay the lowest possible price. Their concerns are fundamentally in conflict, and an agent representing both of these parties has fiduciary obligations to both sides.

Because of this tension between the two sides of a real estate transaction, the intermediary broker is not required to honor the duty of fidelity. This does not mean that the agent can act to undercut the interests of either side; instead, it simply means that the agent is not required to act in the best interests of each party when those interests are directly opposed. However, the broker must treat both parties equally and honestly while maintaining confidentiality for both sides.

Section 1101.558 of Texas License Law provides a statement describing agency relationships in Texas. This statement outlines the duties of an intermediary as follows:

A broker who acts as an intermediary in a transaction:

(1) shall treat all parties honestly;
(2) may not disclose that the owner will accept a price less than the asking price unless authorized in writing to do so by the owner;
(3) may not disclose that the buyer will pay a price greater than the price submitted in a written offer unless authorized in writing to do so by the buyer; and
(4) may not disclose any confidential information or any information that a party specifically instructs the broker in writing not to disclose unless authorized to do so by The Texas Real Estate License Act or a court order or if the information materially relates to the condition of the property.

APPOINTED LICENSEES

Rather than taking on the difficult job of acting as a dual agent, an intermediary broker may choose to appoint licensed associates to represent one or both of the two sides in a real estate transaction.

What is the advantage of assigning these roles to other licensees? When a broker acts as an intermediary, he or she effectively waives the right to give advice or offer opinions to either party with respect to each other. For example, an agent cannot really give a seller truthful advice about what sort of offers to accept if that agent also represents a prospective buyer making an offer on the seller’s property. If the agent were to say that the seller should seek higher offers, then the agent would be compromising the prospective buyer’s interests, but if the agent tells the seller not to seek different offers the agent may be compromising the seller’s interests. By representing two opposed sets of
interests, the agent has created a situation in which he or she can offer only very limited guidance to either party.

However, if licensees are appointed to represent each party then this tension no longer exists. These representatives can freely offer advice and opinions to their respective principals, as long as no confidential information is disclosed. For this reason, appointing licensees is a viable option in a situation where the two parties prefer to have more guidance from their agents.

**COMPLICATIONS OF THE DUAL AGENCY RELATIONSHIP**

There are many potential liabilities in a dual agency relationship. If the agent has not provided full disclosure and obtained the written consent of both principals to participate in the dual agency, serious consequences can arise. The greatest of these risks is the threat of *double exposure*, which occurs when an agent breaches fiduciary duties to one or both parties due to the conflicting obligations of pre-existing agency relationships with either party. Because of this danger, TREC often discourages real estate professionals from entering into dual agency relationships.

Although many real estate licensees view dual agency as a hazardous business practice, there are some compelling reasons to consider dual agency. Some real estate professionals argue that when an intermediary agent represents both parties, the real estate transaction runs more smoothly and the negotiations are more efficient due to an open line of communication and streamlined approach. For example, when a principal’s agent works in cooperation with the representative of the third party, the agent is not in a position to verify the actions of that representative. If the agent represents both parties, he or she can be sure of the disclosures made to each party, and can monitor the transaction at each level to ensure that the laws of agency are upheld and both parties receive equal treatment. Essentially, intermediaries may enjoy more control over the real estate transaction, although their agency relationship is more involved and requires a more attentive approach.

Consider the following scenario:

A couple comes to Broker F’s office looking for a small, two-bedroom house on the north side of town. She listens to their expectations and quickly discovers that she already represents a seller who has listed a property in this area that would satisfy the couple’s desires. Her agency relationship changes with both the buyer and seller at the point when she decides to show this property to the couple, tells them that she currently represents the seller of the property and she obtains the consent of both parties to a dual agency relationship. She is now the intermediary between the two and must treat them impartially, making certain that she never gives one party an advantage over the other. This means that she can offer only limited guidance to either party and that she has an obligation
to provide the couple with the same market data used by the seller to determine the listing price so that the couple can make an informed decision about what to offer for the property. As the intermediary, her basic duties are writing the offer, presenting the offer and managing the negotiation of the transaction in a conscientious, professional and unbiased manner.

**BROKERAGE RELATIONSHIPS AND EMPLOYMENT LAWS**

Up to this point, we have primarily discussed agency relationships between brokers and clients. However, brokers and their affiliated licensees also have agency relationships. These are frequently *general agency* relationships, which means that the licensee has a great deal of authority to represent the broker.

**EMPLOYEES VS. INDEPENDENT CONTRACTORS**

A licensee can be either an employee of the broker or an independent contractor. Depending upon the licensee’s role in the brokerage, the relationship between the broker and the salesperson will differ. Most brokers choose to sponsor licensees as independent contractors, which means that the broker pays the licensee a commission rather than a wage, and the broker has little control over the day-to-day operations of the licensee’s work. However, the broker is still responsible for supervising the licensee’s actions and is liable for his or her wrongdoings or negligence.

The IRS sets guidelines for distinguishing employees from independent contractors. A licensee is an employee—rather than an independent contractor—if:

- The licensee is paid a minimum monthly salary.
- The supervising broker pays the licensee’s licensing fees.
- The company can fire a licensee for violating instructions.
- The company reserves the right to establish quotas.
- The company or supervising broker attempts to control the day-to-day work of the licensee.
- The company views the licensee as a member of the team.

On the other hand, if a licensee is paid commissions instead of a salary, has a great deal of control over his or her own working conditions and has a contact with the supervising broker stating that the licensee is not an employee, then the IRS considers the licensee to be an independent contractor.
DISCRIMINATION IN THE WORKPLACE

Federal and state laws prohibit brokers and other employers from discriminating in hiring and firing on the basis of race, color, religion, national origin, sex, age, familial status or physical or mental disability. The Texas Commission on Human Rights enforces anti-discrimination employment laws. Anti-discrimination laws apply to all businesses with 15 or more employees.

AGENCY RELATIONSHIP SCENARIOS

The five scenarios that follow describe the establishment of different agency relationships. In completing the sentences, some phrases from the word bank may be used more than once, and some phrases may not be used at all.

<table>
<thead>
<tr>
<th>WORD BANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>A subagent</td>
</tr>
<tr>
<td>An intermediary</td>
</tr>
<tr>
<td>The seller’s agent</td>
</tr>
<tr>
<td>A general agent</td>
</tr>
<tr>
<td>A non-agent</td>
</tr>
<tr>
<td>The buyer’s agent</td>
</tr>
<tr>
<td>The compensated agent</td>
</tr>
</tbody>
</table>

1. A seller lists his or her home with a broker. The seller and the broker sign a listing agreement that creates an agency relationship between them. This broker is ________________.

2. The listing agent engages another licensee to facilitate the real estate transaction. This licensee is ________________.

3. A broker decides to represent both the buyer and a seller in a transaction. This broker is ________________.

4. A buyer walks into a broker’s office. The broker provides brokerage services for the buyer. The buyer and the broker agree to enter into an agency relationship, but they do not sign an agreement. This broker is ________________.

5. A broker is representing both the buyer and the seller. She appoints two licensees to represent the clients. The broker is ________________.
ANSWERS:

1
A seller lists his or her home with a broker. The seller and the broker sign a listing agreement that creates an agency relationship between them. This broker is _________________.

The seller’s agent

2
The listing agent engages another licensee to facilitate the real estate transaction. This licensee is _________________.

A subagent

3
A broker decides to represent both the buyer and a seller in a transaction. This broker is _________________.

An intermediary

4
A buyer walks into a broker’s office. The broker provides brokerage services for the buyer. The buyer and the broker agree to enter into an agency relationship, but they do not sign an agreement. This broker is _________________.

The buyer’s agent

5
A broker is representing both the buyer and the seller. She appoints two licensees to represent the clients. The broker is _________________.

An intermediary

SUMMARY

A licensee who is serving as an agent can hold four positions: seller’s agent, buyer’s agent, subagent or intermediary.

Most of the time, the seller’s agent will be the listing agent and the agency relationship between the seller and the agent is created by the listing agreement. The seller’s agent must place the seller’s interests above those of all other parties involved in the transaction, including the agent. Acting in the seller’s best interests requires the agent to maintain confidentiality for the seller about his or her willingness to accept a lower price than the listed price of the property. The seller’s agent should not disclose any information to the buyer about the property or the transaction other than that which is required by law. Sometimes, the seller’s agent may provide helpful services to the buyer, but these services must further the seller’s interests as well.
The buyer’s agent, on the other hand, represents the interests of the buyer in the transaction. The buyer’s agent helps the buyer negotiate and gives him or her advice. A buyer’s agent also maintains confidentiality about private information, such as the buyer’s willingness to pay more than he or she has offered for a property. If the buyer’s agent’s actions result in a sale, the buyer’s agent is frequently entitled to the selling agent’s commission. To receive this commission, the buyer’s agent must be able to prove that he or she was the procuring cause of the sale—that is, that his or her actions were the cause of the sale.

A licensee acting as a subagent represents a principal through the principal’s agent, but is not associated with that agent. In the real estate profession, subagency occurs most frequently when the seller authorizes the listing broker to engage someone other than the listing broker to facilitate the real estate transaction. The cooperating agent is a subagent of the broker and is an agent of the principal seller, which means that he or she is responsible to both parties. Many real estate subagency relationships are created through multiple listing services.

An intermediary is an agent who represents both the buyer and the seller in a particular transaction—that is, he or she is in a position of dual agency. This relationship requires written disclosure to dual representation and written consent to such representation from all parties involved in the transaction. Because an intermediary is supposed to be representing the interests of both sides, he or she may give only limited guidance to either party. In addition, the intermediary must act in an unbiased way and must treat all parties fairly. An intermediary’s role, then, is to act as a facilitator to the transaction. If the parties want to receive more extensive advice, or if the intermediary does not feel comfortable in the position, the intermediary agent may appoint associated licensees to act as representatives for each party. This does not alter the agent’s position as intermediary.

Finally, agency relationships also exist between a broker and his or her affiliated licensees and salespeople. The salesperson is the general agent of the broker and has a great deal of authority to act in the broker’s name, but the broker remains liable for the salesperson’s actions. An affiliated licensee can be either an employee of the broker or an independent contractor. Depending upon the licensee’s role in the brokerage, the relationship between the broker and the salesperson will differ. In addition, it is important for brokers to know that federal and state laws prohibit discrimination in hiring and firing on the basis of race, color, religion, national origin, sex, familial status, age or physical or mental disability. These laws affect all businesses with 15 or more employees.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FOUR
AGREEMENTS AND TERMINATION

This lesson focuses on the following topics:

- Listing Agreements
- Buyer Representation Agreements
- Termination of Agency Relationships
- Matching the Methods of Termination

INTRODUCTION

In real estate transactions, agency relationships are generally created and formalized by using a written agreement. Therefore, a full understanding of the agent’s role and functions requires a grasp of the agreements that are commonly used to bind agents and principals to one another.

The listing agreement is the written contract between the owner of real property and the agent who represents the owner in the marketing and sale of that property. This document outlines each party’s terms and conditions, including the agent’s responsibility to represent the principal to the best of his or her ability and in accordance with the law and the principal’s responsibility to pay the stated commission to the agent for his or her expertise and service.

There are four types of listing agreements that can be used to create an agency relationship between a seller and his or her representative: an open listing, an exclusive right to sell listing, an exclusive agency listing and a net listing. All of these agreements differ significantly from one another and offer a different package of benefits and burdens to the agent and the principal.

The agency relationship between the buyer and the broker is generally created by the buyer representation agreement. As with a listing agreement, buyer representation agreements should be in writing and should define each party’s obligations to one another. The buyer commits to working exclusively with the broker, and the broker agrees to work diligently to locate property for the buyer and to negotiate an offer in the buyer’s best interest.

In addition to knowing how to create an agency relationship, a real estate licensee must also understand the conditions and events that can terminate this relationship. Because agency relationships must be consensual, they can generally be ended at any time by either party or by mutual agreement. However, the principal cannot terminate an agency relationship simply to avoid paying commission to the agent. Agency relationships can also be terminated if the terms of the relationship are completed, if either party dies or becomes incapable of fulfilling her or his role in the contract, by the bankruptcy of either
party, by a change in property use characteristics or zoning, by destruction of the property, by revocation of the agent’s license or by expiration of the contract.

**LISTING AGREEMENTS**

The *listing agreement* is a written contract between the owner of real property and the agent representing the owner in the marketing and sale of that property. This document outlines each party’s terms and conditions, including the agent’s responsibility to represent the principal to the best of his or her ability in accordance with the law and the principal’s responsibility to pay the stated commission to the agent for his or her expertise and service.

A listing agreement should be detailed and comprehensive so as to avoid any misunderstandings regarding the obligations and intentions of each party. At a minimum, the listing agreement should include the following information:

- An “Information about Brokerage Services” form.
- An explanation of the agent’s duties to the principal and the third party.
- The names of the parties involved in the transaction.
- A legal description and the physical address of listed property, along with any other fixtures to be included in the sale (furniture or accessories, for example).
- The beginning and termination dates of the contract.
- The terms of commission for the agent's participation and the seller’s agreement to pay this commission when the agent completes his or her contractual duties.
- The terms of the sale, including the listed price and financing options.
- The remaining balance of the seller’s mortgage, if any, as of the start date of the contract.
- The type of listing.
- Written permission to market the property in a reasonable manner.
- Written permission to keep a lockbox on the premises.
- Written consent to intermediary representation, if applicable.
- The appropriate fair housing language and logo.
- Dated signatures from the parties involved in the transaction, indicating that they have read and understood the agreement, and accept its terms and conditions.

There are four types of listing agreement that an agent and a principal can make: they can agree to an open listing, an exclusive right to sell listing, an exclusive agency listing or a net listing.
OPEN LISTINGS

Open listings allow a seller to list his or her property concurrently with a number of competing brokers, or to sell the property on his or her own without facing liability for a commission payment.

Some sellers believe this type of listing works in their favor because more listings mean more prospects and the seller will not be locked into paying a commission if the property is sold as a result of the seller’s own initiative. In addition, an open listing policy releases the seller from any obligation to inform the other listing brokers when the property goes under contract or is closed. The sale of the property under such an agreement essentially cancels all outstanding listings.

Real estate licensees, on the other hand, generally avoid open listing agreements, primarily because it can be difficult to determine who is entitled to the commission payment when so many brokers are involved. Furthermore, brokers often do not feel protected in this type of agreement because a licensee who diligently advertises a property may not be rewarded for his or her efforts if another licensee secures the sale of the property. Even if the compensated agent benefits from the marketing effort of others, only the individual who closes the sale earns the commission.

EXCLUSIVE RIGHT TO SELL LISTINGS

Real estate professionals generally prefer exclusive right to sell listings rather than other listing agreements. This type of agreement states that as long as the property is sold within the timeframe stipulated in the contract, the listing broker named in the contract will receive a commission for his or her role in the real estate transaction. It does not matter how the sale is secured, whether by the named listing agent, another agent or as a result of the owner finding a buyer without the listing agent’s assistance. Regardless, a commission must be paid to the listing agent, who holds exclusive rights to the commission.

When comparing these terms with those of an open listing agreement, it is clear why real estate licensees would favor this approach. From the licensee’s perspective, holding an exclusive right to a commission protects him or her from the possibility of dedicating time and effort to a sale only to have the commission go to another party. For this reason, real estate professionals encourage sellers to favor exclusive right to sell listings. They argue that when an agent has a vested interest in a property, he or she is more willing to expend time, effort and money on diligently marketing the property. Because the listing agent has a secure hold on the commission, he or she can spend more time and energy finding a qualified buyer. This stands in opposition to an open listing agreement, in which brokers may expend less effort promoting a property and may settle for an offer below the property’s market value, for fear that another broker may
secure the sale of the property before they do and consequently receive the commission.

EXCLUSIVE AGENCY LISTINGS

Exclusive agency listings combine elements of open listing agreements and exclusive right to sell agreements. As with open listings, exclusive agency listings release the owner from any obligation to pay a commission in the event that the owner secures the sale of a property. As with an exclusive right to sell listing, the seller agrees to list the property with only one broker during a specified listing term. The distinguishing characteristic of exclusive agency listings is that the named listing broker is owed commission only if someone other than the owner sells the property.

However, this feature of the agreement can lead to problems on occasion. In an exclusive agency listing agreement, an owner may conspire with the broker’s prospective buyer to execute the sale of the property after the listing agreement expires so as to avoid the payment of a commission to the named listing broker. In this case, the listing broker can only collect commission by proving that he or she was the procuring cause of the sale. That is, the agent must demonstrate that he or she was the individual who found a ready, willing and able buyer and whose actions put the sale into motion.

NET LISTINGS

Net listings are listing agreements in which the seller pays any amount over the listing price set in the contract as commission. A seller may choose to enter into a net listing agreement if that seller has a set price that he or she will accept for the property and does not wish to negotiate other offers with prospective buyers. Net listings can work in conjunction with open listings, exclusive right to sell listings and exclusive agency listings.

Consider the following scenario:

Seller X has a parcel of land that he has been trying to sell on his own for quite some time. Tired of trying to market the property but unwilling to accept the low offers he has received in the past, he calls upon Licensee Y to secure the sale of the lot for no less than $100,000. Seller X agrees that in exchange for not being bothered with the details of the real estate transaction, Licensee Y will receive as commission the difference between the actual sale price and the seller’s desired net price. Shortly thereafter, Licensee Y secures the sale of the property for $110,000 and walks away with a 10% commission.

In many states, net listings are illegal because of the potential risk to both the seller and the licensee. Although they are permitted in Texas, many real estate licensees advise against them and they are not commonly used.
Think back to the previous example of the parcel of land that was sold for $110,000 with a 10% commission. At first glance it may seem that a licensee would be willing to dedicate a lot of time and effort to the marketing of this property because of the opportunity to secure such a high commission rate. Though this may indeed be true in some cases, it is not guaranteed. The following two examples suggest the ways that net listings can work to the disadvantage of either the agent or the principal.

The interaction between Seller X and Licensee Y might have worked out much differently for Licensee Y:

Again, Seller X sets a net price of $100,000 for the parcel of land, allowing Licensee Y to accept as commission any difference between this amount and the actual sale price. Licensee Y, hoping to receive a higher-than-usual commission, puts a lot of time, energy and money into promoting the property, which she lists for $110,000. After Licensee Y has spent a few hundred dollars and a number of hours on marketing of the property, a prospective buyer makes an offer on it. However, the offer is for only $100,000. Because Licensee Y must honor the interests of her client, she must communicate this offer to Seller X, who is pleased that he'll receive the desired amount for the land and accepts the offer. In this scenario, Licensee Y walks away with nothing except lost time, energy and money.

The interaction between Seller X and Licensee Y might also have worked out differently for Seller X:

Seller X again seeks $100,000 for the sale of his property. Choosing not to disclose to Seller X that the actual market value of the property is substantially higher than his desired net amount, Licensee Y lists the property for $130,000.Shortly the licensee puts the property on the market, a buyer agrees to buy the piece of property for the listed price of $130,000, thereby securing a 30% commission for the agent. In this situation, Licensee Y did not disclose the fair market value of the property to Seller X and can be held liable for withholding information and knowingly misleading her client.

The Texas Real Estate Commission permits net listing agreements to be made only if the principal requires or demands this kind of listing and the principal is fully aware of the current market value of the property. Details regarding TREC’s stance on net listings can be found in section 535.16 (b) of TREC’s Rules.

**BUYER REPRESENTATION AGREEMENTS**

Buyer representation agreements, or buyer-broker agreements, are similar to listing agreements between the seller and broker. As with a listing agreement, buyer’s representation agreements should be in writing and should define each party’s obligations to one another. In this sort of agreement, the buyer commits
to working exclusively with the broker and the broker agrees to work diligently to locate property for the buyer and to negotiate an offer in the buyer’s best interest. The buyer-broker agreement should be limited to a specified time period and should contain the following information:

- The names of involved parties.
- The beginning date and termination date.
- The general characteristics of the property search.
- Both the broker’s and the client’s obligations.
- A description of the agency relationship (or intermediary status, if appropriate).
- A compensation agreement.
- Consent for the broker to represent competing prospective buyers.
- The appropriate fair housing language and logo.
- The terms of a protection period after the termination of the contract calling for the client to honor the commission agreement if the client enters into a contract to purchase a property that was introduced to the client by the broker during the term of the buyer-broker agreement (as long as the broker provides a list of all properties shown to the client within 10 days of contract termination).
- Dated signatures from the parties involved in the transaction, indicating that they have read and understand the agreement, and accept its terms and conditions.

**TERMINATION OF AGENCY RELATIONSHIPS**

Under the common law of agency relationships, an agency relationship will continue either until the parties act to terminate it or until certain events take place that bring the work of the relationship to a close (such as the sale or purchase of a property) or which make it impossible to carry out the project(s) named in the agreement (such as the death of one party or the destruction of the property).

**TERMINATION BY THE PARTIES’ ACTIONS**

Because agency relationships must be consensual, either party may choose to end the relationship at any time. This can happen in three ways:

- The client fires the agent
- The agent quits
- Mutual agreement

**The client fires the agent:** The client (the principal) may, at any time, fire the agent. This action is called revocation. The client must usually give written notice of the revocation, and if the client breaches the terms of the contract, he or
she may be liable for damages. For example, the principal would face legal liability if she or he ended an agency relationship simply to avoid paying commission.

**The agent quits:** The agent may, at any time, decide to leave an agency relationship. This action is called renunciation. The agent must usually give written notice of the renunciation, and the agent could be liable for damages if the contract is breached.

**Mutual agreement:** Both parties may agree to end the agency relationship at any time. It is wise to put the mutual agreement in writing.

**TERMINATION BY THE LAW**

The following events terminate an agency relationship by operation of law, regardless of the parties' wishes:

- Death, incapacity or bankruptcy
- Fulfillment of purpose
- Extinction of the subject matter
- Expiration

**Death, incapacity or bankruptcy:** In most states, the death of the agent or principal terminates the agency relationship. Most states also allow the relationship to dissolve if either party files bankruptcy or if either is incapacitated to an extent that prevents him or her from carrying out his or her role in the agreement. Note that an agent generally has no authority to act if the principal dies or becomes incapacitated, even if the agent has no knowledge of the event.

**Fulfillment of purpose:** The agency relationship ends when its purpose is completed, as it would be by closing a real estate transaction.

**Extinction of the subject matter:** If the subject matter of the relationship ceases to exist (for example, if the home that is the subject of a transaction burns down), then the agency relationship is dissolved.

**Expiration:** The agency relationship ends upon the expiration date set in the agreement. If there is no specific expiration date established in the agreement, then a reasonable general time period can be set.

After the agency relationship has been terminated, the agent must still maintain confidentiality for the principal unless required by a subpoena or court order to disclose private information. The agent also continues to owe the principal the duty of accounting, if necessary.
MATCHING THE METHODS OF TERMINATION

Here are five situations that would terminate an agency relationship. Decide which phrases from the word bank are suitable in each relationship.

<table>
<thead>
<tr>
<th>Word Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Death, Incapacity or Bankruptcy</td>
</tr>
<tr>
<td>Mutual Agreement</td>
</tr>
<tr>
<td>Revocation</td>
</tr>
<tr>
<td>Extinction of Subject Matter</td>
</tr>
<tr>
<td>Renunciation</td>
</tr>
<tr>
<td>Fulfillment of Purpose</td>
</tr>
<tr>
<td>Expiration</td>
</tr>
</tbody>
</table>

1. The agent quits: ________________
2. The client fires the agent: ________________
3. The agent and the client agree to end the relationship: ________________
4. The house that was for sale burned down: ________________
5. The client has become mentally incompetent: ________________
ANSWERS:

1. The agent quits: ________________
   Renunciation

2. The client fires the agent: ________________
   Revocation

3. The agent and the client agree to end the relationship: ________________
   Mutual Agreement

4. The house that was for sale burned down: ________________
   Extinction of Subject Matter

5. The client has become mentally incompetent: ________________
   Death, Incapacity or Bankruptcy

SUMMARY

The listing agreement is the written contract between the owner of real property and the agent who represents the owner in the marketing and sale of that property. This document outlines each party’s terms and conditions, including the agent’s responsibility to represent the principal to the best of his or her ability and in accordance with the law and the principal’s responsibility to pay the stated commission to the agent for his or her expertise and service.

There are four types of listing agreements: open listings, exclusive right to sell listings, exclusive agency listings and net listings. Some sellers prefer open listings, in which the seller can list his or her property concurrently with a number of competing brokers. With an open listing, the seller can also sell the property on his or her own without being liable for paying a commission. Brokers, however, generally avoid these agreements, primarily because it is difficult to determine who is entitled to the commission payment when so many brokers are involved. Also, brokers do not want to work diligently to find a buyer for a property without a guaranteed commission.

Most licensees prefer exclusive right to sell listings above other listing agreements. This type of agreement states that as long as the property is sold within the time frame stipulated in the contract, the listing broker named in the
contract will receive a commission for his or her role as agent in the real estate transaction.

Exclusive agency listings combine elements of both open listing agreements and exclusive right to sell agreements. Under this type of agreement, the seller agrees to list the property with only one broker, but the seller does not have to pay commission if he or she sells the property independently. The distinguishing characteristic of exclusive agency listings is that the named listing broker is owed commission only if someone other than the owner sells the property. This fact can lead to problems if the seller conspires to avoid paying the commission by negotiating with one of the agent’s prospective buyers to wait to close until after the exclusive agency listing expires.

The final type of listing agreement is the net listing, in which the seller pays as commission any amount over the listing price set in the contract. A seller may choose to enter into a net listing agreement if that seller has a set price that he or she will accept for the property and does not wish to negotiate other offers with prospective buyers. Net listings can be used in conjunction with open listings, exclusive right to sell listings and exclusive agency listings.

The agency relationship between the buyer and the broker is generally created by the buyer representation agreement. As with a listing agreement, buyer representation agreements should be in writing and should define each party’s obligations to one another. The buyer commits to working exclusively with the broker, and the broker agrees to work diligently to locate property for the buyer and to negotiate an offer in the buyer’s best interest.

An agency relationship can generally be ended at any time by either party or by mutual agreement. However, the principal cannot terminate an agency relationship simply to avoid paying commission to the agent. Agency relationships can also be terminated if the terms of the relationship are completed, if either party dies or becomes incapable of fulfilling her or his role in the contract, by the bankruptcy of either party, by a change in property use characteristics or zoning, by destruction of the property, by revocation of the agent’s license or by expiration of the contract.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FIVE
ANTITRUST LAWS AND DECEPTIVE TRADE PRACTICES

This lesson focuses on the following topics:

- Antitrust Laws
- Texas Deceptive Trade Practices-Consumer Protection Act

INTRODUCTION

All licensees need to be familiar with the federal and state laws that regulate trade practices. Of primary concern here are antitrust laws and the Texas Deceptive trade Practices-Consumer Protection Act. These laws affect the real estate profession as a whole, and they have particular implications for agents.

ANTITRUST LAWS

Real estate licensees are subject to federal antitrust laws, enforced under the Sherman Antitrust Act, that prohibit unfair trade practices in the United States. In essence, antitrust laws prohibit businesses from establishing groups or standards that interfere with normal business competition. These laws are rooted in the idea that competition creates the largest choice of products and services for consumers, thus providing them the broadest range of price and quality. The most common antitrust violations in the real estate industry include price fixing, boycotting competitors and allocating customers or markets.

PRICE FIXING

Price fixing is the practice of establishing prices for goods or services at a predetermined level, as opposed to allowing prices to be set by open-market competition. In real estate, a licensee provides his or her expertise and service to the principal in exchange for compensation. If brokers in a particular market conspire to set the same commission rates for all real estate licensees in that market, they are guilty of price fixing. The law states that a broker must determine the rate of compensation without the influence of any other broker. For this reason, discussion of rates among licensees from different firms is greatly discouraged, as it could easily be construed as an attempt to establish a set rate.

Similarly, professional organizations (such as multiple listing services) cannot make a broker’s participation in the organization contingent upon the commission rate that he or she charges.
BOYCOTTING COMPETITORS

When two or more parties agree to abstain from dealings with other parties to limit competition, they are essentially boycotting their competitors. In real estate, this may occur if a brokerage is unfairly denied access to a particular real estate professional organization or if two or more licensees agree to withhold their patronage from certain brokers.

ALLOCATING CUSTOMERS OR MARKETS

If two or more brokers agree to divide a market area so that each broker only covers a certain segment of that market area, the allocation of these segments is illegal because it restricts open-market competition. For example, if Brokers A, B, C and D are the four major brokers in a city, they cannot have an agreement to exclusively represent the northern, southern, eastern and western areas of the city, respectively. Allocation of markets does not pertain solely to geographic regions; it is also illegal to divide the market in terms of property values.

Beyond these shared principles, the details of real estate practice in regard to the legality of allocation vary from state to state and are more closely regulated and further defined at the state level. Still, many states have similar provisions based on the regulations recommended by the National Association of REALTORS®.

In Texas, the Texas Real Estate Commission (TREC) monitors real estate practices. You can visit the TREC website at http://www.trec.state.tx.us/.

TEXAS DECEPTIVE TRADE PRACTICES-CONSUMER PROTECTION ACT

In addition to the consumer protections granted by federal antitrust laws, the Texas Deceptive Trade Practices-Consumer Protection Act (DTPA) allows an aggrieved consumer to hold a seller of goods and services liable for damages resulting from deceptive or unfair trade practices. In the context of real estate, the consumer is the buyer, and the seller of goods is the seller of real property.

However, when a licensee is the seller’s agent, the licensee can be considered a seller of services, and a consumer can bring action against the licensee for knowingly and intentionally deceiving the consumer in the selling or leasing of any real property. In fact, most lawsuits brought against real estate licensees cite violations of the DTPA.
Overall, the DTPA lists 25 specific violations, commonly referred to as the “laundry list.” Of these 25 violations, the following are applicable to the real estate industry:

- Representing goods as new or original if they are in fact reconditioned or used.
- Representing goods as meeting a certain standard, quality, or grade or as if they are of a particular style when, in fact, they do not fit these descriptions.
- Misrepresenting facts concerning the goods, services or business of another in order to discredit that entity.
- Misrepresenting facts concerning the reasons for a reduction in price of goods or services.
- Representing an agreement as containing rights, remedies or obligations that it does not contain.
- Concealing or misrepresenting the need for replacement or repair services.
- Misrepresenting the authority of the representative to negotiate the transaction.
- Claiming that replacement or repair services have been performed when, in fact, they have not.
- Failure to disclose any information at the time of the transaction, which may have affected the outcome of the transaction.

If the consumer can prove that the seller or the broker knowingly and intentionally committed any of these violations, the offending party can be held liable for damages. However, there are a number of ways for a real estate licensee to ensure that the standards of fair and honest trade practices are satisfied, and thus, to protect themselves from this kind of litigation:

- By being responsible and thorough in disclosing property defects.
- By encouraging all parties to carry out appropriate property inspections.
- By avoiding the offering of opinions or making unwarranted exaggerations about a property.
- By keeping careful notes regarding the transaction process.

**DISCLOSURE**

First and foremost, real estate licensees must be vigilant about the disclosures they make to the prospective buyer concerning any property. Again, the duty of disclosure is central to the agent’s role in a fiduciary relationship, even when dealing with a third party. The licensee must disclose any and all defects in a property (of which he or she is aware), including any additional information about the property that may affect the prospective buyer’s final decision.
The State of Texas requires all sellers of residential property to submit a seller’s disclosure form. TREC offers a Seller’s Disclosure of Property Condition form, but sellers are not obligated to use it, meaning this specific form. As long as the disclosure includes all of the information that TREC requires, any form may be used.

**LEARN MORE:**

Basically, the disclosure notice is an opportunity for the seller to be upfront and comprehensive about all facts and defects concerning the property. It is the real estate licensee’s responsibility to advise the seller about the necessity of the disclosure notice, although the seller should fill out the form itself. (This form is required even when an owner sells his or her own property.) The completed form should be given to the prospective buyer before he or she makes an offer to buy the property.

**RECOMMEND INSPECTIONS**

It is in the best interest of all parties to have the property inspected by a professional property inspector who is not associated with the real estate licensee. The licensee can provide a list of qualified inspectors to the prospective buyer, but he or she should not be present to mediate the conversation between the inspector and the prospective buyer.

If the initial inspection reveals defects in the property and the appropriate repairs are made, the prospective buyer should be encouraged to review the property a second time to ensure that the defects have been addressed to his or her satisfaction. In the event that a prospective buyer chooses not to have a property inspected, the licensee should secure a signed written statement from the prospective buyer stating that he or she made this choice despite the licensee’s recommendation that the property be inspected.

**AVOID OPINIONS AND PUFFING**

It is important for the agent to steer clear of personal opinions when commenting on a property. If the customer believes that the agent made unwarranted exaggerations over the course of the transaction, that agent may be accused of puffing. It is the agent’s responsibility to provide known facts about the property, not his or her opinions. If a client or customer asks for an agent’s opinion, the agent should refer the individual to a specialist (for example, a property inspector, an attorney, or a plumber) who can provide unbiased and informed assistance to the consumer. The agent should, however, avoid recommending a particular specialist; if the consumer is dissatisfied with the work of that
individual, the licensee could be held liable. Instead, the agent can provide the consumer with a list of qualified professionals.

**KEEP CAREFUL NOTES REGARDING THE TRANSACTION**

Finally, the agent should always keep detailed and accurate notes throughout the real estate transaction. This is to ensure that the licensee can provide evidence regarding certain actions or events over the course of a transaction if he or she is later called upon to do so.

**DTPA LAWSUITS**

When a lawsuit is filed under the DTPA, there are a number of ways the problem might be resolved. A reasonable settlement can always be made between the licensee and the consumer if the case is addressed within a set time limit. An agent may be released from liability if that agent can show that any inaccurate information he or she provided to the consumer was obtained from another source (from, for example, governmental records or a seller’s disclosure form) and that the agent had no reasonable way of knowing that information was false. For example, if an agent quotes the wrong square footage for a property based on inaccurate county records, the agent would be protected from liability. Also, if an agent can show that the training he or she received was inadequate or mistaken (for example, an incorrect statement appearing on the state’s real estate exam), and that he or she carried out the business of real estate relying on this information as fact, then the agent is not liable.

Recovery under the DTPA is limited to economic damages. In order for the Texas Real Estate Commission to revoke or suspend an agent’s license, that licensee’s violations of the DTPA must be coupled with violations of provisions set forth in the Texas Real Estate Licensing Act. Some of the infractions for which TREC may revoke or suspend an agent’s license—violations of License Law, which are also violations of the DTPA—are the following:

- Material misrepresentation or failure to disclose any known or latent property defects.
- Deceptive practices in the marketing, selling or offering of real property.
- False promises made to the consumer through advertising or directly through the agent.
- Failure to disclose which party is compensating the agent, or that more than one party is liable for compensation without the written consent of all parties involved.
- Request or acceptance of an undisclosed compensation.
- Acting as agent and undisclosed principal in a transaction.
SUMMARY

Real estate licensees are subject to federal antitrust laws, enforced under the Sherman Antitrust Act, that prohibit unfair trade practices in the United States. These laws are rooted in the idea that competition creates the largest choice of products and services for consumers, thus providing them with the broadest possible range of price and quality. The most common antitrust violations in the real estate industry include price fixing, boycotting competitors and allocating customers or markets.

In addition to the consumer protections granted by federal antitrust laws, the Texas Deceptive Trade Practices-Consumer Protection Act (DTPA) allows an aggrieved consumer to hold a seller of goods and services liable for damages resulting from deceptive or unfair trade practices. When a licensee is the seller's agent, the licensee can be considered the seller of services, and a consumer can bring action against the licensee for knowingly and intentionally deceiving the consumer in the selling or leasing of any real property.

To prevent lawsuits under the DTPA, real estate agents must be diligent about disclosing the known facts about a property. Agents should also recommend that buyers arrange an independent inspection of the property, avoid offering opinions or making exaggerated statements about the property (puffing) and keep careful notes and records regarding the transaction. Recovery under the DTPA is limited to economic damages, but if a licensee's violation of the DPTA is also a violation of Texas License Law, TREC can suspend or revoke the individual's license.

Return to your on-line course player to take the Lesson Quiz.
LESSON SIX
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Field Application of Agency Relationship Concepts
- Insight into Agency Law
- Field Applications of Agency Law

INTRODUCTION

This module has covered a lot of detailed information over a relatively short period of time. To ensure a comprehensive understanding, we will now integrate the information provided in the course through a series of thorough, directed questions and case studies. The first half of this lesson presents comprehensive questions and dilemmas. The second half presents brief case studies illustrating the principles and ideas covered in the rest of this module.

FIELD APPLICATION OF AGENCY RELATIONSHIP CONCEPTS

Now you be presented with situations that deal with some of the principles and ethical dilemmas that a broker may face regarding Texas agency law. Choose the best possible answer from the three choices presented.

Imagine that you are standing in front of an office building housing Smith’s Brokerage. Mr. Jones, a Caucasian man walks into the brokerage and approaches Ms. Smith, an African-American woman, seated behind the front desk. When Ms. Smith speaks, she stands to shake Mr. Jones’s hand.

Smith: Good afternoon! I’m Ms. Smith, the broker. How may I help you?
Jones: I’m looking to buy a home.
Smith: Then I’m sure I can help! Tell me a little about the perfect home for you.

Ms. Smith and Mr. Jones discuss the features that Mr. Jones wants in a home, and Mr. Jones gives Ms. Smith his general price range.

Smith: I can think of two properties offhand that I think you’d really like.
Jones: Great, I’d love to see them!

Ms. Smith is the agent for the sellers of both of the properties she plans to show Mr. Jones. She also has a general policy of refusing to act as an intermediary. Which of the following statements is TRUE about Ms. Smith’s obligations in this situation? Choose the letter representing the correct choice.
A: Ms. Smith isn’t required to tell Mr. Jones that she represents the sellers.
B: Ms. Smith must disclose that she represents the sellers and give Mr. Jones an agency disclosure statement to sign.
C: Ms. Smith must either choose to act as a dual agent or tell Mr. Jones that she can’t help him.
B is the correct choice.

A: Ms. Smith isn’t required to tell Mr. Jones that she represents the sellers.
B: **Ms. Smith must disclose that she represents the sellers and give Mr. Jones an agency disclosure statement to sign.**
C: Ms. Smith must either choose to act as a dual agent or tell Mr. Jones that she can’t help him.

Smith: Mr. Jones, before we proceed, I must let you know that I am the agent for the sellers of these two properties. What this means is that I represent their interests, and although I will be as helpful to you as I can be, I will not be representing your interests. Look over this Information about Brokerage Services form, which explains Texas agency law.
Ms. Smith hands Mr. Jones the form, and he looks it over. While he’s looking at it, the following dialogue happens:

Jones: Hmm… oh… ok, I see.
Smith: Please let me know if you have any questions.
Jones: OK…This form describes your duties to the seller. What are your duties to me?

As the seller’s agent, Ms. Smith owes the buyer all of the following duties EXCEPT which one? Choose the letter representing the correct choice.

A: The duty of reasonable care and skill
B: The duty to disclose all material facts
C: The duty of confidentiality
D: The duty of honesty and fair dealing
The correct response is C.

A: The duty of reasonable care and skill
B: The duty to disclose all material facts
C: The duty of confidentiality
D: The duty of honesty and fair dealing

Smith: Agency law states that I owe you the duties of reasonable care and skill, disclosure of material facts and honest and fair dealing. Even though I represent the seller, I still have to treat you fairly.
Jones: OK, then, I'll agree to this.

Mr. Jones signs the statement.
Smith: Great! Let's go look at these two houses.

Ms. Smith & Mr. Jones walk into house #1. This house is a small, cottage-looking stone house. Mr. Jones looks around as Ms. Smith gestures.

Smith: This first house is an absolute dream. I think you'll love it! It's so cozy.

Ms. Smith knows that the driveway of this house extends onto the neighboring property. This problem is considered a latent defect because it would not be easily discovered in an inspection. However, a survey of the property would reveal this fact. Is she required to tell Mr. Jones this information? Choose the appropriate answer from the following selection.

A: She must tell Mr. Jones about the driveway.
B: She does not have to tell Mr. Jones about the driveway because it is the buyer's responsibility to thoroughly inspect the property.
C: She does not have to tell Mr. Jones unless he outright asks about any latent defects.
The correct response is A.

**A: She must tell Mr. Jones about the driveway.**

B: She does not have to tell Mr. Jones about the driveway because it is the buyer’s responsibility to thoroughly inspect the property.

C: She does not have to tell Mr. Jones unless he outright asks about any latent defects.

Smith: Mr. Jones, I’m required by law to disclose all material facts, so you should know that the driveway of this house extends onto the neighboring property.

Jones: Oh, hmm. Do you think that would be expensive to fix?

Ms. Smith suspects that the driveway would be an expensive fix. However, she is not an expert on this issue. She also knows that if she tells Mr. Jones that it may be expensive to repair, he may not want to buy the house. What should Ms. Smith say? Choose the correct answer from the following selection.

A: Ms. Smith can give Mr. Jones her opinion given that it probably would be very expensive to fix the driveway.

B: Because Ms. Smith is not an expert she should tell Mr. Jones that it probably would not be very expensive to fix the driveway.

C: Because Ms. Smith is not an expert she should refrain from giving any opinion on cost of repair to the driveway.
The correct response is C.

A: Ms. Smith can give Mr. Jones her opinion given that it probably would be very expensive to fix the driveway.
B: Because Ms. Smith is not an expert she can tell Mr. Jones that it probably would not be very expensive to fix the driveway.

C: Because Ms. Smith is not an expert she should refrain from giving any opinion on cost of repair to the driveway.

Ms. Smith: I'm sorry, Mr. Jones, but I'm not a construction expert. You would need to consult a professional to get an estimate of the costs to fix this problem. If you like, I can give you a list of qualified individuals.
Mr. Jones: Well, I don't know. I think this would just be too much trouble. Let's see the next house.
Ms. Smith and Mr. Jones continue on to House #2. This house is brick with two stories and has lots of windows.

Smith: Ok, this house really is great. There are no major defects. It’s in great condition, and no major repairs would be needed.

Jones: Hmm. I really like this house! What was the listing price again?
Smith: $115,000.
Jones: Whew, that’s steep! How low do you think the seller might be willing to go?

Ms. Smith knows that the seller wants to sell this house quickly and is willing to go as low as $80,000. What should she tell Mr. Jones?

A: She must be honest and tell Mr. Jones that the seller is willing to go as low as $80,000.
B: She can be dishonest and say that the seller is willing to go as low as $100,000.
C: She must not give the buyer any advice on this matter because advising prospective buyers about price is at odds with her legal obligation to promote her client’s interests.
The correct response is C.

A: She must be honest and tell Mr. Jones that the seller is willing to go as low as $80,000.
B: She can be dishonest and say that the seller is willing to go as low as $100,000.
C: **She must not give the buyer any advice on this matter because advising prospective buyers about price is at odds with her legal obligation to promote her client’s interests.**

Smith: I’m sorry, but that’s confidential information, and I can’t give you any advice on price negotiation because that would be at odds with my client’s interests. You’ll have to consult your own agent for advice.
Jones: You know, I think I need someone on my side to give me advice about this. I’m going to hire my own agent, and I’ll be back to buy this house!

**INSIGHT INTO AGENCY LAW**

Here are five case studies that deal with the laws, guidelines and ethical issues that we have covered in this module. You are asked to consider the facts of each case study, anticipate the outcome and draw on your knowledge of agency law to answer questions about these situations.

**CASE STUDY ONE**

Four months ago, Seller A listed a home with Broker B’s office, Budget Brokerage. The seller and Broker B signed a listing agreement and agreed to enter into an agency relationship. Broker B is a very busy person, and she assigned the task of finding a buyer for this home to Salesperson C, a new employee. Salesperson C looked over the facts about the property and she noted that the local school district is under-funded and is considered to be one of the worst school districts in the city. She mentioned this to the broker and raised a concern that this information might make it difficult to sell the home. Her broker told her not to worry because Texas law does not require a seller’s agent to disclose that sort of information to buyers.

Two weeks later, Buyer D walked into the brokerage. Salesperson C happened to be the only person in the office and after a brief talk with Buyer D, she realized that Seller A’s property would be perfect for the buyer’s needs. They immediately went to look at the property. Salesperson C mentioned several latent defects in the property but did not mention the problems with the school district. Salesperson C also showed the buyer several other properties, but the buyer decided to purchase Seller A’s home.

The closing went smoothly, with no major concerns. After closing, however, Broker B received a letter of an impending lawsuit from Buyer D. Apparently,
Buyer D moved in and immediately discovered negative information about the school district. She is convinced that Salesperson C and Budget Brokerage misled her by concealing this fact.

Consider this situation. Is Budget Brokerage liable?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY ONE RESPONSE:

It is possible that Budget Brokerage could be held liable. Texas law does not consider information such as the quality of the school district to be a material fact or a latent defect, so the agent is not required to disclose this information. However, this case study does not mention whether the agent gave the buyer a disclosure of agency form and statement of agency law. The buyer in this case may not have been aware that the salesperson was not acting as her agent—and a buyer’s agent would be responsible for providing her client with accurate information about the community in which a property is located. If the salesperson’s actions created a situation of implied agency, then the buyer may have a case.

CASE STUDY TWO

Seller X relocated to another area prior to the sale of his listed property. Shortly thereafter, his agent, Broker Y, found an interested buyer. This prospective buyer, Buyer Z, was able to obtain financing quickly and the transaction soon thereafter progressed towards closing.

Three weeks before the closing date, Buyer Z walked into the agent’s office and explained that she needed to move into the house immediately for personal reasons. If immediate possession was not possible, she said that she would be forced to withdraw her offer on Seller X’s property and move into a rental house instead.

Broker Y considered this offer briefly. Nothing in the original purchase and sales agreement allowed for this. Broker Y decided to call Seller X to get his approval, but the seller could not be reached. The buyer needed an answer right away; Broker Y decided that since Seller X wasn’t living in the house, he probably would not mind allowing the buyer to move in right away and pay rent until the day of closing. Broker Y told her it would be fine and found an attorney to draw up a contract. Buyer Z came back later that day and signed the contract, and the agent signed on behalf of Seller X.

Seller X returned the agent’s call the next morning and said that the decision was fine—of course he wouldn’t mind receiving three weeks worth of rent!

Broker Y originally acted outside of her authority, which is illegal. However, the principal (Seller X) later agreed to the agent’s actions. Does this approval make the agent’s actions acceptable?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY TWO RESPONSE:

Yes*
No

Feedback:
The agent acted outside of her authority, but the seller later approved the action and thereby granted the agent authority by ratification. This particular situation worked out for both parties: the seller was able to receive three weeks of rent money when the house would have sat empty otherwise and the buyer solved her personal situation by being able to move in immediately. However, it is not recommended for agents to act outside of their authority because an agent cannot predict whether a seller will agree to an action. Assuming that a client will grant ratification is risky, and the agent would probably be held liable if the client did not approve of the action(s).

CASE STUDY THREE

Seller M listed a condominium with Broker N, and they agreed to form an agency relationship. Seller M decided to list his condominium at $120,000.

Broker N had also recently put up her own condominium for sale. Both of these condominiums were located in the Happy Pines Condominium complex, and similar in size and layout. Broker N listed her condominium at a comparable price but decided that she was willing to take lower offers.

Shortly thereafter, Buyer O came into Broker N’s office looking to purchase a condominium and explained that his price range was $100,000 to $130,000. Broker N asked him what he was looking for and the features he described matched those of the condominiums owned by both Seller M and Broker N.

Broker N then told Buyer O that she had a lovely condominium in the Happy Pines Condominium complex with a listing price of $110,000. Buyer O asked to see the property and the broker showed the buyer her own condominium.

As they pulled into the building, Seller M happened to see Broker N and the prospective buyer in the car. Seller M asked the broker if she was showing the buyer his condominium, and the broker was forced to say no. The broker later called Seller M to explain, and Seller M fired her.

Did Broker N do anything wrong here?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY THREE RESPONSE:

Yes*
No

Feedback:
An agent must place the principal’s interests above his or her own. Broker N probably might have sold Seller M’s condominium to the buyer, but she didn’t even show the buyer the property. In this situation, the broker placed her own interests above her client’s interests. In short, Broker N breached the duty of fidelity that she owed to her client, Seller M.

CASE STUDY FOUR

Broker J had been representing Buyer K for two months when he finally found a suitable property for her. Buyer K agreed to purchase this property, and presented an offer of $80,000, which was $10,000 less than the listing price. However, the seller (Seller L) agreed, and they proceeded towards closing.

At closing, however, the transaction fell through. It was discovered that there were several liens on the property, and the property could not be sold. Seller L was aware of the liens but had thought he would be able to clear them before the date of closing. He, however, kept this information hidden from his broker, Broker M.

Buyer K is very upset about this issue and wants to file a lawsuit. Which party is liable?

A: The buyer's broker
B: The seller
C: The seller's broker
CASE STUDY FOUR RESPONSE:

The seller

Feedback:
The seller is liable for concealing this information. Although agents are held responsible for their own wrongful actions and negligence, there are only certain circumstances under which they are held liable for a client’s actions, and since the seller concealed this information from the broker in this case, the broker is not responsible to the prospective buyer for undisclosed liens on the property.

In general, the agent is understood to operate under a warranty of authority. This is a kind of guarantee that an agent gives (explicitly or implicitly) to a third party, establishing that he or she has the authority to bind a principal—i.e., to make contracts, agreements and enter into similar arrangements on the principal’s behalf. However, the agent cannot be held responsible if the principal does not or cannot follow through on agreements he or she makes on the principal’s behalf. The warrant of authority concerns only the agent’s authority to act on the principal’s behalf, not on his or her authority to ensure that the principal himself acts in a certain way.

For the purposes of this case, the seller’s broker is merely the seller’s representative and has no liability if the seller is unable to actually turn over title to the property.

CASE STUDY FIVE

Seller S visited one of the offices of the Speedy Sales brokerage firm to list her home. Licensee A works in that office and the seller and this licensee entered into an exclusive listing agreement that authorized the licensee to publish the listing through Speedy Sales’ multiple listing service. Licensee A conducted an open house, advertised in the local paper, and took other active steps to promote the sale of the home.

Four weeks after the property went on the market, Licensee A received a call from Licensee B, who is affiliated with the same firm but works out of a different office. The two licensees had never met. Licensee B explained that he worked for Speedy Sales, had seen the seller’s property in the multiple listing service and was interested in purchasing the property for himself. Licensee B then sent an offer to Licensee A through interoffice mail.

Licensee A spoke to her supervising broker who agreed to function as an intermediary. The broker then appointed Licensee A to serve as the seller’s agent.
When Licensee A, the seller’s agent, met with the seller to present Licensee B’s offer, she disclosed the intermediary relationship and the potential conflict of interest. Seller S consented to this arrangement in writing and agreed to the offer. Seller S then requested that Licensee A take the necessary steps to close the sale. The sale was closed, and Licensee A received a commission from the seller.

Several weeks later, Licensee A received a letter from the seller’s attorney. The attorney was of the opinion that since the buyer was a member of the same firm, Licensee A could not have acted as the agent in the sale and that she was not entitled to any listing commission. The attorney demanded that Licensee A refund the commission.

Would Licensee A have to refund the commission?

Write your answer in the space provided and check your answer on the next page.
CASE STUDY FIVE RESPONSE:

No

Feedback:
Licensee A satisfied her fiduciary duties to the seller and carefully disclosed the fact that the buyer was a member of the same firm. The seller consented in writing to the arrangement. Also, the licensee played no part in the seller’s decision to list with her or the seller’s decision as to the listing price. In this situation, the licensee performed her obligations under the listing contract and promoted the best interests of her client. She would not have to refund the commission.
## Texas Principles of Real Estate
### Module 6: Contracts, Purchase, and Sales Agreements

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### Lesson 6: Contracts, Purchase and Sales Agreements in Texas

- The Statute of Limitations
- The Uniform Commercial Code
- Promulgated Contract Forms
- Contracts for Deed

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INTRODUCTION

Clear, mutually acceptable agreements are an essential component of the legal transference of ownership. In the practice of real estate, contracts are the instruments used to describe and record agreements. Some type of contract is nearly always involved, whether a salesperson is promising to sell a property within a specified period of time, a prospective buyer is placing an offer on a house or a seller is considering an offer on property.

Before entering into a legally binding agreement, real estate professionals must fully understand the contracts that govern their industry. Failure to understand contracts opens a licensee to various kinds of liability and can seriously damage one’s professional reputation. Therefore, it is vital that real estate professionals learn this material so they can protect themselves against errors, oversights and misunderstandings.

In this module, the student will learn about the types of general contracts as well as the different kinds of real estate contracts. The module begins by providing the student with an overview of the various types of contracts: bilateral, unilateral, implied, express, executed, executory, valid, void, voidable and unenforceable. Once the student is introduced to the different types of contracts, he or she learns what makes a contract legally enforceable; these being the five components that make a contract valid: mutual assent, legally competent parties, consideration, lawful objective and adherence to the statute of frauds.

This module includes the following lessons:

- Types of Contracts
- Features of a Legally Valid Contract
- Contract Fulfillment
- Real Estate Contracts

The fifth and concluding lesson in this module presents real-world dilemmas and concrete applications of the information presented in the rest of the course. As the student completes this module, he or she should try to develop a broad picture of environmental issues and how they fit into the larger practice of real estate; the last lesson will help with this project by presenting comprehensive content questions, practice problems and case studies.
KEY TERMS

**Actual Damages:** Compensation given to an injured party for proven injuries or losses that resulted from another party’s actions or omissions.

**Assignment:** A method of transferring the rights and obligations of a contract to a third party without canceling the contract. Assignments vary as to what rights and obligations are transferred, and to what degree.

**Bilateral Contract:** An agreement in which both parties give consideration and promise to perform the actions specified in a contract. This kind of contract creates reciprocal obligations, in which each party is obliged to the other.

**Breach of Contract:** Occurs when there is a violation of the terms of a legally binding agreement. When a breach of contract occurs, the non-breaching party may be able to seek recourse via an array of legal options, including rescinding the contract, suing for damages or for performance of the contract. Contracts can be breached in different ways and to varying extents.

**Competent Parties:** People who are legally capable of entering a contract. To be competent in this sense, an individual must be of majority age and be mentally competent.

**Contract:** A legally binding and enforceable agreement between two or more competent parties, regarding an exchange (of money, promises, property or services). To be valid, a contract must include an offer, acceptance and consideration.

**Consideration:** Something of value, such as money or a promise, is given to show acceptance or acknowledgement of a contract.

**Contract for Deed:** A conditional type of agreement in which the seller holds the title until the buyer has paid in full. This is also known as an installment contract, an installment land contract or a contract sale.

**Counteroffer:** A rejection of an offer to buy or sell, tendered with a simultaneous substitute offer.

**Deceptive Trade Practices Act:** A federal law that allows an individual to sue a provider of goods or services for fraud or misrepresentation.

**Default:** The failure to make timely debt payments or to comply with other conditions of an agreement.

**Earnest Money:** A deposit made by a real estate buyer to show an offer is serious and it is being made in good faith. This money is also often used as a
kind of “marker” to reserve the property while the final contracts are being drawn up or the offer is being considered.

**Enforceable Contract:** A contract in which all the terms and conditions are valid and the parties bound by the contract are responsible for carrying out the obligations set forth in the contract. In short, this is a contract that the contracted parties can be legally forced to carry out.

**Estate:** The extent of an individual’s right or ownership in land. Estates vary in their amount, degree and nature.

**Executed Contract:** A contract in which all terms have been fulfilled by all parties. There are many kinds of contracts, but any of these can become an executed contract once all parties have completed their contractual obligations.

**Executory Contract:** A contract that has not been completely performed and for which the terms have not been fully carried out by one or more parties to the agreement.

**Express Contract:** Oral and written contracts in which parties have explicitly and specifically set out their terms. Express contracts stand in contrast to implied contracts, in which the existence of a contract (and the nature of its terms) is inferred from the parties’ conduct.

**Disclosure:** The act of revealing previously unknown information. Disclosure can be compulsory or obligatory, in which case it becomes an obligation to reveal all the facts of a transaction; disclosure might also be required by a professional code of ethics, in addition to the law. Full disclosure requires that one make known any adverse details that may affect the results of the transaction, even if sharing those facts works against one’s own (or one’s client’s) interests.

**Forbearance:** The act of refraining from actions an individual is legally entitled to take, such as the enforcement of a right or a debt.

**Fraud:** Intentional misrepresentation or concealment of significant facts. Fraud includes false statements and promises that result in losses for other parties.

**Freehold Estate:** A form of real estate interest that requires the property owner to have actual ownership and possession of the property. In a freehold estate, the estate has a specified period of duration.

**Implied Contract:** A contract inferred from the actions of various parties, but is not necessarily written or spoken. Even though these contracts are established by the parties’ conduct rather than a written document or an explicit discussion,
they can have all of the binding power of legal contracts that are made more explicitly.

**Leasehold Estate:** A form of real estate interest (i.e., an estate) in which a tenant (lessee) has an interest in the property he or she leases, but does not have an actual ownership interest in property.

**Liquidated Damages:** When one party breaches a contract, this often causes losses for the other party. “Liquidated damages” are a contractually stipulated amount deemed approximate to the actual damages the injured party could recover if the other party were to breach the contract. When parties agree to a liquidated damages figure, this agreement often sets a limit on recoverable damages, even if the cost of the actual damages exceeds the liquidated damages figure.

**Malice:** The intention to do wrong without excuse or justification. For example, if a licensee makes intentional omissions of fact or knowingly withholds information that can cause substantial injury to another party, the licensee may be judged to have acted maliciously (i.e., with malice).

**Novation:** The substitution of a new contract or obligation for an existing agreement or promise, either by canceling the old contract or substituting a new party in place of the individual(s) who made the previous agreement.

**Performance:** Successfully carrying out the requirements and obligations of a contract. When one has performed one’s part of a contract, one is generally considered to be free of future liability with respect to the contract.

**Promulgate:** To openly declare or announce. This term is especially relevant to real estate licensees because in many states, the regulatory agencies that govern real estate practice offer what they call “promulgated forms.” The use of some of these forms—often including contractual ones—is mandatory; that is, licensees may not substitute other forms or their own paperwork. It is important licensees acquaint themselves with their state’s promulgated forms, because failing to use the required forms can invalidate transactions and create serious legal and professional difficulties.

**Sales Agreement:** A contract in which a seller promises to transfer property ownership (either now or in the future) to a buyer for an agreed-upon price.

**Specific Performance:** A court-ordered solution to a breached contract in which the party who has violated the contract is required to fulfill the obligations of the contract. Specific performance is important because there are situations in which awarding monetary damages fails to honor the spirit of the contract, such as when two parties have agreed to transfer a piece of real estate and the seller
breaches the contract. In this case, a monetary award fails to provide anything like what the would-be buyer was promised.

**Statute of Frauds:** A state law that establishes the features of a valid contract. For example, a state’s statute of frauds will generally require certain types of contracts be set out in writing and written contracts be signed by all the parties bound by the contract. Licensees should acquaint themselves with the specific requirements set out in their states’ statutes, because there are frequently subtle differences between one state’s statute of frauds and of another state.

**Statute of Limitations:** A state’s statute of limitations is a law establishing a time limit for civil suits, setting a maximum period of time to elapse between the date an injury occurs (or the basis of a legal claim is discovered) and the date a civil lawsuit is filed. There are also federal statutes that set maximum time limits regarding federal crimes and suits filed in federal courts.

**Unauthorized Practice of Law:** Offering legal services or advice for a fee or other valuable consideration when one is not a licensed attorney. This is an important consideration for licensees because many states have promulgated real estate contract forms—that is, contract forms which licensees are required to use in their transactions. Licensees are only authorized to fill out these forms; they are not authorized to create contractual forms or to provide their clients with legal advice, because doing so would constitute the unauthorized practice of law. If a licensee thinks a special contractual form should be created, or believes his or her clients need legal guidance, he or she should refer those clients to a licensed attorney.

**Unenforceable Contract:** A contract that is valid but cannot be enforced, due to a technical defect or because it is at odds with the statute of frauds or some similar legislation. It is important to understand that this kind of contract cannot be legally enforced. That is to say, neither party bound by the contract could seek legal action against the other for breach of contract.

**Unilateral Contract:** A contract made between at least two parties in which only one of those parties makes a promise or otherwise accepts an obligation. In short, this is a contract in which only one of the contracting parties needs to do something in order for the contract to be executed.

**Valid Contract:** A legal agreement having all the essential features of a contract and reflecting the contracting parties’ intentions, which are thus binding and enforceable for all parties.

**Void Contract:** A contract that, for various reasons, has no legal validity. For example, an agreement that did not meet the minimum requirements of a contract would have no legal effect or impact. A contract that is not legally valid cannot be enforced by any of the contracting parties.
Voidable Contract: A contract structured so it may be terminated or rescinded by either party.
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Name and explain the various components of a valid contract.
- Identify the differences between a unilateral and bilateral contract.
- Describe the various types of contracts.
- Recognize the difference between a forbearance and performance agreement.
- Outline the features of a contract (and the contracting parties) that make a contract legally binding.
- Recognize the general features of a completed contract.
- Identify when a contract can be discharged.
- Recognize the different kinds of real estate contracts.
LESSON ONE
TYPES OF CONTRACTS

This lesson focuses on the following topics:

- Implied Contracts
- Express Contracts
- Bilateral Contracts
- Unilateral Contracts
- Executed Contracts
- Executory Contracts
- Valid Contracts
- Void Contracts
- Voidable Contracts
- Unenforceable Contracts

INTRODUCTION

Real estate professionals expend a great deal of effort on listings. Obtaining, showing and selling listings occupy much of any licensee’s working time. Because these listings are so important to a successful licensee, it would be unfortunate if a transaction fell through because of a misunderstanding or uncertainty surrounding an agreement to buy or sell a listing.

To avoid these problems, licensees should make an effort to understand contracts, which are the legally binding agreements that prevent such misunderstandings and uncertainties in real estate transactions. Clear, mutually acceptable agreements are an essential component of the legal transference of ownership, and contracts are the instruments by which such agreements are legalized in real estate transactions.

Parties who are entering into an agreement regarding ownership or other kinds of interest in real estate need a contract because it establishes the terms of the agreement in clear and comprehensible language. It allows the parties to understand their role in their agreement and to know what is expected of them. If either party disputes the agreement, the parties should be able to use the contract to resolve any confusion. A well-defined and comprehensive contract establishes the facts of the agreement in mutually acceptable terms, and can often prevent the parties from having to go to court to resolve their conflicts.

Both parties are liable for carrying out the terms of the contract—that is, they are obligated to perform (or refrain from performing) any actions required by a legally valid contract that they have signed or otherwise accepted. Because contracts create obligations that can be legally enforced, it is extremely important that both parties understand and accept all of the stipulations in any contractual
agreement. This requires that parties understand the different types of contracts that exist (so that they know what options they have); they should also be able to recognize the basic components of a legally valid contract, so they can tell whether a given contract will have the legal effects that it should.

Because contracts serve many purposes, they take many forms. This lesson will focus on those that are most commonly involved in real estate transactions, although it will also provide a more general discussion on the various types of contracts that exist. For example, legally valid contracts can be written or oral. Another perhaps surprising fact about contracts is that (depending upon the intent of the agreement) a contract can require action on the part of all the contracting parties, or it may impose obligations on only one of the contracting parties.

Because of the variety of contracts and the important differences between them, it is prudent for contracting parties to consult with knowledgeable professionals who can help guide them through the process of choosing and agreeing to a contract. This lesson will examine these issues and other related topics in considering the various types of contracts.

**TYPES OF CONTRACTS**

This first lesson discusses the general types of contracts available along with their purposes and differences. Contracts take on specific forms in order to carry out specific purposes and can be as simple or as complicated as a given situation may require. Contracts do not always have to be written and signed. A strictly oral or implied contract can be just as legally binding as a written contract.

Contracts can require the action of all the parties involved or merely the action of one party, along with the acceptance of the one party’s action from the other parties. The real estate industry relies heavily on certain types of contracts that facilitate common tasks. It is wise to acquire the consultation of a professional who can guide all parties involved through the process of choosing, writing and accepting a contract that caters to their needs.

**NOTE:**

Oral contracts are established when the offeror states the offer and the offeree accepts the offer. In an oral contract, there are no formal or written documents spelling out the terms and conditions of the agreement. Instead, each party relies on the word of the other.

**IMPLIED CONTRACTS**

Implied contracts are inferred from the actions of various parties, but are not necessarily written or spoken. Even though these contracts are established by
the parties’ conduct rather than a written document or an explicit discussion, they can have all of the legally binding power of more explicit contracts.

For implied contracts to be legally enforceable there must be an exchange of promises. One party offers money, services, property rights, etc., in exchange for something else of value. Implied contracts have an offer and acceptance that are simply understood and not explicitly spoken or written.

**EXAMPLES OF IMPLIED CONTRACTS**

- When individuals visit their doctor for an examination, they generally expect to pay for the exam at the end of the visit. It is the general social convention surrounding medical practices combined with an individual's acceptance of the doctor's services that create an implied contract between doctor and patient. The patient owes the doctor compensation for services rendered.
- When an individual dines at a restaurant, orders food and eats it, he or she creates an implied contract with the restaurant. The individual is expected to compensate the restaurant for the meal.
- When an individual takes a taxi to a destination, this creates an implied contract with the cab driver. The passenger must compensate the driver for the transportation provided.

**NOTE:**
Social conventions play a large role in creating implied contracts. To avoid errors, oversights and misunderstandings from an individual not familiar with a specific service, many individuals take steps to spell out the terms of implied contracts. Taxi drivers post rates on the windows of their cabs just as restaurants post prices on their menus. This makes it clear services are for sale, not free of charge.

Real estate licensees should not let any aspect of their services be defined by implied contracts. Implied contracts do not help avoid errors, oversights and misunderstandings of an agreement with individuals outside the real estate industry. Implied contracts are likely to be a source of confusion. For instance, a licensee can show prospective clients many properties and not be their real estate agent.

**EXPRESS CONTRACTS**

Express contracts are oral and written contracts in which parties explicitly state, or “express,” their intentions and their expectations regarding a contract. They stand in contrast to implied contracts where the existence of a contract (and the nature of its terms) is inferred from the parties’ conduct.
If one party deviates from the agreed-upon terms of an express contract, the injured party can seek damages and legal recourse. Express contracts essentially serve as a reference in the event of errors, oversights and misunderstandings. An express contract best serves as a reference when it is written.

EXAMPLE OF EXPRESS CONTRACTS

A lease agreement is an express contract in which both the lessee (tenant) and the lessor (landlord) sign the agreement. If the lessee fails to uphold the terms in the lease, then the lessee is subject to the conditions set forth in the lease agreement concerning such violation. Most written leases explicitly state the penalties (such as late fees or eviction), for violations (such as non-payment of rent), which provide prospective tenants and landlords an opportunity to see and consider all terms before accepting a lease.

BILATERAL CONTRACTS

This is an agreement in which both parties give consideration and promise to perform the actions specified in a contract. This kind of contract creates reciprocal obligations, in which each party is mutually obliged to the other.

EXAMPLES OF BILATERAL CONTRACTS

• In a bilateral contract, Party A must promise to do something for Party B and Party B must promise to do something for Party A. This contract obligates both parties to fulfill certain terms. To satisfy or complete a bilateral contract, all parties involved must carry out their promises.
• In a real estate transaction, the buyer (Party A) promises to pay the seller (Party B) the agreed-upon price and the seller (Party B) promises to transfer the property title to the buyer (Party A). There are thus specific things both sides must do before the contract can be considered complete. If the buyer pays the seller, but the seller does not transfer the title, then the contract is not complete and the buyer can seek legal recourse against the seller for failing to honor the obligations imposed.

UNILATERAL CONTRACTS

This is a contract made between two or more parties in which only one of those parties makes a promise or otherwise accepts an obligation. In short, this is a contract in which only one of the contracting parties is bound to act.

EXAMPLES OF UNILATERAL CONTRACTS
In a unilateral contract, Party A makes a commitment that Party B accepts. This contract is completed or fulfilled when Party A has carried out the commitment. There is nothing Party B must do to execute such a contract. Party A does not have to agree to the contract openly or explicitly. Instead, Party A agrees to the contract by carrying out the action specified.

A broker promises to pay a $1,000 bonus to any salesperson that brings in 10 new listings. The broker unilaterally agrees to give $1,000 to any salesperson who satisfies these set performance standards. No salesperson in the office has to agree to anything but may collect on the promise if he or she so chooses.

**EXECUTED CONTRACTS**

An executed contract is simply a pre-existing one for which all terms have been fulfilled by all parties. There are many kinds of contracts, but all contracts become executed once all parties have completed their contractual obligations.

When a contract is fulfilled, it ceases to exist. Meaning, it has no further legal power to bind any party.

**EXAMPLE OF AN EXECUTED CONTRACT**

A buyer pays a seller the agreed to price for a property and the seller transfers title to the buyer. If there are no further stipulations in their particular contract, then they have executed a contract.

**EXECUTORY CONTRACTS**

This is a contract that is not completely executed or performed. Its terms are not fully carried out or are in the process of being carried out by one or more parties in the agreement. Usually, executory contracts are created when one party fulfills his or her end of the agreement, but the other party has yet to fulfill his or her part.

**EXAMPLE OF EXECUTORY CONTRACTS**

A broker promises to pay his top salesperson $5,000 at the end of the year. However, the broker has yet to pay anyone this bonus. In this instance, the broker and the top salesperson have an executory contract; the salesperson has fulfilled one end of the contract, but the broker has yet to fulfill his promise.
VALID CONTRACTS

Valid contracts are legal agreements meeting all the essential, basic requirements of the law. They accurately reflect the contracting parties’ intentions making them legally binding and legally enforceable for all parties involved.

The five components of a valid contract are:

- Mutual assent
- Legally competent parties
- Consideration
- Lawful objective
- Adherence to a statute of frauds

The features of a valid contract will be discussed at length in the next lesson.

VOID CONTRACTS

This is a contract failing to meet the legal requirements defining a valid contract. A void contract is not legally enforceable against any of the contracting parties. It is a contract in name only. All contracts have the potential to become void contracts, because all contracts can be invalidated if they involve minors, mentally incompetent individuals, misrepresentation, or fraudulent or illegal actions.

EXAMPLE OF VOID CONTRACTS

If Party A and Party B enter into a contract, but the fulfillment of the contract involves an illegal activity, the contract is void; that is, either the parties to the contract or terms of the contract have rendered it void. The contract was not valid in the first place.

VOIDABLE CONTRACTS

This is a valid contract structured so it can be terminated or rescinded by either party. Voidable contracts specifically permit one or both parties to opt out of an agreement under specific reasons, often having to do with non-performance of some or all terms of the contract.

EXAMPLE OF A VOIDABLE CONTRACT

A seller agrees to deliver a valid title, clear of any financial obligations to the buyer. Their contract specifically states the buyer can opt out of the agreement with no legal consequences if such conditions are not met. The buyer discovers
a lien has been placed on the title. The voidable contract permits the buyer to invalidate the contract and walk away without facing legal repercussions, if for example the seller failed to produce the kind of title required in the contract.

**UNENFORCEABLE CONTRACTS**

An unenforceable contract is a *valid* contract that cannot be enforced legally due either to a technicality or a contradiction with the state’s legislation.

Some of the most common reasons a valid contract becomes unenforceable stem from the following legalities:

- **Statute of Frauds:** A state law establishing the features of a valid contract. The law generally requires certain types of contracts to be set out in writing and signed by all the parties bound by them.

- **Statute of Limitations:** A state’s statute of limitations is a law establishing a time limit for civil suits, by setting a maximum period of time that can elapse between the date an injury occurs (or the basis for a legal claim is discovered) and the date a civil lawsuit is filed. There are also federal statutes setting maximum time limits regarding federal crimes and suits filed in federal courts. All claims must be filed prior to the statutory deadline, or the legal right to press a claim is barred.

- **Doctrine of Laches:** The doctrine of laches is a principle that courts use to bar dated claims. Under this doctrine, unreasonable delay or negligence in asserting or defending one’s rights can create a legal bar to equitable relief if a delay or negligence has importantly influenced the conduct of the person responsible for the violation.

**NOTE:**
Licensees should acquaint themselves with the specific requirements set out in their state’s statutes because there are frequently subtle differences between one state’s statutes compared to another state’s.

**EXAMPLES OF UNENFORCEABLE CONTRACTS**

Person A has a legitimate claim against her old firm for sexual harassment. She waits many years to file her claim but is still within the statute of limitations. During the many years she waited, the alleged harasser passed away and all witnesses relocated. Person A does not have a reasonable explanation for her delay in filing the claim. The courts deny her claim under the doctrine of laches, as she has no explanation for delay in filing her claim. A trial cannot be held without the accused harasser, evidence and witnesses. In this case, Person A receives no legal relief on a valid claim, still within the statute of limitations, due to her negligence in filing the claim within a reasonable time period.
SUMMARY

- **Implied contracts**
  - Are inferred from the actions of various parties not necessarily written or spoken
  - Can be just as legally binding as more explicit contracts

- **Express contracts**
  - Are the opposite of implied contracts
  - Are often in writing where the terms of the contract are explicitly stated and accepted

- **Bilateral contracts**
  - Creates mutual or reciprocal obligations involving a promise being exchanged for a promise
  - Requires all parties to carry out all promises

- **Unilateral contracts**
  - Are those in which one party promises to perform and the other party accepts this promise
  - Require only one party to act

- **Executed contracts**
  - Are pre-existing contracts in which all terms have been fulfilled by all parties
  - Are what all contracts become and then cease to legally exist

- **Executory contracts**
  - Are partially or wholly incomplete
  - Are usually created when one party completely fulfills his or her end of the agreement, but the other party has not

- **Valid contracts** have five components:
  - Mutual assent
  - Legally competent parties
  - Consideration
  - Lawful objective
  - Adherence to a statute of frauds

- **Void contracts**
  - Are contracts only in name
  - Are not legally enforceable
  - Are not legal, but also not illegal if fulfilled

- **Voidable contracts**
  - Have all the essential features of a valid contract
  - Have additional provisions allowing either party to opt out of the agreement

- **Unenforceable contracts** cannot be legally enforced:
  - Due to a technicality or mistake
  - Because of failure to adhere to the statute of frauds
  - Because of failure to adhere to the doctrine of laches

*Return to your on-line course player to take the Lesson Quiz.*
LESSON TWO
FEATURES OF A LEGALLY VALID CONTRACT

This lesson focuses on the following topics:

- Mutual Assent
- Legally Competent Parties
- Consideration
- Lawful Objective
- Adherence to a Statute of Frauds

INTRODUCTION

A legally valid contract is an agreement meeting all essential, basic requirements of the law reflecting the contracting parties' intentions making it legally binding and legally enforcing for all parties. If a contract is not legally valid, other facts in or about the contract are unimportant because it ceases to legally exist.

MUTUAL ASSENT

A major requirement for a legally valid contract is mutual assent. This requires all the contracting parties to agree to all of the contract's provisions and conditions. In short, parties can indicate their agreement to a contract's provisions and conditions via actions and/or words.

Mutual assent requires:

- An offer and an acceptance
  - Although, a counteroffer to the original offer can exist
  - Acceptance of the original offer is not required
- The absence of fraud, misrepresentation or duress
- The absence of mistakes

EXAMPLE OF MUTUAL ASSENT

A buyer offers to purchase a seller's property for a mutually agreed upon price of $50,000. Both the seller and buyer agree to this price. The seller transfers the title to the buyer, and the buyer places a down payment on the property. The seller and buyer show mutual agreement to their real estate contract through their actions.
OFFER AND ACCEPTANCE

When making an offer it is important to remember:

- The offeror is the person extending the contract.
- The offeree is the person accepting the contract.

An offer remains open until it:

- Is accepted
- Is rejected
- Is retracted prior to acceptance
  - For example: The offeror can revoke the offer at any time whether the offeree has technically accepted the offer or not.
- Is countered
- Expires

There are three types of acceptance:

- Express acceptance
  - Is a candid and unqualified outward manifestation of an agreement
  - Is worded in such a way as: “Yes, I agree to your offer.”
- Implied acceptance
  - Is when the parties bound by the contract act in a manner implying acceptance of the offer
  - Is expressed when all parties involved act out the contract’s obligations instead of openly stating an agreement or acceptance
- Conditional acceptance
  - Requires a specific condition to be satisfied or an event to take place before acceptance of the contract
  - Can be viewed as a counteroffer
  - Is worded in such a way as: “I will buy this shirt if you give me a 20% discount.”

Example of Offer and Acceptance

A seller advertises that a property is selling for $250,000. A buyer contacts the seller by phone and verbally accepts the terms of his offer of $250,000 for title to the property. The seller accepts the money and gives the buyer the title to the property. The buyer accepts the title to the property and gives the seller $250,000. The contract is signed, the money deposited into the seller’s account and the title transferred into the buyer’s name.

What is the offer in this example?
What is the acceptance in this example?
You would consider this to be what type of contract?

A: Bilateral contract
B: Unilateral contract
C: Voidable contract
What is the offer in this example?
The seller listing the property for $250,000 represents the offer.

What is the acceptance in this example?
The buyer expressly accepts the offer when he calls him on the phone.

You would consider this to be what type of contract?
A is the correct response.

A bilateral contract is when both parties give consideration and promise to perform the actions specified in a contract. This kind of contract creates reciprocal obligations, in which each party is mutually obliged to the other. Given the three options, this is a bilateral contract. It can also be considered an express contract.

A unilateral contract is made between two or more parties in which only one of those parties makes a promise or otherwise accepts an obligation. In short, this is a contract in which only one of the contracting parties is bound to act. Therefore, this is not a unilateral contract.

A voidable contract is a valid contract structured so it can be terminated or rescinded by either party. Voidable contracts specifically permit one or both parties to opt out of an agreement under specific reasons often having to do with non-performance such as in a prenuptial agreement. Therefore, this is not a voidable contract.

COUNTEROFFERS

Counteroffers are attempts to find mutually acceptable contract terms. A counteroffer is a modification of the terms that the offeree does not agree to and are presented to the offeror as a modified contract. An offer is considered rejected if the offeree makes the changes to the offer. A new offer (the counteroffer) is then on the table.

Example of Counteroffers

The seller advertises a property selling for $250,000. A buyer contacts the seller and offers him a counteroffer, $225,000 for the property. The seller tells the buyer he will consider the offer. The buyer states to the seller the offer will be revoked in two weeks. The buyer has two weeks to make a decision.

The seller has the following options:

- To accept the offer by
o Express acceptance
o Implied acceptance
o Conditional acceptance

- To reject the offer by
  o Allowing the offer to expire
  o Verbally rejecting the offer

The buyer can:

- Wait until the offer is accepted
- Wait until the offer is rejected
- Retract the offer, prior to acceptance
- Wait until the offer is countered
- Wait until the offer expires

**FRAUD AND MISREPRESENTATION**

Contracts involving fraud, misrepresentation or duress create a situation in which the parties involved are unable to make a free, fully informed decision about the agreement.

*Fraud* is intentional misrepresentation or concealment of significant facts. Fraud includes false statements, false promises and intentional failure to disclose important information resulting in losses for other parties.

*Misrepresentation* means to give a false or misleading representation, usually with the intent to deceive or be unfair.

**NOTE:**

*Innocent* misrepresentation is not fraud. Innocent misrepresentation occurs when an individual provides incorrect information, but does not intentionally deceive another person. For example, suppose a buyer visits a seller’s home and notices a hiking trail behind the property. The seller speaks highly of the trail and the benefits it adds to the location. The buyer loves the prospect of living near a trail and makes an offer on the house, which the seller accepts. The city closes the trail to the public two weeks before the buyer moves into the home. The seller genuinely did not know about the city’s plans to close the trail and had no intention of misrepresenting the trail as a benefit of his property. The seller did not intentionally withhold information with the intention of deceiving the buyer.

**Example of Fraud and Misrepresentation**

Suppose a buyer tells a realtor to look for a home in a safe neighborhood in which the buyer can raise a family. The realtor shows the buyer a wonderful three-bedroom home. The buyer specifically asks if crimes have recently been
committed in the area. The realtor states there have been no crimes committed in the area. The realtor knows five cars in the area were stolen within the last three months. The realtor purposefully withholds information that will affect the buyer’s decisions about a specific property. The realtor is now committing fraud.

DURESS

_Duress_ is compulsion by threat; that is, _specifically:_ unlawful constraint.

When a contract is not freely accepted it is made under duress. The contract is not legally binding and may be revoked. However, it is not enough for the offeree simply to say a contract was made under duress in order to invalidate a contract, duress needs to be legally proven.

Example of Duress

A tenant blackmails a landlord into reducing the rent. A new contract, or lease, is made under duress. This new contract is not legally enforceable if the landlord can legally prove the contract was made under duress for reason of blackmail.

MISTAKES

Mistakes regarding the terms or conditions of a contract occur when there is an unintentional ambiguity or an oversight affecting the entire agreement. A contract containing mistakes is not a contract. Ambiguity or an oversight can turn the contract into a completely different contract.

Example of Mistakes

A seller advertises a beachfront property for sale. A buyer contacts the seller to view the property. The seller explains he or she is not available to show the property, but to look over the exterior of the property if he or she chooses to do so. After viewing the property, the buyer makes an offer on the property. Upon further discussions with the buyer, the seller realizes the buyer misinterpreted the directions and viewed the wrong property. The buyer made a mistake, and his offer cannot rightly be viewed as a contract with the seller.

LEGALLY COMPETENT PARTIES

The notion of “legal competency” implies two things:

- Individuals involved are of 18 years of age or older or have parental consent
- Individuals without impaired mental capacity
Majority laws protect minors from entering into agreements they do not have the experience or knowledge to fully understand. A contract in which one or more of the contracting parties is a minor is considered void or voidable. If the contract is considered void, it ceases to have legal existence. If the contract is considered voidable, the minor can withdraw from the contract at any time and the majority party is still bound to the contract until such time.

Mental competency laws protect individuals of unsound mind from agreeing to terms they do not fully understand. Individuals who have been declared mentally incompetent by a judge or who are under the influence of drugs or chemicals and incapable of comprehending contracts (but who have not officially been declared incompetent by a judge) cannot legally enter into a contract.

If an individual wishes to enter into a contract with someone of unsound mind, he or she must involve a third party who is “legally competent” and has power of attorney to represent the mentally incompetent individual in legal matters.

**POWER OF ATTORNEY**

There are two terms you need to know for this section:

- **Principal**: this is the individual giving another person the power of attorney to act on his or her behalf

- **Attorney-in-fact**: this is the person to whom the power of attorney is granted

There are four basic types of power of attorney:

- **Limited** power of attorney:
  - Grants limited rights to the attorney-in-fact
  - Is revoked if the principal becomes mentally disabled
  - For example, the principal gives an attorney-in-fact (for example, a friend) check-writing powers while on an extended vacation

- **Ordinary** power of attorney:
  - Grants broad powers to the attorney-in-fact over personal finances
  - Is revoked if the principal becomes mentally disabled

- **Durable** power of attorney:
  - Grants the broadest powers of all to the attorney-in-fact
  - Remains effective if the principal becomes incapacitated

- **Springing** power of attorney:
  - Becomes effective when the principal becomes mentally disabled or otherwise incapacitated
  - Allows the principal to provide his or her own definition of "incapacitated"
  - Here are two examples:
The principal wants to limit the term "incapacitated" to a judgment, rendered by the court, stating the principal is senile. The principal defines "incapacitated" as lapsing into a coma for more than a specified number of days.

The power of attorney gives the attorney-in-fact power over the principal's affairs for various purposes, such as:

- To buy or sell real estate on the principal's behalf
- To manage the principal's properties
- To conduct the principal's banking transactions
- To invest the principal's money
- To make legal claims and conduct litigation
- To give gifts on the principal's behalf

**CONSIDERATION**

All contracts must have consideration exchange, which means:

- No one may obtain anything of value without providing some form of compensation (in a contract, you cannot get something for nothing)
- Examples of compensation include:
  - Money
  - Property
  - Giving up a right or valid claim
  - Making a promise to do or not do something
  - Services
- If there is no consideration, then the contract is not legally binding
- All contracts are created out of self-interest and all parties acknowledge the self-interested character of the contract, and agree that something valuable is changing hands because of the contract

**LAWFUL OBJECTIVE**

Thus far, we have discussed legally competent parties and mutual assent as features of a legally valid contract. The third feature of a legally valid contract is that it must have a lawful objective. This requirement means that a contract cannot explicitly or implicitly call for any illegal activities. When a contract has a lawful objective, it considers all the relevant laws and statutes to ensure that the contract is not suggesting or requiring actions that are against the law. Lawful objective in a contract includes:

- Considering all relevant laws and statutes
• Confirming there are no illegal action(s) being required of any parties involved
• Becoming void if it implicitly or explicitly requires illegal conduct
• Being held accountable for attempting to fulfill a contract devoid of lawful objective(s)

ADHERENCE TO A STATUTE OF FRAUDS

The *statute of frauds* is a state law establishing the features of a valid contract. It generally requires certain types of contracts to be set out in writing and written contracts to be signed by all the parties bound by the agreement. The statute of frauds can vary slightly from one state to another. A statute of frauds is designed to prevent dishonorable conduct. The statute of frauds generally does not void a valid contract that fails to adhere to a statute of frauds, but makes it *voidable*. This contract remains valid until one party opts to void it.

**NOTE:**
The term “statute of frauds,” is derived from “An Act for Prevention of Frauds and Perjuries.” This was an act ratified by the English Parliament in 1677, over 300 years ago.

A majority of states’ statutes of frauds require contracts to be in writing if:

• The contract involves the sale or transfer of real estate
• It concerns debts or specific duties
• The terms extend for a period of more than one year
• The terms extend beyond the lifetime of the promissor
• It involves the sale of goods valued at $500 or more under the Uniform Commercial Code

**NOTE:**
The Uniform Commercial Code (UCC) is a body of statutory laws aiming to regulate important categories within contracts and to standardize business transactions. Every state, except Louisiana, has a Uniform Commercial Code. You can view the Uniform Commercial Code (UCC) online at: [http://www.law.cornell.edu/ucc/ucc.table.html](http://www.law.cornell.edu/ucc/ucc.table.html).

REAL ESTATE APPLICATIONS OF THE STATUTE

Most real estate contracts are in writing. The statute of frauds applies to most of real estate contracts including, but not limited to:

• Trust deeds
• Mortgages
• Leases for periods of longer than one year
• Rights to rights of way through property and any and all encumbrances incurred or suffered by the owners or by operation of law

NOTE:
The statute of frauds does not apply to lease agreements of one year or less.

PAROL EVIDENCE RULE

Parol literally means “word of mouth.” Parol evidence, then, are the terms and conditions the parties discuss before the final contract is written. This discussion provides evidence of what the parties expect from the contract. However, the parol evidence rule holds that when important details of an agreement discussed between two or more parties fail to make it into the written contract, the written, signed contract is given authority over any parol evidence.

This rule can be invoked when a court is deciding whether to admit parol evidence during a contract dispute. Once a court reviews the contract in question, the details of the case are used to decide whether the parol evidence rule should apply.

SUMMARY

This lesson provided a detailed discussion of the conditions a contract must satisfy if it is to be legally valid. A legally valid contract must be comprised of the following components:

• Mutual assent
  o Requires an offer and an acceptance
  o Requires the absence of fraud, misrepresentation or duress
  o Requires the absence of mistakes
• Legally competent parties
  o Individuals involved are of 18 years of age, or older, or have parental consent
  o Individuals without impaired mental capacity
    ▪ Individuals can enter into a contract, with a power-of-attorney, with a person of unsound mind.
• Consideration
  o No one may obtain anything of value without providing some form of compensation.
• Lawful objective
  o The contract cannot expressly or implicitly require illegal activity.
• Adherence to a statute of frauds
  o A contract must adhere to the statute of frauds of the state in which it is created.
  o Statute of frauds does not apply to oral contracts as imposed by the parol evidence rule.
NOTE:
Adherence to a state's statute of frauds is often the weakest of these requirements. A contract containing the other four features can sometimes be a legally valid contract.

Individuals having questions on the legal validity of a contract should always ask for legal advice from a lawyer.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
CONTRACT FULFILLMENT

This lesson focuses on the following topics:

- Performance of a Contract
- Non-Performance of a Contract

INTRODUCTION

In the first lesson, 10 types of contracts were discussed, including: implied contracts, express contracts, bilateral contracts, unilateral contracts, executed contracts, executory contracts, valid contracts, void contracts, voidable contracts and unenforceable contracts. This lesson will discuss what must happen to fulfill the terms of a contract after it has been made and accepted. The result will be either the performance or non-performance of a contract. We will discuss the performance of a contract first.

When there is a contract, there must be an offer, acceptance and performance. The previous lesson discussed offers and acceptances. This lesson will cover the two types of agreements that affect performance: forbearance agreements and performance agreements. We will also cover performance of a contract by novation and assignment.

PERFORMANCE OF A CONTRACT

A contract aims to create a specific state of affairs desired by one of the contracting parties. The obligations a contract imposes on the contracting parties are the actions required to make this desired state of affairs a reality. Thus, once an offer has been made and accepted, the terms of the contract need to be carried out in order to complete (or “execute”) the contract. This means what is legally called “performance” needs to occur—that is, the contracting parties need to successfully complete their contractual obligations and duties.

EXAMPLE:
Once Seller A accepts Buyer B’s offer and they sign a real estate purchase contract, Seller A performs his or her contractual duties by transferring title to Buyer B, and Buyer B performs his or her contractual duties by making a down payment.

TIME IS OF THE ESSENCE

All contracts should contain language emphasizing that all promises are to be completed in a timely fashion. This may include the specific statement “Time is of the essence.” This phrase essentially means that the specified times and
dates in the contract are mandatory and failure to meet those deadlines may result in a party being held liable for compensatory damages.

Typically, contracts also contain a section similar to the following paragraph:

The Seller and the Purchaser will make full settlement in accordance with the terms of this Contract ("Settlement") on, or with mutual consent, before, ________________ ("Settlement Date") except as otherwise provided in the Contract.

This section establishes a fixed date, which serves as a set point for making judgments about what counts as timely performance. Writing a date into the contract helps to make “timely” a more objective notion.

Emphasizing timely performance helps to ensure all parties perform according to the terms of the contract, within the allotted period of time. If one party fails to meet the deadline, he or she is subject to whatever penalties are established for breaching the contract. He or she may also face various kinds of legal liability, depending on the nature of the contract and the events that result from breaching it.

FORBEARANCE AGREEMENTS

Forbearance agreements require one or more of the contracting parties to refrain from actions they are otherwise legally entitled to perform.

For example, if a borrower cannot repay a loan within the agreed-upon time period, then he or she can ask the lender for a forbearance agreement. In this case, if the lender granted a forbearance agreement, the lender would effectively be promising not to take action against the borrower for non-payment during the period covered by their agreement. The lender has the legal right to pursue this debt, but the lender waives this right when he or she makes a forbearance agreement with the borrower.

PERFORMANCE AGREEMENTS

Performance agreements require that the contracting parties either perform certain actions or uphold certain contractual promises. Performance agreements exist in addition to the contract itself. They do not require the performance of contractual duties but do require that the parties carry out actions facilitating the successful completion of their contractual duties.

For example, imagine a tenant enters into a lease agreement. Say that within this lease agreement, the tenant is responsible for damages made to the apartment during her tenancy. The tenant also enters into a performance agreement, which prohibits pets living in the apartment. The purpose of this
performance agreement is to reduce the likelihood of damages to the apartment and facilitate the landlord’s goal of keeping tenants from doing any significant damage to the apartment.

ASSIGNMENT

Sometimes, one or more of the parties involved in a contract want to withdraw from it without actually terminating the contract. In cases like these, the contracting parties have the option of transferring their rights and duties to a third party. This transferal is known as “assignment.” When these duties and rights are transferred (or assigned) to another party, the party who originally assumed the contractual obligations usually remains secondarily liable for the terms of the contract, unless the original party is expressly released from those duties. This means, if the individual to whom the rights and obligations are transferred fails to fulfill those obligations, then the other parties to the contract can demand performance from the original party.

For example, a buyer agrees to purchase a home already under an existing loan, often referred to as an agreement to “take on payments”. The person who originally assumed the loan contract transfers the loan responsibilities to the new buyer. However, the person who initially took on the loan remains as a party to the agreement in case the new buyer defaults on the loan.

NOVATION

Novation is an alternative to assignment. It is the act of substituting one obligation for another or replacing one contracting party with a new contracting party. Legally, it is understood to be the exchange of one contract for another.

For example, a contractor has a loan with Bank B. If Bank C later obtains Bank B, the contractor’s loan is now with Bank C. In other words, the contract with Bank C replaces the contract with Bank B.

A new contract under these circumstances is generally understood to be subject to the same promises and obligations as the original contract.

PROMISSORY ESTOPPEL

Estoppel: Refers to a legal limit on enforcing a claim or right at odds with what was previously said or done.

Promissory estoppel: Connected to the basic concept of estoppel, aims to stop a party from altering or rescinding a promise.

Promissory estoppel is used to force all parties to continue to be held legally liable to their contractual obligations made without consideration exchange. This
legal doctrine is used to force all parties to honor a contract that does not satisfy an otherwise important condition of a legally valid contract.

In general, it is used to keep parties from defaulting on reasonable contracts if it results in a serious injustice to the other party. If courts judge the person making the promise could reasonably have expected the other contracting party to rely on the promise, and the party did rely on the promise, then courts often force the promise-maker to perform rather than let the other party suffer significant damages simply for taking the promise-maker at his or her word.

**NON-PERFORMANCE OF A CONTRACT**

If one or more of the contracting parties either partially or completely fails to fulfill the contractual obligations, this is referred to as breach of contract. When this occurs, the injured party can seek compensation for any damages created by the breach.

The injured party also retains the option of discharging the contract. When a contract is discharged, the terms and conditions of the contract are either cancelled or satisfied. Most contracts contain a section discussing when a discharge is allowed as well as the full consequences of a breach of contract.

**DISCHARGING A CONTRACT**

There are several situations in which one or more of the contracting parties can usually discharge a contract:

- **Partial performance**: Occurs when one or more of the contracting parties perform only a portion of the agreed-upon contractual duties. The party who suffers damages by the other party’s failure to perform can seek legal restitution or discharge the contract.

- **Substantial performance**: Created when a party performs the majority of the contract’s requirements but does not perform according to the contract’s stipulations. The injured party has usually performed enough of contract’s obligations to gain legal enforcement of the other party to complete the contract.

- **Non-performance due to legal issues**: Requires one or all parties involved to act illegally. Any party called upon to perform illegal acts is not required to meet the terms of the contract and can discharge the contract.

- **Mutual agreement**: Occurs when all parties mutually agree to cancel the contract.

- **Operation of law**: Occurs when a contract is not legally valid or becomes unenforceable due to a statute of frauds, a statute of limitations or other legal regulations. Enforcing such contracts is a violation of the law.
BREACH OF CONTRACT

A breach of contract occurs when the terms or conditions of a contract are violated. When one of the contracting parties violates the contract’s terms, he or she assumes the consequences of defaulting, which are generally set out in the contract itself. In these cases, the party who has honored his or her contractual obligations has the right to seek compensation for any damages suffered as a result of the other party’s breach.

Consequences of a Breached Contract

When there is a breach of contract, the non-breaching party or the party who fulfills (or wants to fulfill) his or her part of the contract has four options:

- **To forfeit**
  - There is no longer any contractual relationship.
  - This means the seller is entitled to keep the earnest money and all other payments collected from the prospective buyer.

- **To rescind**
  - This means the non-breaching party can cancel the contract entirely.
  - It also means the seller must return all payments received from the buyer.

- **To sue for specific performance**
  - “Specific performance” is a court order requiring all parties to carry out the promises stipulated in the contract.
  - This is a court enforcement of the original contract.

- **To sue for compensatory damages**
  - This means the party who fulfilled the promises of the contract can take the party who failed to fulfill the promises of the contract to court in order to recover any damages suffered due to breach of contract.
  - This does not force the parties to abide by the original contract, but it does require the party who breached the contract to compensate the party who did not.

CONTINGENCIES

Contingencies are stipulations or conditions that must be satisfied before the contract can be performed. Most real estate contracts should include at least two contingencies:

- **Financing contingency**: Makes the purchase contract conditional upon the buyer’s ability to obtain financing.
• **Inspection contingency**: Makes the purchase contract conditional upon the outcome of the home inspection report or appraisal report.

If contingencies are not met, the contract can be discharged.

For example, if a buyer agrees to pay $150,000 for a house, but the appraisal report concludes it is only worth $120,000, the buyer can back out of the agreement. In this case, the contract should be discharged, and the buyer should receive his or her deposit back.

However, if the prospective buyer backs out of the contract for reasons not stipulated or allowed for in the contract, then he or she has breached the contract and thereby forfeits his or her deposit.

For example, if the prospective buyer has signed the purchase contract, but decides at the last minute that he or she does not want the property, having found a better one; he or she will lose the deposit unless the original contract is honored.

**SUMMARY**

This lesson covered the two types of agreements affecting the performance of a contract: performance agreements and forbearance agreements. In a performance agreement, one party promises either to perform or refrain from performing a specific action, generally one related to the successful completion of his or her contractual obligations. The failure to honor a performance agreement often leaves the individual vulnerable to various kinds of liability.

In a forbearance agreement, one party agrees not to take actions he or she would be legally entitled to take if the other party violated the terms of the contract. For example, a forbearance agreement might create an understanding between a borrower and a lender when a borrower cannot repay a loan in the agreed-upon time period. If the lender grants a forbearance agreement, the borrower is given more time to pay the loan and is immune from legal action for nonpayment from the lender for the time period covered by the forbearance agreement.

Sometimes one or more of the contracting parties may wish to withdraw from a contract without actually canceling the contract. In such a case, those who wish to withdraw have two basic options: assignment and novation. The assignment method allows an individual to transfer his or her rights and obligations to a third party, who then takes on the role originally played by the person who made the transfer. The novation method allows an individual to create a new contract and replace the existing contract with the new, modified one. Both of these methods require the other contracting parties to agree to the change.
Non-performance of a contract occurs when one or more of the contracting parties leave contractual obligations partially or wholly unperformed. When this happens, discharging the contract is one of the options open to those who have completed their obligations. A contract can be discharged when there is partial performance, substantial performance or non-performance due to legal reasons on the part of either party. Additionally, either party may discharge a contract if it does not conform to relevant laws. Finally, a contract can be discharged simply by mutual agreement, if both parties agree to cancel.

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LESSON FOUR
REAL ESTATE CONTRACTS

This lesson focuses on the following topics:

- Legal Forms
- Sales Contracts
- Listing Agreements
- Option Agreements
- Contract-for-Deed Agreements
- Leases

INTRODUCTION

Real estate professionals need to be familiar with the different contracts governing their industry. Whether they are listing a property, selling a property or closing a sale, contracts are involved and licensees need to be able to understand and evaluate them. These skills help to ensure real estate professionals provide their clients with comprehensive service; having a good grasp of contracts and the roles they play helps licensees to foresee and correct oversights and mistakes affecting transactions, and thereby protect themselves against legal liability.

This lesson discusses the most common legal forms used within the real estate industry.

NOTE:
Licensees are only authorized to fill out standardized contract forms created by their real estate commission or created by an attorney. They are not authorized to create contract forms or to provide any other kind of legal advice to their clients. This is practicing law without a license and the unauthorized practice of law is not only imprudent (because it makes a licensee vulnerable to serious legal liability), it is illegal. If a licensee thinks a special contract form should be created, or believes his or her clients need legal guidance, he or she should refer clients to a licensed attorney.
LEGAL FORMS

To help licensees develop a useful understanding of real estate contracts, this lesson will discuss sales contracts, listing agreements, option agreements, contracts-for-deed and leases.

- **Sales Contracts**, including:
  - Legal property description
  - Earnest money contract
  - Escrow account
  - Purchase-and-sale agreement addendum
  - Lead-based paint addendum
  - Terminating a sales contract

- **Listing Agreements**, including:
  - Exclusive right-to-sell listing
  - Exclusive agency listing
  - Open listing
  - Net listing
  - How to terminate a listing agreement

- **Option Agreements**

- **Contract-for-deed agreements**

- **Leases**, including:
  - Leasehold estates
  - Estate for years
  - Periodic estate
  - Estate at will
  - Tenancy at sufferance

When creating a contract with other parties, it is important to:

- Make sure you fully understand and accept all written terms and conditions for which you are to be held legally responsible.
- Make sure you fully understand the penalties for failing to abide by all terms written in the contract.
- Discuss any questions or doubts you have about the agreement before it is put into writing and especially before you sign it.

Written and signed contracts in the process of being carried out are to be used as references if any confusion arises during execution. If a contract is going to cover all the bases and avoid any confusion or misunderstandings, then it needs:

- To be well organized
- To be well thought out
- To use clear and concise language
- To avoid any legal jargon and complicated phrasing
• And last but not least, have all five requirements of a legally valid contract.

**CONTRACT COMPONENTS**

Most contracts generally have two sections:

• The duties and obligations section:
  o Listing the expectations, terms and deadlines of the agreement
  o Establishing the requirements for contract fulfillment

• The representations and warranties section:
  o Containing statements ensuring that any goods and services described in the contract will be provided or performed according to the terms of the contract
  o Establishing a guarantee

**SALES CONTRACTS**

Sales contracts, also called “purchase contracts”, are the most important documents in real estate transactions. They establish the details of an agreement between a buyer and a seller along with their rights and obligations. They are the prospective buyer’s written offer to a property owner to purchase a specific piece of real estate.

Sales contracts include:

• The price the buyer agrees to pay
• The amount of earnest money the buyer will pay
• Mortgage details and any financing conditions the prospective buyer wishes to stipulate
• The deposit the buyer agrees to put down
• When and where the closing of the transaction is to take place
• Inclusions and exclusions (that is, an itemization of personal property like appliances which may or may not be included in the selling price)
• An appraisal section and a termite and pest inspection section
• Warranties
• Acceptance procedures and deadlines
• Property disclosures

Sales contracts establish a relationship between the buyer and the seller. This relationship requires a little give and take of all the parties, usually involving the seller transferring the property title to the buyer and the buyer paying the negotiated price to the seller.

Sales contracts protect both the buyer and seller by creating a legal framework that strongly encourages both parties to uphold their ends of the bargain. Valid
sales contracts must have all five requirements of a legally valid contract plus an additional sixth condition:

- Sales contracts must contain a legal description of the property being conveyed.

**LEGAL PROPERTY DESCRIPTION**

A legal property description makes it clear to all parties exactly what property is being bought or sold. Courts may use it to clarify any disputes about the property.

**NOTE:**
A property’s street address provides identification, but not enough. It is insufficient because “123 Main Street” might be the address of any given property in any given town that happens to have a street called “Main Street.” If we spell out the address further, as “123 Main Street, Anytown, Anystate,” this does not tell us the size of the property or its specific boundaries. Not all properties have a street address. Thus, they require a legal description, and one needs a way of describing property that can apply to all real estate.

A legal property description must include:

- **Metes and bounds:** A legal land description method identifying a lot’s exact dimensions and location in reference to a fixed and permanent monument.
  - **Metes:** refers to the distance measurements used in the description
  - **Bounds:** refers to the directions of the boundaries that enclose a parcel of real estate.
- **The rectangular survey system:** Also known as a government survey or U.S. public lands survey, it uses a more refined version of the longitude and latitude system of mapping. This method uses a surveyed grid of meridians, baselines, townships and ranges to describe a particular piece of land.
- **Recorded plats:** Also known as the “lot-block-tract system,” the “recorded survey” or the “recorded map” method, it uses the metes and bounds method of land description to locate the borders of each parcel, and once a surveyor establishes the property’s perimeter, he or she records the dimensions on a plat (map) for easy reference. This map is then filed with the proper local authority, such as the county clerk or the county records office.
Given this general overview, the important thing for the reader to remember is a sales contract must contain a legal property description uniquely identifying the property involved in the transaction.

**EARNEST MONEY CONTRACT**

Earnest money contracts show a serious and able intent by the buyer to purchase a property while the actual sales contract is being put together. This is done in order to reserve a property the buyer is interested in purchasing. Once a purchase contract is signed, the buyer then begins to fulfill the earnest money contract as a step towards completing the sales contract.

What is earnest money?

Write your answer in the space provided and check your answer on the next page.
ANSWER:
Earnest money is the amount a potential buyer pays as a deposit along with an offer in order to show serious intent in purchasing a property.

Deciding what constitutes a reasonable amount of earnest money is determined by mutual agreement between the buyer and the seller. A seller may stipulate that a deposit, or earnest money, is nonrefundable in an effort to ensure a buyer is serious when he or she puts down a deposit. The amount of earnest money may depend on the buyer’s level of interest in the property. Earnest money also provides the seller with some compensation if the deal ultimately falls through.

As you know, earnest money is not one of the five requirements of a legally valid contract. It also does not serve as consideration in a sales contract.

Earnest money cannot be deposited until the offer is accepted and the seller notifies the buyer of the acceptance. There is usually a license law limiting the amount of time in which a licensee may make a deposit. Two to three working days is generally the maximum time span. Licensees handling earnest money should be familiar with this section of their license laws.

Most states require that earnest money contracts:

- Be in writing.
- Be signed by the parties bound by the contract.
- Contain evidence of intent to convey ownership interest.
- Identify the seller and the buyer.
- Identify the property being transferred in the transaction.

Usually, a title insurance company holds the earnest money, or “holds the check”, until the offer is accepted. When a broker is involved, license laws generally require these funds be deposited into an escrow account.

**Escrow Account**

Placing money into an escrow account is placing earnest money into the custody of a third party until a contract is executed. Escrow accounts ensure the funds are available to be dealt with honorably, either to meet the terms of an agreement or to compensate the parties involved for their time and effort if default occurs.
PURCHASE AND SALES AGREEMENT ADDENDUM

Addendums are additions to completed contracts. They are attached as requirements and/or supplementary information to a contract and also must be accepted by all parties involved.

Addendums contain items, such as:

- Additional agreements
- Disclosures
- Contingencies

For example, an addendum might state if certain components of a home inspection, property appraisal or loan application do not work out the way one party expects, then either party has the right to withdraw from the contract without penalty.

Other common addenda include:

- Third party financing condition addenda
- Loan assumption addenda
- Lead-based paint addenda
- Seller financing addenda

Some states' license laws require the use of standardized contracts and addenda. Each state’s real estate commission has their own addenda forms and standardized contracts, which are prepared by an attorney.

Lead-Based Paint Addendum

The lead-based paint addendum is the most common addendum, used with properties built before 1978. It establishes the seller’s knowledge of the use of lead-based paint on the property and ensures the seller has provided the buyer with any and all documents pertaining to the use of lead-based paint. It often includes contingencies allowing the buyer to withdraw from the contract if an inspection shows there are any undisclosed lead-based paint hazards on the property.

TERMINATING A SALES CONTRACT

Sometimes individuals enter into a contract then later decide to withdraw from it. A sales contract is terminated under the same conditions as any contract. There are also specific cases where a contract may simply be cancelled.
EXAMPLE:
If the buyer is uncertain as to whether he or she is going to obtain adequate financing, then the buyer must explain this to the seller when making an offer on a property. A financing addendum should be included in the sales contract, which allows the buyer to withdraw from the contract if he or she is unable to get a loan.

A sales contract can be discharged when:

- There is a breach of contract; recall the four choices discussed earlier
- There is non-performance due to illegal terms or other specific terms
- The parties involved mutually agree to its termination
- It is rendered unenforceable due to operations of the law, such as:
  - When the statute of limitations has expired

QUICK REVIEW

- Sales Contracts include:
  - All five requirements of a legally valid contract plus an additional sixth condition:
    - Sales contracts must contain a legal description of the property being conveyed.
- A legal property description must include:
  - Metes and bounds
  - The rectangular survey system
  - Recorded plats
- Again, what is earnest money?
  - Earnest money is what a potential buyer pays to show serious intent in purchasing a property.
LISTING AGREEMENTS

A listing agreement is basically an employment contract made between a seller or owner and a licensee. It is not a sales contract or lease agreement, even if the marketed property is sold or rented. It includes marketing the property and obtaining and submitting offers to lease or buy the property.

Again, most states require a listing agreement be in writing if it is to be enforceable in court, and provide standardized forms for listing agreements which comply with state regulations and multiple listing service standards.

NOTE:
In addition, the National Association of REALTORS® (the largest real estate trade organization) develops its own forms for REALTORS® to use. Even though many brokerages and services develop their own listing agreement forms, these forms share many of the same features, which are discussed later in this section.

Listing agreements create a relationship, called an “agency relationship”, authorizing a licensee to represent the principal (the seller or owner) and the principal’s property to third parties (buyers or tenants).

It places a licensee in a position of trust or fiduciary duty, or an “allegiance”. In this case, the licensee owes the principal the duties of loyalty, confidentiality, obedience, full disclosure, care, diligence and accountability for all funds entrusted to him or her.

The licensee generally agrees to provide all of the real estate services the seller requires until the property is actually sold or rented. A licensee might allow other

- Escrow Accounts are usually brought into play to ensure that funds are available to be dealt with honorably
- Purchase and Sales Agreement Addendum contain items, such as:
  - Additional agreements
  - Disclosures (or disclaimers)
  - Contingencies
- The Lead-based Paint Addendum is the most common addendum, used with properties built before 1978.
- A sales contract is terminated under the same conditions as any contract.
people (such as salespeople) to help carry out his or her contractual duties provided they do so under his or her supervision.

The licensee is usually given the legal status of “special agent” for the principal. This means the licensee is under contract for one specific act or business transaction (i.e., finding a buyer or tenant). Each state's license law discusses the specific requirements and duties of special agents. These laws can also define which parties (e.g., salespeople) may act on an agent’s behalf and under what circumstances. Real estate professionals should always consult their states’ laws for the specific details affecting their work.

Four common types of listing agreements are:

- Exclusive right-to-sell agreements
- Exclusive agency listing agreements
- Open listing agreements
- Net listing agreements

**EXCLUSIVE RIGHT-TO-SELL LISTING AGREEMENT**

In an exclusive right-to-sell listing agreement, a licensee is exclusively granted the right to offer the property for sale. It even requires the seller to pay the licensee a commission on the selling price of the property regardless of who sells the property. Many brokerage firms limit their listing agreements to this type of contract.

**EXCLUSIVE AGENCY LISTING AGREEMENT**

In an exclusive agency listing agreement, one licensee is exclusively authorized to be the principal’s agent. Unlike the exclusive-right-to-sell listing, the seller retains the right to sell the property. This means if the principal finds a buyer, then the principal does not pay the listing agent a commission. For the licensee to be entitled to a commission, the licensee must sell the property. In other words, the licensee’s efforts resulted in the sale, or the licensee produced the ultimate buyer of the property.

**OPEN LISTING AGREEMENT**

Open listing agreements allow property owners to employ one or more licensees to market their property. The property owner still retains the right to sell the property without paying a commission to any licensee marketing the property. The licensee who procures the sale is entitled to receive the commission. Builders and developers work with licensees in the marketing of new homes and lots through open listing agreements.
NET LISTING AGREEMENT

Net listing agreements allow licensees to keep the amount of the selling price which is more than what the seller is asking for the property, minus the closing costs. This agreement is rarely used because it creates a conflict of interests between the licensee’s interests and the property owner’s interests.

For example, if the property owner is not aware that the property is worth quite a bit more than the asking price, a licensee who is aware of the actual property value stands to benefit a great deal from a net listing agreement. That is, if the licensee withheld this information from the property owner.

Licensees are required by their fiduciary duty to provide a property owner with all and accurate information required to protect the property owner’s interests. Because open listing agreements present such an opportunity for dishonesty, they are illegal in some states. Licensees should always consult their state laws before entering into open listing agreements.

MULTIPLE LISTING SERVICE

Aside from the listing agreements discussed above, some states have a multiple listing service option in which brokers agree to share their listings with other brokers by pooling the information in a database in exchange for a share of the commission earned by a transaction. The most common form of such an arrangement is when brokers are members of a board of realtors or real estate agents with all members agreeing to be bound by rules governing that organization.

As part of agreeing to be a member, such entities usually have their own listing agreement form with a stipulation clause giving the listing broker both the authority and an obligation to share the listing with other brokers by submitting the property information into the MLS database, unless the seller specifically requests that the property not be listed in the MLS. (There is usually an option for this in the agreement.) And, as part of being advertised in the MLS system, the seller’s broker advertises a fee or commission that will be paid to the “cooperating” broker in a sales transaction.

The cooperating broker is the other broker or salesperson that shows the listed property to a buyer who subsequently purchases the property, entitling the cooperating broker to the fee or commission as the “procuring cause.” The amount offered to a cooperating broker is at the sole discretion of the listing broker. If the cooperating broker or salesperson represents the buyer, the listing agent must receive authorization from the seller in order to share part of the commission, although this is usually covered in the original listing agreement.
A multiple listing service offers advantages to the owner/seller, brokers and buyers. The owner/seller receives greater exposure of their property through the MLS system and the property is, in turn, shown by a larger number of brokers and salespeople to a larger audience of buyers. As a result, the increased exposure of the property gives the broker more opportunity to sell the property and earn the commission. The buyer also benefits by having the opportunity to select more properties from which to purchase.

MLS systems have set rules established by the member brokers as to how soon a broker must enter the property listing into the system, thereby keeping the broker from attempting to “hide” the listing so other member brokers won’t have a chance to help show it. Other rules are also set by each system to allow for fairness amongst members.

TERMINATING A LISTING AGREEMENT

Listing agreements may be terminated:

- If the property is not sold within the specified time period stated in the original contract (i.e., expired contract).
- By unilateral revocation by the owner or licensee for just cause.
- For example:
  - A seller refuses to cooperate with a licensee in order to show the property
  - The seller wants to terminate the agreement due to lack of activity

If there is any type of falling out between the seller and the listing licensee, it is usually prudent to terminate the listing agreement rather than exacerbate hard feelings and/or risk ending up in litigation.

More specific reasons for terminating a listing agreement include:

- The fulfillment of the listing agreement (i.e., the property sells).
- The property owner declares bankruptcy.
  - A bankruptcy court has the right to block the sale of a property and assign a trustee over the bankrupt property to assist in obtaining court approval to proceed with selling a property. This automatically stays any further action by law.
- The property being destroyed or damaged beyond repair.
- The death or incapacity of the property owner.
- The death or incapacity of the licensee.
- A mutual agreement between the licensee and the property owner—usually required to be documented in writing.
- A change in the permissible use of the property, such as a zoning change
- For example:
A property previously zoned for commercial use is located in an area no longer permitting commercial operations.
A licensee originally retained to sell a property as commercial can no longer legally execute such a contract.

**OPTION AGREEMENTS**

An option agreement is also referred to as:

- A “lease purchase”
- A “lease option”
- A “lease-option-to-buy”

This kind of agreement combines the components of a basic lease contract with an option-to-purchase contract.

In an option agreement, the optionee (a buyer or tenant) pays the optioner (a seller or landlord) an option fee (a nonrefundable deposit), which is ultimately applied to the purchase price of the property. The option fee in effect “buys” the optionee the choice to buy or not to buy the property at the end of the lease agreement.

Once the option fee is paid, the corresponding monthly payments are usually applied towards the purchase price of the property or considered as a down payment on the property. The optionee retains the option of purchasing the property (according to the terms of the option agreement contract) during the term of the lease. Once the lease expires, the option expires.

A legally enforceable option agreement must define the following elements:

- **The option fee**: This is the deposit the optionee must make in order to have the option to purchase the property during the lease term. The option fee is nonrefundable and is applied to the purchase price of the property only if the optionee decides to purchase the property.
- **The option term**: This is the amount of time the optionee has to exercise his or her right to purchase the property; the contract should specify the final date by which the optionee must either exercise the option or lose it.
- **The methods for exercising the option**: This part of the contract should describe the steps the optionee must take in order to exercise the option to purchase. Most option agreements require the optionee to send the optioner a written intent to purchase the property.
- **The payment agreement**: Often, rent payments (monthly payments) are credited towards the purchase of the property. The option agreement should clearly address the guidelines for these types of situations.
CONTRACT-FOR-DEED AGREEMENTS

A contract-for-deed agreement is also known as:

- A “land contract”
- An “installment contract”
- A “contract of sale”

A contract-for-deed agreement is a conditional agreement regarding the sale of real estate that requires the buyer to uphold certain promises after taking possession of the property.

For example, a contract-for-deed agreement might allow a buyer to defer a portion of the purchase price, still taking possession of the property but paying out the remaining balance over time, in installments. Effectively, this makes the buyer a long-term renter who actually receives legal title after paying a certain amount of money to the seller.

What sets apart a contract-for-deed agreement from a regular sales agreement is the seller retains the legal title of the property while the buyer takes possession of the property and holds the “equitable title” to the property. Even though there is an exchange of payment, there is not a transfer of the property title until all conditions of the contract are satisfied.

In a contract-for-deed agreement the seller must provide the buyer with:

- Copies of a current survey
- A tax certificate
- An insurance policy
- Property condition disclosures
- Information regarding utilities, liens and financing terms

LEASES

A lease is an agreement between a tenant (lessee) and a landlord (lessor) allowing the tenant to occupy the landlord’s property and make payments at a set rate for a specified period of time. A comprehensive lease agreement defines the tenant’s rights and obligations as well as the landlord’s rights and obligations, the time period covered by the contract and the amount of money the tenant must pay the landlord for use of the property.

**Reversionary right:** This means possession of the property reverts back to the landlord after the lease term has expired. The landlord’s interest in the property is specifically known as a “leased fee estate plus reversionary right.”
Land ownership is described by two basic terms:

- **Freehold estate**: the property owner has actual ownership and possession of the land (or real estate), which lasts for an unspecified period of time.

- **Leasehold estate**: the tenant has possession of the property (but does not own it), and his or her estate in the property lasts for a limited period of time.

**LEASEHOLD ESTATES**

A leasehold estate is a type of property interest allowing tenants to occupy and use a property they do not own. Leasehold estates are established when a tenant has possession of a property and has the legal right to use the property but does not have actual ownership interest (i.e., he or she does not hold legal title and cannot legally sell the property). Instead, he or she has a special kind of “possessory estate” in the property for the duration of his or her lease, as long as he or she honors the terms and conditions of the lease contract.

There are four general types of leasehold estates:

- Estate for years
- Periodic estate
- Estate at will
- Tenancy at sufferance

We will now discuss the details of these various leasehold estates.

**Estate for Years**

Estate for years, or “tenancy for years”, is a leasehold estate with a specific starting date and a specific ending date. The exact span of time is decided by the landlord, agreed to by the tenant and may range from days to years. The tenant in this agreement occupies and uses the property as long as the terms of the lease agreement are honored. Importantly, the agreement can be discharged under the conditions previously discussed.

Once an estate for years expires, no special action is required by either the landlord or the tenant to terminate. Instead, it is implicitly understood that the contract is terminated. If the tenant wishes to continue to occupy and use the property, the lease must be renewed. Renewal requires the landlord and tenant come together and expressly agree, either to renew the existing lease or to create a new one.
Periodic Estate

A periodic estate, or a “periodic tenancy”, defines tenancy as automatically continuing for consecutive periods of time. They are most commonly referred to as month-to-month leases. This kind of lease is generally understood to automatically renew at the end of each lease period, until the landlord or tenant takes special action (such as submitting a written request) to terminate the agreement.

For example, in a month-to-month lease, both the tenant and the landlord generally have the option of terminating the lease agreement at the end of any given month. However, if neither party expressly terminates the lease, then it is usually understood the lease is renewed for another month.

Estate at Will

An estate at will, or a “tenancy at will”, is created by a lease agreement that permits either the tenant or the landlord to terminate the lease agreement at any given time. Usually, the terminating party is required to give written notice and ample warning to all parties involved. The distinguishing feature of an estate at will is its lack of a specific tenancy period. Apart from this, the landlord and the tenant involved with the estate have all or most of the rights and obligations they would have under any other type of leasehold estate agreement.

Tenancy at Sufferance

A tenancy at sufferance is not a lease agreement. It is created when a tenant continues to occupy a property beyond the period specified in a previously existing lease agreement without the consent of the landlord. This does not mean the tenant is remaining on the property after the landlord has expressly asked him or her to leave. It does mean, however, that the tenant is understood to be violating the law.

In a tenancy at sufferance, the landlord and the tenant have chosen to ignore the fact that their formal lease agreement has expired. Everything goes on as before, but there is no formal lease contract governing relationships or defining the tenant’s estate in the leased property. When this occurs, the tenant is referred to as a “holdover tenant”.

When a tenant remains in possession of a property beyond the expired lease agreement, the landlord has a right to evict the tenant. However, if the tenant continues to pay the landlord rent after the formal lease has expired, and the landlord accepts, then the tenancy at sufferance becomes a periodic estate.
SUMMARY

To provide skillful service, real estate professionals must understand the different real estate contracts that codify and regulate transactions in their field. This lesson discussed five types of contracts vital to the practice of real estate: sales contracts, listing agreements, option agreements, contract-for-deed agreements and leases.

The sales contract, which is also referred to as the “purchase contract,” is generally the most important document in a real estate transaction. It establishes the details of the agreement between the prospective buyer and the seller, and it identifies their legal rights and obligations with respect to the transaction being made between them. The sales contract also includes important information, such as the price the buyer has agreed to pay, the amount of earnest money he or she will give and any other conditions the prospective buyer wants to stipulate. The sales contract is essentially the prospective buyer’s written offer to purchase a specific piece of real estate.

A listing agreement is a contract made between a seller and a licensee. It is an employment contract under which the licensee markets, as opposed to sells, real property. This contract is not legally connected to a sales contract, even if the property being marketed is later sold. Listing agreements create a special kind of fiduciary relationship between a licensee and the person who owns or is selling a property (the principal), authorizing the licensee to act as an agent on behalf of the principal. Each state’s license law discusses the specific requirements and duties imposed on licensees who act as agents; these laws also generally define which parties (e.g., salespeople) may act on an agent’s behalf and in what circumstances. In addition, most states require a listing agreement be in writing if it is to be enforceable in court.

An option agreement combines the components of a basic lease contract with an option-to-purchase contract. It is a contract made between a tenant and landlord, giving the tenant the option of purchasing the property at the end of the lease period. Option agreements require the tenant to pay an option fee, which is a non-refundable deposit applied to the final purchase price if the tenant chooses to buy the property. The tenant must tell the landlord whether he or she wishes to purchase the property before the lease expires.

A contract-for-deed agreement is a conditional agreement between a seller and a buyer regarding the sale of real estate. In a contract-for-deed agreement, the sale of the property (i.e., the conveyance of legal title to the property) is generally contingent upon the buyer meeting certain requirements after he or she takes possession of the property. Though many contract-for-deed agreements establish an arrangement in which the buyer pays part of the purchase price to the seller after taking possession of the property, this kind of arrangement does not define contract-for-deed agreements. They are distinguished by the fact
they are conditional. Under a contract-for-deed agreement, the seller retains *legal title* to the property until the conditions of the agreement are met, even though the buyer often takes *possession* of the property (and holds what is called “equitable title” to the property) before those conditions are fulfilled.

A lease is an agreement between a tenant (lessee) and a landlord (lessor) allowing the tenant to occupy the landlord’s property, generally for a specified period of time and at a fixed rate. A comprehensive lease agreement usually defines the tenant’s rights and obligations as well as those of the landlord, the time period covered by the contract and the amount of money the tenant must pay for use of the property. The tenancy periods specified in lease agreements vary widely, creating different kinds of leasehold estates.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FIVE
REAL ESTATE PRACTICE LESSON

This lesson focuses on the following topics:

- Insight into Contracts, Purchase Agreements and Sales Agreements
- Activity
- Contracts, Purchase Agreements and Sales Agreements: Field Applications

INTRODUCTION

This module has covered a lot of specific information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided in this module by using a series of exercises and case studies. The first half of this lesson presents comprehensive questions and dilemmas, as well as an activity. When evaluating these dilemmas and questions, please write down your thoughts and ideas. The second half of this practice lesson presents brief case studies that illustrate the principles and ideas presented throughout the module.

INSIGHT INTO CONTRACTS, PURCHASE AGREEMENTS AND SALES AGREEMENTS

This section presents you with comprehensive questions and dilemmas that require you to apply the information you have learned in this course. Read each question carefully before formulating your response.

Q: Why should licensees follow the requirements imposed by most states' statutes of frauds and put all real estate contracts in writing?
A: Putting real estate contracts in writing helps to prevent misunderstandings and provides each party with a clear description of his or her role in completing the contract. If the parties have a detailed contract, they will often not need to go to court to settle disputes because they are assured the terms of their contract will be upheld in a court of law. Parties cannot dispute an accepted contract that defines its terms clearly.

It is also helpful to have a written contract because fixing the terms and conditions of the contract in this way means none of the contracting parties can change the terms of the agreement without the other party or parties’ consent.

Q: Suppose an individual wants to lease a property. She knows she will need the property for at least a year, but is not sure whether she will need it for longer than that, and would like to avoid the trouble of renewing her lease at the end of the first year. In this case, what type of leasehold estate does the tenant want?
A: This tenant wants a periodic estate. This kind of leasehold estate allows the tenant to have a fixed lease period—it is not like an estate at will, in which there is no specified lease term. The lease agreement creates a periodic estate allowing the lease to automatically renew at the end of the lease period, unless the landlord or the tenant takes special action to terminate it. Therefore, someone who would like to have her lease automatically renew after the term is up—and thus avoid the effort of renewing it herself—should ask for a lease agreement that creates a periodic estate.

Q: What is the difference between an express contract and an implied contract?
**A:** The primary difference between an express contract and an implied contract can be deduced from their names. An express contract is an agreement in which the terms are clearly stated (expressed). The parties to an express contract understand the terms and obligations of the agreement, and have openly accepted them. An implied contract, on the other hand, is an agreement in which the terms are not openly stated, but are instead inferred from the parties’ actions. Therefore, an express contract can be distinguished from an implied contract by determining whether the contract’s terms and conditions are actually stated outright or are merely implied.

**Q:** What is the difference between a *void* contract and a *voidable* contract?
A: A *void* contract is a contract that, for various reasons, has no legal validity. For example, an agreement that does not meet the minimum requirements of a contract would have no legal effect or impact. A contract is not legally valid cannot be enforced against any of the contracting parties. A *voidable* contract, on the other hand, contains the essential components of a valid, enforceable contract, but also contains provisions allowing the contract to be terminated or rescinded by either party.

Q: Why might a principal grant power of attorney to another party?
A: Individuals (known as “principals”) give another person the power of attorney when they grant that person the power to act on their behalf (either in general or in some limited realm of their affairs). People grant limited power of attorney for a variety of reasons—for example, some individuals might grant other people power of attorney over their financial affairs because they feel they do not have the expertise needed to make the necessary decisions. More sweeping power of attorney is often granted when a person loses (or anticipates losing) the mental or physical competence necessary to oversee his or her own affairs.

Q: What are the differences between a leasehold estate and a freehold estate?
A: There are two basic terms used to describe land ownership, “freehold estate” and “leasehold estate.” In a freehold estate, the property owner has actual ownership and possession of the land (or real estate), and his or her ownership lasts for an unspecified period of time. In a leasehold estate, the tenant has possession of the property (but does not own it), and his or her stake in the property lasts for a limited period of time.

Q: What is the purpose of the statute of frauds?
A: In most states, the basic function of the statute of frauds is to establish the features of a valid contract. For example, a state’s statute of frauds will generally require certain types of contracts to be set out in writing, and written contracts to be signed by all parties bound by the contract. Licensees should acquaint themselves with the specific requirements set out in their states’ statutes because there are frequently subtle differences between one state’s statute of frauds and that of another state.

ACTIVITY

In this exercise, you will use terms referring to various types of contracts to fill in blanks and complete the sentences.

<table>
<thead>
<tr>
<th>WORD BANK</th>
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<tbody>
<tr>
<td>Implied contract</td>
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<tr>
<td>Express contract</td>
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<td>Bilateral contract</td>
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<td>Unilateral contract</td>
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<tr>
<td>Void contract</td>
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<tr>
<td>Voidable contracts</td>
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</tbody>
</table>

1 A(n) _____ is an agreement that may be terminated or rescinded by either party.

2 A(n) _____ is an agreement that has no legal effect or impact because it does not meet the minimum requirements of a contract.

3 A contract in which two parties are involved, but only one party is bound to act, is called a(n) _____.

4 An oral or written contract in which both parties explicitly state their conditions and promises is called a(n) _____.

5 When the terms and conditions of a contract are inferred from the parties’ conduct, a contract is called a(n) _____.

6 An agreement in which both parties are bound by mutual or reciprocal obligations is called a(n) _____.

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1. A(n) _____ is an agreement that may be terminated or rescinded by either party.  
   (Voidable contract)

2. A(n) _____ is an agreement that has no legal effect or impact because it does not meet the minimum requirements of a contract.  
   (Void contract)

3. A contract in which two parties are involved, but only one party is bound to act, is called a(n) ____.  
   (Unilateral contract)

4. An oral or written contract in which both parties explicitly state their conditions and promises is called a(n) ____.  
   (Express contract)

5. When the terms and conditions of a contract are inferred from the parties’ conduct, a contract is called a(n) ____.  
   (Implied contract)

6. An agreement in which both parties are bound by mutual or reciprocal obligations is called a(n) ____.  
   (Bilateral contract)

**CONTRACTS, PURCHASE AGREEMENTS AND SALES AGREEMENTS: FIELD APPLICATIONS**

Please consider the following case studies. After reading the situations, decide how one could best resolve the dilemma or complication. Please make sure your response caters not only to the individual in the given situation but to the community as well. Read each case study carefully before formulating your response.
CASE STUDY ONE

Patient A visits Doctor B for an annual examination. During the exam, Doctor B checks Patient A’s heart rate, cholesterol level and physical condition. At the end of the exam, Doctor B tells Patient A he is in great condition. As Patient A leaves the examination room, the receptionist hands him a bill for $200. Patient A looks over the bill in disbelief. In fact, Patient A claims no one ever explained to him that he would be personally charged for a “bill of clean health”. The receptionist explains to Patient A that all clients must pay for the doctor’s services, whether or not they require additional treatment. Who is correct in this situation?
CASE STUDY ONE RESPONSE:
Patient A is incorrect in this case, because there does not have to be a verbal exchange in order to create a binding contract.

Many of our daily interactions create or rely upon implied contracts. No words or written documents must be exchanged for an implied contract to exist. The terms and conditions of this kind of contract are inferred from the parties’ conduct.

All legally binding contracts involve the exchange of consideration, i.e., the exchange of something valuable, such as money or a promise, which is given to show acceptance or acknowledgement of a contract. In this case, Doctor B provided Patient A with his services, which have a known market value. Although Patient A did not gain from this interaction materially (e.g., the doctor did not pay him or give him anything tangible), he still gained the satisfaction of knowing that he is in good health.

CASE STUDY TWO

Seven years have gone by since Client C failed to pay proper commission to Broker B. Finally, Broker B decides to file a lawsuit against Client C to collect the unpaid balance. However, when Broker B attempts to file this claim, he is told the statute of limitations for collecting debts in the state is six years. The clerk explains to Broker B that he now has an unenforceable contract and cannot force Client C to make payment. Broker B replies that the contract contains all the components of a legally enforceable contract, and Client C should therefore be forced to pay the debt. Is Broker B correct?
CASE STUDY TWO RESPONSE:
Broker B is mistaken. His contract may well be legally valid, which is to say it meets the following conditions:

- The contract was made between legally competent parties.
- The contract was mutually agreeable to all contracting parties.
- The contract has a lawful objective.
- The contract involves some sort of consideration (i.e., something of value given to show acceptance or acknowledgement of a contract, such as funds or a promise).
- The contract must comply with the requirements imposed by the statute of frauds.

However, the validity of Broker B’s contract is not at issue here. Even if the contract was valid when it was made, the problem at present is that the statute of limitations for enforcing the contract has expired. This means the contract is now unenforceable—i.e., Client C cannot be forced to pay Broker B’s commission—because enforcing the contract would violate the state’s statute of limitations. In this case, Broker B has no enforceable claim against Client C because the statute of limitations bars him from seeking compensation.

CASE STUDY THREE

Principal A has granted her son power of attorney because she wants him to be able to take over her affairs if some event renders her incapable of making her own decisions. After talking to her lawyers, Principal A decides to grant her son a springing power of attorney; she signs all the legal paperwork needed to create this agreement, as does her son. One week later, the son walks into Principal A’s bank asking that the bank transfer $20,000 to his account so he can place a down payment on a house for Principal A.

The bank clerk explains to the son that he does yet not have a functional power of attorney and he must wait for Principal A to become mentally or physically impaired before he can exercise his springing power of attorney. The son tells the bank that having the power of attorney allows him to make executive decisions for Principal A, regardless of whether or not she could make those same decisions herself. Who is correct?
CASE STUDY THREE RESPONSE:

The bank clerk is correct in this case.

A springing power of attorney allows the person who receives this power (the attorney-in-fact) to take over control of the principal’s affairs only when the principal becomes incapable of making decisions—that is, authorization springs into effect at that time. When establishing a springing power of attorney, the principal will usually specify an event (or a type of event), which when it occurs, will mark the beginning of the power of attorney and empower the attorney-in-fact to act on the principal’s behalf. For example, a principal might indicate he or she wants the attorney-in-fact to take over if he or she suffers a stroke or becomes paralyzed. Until this event occurs, however, the attorney-in-fact does not have any power to make decisions for the principal.

CASE STUDY FOUR

Homebuilder A calls Tile Supplier B, and asks for an estimate on the cost of tiles for a building project. Homebuilder A tells Tile Supplier B that he can only afford to pay $5,000 for tiles. Tile Supplier B tells Homebuilder A his company can provide the kind and number of tiles Homebuilder A needs for $5,000. Homebuilder A agrees to this price and Tile Supplier B says he will deliver the order in two weeks. Two weeks later, as Homebuilder A is nearing completion of his home, Tile Supplier B delivers the tile order to Homebuilder A. However, Tile Supplier B explains to Homebuilder A he will have to charge an extra $5,000, due to unexpected import tax increases. Tile Supplier B says Homebuilder A is responsible for any additional costs. Homebuilder A refuses to pay the extra $5,000; Tile Supplier B replies that unless A pays, he will take A to court to recover his losses. Who would probably win this case in court?
CASE STUDY FOUR RESPONSE:

It is very unlikely Tile Supplier B could win this case in court.

There was a spoken understanding between A and B about the cost of the tile, but they did not exchange any consideration, which means their agreement lacks one of the important features of a legally valid contract. Promissory estoppel is a legal doctrine that can be used to force a party to keep a contractual promise without the exchange of consideration—that is, the doctrine can be used to force a party to honor a contract that does not satisfy one of the important conditions of a valid contract.

In general, this doctrine is used to keep people from defaulting on otherwise reasonable contracts when their so doing would result in serious injustice to the other contracting party. If courts judge the person making the promise could reasonably have expected the other contracting party to rely on the promise, and that party did rely on the promise, then courts will often force the promise-maker to perform rather than let the other party suffer significant damages simply for taking the promise-maker at his or her word.

In this case, it is clear A would suffer a significant and totally unanticipated detriment if B is permitted to force payment of this additional charge. Homebuilder A has already started his project and is working under the assumption that Tile Supplier B will deliver tiles at the quoted price of $5,000. Homebuilder A explicitly stated he could not afford to pay more than $5,000, and would thus suffer a significant loss if he had to pay Tile Supplier B the extra money.

In a court of law, Tile Supplier B would be held accountable for his original quote of $5,000; he cannot rescind his original quote without renegotiating his agreement with Homebuilder A. Tile Supplier B offered Homebuilder A a quote of $5,000, which A accepted. For Tile Supplier B to collect $10,000 from Homebuilder A, he would have to make a new offer of $10,000 to Homebuilder A, and Homebuilder A would have to accept this new offer as well.
CASE STUDY FIVE

Buyer B owes Seller A a total of $2,000, which must be paid before they can proceed with their sales contract. A and B created a payment agreement under which Buyer B was to pay Seller A five payments of $400 each. Buyer B made two payments to Seller A, but has defaulted on the last three payments. Because Buyer B is not honoring the terms of their agreement, Seller A now has four options: he can rescind the contract, he can forfeit the contract, he can sue for specific performance or he can sue for compensatory damages. In this case, Seller A decides to rescind the contract. Buyer B contacts Seller A and explains that since A has rescinded the contract, A needs to return the $800 B has given him. Seller A explains to Buyer B he does not owe anything since B defaulted on the contract. Who is correct?
CASE STUDY FIVE RESPONSE:
Buyer B is correct here. In this case, Seller A must return all payments to Buyer B. When a seller rescinds a contract, he or she is required to return any payments he or she has received from the buyer. When a seller opts to rescind a contract, this means he or she cancels or voids the contract; the situation is then as if the agreement never existed. If Seller A wanted to keep the payments, he should have forfeited the contract. This would have allowed him to keep any earnest money, payments or deposits he might have received.

CASE STUDY SIX
After viewing Seller A’s property, Buyer B makes an offer on the property. Seller A tells Buyer B he will consider the offer and will let Buyer B know what he has decided in two weeks. However, two weeks pass without Seller A contacting Buyer B; Buyer B assumes Seller A has rejected the offer, so he makes an offer on another property. Three days later, Seller A contacts Buyer B to accept the offer. Buyer B tells Seller A that since he was not contacted within two weeks, he assumed Seller A had declined the offer. Seller A tells Buyer B the offer was never officially rejected because Buyer B was never expressly informed that this was so. Seller A claims Buyer B must honor his offer on the property, but Buyer B thinks Seller A is mistaken. Who is correct?
CASE STUDY SIX RESPONSE:
Buyer B is correct here. There are two ways an offer can be rejected: it can be rejected outright or can be allowed to expire, in which case it is understood to have been implicitly rejected. When an offer is made, the seller is generally given a specific amount of time to accept the offer expressly and officially. Once the time period is up, the offer is understood as being rejected. In this case, Seller A specifically stated he would let Buyer B know about the status of his offer within two weeks, which means Buyer B can assume the offer has been rejected (by expiration) after two weeks. So, he is not bound to the offer.

However, after Buyer B made the offer on A’s property, even though he had heard nothing regarding the status of the offer, it would have been in everyone’s best interest for him to retract his original offer before making an offer on another property. Luckily, Buyer B has the right to retract his offer if he has not heard of its express acceptance, as was true in this case.

CASE STUDY SEVEN

Tenant A is an independent contractor for a consulting company, a job that requires him to relocate frequently. Tenant A approaches Landlord B and explains that he is looking for a small apartment to rent, but he does not know how long he will be able to stay in that particular city. Tenant A asks Landlord B if he can create a lease under an estate for years. Instead, Landlord B suggests they create a lease under a periodic estate. Is one type of lease agreement more beneficial to Tenant A than the other, or would they both be equally useful?
CASE STUDY SEVEN RESPONSE:
A lease agreement creating a periodic estate would probably be most beneficial for Tenant A. A periodic estate (also known as "periodic tenancy") is created by a lease agreement that defines tenancy as automatically continuing for consecutive periods of time. Most of us are familiar with month-to-month leases, which are examples of the kinds of agreement that create a periodic estate. This kind of lease is understood as automatically renewing at the end of the lease period, until the landlord or tenant takes special action (such as submitting a written request) to terminate. For example, in a month-to-month lease, both the tenant and the landlord generally have the option of terminating the lease agreement at the end of any particular month. However, if neither party expressly terminates the lease, then it is usually understood the lease is renewed for another month.

This arrangement fits better with Tenant A’s unpredictable schedule than does a lease agreement creating an estate for years. An estate for years lease need not actually extend for years—remember it can be for days, weeks, or months. However, regardless of the period of tenancy established in the lease, it is still the case that the period is fixed. Because Tenant A is unsure how long he will be in the area, a fixed period of any kind might prove to be either too long or too short to meet his needs. A lease creating a periodic estate gives Tenant A greater flexibility; it also means Tenant A will not have to meet with his landlord to renew or otherwise renegotiate his lease. He can simply stay until he needs to leave, and all he needs to do when he wants to leave is make sure he provides his landlord with proper notice of terminating their lease agreement.

CASE STUDY EIGHT

Buyer B takes a tour of Seller A’s property and decides to make an offer. Seller A tells Buyer B he will consider the offer and make a decision in three weeks. In order to show he is making a serious offer in good faith, Buyer B gives Seller A $3,000 in earnest money. He signs an earnest money contract, which stipulates if he withdraws from the contract, his earnest money is not refundable. However, one week later, Buyer B finds another property he likes better, and retracts his offer on Seller A’s property. Buyer B asks Seller A to return the earnest money given that Seller A never accepted his offer. Seller A explains to Buyer B the earnest money is non-refundable and he is entitled to keep it. Who is correct?
CASE STUDY EIGHT RESPONSE:

In this case, Seller A is entitled to keep the earnest money.

Earnest money is generally used to show the buyer is making a serious offer in good faith. It is also often used as a kind of “marker” to reserve the property while the final contracts are being drawn up or the offer is being considered. Usually, earnest money is kept in an escrow account or is held by a title insurance company to ensure that there are funds available to compensate for any losses a seller or broker might suffer if the buyer withdraws from the contract.

In this case, Seller A has a signed agreement with Buyer B stipulating the earnest money is non-refundable. It is true Seller A had not yet expressly accepted Buyer B’s offer, but it is also true Buyer B had no reason to think A had rejected his offer. In addition, the fact that he had deposited earnest money with A indicates A was giving his offer serious consideration. If B wanted to reclaim his earnest money, the simplest way of doing this would have been to wait for three weeks—the time period within which A said he would make a decision regarding B’s offer. At that point, B could reasonably infer A had rejected his offer, and it would have been A, not B, who had withdrawn from the contract, in which case the stipulations making B’s earnest money non-refundable would not have applied.

CASE STUDY NINE

Minor A signed a contract with Homeowner B, agreeing to mow Homeowner B’s lawn for the entire summer. In return, Homeowner B agreed to pay Minor A a flat rate of $200 for the whole summer. However, one month later, Minor A tells Homeowner B that he no longer wants to mow Homeowner B’s lawn. Homeowner B tells Minor A that he signed a legal contract and is bound by its terms. Homeowner B warns that if Minor A does not complete the contract, he will take him to court to force performance. Minor A tells Homeowner B that because he is not yet 18, he is not legally capable of entering into contracts and the fact that he is a minor makes their contract legally void. Who is correct?
CASE STUDY NINE RESPONSE:

Minor A is correct.

A void contract is a “contract” that has no legal effect—but because it has no legal power, it is a contract in name only. The contracting parties may have intended to create a contract, and the agreement they created may even superficially resemble a contract. However, for a variety of reasons, a contract may fail to meet the legal requirements that define a valid contract. When this happens, the contract’s stipulations and conditions cannot be legally enforced. A void contract cannot impose any obligations, establish any legal rights or otherwise perform any of the functions of a legally valid contract.

For these reasons, if Homeowner B were to take Minor A to court in an effort to have the contract legally enforced, Homeowner B would lose. Minor A is not legally capable of entering into contracts. Therefore, Minor A cannot be bound by the terms of this contract with Homeowner B. However, Minor A can hold Homeowner B accountable for any labor wages he accrued during the summer, and Homeowner B will most likely have to compensate Minor A for the amount of work he did during the summer despite the fact that A did not fulfill the entirety of their agreement.

CASE STUDY TEN

Salesperson A shows Buyer B an oceanfront property. Buyer B asks Salesperson A if the beach in front of the property is part of the lot she would be purchasing if she bought the home. Salesperson A tells Buyer B it is, even though he knows it is not. Relying on Salesperson A’s claims, Buyer B places an offer on the property. Three days later, the offer is accepted, and three weeks later, Buyer B moves into the property. However, soon thereafter, Buyer B discovers the area in front of the beach does not belong to her—instead, it is city property. Buyer B files a lawsuit against Salesperson A, claiming fraud. Is she likely to win?
CASE STUDY TEN RESPONSE:

Presuming she can show Salesperson A knowingly gave her false information, Buyer B is likely to win this case.

Fraud occurs when an individual purposefully deceives another individual to gain something of value. Usually fraud consists of a failure to disclose vital information, making a false promise or telling a lie. In this case, Salesperson A knowingly told Buyer B the property she was considering included the beach area. Since Salesperson A intentionally deceived Buyer B, he is liable for any damages and losses Buyer B suffered as a result of deception.

It is also worth noting that fraud can invalidate an otherwise legal contract. So if, for example, Salesperson A and the person selling the beachfront home conspired to deceive Buyer B, then her contract with this buyer would almost surely be legally invalidated and she would not be bound by any of its terms.
LESSON SIX
CONTRACTS, PURCHASE AND SALES AGREEMENTS IN TEXAS

This lesson will focus on the following topics:

- The Statute of Limitations
- The Uniform Commercial Code
- Promulgated Contract Forms
- Contracts for Deed

THE STATUTE OF LIMITATIONS

Each state has a statute of limitations, which places a limit on the amount of time an individual has to take legal action against another individual in order to recover any losses and/or damages. In Texas, the statute of limitations is four years for written contracts and two years for oral contracts.

THE UNIFORM COMMERCIAL CODE

The Uniform Commercial Code (UCC) strives to standardize commercial and business transactions throughout the country. Currently, all states, except for Louisiana, have adopted the UCC; each state has its own version of the Code. In Texas, real estate professionals should refer to Section 9 of the Texas Business and Commerce Code. This section relates to using personal property to secure a loan or credit purchase.

Section 9 requires that real estate sales transactions use a security agreement, which is a document that contains a description of the loan collateral. The security agreement essentially establishes the lender’s right to confiscate the collateral if the borrower defaults on the loan. Section 9 also requires that a financing statement, which is the final contract documenting the negotiation process between the lender and borrower, be filed at the county clerk’s office. The financing statement also contains a notice of the security agreement. Once the financing statement has been recorded, it serves as notice to subsequent buyers and mortgagees of the security interest in that property.

PROMULGATED CONTRACT FORMS

The Texas Real Estate License Act established the Texas Real Estate Broker-Lawyer Committee; this Committee is in charge of drafting and revising standard contract forms that are used by real estate professionals. By having the Committee create and modify contract forms, all real estate professionals will be able to use the same forms for the same type of real estate transactions. Once
the Committee has created a contract form, the Texas Real Estate Commission (TREC) decides whether or not those forms will be mandated for their salespeople and brokers. TREC can promulgate contract forms, addendums and temporary residential lease forms. If TREC decides to mandate that a certain form be used for a specific transaction, real estate professionals must use that particular form.

However, there are four exceptions for when a real estate licensee does NOT have to use a form mandated by TREC:

1. In transactions where the licensee acts as the principal, and not an agent.
2. In transactions where the government requires that a different form be used for a particular real estate transaction.
3. In transactions where the seller has created and supplied the contract forms.
4. In transactions where no standard contract forms are mandated by TREC, and the licensee uses a form prepared by an attorney and approved by the Texas Real Estate Broker-Lawyer Committee.

**CONTRACT FORMS PROMULGATED BY TREC**

The following is a list of contracts that real estate licensees in Texas must use in their real estate transactions:

1. One to Four Family—Resale, All Cash, Assumption, Third-Party Conventional or Owner Financed
2. One to Four Family FHA Insured
3. VA Guaranteed Loans
4. Unimproved Residential Property
5. New Home, Incomplete Construction
6. New Home, Completed Construction
7. Farm and Ranch
8. Condominium (Cash, Assumption, Conventional)
9. Condominium (FHA & VA)
Anyone can obtain these forms from TREC; however, only licensed and/or certified salespeople and brokers should complete these forms because they are trained and experienced in handling contract forms. TREC has established specific guidelines that oversee the preparation of contracts by real estate licensees. Section 16 of the Texas Real Estate Licensing Act (TRELA) covers a licensee’s ability to prepare legal documents. Essentially, Section 16 states that a licensee should not create legal documents that define a principal’s legal rights; real estate licensees should use the appropriate TREC approved forms for the corresponding contract situations. When filling out the TREC contract forms, licensees should only include information known as factual and truthful. The licensee should only include the information mandated by the form; if the licensee needs to add more information, and there exists a contract addendum, lease or form promulgated by TREC for that information, the licensee must use that form.

**CONTRACTS FOR DEED**

Texas currently does not have a promulgated contract for deed; therefore, real estate licensees should suggest that both parties obtain the services of an attorney to create or review a contract for deed. Parties should always ensure that terms of the contract are clearly established and that they understand those terms. Having an attorney review the contract prior to its signing prevents each party from being responsible for any obligations and damages for which he or she is unaware.

**DEFAULTING ON A CONTRACT FOR DEED**

When the buyer defaults on a payment, the seller has the right to forfeit the contract, which allows him or her to keep all payments received and evict the buyer. In Texas, the seller must give the buyer a specific statutory notice before forfeiture or cancellation if the subject property is going to be the buyer’s residence.

The notice period depends on how much the buyer has paid towards the purchase price.

- If the buyer has paid less than 10% of the purchase price, the notice period must be for 15 days.

- If the buyer has paid 10% of the purchase price, the notice period must be 30 days.

- If the buyer has paid 20% or more of the purchase price, the notice period must be 60 days.
REPOSSESSION

In some installment contracts, there are clauses that allow the seller to recover possession of the property, in the case that the buyer defaults. These clauses disallow the buyer from recording the title without the seller’s consent. If the buyer records the sales contract with the public recorder, he or she shows an interest in the property; this places a cloud on the seller’s title. When this happens, it makes the process of repossession difficult for the seller because another party has shown an ownership interest in the property. Most states outlaw these types of clauses; however, not Texas.

FEDERAL CLAUSES

The government requires that specific clauses be added to contracts in two particular instances:

1. Before a buyer receives an FHA Appraised Value or a VA Certificate of Reasonable Value on a property, an amendatory language clause must be added to the sales contract. This clause ensures that the buyer can terminate the contract without suffering a loss if the agreed purchase price exceeds the appraised value. This amendatory language clause can be found in the TREC form for FHA-insured or VA-guaranteed financing; it must be used verbatim.

2. When there is an earnest money contract, the Federal Trade Commission (FTC) requires that all new homebuilders and sellers must include insulation disclosures with the contract. Insulation disclosures should describe the type, thickness and R-value of the insulation used in the home. The insulation disclosure may be found in the TREC promulgated New Home Insulation Addendum.
## Texas Principles of Real Estate
### Module 7: Environmental Hazards

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| Total Time: 240 minutes (4 Hours)                                           |            |
INTRODUCTION

This module covers major environmental hazards. The objective here is to familiarize licensees with environmental issues because they have a responsibility to disclose to buyers any information that might affect a decision to buy. Environmental hazards can dramatically affect a property’s value, so buyers, sellers, lenders and licensees can all be affected.

In accordance with TREC rules, sections 535.71 and 535.72D, this module aims to teach students to identify internal and external environmental issues. Students will learn about health hazards, environmental legislation, liability and responsibility for cleanup. They will also learn about actions they should take and how protective measures affect licensees and lending. Licensees are not expected to be environmental experts, but should acquire a degree of competency with environmental issues that will help them in advising buyers, sellers and lenders. A working knowledge of environmental issues is also helpful in protecting oneself from facing charges of nondisclosure.

The conclusion of this module presents real world dilemmas and application of the information presented. As the student completes this module, he or she should try to paint a broad picture of environmental issues and how these specifically relate to the real estate industry.
KEY TERMS

**Asbestos:** Naturally occurring mineral fibers, which are mined and processed into materials used in building and other kinds of manufacturing. Asbestos is used to strengthen materials, provide thermal and acoustic insulation on exposed surfaces, and to fireproof certain products or materials. Asbestos fibers have been linked to cancer of the lungs, stomach and intestines, as well as to a disease called asbestosis.

**Black Mold:** A slimy, black fungus that can create health problems for people when it is allowed to flourish indoors. It has been linked to rashes, headaches, nausea, muscle aches and fatigue.

**Brownfield:** A “brownfield” is defined as a property, or part of a property, that has (or is perceived as having) environmental contamination or hazards. This term is generally applied to property that has active potential for reuse or redevelopment, both of which may be complicated by the presence or potential presence of a hazardous substance, pollutant or contaminant.

**CERCLA:** An acronym identifying the Comprehensive Environmental Response, Compensation, and Liability Act. This Act is also called “Superfund,” because it provides money to clean up uncontrolled or abandoned environmental hazards, as well as other environmental accidents and emergencies. CERCLA addresses many liability and management issues regarding hazardous waste.

**Common Enemy Doctrine:** This doctrine gives individual property owners an absolute right to dispose of surface water. Its name arises from the common law idea that unregulated surface waters are the common enemy of property owners, each of whom may manage them as he or she thinks best. This includes using retention, diversion, repulsion and course alteration to control the flow. Because property owners have this right, there is not cause for legal action even if the chosen water management method causes injury or damage. It is worth noting, however, that all property owners are legally required to use their property in a reasonable way that does not cause unnecessary damage to other people or other people’s property.

**Electromagnetic Fields (EMF):** Also called “electromagnetic field radiation.” These fields are created by the flow of current in anything powered by electricity, and can be put out in substantial quantities by some devices, such as power lines and high-tension wires. Some people claim that they cause cancer and other health problems, but these claims have not been scientifically proven. Despite the lack of decisive evidence, EMFs can still be an influential factor in some people’s decisions about buying or selling property, so real estate professionals should know about them.
Endangered Species Act (ESA): This is a piece of federal legislation aimed at helping to protect animals and plants in danger of extinction due to human activity. The Act also makes various provisions promoting the recovery of species that have already suffered significant damage to their populations or habitats. The first version of this Act was passed in 1973; regulations have substantially expanded the original Act. The ESA can have a profound impact on land value by affecting what, if any, development activities may be carried out; landowners and licensees alike pay increasing attention to the Act.

Environmental Impact Statement: A statement that predicts a project’s total anticipated environmental effects, and presents research supporting its claims. All federally funded projects must submit an environmental impact statement.

Environmental Site Assessment: Also called a Due Diligence Audit, this is an investigation carried out to identify the environmental hazards or concerns that could affect the use of a property or impose future financial liability on an owner. Conducting this assessment is part of acting as a responsible landowner. These assessments are classified as Phase I, Phase II or Phase III, depending on the likelihood of environmental damage or the extent of known environmental problems.

Formaldehyde: A colorless, pungent-smelling gas that can cause watery eyes, burning sensations in the eyes and throat, nausea and difficulty breathing in some humans who are exposed to elevated levels of the gas. Formaldehyde occurs naturally in relatively small quantities; it is also widely used in the manufacture of building materials and numerous household products.

Friable Asbestos: The soft or crumbling form of asbestos that is considered more dangerous than hard form because it is easier for these fine fibers to escape into the air.

Indoor Air Pollution: The air inside homes and buildings can become polluted, just like the air outside. Three types of indoor air pollution are considered to be the most dangerous and difficult to assess: formaldehyde gas, radon and asbestos fibers. Tobacco smoke, viruses, fungi and volatile organic compounds may also contribute to indoor air quality problems.

Innocent Landowner Defense: This defense can be invoked to relieve defendant landowners of liability for toxic waste cleanup. To invoke the defense successfully, however, the landowners must be able to prove that they have taken the proper steps to ensure the environmental integrity of their site.

Joint and Several Liability: This term refers to the fact that defendant parties are both individually and jointly liable for legal damages.
Lead Poisoning: Lead is a metallic element found in rocks and soils. It accumulates in the blood, bones and soft tissue of the body; high concentrations of lead in the body can cause death or permanent damage to the central nervous system, brain, kidneys and red blood cells. With respect to real estate, this is of special concern in regard to lead paint and lead-contaminated soils.

Polychlorinated Biphenyls (PCBs): PCBs are man-made chemicals, mixtures of up to 209 individual chlorinated compounds. They readily enter the air, water and soil, and are not easily broken down in the environment. They have not been manufactured in the United States since 1977 because they are harmful to human health, causing skin rashes, liver damage and cancer, among other problems. Prior to being banned, PCBs were widely used for a variety of purposes.

Radon: Radon is an inert, radioactive gas that can come from well water, from the ground beneath a structure or from building materials. It is odorless and colorless. Radon is highly toxic and is a known carcinogen. Any home may have a radon problem—new or old, whether well-sealed or drafty or with or without basements.

Reasonableness Rule: This rule is connected to the Common Enemy Doctrine, which grants landowners an absolute right to manage unregulated surface water. The reasonableness rule requires that a landowner’s efforts to manage unregulated water meet a standard of reasonableness and necessity. If his or her management methods do not meet this standard, he or she may be held liable for any injury or damage that results from employing those methods.

Strict Liability: In cases of strict liability, the person responsible for damage, injury or legal violation is held liable regardless of fault.

Taking: In the context of the Endangered Species Act, “taking” means the killing of any environmentally protected plant, animal, fish or insect.

Underground Storage Tanks: Any federally regulated underground tank (and all piping connected to the tank) that is buried in such a way that at least 10 percent of the tank is underground and which contains some type of hazardous chemical (usually petroleum).

Wetlands: As defined by the U.S. Army Corps of Engineers, wetlands are "Areas 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."
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Identify recent laws that have an impact on environmental issues, including lead-based paint disclosure laws.
- State the procedures used to locate toxic waste sites, the responsibilities for cleanup and steps that may be taken to minimize future liabilities.
- Describe the nature of major air pollutants and the remedies that may be applied to minimize their effects.
- Identify at least three sources of human exposure to PCBs and at least two health effects seen in humans exposed to PCBs.
- Outline landowners’ responsibility for the protection of wetlands areas on their property.
- Identify the issues landowners and developers face regarding endangered-species protection.
- Sketch the nature of electromagnetic fields (EMFs) and the possible need for testing in areas where these are present.
- Describe at least two major provisions of the Small Business Liability Relief and Brownfields Revitalization Act.
- Outline the current status of environmental laws and their effect on property insurance and mortgage lending.
LESSON ONE
THE INDOOR ENVIRONMENT

This lesson focuses on the following topics:

- Formaldehyde
- Radon Gas
- Asbestos
- Mold
- Lead and Lead-Based Paint

INTRODUCTION

Environmental hazards can greatly affect the sale and purchase of real estate, as well as the health of those buying, selling or inhabiting a property. It is the responsibility of real estate agents to be able to identify situations in which environmental hazards may be an issue and to warn clients about potential damage to health and property value. Note that this does not mean that licensees can or should do the work of environmental scientists. Judgments on these issues should always be based on well-researched information, and licensees should not offer advice outside their area of expertise. Nonetheless, it is often true that real estate professionals have specialized knowledge of a property and its history, and are thus in a unique position to guide and inform their clients in ways that environmental scientists and other professionals may not be able. In this lesson, we will discuss the major environmental hazards associated with real estate and how, when and if they can be rectified.

FORMALDEHYDE

Formaldehyde is a colorless, toxic, water-soluble gas with a pungent smell. It occurs naturally in relatively small quantities but can be emitted in larger amounts by a number of building materials, including urea-formaldehyde foam insulation (UFFI) and formaldehyde-based adhesives used in pressed wood, particleboard, plywood, shelves, cabinets and office furniture. Draperies and carpeting may also emit this gas.

LEARN MORE:
Individuals who want to learn more about formaldehyde, the consumer products that may contain the substance and ways to determine whether formaldehyde may be a problem in a particular property can contact the Environmental Protection Agency's Toxic Substance Control Act (TSCA) Assistance Line at (202) 554-1404.
The EPA can also direct you to local contacts via a map linked to regional resources, which you can find online at: http://www.epa.gov/iaq/whereyoulive.html.

HEALTH ISSUES ASSOCIATED WITH FORMALDEHYDE

Exposure to elevated levels of formaldehyde can cause watery eyes, a burning sensation in the eyes and throat, nausea and difficulty breathing. This gas can cause health problems ranging from minor eye, nose and throat irritation to more serious effects such as impaired breathing and asthma attacks in asthmatics. It has been shown to cause several kinds of cancer in animals and may be carcinogenic to humans as well.

Hazardous levels of formaldehyde gas are not common in most buildings; this is due at least in part to the fact that formaldehyde’s strong smell generally alerts people to the problem. However, dangerous levels of formaldehyde can be found in manufactured or mobile homes, extremely energy efficient houses, tightly-constructed newer office buildings and even in schools. Manufactured homes are required to carry warning labels if they contain products made with formaldehyde.

Individuals who buy manufactured homes must sign statements acknowledging that they have been informed about the presence of any formaldehyde-based materials. Other buildings mentioned have no formal, regulated process for formaldehyde disclosure, so real estate licensees must disclose the known presence of UFFI or potentially harmful concentrations of other formaldehyde-gas-emitting materials.

TESTING

Property owners and prospective buyers can test for formaldehyde gas, either by hiring a professional or purchasing a testing device. Professional testing is generally advisable, because amateur testing runs a higher risk of returning inaccurate results. In some cases, professional testing may be required in order to show that an owner has exercised due diligence in assessing the environmental hazards that may be present on a property.

REMEDIES

Several methods can help to reduce the problem of formaldehyde gas pollution. Increased ventilation and air circulation can help accelerate the elimination of formaldehyde from surfaces and rooms. However, studies have found that ventilation is sometimes not a sufficient remedy, and other measures may need to be taken. Sealing off all of the exposed surfaces on particleboard furnishings with multiple layers of water resistant sealants—such as polyurethane, vinyl
laminate, lacquers, alkyd paints or other water-resistant coatings—can reduce formaldehyde emissions.

**RADON GAS**

Radon is an inert, radioactive gas that can enter a property via well water, the ground below a structure or from building materials. It is odorless and colorless. Radon is highly toxic and is a known carcinogen. Any home may have a radon problem—new and old homes, well-sealed and drafty homes or homes with or without basements.

Most commonly, radon enters a home or building from the ground beneath the structure, through cracks and other openings in its foundation or basement.

**LEARN MORE:**
The EPA offers a publication directed at real estate professionals and their clients, called “The Home Buyer’s and Seller’s Guide to Radon.” You can find it online at: [http://www.epa.gov/radon/pubs/hmbyguid.html](http://www.epa.gov/radon/pubs/hmbyguid.html).

**HEALTH ISSUES ASSOCIATED WITH RADON GAS**

In 1989, the Administrator of the Environmental Protection Agency (EPA), William Reilly, pronounced radon "the second leading cause of cancer in this country.” The EPA estimates that radon causes more than 20,000 deaths from lung cancer each year. The hazard posed by radon was not discovered until 1984, when an engineer working on the construction of the Limerick Nuclear Plant in Pennsylvania was found to be bringing radiation into the plant from his home.

Radon is located throughout the earth’s crust, but some areas contain higher concentrations than others. Danger arises when a source of radon gas is located directly beneath an inhabited building and the gas seeps inside. Radon gas can enter a building through cracks in the slab, through openings found around pipes or through well water. In structures like basements that often lack adequate ventilation, the gas can become concentrated and dangerous.

While radon sources may be numerous, they cannot be found everywhere. Local, state and federal environmental health officials can provide information about radon’s presence in a particular geographic area.

**LEARN MORE:**
The EPA can direct you to local resources that provide information and help in assessing indoor air quality. Furthermore, a map linked to regional resources can be found online at [http://www.epa.gov/iaq/whereyoulive.html](http://www.epa.gov/iaq/whereyoulive.html).
If structures near a given property have known radon problems, this may indicate a problem within the property; it certainly gives an owner (or prospective buyer) good reason to have radon levels evaluated. While any building can contain radon gas, well-insulated and energy-efficient homes sometimes have higher levels of contamination because they generally are not as well ventilated.

**TESTING**

Air tests should be undertaken if the presence of radon is suspected. The simplest test involves an activated charcoal filter canister that can be purchased at hardware stores or home centers. The canister is placed in the basement or ground level of a building for four to seven days, and then returned to a laboratory for analysis (radon does not normally pose a problem in the upper floors of a building, so the testing focuses on the structure’s lower levels). Full disclosure of any radon test results must be given to prospective buyers when a building is up for sale.

**LEARN MORE:**
The EPA offers guidance in finding a qualified contractor who can conduct thorough radon testing. That information can be found online at [http://www.epa.gov/radon/radonqa1.html#finding%20a%20qualified%20radon%20service%20provider](http://www.epa.gov/radon/radonqa1.html#finding%20a%20qualified%20radon%20service%20provider).

**REMEDIES**

Owners should seal basement floor cracks and pipe openings to prevent radon from seeping into a building. Ventilation systems that draw radon out of a building’s lower levels via pipes and fans and then disperse the radon outside may be sufficient to reduce the radon concentration to a minimal level without any additional efforts.

**ASBESTOS**

The term “asbestos” refers to a group of naturally occurring mineral fibers found in rocks. Asbestos has been used in a wide variety of products and building materials, such as patching compounds, wood-burning stoves, siding, roofing shingles and vinyl floors. Asbestos has a number of advantages: it can strengthen a material, provide thermal and acoustic insulation on exposed surfaces and fireproof a product or material. However, it also poses serious health risks to those who live or work around it.

**HEALTH ISSUES ASSOCIATED WITH ASBESTOS**

The inhalation of airborne asbestos fibers has been linked to a disease called asbestosis, a non-cancerous disease that scars the lung tissues. In addition,
asbestos can cause lung cancer and mesothelioma, cancer of the chest and the lining of the abdominal cavity. Asbestos has been known dangerous since the discovery of its connection to asbestosis (then called “fibrosis”) in 1924.

The dangers of asbestos pollution are difficult to assess accurately. Media attention focused on asbestos as a health hazard in schools and office buildings has increased concern in general. While more public attention has been directed to commercial properties, it is important to remember that the same problems may exist in private homes. (Studies have indicated that the most serious danger is associated with loose asbestos, the soft or crumbling form called “friable asbestos,” rather than asbestos in a more solid form.)

Any activity that disturbs asbestos materials has the potential to release asbestos fibers into the air. For example, damaged asbestos insulation around pipes or ceiling tiles may shed microscopic fibers into the air inside a structure. These fibers may cause respiratory diseases several years after an individual is exposed to them. To date, there have been no conclusive studies showing that food or water containing asbestos represents a health hazard, or that the fibers can penetrate the skin. The dangers associated with asbestos arise when it breaks down (or is otherwise disturbed) and its fibers release into the air.

**TESTING**

Buyers, investors, sellers and licensees need to know whether the homes or buildings with which they are dealing contain asbestos. A certified asbestos inspector can take bulk samples and determine if any suspected problem materials contain the substance. Once a laboratory analysis determines the material's content, the buyer and seller can consider their options. Full disclosure to a potential buyer is mandatory.

**NOTE:**
The EPA can help direct you to local resources providing information and help in assessing indoor air quality issues like those related to asbestos. A map linked to regional resources can be found online at: [http://www.epa.gov/iaq/wherelyoulive.html](http://www.epa.gov/iaq/wherelyoulive.html).

**ECONOMIC CONSEQUENCES**

The discovery of asbestos on or in a property can lead to serious problems for owners. Federal and state laws govern the handling and proper disposal of asbestos and materials containing asbestos; these materials must transported using proper precautions and discarded with care. Asbestos presents two primary economic risks for property owners: the potential of health-related lawsuits and the risk of lowered income due to a lack of tenants. This translates into a lower property value and may make adequate insurance coverage difficult.
to obtain. When faced with asbestos problems, building owners may consider an asbestos management plan suggested by the EPA.

**ASBESTOS LIABILITY**

Asbestos-related liability cases have been increasing in the last decade. Companies involved in asbestos litigation include automakers, shipbuilders, textile mills, retailers, insurers, electric utilities and other companies involved in manufacturing or construction in the last 30 years. Asbestos lawsuits have forced more than 60 U.S. corporations into bankruptcy. Nationwide, according to the *Wall Street Journal*, there were some 200,000 pending asbestos claims in 2004 alone.

**Recent Litigation**

In a recent case, a court ruled that the claims in the National Emission Standards for Hazardous Air Pollutants for Asbestos (Asbestos NESHAP) about “visible emissions” also apply to visible dust, which may contain invisible asbestos fibers or particles. The court ruled against the defendant, a company that (among other projects) disassembled brakes shoes and discarded their parts, some of which were known to have contained asbestos. The defendant was fined, having to pay a $50,000 civil penalty. (*United States v. Midwest Suspension & Brake*, 1995)

**REMEDIES**

Building owners and managers have had to decide whether to remove asbestos or to implement in-place management programs. Many owners have removed asbestos rather than face possible liability, even when significant health risks were not evident. Since 1985, the EPA has held that property owners should not always remove asbestos; remember that asbestos is not dangerous unless it is damaged or disturbed in a way that causes asbestos fibers to be released into the air. Given that removal costs can run as high as thirty to fifty dollars per square foot of floor area, in-place management is often a better and far less costly alternative.

The EPA defines an effective management program as a “formulated plan of training, cleaning, work practices, air monitoring and surveillance to maintain asbestos-containing materials in good condition.” Under such a program, maintenance, custodial and administrative staff members are educated about the asbestos on a property, and owners inform tenants and other occupants that there is asbestos in the building.
MOLD

Molds are microscopic fungi that grow throughout the natural and manufactured environment. Although some of their appearance and development mimics that of plants, they lack chlorophyll and thus must gather nutrients from other organic matter (living or dead), such as plants and animals (including humans). Molds are a primitive form of life found almost everywhere that moisture is present. Molds also serve many useful purposes. We utilize molds in the production of beer, wine and pharmaceuticals (like penicillin); molds are a natural part of all biological systems, coexisting in symbiosis.

Even though molds are useful to us, they can be a serious problem when large numbers are allowed to multiply indoors. Mold problems can arise in houses and other buildings because they require very simple conditions to grow and multiply, namely:

- Moisture
- Nutrients and
- A suitable growing surface

Excess moisture is the primary cause of indoor molds. Molds can cause serious health problems; they can also permanently damage building materials, furniture and personal belongings. According to the EPA, the following structural and design problems contribute to mold growth:

- Poor indoor air circulation
- Wind washing
- Poor insulation
- Surface area heat loss

Many molds can cause minor respiratory problems and hay-fever-like symptoms. A particular type of slimy black mold (*Stachybotrys chartarum*, sometimes also called *Stachybotrys atra*) is commonly found indoors in humid or wet conditions and has been associated with more serious health problems in some individuals. Not all people respond to this mold in the same way; when it causes serious health problems, these generally occur in people with chronic respiratory conditions or people whose immune systems are already suppressed or otherwise compromised. Testing and scientific data regarding the problems caused by black mold are inconclusive in many cases. However, black mold has been linked to headaches, nausea, muscle aches and fatigue.

LEARN MORE:
The EPA offers an array of mold resources that may be useful to licensees and consumers. You can find links to these items online at [http://www.epa.gov/mold/moldresources.html](http://www.epa.gov/mold/moldresources.html).
HEALTH ISSUES ASSOCIATED WITH MOLD

The most common problems caused by indoor mold are allergy symptoms. People, who have allergies to airborne particulates (such as dust) as well as those with hay fever or asthma problems, are usually more strongly affected by mold than those without pre-existing allergies or respiratory problems. People exposed to high levels of mold growth indoors commonly report problems such as:

- Nasal and sinus congestion
- Coughing
- Wheezing and breathing difficulties
- Sore throat
- Eye irritation

More serious problems can occur in people who are exposed to unusually large amounts of mold, people with chronic respiratory conditions or people whose immune systems are suppressed or otherwise compromised. In these cases, fever and shortness of breath are not uncommon in combination with the problems listed earlier. People with chronic illnesses that affect the respiratory system may also develop mold infections in their lungs.

TESTING

In general, mold problems can be seen or smelled. If there is enough to affect indoor air quality, it can usually be detected without special equipment by people living or working in the structure. The main problem with mold is usually not finding it, but rather in eliminating it. Because climate is enormously influential on the kinds of mold that grow indoors, states often have their own recommendations for identifying and dealing with problems common in a given region. In general, look for white, threadlike fibers, clusters of black spots or a pervasive musty odor in moisture-rich places such as kitchens or bathrooms. Mold often grows underneath building materials where water has damaged surfaces or behind walls. In addition, look for discoloration and leaching from plaster and drywall.

Search for Problems

Licensees can conduct a search for mold problems. They can go through the house, including the attic, basement and crawlspaces, and look for obvious mold growth. Outside the house, downspouts should route water away from the house; improper drainage leads to water pooling around the foundation, which in turn can create mold problems indoors. Licensees can also check the exhaust fans in kitchens and bathrooms, to verify that there is proper ventilation in areas that are often humid. If there are no windows, this lack of ventilation creates the increased potential for mold growth. Rotten building materials (like wood or
plaster) and stains on ceilings, floors and carpeting may indicate leaks or moisture problems; these problems should be investigated thoroughly to pinpoint their causes. Professionals should also check heating and cooling systems, including humidifiers, vents, duct linings and insulation for mold growth.

**PREVENTION**

There is no practical way to eliminate all mold spores from a structure that is open to the outdoors. Therefore, the key to preventing mold problems is moisture control. Owners and landlords need to maintain their properties carefully, with an eye toward minimizing the amount of moisture in their buildings. Steps that can help achieve this goal include:

- Fixing leaks and seepages promptly.
- Using proper insulation to prevent condensation.
- Installing and using exhaust fans to vent moisture from bathrooms, dryers and other sources of indoor moisture.
- Keeping carpets and other floor coverings clean and dry, as well as removing carpet from places that are frequently wet, such as bathrooms and sink areas.
- Ventilating crawl spaces.
- Cleaning and drying any water-damaged areas within 48 hours after the leak or spill.

All appliances that come into contact with water, such as furnaces, heat pumps, central air conditioners, dehumidifiers and humidifiers should be properly maintained and kept clean. Owners should replace moldy shower curtains and clean all moldy surfaces thoroughly, using a weak bleach solution, as recommended by the Centers for Disease Control and Prevention. Carpet or baseboards that are significantly infested with mold should be discarded and the source of the mold problem found and controlled before the materials are replaced. Painting over mold without cleaning does not usually solve mold problems; it can resurface through new paint.

The EPA suggests that homeowners and renters keep the indoor humidity level between 30 and 60 percent. In addition, temperature should generally be kept above dew point, to decrease condensation and associated opportunities for mold growth. As mentioned earlier, each state may have its own suggestions for preventing mold growth, and property owners should familiarize themselves with these recommendations.

**REMEDIES**

There are several solutions to mold problems, many of which we have already discussed under “prevention.”
When cleaning up a mold problem, one should focus in the following goals:

- Reducing the moisture content in the air
- Increasing air movement
- Increasing the temperature (either the general indoor temperature the temperature of the moldy surface)

Mold should be cleaned off of hard surfaces using a weak bleach solution. But because one cannot clean absorbent surfaces like plaster or ceiling tiles in this way, these materials would likely require replacement. When cleaning molds, make certain that your work area is well ventilated, and consider using a dust mask or other respiratory protection. It is also best to use rubber gloves or other coverings to prevent both the mold and any cleaning solutions from coming into direct contact with your skin. Minimize the amount of water used in the cleaning process, and make certain that any standing water is cleaned up quickly.

Some serious mold problems may require professional cleanup. The EPA offers numerous publications that can help licensees address the concerns of both residential and commercial property owners. As noted earlier, you can find an index to these resources online at the following address: http://www.epa.gov/mold/moldresources.html.

**LEAD AND LEAD-BASED PAINT**

Lead is a heavy, relatively soft, bluish-grey metal. Because of the ease with which it can be shaped, lead has long been used in pipes and other building materials. More recently it has been alloyed for use as solder for pipe joints and as a component in paint. Paint containing high levels of lead was found to be more durable and looked fresher for a greater length of time. Lead has many useful properties. However, it is also highly toxic. It does not break down in the environment and accumulates readily in the human body, creating serious health problems for children and adults.

Water passing through lead pipes or through copper pipes with lead-soldered joints, older paint, household dust (particularly in homes containing lead-based paint) and the soil around a house may all contain significant amounts of lead. According to the EPA, other sources of lead include older painted toys and furniture, as well as foods and drinks stored in lead crystal or lead-glazed pottery or porcelain. Lead can also be introduced into a home via industrial emissions (such as those from lead smelters), the clothes and shoes of residents or employees who work with lead, and through hobbies such as glazing pottery, working with stained glass, or refinishing older furniture.

Lead can be harmful if ingested or inhaled, which is problematic because there is a substantial amount of airborne lead in our environment. Airborne lead comes from some industrial plants, from the exhaust released by internal combustion engines (primarily from vehicles using gasoline) and from household dust derived
from lead-based paint. Dust that contains lead can also be transmitted from the workplace. Restrictive rules to minimize airborne lead have succeeded to a great extent; in 1995, the EPA reported an 88 percent reduction in airborne lead.

HEALTH ISSUES ASSOCIATED WITH LEAD

High levels of lead in the bloodstream may cause lead poisoning. A simple blood test can determine the amount of lead in a person’s system. If this test shows high levels of lead, treatment may involve changes in diet, medication or a hospital stay, depending on the severity of the poisoning.

Children younger than seven are at the highest risk for lead poisoning. Their growing bodies absorb lead more readily and children’s developing brains and nervous systems are more sensitive to its damaging effects. Lead poisoning can cause many serious health problems in children, including permanent brain damage, slowed growth, hearing problems, headaches and learning and behavior problems such as hyperactivity.

LEAD-BASED PAINT RULES

Because the health problems associated with lead are so serious, the federal government has created regulation aimed at decreasing people’s exposure to lead-based paint in residential property. On March 6, 1996, HUD and the EPA issued a joint final ruling that requires the sellers and lessors of residential property built before 1978 to inform prospective buyers or tenants of the actual or possible presence of lead-based paint hazards in a property. Leases and sales contracts must include a disclosure form regarding lead-based paint.

Homebuyers have a 10-day period to conduct their own lead-based paint inspection or risk assessment, giving both the buyer and seller the flexibility to negotiate key terms of the evaluation. In addition, sellers, lessors and real estate professionals share responsibility for ensuring compliance. Failure to comply can result in large fines.

As of June 1, 1999, renovators who will be disturbing more than two square feet of paint in dwellings built before 1978 must give owners or occupants a copy of the EPA publication Protect Your Family from Lead in Your Home (http://www.epa.gov/lead/pubs/leadpdfe.pdf). This disclosure must be made prior to any renovation activities that disturb paint. Renovators generally must secure signatures as evidence that they have made the proper disclosures and supplied information from the EPA, but other kinds of proof may be used when signatures cannot be obtained.
LEARN MORE:
The EPA offers a special guide for contractors, property managers and maintenance personnel, called *The Lead-Based Paint Pre-renovation Education Rule*. This guide details the legislation and regulation governing these individuals’ role(s) with respect to tenants, property owners and lead management. You can find it online at: http://www.hud.gov/offices/lead/406b/406binteriorfinal.pdf.

Recent Applications of Lead-Based Paint Rules

*Richwind Joint Venture 4 et al. v. Brunson et al., 335 Md. 661, 645 A.2d 1147 (1994)*

This case set the legal standard for landlord liability regarding lead exposure. In Baltimore, MD a jury ruled against a landlord, in favor of a tenant and her two children for injuries that the children allegedly sustained as a result of being exposed to lead-based paint. The courts held that the landlord had acted negligently, having failed to disclose the risk of lead exposure to the tenant. In addition, the landlord did not remove the hazard, despite having reasonable opportunity to do so.

PAINT TESTING

Given the dangers posed by lead-based paint, people are often concerned about determining whether or not the paint in their homes contains unsafe levels of lead. There are a variety of paint-testing methods that can help to determine this. It is important to note, though, that paint testing only tells you what the lead levels are; it does not tell you whether they are hazardous or how to deal with dangerous paint. This other information can be gathered in a risk assessment.

The EPA currently recognizes two valid methods of testing paint for lead: portable x-ray fluorescence analyzers (XRFs) and paint chip sampling combined with laboratory analysis.

X-Ray Fluorescence

Portable x-ray fluorescence analyzers (XRFs) are sophisticated instruments that expose a surface to a radioactive source and determine its lead content, generally without damage to the surface. Results are available immediately and are often highly accurate if the XRF operator is well trained. However, this method can be costly, and operators may have to default to a paint chip method if problems arise when sampling irregular surfaces or if subsurface materials such as brick or metal distort readings. Also, at times XRF readings are inconclusive, requiring testers to employ the paint chip method to get a definite result.
Paint Chip Sampling

When testers employ paint chip sampling, small sections of paint (one to four inch areas) are removed and submitted for laboratory analysis. A certified professional tester should then repair the area, so that paint does not chip off, and clean up any dust that may have been created while obtaining the sample. To ensure that the analysis is done competently, a laboratory recognized by the EPA’s National Lead Laboratory Accreditation Program (NLLAP) should test the paint chips.

This type of testing can be very accurate, but it does damage the painted surface and residents (or prospective residents) must often wait some time for test results.

REMEDIES

Living with Lead-Based Paint

Renters should notify their landlord about any peeling or chipping paint. However, there may be circumstances in which lead-based paint cannot be removed or encapsulated immediately. According to the EPA publication Protect Your Family from Lead in Your Home, there are a number of steps occupants can take to reduce the risk associated with lead-based paint. These measures include cleaning up paint chips immediately, cleaning surfaces on a weekly basis and washing children’s hands frequently. For a complete list see page seven of the EPA booklet.

Preventing Lead Exposure

There are five basic methods for preventing exposure to lead in residential properties. Remember that lead-based paint should be removed only by trained professionals who have the proper equipment and expertise; the removal of lead-based paint by unqualified personnel is likely to do more harm than good, and poses serious risks to the people who are removing the paint and the people who reside in the property.

Replacement

It is often easiest to replace old doors, windows, trim and other woodwork with new materials.

Encapsulation

Wood, vinyl, aluminum, tile, stone, plaster and special coatings are some of the products used to cover lead paint. Encapsulating coverings or coatings can be used on exterior and interior surfaces. When using this method, the surface is
prepared by wet scraping; encapsulate is then applied to ensure seams are sealed.

**Caustic and Off-Site Chemical Stripping**

This technique can be messy and expensive, but it allows property owners to keep decorative, expensive or irreplaceable trim. The wood is taken out of the house and stripped of lead-based paint by dipping it into a chemical solution. This procedure is not recommended for windows or other surfaces that are regularly exposed to friction.

**Wet Scraping**

In this method, paint is thoroughly wetted and a wire brush, paint scraper or other abrasion tool is used in removal. People typically use wet scraping in limited areas where paint is peeling. This method may not entirely eliminate lead hazards because small amounts of lead-based paint can be left behind.

Additionally, when employing wet scraping, one must clean the area thoroughly after scraping. Similarly, one must make certain to properly handle the material cleanup (e.g., paint dust, paint chips and liquid waste); otherwise, one is simply moving the lead hazard from one location to another.

**Heat Guns**

Heat guns are typically used to soften thick paint prior to scraping. Due to the potential risk of breathing in lead vapors, special care must be taken with the operating temperature of the gun. Respirators are strongly recommended. As with wet scraping, special care must be taken to properly dispose of paint that has been removed.

**SUMMARY**

Recent EPA studies have indicated that indoor air can be several times more polluted than outdoor air. The three most dangerous types of indoor air pollution result from formaldehyde gas, radon and friable asbestos. Licensees and prudent investors should be aware of the hazards that have been identified as well as those problems that may be unique to a geographic area. Visual inspections should be performed to evaluate known or suspected hazards; consultations with experts should be arranged as necessary.

Formaldehyde gas is a colorless, toxic, water-soluble gas that can cause health problems ranging from minor eye, nose and throat irritation to more serious effects such as impaired breathing and asthma attacks. It has been shown to cause several kinds of cancer in animals and may be carcinogenic to humans as well. Formaldehyde occurs naturally, but building materials—such as
formaldehyde foam insulation (UFFI) and formaldehyde adhesive—may emit problematic levels of this gas. Real estate licensees must disclose the known presence of UFFI, as well as any other harmful concentrations of formaldehyde-gas-producing materials.

Radon is an invisible, radioactive gas; it is highly toxic and is a known carcinogen. The gas may cause harm when it seeps into a building from an underground source. It can be detected with the use of an activated charcoal filter canister or through professional testing. Ensuring proper ventilation and sealing areas where seepage occurs can help prevent radon from building up in harmful levels.

The term “asbestos” refers to a group of naturally occurring mineral fibers found in rocks, and it is used in various building materials. Airborne asbestos fibers can be lethal, causing asbestosis and several kinds of cancer. Because it is associated with these serious health hazards, asbestos creates a major liability risk for property owners and managers. Most have opted to remove asbestos or to implement in-place management programs. The EPA favors in-place management programs over removal, because disturbing asbestos often creates greater dangers than leaving solid, stable asbestos in place.

Molds can be another major contributor to indoor air pollution. They are types of fungi that grow almost anywhere that moisture can be found. Although they serve many useful purposes, molds can be hazardous when reproducing in large numbers in a confined indoor environment. Signs of mold growth include white, threadlike fibers, clusters of black spots or a general "musty" odor. Controlling indoor moisture is the most effective thing that homeowners can do to avoid excessive mold growth. Raising temperatures, increasing ventilation and reducing moisture can help reduce mold growth. Depending on the severity of the problem, a professional follow-up may be necessary.

Lead is another hazard often found inside properties. This malleable metal can be found in many building materials, including pipes and paint. Lead can be extremely toxic to human beings and is most hazardous to children under the age of seven. Because lead-based paint readily creates lead dust and paint chips in a residence, several lead-based paint rules established in 1996, aim to minimize this danger. The most important perhaps being a joint final rule issued by HUD and the EPA. This rule requires that sellers and lessors of residential property built before 1978 inform prospective buyers or tenants of the actual and/or possible presence of lead-based paint hazards in a property. Leases and sales contracts must include a disclosure form regarding lead-based paint. Individuals who renovate dwellings built before 1978 are bound by lead regulations as well. In that, they must give owners or occupants a copy of the EPA publication Protect Your Family from Lead in Your Home whenever more than two square feet of paint will be disturbed.
Given that lead-based paint poses serious health hazards, many people may be concerned to find out more about the lead content of paint in their own properties. Paint can be tested for lead using x-ray fluorescence and paint chip sampling. If hazardous levels of lead are found in paint, residents must decide how to handle the problem. Specifically, under a management plan, one can choose to live with lead-based paint; or, elect to remove it in a variety of ways: including replacement, encapsulation, caustic or off-site chemical stripping, or by using wet scraping or heat gun removal.

_Return to your on-line course player to take the Lesson Quiz._
LESSON TWO
THE EXTERNAL ENVIRONMENT

This lesson focuses on the following topics:

- Hazardous Waste
- Polychlorinated Biphenyls (PCBs)
- Underground Storage Tanks and Electromagnetic Forces
- Water Damage

INTRODUCTION

In the previous lesson, we discussed the different types of environmental hazards to be found within a property. This lesson covers the hazards associated with a property’s exterior, that is, with the ground upon which it stands and the areas surrounding a property. We will discuss liability, as well as relevant federal legislation. This lesson will also cover compensation and incentives as they relate to the management and control of environmental hazards on a property.

HAZARDOUS WASTE

A toxic waste site is an area identified by the Environmental Protection Agency as containing a concentration of hazardous materials. We know of about 1,290 such sites in the United States. While toxic waste sites pose less of a problem than some other contaminants, they have attracted a great deal of popular attention. Two major pieces of legislation establish rules for toxic waste sites: the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Small Business Liability Relief and Brownfields Revitalization Act.

CERCLA

On December 11, 1980, Congress enacted the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). CERCLA is Title 42, Chapter 103 of the U.S. Code. This Act is commonly called “Superfund” or “the Superfund Act.” It created a tax on the chemical and petroleum industries, drawing money from the kinds of companies that are frequently involved in large-scale pollution incidents to establish a trust fund for cleaning uncontrolled toxic waste sites. The Act also expanded the federal government’s power to regulate and deal with hazardous substances.
This section of the lesson discusses three broad subjects covered under the Act:

- The definition of hazardous materials
- Establishing the legal liability of responsible parties
- Initial provisions for the innocent landowner defense

**Hazardous Materials Covered by CERCLA**

CERCLA defines a hazardous substance in Section 9601 (14). A hazardous substance is a material specifically designated as poisonous or otherwise dangerous in several pieces of environmental legislation, including the Federal Water Pollution Control Act, the Clean Air Act and the Toxic Substances Control Act.

The EPA currently maintains a list of over 800 hazardous substances, with additional substances classified as potentially hazardous. CERCLA does not classify all dangerous substances as hazardous materials, though other laws may establish liability for substances not covered by CERCLA.

LEARN MORE:
You can read more about the hazardous substances covered by CERCLA at the following EPA Web site:

The act specifically excludes several substances from its definition. For example, petroleum and its derivatives do not fall under CERCLA, unless substances are expressly listed as a hazardous by other statutes (such as the Clean Water Act). CERCLA also excludes natural gas, natural gas liquids, synthetic natural gas usable for fuel, mining wastes, cement dust and wastes generated from the combustion of coal or other fossil fuels.

**Liability of Responsible Parties**

CERCLA places extensive liabilities on all parties involved with a waste site, regardless of whether they played a direct role in creating a particular hazardous waste problem or not. By allocating liability broadly, CERCLA discourages careless behavior motivated by the belief that the problem will be blamed on someone else. As defined under Section 9607 (a) 1-4, the four responsible parties in any hazardous waste incident are:

- The current owner(s) and operator(s) of a vessel or facility.
- Any individual(s) who owned or operated that vessel or facility at the time when hazardous substances were disposed of in that location.
- Any individual who agreed to or otherwise arranged for the disposal or treatment of hazardous substances belonging to him or her, at a facility or vessel owned or operated by someone else; also, any individual(s) who
agreed to or otherwise arranged for the transport of hazardous substances to someone else’s facility or vessel.

- Any individual who accepted hazardous substances for transport to a disposal or treatment facility, or any other site from which a release of these substances creates a real or threatened hazardous waste management problem.

**NOTE:**
The phrase “owner or operator” refers to the person or people who own, operate or otherwise control a facility or vessel, either presently or in the past. If a facility has been conveyed to a unit of state or local government in connection with bankruptcy, foreclosure or abandonment, the owner or operator is understood to be the person who controlled the facility immediately prior to such conveyance. This phrase does not refer to a person who holds a deed primarily to protect a security interest in a facility and does not participate in its management.

These various individuals are responsible for:

- All costs of removal or remedial action consistent with the national contingency plan for handling hazardous waste incidents.
- Any other costs that are a necessary part of managing or remediating the hazardous waste incident, which are consistent with the national contingency plan.
- Damages for the injury, destruction or loss of natural resources, including the costs associated with determining what damages may have occurred to natural resources as a result of the hazardous waste incident.
- The costs of any health assessment or health effects study carried out in an effort to collect the epidemiological and toxicological data required by Section 9604 (i) of CERCLA.

**Extent of Liability**

CERCLA imposes *strict liability* as well as *joint and several liability* for cleanup costs on all of the responsible parties. “Strict liability” is liability imposed regardless of fault; under joint and several liability, the parties are held both singularly and jointly liable for all cleanup costs. This applies regardless of whether the particular party involved had anything to do with creating the problem at issue. There is no minimum amount of contamination required to create liability for cleanup.

Liability may not be allocated to the government. However, responsible parties may seek an allocation of costs among themselves. So far, much of the money invested in resolving toxic waste problems has been spent on litigation, primarily on contesting insurance companies’ denials of liability. The question of whether
liability policies cover pollution costs, when insurers never envisioned such exposure, dominates these suits.

**Innocent Landowner Defense under CERCLA**

A 1986 amendment to CERCLA contained the original provisions for the innocent landowner defense, by which a defendant landowner can be found innocent of liability for toxic waste cleanup. For the landowner to escape responsibility, the damages must have been caused by a third party who was not an employee and who did not stand in any contractual relationship with the defendant landowner. It must also be the case that the defendant could not have known, or have had reason to know, that the property had been used for the disposal of hazardous substances prior to his or her acquisition of the property.

The most equivocal section, however, required defendants to have undertaken “all appropriate inquiries” to determine whether the site was contaminated prior to purchase. In concept, this makes sense—it requires that landowners take active steps to determine the environmental condition of the land they purchase. In practice, however, it is much more difficult to determine exactly what would count as making “all appropriate inquiries.” Determining whether a landowner has satisfied this condition can be a very complex matter because the actual steps and tests that constitute “appropriate inquiries” are not specified under law. This vague phrasing makes it difficult to invoke the innocent landowner. We will discuss this issue further in Lesson Four, when we cover environmental site assessments, which are a necessary part of the innocent landowner defense.

**SMALL BUSINESS LIABILITY RELIEF AND BROWNFIELDS REVITALIZATION ACT**

On December 20, 2001, Congress passed a law entitled the Small Business Liability Relief and Brownfields Revitalization Act, which aimed to clarify the confusion created by CERCLA’s “all appropriate inquiry” provision. On January 11, 2002, the Act was signed into law. This Act produced at least two important benefits: first, the Act gave additional incentives for the purchase and revitalization of brownfields, which are defined as properties, or parts of properties, the development or use of which is complicated by their real or perceived environmental contamination or hazards. Second, this Act gave increased structure and contingency to the phrase “all appropriate inquiry,” making the innocent landowner defense more feasible.

**Brownfields Purchase Incentives**

Beginning in the 1990s, states began to encourage redevelopment of lightly contaminated brownfields sites; they did this by offering incentives like liability protection to prospective purchasers. The EPA also tried to help achieve this goal by providing federal funds for the environmental assessment and
revitalization of these sites. However, developers still shied away from working with brownfields, due to the lack of clarity surrounding the innocent landowner defense and the risk of liability associated with developing sites known as contaminated with hazardous substances.

The Small Business Liability Relief and Brownfields Revitalization Act aimed, in part, to help overcome developer's reluctance in this regard. The Act is structured to protect people who would buy and develop these lands from becoming the “current owners and operators” who face CERCLA liability. By doing so, it shelters those who would voluntarily undertake cleanup of these sites (to enable future development) from prosecution and other legal penalties. It thus creates an additional incentive for the re-development of brownfields sites.

**Innocent Landowner Defense under the Act—
“All Appropriate Inquiry” Defined**

To resolve the lack of clarity in the innocent landowner defense, the Brownfields Act required the EPA issue a standard defining “all appropriate inquiry” no later than January of 2004 (the proposed standard was actually issued in August 2004).

SEE MORE ABOUT: The proposed standard in volume 69, number 105 of the *Federal Register*.

The Act established criteria for this standard, including inquiry by an environmental professional; interviews of past and present owners, operators and occupants of a site; reviews of historical sources such as chain of title documents, recorded environmental liens and governmental records; as well as visual inspection of the site and adjoining properties.

**NOTE:** The Act established interim measures that will be in place until the EPA's proposed standard receives final approval.

**Properties Purchased Prior to June 1, 1997**

For properties purchased before June 1, 1997, the Brownfields Act directs the court to consider the following standards in regard to *all appropriate inquiry* and the *innocent landowner defense*:

- Any specialized knowledge of the party invoking the defense
- Relationship of purchase price to the value of the contaminated property
- Widely accepted information about the property
- Obviousness of contamination
- Ability to detect contamination by appropriate inspection
FAST FACT: The Brownfields Act does not explicitly require that a formal environmental site assessment be performed for sites as a condition of invoking the innocent landowner defense.

Properties Purchased After May 31, 1997

For properties purchased after May 31, 1997, the Act defines performing “all appropriate inquiry” as employing the American Society for Testing and Materials (ASTM) Standard E 1527 for a Phase I environmental site assessment. You may obtain details about what this standard requires of landowners from the EPA or from your state and local environmental regulatory agencies.

Additional Landowner Burden

Although the Brownfields Act’s definition of the phrase “all appropriate inquiry” represents a positive change for owners and operators, the Act also establishes an additional burden on landowners who wish to use the innocent landowner defense. When contamination is discovered on a site, a landowner intending to invoke this defense must:

- Cooperate fully with the EPA and state-regulated cleanup efforts.
- Provide access and assistance to those authorized to conduct a response action.
- Comply with any land-use restrictions established or relied upon in connection with a response action.
- Refrain from impeding the effectiveness institutional controls employed for a response action.
- Take reasonable steps to stop any continuing hazardous release.
- Prevent any threatened future release.
- Limit or prevent any human or environmental exposure to a previously released hazardous substance.

Prior to the passage of the Brownfields Act, the only landowners who could invoke the innocent landowner defense were those who could demonstrate that they had no knowledge of any contamination prior to purchasing a property. In the wake of the Brownfields Act, a *bona fide prospective purchaser* liability defense for owners arose. Meaning, owners who acquired contaminated property following the Act’s inception, and who meet inquiry and care requirements similar to those establishing grounds for the innocent landowner defense, had a liability defense of their own.

FAST FACT: In addition to a *bona fide prospective purchaser* protection, the AAI rule has amended the innocent purchaser defense (also known as the *innocent landowner defense*) not only by protecting those who knowingly purchase contaminated property but also by adding a *contiguous property owner* provision.
further protecting the buyer from contamination caused by any migration of hazardous substances onto his or her property from off-site.

**POLYCHLORINATED BIPHENYLS**

Polychlorinated biphenyls (PCBs) are mixtures of synthetic organic chemicals; they have many useful properties—for example, they will not burn readily and are good insulators. Qualities like these made them popular for many industrial and commercial endeavors. They can be found in old fluorescent light fixtures, hydraulic oils, transformers and electrical devices with PCB capacitors. However, concern about their effects on human health and the extent to which they were accumulating in the environment led Congress to enact the Toxic Substances Control Act in 1976. PCBs have not been manufactured in the United States since 1977, and have no known natural sources.

**HEALTH ISSUES ASSOCIATED WITH PCBS**

The effects of PCB exposure vary according to many factors, including:

- The amount of PCB exposure.
- The method of exposure.
- Personal traits and habits.
- Whether or not other chemicals were present.

Since PCBs do not breakdown easily, they remain in the environment for a long time. When exposed to water, PCBs tend to bind with organic compounds and soil, and can enter into the food chain through aquatic animals. Because PCBs accumulate in fish, the concentration of the chemicals may be much higher in their systems than in the surrounding water.

PCBs have been linked to acne-like skin conditions in adults and adverse effects on the liver, reproductive and nervous system. Motor-skill developmental problems, decreased short-term memory and immune-system effects have been noted in children. Although the evidence is not overwhelming at this time, several government agencies (including the EPA) believe that PCBs are probably carcinogenic and associated with cancer of the liver and its associated organs (e.g., the gall bladder and bile ducts).

**REDUCTION OF RISK**

According to the Agency for Toxic Substances and Disease Registry (ATSDR), families may take the following steps to reduce risk of exposure to PCBs:

- Children should not play with old appliances, electrical equipment, or transformers, since PCBs were commonly used in this kind of equipment before they were banned.
• People should seek to make themselves aware of local warnings about PCB-contaminated fish and other water-dwelling animals. Individuals should avoid eating these fish, as well as wild animals whose diet is composed largely of PCB-contaminated fish.
• Children should be discouraged from playing in the dirt near hazardous waste sites and should also avoid locations of known or suspected transformer fires.
• Children should generally be discouraged from eating dirt, and parents should make an effort to keep children’s toys and hands clean.
• As was true of lead, PCBs can be carried home from the workplace on clothing, shoes and tools. As much as possible, items exposed to these chemicals should be kept out of the home. Anyone who works with PCBs should remove his or her clothes and shoes immediately after work. These items should be laundered and cleaned separately.

NOTE:
The list above draws on material that can be found at the ATSDR’s Web site, at http://www.atsdr.cdc.gov/TFacts17.html.

UNDERGROUND STORAGE TANKS AND ELECTROMAGNETIC FIELDS

Underground storage tanks and electromagnetic fields are two other possible sources of exterior environmental hazards.

UNDERGROUND STORAGE TANKS

The EPA defines an underground storage tank (UST) as any tank (and its connected underground piping) that has at least 10 percent of its volume below ground. Federal regulations apply only to USTs that contain either petroleum or hazardous substances. USTs containing hazardous substances are subject to different regulations than those containing petroleum; they must make provisions for secondary containment (in case of a leak in the primary container) and must employ more sophisticated leak detection.

When the EPA’s UST program began, there were more than two million USTs covered by regulations; there are fewer today, because many substandard UST systems have been closed down. At present, there are approximately 676,000 USTs that store petroleum and related products, and approximately 25,000 USTs containing hazardous substances.

The Resources Conservation and Recovery Act of 1976 (RCRA) was amended in 1986, requiring the EPA to develop a comprehensive program of regulation and legislation aimed at preventing, detecting and correcting releases from
USTs. The EPA has also established regulations defining the financial responsibilities of UST owners and operators.

**LEARN MORE:**
The EPA’s Office of Underground Storage Tanks (OUST) has produced a 16-page booklet, entitled *Dollars and Sense* that outlines these financial requirements. You can read that document online at: [http://www.epa.gov/swerust1/pubs/dol&sens.pdf](http://www.epa.gov/swerust1/pubs/dol&sens.pdf).

These regulations require that owners and operators maintain specified amounts of financial responsibility coverage; the amount of coverage required varies depending on the type and size of the business. The EPA designed these measures to ensure that the owners and operators of USTs have the financial resources that may be needed to clean up a site, to correct the environmental damage caused by a tank leak and to compensate any injured parties. To view a chart that outlines the amount of coverage required, go to: [http://www.epa.gov/swerust1/ustsystm/finresp.htm](http://www.epa.gov/swerust1/ustsystm/finresp.htm).

**Abandoned Storage Tanks**

Abandoned storage tanks pose a unique challenge. There are federal regulations (as well as state regulations) that require tank owners to clean up contamination and maintain a safe open or closed system. However, sometimes the owners of defective tanks cannot be identified or cannot be reached by authorities. When authorities cannot reach the owner or the owner is unable to pay for damages, the Leaking Underground Storage Tanks (LUSTs) Trust Fund will oversee cleanup and help with funding.

**ELECTROMAGNETIC FIELDS**

Electromagnetic fields (EMFs) indicate “electromagnetic field radiation.” These fields are created by the flow of current in anything powered by electricity, and can be put out in substantial quantities by some devices, such as power lines and high-tension wires. Some people have claimed that EMFs cause cancer and other health problems, but these claims have not been proven scientifically. However, claims have not been conclusively disproven, either, which means that EMFs present a more ambiguous hazard than any of the other issues we have previously discussed.

Despite the lack of decisive evidence, EMFs are still an influential factor in some people’s decisions about buying or selling property, so real estate professionals should have some degree of knowledge about them.
Real Estate Professionals and Electromagnetic Forces

Because the possible dangers of EMFs have been a subject of media attention, potential buyers may ask questions about these fields when considering a property likely to be affected by them. Commercial buyers may request EMF testing as a part of the usual environmental audit. Residential buyers may include EMF testing as a part of a structural inspection. Lenders may also require such testing. Utility companies usually offer testing for free or for a reasonable price; individuals can conduct their own tests inside a residence by holding a small Gauss meter near appliances and checking measurements room to room. This device costs about $150.

WATER DAMAGE

Unregulated surface water creates a different sort of environmental hazard, one that can do serious damage to property and to people. Most water-damage suits involve flooding resulting from rainwater runoff. The law generally does not hold an individual landowner responsible for damage to neighboring properties that results from natural occurrences like rain or wind. However, in some cases the courts may consider an individual’s alteration of his or her property to be the real cause of the damage (for example, if a landowner reroutes a creek to flow near or onto a neighboring property). There are two rules that have traditionally been applied to determine responsibility in water damage cases: the Common Enemy Doctrine and the reasonableness rule. We will discuss these in more detail shortly, as well as liability costs for the party at fault and homeowner’s insurance.

COMMON ENEMY DOCTRINE

This doctrine gives individual property owners an absolute right to dispose of surface water. Its name arises from the common law idea that unregulated surface waters are the common enemy of property owners, each of whom may manage them as he or she thinks best fit. This includes using retention, diversion, repulsion and course alteration to control the flow of water. Because property owners have this right, there is not cause for legal action even if the chosen water management method causes injury or damage.

Because the Common Enemy Doctrine gives landowners this broad right, it is seldom invoked in its original form by contemporary courts. Instead, the right to manage unregulated waters on one’s land is tempered by the reasonableness rule.

REASONABLENESS RULE

Under the reasonableness rule, all property owners are legally required to use their property in a way that does not cause unnecessary damage to other people
or other people’s property. When this rule is invoked, an individual will be held responsible for water damage to neighboring properties if it is determined that he or she has made an unreasonable change to his or her land. For example, if a landowner constructs a house without any kind of gutter system, then a court may find that landowner responsible for water damage to a neighbor’s property if it can be shown that the damage was caused by unregulated runoff from the house.

It is not the case that a “reasonable” land use is one that causes no damage to neighboring properties. The reasonableness rule generally inclines courts to consider the benefit created by an alteration to a property as compared to the damage the alteration causes (or might cause) to neighboring properties. If, for example, the change creates a major benefit but only a small amount of damage, this land use is likely to be judged reasonable and the landowner may not be held liable for damages to neighboring properties.

Although the Common Enemy Doctrine plays some role even in contemporary water damage cases, the reasonableness rule continues to play a large role. Additionally, landowners should be aware that many states have their own laws governing the diversion and management of unregulated water on privately owned land.

**COMPENSATION**

Individuals who are found to be legally responsible for water damage to another property (or properties) may have to compensate the injured party (or parties) for:

- Expenses generated by the water damage (such as the cost of having water pumped out of a flooded home).
- Medical bills and mental anguish.
- Repairs to the damaged property.

If a court judges that the person responsible for the damage acted malevolently, he or she may also be ordered to pay punitive damages. If, for example, a person intentionally diverts water onto a neighbor’s property out of, say, spite (i.e., with the intention of causing harm or damage), he or she may be punished by having to pay other fines, in addition to the compensations mentioned earlier.

If a landowner can easily prevent future damage to neighboring properties, courts will often order him or her to do so. If preventing this future damage would require extensive or expensive changes to the land, then preventive measures are less likely to be legally required. For example, a landowner might have to clean out a creek bed to prevent future flooding, but would probably not be ordered to entirely change the property’s landscaping in an attempt to control runoff patterns.
HOMEOWNERS’ INSURANCE

When neighboring properties are damaged because of a landowner’s actions, his or her homeowners’ insurance may compensate the injured parties for exterior water damage. Neighboring homeowners are more likely to receive compensation when the damage originates from inside a neighbor’s residence. In this case, the neighbor’s homeowner’s insurance company may pay for the damages and seek compensation elsewhere.

None of this should be taken to suggest that homeowners’ insurance take the place of flood insurance. Homeowners’ insurance does not generally cover the damage caused by naturally occurring floods.

SUMMARY

This lesson has covered the main environmental hazards associated with a property’s exterior, that is, with the ground upon which a structure is built and the area surrounding the property.

Ineffective management of hazardous waste, which creates toxic waste sites, in turn spawns many exterior hazards. A toxic waste site is an area identified by the EPA as containing a concentration of hazardous materials. Two major pieces of legislation establishing rules for toxic waste sites are the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), also called Superfund, and the Small Business Liability Relief and Brownfields Revitalization Act.

CERCLA defines hazardous materials and makes provisions for allocating liability among responsible parties. This Act imposes strict liability as well as joint and several liability on those who transport and dispose of hazardous material, and for the current and past owners of the contaminated site. In some cases the owners of contaminated sites are not held liable for the damages, if they can establish that the innocent landowner defense applies in their situations. The original provisions for the innocent landowner defense specified that landowners must show that they conducted “all appropriate inquiries” into the environmental condition of their properties, thus demonstrating that they had taken the proper steps to evaluate the land, and yet remained genuinely unaware of environmental problems at these sites. However, the vagueness of the phrase “all appropriate inquiries” made it difficult to use the innocent landowner defense successfully.

The Small Business Liability Relief and Brownfields Revitalization Act aims, in part, to clear up this vagueness by establishing a standard specifying tests and practices that should indicate “all appropriate inquiries.” This Act also provides additional incentives for the purchase and revitalization of brownfields. However,
the Act also imposes additional burdens on those who would use the innocent landowner defense.

PCBs are chemicals that have played a large role in creating some of the toxic waste sites that are affected by the legislation we have just discussed. They are mixtures of synthetic organic chemicals, the many useful properties of which made them popular for industrial and commercial endeavors. The production of PCBs has been banned in the U.S. since 1977; they are associated with many serious health problems in human beings and are suspected carcinogens. If a real estate professional knows that a property may be affected by or contaminated with PCBs, this information should be disclosed to prospective buyers.

Underground storage tanks (USTs) are another significant source of environmental contamination. The EPA defines an underground storage tank (UST) as any tank (and its connected underground piping) that has at least 10 percent of its volume below ground. The EPA’s UST regulations apply only to USTs that contain either petroleum or hazardous substances. In addition to regulating the structure and upkeep of USTs, the EPA has also established regulations defining the financial responsibilities of UST owners and operators.

Real estate professionals also need to be aware of the controversy surrounding electromagnetic fields. EMFs may or may not pose a significant health risk, but commercial or residential buyers, as well as lenders, may wish to conduct testing to determine the extent of EMF exposure that people may receive on or in a particular property.

Unregulated surface water creates a different sort of environmental hazard, one that can do serious damage to property and people alike. Two rules are generally invoked in water damage cases: the Common Enemy Doctrine and the reasonableness rule. The Common Enemy Doctrine establishes a landowner’s absolute right to regulate surface water as he or she sees fit, relieving him or her of liability for damage to neighboring properties that may result from these management efforts. However, this rule is seldom solely used in contemporary cases; instead, the rights it grants are tempered by the reasonableness rule. This rule requires that efforts to manage surface water be conducted in a reasonable way, that is, in a way that does not cause unnecessary damage to others or to their property. If a landowner’s actions are judged to be unreasonable, then he or she can be held liable for the damages caused by those actions, and the landowner may have to compensate injured parties for repairs, expenses and general distress.

Return to your on-line course player to take the Lesson Quiz.
LESSON THREE
LEGISLATION

This lesson focuses on the following topics:

- Clean Water Act and Wetlands Protection
- Endangered Species Protection

INTRODUCTION

In the previous two lessons, we covered different types of environmental hazards, both those found within a structure and those found outside of it. In the last lesson, we discussed some of the legislation that has been enacted in an attempt to manage environmental hazards, specifically the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA, also called the Superfund) and the Small Business Liability Relief and Brownfields Revitalization Act.

This lesson will discuss other pieces of legislation that were created to help protect surface water, wetlands and endangered species. Obviously, these things are not themselves environmental hazards. However, all of them can be significantly affected by the release of toxic substances, and their destruction creates an important kind of harm to our natural environment, just as does the release of toxic substances.

CLEAN WATER ACT AND WETLANDS PROTECTION

CLEAN WATER ACT

Congress passed the Clean Water Act (CWA) in 1972, as an amendment to the Water Pollution Act of 1948; the general aim of both of these pieces of legislation is keeping the nation’s water free from pollution. The CWA is also known as the Federal Water Pollution Control Act. This Act has three main goals: to lower the amount of pollution deposited directly into water bodies, to control contaminated runoff and to financially support wastewater treatment facilities. These measures help conserve the water that we use for recreation, as well as the water that also serves as a resource for fish and other wildlife.

The CWA’s focus is surface waters; it does not address groundwater, nor does it regulate water usage. The Act aims to preserve the chemical, physical and biological integrity of these waters. It tries to achieve this broad goal by using both regulation and non-regulatory tools like voluntary compliance programs to decrease the pollution levels in surface water. Regulation focuses largely on “point sources,” which are localized sources of pollution such as sewage plants.
and industrial facilities; some point sources are created by wet weather—for example, urban storm drains often become point sources during heavy rains.

LEARN MORE:
The EPA makes the full text of the Clean Water Act available online. You can view it here: http://www.epa.gov/r5water/cwa.htm.

WETLANDS PROTECTION

While the Clean Water Act is definitely important, real estate professionals and their clients are more likely to need information about wetlands. This is true because it is much more common for people to buy or lease property that contains wetlands than it is for them to buy or lease surface water. Wetlands management is connected with the Clean Water Act because Section 404 of that Act (particularly parts [c] and [q]) speaks to the permitting process involved in dredging, draining and filling in wetlands. A Section 404 permit is required for discharges in mudflats, sand flats, wetlands, sloughs, prairie potholes, wet meadows, playa lakes and natural ponds, in addition to intrastate lakes, rivers and streams. Destruction of these areas was determined to affect interstate commerce.

In the past, swampy, marshy or water-saturated soils were considered a source of sickness and a breeding place for disease-bearing mosquitoes. For these reasons, farmers were encouraged to drain or fill these areas. Large areas of wetlands were also eliminated in federal flood-control projects, canal building and mosquito control projects.

Scientists later learned that wetlands have many beneficial effects, including helping to control flooding, filtering pollution out of water that drains through their area, cleaning drinking water and providing habitats for fish and other wildlife. This knowledge led to the passage of environmental legislation with far-reaching results for the preservation and creation of wetlands. However, the term “wetlands” has not been easy to define.

Definition

As defined by the U.S. Army Corps of Engineers (hereafter “Corps”), wetlands are "areas 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.” This broad definition leaves many landowners with little understanding of what it means for their particular property. For example, if cattails are growing in a landowner’s swampland, then it most likely qualifies as a wetlands area since it features vegetation adapted to these wet areas. Other areas may be more
difficult to classify, because the phrases “normal circumstances” and “prevalence of vegetation” in the Corps’ definition are open to interpretation.

Both the Corps and the EPA exercise regulatory authority over wetlands. In 1987, the two agencies combined to produce the *Federal Wetlands Determination Manual*, which explains the technical criteria that define wetlands in greater detail. This manual does not, however, distinguish between natural and man-made wetlands. Thus, it could be the case that a wet area in a cornfield, say one created by a farmer’s irrigation system, might be classified in the same way as an ancient cypress swamp in the Florida Everglades.

Decorative lakes or water hazards on golf courses can also become protected wetlands. The only way to be certain about whether an area falls under the wetlands definition is to request that the Corps make an inspection of the area and issue its own determination. Each of the 26 Corps District Offices throughout the country has the authority to make these determinations. Landowners must bring suit in federal court to overturn a Corps decision; they have no right to administrative appeal.

**Protection**

Wetlands are protected by environmental law and may not be damaged, altered or destroyed. If a person disturbs a wetland, even before it has been defined as such, the result can be enforcement action, including the assessment of administrative, civil and criminal penalties.

A legal loophole is used to allow drainage of wetland areas. In 1993, the administration attempted to solve the problem, but drainage was restored as a legal procedure in 1996. However, several restrictions apply:

- The streamlined drainage procedure applies only to residential property and does not apply to land used for business purposes.
- The government expects the landowner to minimize any damage to wetlands. For instance, on a 10-acre lot featuring half an acre of wetlands, one cannot build on the half-acre of wetland; rather, one must choose a site from the remaining nine-and-a-half acres of non-wetland property.
- Only one permit can ever be obtained for each parcel of land. This means that if the present owner is permitted to drain or otherwise disturb wetland on a property, no future owner will be allowed to disturb other wetland areas on the property.

A regulatory change made in the summer of 1995 affected small tracts of land containing half an acre, or less, of non-tidal wetlands; it allowed landowners to seek an expedited permitting process if they were building a single-family home by filing for a Nationwide Permit (NWP) 29. However, Nationwide Permit 29 was
suspended in 1998; then, in 2002, a revised version of Nationwide Permit 29 was enacted. The requirements of the new NWP are fairly detailed; of primary importance for our purposes are the stipulations that any wetlands drainage, filling or disturbance covered by permit must:

- Be for the building of a single-family home to be used as a personal residence by the individual seeking the permit.
- Not cause the loss of more than one quarter of an acre of non-tidal waters, including non-tidal wetlands.
- Take all practicable actions to minimize on-site and off-site effects of the drainage or disturbance.
- Be used only once per parcel.

**LEARN MORE:**

**Controversy**

Wetlands have generated a great deal of controversy under the Clean Water Act because of the burdens that wetlands management and preservation can impose on landowners. For example, landowners argue that small potholes do not affect interstate commerce, and therefore do not fall under the jurisdiction of the federal government. However, the Corps has ruled that if migratory waterfowl can use a pothole for a resting area, then interstate commerce is affected (this rule is also known as the "glancing goose rule").

A 1995 court case supports the rule. The defendant in this case owned property abutting a national wildlife refuge and the tidal arm of a bay. Until 1959, the property had been used for salt manufacturing; it still featured pits that had been used to collect and crystallize salt. During much of the year, the pits remained dry, but during the winter and spring, rainwater created temporary ponds used by migratory birds.

**ENDANGERED SPECIES PROTECTION**

The Endangered Species Act (ESA) of 1973 can have a profound impact on the value of land because it can impose strict limits on what sort of development, if any, is permissible there. The scope of this Act has been substantially expanded by bureaucratic regulations over the years; landowners have given it increased attention as its reach has grown. The 1973 version of the Act was intended to protect endangered species on federal land; it was passed by a vote of 92-0 in
the Senate and 355-4 in the House. In spite of this overwhelming initial support, the Act quickly caused serious consternation when it threatened to shut down construction of the Tellico Dam in Tennessee to protect the snail darter.

When Congress first passed the Endangered Species Act, it mandated that protected, endangered species should be identified by the best scientific and commercial data available. However, no specific standards have been set that tell us how to determine “best available” data; the agencies responsible for overseeing and enforcing the Act currently make their own determinations without peer review.

The standards that do exist for making these determinations specifically require that economic consequences shall not be considered. Economic considerations are precluded because so little is known about the value of any particular endangered species to the environment; similarly, we usually know very little about the value of preserving a environment as an integrated ecological whole, versus eliminating one or more of the species that inhabit it. Even if we did know the value or importance of these things, it would be difficult to translate their worth into the simple dollar figures generally used by developers and landowners. For these reasons, the individuals making judgments under the ESA are discouraged from using economic consequences as a metric for their decisions.

**TAKING IS PROHIBITED**

The Act prohibits the taking of any endangered species listed by the federal government. In this context, “taking” means the killing of any listed plant, animal, fish or insect. Also, U. S. Fish and Wildlife Service regulations forbid harming or harassing an endangered species, which is understood to include modifying, damaging or destroying habitat areas, even though the species may not be present at the time or in that specific location. An unintentional violation may receive a $500 fine, and a knowing or intentional violation can result in a fine of $25,000 to $100,000, and up to one year in jail. The regulatory definition of “taking” is broad and it has not been clearly defined by case law.

These issues are important because some developers and landowners have tried to evade the ESA’s restrictions by removing endangered species from their land or by trying to drive the protected species away. These regulations make such actions illegal; the fines associated with prosecution are intended to make this conduct unattractive to landowners and developers who might have thought this was a simple way to get around the ESA.

**COMPENSATION**

The 5th Amendment to the U. S. Constitution includes a provision requiring that landowners be compensated when private property is taken for public use.
(“…nor shall private property be taken for public use without just compensation.”). In the past, this clause has been interpreted to mean that compensation is due only when property is taken under eminent domain. As we noted earlier, legislation and regulation like the ESA can greatly restrict the ways in which a landowner can use and develop private land. As a result, complicated Constitutional law issues have arisen around the partial taking of property, in which landowners maintain their titles but must respect significant federal limits on the exercise of their property ownership rights.

Whether a landowner is entitled to compensation because of ESA restrictions on his or her land remains a complex issue that is generally decided on a case-by-case basis. Questions about what constitutes appropriate compensation are similarly controversial and no general standard has been set in case law.

**ACTIVIST CHALLENGES**

One by-product of the ESA is the provision for a legal procedure by which environmentalists and no-growth activists can challenge any new development. The Act authorizes citizen suits to compel the Secretary of the Interior to enforce the ESA’s provisions when they are being violated. It also allows recovery of awards and attorney’s fees in connection with private actions.

Response to this provision has been mixed. Some developers and landowners see these challenges as posing a substantial increase in the financial risks associated with any new development, creating increases in costs that the consumer must eventually bear. However, these challenges are rarely made without good cause, and when landowners and developers are violating the ESA it is important that this be brought to the attention of regulatory agencies. Preserving our natural environment provides benefits to us all, benefits which many people believe are worth whatever cost may be created by these challenges.

**SAFE HARBOR AGREEMENT**

The strict requirements of the ESA have encouraged some landowners to engage in illegal activities in an effort to evade the requirements of the ESA, activities that result in exactly the damage to species and habitats that the law was enacted to prevent. For this reason, the U. S. Fish and Wildlife Service has recently been making deals, called “Safe Harbor Agreements,” that relax some sections of the law. For example, golf course developers in the Carolinas have agreed to provide a habitat for the Red-cockaded Woodpecker, a species attracted to the open spaces of golf courses, in exchange for a government promise not to legally impair the future use of their land. In this case, owners and developers were able to continue using land in the way they had chosen while
making special provisions for the species that was affected by their choice of land usage. When options like these exist, people are less likely to take extreme and illegal measures that result in the destruction of species and their habitats.

**SUMMARY**

This lesson has covered legislation that aims at preserving important elements of the natural environment, such as surface water, wetlands and endangered species.

Wetlands were once considered to be little more than breeding-places for disease. We know now that wetlands serve many useful functions, such as controlling flooding and filtering pollution from runoff water. The U.S. Army Corps of Engineers has defined the distinguishing features of a wetland, but this definition is not as clear or specific as some people might like. To resolve confusion created by the initial definition, the EPA and the Corps produced the Federal Wetlands Delineation Manual. This manual helped to clarify matters, but did not distinguish between natural and man-made wetlands areas. The only sure way to identify wetlands is by subjecting the area in question to a Corps inspection and determination.

Once an area is identified as a wetland, it is protected by special legislation. Wetlands may not be damaged, altered or destroyed, but some small wetlands areas may be drained for residential purposes, with a proper government permit. Even with this permit, development activities are importantly limited. For example, no more than a quarter of an acre of wetlands may be disturbed on any individual lot, and these permits are not issued for commercial developers.

The Endangered Species Act of 1973 originally protected endangered species living on federal land. Bureaucratic expansion of the law's scope, however, has established rules for privately held lands; the requirements imposed on private land can have a profound impact on value, because they can significantly limit what sort of development, if any, is permitted.

The ESA requires that the best scientific and commercial data available be used to determine the presence of endangered species and their habitats. However, there are no set standards to help a person determine what it is that makes a particular set of data the “best available.” The Act prohibits the killing, or “taking,” of any plant, animal, fish, or insect listed as endangered. U.S. Fish and Wildlife Service regulations also prohibit harming or harassing an endangered species, which includes modifying, damaging or destroying habitat, even when a species does not currently reside there.

These laws can complicate issues for landowners because they can render land effectively unusable for development purposes. Landowners who are judged to have violated the ESA and its associated regulations can be tried for civil and
criminal penalties. An unintentional violation may warrant a $500 fine, while an intentional violation can result in a fine of $25,000 to $100,000, and up to one year in jail for the violator.

The ESA allows citizen suits to challenge any new land developments that are believed to be violating the Act. The strict requirements of the ESA have led some landowners and developers to take illegal measures in an effort to eliminate endangered species from their land. To discourage this kind of behavior, the U.S. Fish and Wildlife Service has begun to make deals, called “Safe Harbor Agreements,” that relax some sections of the law.

Return to your on-line course player to take the Lesson Quiz.
LESSON FOUR
DISCLOSURE AND SITE ASSESSMENT

This lesson focuses on the following topics:

- Appraisal and Property Contamination
- Environmental Site Assessment
- Effects on Licensees and Lending

INTRODUCTION

This lesson focuses mainly on appraisers’ responsibilities for reporting environmental contamination. Appraisers need to be aware that they may face civil or criminal charges for not reporting possible hazards. Because environmental issues receive such widespread coverage by the media, and because general information about contamination continues to evolve, everyday knowledge of these subjects will only expand. Appraisers must be prepared to deal with an increasingly educated population, many individuals of whom are actively concerned about environmental hazards.

APPRAISAL AND PROPERTY CONTAMINATION

Appraising environmental contamination on a property is a very serious responsibility. When an appraiser fails to notice or properly understand a serious environmental problem, lenders, landowners and homeowners (that is, whoever has employed the appraiser) can bring claims against the appraiser for failing to recognize the problem. In these cases it is possible for an appraiser to be charged with contributory negligence, which can be very damaging both professionally and financially. While there are no specific case-law examples, nothing shields appraisers from these types of charges or from being found liable for damages suffered as a result of the defective appraisal, such as environmental remediation costs.

APPRAISER RESPONSIBILITY

An appraiser should strive to provide clients with at least the same level of expertise provided by his or her colleagues in the area. Ideally, he or she will strive to surpass the quality of the standard services offered. This goal is important for two reasons:

- Appraisers lose their competitive edge when they fail to provide a service that other appraisers consistently provide.
- Appraisers expose themselves to liability risks if they fail to notice hazards that most other appraisers would notice.
The appraiser may be the only expert eye looking at the property, and may be the client’s only hope of noticing undisclosed contamination. Lenders, landowners and homeowners all have good reason to prefer appraisers who are well educated and sensitive to environmental issues.

**Secondary Market Investors**

Secondary market investors like Fannie Mae (the Federal National Mortgage Association) also have a clear interest in accurate environmental appraisals, because they provide some of the funds that are lent to homebuyers. Fannie Mae outlines its general policies in Part XI, Chapter 3, section 307 (“Properties Affected by Environmental Hazards”) of its *Selling Guide*, last updated in June of 2002. In this section, they state the following position:

“When the appraiser has knowledge of any hazardous condition (whether it exists in or on the subject property or on any site within the vicinity of the property)—such as the presence of hazardous wastes, toxic substances, asbestos—containing materials, urea-formaldehyde insulation, radon gas, etc.—he or she must note the hazardous condition in the appraisal report and comment on any influence that the hazard has on the property’s value and marketability (if it is measurable through an analysis of comparable market data as of the effective date of the appraisal) and make appropriate adjustments in the overall analysis of the property’s value.”

We do not consider the appraiser to be an expert in the field of environmental hazards. The typical residential real estate appraiser is neither expected nor required to be an expert in this specialized field. However, the appraiser has a responsibility to note in the appraisal report any adverse conditions that were observed during the inspection of the subject property or information that he or she became aware of through the normal research involved in performing an appraisal.”

Appraisers need to report any suspected environmental issues. However, they are not expected to be scientific experts, and unless they have the help of an environmental professional, they are not generally qualified to identify unusual types of contamination, to estimate the cost of remediation or to estimate the value of an environmentally troubled property.

**Appraisal Foundation Advisory Opinion**

The Appraisal Foundation’s Appraisal Standards Board has issued an advisory opinion entitled “The Responsibility of Appraisers Concerning Toxic or Hazardous Substances Contamination” (Advisory Opinion G-9), which offers some useful advice on this topic. This opinion, which is part of the Uniform Standards of Professional Appraisal Practice (USPAP), emphasizes the
importance of honesty and professional competency. Appraisers who lack the education or qualifications needed to perform a particular appraisal should not claim or imply that they have the proper expertise. They need to represent their knowledge of environmental issues honestly and accurately.

To compensate for gaps in their knowledge or qualifications, appraisers may reasonably rely on the findings and opinions of other properly qualified specialists and may work in concert with other professionals in multidisciplinary groups. However, an appraiser who works in this way must acknowledge the contributions these other professionals have made to his or her report.

Appraiser Awareness

Appraisers can come to be aware of environmental contamination on a property in several ways:

- Thorough disclosure by the client
- By using facts known prior to the appraisal
- Thorough observation or research
- By working with environmental experts

Disclaimer

Because most appraisers are not trained as experts in the scientific identification of environmental hazards, an appraisal report should always include an environmental expertise disclaimer or statement of limitation. These statements should carefully describe the level of care and detail involved in the inspection, and should specify the appraiser’s level of expertise. Disclaimers and statements of limitation can protect appraisers from liability risks. However, only a qualified attorney can give advice about the specific features of a disclaimer that will actually offer solid legal protection; appraisers should seek this kind of advice before including disclaimers in their reports.

VALUATION OF CONTAMINATED PROPERTIES

There is no standard formula for valuing contaminated properties, nor is there a generally accepted method. The value of a contaminated property cannot be measured by simply deducting the remediation cost estimates from the estimated value of the property as if it were problem-free. We cannot figure value in this way because other factors beyond remediation costs may affect value, including any negative effects on marketability created when the property is known to have been the site of past contamination and the persistence of environmental hazards.
NOTE:
In some appraisals, an appraiser may be asked to value a contaminated property as if it were uncontaminated. This is a complex process, requiring that the appraiser meet numerous requirements.

Peter Patchin, MAI, has written on the valuation of environmentally contaminated properties; in his work, he divides market-value loss into three categories: cleanup costs, liability to the public and stigma after cleanup.

Cleanup Costs

Environmental professionals can provide cost estimates based on what the owner wishes to do about the environmental contamination and what the EPA requires that he or she do about it.

Liability to the Public

Contamination on one property may affect, and even contaminate, surrounding properties. For example, waste might seep into deep aquifers that supply local wells and springs with water. In such cases, owners of neighboring properties may bring liability lawsuits against the owner of a contaminated property.

Lingering Stigma after Cleanup

The lingering stigma of contamination (past, present or suspected) cannot be easily measured or understood. It varies according to the situation, the location and the type of contamination. Seriously contaminated properties are unmarketable, but valuing more mildly contaminated properties, or properties suspected of being contaminated, presents a challenge. The very suspicion of contamination affects value because potential buyers fear they may be compromising their own safety.

EVALUATION OF ENVIRONMENTAL PROFESSIONALS

When working with environmental professionals to enhance the competency and completeness of an appraisal report, appraisers must make certain that they have a clear and accurate picture of these other professionals.

When working with environmental consulting firms, an appraiser should check:

- Their expertise in the indicated problem.
- Whether or not they appear on a state-approved list of contractors, if appropriate.
- The education and experience of the firms’ managers.
- The services and support the firms offer.
- Their regulatory expertise.
Their insurance coverage.
Their references and contract terms.

When working with environmental law firms, an appraiser should check:

- The attorneys’ experience.
- The attorneys’ educational backgrounds (if they are experts in fields other than law—such as the sciences or engineering—this is a plus).
- The attorneys’ continuing education—that is, how well they have kept up with developments in their field.
- Their regulatory experience.
- Their field(s) of specialization.
- Their fee structures.
- Their references.

In both cases, reference checks are particularly important. Only by checking references can an appraiser develop a sense of how the consultant or firm being considered works with clients.

ENVIRONMENTAL SITE ASSESSMENT

ENVIRONMENTAL IMPACT STATEMENT

The National Environmental Policy Act of 1969 requires that the drafter(s) of a federally funded project submit reports outlining the effects that the project is expected to have on the environment. These reports are called environmental impact statements (EIS). State and local governments use similar statements to evaluate the environmental effects of new projects or zoning change requests. Environmental impact statements can address any or all of the following:

- Noise
- Air quality
- Public health and safety
- Wildlife
- Vegetation

Statements may also include an analysis of the need for sewer and water facilities and anticipated changes in population density, vehicle traffic, energy consumption, employment and school enrollment.

These statements must be made available to the public, and open hearings must be held to provide an opportunity for public comment on the statements. These hearings offer a chance for civic groups and private citizens to voice their ideas about modifications and alternatives before a project begins. The highly detailed information provided in an environmental impact statement also prepares
government agencies to administer any additional services that might be needed as a result of the project. In addition, municipalities use this information to charge developers the appropriate impact and user fees.

ENVIRONMENTAL SITE ASSESSMENT

An environmental site assessment (ESA), also called a due diligence audit, is an investigation carried out to identify any environmental hazards or concerns that could affect the use of a property or impose future financial liability on its owner. An environmental professional or a team of professionals conducts the property examination that makes up the central part of an ESA. You may recall that the innocent landowner defense, discussed in Lesson Two, required an assessment under CERCLA. An ESA is not the same as an Environmental Impact Statement, nor should it be confused with an environmental audit, which evaluates a company’s business practices in terms of how well they conform to environmental law.

Site assessments range from fairly cursory to highly detailed. Any property, from an industrial site to an undeveloped tract of land, has the potential for unique problems, so each property must be addressed individually and dealt with accordingly. Assessments protect the seller, the buyer, the lender and the licensee because they increase all of these individuals’ understanding of the property so that they can adapt their attitudes and goals accordingly. For example, sellers can determine the cost of remedial work and factor it into sales negotiations, while buyers can limit their exposure to unknown and expensive cleanup liabilities after purchase. Similarly, lenders generally want to know about any hazards or other environmental considerations that might negatively affect a property’s market value.

Phases of Site Assessment

There are three phases of site assessment. This does not mean that there are three steps in every assessment, but rather that there are three types of site assessment, each of which is called a “phase.” The extent of the environmental damage to a site will determine whether it requires a Phase I, Phase II or Phase III assessment.

Phase I Assessment

This is the most basic type of site assessment performed by an environmental professional. It requires no materials or samples to be taken from the property.

**FAST FACT:** Recall that the EPA was to establish a standard for Phase I site assessment no later than January 2004. However, as of August 2004, the ASTM Standard E 1527-97 (reissued as E 1527-00) still provides interim guidelines, pending adoption of a final rule.
The purpose of E 1527 is to “determine whether a piece of property is affected by ‘Recognized Environmental Conditions’ (‘REC’) —the presence or likely presence of any hazardous substance or petroleum products on a property under conditions that indicate an existing release, a past release, or a material threat of a release of any hazardous substances or petroleum products.”

**Phase II Assessment**

In a Phase II assessment, environmental professionals examine specific environmental problems that have been identified on a property. They send samples of groundwater and soil for laboratory analysis, and when necessary, evaluate the viability of a specific cleanup plan.

**Phase III Assessment**

The most expensive and extensive assessment involves a detailed plan that addresses a specifically identified problem. It requires site remediation and often requires regulatory agencies to participate and approve the assessment. But because not all hazards are immediately visible, and because some hazards may remain hidden, a thorough investigation of the site should be conducted.

**NOTE:** These three different assessments have distinct objectives. A property’s intended use may dictate the need for certain tests, or specific environmental problems may simply be suspected. These factors can influence the type of assessment that is performed or deemed necessary.

**Examining a Property**

Before inspecting the site itself, examiners review its historical usage by looking at old aerial photographs, chain-of-title searches, topographic maps and old building plans.

On-site inspectors search for barren brown patches, strong odors, pipes that protrude from the ground or anything out of the ordinary that might indicate environmental contamination. They consult regulatory agencies and interview any personnel familiar with the site. Neighboring properties also need to be thoroughly checked for pesticide drainage, toxic wastes or illegal dumping that could contaminate the property being assessed. In both commercial and multi-family dwellings inspections, inspectors specifically look for asbestos, lead-based paint and urea-formaldehyde foam insulation (UFFI).
HIRING A SITE INSPECTOR

Although appraisers may notice obvious problems, buyers and lenders should hire a specialist who is trained to find environmental hazards such as asbestos or UFFI and to identify the problems posed by nearby industrial plants or commercial establishments that use oil or chemical products.

Unlike some other forms of engineering, environmental engineering does not yet have a specific code or standard, and only a few states have any certification requirements. There are, however, two types of consultants available: a specialty consultant who looks at only part of the site on a limited basis and a full-service consultant who will handle aspects of cleanup. When hiring a contractor or inspector, one should do the following:

- Determine whether the firm is technically qualified, and whether it meets its deadlines.
- Determine whether the firm has staff members with education or experience that is specifically relevant to this sort of project.
- Ask to see the reports from previous projects. Are the reports comprehensive? Do they identify the scope of assessment?
- Ask for and check references. Were their clients pleased? Was the work done in a timely and cost-efficient fashion? Perhaps most importantly, would former clients use the consultant again?
- Interview state and federal agencies, environmental attorneys and colleagues in the industry to help verify a firm’s competency.
- Find out whether the firm uses subcontractors. If they do, you will need to investigate these subcontractors as well.
- Determine whether the consultant or a third party, separate from the company, will do the work.
- Find out what certification(s) the consultant has, if any.

EFFECTS ON LICENSEES AND LENDING

Environmental issues occupy an increasingly prominent role in commercial real estate transactions and, to a lesser degree, in residential transactions. Whenever salespeople are aware of information about the environmental condition of a property that could affect a prudent purchaser’s decision to buy, they must disclose that information. Therefore, licensees should be aware of environmental issues and the laws and regulations pertaining to them, so that they can better judge what kind of information they are obligated to disclose.

There are a number of factors that can make it difficult to develop a clear understanding of environmental issues, including the large number of environmental laws, the ways in which they overlap and the many regulatory agencies involved with their implementation and enforcement. Vague and
loosely written laws can also create the potential for innocent and unintentional violations. Failure to comply with these laws and regulations can result in massive liabilities for landowners or the loss of private property to federal or state custody, without compensation. Because they expose us all to potential harm, many environmental violations can result in criminal penalties.

The complexity of the laws, and the seriousness of the penalties for violating them, should be enough to discourage most licensees from not advising their clients about environmental law. However, it is worth reminding real estate professionals that unless they are also licensed attorneys, they should not offer their clients anything that might be construed as legal counsel.

LAND VALUE

Aside from the issues arising from liability for environmental hazards, environmental risk has become an important factor in all real estate transactions due to the potential impact on land value. Environmental damage is not always visible on the surface. It may be deep underground or it could be seeping in from neighboring property. However, under current law, a landowner’s ignorance of an environmental problem does not relieve him or her of liability, even when he or she had no role in creating the contamination.

Conducting a professional environmental investigation before acquiring a property may help to reduce potential environmental risks. Environmental assessments are a standard requirement in all commercial transactions. For residential loans, lenders often rely on an appraiser’s evaluation of possible contamination on or near the property to determine whether further assessment will be required.

LICENSEE DISCLOSURE OBLIGATIONS

Like appraisers, licensees should disclose any information about environmental problems that might affect a prudent buyer’s decision. Buyers need advice about many environmental issues so they can decide what tests they would like performed prior to purchase. Some environmental problems recur in certain areas and licensees should be especially certain to advise buyers about the existence of persistent problems like these.

In addition to discussing hazardous materials, licensees should discuss some natural factors with their clients. These include natural disasters in areas that are prone to hurricanes, earthquakes, tornadoes, fires, or volcanoes; more generally, licensees should discuss the potential problems posed by floodplains, wetlands, high water tables and steep slopes. Licensees should also make certain to disclose any knowledge they might have regarding the existence of endangered species or their habitats on a property.
To protect themselves against charges of nondisclosure, real estate licensees should encourage all parties to identify problems and defects as early in the transaction as possible. While licensees can offer some guidance on these issues, they should also encourage prospective buyers and others to seek professional counsel. It is important to note that licensees should mention and support these investigations prior to entering into contracts.

**Recommendations**

Many clients turn to their real estate professional for assistance in hiring a professional advisor or service provider when a problem is discovered. For this reason, it is important that licensees investigate whether their state has certification requirements for environmental professionals; if there are certification standards, licensees should obtain listings of certified consultants to share with their clients. Whatever the task entails, they should encourage the clients to specify that they are seeking a defined testing or assessment standard, like that described in the ASTM standard.

To avoid potential liability, real estate licensees should be cautious in recommending professionals. It is prudent to offer clients a list from which they can make their own selection, rather than recommending a single professional who may or may not provide satisfactory service. Each brokerage firm needs to establish a standardized approach to handling client requests for names of environmental inspectors.

**LOAN REQUIREMENTS AND PROTECTION**

**Home Loans**

The term "residential" can apply to multi-family properties, but environmental law treats multi-family properties as commercial real estate. An EPA rule grants owner-occupied multi-family dwellings a broad exemption from liability for cleanup of toxic waste sites.

As mentioned earlier in this lesson, an appraiser evaluating a property for a home loan must report any obvious contamination on or near a property. Appraisers should also report any charges of environmental violations against the homeowner to the mortgagee (that is, to the lender).

**Commercial Loans**

Almost all commercial loan applications must include an environmental site assessment. This includes loans for multi-family dwellings. Until recently, precisely what a complete environmental assessment requires was not clearly defined, and requirements still vary among different lenders. Market terminology does not always make a distinction between a Phase I Assessment and an
environmental site assessment; for this reason, licensees should make sure that all parties involved have a mutual understanding of what will be covered in any particular assessment.

**Bankers’ Environmental Risk Insurance**

Commercial real estate lenders have had a difficult time determining the risk level associated with certain loans that could entail environmental hazards. In an effort to understand and manage these risks better, borrowers usually engage in extensive site research and buy insurance coverage. Recently, another option, called “bankers’ environmental risk insurance,” has become available. It insures lenders when a loan goes into default, and there is environmental contamination on the property. The insurance either covers the cost of cleaning up the property or it pays off the balance of the loan. This helps the lender avoid foreclosing on contaminated property and thereby becoming liable for cleanup costs.

**Secondary Markets**

While home loans dominate the secondary market, some commercial loans are moving into the hands of secondary market investors. For multi-family loans, both Fannie Mae and Freddie Mac require a Phase I Assessment with information on asbestos, polychlorinated biphenyls (PCBs), radon, underground storage tanks, waste sites, lead-based paint and other hazardous contaminants.

**SUMMARY**

An appraiser may be the only person who looks at a property who has sufficient education and experience to identify environmental issues. Though appraisers are not usually specialized environmental professionals, they still need to disclose any obvious or suspected environmental hazards in their reports. That is, they are not expected to have the insight of a specialist, but they are expected to notice the kind of problems that would be noted by their peers—failure to do so would create liability issues. The appraiser’s comments regarding a suspected environmental hazard should lead to a more formal assessment by a trained environmental expert. There exists no standardized formula for the valuation of contaminated properties, but Peter Patchin (MAI) notes that cleanup costs, liability to the public and lingering stigma after cleanup should all be considered when calculating the value of a contaminated site.

All federally funded projects must submit an environmental impact statement, which is a highly detailed report outlining the project’s anticipated environmental effects. Government agencies, municipalities and the public all use the information contained in this statement to evaluate the project and to prepare for any action(s) they might need to take regarding the project.
Environmental site assessments, also called due diligence audits, are professional investigations carried out to identify environmental hazards. Phase I assessments are the most basic. Phase II assessments address an identified problem; they involve sampling and may evaluate clean-up plans. Phase III assessments outline a detailed plan to address an identified problem, and often require the approval of regulatory agencies. Whenever a property is being inspected, those responsible should make a thoughtful and educated choice about the environmental consultants employed to carry out the assessment. It is imperative that real estate professionals familiarize themselves with the role that an ESA plays in an innocent landowner defense, so they can advise their clients of its importance. The ESA must be done prior to a purchase of land if it is to relieve potential buyers of any liability.

Environmental issues occupy an increasingly prominent role in real estate transactions. Licensees must disclose any environmental information that might affect a prudent buyer’s decision. Environmental concerns should be addressed as early as possible to avoid charges of nondisclosure. Although prospective buyers often ask licensees to recommend an environmental professional, many firms provide a list and encourage buyers to interview and evaluate several professionals before making a selection.

Appraisers who are assessing property for home loans need to report any environmental problems to the mortgagee. Commercial loan applications now require an environmental site assessment; multi-family properties are considered commercial properties, and thus, require this kind of assessment as well. Bankers’ environmental risk insurance helps lenders avoid foreclosing on contaminated property and, thereby, becoming liable for potential cleanup costs.

Return to your on-line course player to take the Lesson Quiz.
LESSON FIVE
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Environmental Hazards Activity
- Field Applications Concerning Environmentally Hazardous Material

INTRODUCTION

This module has covered a lot of specific information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided in this module, using a series of exercises and case studies. The first half of this lesson presents a list of environmental hazards that must be matched up with their associated health problems, remedies and legislation. The second half presents brief case studies that examine the principles and ideas presented in this module. Upon completion, the student should have a better understanding of the real-world applications of the information he or she has been studying in this module.

ENVIRONMENTAL HAZARDS ACTIVITY

In this exercise, you will be presented with a series of sentences regarding health problems, remedies and legislative acts associated with specific environmental hazards. You will have a word bank from which to choose the environmental hazard that correctly completes each sentence. Some of the environmental hazards in the word bank may be used more than once, while others might not need to be used at all. You must complete all sentences correctly to proceed.

WORD BANK

- Environmental Hazards
- Asbestos
- Electromagnetic Fields (EMFs)
- Formaldehyde
- Hazardous Waste
- Lead
- Mold
- Polychlorinated biphenyls (PCBs)
- Radon
- Underground storage tanks (USTs)
- Water Damage
Health Issues

1. Coughing, breathing difficulties, sore throat and upper respiratory infections are symptoms associated with exposure to _____.

2. Some individuals have claimed that _____ cause(s) cancer, but these claims have not been scientifically proven.

3. _____ is one of the leading causes of lung cancer in the United States.

4. _____ has/have been linked to acne-like skin conditions in adults and adverse effects on the liver.

5. Eye, nose and throat irritation are symptoms of exposure to high levels of _____, which has been linked to nasal cancer in animals.

6. Exposure to high levels of _____ may cause slowed growth, hearing problems, headaches and learning and behavioral problems such as hyperactivity in children.

7. _____ has/have been linked to cancer of the lungs, stomach, and intestines.

Remedies

1. Children should be kept away from old electrical equipment, old appliances and areas of previous transformer fires to minimize the health risks of exposure to _____.

2. To decrease _____, owners should decrease the moisture content in the air and increase ventilation.

3. Sealing all exposed surfaces of particleboard furnishings with multiple layers of water resistant sealants—such as polyurethane, vinyl laminate, lacquers, alkyd paints or other water-resistant coatings—will help minimize exposure to _____.
4 Replacement, encapsulation and caustic and offsite chemical stripping are several ways to deal with _____ in paint.

5 The EPA suggests in-place management programs for dealing with _____, the proper disposal of which is often very expensive.

6 Sealing cracks in basement floors and pipe openings can help in managing _____.

Legislation

1 The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) addresses the management of _____.

2 The Common Enemy Doctrine pertains to _____.

3 The Resources Conservation and Recovery Act (RCRA) of 1976, includes an amendment requiring the EPA to develop comprehensive regulation covering _____.

4 The Business Liability Relief and Brownfields Revitalization Act is concerned, in part, with the management of _____.
Health Issues

1. Coughing, breathing difficulties, sore throat and upper respiratory infections are symptoms associated with exposure to ______. Mold

2. Some individuals have claimed that ______ cause(s) cancer, but these claims have not been scientifically proven. Electromagnetic Fields (EMFs)

3. ______ is one of the leading causes of lung cancer in the United States. Radon

4. ______ has/have been linked to acne-like skin conditions in adults and adverse effects on the liver. Polychlorinated biphenyls (PCBs)

5. Eye, nose and throat irritation are symptoms of exposure to high levels of ______, which has been linked to nasal cancer in animals. Formaldehyde

6. Exposure to high levels of ______ may cause slowed growth, hearing problems, headaches and learning and behavioral problems such as hyperactivity in children. Lead

7. ______ has been linked to cancer of the lungs, stomach, and intestines. Asbestos

Remedies

1. Children should be kept away from old electrical equipment, old appliances and areas of previous transformer fires to minimize the health risks of exposure to ______. Polychlorinated biphenyls (PCBs)

2. To decrease ______, owners should decrease the moisture content in the air and increase ventilation. Mold

3. Sealing all exposed surfaces of particleboard furnishings with multiple layers of water resistant sealants—such as polyurethane, vinyl laminate, lacquers, alkyd paints or other water-resistant coatings—will help minimize exposure to ______. Formaldehyde
Replacement, encapsulation and caustic and offsite chemical stripping are several ways to deal with ____ in paint. **Lead**

The EPA suggests in-place management programs for dealing with _____. The proper disposal of which is often very expensive. **Asbestos**

Sealing cracks in basement floors and pipe openings can help in managing _____. **Radon**

**Legislation**

1. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) addresses the management of ____. **Hazardous Waste**

2. The Common Enemy Doctrine pertains to _____. **Water Damage**

3. The Resources Conservation and Recovery Act (RCRA) of 1976 includes an amendment requiring the EPA to develop comprehensive regulation covering _____. **Underground storage tanks (USTs)**

4. The Business Liability Relief and Brownfields Revitalization Act is concerned, in part, with the management of _____. **Hazardous Waste**

**FIELD APPLICATIONS CONCERNING ENVIRONMENTALLY HAZARDOUS MATERIAL**

Please consider the following case studies. After reading the details of each situation, think about how one could resolve the dilemma or complication. Keep in mind that environmental legislation protects the public’s welfare, so your response must not only serve the individual(s) directly involved in the situation—it must look out for the community, as well.
CASE STUDY ONE

Homeowner A has lived in the same house for 15 years. Homeowner B has just finished building a new house next door, which stands on higher ground. Homeowner A leaves town for a week; he returns to find extensive water damage to his wooden porch and evidence of flooding on the east side of his home, which is adjacent to Homeowner B's property. Homeowner A has never had problems with flooding before. Is Homeowner B responsible for the damage to Homeowner A’s home?

Write your response in the space provided and check your answer on the next page.
CASE STUDY ONE RESPONSE

Homeowner B may or may not be liable, depending on whether and how the features of the new home contributed to the problems on Homeowner A’s property. If, for example, Homeowner B failed to install drainage gutters, or built a drainage ditch which flows directly onto Homeowner A’s property, then in all likelihood Homeowner B will have to pay for the damage to Homeowner A’s home because the alterations he has made to his land will be deemed unreasonable, given that it was easy to foresee the problems they would create. If, however, Homeowner B made only reasonable alterations to the property, then under the reasonableness rule Homeowner A might have to pay for the damage. Perhaps the rain was unusually heavy while Homeowner A was out of town, and thus, the weather is more to be blamed than Homeowner B. Ultimately a court must decide responsibility.

CASE STUDY TWO

Landowner A decides to build an apartment complex on a piece of land that she has owned since January 2000. During the initial site preparation, workers unexpectedly discovered an old underground tank. A professional soon determines that it has been leaking toxic waste into the ground, and the property is eventually identified as a toxic waste site. Infuriated, Landowner A wishes to find the previous owner, who she believes should be required to clean up the mess and to compensate her for the problems it has created. The previous owner cannot be found, and Landowner A did not have an environmental site assessment performed before she bought the property. What options does Landowner A have?

Write your response in the space provided and check your answer on the next page.
CASE STUDY TWO RESPONSE
Regardless of whether Landowner A had found the previous owner, she is still at least partially liable for cleaning up the site. Landowner A cannot invoke the innocent landowner defense. She purchased her property in January of 2002; for all properties purchased after May 31, 1997, the innocent landowner defense requires that a Phase I environmental site assessment following the ASTM standard be performed prior to purchase. Had Landowner A performed such a site assessment, she might have been able to avoid liability. Remember, CERCLA establishes strict and joint and several liability for current and past owners, as well as those involved in arranging the transportation of toxic wastes to and from the site and permitting the disposal of toxic wastes at the site. If Landowner A can determine who was responsible for the toxic waste transport and disposal that affected her site, those individuals will also be held legally responsible for cleanup.

CASE STUDY THREE
Commercial Property Owner A has heard of health problems associated with asbestos. Concerned about liability, he asked Licensee B what he should do about asbestos-related problems. Homeowner A suggests to Licensee B that he is a skillful construction worker and can easily remove any materials that contain asbestos and replace them. What advice should Licensee B give to Commercial Property Owner A?

Write your response in the space provided and check your answer on the next page.
CASE STUDY THREE RESPONSE

Licensee B can tell Commercial Property Owner A that he should definitely be concerned about asbestos liability, because there have been many successful cases pressed against people who knowingly or negligently exposed people to asbestos. Inhalation of asbestos has been linked to cancer and asbestosis, a disease that seriously damages lung tissue. An EPA-certified inspector can examine his property for any problems and can send material samples to a laboratory to determine their asbestos content.

Licensee B should also tell Commercial Property Owner A that he should not remove any materials that are known or suspected asbestos-containing materials on his own; not only does he expose himself to health risks by doing this, there are also federal and state laws governing the handling and disposal of asbestos. Commercial Property Owner A may wish to consider an in-place management plan, as removal is often extremely costly and stable asbestos does not pose any significant hazards. Under such a plan, maintenance, custodial and administrative staff members are trained about working with the asbestos in their building, and tenants and other occupants are informed of the presence of asbestos in the building.

CASE STUDY FOUR

Licensee A is walking through Seller B’s house and, while entering the bathroom, she notices a musty odor and small black spots on the wall. She suspects that these spots may be mold. Should Licensee A inform Seller B of this possible mold problem? Prospective Buyer C will be visiting the house any minute; should Licensee A tell him about the possible problem?

Write your response in the space provided and check your answer on the next page.
CASE STUDY FOUR RESPONSE
The licensee has a responsibility to inform both the buyer and the seller about a possible mold problem. Molds represent a potential health problem and are damaging to the home; the presence of mold is thus the kind of problem that might influence a prudent buyer’s decision(s) about a property. Because the mold has most likely been caused by excess moisture, Licensee A may recommend that Seller B reduce the moisture content in the air, increase ventilation or increase the temperature to help solve the mold problem.

CASE STUDY FIVE
Homeowner A’s home was built in 1956; he now wishes to rent this property out for the first time. He plans to find a tenant immediately, and in several months he wishes to renovate a portion of the house. He wants to know what, if any, information needs to be provided to the new tenant. What advice can a licensee give Homeowner A?

Write your response in the space provided and check your answer on the next page.
CASE STUDY FIVE RESPONSE

The licensee should inform the homeowner that, according to a joint final ruling issued by HUD and the EPA, renters of houses built before 1978 must disclose the presence or potential presence of a lead-based paint hazard to tenants.

As a renovator of a house built before 1978, the owner has additional responsibilities. If more than two square feet of paint will be disturbed in the renovation process, he must give the occupants a copy of the EPA document *Protect Your Family from Lead in Your Home*. He must provide this information at least 60 days prior to this disturbance and needs to obtain the tenants’ signatures as proof that they have received this information.

CASE STUDY SIX

Landowner A submits plans to the city for the construction of a restaurant. She acquired the property a year before, had a Phase I site assessment performed, and has finally organized the financing to move forward with her development plans. She receives permission from the city, but citizens in the community who oppose her plans have discovered the presence of an endangered species of beetle on her property. They wish to challenge her development. Is their challenge cause for concern? If courts eventually decide that she must not develop her land because of the beetles' presence, will she receive compensation?

Write your response in the space provided and check your answer on the next page.
CASE STUDY SIX RESPONSE

Under the Endangered Species Act (ESA), activists may compel the Secretary of the Interior to enforce the provisions of the ESA, which in this case would mean enforcing protection of the endangered beetle. If the beetle does actually live on her property, Landowner A’s development plans will likely be thwarted and she will be forced to leave the beetles, as well as their habitat, undisturbed. Furthermore, she will probably not receive compensation from the federal government for the effective loss of her land because the overall benefits of the ESA apply to her just as much as they do to any other citizen. It just so happens that giving up her development plans is part of the burden she must bear to gain the benefits of this legislation.

CASE STUDY SEVEN

Landowner A possesses a seven-acre lot in the country and wishes to build a house there. The location on the property that offers the best view also happens to be a generally boggy area. There are no other wet areas like this on the property. Landowner A wishes to build on this spot. After consulting with her builder, she has discovered that she can easily drain the water and fill in the site to make it stable. Can she drain the area and build at her chosen site?

Write your response in the space provided and check your answer on the next page.
CASE STUDY SEVEN RESPONSE

She must first determine whether the wet area on her property fits the definition of a wetlands. The best way to find this out is to ask inspectors from the Army Corps of Engineers to evaluate the area. If the area is not a wetland, Homeowner A can probably proceed with her plans. If the area is a wetland, however, several restrictions apply. Under normal circumstances, Landowner A could likely obtain a permit to drain less than a quarter of an acre of wetlands area, because she is building a home that she intends to occupy. However, the law requires that even people building personal residences make some effort to protect wetlands areas.

In this particular case, Landowner A most likely would not be able to obtain a permit, because she wishes to disturb the only wetlands area on a seven-acre tract of land. The law would probably expect that she build somewhere else on her property, even if those other possible locations offer (in her opinion) a less attractive view.

CASE STUDY EIGHT

Seller A notices cracks in his home’s basement floor. He approaches Licensee B and asks her if these cracks might pose any kind of problem. He does not want to expose himself to a possible liability. What advice should Licensee B give to him?

Write your response in the space provided and check your answer on the next page.
CASE STUDY EIGHT RESPONSE

Licensee B should inform Seller A that radon could be seeping through these cracks and into the home. The licensee should recommend testing, especially if the house is heavily insulated or is otherwise an energy-efficient home. If the tests detect radon gas, these cracks in the floor should be sealed. Licensee B might also encourage the seller to install ventilation fans to help diffuse any radon that does get into the basement.

CASE STUDY NINE

Homeowner A, the recent purchaser of a manufactured home, noticed that the home came with a warning that it had been built with materials containing formaldehyde. Since moving in a month before, she has noticed that her eyes often burn and her throat feels irritated. She suspects that formaldehyde is the cause. What actions can Homeowner A take to determine whether formaldehyde is the problem, and what can she do to fix it?

Write your response in the space provided and check your answer on the next page.
CASE STUDY NINE RESPONSE
Homeowner A can either hire a professional to evaluate the levels of formaldehyde in her home, or she can buy a testing device that she can use and then send it to a reputable company for analysis. If testing suggests that formaldehyde is the cause of her health problems, then she can take several steps to reduce its presence in the air. She can seal any exposed particleboard furnishings with sealants like vinyl laminate, alkyd paints, polyurethane or lacquers. UFFI and other materials known to emit substantial amounts of formaldehyde might be replaced or properly sealed so that they do not release formaldehyde into the air inside her home. Increasing ventilation may help, but studies have shown that this may not be a sufficient solution on its own.

CASE STUDY TEN
Licensee A takes a prospective buyer, Buyer B, to look at a house. Several large power lines run overhead in the property’s back yard. Buyer B seems concerned and asks Licensee A if these power lines emit electromagnetic fields, and whether those fields really are damaging to one’s health. What should Licensee A tell the buyer?

Write your response in the space provided and check your answer on the next page.
CASE STUDY TEN RESPONSE

Because electricity runs through the power lines, it is more or less certain that the lines emit electromagnetic fields (EMFs). Research has not yet proven that strong electromagnetic fields cause any health problems, but Licensee A should take care to explain to Buyer B that there is indeed a possible risk. Because some reasonable people believe that EMFs may cause health problems, licensees risk accusations of non-disclosure if they fail to address this issue.

Licensee A should encourage Buyer B to gather the information he needs to make his own judgment about the property. For example, the prospective buyer may have EMF testing performed; utility companies usually offer free or low-cost EMF testing.
# Texas Principles of Real Estate

## Module 8: Deeds

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| Total Lesson Time: | 210 minutes (3.5 Hours) |
INTRODUCTION

A deed is a written instrument that is commonly used to convey title to real property. Consequently, all real estate professionals must have a clear understanding of the uses and purposes of different types of deeds. This module also illustrates the difference between the concept of title and the concept of a deed.

The first lesson of this module reviews the requirements of a legally enforceable contract. A deed is a legal contract made between two parties for land conveyance; therefore, the requirements for a deed to legally convey the title to real property are also reviewed and explained in detail.

The second lesson of this module covers types of deeds and their different uses. Types of deeds for voluntary land conveyance differ in the extent of covenants and warranties on title offered to the grantee. The most common types of deeds for voluntary land conveyance are general warranty deeds, special warranty deeds, bargain and sale deeds and quitclaim deeds. The lesson then identifies other types of deeds that may be used for special purposes.

All states have distinctive legislation pertaining to title conveyance. As a result, the third lesson of this module outlines relevant state statutes that affect the creation and execution of deeds, including those that differentiate between the unauthorized practice of law and the lawful role of real estate professionals.

The last lesson in this module is a real estate practice lesson in which the student is presented with real world situations that licensees might face in the field. This lesson gives the student an opportunity to employ his or her knowledge, and to use material presented in this module in determining how to properly manage ethical predicaments and problematic transactions.
KEY TERMS

Bargain and sale deed: A deed without warranties with which a grantor may transfer all of his or her ownership interest to a grantee. A bargain and sale carries no guarantees as to the condition of the title; however, the grantor does acknowledge that he or she has title to and possession of the interest to be conveyed.

Contract: A legally enforceable document made between two or more parties who promise either to engage in or refrain from doing some action for consideration.

Deed: A written instrument (usually under seal) that, when properly delivered and accepted, transfers or conveys a property owner’s right, interest or title in a property.

Deed books: A collection of records in which copies of deeds are recorded, usually located in the county clerk’s office or recorder’s office; these volumes of records are also called “libers.”

Deed of reconveyance: (also called a “release deed”) A deed used to transfer title from the trustee back to the trustor (borrower) upon full repayment of a deed of trust loan.

Deed of trust: (also called a “trust deed”) A special purpose deed that conveys title to a neutral third party, with the understanding that title will be returned to the original owner once certain conditions are met. This type of deed can be used when property is offered for security on an outstanding debt, creating a security device similar to a mortgage.

Escrow: An agreement between two or more parties that requires certain instruments and/or property be placed with a third party for safekeeping, pending the fulfillment or performance of a specified act or condition.

General warranty deed: A deed in which the grantor guarantees a good and clear title, attesting to the absence of any title defects that arose prior to and during the grantor’s period of ownership; this deed carries all available covenants and warranties.

Quitclaim deed: A deed that releases a grantor’s interest, if any, in a subject property to a grantee while making no claims as to the existence of title or title defects; a deed that, out of convention, conveys unknown interest. Quitclaim deeds are often not recognized as proof of title or ownership, nor do they guarantee that there are no other ownership claims on the property.
Special warranty deed: A deed, most commonly used by fiduciaries, in which the grantor guarantees the absence of title defects created only during his or her ownership (i.e., it makes no warranties for title defects that may have been created prior to this grantor’s ownership); a conveyance instrument attesting that the grantor has not clouded or otherwise impaired or encumbered title.

Statute of frauds: A law that requires certain contracts be in writing in order to be legally enforceable; contracts pertaining to the sale of land or the sale of interest in land, as well as other real estate contracts such as leases, must be in writing.

Title: Is the legal right of property ownership—the intangible, just possession of real estate.

LEARNING OBJECTIVES

Upon completion of the course, the student will be able to:

- List the general requirements of a legally enforceable contract.
- Describe the difference between title and deed.
- Explain the basic use and purpose of deeds.
- Identify the required elements of a deed.
- Recognize the different types of deeds and identify what type of deed should be used, depending on the quality of estate and condition of title to be transferred.
- Distinguish between the role of a real estate professional and the role of a licensed attorney in real estate transactions.
- Describe state laws pertaining to title conveyance.
LESSON ONE
INTRODUCTION TO DEEDS AND TITLE CONVEYANCE

This lesson focuses on the following topics:

- Contracts
- Deed Versus Title
- Deeds
- Elements of a Valid Deed

INTRODUCTION

This lesson will familiarize the student with the definition of a contract and a deed. It will also present other instruments of land conveyance in addition to deeds and discuss the different elements of a contract that are necessary for valid land conveyance. We’ll begin our discussion with the definition of a contract and the elements of a legally enforceable contract.

CONTRACTS

When two or more parties willingly agree to perform or refrain from performing a specific action, their agreement is acknowledged by a legally enforceable document called a contract. A deed is a type of a contract, because it acknowledges an agreement to convey title to real property from one party to another. Although states may have specific criteria for legally enforceable contracts, the following elements are typically found in all contracts.

ELEMENTS OF A LEGALLY ENFORCEABLE CONTRACT

In order for a contract to be legally enforceable, it must:

- Be entered into by **legally competent parties**.
- Contain **mutual assent** by all parties to the contract.
- Contain a **lawful objective**.
- Involve **consideration** (i.e., something of value given to show acceptance or acknowledgement of a contract, such as funds or a promise).
- Be in **writing**, as required by the Statute of Frauds.
More Info—

Legally competent parties: An individual who enters into a legally binding contract must be of legal capacity to contract. Age and competence are two considerations of legal capacity. Generally, a party must be at least 18 years or older; minors cannot be party to a legally enforceable contract. All contracting parties must also be of sound mind, meaning that they have not been, or would not be, declared mentally incompetent by a judge. A person who is under the influence of drugs or alcohol may also be judged to be temporarily incompetent to contract.

Mutual assent: Mutual assent, also called “mutual consent” or a “meeting of minds,” means that the contracting parties voluntarily agree to the terms and conditions of the contract. No party may be forced into a contract by an undue or hostile influence. Mutual assent is generally established through the offer and acceptance of specific terms and conditions.

Lawful objective: A contract seeks to effect an agreement. This objective is the purpose of the contract, and no contract with an illegal purpose is legally enforceable. No court of law may force an individual to perform an illegal action, and the terms of such contract cannot be upheld.

Consideration: Consideration is an item of value or performance of some action that the parties promise to exchange as a demonstration that they acknowledge and agree to the terms of the contract. Consideration may be money, property, forbearance or the performance of services. Usually, consideration takes the form of a reciprocal promise. For example, a seller may agree to transfer title to real property if the buyer fulfills his or her promise to pay the seller a certain amount of money. The inclusion of consideration distinguishes a contractual exchange from a gift.

In writing: Although many types of contracts may be oral or written, the Statute of Frauds requires that most contracts be in writing in order to be legally enforceable. Contracts for the conveyance of title to real property must be in writing. We will discuss the Statute of Frauds in more detail later in this lesson.

DEED VERSUS TITLE

It is very important for property owners and real estate licensees to understand what is meant by the term “title”, how title may be transferred from an owner to another party, and what distinguishes a title from a deed. The term “title” refers to ownership rights in real property—having or holding title means that a person owns interest in the property and is entitled to a bundle of rights associate with it. These rights include the right to possession, enjoyment, control, use and exclusion to the owned property. A “deed” is a written instrument used to legally
transfer title from one person to another by voluntary conveyance. When a deed is recorded in public record, it serves as physical proof of the title holder’s ownership rights to a property. Under no circumstances are these terms interchangeable.

**DEEDS**

A deed is a type of contract that conveys title to and ownership interest in a parcel of real property from one party to another. Deeds as they are used and executed today have evolved from origins in 17th century England.

**HISTORICAL DEVELOPMENT OF DEEDS**

Up to the year 1677, land in England was passed between individuals by a traditional ceremony. The owner of the land, or grantor, would pass a clump of earth to the receiving individual, or grantee, before witnesses to demonstrate that he or she was transferring ownership of the land. This simple ceremony was sufficient at the time because land sales were rare, and most land transferred by inheritance. Also, witnesses who could attest to the rightful transfer of land rarely relocated, and could be called upon to verify the owner’s rights.

However, the lack of any tangible evidence of a transfer made this system largely inadequate as land sales became more frequent, and individuals who once acted as witnesses began to relocate. Furthermore, because evidence of land ownership depended almost entirely upon witnessed testimony, this system was vulnerable to fraud. Because bribing or coercing witnesses could at some times secure land ownership, some individuals were deprived of their rightful possession(s).

In response to these acts of corruption, England passed a law referred to as the Statute of Frauds, also called “An Act for Prevention of Frauds and Perjuries,” in 1677. This law required all contracts pertaining to the transfer of land interest be documented in writing. The implementation of this law in 1677 led directly to the development of a deed, as it is used today.

Many states in the United States have adopted laws that are similar to the original Statute of Frauds. However, there is no federal statute on this subject, and states possess the authority to implement regulations for the creation and execution of contracts within their jurisdictions.

**OTHER INSTRUMENTS OF LAND CONVEYANCE**

The process and act of transferring property from one party to another is called “alienation.” Alienation may be voluntary, usually by sale or gift, or involuntary, usually by an operation of the law. The most common instrument for voluntary
alienation is a deed. However, voluntary alienation may also occur by dedication or through will.

**Dedication:** Dedication is the voluntary gift of one’s land to the public. Some dedications are philanthropic and are conveyed to the government for the good of the public. Other dedications often result from the development of a subdivision. For example, when a developer buys a large parcel of land and intends to develop a subdivision, he or she must pave some of the land with streets to service the lots. After a subdivision is developed, the developer will usually dedicate the paved streets to the public by transferring all street rights to the government by a cession deed.

**Will:** A last will and testament specifies the names of individuals to whom a property owner wishes to distribute his or her property after death. A person who dies with a will is said to have died testate. A valid will is similar to a deed, in that it is an instrument for voluntary alienation. The recipient of real property by will is called a devisee while the recipient of personal property by will is called a beneficiary. Generally, there are three types of wills. A “formal” will is prepared by an attorney and signed by the testator (the grantor) before witnesses. A “holographic” will is handwritten and prepared entirely by the testator, while a “nuncupative” will is an oral will communicated to witnesses by a person who has an immediate fear of dying. However, most states do not recognize nuncupative wills for the transfer of real property, only for personal property.

The title to real property may also be transferred by involuntary alienation. Involuntary alienation occurs without the express consent of the property owner, and usually by an operation of law such as adverse possession, easement by prescription, eminent domain, escheat, descent or reversion. Accession is also a type of involuntary alienation that may occur by natural or artificial means.

**More Info—**

**Accession:** Accession refers to the acquisition of new land or real property by artificial or natural means. Natural means of accession include the gradual accumulation of rock, the recession of a lake or river or the accumulation of water-borne soils. Artificial accession occurs through labor and man-made improvements, for example, when someone combines elements of personal property (cement, lumber, etc.) to build a house. This process does not employ or require an instrument of conveyance, such as a deed.

**Adverse possession:** Title may be transferred by adverse possession when a person develops legitimate ownership interests in another person’s property through an openly hostile and continuous occupation of the land. In this case, the adverse possessor does not have permission to use or occupy the property, but has some kind of claim or right to the land.
—that is to say, the adverse possessor cannot simply stroll onto someone else’s property and claim it as his or her own. Most states have specific requirements that must be met for title to transfer by adverse possession. These requirements usually include a continuous and openly hostile possession of the property without permission from the owner, a claim on the title, payment of taxes on the property by the adverse possessor, and the owner’s failure to take action to reclaim the land. Essentially, adverse possession occurs when a property owner “sleeps on his rights.”

**Easement by prescription:** An easement or “right-of-way” is the right to use or access a part of someone else’s property for a specific length of time and for a particular purpose. Easements are usually expressly included in an instrument of conveyance, such as a deed or a lease. However, a person can also acquire an easement by prescription (or a “prescriptive easement”) through a continuous and adverse use of a property, rather than through any formal instrument of conveyance. In an easement by prescription, the possessor does not have permission from the owner to use the land, and does not pay the owner for its use.

**Eminent Domain:** At all times, the government has the right to take private property from an owner by the power of eminent domain. This process of taking private property is called “condemnation,” and is legal provided that the taking is for the public benefit and use, if the owners are justly compensated and the owners’ rights are protected by due process.

**NOTE:** Due to recent legislation, it remains to be seen whether or not the former rights of the property owner by due process will continue. Under previous legislation, the property owner could not challenge the taking of his or her property. However, if the property owner felt like the allotted compensation was unjust or inadequate, testimony or evidence bearing upon the use, condition, occupancy or operation of the property might prove admissible in fixing compensation or damages.

**Escheat:** If an individual dies not having left a will, also called *intestate*, and has no surviving spouse, lineal descendents or other known heirs, the decedent’s property will pass to the state by the legal doctrine of escheat. Via escheat, the decedent’s ownership interest in any property is transferred directly to the state, without his or her consent.

**Descent:** If an individual dies not having left a will, his or her property will descend to heirs by intestate succession. This means that because there is no valid will a probate court of the state distributes any property to the decedent’s legal heirs by the statute of descent and distribution. The probate court gives precedence of property distribution to the decedent’s
blood relatives; e.g., the decedent’s surviving spouse, children, parents and siblings.

**Reversion:** A reversion is a future interest in land that is created when a grantor transfers a qualified interest to another party for a specific amount of time, under the condition that the interest will revert to the grantor when that period expires. For example, when a grantor transfers property for a term of years, ownership of that property returns to the grantor when that term expires. Reversion can also refer to a grantee’s forfeiture of property whereby the property reverts back to a grantor as a result of improper property usage. For instance, if a grantor specifically states in a deed that a property may only be used for residential purposes, and a grantee builds a commercial building on it, then the grantor may be able to reclaim the property as a result of the grantee’s violation of their contract.

**ELEMENTS OF A VALID DEED**

A deed must meet the requirements of a valid contract and satisfy all other state-imposed criteria in order to convey title successfully. Generally, a deed must:

- Name the **grantor** and the **grantee**. The grantor must have the legal capacity to be party to a contract.
- Describe the **consideration** exchanged in the transaction.
- Include a **granting clause**.
- Include a **habendum clause** that defines the quality of the ownership interest being conveyed.
- Include a **legal description** of the property.
- Include a statement of any **encumbrances**, including liens, deed restrictions and easements, and any **exceptions** or **reservations** associated with the property.
- Bear the **signature of the grantor**.
- Be **acknowledged** before a public official.
- Be **delivered to** and **accepted by** the grantee.

The following sections discuss each of these requirements in detail. At the end of this lesson, you will be asked to complete a review activity using terminology and concepts from this section.

**GRANTOR AND GRANTEE**

The name of the grantor must be included in a deed. The grantor is the individual who voluntarily conveys title to another person. In order to be party to the conveyance of title by deed, the **grantor** must be:

- 18 years of age or older
• Of sound mind
• Otherwise legally competent (i.e., generally capable of understanding a contract’s terms and conditions)
• A legally recognized entity or individual

It is critical that the grantor's name be properly and consistently spelled throughout the deed. If a grantor's name has changed since he or she acquired title, then any future conveyance document should include both the original and the changed names. This might, for example, be the case if a now-married woman acquired her home under her maiden name or if an individual legally changed his or her name for any other reason. If two names are needed, this information may appear on the deed in something like the following form:

“Alicia Mirza, now known as Alicia Moreno . . . ”

If a grantor is married, some states—including community property states—require the signature of the grantor’s spouse as well. When spouses have shared ownership rights in a property, both spouses must sign the deed in order for that deed to function as a complete conveyance of their ownership rights in a property.

The name of the **grantee** must also be included in a deed. The grantee is the individual who accepts the title from the grantor. Without a named, legally valid grantee, a deed cannot convey title. It is important to note that, unlike the grantor, the grantee does not have to be legally competent and need not sign the deed.

**CONSIDERATION**

All contracts, including deeds, require consideration. Consideration is a promise by the grantor and grantee to exchange something of value to demonstrate that both parties agree to the terms of the contract or deed. Consideration may be money, a specific item or the performance of services that both parties determine to be of value. Consideration must be included because it distinguishes a contractual agreement from a gift. Consideration may not be for the exchange of an illegal item or performance of an illegal act.

In most real estate transactions, consideration is the grantor’s promise to transfer the title to a property upon receipt of a payment from the grantee for an agreed upon purchase price. However, most deeds do not state the actual purchase price of the property. Instead, they contain a brief phrase that notes that the transfer involves consideration. Many common purchaser/seller deeds, for example, include a statement such as “. . . for ten dollars and other good and valuable consideration.” If a grantor transfers the title by gift, consideration may be phrased: “. . . for natural love and affection.” In both instances, the written acknowledgment of consideration is sufficient to satisfy the consideration
requirement. A deed contains the full consideration amount only when a corporation or trustee executes an instrument or when a court orders conveyance.

**GRANTING CLAUSE**

A *granting clause*, also called “words of conveyance,” is a formal statement that indicates the grantor’s wish to convey his or her current interest in a specific, identified property at that time. No deed may state that a grantor wishes to convey interest in the future. Deeds can only convey a current interest at the time of conveyance.

The extent and wording of a granting clause depends upon the type and quality of ownership interest being conveyed. For example, a granting clause may include any of the following phrases:

- “Grant"
- “Grant, bargain and sell”
- “Remise, release and quitclaim”

If there is more than one grantee, the granting clause must specify the type of interest passed to each party. Generally, the granting clause distinguishes what type of deed is being used.

**HABENDUM CLAUSE**

A *habendum clause* generally follows a granting clause, and describes the extent of the ownership interest that is being conveyed by the deed. A habendum clause usually starts with the phrase, “To have and to hold.” The habendum clause also often lists any conditions or limits imposed on the interest being transferred.

For example, if a grantor conveys a fee simple estate, the habendum clause might be written as:

“To have and to hold unto said Jessica Mao and to her heirs and assigns forever . . . ”

If a grantor conveys a life estate, the habendum clause might be written as:

“To have and to hold unto said Jessica Mao for the duration of her natural life . . . ”

The most common types of interest conveyed are fee simple estate and life estate.
Fee Simple Estate

A fee simple estate is the least limited, most absolute interest in real property. It is of indefinite duration, freely transferable and freely inheritable. When a grantor conveys a fee simple estate, the grantor conveys to the grantee full ownership of a property for the grantee’s lifetime. The grantee then has the right to use, occupy and dispose of the property as he or she sees fit. A fee simple estate may also descend to heirs.

Life Estate

A life estate is a more limited interest in real property than fee simple estate, because ownership is limited to the lifetime of the owner or some other designated party. The owner does not have the right to dispose of the property, nor allow the property to descend to heirs. Instead, a life estate owner may designate a third-party as a remainderman for the reversion. A reversion is the remaining estate of the grantor that is conveyed to the remainderman upon the grantor’s death. Life estates may be created by agreement of the parties, or by operation of the law.

LEGAL DESCRIPTION

Any property that is to be transferred by a deed must be properly identified in order to distinguish it from all other properties in the world. It is therefore necessary to include a legal description of the property in a deed. A legal description is defined as a method of describing the location of real estate that will be accepted by a court of law. Two methods commonly employed to describe real estate include metes-and-bounds and rectangular survey. Street addresses, district numbers and other forms of informal land description are not sufficient for deeds.

ENCUMBRANCES

An encumbrance is any claim or liability attached to real property that may lessen the owner’s bundle of rights or the value of the property. Encumbrances may affect the title to a parcel of real property or the physical condition of the property. The most common encumbrance that affects title is a lien. The most common encumbrances that affect the physical condition of the property are deed restrictions and easements.

Liens

A lien is a claim or charge against property, usually as security for a debt. Liens may either be specific or general; a specific lien attaches to a specific parcel of property, and a general lien attaches to all of a borrower’s real and personal
property. Specific liens include mortgage liens, ad valorem tax liens and mechanic’s liens. General liens include judgment liens and income tax liens.

A mortgage lien, for example, places a lien on a borrower’s property, pledging the property as collateral for payment of the debt to the lender. If a claim or lien on a property is not satisfied within a prescribed amount of time or if the borrower defaults on payments, the lienholder may foreclose on the property and use the proceeds from the sale to satisfy the debt.

**Deed Restrictions**

A deed restriction is a private land use control that limits the way a property may be used and developed. A deed restriction usually includes a time limit or renewal clause, and must be written into the deed in order to be legally binding. Deed restrictions that discriminate against racial, gender, age, familial status or religious classes are necessarily prohibited and void. Public restrictions, such as zoning ordinances, may also be written into deeds.

Most deed restrictions are restrictive covenants created by neighborhood associations or subdivision developers. Restrictive covenants typically regulate such design specifications as the minimum square footage for each home and the number and size of structures that may be placed on each lot. Restrictive covenants seek to stabilize the property value of the subdivision by making the properties homogeneous.

**Easements**

An easement is a non-possessory interest in, or a right to use, part or all of another individual’s land or property for a specific purpose and length of time. For example, if an individual wishes to use resources on another individual’s property, or to run wiring or pipes through owned land, he or she is likely to obtain an easement or right-of-way. An easement is an actual interest in land, and may be conveyed by a separate deed or by including the easement as a reservation in the deed.

**EXCEPTIONS AND RESERVATIONS**

An exception excludes from conveyance some part of the property that is to be conveyed by the deed. The grantor retains the title to the withdrawn part of the property by virtue of the original title rights. The term “exception” may also refer to any liens (such as mortgages, mechanic’s liens or tax liens) and encumbrances that are excluded from title insurance coverage.

Exceptions are any matters included in the “subject to” clause of a deed. For example, a deed for a property with an outstanding first mortgage may convey a title that is properly described as being “subject to an existing first mortgage loan,
which the grantee assumes and agrees to pay.” In the “subject to” clause, the grantor agrees to convey a clear and marketable title “subject to” certain exceptions.

Conversely, a reservation is the creation of a new right issuing out of the thing granted on behalf of the grantor. A reservation might be an easement to use the grantee’s property or the reservation of a life estate in the property. A right or interest cannot be reserved on behalf of a third party.

**APPURTENANCES**

Appurtenances are all rights, privileges and improvements that are associated with the property and are usually conveyed with the property by a deed. However, appurtenances are not part of the actual property, and may be excluded from conveyance if directly specified in the deed. Appurtenances generally include easements, water rights, parking spaces and improvements.

**GRANTOR’S SIGNATURE**

All the grantors listed on a deed must sign the deed to convey title. If for any reason, a grantor is unable to sign the deed, the deed may:

- Bear the grantor’s signature by mark.
- Bear the signature of an attorney-in-fact on behalf of the grantor

**Signature by Mark**

In most states, a grantor who is unable to write, or cannot otherwise sign his or her name may sign a deed using a mark. If a grantor signs using a mark, two or more witnesses must be present. A witness must print the grantor's name on the deed, next to a written statement of his or her witness to the signing. The grantor must then mark the deed next to his or her printed name, and all witnesses must sign the deed.

**Signature by an Attorney-in-Fact**

Most states also permit an individual acting under the power of attorney, an “attorney-in-fact,” to sign a deed on behalf of a grantor. An attorney-in-fact is an individual who, through specific written authority assigned by the grantor, may execute various legal documents in the interest of managing the grantor’s personal affairs. The assignment of power of attorney must be recorded in the county in which the property is situated. The signature of the attorney-fact on the deed must be subscribed by the attorney-in-fact’s own hand.
ACKNOWLEDGEMENT

Acknowledgement is an individual’s formal declaration that he or she is acting voluntarily. By signing a document before a public notary (or other duly authorized public officer who validates the authenticity of the grantor’s signature by checking forms of identification), this declaration is made. In essence, acknowledgment serves as public proof that signatories are who they say they are and that they are acting voluntarily. Acknowledgement is intended to prevent forgery or fraud.

Some states do not require deeds to be acknowledged in order to be valid. However, many states require that a deed be acknowledged before it can be recorded in public record.

DELIVERY AND ACCEPTANCE

Title actually passes from the grantor to the grantee when the deed is delivered to and accepted by the grantee. Either the grantor(s), the grantor’s attorney, a third party or an escrow agent may deliver the deed to a grantee. This delivery must occur during the lifetime of both the grantor and the grantee because title cannot be transferred either to or from an individual after death. If an escrow agent or other third party delivers the deed, then the delivery date is the day the deed passed to the third party.

Acceptance means that the grantee receives the deed and agrees to be bound by the terms of the agreement. Acceptance must be in writing, and may also be inferred from certain acts of the grantee, such as taking possession of the property, recording the deed or paying the sale price. Acceptance forgoes the need for the grantee to sign the deed.

It is important to note that the delivery date of a deed is not always the day the deed physically passes to the grantee. If a property is registered under the Torrens system, the title does not pass until the deed is authenticated and recorded.

Torrens System

In 1857, Australian Sir Robert Torrens developed a system of land registration in which all records pertaining to title to real property are registered in a public record. The Torrens system purports to provide individuals with the assurance that all rights or claims to a title are recorded in the system.

Although the exact provisions of the Torrens system vary, in general, the procedure for transferring title is the same. A property owner who wishes to transfer the title under the Torrens system must first file a written application with the appropriate authorities. This application must list all liens and encumbrances
pertaining to the status and condition of the property’s title. A court will then hold a hearing and give notice to all parties known to hold interest in the subject property that the owner intends to transfer the title. Any party who wishes to make a claim to title may then do so. If no other party makes a claim on the title, the title is determined to be clear, and it may pass by deed.

Only about 10 states use the Torrens System today. Other than the fact that the Torrens system of land registration confirms the existence of clear title, there are a few other advantages for owners under this system. For instance, the Torrens system does not eliminate the need for most titles to be insured by title insurance companies.

ACTIVITY

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<td>Acceptance</td>
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<td>Granting clause</td>
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<td>Grantor’s name</td>
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<td>Habendum clause</td>
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<td>Legal land description</td>
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<td>Restrictive covenant</td>
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<td>Signature</td>
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1. The deed provision, “Each dwelling must be at least 1,500 square feet, and only one single-family dwelling may be constructed per lot,” may be an example of a(n) _________________.

2. “Remise, release and quitclaim . . .” are words of conveyance that may be used in a(n) _________________.

3. The words, “To have and to hold…” commonly begin a(n) _________________.

4. The phrase, “For natural love and affection …” may be used to describe ________________ in a deed.

5. “Alicia Mirza, now known as Alicia Moreno” is an example of language that might be used to indicate the ________________ in a deed.
Matching Elements of a Deed ANSWERS

1
Restrictive covenant

Feedback: A restrictive covenant is a private land use control that limits the use and development of land. Homeowners’ associations and subdivision developers usually write restrictive covenants in order to give developments a more standard appearance, thereby protecting the overall value of the homes. Common restrictive covenants include minimum square footage for dwellings, and the number of dwellings that may be constructed on one lot.

2
Granting clause

Feedback: “Remise, release and quitclaim . . .” are words of conveyance that may be used in a granting clause. A granting clause is a formal statement in a deed that indicates the grantors’ wish to convey his or her current interest in real property at that time. The extent and wording of a granting clause indicates the type of deed being used to transfer title.

3
Habendum clause

Feedback: The words, “To have and to hold…” commonly begin a habendum clause. A habendum clause defines the extent of the estate being granted by the deed. For example, a habendum clause in a deed conveying a fee simple estate might include the words, “To have and to hold unto said grantee and his heirs and assigns forever…”

4
Consideration

Feedback: The phrase, “For natural love and affection…” may be used to describe consideration in a deed. All contracts—including deeds—must involve consideration. Consideration is the promise to exchange an item or service of value between the two contracting parties to demonstrate that both parties accept the terms and conditions of the contract. However, the consideration listed in a deed need not reflect the full or specific consideration that is actually involved in the transaction. For example, a deed that transfers title in exchange for money commonly contains a phrase such as “. . . for ten dollars and other valuable consideration. . . .” A deed that passes title “for natural love and affection” usually conveys title by gift.

5
Grantor’s name
Feedback: “Alicia Mirza, now known as Alicia Moreno” is an example of language that might be used to indicate the grantor’s name in a deed. All deeds must contain the grantor’s and the grantee’s name, and both must be spelled correctly and consistently throughout the deed. If the grantor’s name has changed since he or she acquired title, then both the grantor’s present and former names must be identified in the deed.

**SUMMARY**

A deed is a written instrument used to convey the title to real property. A deed is a type of contract, and must therefore satisfy all requirements of a valid contract to be legally enforceable. A legally enforceable contract must be entered into by legally competent parties, arise from mutual assent, have a lawful objective, involve consideration and be in writing to comply with the Statute of Frauds.

It is important to distinguish between a “deed” and a “title.” A deed is a contract, or instrument, used to convey ownership in real property. Title is the right to or ownership of land. Deeds may serve as evidence of ownership when they are recorded in the public record. The terms “deed” and “title” cannot be used interchangeably.

Most states share the same criteria for a deed to be considered legally enforceable. Generally, a deed must name the grantor and grantee, describe the consideration involved in the transaction, contain a legal description of the property, include a granting clause and a habendum clause, state any encumbrances on the title or physical condition of the property and bear the signature of the grantor. Deeds must be acknowledged before they may be recorded in the public record, and deeds actually and effectively transfer title when they are delivered to and accepted by the grantee.

In a deed, the grantor is the party who conveys title to the recipient party, the grantee. Consideration is the promise to exchange an item or service of value to demonstrate that both parties acknowledge and agree to the terms and conditions of the contract. Consideration may be a promise, money, property, forbearance or services rendered. A legal description is a land description that distinguishes the subject property from all other properties in the world.

A granting clause, also called “words of conveyance,” declares a grantor’s intent to convey his or her ownership interest in the subject property at the present time. A habendum clause clarifies the type and extent of the ownership interest being conveyed. For example, a habendum clause may clarify whether the deed conveys a fee simple or life estate.

Encumbrances are claims, charges or liabilities that affect title to a property or the condition of the property. Common encumbrances that affect title include
mortgage, mechanic’s and tax liens. Encumbrances that affect the condition of the property typically include deed restrictions, restrictive covenants and easements. Exceptions and reservations are included in the “subject to” clause of a deed, and are additional limitations on the property or its title. The grantor’s signature is required for valid conveyance, but an attorney-in-fact (i.e., an individual acting under a power of attorney agreement) may sign the deed on behalf of a grantor. A grantor can also sign his or her name by mark, provided that there are legally appropriate witnesses to the signing.

Although not always required, acknowledgement verifies the validity of the grantor’s signature and ensures that he or she is acting voluntarily. Acknowledgment involves signing the deed before a notary as a formal declaration that the person signing is who he or she claims to be and is acting voluntarily. Finally, after a deed has satisfied these requirements, it actually and effectively transfers title when it is delivered to and accepted by the grantee.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON TWO
TYPES OF DEEDS

This lesson focuses on the following topics:

- General Warranty Deeds
- Special Warranty Deeds
- Bargain and Sale Deeds
- Quitclaim Deeds
- Other Types of Deeds
- Business Executions

INTRODUCTION

The extent of ownership interest and condition of title to be conveyed by a deed determine what type of deed should be used. Types of deeds differ in the extent of protection given to the grantee by covenants and warranties, which cover title defects and ownership rights. The four most common types of deeds used are general warranty deeds, special warranty deeds, bargain and sale deeds and quitclaim deeds. This lesson will explain the concept of “title warranty,” and distinguish between the various deeds that carry warranties from those that do not.

There are other types of deeds that are not commonly used in most real estate practices. However, a familiarity with the purpose and function of these deeds contributes to a student’s complete understanding of deeds. The last section of this lesson explains how commercial groups and businesses execute deeds for title conveyance, and how business executions differ from residential property transactions.

Upon completion of this lesson, the student should have a firm understanding of the different types of deeds, what type of deed should be used to convey the title to an interest in real property and how the execution of a deed changes when a business entity or other commercial group is involved.

GENERAL WARRANTY DEEDS

A general warranty deed offers the grantee the most possible protection against past and future claims on title by carrying all available warranties and covenants. In a general warranty deed, the grantor essentially guarantees that there are no limitations or encumbrances on the title that are not otherwise expressly listed in the deed. The grantor also attests to the absence of any title defects that arose prior to and during the grantor’s period of ownership.
GENERAL WARRANTY DEED COVENANTS

A general warranty deed binds the grantor to the following five covenants:

- Covenant of seisin
- Covenant of quiet enjoyment
- Covenant for further assurance
- Covenant against encumbrances
- Covenant of warranty forever

More Info—

Covenant of seisin: The grantor guarantees that he or she owns and is in full possession of the subject property, and has the right to transfer the title to that property at the time of conveyance. If this covenant is broken, such as when the grantor does not actually possess the extent of estate intending to be conveyed, the grantee may receive damages up to the full purchase price of property.

Covenant of quiet enjoyment: The grantor guarantees that the grantee will not face litigation, eviction or experience any other disturbance arising from a third party’s claim on the property’s title while in possession of the property. By this covenant, the grantor essentially guarantees the grantee that the title is valid against any other claims to the property. If a claim is made and the grantee’s title is found to be deficient in court, the grantor is liable for damages.

Covenant for further assurance: The grantor guarantees that if the title proves to have defects, he or she will take the necessary steps to perfect the title. If there is any complication with the title, then the grantor must obtain and deliver the proper instrument that will clear the title. For example, suppose a grantor is married. If the grantor’s spouse has dower or marital rights to the property, the grantor is responsible for clearing the title on behalf of the grantee. This covenant is broken when the grantor refuses to pay the expenses for correcting the deed.

Covenant against encumbrances: The grantor guarantees that there are no liens or other encumbrances associated with the property’s title that could complicate the grantee’s title, other than those explicitly listed in the deed. Common encumbrances include mortgages and rights-of-way.

Covenant of warranty forever: The grantor guarantees that he or she will pay the expenses of defending the grantee against any third party claims on the property title. If the third party proves to have a superior claim on the
property’s title, the grantee may sue the grantor for damages up to the full purchase price of the property.

**GENERAL WARRANTY DEED GRANTING CLAUSE**

The granting clause of any deed indicates what type of deed is being used to convey the title to real property. The granting clause for a general warranty deed usually contains such language as:

- “Grant, bargain, sell and convey”
- “Warrant generally”
- “Grant, sell and convey”
- “Convey and warrant”

The exact format of a general warranty deed is not essential to its purpose, provided that the granting clause clearly indicates the grantor’s intent to convey title under general warranty.

**SAMPLE GENERAL WARRANTY DEED**

The following is an example of a general warranty deed. Compare the numbered sections of the deed to the numbered explanations.

```
Warranty Deed¹

NOTICE: Prepared by the State Bar for use by Lawyers only.²

The State of ______
County of ______³

KNOW ALL MEN BY THESE PRESENTS:

That GRANTOR⁴ and GRANTOR’S SPOUSE⁵ of the County ___________ State of_________,⁶ for and in consideration of the sum of $__________ and other valuable consideration⁷ to the undersigned paid by the grantees herein named, the receipt of which is hereby acknowledged,

have GRANTED, SOLD AND CONVEYED, and by these presents do GRANT, BARGAIN, SELL AND CONVEY⁸ unto GRANTEE and GRANTEE’S SPOUSE of the County of ______ and the State of ______,⁹ all of the following described real property in ______ County, ______ State, to-wit:

   Lot 1, Block 1, Harrison Park,
   Y County, X State, as shown of record
   at Volume 1, Page 1, of the Map Records
   of Y County, X State.¹⁰

TO HAVE AND TO HOLD¹¹ the above described premises, together with all and singular the
```
rights and appurtenances thereto in anywise belonging, unto the said grantees, their heirs and assigns forever.

And the Grantor hereby covenants with the said grantee that the grantor is lawfully seized of the said premises; that the grantor has good right and lawful authority to sell and convey said premises; and hereby warrants the title to said premises and will defend the same against lawful claims of all persons whomsoever; and that said premises is free of all encumbrances, excluding exceptions named herein.

EXECUTED this _____ day of _______, A.D. _______.

Signed, sealed and delivered in the presence of:

(Signature of Witness)  
(Signature of Seller)  
(Signature of Seller’s Spouse)

ACKNOWLEDGEMENT

The State of X
The County of Y

Before me, the undersigned authority, on this day personally appeared

SELLER and SELLER’S SPOUSE

Known to me to be the persons whose names are subscribed to the forgoing instrument, and acknowledged to me that they executed the same for the purpose and consideration therein expressed.

Given under my hand and seal of office on this ____ day of ______, A.D. _______.

(Signature of Notary in and for Y County, X State)

1. Warranty Deed Title: As this sample deed illustrates, titles are commonly included as part of all deeds. However, if the title of the deed is inconsistent with the deed’s actual wording or purpose, then the title of the deed is ignored. The wording of the granting clause determines the type of deed being used.

2. Notice from the State: This notice indicates that real estate professionals are not permitted to create deeds. Attorneys may create deed forms, which may be completed with transaction-specific information by a real estate licensee.

3. Deed Introduction: A deed introduction usually includes the state and county in which the property is situated. The deed will also be recorded in this county.

4. Grantor’s Name: The name(s) of the grantor appear here on the deed. If there is more than one grantor involved in a transaction, all of the grantors must be listed.

5. Grantor’s Name: If a grantor’s spouse holds any interest in the subject property, the spouse’s name must also appear on the deed. In addition, it is
common for all deeds to reflect the grantor's marital status; this information helps to clarify the chain of title, and can be useful in clearing any discrepancies that may later arise.

6. **Place of Residence:** The grantor’s place of residence is not essential to the contract. However, this information is generally included because it makes it easier to locate the grantor, and helps to further distinguish the grantor from other individuals. For example, if a grantor has a particularly common name, then his or her place of residence may provide further identification.

7. **Consideration:** Consideration must be included in any deed for title conveyance. Consideration is an item or service of value that the contracting parties promise to exchange in demonstration that they acknowledge and agree to the terms and conditions of the contract.

8. **Granting Clause:** All valid deeds of conveyance must contain a granting clause, or words of conveyance. Usually, the words “grant, bargain, sell and convey” are used in a general warranty deed, although the specific wording may vary slightly.

9. **Grantee(s) name(s) and place of residence:** All legally valid deeds of conveyance must name and distinguish a grantee. As with the grantor, if a grantee is married, the name of grantee’s spouse will also appear on the deed. This information helps to clarify the chain of title, and can be useful in clearing any discrepancies that may later arise. Although the grantee’s place of residence is not required for valid conveyance, it is often included.

10. **Legal Description:** A legal description of the subject property is needed for valid conveyance. This sample deed utilizes the recorded plat method of legal land description; this method is indicated by the use of a block number and a lot number to describe the property. The term “plat” refers to a developer’s map. When developers buy undeveloped parcels of land to build a subdivision, they generally begin their projects by dividing the undeveloped parcels into lots and blocks (with “blocks” being street blocks and “lots” being individual parcels for homes). After construction, the developer may enter his or her plat into a public record. A recorded plat can provide references (lot and block numbers) that can serve as legal land descriptions. Keep in mind that there are other methods of creating a legal land description, such as the rectangular survey method, vertical land description and metes and bounds. While all deeds require some legal description of the property, no particular method of description is mandated.

11. **Habendum Clause:** A habendum clause defines the extent of interest to be conveyed by the deed. A habendum clause is not always required for a deed, and may be omitted when appropriate. Any restrictions, both public and private, or encumbrances on the use of the property will be included in the habendum clause. Usually habendum clauses do not list every applicable ordinance or
deed restriction—they focus on those that are unique to the property being conveyed. Instead of listing all relevant general restrictions, a habendum clause will usually state that the property is subject to all public and private regulations within the governing jurisdiction.

12. **Covenants:** The covenant of seisin, covenant against encumbrances, covenant of quiet enjoyment, covenant for further assurances and covenant of warranty are included in a general warranty deed as protection against title defects.

13. **Date:** Generally, the date that is written on the deed (i.e., the date the deed is delivered to and accepted by the grantee) is considered to be the official date of the transfer. In the event of a title discrepancy, the recorded date (i.e., the date that the grantee records the deed in the public records) is the date that will be recognized by a court.

14. **Witness Signature:** Some states require deeds to be witnessed by third parties. In this case, the witness’ signature is included in this section of the deed.

15. **Grantor’s Signature:** The grantor’s signature is required for valid conveyance. If there is more than one grantor, all grantors must sign the deed.

16. **Acknowledgment:** Acknowledgement is not required for valid conveyance. However, a deed that is not acknowledged may not be recorded in the public record. Acknowledgment is made before a public official, usually a notary public, and serves to prove that the grantor is who he or she claims to be and is acting freely.

**SPECIAL WARRANTY DEEDS**

A special warranty deed is a deed that carries a limited covenant of protection against title defects. In a special warranty deed, the grantor warrants the title against defects occurring during his or her ownership. In essence, a special warranty deed amounts to the grantor’s declaration that the property was not encumbered during his or her possession, whereas a general warranty deed protects the grantee against defects created prior to and during the grantor’s ownership. It is possible for grantees that receive a special warranty deed to seek further protection against claims on the title by purchasing title insurance. A special warranty deed may also be called a “bargain and sale deed with a covenant against the grantor’s acts.”

Typically, fiduciaries (such as executors, trustees and corporations) use special warranty deeds, because they are in no position to guarantee the title on behalf of their predecessors. Instead, they attest that nothing has been done to cloud or cause a defect in the title during their period of ownership.
As noted previously in this course, the granting clause and habendum clause of a deed define the extent and condition of the ownership interest conveyed. Hence the most observable difference between a general warranty deed and a special warranty deed can be found in their respective habendum and granting clauses. Typically, a special warranty deed will use a phrase such as “grant, convey and sell, by, through or under the grantor but not otherwise” in the granting clause. For all practical purposes, all other elements of a general warranty are also included in a special warranty deed.

**BARGAIN AND SALE DEEDS**

The deeds we have discussed thus far carry certain covenants that protect the grantee from receiving a clouded or defective title. However, a bargain and sale deed, also called a “deed without warranty,” is a deed that offers no warranty against defects in the title or encumbrances associated with the title. Grantors declare that they have an actual interest in the real property, and the bargain and sale deed conveys all of a grantor’s interest to a grantee. However, the grantor does not guarantee to warrant and defend the title against future claims that may arise from title defects. It is therefore the responsibility of the grantee to research the history to the title to ensure that the deed is conveying a clear and marketable title.

The granting clause in a bargain and sale deed usually contains the words, “grant, bargain and sell,” and transfers the grantor’s complete interest in a property. A bargain and sale deed also includes a habendum clause to define the extent of the estate.

**SAMPLE BARGAIN AND SALE DEED**

The following is a sample of a bargain and sale deed. Each element that differs from the general warranty deed is numbered. Elements such as consideration, the grantor and grantee’s names, signatures and legal description will not be explained again. Compare the numbered sections of the deed to the numbered explanations.

1. **Bargain and Sale Deed Title**: As this sample deed illustrates, titles are commonly included as a part of all deeds. However, if the title is inconsistent with the deed’s actual wording or purpose, then the title is ignored. The wording of the granting clause determines the type of deed, regardless of the title.

2. **Granting Clause**: All valid deeds of conveyance must contain a granting clause. The granting clause in a bargain and sale deed will usually use language such as “grant and release,” or “grants, bargains and sells.”

3. **Habendum Clause**: The habendum clause in a bargain and sale deed will generally clarify the absence of warranties and covenants. While the use of a bargain and sale deed generally implies that the grantor holds title, this sample
deed uses the phrase: “This conveyance is made without warranty, express or implied,” and thus leaves little legal recourse for the grantee if it turns out that the grantor does not hold title or if the grantor’s title is defective.

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**Bargain and Sale Deed**

NOTICE: Prepared by the State Bar for use by Lawyers only.

The State of _____
County of ______

KNOW ALL MEN BY THESE PRESENTS:

That GRANTOR and GRANTOR’S SPOUSE of the County of _____ and State of _____ for and in consideration of the sum $____________ and other valuable consideration to the undersigned paid by the grantees herein named, the receipt of which is hereby acknowledged,

have GRANTED, BARGAINED AND SOLD and by these presents do GRANT, BARGAIN AND SELL unto GRANTEE and GRANTEE’S SPOUSE of the County of ____ and the State of _____, all of the following described real property in ______ County, ____State, to-wit:

Lot 1, Block 1, Harrison Park,
Y County, X State, as shown of record
at Volume 1, Page 1, of the Map Records
of Y County, X State.

TO HAVE AND TO HOLD all our right, title and interest in and to the above described property and premises unto the said grantees, their heirs and assigns forever, so that neither we nor our heirs, legal representatives or assigns shall have claim or demand any right or title to theforesaid property, premises or appurtenances or any part thereof.

EXECUTED this _____day of ______, A.D. ______

(Signature of Witness)_____
(Signature of Seller)_____
(Signature of Seller’s Spouse)_____

ACKNOWLEDGEMENT

The State of ______
The County of ______

Before me, the undersigned authority, on this day personally appeared

SELLER and SELLER’S SPOUSE

Known to me to be the persons whose names are subscribed to the forgoing instrument, and acknowledged to me that they executed the same for the purpose and consideration therein expressed.

Given under my hand and seal of office on this____ day of ________, A.D. ______

(Seal)_____
(Signature of Notary in and for _____ County, State)_____

QUITCLAIM DEEDS
A quitclaim deed releases a grantor’s interest, if any, in a subject property to a grantee with no warranties. The grantor does not state in the deed that he or she has any title or interest to the property, and effectively quits whatever interest he or she may have. Quitclaim deeds are most often used to clear a cloud on the title, or possible claim or defect on the title.

A bargain and sale deed generally leaves a grantee with little legal recourse if a title turns out to be defective or otherwise problematic. A quitclaim deed provides even less security for the grantee, virtually eliminating the possibility of legal recourse in such cases. This is true because the grantor of a quitclaim deed often openly admits to not knowing the quality or condition of his or her title or to knowing whether he or she holds title at all.

A quitclaim deed conveys whatever interest a grantor may have in a property to a grantee, which means that whatever rights and possession a grantor has towards a property is given to the grantee. However, if the grantor has no real claims to the property, then the grantee receives nothing even if he or she has exchanged money or some other valuable item for the deed. In practice, then, a quitclaim deed offers the least title security to a prospective grantee.

**USES OF A QUITCLAIM DEED**

Although quitclaim deeds carry no warranties and thus are not a very prudent way to acquire property, they can be very useful in relinquishing title or ownership interest. When, for example, partial or incomplete ownership claims arise due to inheritances, dowers, easements, community property rights or foreclosure, a cloud on the title occurs; quitclaim deeds are commonly used to clear these types of clouds.

**EXAMPLE:**

A fence divides Neighbor A’s and Neighbor B’s properties. When Neighbor A attempts to sell her home, she discovers that the line of the fence does not actually follow the surveyed property lines—it does not deviate by much, but the fence is off by enough that it includes a bit of property to which Neighbor A does not have legal title.

Neighbor A speaks with Neighbor B about the matter and the two decide that it would be better just to make a minor change in the property boundaries, rather than to remove the fence and build a new, accurate one. The easiest way for the neighbors to make this agreement into a legal arrangement is to write up a quitclaim deed that relinquishes all rights, if any, that Neighbor B holds to the property on the other side of the fence. That is, the quitclaim deed would state that Neighbor A relinquishes all rights, if any, to property on Neighbor B’s side of the fence, and vice versa.
A quitclaim deed can also be used when a grantor is generally unsure about the validity of his or her title. For example, if a potential grantor has inherited a property, but is unsure as to whether or not he or she acquired legitimate, clear title or any title at all, then the grantor will commonly use a quitclaim deed to convey interest.

Like other types of deeds, the wording of the granting clause distinguishes a quitclaim deed from other deeds. Generally, the granting clause in a quitclaim deed will include language such as “does hereby quitclaim” or “releases and quitclaims all interest, if any.”

SAMPLE QUITCLAIM DEED

The following is a sample of a quitclaim deed. Each new element is numbered, and the elements that are included in all types of deeds have been omitted. Compare the numbered sections on the deed to the numbered explanations.

1. Quitclaim Title: As this sample deed illustrates, titles are commonly included as part of all deeds. However, if the title is inconsistent with the deed’s actual wording or purpose, then the title is ignored. The wording of a deed determines a deed’s type, regardless of the title attached to the deed.

2. Granting Clause: All valid deeds of conveyance must contain a granting clause. The granting clause in a quitclaim deed usually uses language such as “does hereby quitclaim” or “releases and quitclaims all interest, if any.” Regardless of the exact phrasing, the word “quitclaim” must be present in the granting clause. If the word “quitclaim” is not present in this part of the deed, then it is likely to be treated as a bargain and sale deed.

3. Habendum Clause: The habendum clause in a quitclaim deed clarifies the absence of all covenants. In a quitclaim deed, the habendum clause states that the grantor transfers all present interest (if any) to the grantee(s) completely, so that the grantor(s) (as well as any respective heirs or legal assignees) can never assert title to the subject property. This phrase does not imply a certain type of interest, however; that is to say, there is nothing about a quitclaim deed that implies that a certain type or quantity of ownership interest is being conveyed.

| Quitclaim Deed
| NOTICE: Prepared by the State Bar for use by Lawyers only.
|
The State of __________
County of ______

KNOW ALL MEN BY THESE PRESENTS:

That GRANTOR and GRANTOR’S SPOUSE of the County of ___ and State of ____ for and in consideration of the sum of $________ and other valuable consideration to the undersigned paid by the grantees herein named, the receipt of which is hereby acknowledged,

have RELEASED AND QUITCLAIMED ALL INTEREST, IF ANY, and by these presents do RELEASE AND QUITCLAIM ALL INTEREST, IF ANY2 unto GRANTEE and GRANTEE’S SPOUSE of the County of _____ and the State of _____, all of the following described real property in _____County, ______State, to-wit:

Lot 1, Block 1, Harrison Park,
Y County, X State, as shown of record
at Volume 1, Page 1, of the Map Records
of Y County, X State.

TO HAVE AND TO HOLD the above described property and premises unto the stated grantees, their heirs and assigns forever, so that neither we nor our heirs, legal representatives or assigns shall have, claim or demand any right or title to the aforesaid property, premises or appurtenances or any part thereof. 3

EXECUTED this ___day of ______, A.D. ______

(Signature of Witness)  
(Signature of Seller)  
(Signature of Seller’s Spouse)

ACKNOWLEDGEMENT
The State of _____
The County of ______

Before me, the undersigned authority, on this day personally appeared

SELLER and SELLER’S SPOUSE

Known to me to be the persons whose names are subscribed to the foregoing instrument, and acknowledged to me that they executed the same for the purpose and consideration therein expressed.

Given under my hand and seal of office on this _____day of ______, A.D. ______

(Signature of Notary in and for County, State)
OTHER TYPES OF DEEDS

In addition to general warranty, special warranty, bargain and sale and quitclaim deeds, several other types of deeds may be used to transfer title to real property for special purposes. Other types of deeds include:

- Deeds of Trust
- Gift Deeds
- Guardian's Deeds
- Correction Deeds
- Sheriff's Deeds
- Tax Deeds

DEEDS OF TRUST

When a property owner has a debt to a lender, he or she may convey the title to his or her interest in real property to a disinterested third party by a deed of trust. The third party holds the title in trust as security for the payment of a loan until the borrower's debt is satisfied. A deed of trust is similar to a mortgage in that the property is collateral for payment of the loan. However, in a deed of trust, the third party holds the title until the loan is repaid in full to the lender.

GIFT DEEDS

A gift deed is used to transfer title in real property in consideration of “natural love and affection.” Consideration for a gift deed may also be for a nominal fee, such as “for $1.00 and other valuable consideration.” Most gift deeds do not contain warranties or guarantees on the title, and are considered to be a type of bargain and sale deed or quitclaim deed. Gift deeds may also be called “deeds of gift” or “gratuitous deeds.”

GUARDIAN’S DEEDS

A guardian’s deed may be used to convey an interest in real property held by a minor. A guardian’s deed must state in what capacity the guardian has the authority to convey the minor’s property, and carry the covenant that guarantees the grantee that neither the guardian nor the minor encumbered, or otherwise clouded, the title. A guardian’s deed is essentially a special warranty deed used for minors.

CORRECTION DEEDS

A correction deed, also called a “deed of confirmation,” is used to repair errors in previously executed deeds. For example, if the subject property was described incorrectly, or if a grantor’s name was misspelled, a correction deed may be
created to correct those errors. A correction deed is a special execution deed that serves the single, limited goal of correcting an inaccurate deed; it does not convey ownership interest from a grantor to a grantee.

**SHERIFF’S DEED**

When a parcel of real property is sold at a court-ordered public auction as the result of foreclosure, title may transfer to a buyer by a sheriff’s deed, also called a “deed in foreclosure.” Foreclosure most often results from a default on a judgment order or mortgage payment. The proceeds from the auction sale are used to satisfy the borrower’s debt to the lender, and title passes to the buyer. A sheriff’s deed does not have any warranties on the title; however, some sheriff’s deeds will include a covenant, which asserts that the authority conveying the property (e.g., the sheriff’s office) did not encumber the title. A sheriff’s deed should cite the authority with which the property is dispensed and the sale price of the property.

**TAX DEEDS**

When a taxpayer defaults in the payment of real property taxes, the government may sell the taxpayer’s property to pay for the delinquency. Title transfers by a tax deed to the buyer when the property is sold. Like a sheriff’s deed, a tax deed does not make any warranties on the title, as the deed is intended to serve a specific, limited function.

**BUSINESS EXECUTIONS**

A business is an entity that is organized for profit, and that may have a legal existence independent of the people who own and work for it. For example, a corporation holds what is called “legal personhood,” which means that the corporation itself can make contracts, assume debts, and otherwise act in many of the same ways that a businessperson can. Most partnerships do not have this kind of legal personhood.

Business entities that have been assigned legal personhood may hold title to real property; for example, a corporation can hold property in its own name, and partnerships can hold property in the names of various partners. This kind of arrangement makes it possible for multiple people to share ownership interest in a single property, in fact, many more people than one might usually encounter in a residential property transaction.

Generally, the type of deed used to convey interest or a financial investment on behalf of a business entity depends upon whether the business entity itself or the individual members of the entity hold property interest. Either way, complex legal questions are likely to arise whenever a business entity or its members act as principals in transactions involving commercial real estate or investment.
properties. In business executions, licensees should advise their clients to seek professional legal advice.

**SUMMARY**

Types of deeds differ in the extent of protection against title defects offered to the grantee through the grantor's covenants and warranties. The four most common types of deeds are general warranty deeds, special warranty deeds, bargain and sale deeds, and quitclaim deeds. Of these four types, general warranty deeds offer the grantee the most protection and quitclaim deeds offer the grantee the least.

A general warranty deed includes all available covenants and warranties, and conveys the highest and most complete ownership in real property. By the covenant of seisin, the grantor guarantees that he or she is in full possession of the interest to be conveyed and has the right to transfer title at the time of conveyance. By the covenant against encumbrances, the grantor guarantees that there are no liens or other encumbrances associated with the property's title. By the covenant of quiet enjoyment, the grantor guarantees the grantee the right to occupy and enjoy the property without disturbance from a third party's claim on the title. By the covenant for further assurances, the grantor guarantees that if the title proves to have defects, he or she will take the necessary measures to perfect the title. And, by the covenant of warranty forever, the grantor guarantees that he or she will pay the expenses of defending the grantee against a third party's claim on the title. Words of conveyance for general warranty deeds usually include the words, “grant, sell, convey and warrant.”

A special warranty deed is similar to a general warranty deed. However, in a special warranty deed the grantor only guarantees the title against defects occurring during his or her ownership. (A general warranty deed guarantees the title against defects occurring prior to and during the grantor's ownership.) The granting clause for a special warranty deed usually uses a phrase like “grant, sell and convey, by, through or under the grantor but not otherwise.” Special warranty deeds are commonly used by fiduciaries that cannot guarantee the title on behalf of their predecessors.

A bargain and sale deed does not contain warranties on the title. Grantors do acknowledge that they have an interest in real property at the time of conveyance, but do not warrant the title against claims or defects. The granting clause of a bargain and sale deed usually contains the words, “grant, bargain and sell.” A quitclaim deed also does not contain warranties on title, and the grantor effectively releases his or her interest, if any, in the property. As a result, quitclaim deeds provide a grantee with the least amount of protection or legal support for a property's title. Quitclaim deeds are most commonly used to clear a cloud on a title by releasing any claims on the property. The granting clause in
quitclaim deed will usually use language such as “. . . does hereby quitclaim or releases and quitclaims all interest, if any. . . .”

In addition, there are also other types of deeds used to transfer title for specific purposes. A deed of trust may be used to transfer title to an owner’s property to a third party to secure the payment of a debt. A gift deed transfers the title to real property in consideration of “natural love and affection,” or some other nominal sum. A guardian’s deed may be used to transfer the title to real property on behalf of a minor, whereas a correction deed may be used to correct an error in a previously executed deed. A sheriff’s deed transfers the title to real property to a buyer upon a foreclosure sale, and a tax deed transfers title when a parcel of real property is sold to pay for delinquent taxes.

Business entities, as a legal personhood, may hold title to real property. For example, a corporation can hold property in its own name, and partnerships can hold property in the names of the various partners. Generally, the type of deed that must be used to convey an interest in property or financial investment on behalf of a business entity depends upon whether the business entity itself, or the individual members of the entity, holds the property interest. Either way, complex legal questions are likely to arise whenever a business entity or its members act as principals in transactions involving commercial real estate or investment properties. In short, in business executions and commercial real estate transactions, licensees should advise their clients to seek professional legal advice.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
TEXAS CONVEYANCE STANDARDS AND LEGISLATION

This lesson focuses on the following topics:

- Texas Statute of Frauds
- Requirement of Recording
- Owner’s and Seller’s Agent Disclosures
- Role of Licensees and Attorneys
- Contract Forms
- TREC Rules Regarding Promulgated Forms

INTRODUCTION

Thus far this module has covered the general application, types and uses of deeds that are consistent throughout the country. While many laws pertaining to deeds are identical, regardless of location, some laws are not. There are small variances between agreements, requirements for valid conveyance, recording, legal land description and statute of frauds verbiage from state to state.

This lesson is divided into two parts. The first section contains Texas specific laws pertaining to deed executions, required disclosures, and breach of contract remedies. The second half covers the specific role of real estate licensees and attorneys in the State of Texas and clarifies the meaning of an unauthorized practice of law.

TEXAS STATUTE OF FRAUDS

As previously noted, every state, including Texas, developed a statute of frauds that requires many contracts, such as those conveying title in real property, to be in writing. The Texas Statute of Frauds is Chapter 26 of the Business and Commerce Code. It is composed of two parts. The first part lays out those agreements that must be in writing (26.01), and the second part requires lending agreements be writing. (26.02). For the sake of presenting the statute in its entirety, the second half is included; however, the following source relates only to the first section, which is deed specific.

STATUTE SUMMATION

According to Texas State Law all of the following agreements must be in writing:

- Debt clearances on one’s own or another’s behalf
• Marriage and common law agreements
• Contracts for the sale of real property
• Leases that extend for longer than one year
• An agreement to be carried out one year or later from the date the agreement is made
• Promise of commission for the sale or lease of certain oil, gas and mineral rights

The following sections present the law verbatim. Please pay special attention to Section B Subsection 4, as it is the statute that requires the use of deeds. It is also worth noting that Section B Subsection 5 pertains to lease agreements that must also be in writing.

Chapter 26: Statute of Frauds § 26.01.

Promise or Agreement Must Be in Writing

(A)
A promise or agreement described in Subsection (b) of this section is not enforceable unless the promise or agreement, or a memorandum of it, is

(1) in writing; and
(2) signed by the person to be charged with the promise or agreement or by someone lawfully authorized to sign for him.

(B)
Subsection (a) of this section applies to:

(1) a promise by an executor or administrator to answer out of his own estate for any debt or damage due from his testator or intestate;
(2) a promise by one person to answer for the debt, default, or miscarriage of another person;
(3) an agreement made on consideration of marriage or on consideration of nonmarital conjugal cohabitation;
(4) a contract for the sale of real estate;
(5) a lease of real estate for a term longer than one year;
(6) an agreement which is not to be performed within one year from the date of making the agreement;
(7) a promise or agreement to pay a commission for the sale or purchase of:

(a) an oil or gas mining lease;
(b) an oil or gas royalty;
(c) minerals; or
(d) a mineral interest; and
an agreement, promise, contract, or warranty of cure relating to medical care or results thereof made by a physician or health care provider as defined in Section 1.03, Medical Liability and Insurance Improvement Act of Texas. This section shall not apply to pharmacists.


§ 26.02. Loan Agreement Must be in Writing

(A) In this section:

(1) "Financial institution" means a state or federally chartered bank, savings bank, savings and loan association, or credit union, a holding company, subsidiary, or affiliate of such an institution, or a lender approved by the United States Secretary of Housing and Urban Development for participation in a mortgage insurance program under the National Housing Act (12 U.S.C. Section 1701 et seq.).

(2) "Loan agreement" means one or more promises, promissory notes, agreements, undertakings, security agreements, deeds of trust or other documents, or commitments, or any combination of those actions or documents, pursuant to which a financial institution loans or delays repayment of or agrees to loan or delay repayment of money, goods, or another thing of value or to otherwise extend credit or make a financial accommodation. The term does not include a promise, promissory note, agreement, undertaking, document, or commitment relating to:
   (A) a credit card or charge card; or
   (B) an open-end account, as that term is defined by Section 301.002, Finance Code, intended or used primarily for personal, family, or household use.

(B) A loan agreement in which the amount involved in the loan agreement exceeds $50,000 in value is not enforceable unless the agreement is in writing and signed by the party to be bound or by that party's authorized representative.

(C) The rights and obligations of the parties to an agreement subject to Subsection (b) of this section shall be determined solely from the written loan agreement, and any prior oral agreements between the parties are superseded by and merged into the loan agreement.

(D)
An agreement subject to Subsection (b) of this section may not be varied by any oral agreements or discussions that occur before or contemporaneously with the execution of the agreement.

(E)
In a loan agreement subject to Subsection (b) of this section, the financial institution shall give notice to the debtor or obligor of the provisions of Subsections (b) and (c) of this section. The notice must be in a separate document signed by the debtor or obligor or incorporated into one or more of the documents constituting the loan agreement. The notice must be in type that is boldface, capitalized, underlined, or otherwise set out from surrounding written material so as to be conspicuous. The notice must state substantially the following:

"This written loan agreement represents the final agreement between the parties and may not be contradicted by evidence of prior, contemporaneous, or subsequent oral agreements of the parties.

"There are no unwritten oral agreements between the parties.

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<th>&quot;Debtor or Obligor&quot;</th>
<th>&quot;Financial Institution&quot;</th>
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(F)
If the notice required by Subsection (e) of this section is not given on or before execution of the loan agreement or is not conspicuous, this section does not apply to the loan agreement, but the validity and enforceability of the loan agreement and the rights and obligations of the parties are not impaired or affected.

(G)
All financial institutions shall conspicuously post notices that inform borrowers of the provisions of this section. The notices shall be located in such a manner and in places in the institutions so as to fully inform borrowers of the provisions of this section. The Finance Commission of Texas shall prescribe the language of the notice.


**REQUIREMENT OF RECORDING**

The State of Texas requires that all interest in land be recorded in the county clerk’s office in the county where the property is located. As noted in Lesson 1,
acknowledgement is not required for valid conveyance or for a valid contract; however, in the State of Texas, only acknowledged deeds can be recorded in the public record. Consequently, all deeds in Texas must be acknowledged.
STATUTE SUMMATION

The law that requires all interest to be recorded is Chapter 13 of the Property Code. The law stating only acknowledged deeds may be recorded is Chapter 12 of the Property Code. The following pages will present these two laws verbatim. Please pay special attention to A and B of Chapter 12 §12.001, which state that only acknowledged deeds may be recorded, and A of Chapter 13 § 13.001, which requires the recording of deeds. Chapter 13 § 13.002 reinforces the role of a recorded deed as notice to all persons of the existence of the instrument.

Chapter 12. Recording of Instruments § 12.001.

Instruments Concerning Property

(A)
An instrument concerning real or personal property may be recorded if it has been acknowledged, sworn to with a proper jurat, or proved according to law.

(B)
An instrument conveying real property may not be recorded unless it is signed and acknowledged or sworn to by the grantor in the presence of two or more credible subscribing witnesses or acknowledged or sworn to before and certified by an officer authorized to take acknowledgements or oaths, as applicable.

(C)
This section does not require the acknowledgement or swearing or prohibit the recording of a financing statement, a security agreement filed as a financing statement, or a continuation statement filed for record under the Business & Commerce Code.

(D)
The failure of a notary public to attach an official seal to an acknowledgment, a jurat, or other proof taken outside this state but inside the United States or its territories renders the acknowledgment, jurat, or other proof invalid only if the jurisdiction in which the acknowledgment, jurat, or other proof is taken requires the notary public to attach the seal.


Validity of Unrecorded Instrument

(A) A conveyance of real property or an interest in real property or a mortgage or deed of trust is void as to a creditor or to a subsequent purchaser for a valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed for record as required by law.

(B) The unrecorded instrument is binding on a party to the instrument, on the party's heirs, and on a subsequent purchaser who does not pay a valuable consideration or who has notice of the instrument.

(C) This section does not apply to a financing statement, a security agreement filed as a financing statement, or a continuation statement filed for record under the Business & Commerce Code.


§ 13.002. Effect of Recorded Instrument

An instrument that is properly recorded in the proper county is notice to all persons of the existence of the instrument.


OWNER’S AND SELLER’S AGENT DISCLOSURES

In the State of Texas, an owner’s agent and a property owner are required to disclose certain information. A seller’s broker or salesperson and a seller must disclosure all material facts pertaining to a property. A fact is material if it would change or alter the mind of a prudent buyer. In addition to the disclosure of all material facts, an owner’s agent must ensure four key disclosures listed below.

- Lead-Based Paint Disclosure
- Seller’s Disclosure Notice
- Notice of Additional Tax Liability
- Conditions under Surface
More Info—

Lead-Based Paint Disclosure: Lead is a marked carcinogen linked to many different health risks, including mental impairment. It is particularly hazardous to children and pregnant women. All sellers and landlords of properties built before 1978 (with few exceptions) must disclosure the possibility of a lead-based paint hazard. There is a TREC-approved addendum that owners may use to prove that they have issued all of the following disclosures:

1. Provided potential lessor or buyer with a document entitled *Protect Your Family from Lead in Your Home*
2. Permitted the buyer 10 days to complete lead-based paint hazard assessment
3. Stated whether or not they know lead to be present
4. Provided the buyer or tenants with copies of records and reports pertaining to lead on the property.

Seller’s Disclosure Notice: Owners must disclose any known structural or latent defects. Sellers of one-unit residential properties must deliver a Seller’s Disclosure Notice to the buyer on or before the effective date of the sales contract. If a seller fails to do so, then the buyer may terminate the contract for any reason within seven days after receiving notice.

Notice of Additional Tax Liability: The State of Texas requires sellers to include a notice in a sales contract stating the possible liability of additional taxes. This notice explains to the buyer that sometimes a change in ownership or status of a property can trigger new taxes, for which the buyer would then be liable. If a seller fails to make this disclosure, then the tax burden and interest falls onto him or her.

Conditions Under Surface: A seller of unimproved land to be used for residential purposes must disclose the presence and location of any transportation pipelines for natural gas and related products under the property. If the seller fails to do so on or before the contract’s effective date, then the buyer may terminate the contract for any reason up to seven days after the contract’s effective date.

BREACHES OF CONTRACT

Previously in the course we covered the elements of a contract. However, even if a contract is valid, it does not literally guarantee that both parties will fulfill their stated roles in the agreement. If both parties completely fulfill their duties stated in a contract, then we say the contract is *completely performed*. However, if one party does not fulfill his or her role in an agreement, then he or she has *breached* the contract. A breach of contract refers to any violation of any of the terms or conditions listed in a contract and done without legal cause. If either a buyer or a
seller breaches a contract, then, in Texas, the aggrieved party has certain legal options.

**Seller’s Options**

In the State of Texas, if a buyer breaches a contract, then a seller has four options:

1. **Rescind the contract:** This means that the contract is terminated or canceled. In essence, it is as if the contract never existed.

2. **Declare the contract forfeited:** Most contracts include the right to forfeit upon default. This means that if a buyer fails to uphold his or her side of the bargain, then he or she effectively forfeits the contract and the seller usually keeps all earnest money and payments received.

3. **Sue for specific performance:** This means that the seller sues the buyer for some specific action to occur. In order for this to go through, the seller will probably have to present his or her deed to show his or her compliance with the contract.

4. **Sue for compensatory damages:** This is usually coupled with option three. If a seller does take a buyer to court, then they can lawfully sue for compensatory damages.

**Buyer’s Options**

If a seller breaches a contract, then, under Texas law, the buyer has three options:

1. **Rescind the contract:** Similar to when a seller rescinds a contract, this cancels a contract. In this situation, the buyer will receive his or her earnest money back.

2. **File a suit for specific performance:** This is a lawsuit filed in court that would force the seller to comply with a contract and, more than likely, sell the property.

3. **Sue for compensatory damages:** This is usually done in conjunction with suing for specific performance. In addition to forcing a seller to comply with a contract, the court can also force him or her to pay damages for breaching the contract to the buyer.

**LEGAL LAND DESCRIPTION IN TEXAS**

There are several methods of legal land description that adequately distinguish one property from all other properties in the world, but most states will pick one method and use it consistently. The State of Texas uses the metes and bounds
method of land description. Metes and bounds is a legal land description method that distinguishes the exact dimensions and location of a lot in reference to a fixed and permanent monument.

To use the metes and bounds method, a surveyor places a monument, usually a metal pole or stone/concrete fixture one to two inches in diameter, in a corner of a parcel. He or she then describes the parcel's distance and direction from that point by measuring the perimeter of the lot in feet, usually to the tenth or hundredth of a foot. He or she indicates direction in degrees, minutes and seconds by using a 360-degree compass marked with cardinal directions.

**ROLE OF LICENSEES AND ATTORNEYS**

Licensees are not attorneys and may not engage in the unauthorized practice of law. The penalties for the unauthorized practice of law are stringent. Consequently, it is important that all licensees understand their roles as real estate professionals and what they may and may not legally do.

No licensee may generate or prepare legal documents, and both deeds and mortgages are legal documents. At first, this may seem to complicate a broker’s ability to carry out his or her daily tasks. However, the Real Estate License Act provides a remedy. To help licensees in the practice of real estate and protect them from prosecution for the unauthorized practice of law, the Real Estate License Act provides for the Real Estate Broker-Lawyer Committee. This Committee, comprised of brokers, lawyers and one public member appointed by the governor, promulgates forms for use by brokers and their salespersons.

**TEXAS REAL ESTATE BROKER-LAWYER COMMITTEE**

Once the Broker-Lawyer Committee drafts a form, all real estate brokers and their salespersons must use it, with a few exceptions listed in the upcoming sections. If a licensee needs a form for an occasion that the Committee has not drawn a form for, then he or she may use any form approved by the Committee. In essence, this organization provides documents that licensees can fill out, negating the fear of illegally practicing law.

The Texas Real Estate Broker-Lawyer Committee has promulgated 23 forms for licensee use: eight contract forms, two temporary lease forms and 13 special condition forms, all of which are listed in the upcoming sections. The most commonly used document, and the document that licensees will usually fill out in the sale and purchase of residential real estate, is the *One to Four Family Residential Contract (Resale)*, Standard Contract Form No. 20-6. The law states:

“Standard Contract Form 20-6 is promulgated for use in the resale of residential real estate” (Title 22, Part 23, Chapter 537.11).
Filling in information on this form, or any other forms promulgated by the Committee does not constitute the unauthorized practice of law. Please note that these forms include a disclaimer advising both the buyer and seller to seek legal advice as the broker and/or salesperson is unable to do so.

**CONTRACT FORMS**

The following list compiles all of the contractual forms that brokers and salespersons may fill out.

- One to Four Family (Resale)
- One to Four Family FHA Insured or VA Guaranteed Loans (Resale)
- Unimproved Residential Property
- New Home, Incomplete Construction
- New Home, Complete Construction
- Farm and Ranch
- Condominium (Cash, Assumption, Conventional, etc.)
- Condominium (FHA and VA)

**SPECIAL CONDITIONS ADDENDUM FORMS**

The following list compiles all the special condition addendum forms that broker and salespersons may fill out.

- Sale of Other Property by Buyer
- Second or Back-up Contract
- New Home Insulation
- Seller Financing
- VA Release of Liability/Restoration of Entitlement
- Environmental Assessment
- Abstract of Title
- Condominium Resale Certificate
- Coastal Area Property
- Agreement for Mediation
- Resale Certificate for Property Subject to Membership in an Owner’s Association
- Property Located Seaward
- Property Subject to Membership in an Owner’s Association

Temporary Residential Lease Forms

- Buyer’s Lease
- Seller’s Lease

**ONE TO FOUR FAMILY RESIDENTIAL CONTRACT (RESALE)**
Form 20-7 (formerly 20-6), the One to Four Family Residential Contract (Resale), is one of the most commonly used sales contracts for residential real estate transactions. Consequently, it is important that real estate licensees are familiar with it. Please note that use of this sample contract is restricted. Do not use this sample contract in any real estate transaction. For direct information on forms, use and/or copies contact TREC at [http://www.trec.state.tx.us](http://www.trec.state.tx.us). This sample page (1 of 8) may be found at [http://www.trec.state.tx.us/pdf/contracts/20-7.pdf](http://www.trec.state.tx.us/pdf/contracts/20-7.pdf).

<table>
<thead>
<tr>
<th>1. PARTIES:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(Seller) agrees to sell and convey to ___________________________, and Buyer agrees to buy from Seller the Property described below.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. PROPERTY:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. LAND: Lot ______ Block _________, __________, County of __________, City of __________, Texas, known as __________ (address/zip code), or as described on attached exhibit.</td>
<td></td>
</tr>
<tr>
<td>B. IMPROVEMENTS: The house, garage and all other fixtures and improvements attached to the above-described real property, including without limitation, the following permanently installed and built-in items, if any: all equipment and appliances, valances, screens, storm windows, wall-to-wall carpeting, mirrors, ceiling fans, attic fans, mail boxes, television antennas and satellite dish system and equipment, heating and air-conditioning units, security and fire detection equipment, wiring, plumbing and lighting fixtures, chandeliers, closet shelving, kitchen equipment, garage door openers, cleaning equipment, shrubbery, landscaping, outdoor cooking equipment, and all other property owned by Seller and attached to the above-described real property.</td>
<td></td>
</tr>
<tr>
<td>C. ACCESSORIES: The following described related accessories, if any: window air conditioning units, stove, fireplace screens, curtains and rods, blinds, window shades, draperies and rods, controls for satellite dish system, controls for garage door openers, entry gate controls, door keys, mailbox keys, above ground pool, swimming pool equipment and maintenance accessories, and artificial fireplace logs.</td>
<td></td>
</tr>
<tr>
<td>D. EXCLUSIONS: The following improvements and accessories will be retained by Seller and removed prior to delivery of possession.</td>
<td></td>
</tr>
</tbody>
</table>

The land, improvements and accessories are collectively referred to as the "Property".

<table>
<thead>
<tr>
<th>3. SALES PRICE:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Cash portion of Sales Price payable by Buyer at closing $_________________________</td>
<td></td>
</tr>
<tr>
<td>B. Sum of all financing described below (excluding any loan funding fee or mortgage insurance premium) $_________________________</td>
<td></td>
</tr>
<tr>
<td>C. Sales Price (Sum of A and B) $_________________________</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>4. FINANCING:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. THIRSD PARTY FINANCING: One or more third party mortgage loans in the total amount of $_________________________ (excluding any loan funding fee or mortgage insurance premium).</td>
<td></td>
</tr>
<tr>
<td>(1) Property Approval: If the Property does not satisfy the lenders' underwriting requirements for the loan(s), this contract will terminate and the earnest money will be refunded to Buyer.</td>
<td></td>
</tr>
<tr>
<td>(2) Financing Approval: (Check one box only)</td>
<td></td>
</tr>
<tr>
<td>(a) This contract is subject to Buyer being approved for the financing described in the attached Third Party Financing Condition Addendum.</td>
<td></td>
</tr>
<tr>
<td>(b) This contract is not subject to Buyer being approved for financing and does not involve FHA or VA financing.</td>
<td></td>
</tr>
<tr>
<td>B. ASSUMPTION: The assumption of the unpaid principal balance of one or more promissory notes secured by the Property.</td>
<td></td>
</tr>
<tr>
<td>C. SELLER FINANCING: A promissory note from Buyer to Seller of $_________________________ secured by the Property and containing the terms and conditions described in the attached TREC Seller Financing Addendum. If an owner policy of title insurance is furnished, Buyer shall furnish Seller with a mortgagee policy of title insurance.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>5. EARNEST MONEY:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Upon execution of this contract by both parties, Buyer shall deposit $_________________________ as earnest money with ___________________________ (escrow agent), at __<em><strong><strong><strong><strong><strong><strong><strong><strong><strong><strong><strong><strong>. Buyer shall deposit additional earnest money of $</strong></strong></strong></strong></strong></strong></strong></strong></strong></strong></strong></strong></em> with escrow agent within ________ days after the effective date of this contract. If Buyer fails to deposit the earnest money as required by this contract, Buyer will be in default.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>6. TITLE POLICY AND SURVEY:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A. TITLE POLICY: Seller shall furnish to Buyer at Seller's expense an owner policy of title insurance (Title Policy) issued by [Title Company] in the amount of the Sales Price, dated at or after closing, insuring Buyer</td>
<td></td>
</tr>
</tbody>
</table>

Initiated for identification by Buyer _______ and Seller _______ TREC NO. 20-7
TREC RULES REGARDING PROMULGATED FORMS

The Texas Administrative Code is a compilation of all the rules made by various government bodies and published by the Secretary of State. When TREC passes new rules, they are published there. All the rules pertaining to forms promulgated by the Broker-Lawyer Committee are under Title 22 Part 23 and are reproduced in upcoming sections.

STATUTE SUMMATION

The following statute will clarify two issues: the use of promulgated forms by licensees and the roles and relationship between attorneys and brokers.

Rule 537.11, A and B require licensees to use promulgated forms and lists the exceptions to form usage. Before viewing the law, consider the following list detailing the only exceptions to the use of promulgated forms:

- The licensee is only a principal in the transaction.
- The licensee is using a form prepared by a property owner.
- The licensee is using a form prepared by a Texas-licensed attorney.
- The transaction involves a US agency that must use a different form.

Please note that if the Committee has not produced a form for a specific transaction, then a licensee may use another form approved by the Committee.

In general, it is a good idea for licensees to check with TREC before assuming an exception. As noted in Subsection C of the Code, licensees may not practice law and do not want to get caught up in the unauthorized practice of it.

Rule 537.11, Subsections C-G discusses the roles of attorneys and licensees. Subsection C states that licensees may not discourage any principal from employing an attorney and may not perform any of the following actions:

- Give legal advice
- Give opinions on legal issues
- Comment on the legal effects of a contract
- State the legal roles of the principals in a transaction

Subsection D specifically outlaws the unauthorized practice of law by real estate licensees. Subsection E states that as unusual circumstances arise, real estate licensees must advise principals involved in transactions to seek legal counsel. Subsection F states that no real estate licensee may personally employ—directly or indirectly—or pay for an attorney’s services on behalf of a principal, as this would create a conflict of interest. Subsection G clarifies that all licensees must inform all principals to a real estate transaction that contracts signed, such as deeds, are binding.
The following pages present the law in its entirety. Please review each section carefully.

**Texas Administrative Code**

**Title 22, Part 23, Chapter 537 § Rule 537.11**

(A)
Standard Contract Form TREC No. 9-5 is promulgated for use in the sale of unimproved property where intended use is for one to four family residences.

Standard Contract Form TREC No. 10-4 is promulgated for use as an addendum concerning sale of other property by a buyer to be attached to promulgated forms of contracts.

Standard Contract Form TREC No. 11-4 is promulgated for use as an addendum to be attached to promulgated forms of contracts which are second or "back-up" contracts.

Standard Contract Form TREC No. 12-1 is promulgated for use as an addendum to be attached to promulgated forms of contracts where there is a Veterans Administration release of liability or restoration entitlement.

Standard Contract Form TREC No. 15-2 is promulgated for use as a residential lease when a seller temporarily occupies property after closing.

Standard Contract Form TREC No. 16-2 is promulgated for use as a residential lease when a buyer temporarily occupies property prior to closing.

Standard Contract Form 20-6 is promulgated for use in the resale of residential real estate.

Standard Contract Form TREC No. 23-5 is promulgated for use in the sale of a new home where construction is incomplete.

Standard Contract Form TREC No. 24-5 is promulgated for use in the sale of a new home where construction is completed.

Standard Contract Form TREC No. 25-4 is promulgated for use in the sale of a farm or ranch.

Standard Contract Form TREC No. 26-4 is promulgated for use as an addendum concerning seller financing.

Standard Contract Form TREC No. 28-0 is promulgated for use as an addendum to be attached to promulgated forms of contracts where reports are to be
obtained relating to environmental assessments, threatened or endangered species, or wetlands.

Standard Contract Form TREC No. 30-4 is promulgated for use in the resale of a residential condominium unit.

Standard Contract Form TREC No. 32-0 is promulgated for use as a condominium resale certificate.

Standard Contract Form TREC No. 33-0 is promulgated for use as an addendum to be added to promulgated forms of contracts in the sale of property adjoining and sharing a common boundary with the tidally influenced submerged lands of the state.

Standard Contract Form TREC Form No. 34-1 is promulgated for use as an addendum to be added to promulgated forms of contracts in the sale of property located seaward of the Gulf Intracoastal Waterway.

Standard Contract Form TREC Form No. 36-2 is promulgated for use as an addendum to be added to promulgated forms of contracts in the sale of property subject to mandatory membership in an owners' association.

Standard Contract Form TREC Form No. 37-1 is promulgated for use as a resale certificate when the property is subject to mandatory membership in an owners' association.

Standard Contract Form TREC Form No. 38-1 is promulgated for use as a notice of termination of contract.

Standard Contract Form TREC Form No. 39-4 is promulgated for use as an amendment to promulgated forms of contracts.

TREC Form No. 40-0 is promulgated for use as an addendum to be added to promulgated forms of contracts when there is a condition for third party financing.

TREC Form No. 41-0 is promulgated for use as an addendum to be added to promulgated forms of contracts when there is an assumption of a loan.

(B)
When negotiating contracts binding the sale, exchange, option, lease or rental of any interest in real property, a real estate licensee shall use only those contract forms promulgated by the Texas Real Estate Commission for that kind of transaction with the following exceptions:

(1) transactions in which the licensee is functioning solely as a principal, not as an agent;
(2) transactions in which an agency of the United States government requires a different form to be used;

(3) transactions for which a contract form has been prepared by the property owner or prepared by an attorney and required by the property owner;

(4) transactions for which no standard contract form has been promulgated by the Texas Real Estate Commission, and the licensee uses a form prepared by an attorney at law licensed by this state and approved by the attorney for the particular kind of transactions involved or prepared by the Texas Real Estate Broker-Lawyer Committee and made available for trial use by licensees with the consent of the Texas Real Estate Commission.

(C) A licensee may not practice law, offer, give nor attempt to give advice, directly or indirectly; the licensee may not act as a public conveyancer nor give advice or opinions as to the legal effect of any contracts or other such instruments which may affect the title to real estate; the licensee may not give opinions concerning the status or validity of title to real estate; and the licensee may not attempt to prevent nor in any manner whatsoever discourage any principal to a real estate transaction from employing a lawyer. However, nothing herein shall be deemed to limit the licensee's fiduciary obligation to disclose to the licensee's principals all pertinent facts which are within the knowledge of the licensee, including such facts which might affect the status of or title to real estate.

(D) A licensee may not undertake to draw or prepare documents fixing and defining the legal rights of the principals to a transaction. In negotiating real estate transactions, the licensee may fill in forms for such transactions, using exclusively forms which have been approved and promulgated by the Texas Real Estate Commission or such forms as are otherwise permitted by these rules. When filling in such a form, the licensee may only fill in the blanks provided and may not add to or strike matter from such form, except that licensees shall add factual statements and business details desired by the principals and shall strike only such matter as is desired by the principals and as is necessary to conform the instrument to the intent of the parties. A licensee may not add to a promulgated earnest money contract form factual statements or business details for which a contract addendum, lease or other form has been promulgated by the commission for mandatory use. Nothing herein shall be deemed to prevent the licensee from explaining to the principals the meaning of the factual statements and business details contained in the said instrument so long as the licensee does not offer or give legal advice. It is not the practice of law as defined in this Act for a real estate licensee to complete a contract form which is either promulgated by the Texas Real Estate Commission or prepared by the Texas Real Estate Broker-Lawyer Committee and made available for trial use by licensees with the consent of the Texas Real Estate Commission. Contract forms
prepared by the Texas Real Estate Broker-Lawyer Committee for trial use may be used on a voluntary basis after being approved by the commission. Contract forms prepared by the Texas Real Estate Broker-Lawyer Committee and approved by the commission to replace previously promulgated forms may be used by licensees on a voluntary basis prior to the effective date of rules requiring use of the replacement forms.

(E)
Where it appears that, prior to the execution of any such instrument, there are unusual matters involved in the transaction which should be resolved by legal counsel before the instrument is executed or that the instrument is to be acknowledged and filed for record, the licensee shall advise the principals that each should consult a lawyer of the principal's choice before executing same.

(F)
A licensee may not employ, directly or indirectly, a lawyer nor pay for the services of a lawyer to represent any principal to a real estate transaction in which the licensee is acting as an agent. The licensee may employ and pay for the services of a lawyer to represent only the licensee in a real estate transaction, including preparation of the contract, agreement, or other legal instruments to be executed by the principals to the transactions.

(G)
A licensee shall advise the principals that the instrument they are about to execute is binding on them.

(H)
Forms approved or promulgated by the commission may be reproduced only from the following sources:

(1) numbered copies obtained from the commission, whether in a printed format or electronically reproduced from the files available on the commission's Internet site;
(2) printed copies made from copies obtained from the commission;
(3) legible photocopies made from such copies; or
(4) computer-driven printers following these guidelines.

(a) The computer file or program containing the form text must not allow the end-user direct access to the text of the form and may only permit the user to insert language in blanks in the forms or to strike through language at the direction of the parties to the contract.
(b) Typefaces or fonts must appear to be identical to those used by the commission in printed copies of the particular form.
(c) The text and number of pages must be identical to that used by the commission in printed copies of the particular form.
(d) The spacing, length of blanks, borders and placement of text on the page must appear to be identical to that used by the commission in printed copies of the form.

(e) The name and address of the person or firm responsible for developing the software program must be legibly printed below the border at the bottom of each page in no less than six point type and in no larger than 10 point type.

(f) The text of the form must be obtained from a copy of the form bearing a control number assigned by the commission.

(I)
The control number of each copy must appear on all forms reproduced from the copy, including forms reproduced by computer-driven printers.

(J)
Forms approved or promulgated by the commission must be reproduced on the same size of paper used by the commission with the following changes or additions only.

   (1) The business name or logo of a broker, organization or printer may appear at the top of a form outside the border.
   
   (2) The broker's name may be inserted in any blank provided for that purpose.

Source Note: The provisions of this §537.11 adopted to be effective January 1, 1976; amended to be effective January 4, 1983, 7 TexReg 4462; amended to be effective October 20, 1983, 8 TexReg 3999; amended to be effective May 16, 1985, 10 TexReg 1419; amended to be effective August 1, 1985, 10 TexReg 1075; amended to be effective May 19, 1986, 11 TexReg 2093; amended to be effective February 12, 1987, 12 TexReg 346; amended to be effective October 5, 1990, 15 TexReg 5483; amended to be effective September 1, 1992, 17 TexReg 2394; amended to be effective February 1, 1994, 18 TexReg 8200; amended to be effective September 1, 1994, 19 TexReg 3576; amended to be effective March 1, 1995, 19 TexReg 9996; amended to be effective January 3, 1996, 20 TexReg 11016; amended to be effective January 1, 1998, 22 TexReg 10133; amended to be effective September 1, 1998, 23 TexReg 6956; amended to be effective March 1, 1999, 23 TexReg 13075; amended to be effective January 1, 2000, 24 TexReg 9001; amended to be effective April 19, 2000, 25 TexReg 3270; amended to be effective September 1, 2000, 25 TexReg 6700; amended to be effective April 1, 2001, 26 TexReg 978; amended to be effective February 1, 2002, 26 TexReg 9383; amended to be effective April 1, 2003, 28 TexReg 677.

**SUMMARY**

This lesson covered the Texas specific laws pertaining to contracts, and, consequently deeds. The first sections of this lesson explained and presented all
the Texas statutes relating to contracts, including the Statute of Frauds, disclosures, remedies for breach of contract and legal land description. The second part of this course clarified the meaning and implications of the unauthorized practice of law and presented TREC rules pertaining to promulgated forms.

Texas has its own Statute of Frauds legislation that requires many contracts, including deeds and lease agreements for longer than a year, to be in writing. In addition, the state of Texas requires everyone to record any interest they hold in land in the county clerk's office in the county where the land is located. The law states that only acknowledged deeds may be recorded. This means that, although not generally required for valid conveyance, all deeds must be acknowledged and properly recorded.

Texas also has a list of required disclosures. While sellers, and their respective agents, must disclose all material facts pertaining to a property, Texas lists four, specific disclosures that must be made: the risk of lead-based paint, the presence of any structural or latent defects, the potential for additional tax liability and the conditions under the surface of undeveloped property.

A breach of contract refers to when a party does not fulfill (without legal cause) its stated role in a contract. In the State of Texas, both a buyer and a seller have certain legal remedies for breach of contract. If a buyer breaches a contract, then the seller could: rescind the contract, declare the contract forfeited, sue for specific performance and/or sue for compensatory damages. If a seller breaches a contract, then a buyer has three options: rescind the contract, file a suit for specific performance and/or sue for compensatory damages.

While there are many legal land description methods that distinguish a property from all other properties in the world, most states will pick one method and use it consistently. The State of Texas uses the metes and bounds method of land description. To use the metes and bounds method, a surveyor places a monument, usually a metal pole or stone/concrete fixture 1 to 2 inches in diameter, in a corner of a parcel. He or she then describes the parcel's distance and direction from that point by measuring the perimeter of the lot in feet, usually to the tenth or hundredth of a foot.

Licensees are not attorneys and may not engage in the unauthorized practice of law. To help licensees carry out their daily tasks, the Real Estate License Act provides for a Real Estate Broker-Attorney Committee, which creates and approves standardized forms for use by real estate brokers and salespersons. Brokers and salespersons may only use these documents. They may not prepare or generate any legal document, including a deed. The most common promulgated form used in residential sales is the *One to Four Unit Residential (Resale)*, which is TREC Form No. 20-7. In addition to using only promulgated forms, licensees must avoid giving legal advice, opinions or making any
comments as to the legal effects of any legal document. Texas also forbids licensees from directly or indirectly employing an attorney for a real estate transaction or paying attorney fees on behalf of a principal in a transaction as this could create a conflict of interest. TREC rules pertaining to these issues, and a few other particularities of the different roles of attorneys and licensees, are available in the Texas Administrative Code, Title 22, Part 23, Chapter 537.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FOUR
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Matching
- Field Application of Deeds Material

INTRODUCTION

This module has covered a substantial amount of detailed information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided in this module, using a series of exercises and case studies. The first half of this lesson uses a matching exercise to illustrate different types of deeds and their functions. The second half presents case studies that examine the principles and ideas presented in this module. Upon completion of this lesson, the student will have a better understanding of the real-world applications of the information he or she has been studying.

MATCHING

DEED TYPES AND CLAUSES

As the real estate market becomes increasingly competitive, only knowledgeable, skilled licensees will continue to stand apart. Licensees must respect their legally defined roles, meaning that they cannot create deeds. However, it is well within a licensee's authority to properly identify documents (without commenting on their legal implications). Offering this kind of competent insight is also a good way to show a client your exceptional level of expertise.

Now, imagine that you are a real estate salesperson. You see a deed in your client's hand. Could you properly identify what section you are looking at and what type of deed it is? The following is an exercise to test your skills in this regard.

Activity Instructions

Below is a list of statements regarding phrases that commonly appear in the deeds we have discussed. This activity asks you to identify the clause in the deed in which such a phrase would be expected to appear, and then to identify the type of deed that would typically contain such a phrase. The first blank will thus always need to be filled in with some kind of clause and the second blank
with some type of deed. Some words and phrases may not need to be used at all, and some terms may be used more than once.

**WORD BANK**

Granting  
Habendum  
Bargain and sale  
General Warranty  
Special Warranty  
Quitclaim

1. If you see the phrase “grant, bargain, sell and convey,” you can generally conclude that this is part of the _____ clause in a _____ deed.

2. If you see the phrase “this conveyance is made without warranty, expressed or implied,” you can generally conclude that this is part of the _____ clause in a _____ deed.

3. If you see the phrase “hereby . . . and releases,” you can generally conclude that this is part of the _____ clause in a _____ deed.

4. If you see the phrase “remiss, release, alienate and convey,” you can generally conclude that this is part of the _____ clause in a _____ deed.
DEED TYPES AND CLAUSES ANSWERS

1
If you see the phrase “grant, bargain, sell and convey,” you can generally conclude that this is part of the _____ clause in a _____ deed.
(Granting, general warranty)

2
If you see the phrase “this conveyance is made without warranty, expressed or implied,” you can generally conclude that this is part of the _____ clause in a _____ deed.
(Habendum, bargain and sale)

3
If you see the phrase “hereby . . . and releases,” you can generally conclude that this is part of the _____ clause in a _____ deed.
(Granting, quitclaim)

4
If you see the phrase “remit, release, alienate and convey,” you can generally conclude that this is part of the _____ clause in a _____ deed.
(Granting, special warranty)

FIELD APPLICATIONS OF DEEDS MATERIAL

This section contains situations that licensees may face in the field. Please read each case study and then answer the question following it.

CASE STUDY ONE

Licensee A represents Seller B in a residential real estate transaction. They find a party interested in Seller B’s home and begin negotiations. Licensee A and Seller B disclose to Potential Buyer C the possibility of additional taxation. Upon hearing that a change in ownership could change the tax status of the property, Potential Buyer C decides he should seek legal counsel. Knowing that Potential Buyer C is truly interested in the home, and not wanting to lose the sale over additional costs incurred by Potential Buyer C, Licensee A offers to hire an attorney on the buyer’s behalf. Licensee A says she will contact adequate representation and that her brokerage will cover any associated attorney’s fees.

Is Licensee A’s actions in accordance with Texas Law and TREC Rules? Choose the correct letter from the choices that follow. Write your response in the space provided and check your answer on the next page.
A: Yes, because she adequately disclosed the possibility of additional taxation.
B: Yes, because she adequately disclosed the possibility of additional taxation and encouraged a principal to a transaction to seek legal council.
C: No, because disclosing the possibility of additional taxation constitutes the unauthorized practice of law.
D: No, because, although her disclosure and encouraging legal council is the correct course of action, offering to hire an attorney and/or pay for incurred costs on behalf of a principal violates TREC Rules.
CASE STUDY ONE RESPONSE

The correct response is D.

Although Licensee A seems well meaning and does properly disclose the risk of additional taxation, she does in fact violate TREC Rule 537.11 Section F, which states:

“A licensee may not employ, directly or indirectly, a lawyer nor pay for the services of a lawyer to represent any principal to a real estate transaction in which the licensee is acting as an agent. The licensee may employ and pay for the services of a lawyer to represent only the licensee in a real estate transaction, including preparation of the contract, agreement, or other legal instruments to be executed by the principals to the transactions” (Title 22, Part 23, Chapter 537, Rules 537.11 (F)).

According to TREC Rules, licensees may not directly or indirectly employ the legal council of any party to a transaction. In addition, no licensee may pay the fees associated with legal representation. This is because it could lead to a conflict of interest. All principals must seek and employ their own legal council, if desired.

CASE STUDY TWO

Licensee X found a buyer for Residential Home Y. He knows that he may not prepare a legal document, such as a deed, so he starts going through the promulgated forms provided by TREC. Given that the property is a standard, residential, single-family, pre-owned home which form should Licensee X use to transfer title from the grantor to the grantee?

A: One to Four Family Resale
B: New Home, Complete Construction
C: Farm and Ranch
D: Condominium
CASE STUDY TWO RESPONSE

The correct response is A.

The Real Estate Broker-Attorney Committee promulgates forms for licensee use. In a standard, residential resell, a licensee should use TREC Form No. 20-7, the *One to Four Family Resale* document.

CASE STUDY THREE

Licensee A represents Buyer B in a sales transaction for the purchase of a residential property. Although Buyer B paid for the home, Seller C does not deliver title to the property.

Buyer B could seek all of the following legal remedies, EXCEPT which one?

A: Sue for specific performance
B: Rescind the contract
C: Declare the contract forfeited
D: Sue for compensatory damages
CASE STUDY THREE RESPONSE

The correct response is C.

In this situation, the seller breached the contract. This means that the seller did not perform as stated in the contract (without any legal cause). The aggrieved buyer has three options: to sue for specific performance, to rescind the contract and/or to sue for compensatory damages. Specific performance refers to a court order that would force the seller to comply with the terms of the contract and relinquish title to the subject property. Rescinding the contract would affectively cancel the contract, and the buyer would receive his or her earnest money back. In addition to these two legal remedies, a buyer could sue for compensatory damages. Generally, compensatory damages accompany one of the previous legal remedies. Answer option C is not a buyer remedy; rather, it is a remedy for a seller in the event that a buyer breaches a contract. Declaring a contract forfeited means that the contract is cancelled and the seller retains all earnest money or other funds paid by the buyer.

CASE STUDY FOUR

Homeowner Y holds title in Residential Property X. He has just recently learned that the State of Texas requires all interest in real property to be recorded in the county clerk’s office of the county in which the property is located. He goes down to the county clerk’s office to record his deed, but is unable to do so. The officer tells Homeowner Y that the deed is not acknowledged, and consequently, may not be recorded.

Why do all deeds in Texas require acknowledgment?

A: Because in Texas it is required for a valid contract  
B: Because in Texas only acknowledged deeds may be recorded
C: Because in Texas it is required for valid conveyance
D: Because in Texas it supercedes the granting clause
CASE STUDY FOUR RESPONSE

The correct response is B.

Acknowledgment refers to a formal declaration before specific authorities that a person is who he or she says he or she is, and that he or she has signed a document voluntarily. While acknowledgment is commonly included, it is not required for valid conveyance or for a valid contract. However, like many other states, the State of Texas requires all interest in real property to be recorded and only acknowledged deeds may be recorded. The result of holding an unacknowledged deed in Texas is complex and Homeowner Y will need to seek legal council.

CASE STUDY FIVE

Buyer C wants to purchase Seller C’s house. They have known each other for years and, consequently, want to remove a lot of the legal actions involved with a standard transaction kept at an arm’s length. The two principals approach Licensee A about the issue and ask her if an oral contract will adequately convey title to the subject property.

How should Licensee A respond?

A: She should tell them that the Statute of Frauds prevents this and offer to prepare a deed for them.
B: She should offer to look for exceptions to the Statute of Frauds.
C: She should tell the parties that she is unable to comment on legal issues and direct both parties to legal council.
D: She should state that such a contract might not be binding and offer to fill out TREC Form 20-7, One to Four Unit Residential Resale.
CASE STUDY FIVE RESPONSE

The correct response is C.

This is a difficult situation. Although it is true that the Statute of Frauds prevents oral contracts in the conveyance of real property and that an oral contract is unlikely binding, it is not the licensee’s place to say this, as doing so would violate TREC Rule 537.11. If a licensee offers legal opinions or advice, presents a deceptive level of expertise and/or prepares a legal document, such as a deed, then he or she could be guilty of the unauthorized practice of law. Given the situation, Licensee A should tell the parties that she is unable to comment on legal issues and recommend that both parties seek legal council.
# Texas Principles of Real Estate

## Module 9: Titles and Records

### Introduction
- Learning Objectives
- Key Terms

<table>
<thead>
<tr>
<th>Time</th>
<th>Activity</th>
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### Lesson 1: Public Records and Recording
- Recording
- Public Records
- Prospective Buyer's Responsibilities When Researching a Property

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### Lesson 2: Titles
- Voluntary Alienation
- Involuntary Alienation
- Title History
- Evidence of Title
- Marketable Title

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### Lesson 3: Title Transfers
- Types of Ownership
- Types of Deeds

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### Lesson 4: Real Estate Practice
- Activity
- Insight into Titles and Records
- Field Application of Titles and Records Information

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### Total Time:
- 210 minutes (3.5 Hours)
INTRODUCTION

Recording entails the placement of a document into the public record. This process is necessary because it allows sellers to guarantee potential buyers of a valid title conveyance by presenting records that reveal a clean and good title. The county clerk’s office maintains the public record, which is comprised of *libers*. This is where individuals can file or access documents pertaining to real estate interests, conveyances, liens, encumbrances, etc.

In accordance with TREC rules Sections 535.71 and 535.72D, this module will cover how to record public documents and the importance of doing so. In addition, it will outline the priority that recorded documents hold, as well as why either constructive or actual notice is important and the difference between the two.

Upon completion of this module, students will be better equipped to assist customers and clients through the home-finding and marketing steps of the real estate transaction, as well as through closing. In addition, students will understand why it is important to tell consumers to obtain abstracts and why they should have the abstracts reviewed by a licensed attorney.

This module includes the following lessons:

- Recording and Public Records
  - Titles
  - Title Transfers

The concluding lesson in this module presents real-world dilemmas and concrete applications of the information presented in the rest of the course. As the student completes this module, he or she should try to develop a broad picture of titles and records and how they fit into the larger practice of real estate; the last lesson will help with this project by presenting comprehensive content questions, practice problems and case studies.
KEY TERMS

Abstract of Title: A brief history of title to a particular parcel of real estate. It is a summary of the public records that exist regarding that parcel and presents a compressed listing of the various events and changes that have affected it over time. The abstract chronicles any transfers in ownership as well as any divisions of ownership interest. It also records liens and other encumbrances that may be associated with the property. A certificate identifying the period of time covered accompanies most abstracts, but there are no standard forms or methods for presenting or creating one.

Action to Quiet Title: (Also called “suit to quiet title” and “quiet-title action”) This is a legal proceeding which attempts to establish ownership when there is a real or potential defect in a title created by a lien or other encumbrance. Generally, the action aims to resolve difficulties created by the tension between the apparent or legally recognized owner’s claim to a property and the rights or interests in that property that may have been acquired by creditors or other parties who are not (presently) the recognized, legal owners of the property.

Actual Notice: In the context of our course, “notice” is the communication (sometimes required by a contract or by law) that alerts an individual to some fact. “Actual notice,” then, is some form of communication given directly to the individual being alerted to the existence of the fact—that is, it is notice he or she has received personally. One can also gain “actual notice” on one’s own, without receiving any explicit communication from another person. For example, one would have direct knowledge—that is, “actual notice”—about a property after researching that property through public records or by performing a property inspection.

Chain of Title: The chain of title traces the history of who has owned a particular parcel of land, and for what time period. The chain of title is effectively the lineage of ownership, showing the history of transfers and divisions of interest, if any, and displaying the complete line of property owners in chronological order. The term “chain of title” can also identify a part of a title search that aims at finding this information.

Cloud on Title: This phrase refers to a real or potential flaw in title, created by a lien or other encumbrance associated with the property. These defects can be problematic because they create a tension between the legally recognized owner’s claims to the property and the rights or interests which may have been acquired by creditors or other parties that are not the recognized, legal owners of the property.

Constructive Notice: In the context of our course, “notice” is the communication (sometimes required by a contract or by law) that alerts an individual to some fact. “Constructive notice” is a kind of notice that an individual
is presumed to have—there is no explicit communication of a fact, but the facts involved are such that the individual can reasonably be expected to have this information. For example, the act of publicly recording the documents related to real estate conveyance makes this information accessible to others, such that in some cases they might reasonably be presumed to have constructive notice of the facts contained in those documents.

**Deed:** A written instrument used to transfer or convey a property owner’s right, interest or title in a property. We should note that a deed is importantly different from a title—a title is not an instrument of conveyance, but a deed is.

**Evidence of Title:** The information, documents or other data that provides proof that an individual owns a particular parcel of real estate. The specific data that can count as evidence of title may vary from state to state.

**Fee Simple Estate:** “Fee simple” is the broadest possible category of ownership interest, in which an individual holds ownership rights in full and there are no time limits or other terms imposed on that individual’s ownership. Thus, an individual who holds a “fee simple estate” is permitted to use and distribute the owned property as he or she sees fit, as long as he or she respects the law.

**Granting Clause:** For the purposes of our course, a “granting clause” is a statement of the grantor’s intention to convey the ownership rights he or she has in a property, in which he or she transfers interest in the deed to that property.

**Habendum Clause:** This clause is part of a deed. The clause describes the extent of ownership interest that is being conveyed by the transfer of the deed, as well as any conditions or limits that the grantor is imposing on the interest being transferred.

**Liber:** A book of public records, frequently composed of photocopies of recorded documents such as deeds. A public records office, such as a county clerk’s office, generally holds these books although their specific location will vary from state to state and can vary from one county to another. Multiple books of this sort are called “libers.”

**Lien:** When an individual fails to pay a debt, the creditor to whom that debt is owed can sometimes acquire a legal right to or interest in the debtor’s property. This right or interest is generally relinquished when the debt is paid. Such a right or interest is called a “lien.”

** Marketable Title:** A title to a parcel of real estate that would generally be acceptable in a transaction because it is apparently complete and otherwise in proper order. This does not mean that it is in fact free of defects or other inaccuracies, only that it seems to cover the subject property in its entirety and to be otherwise complete.
**Owner's Bundle of Rights:** The intangible ownership rights associated with real property rather than real estate, including the right to control the property within the framework of the law, the right of exclusion, the right of possession, the right of disposition and the right of enjoyment. These rights are what distinguish real estate from real property; the latter notion includes these rights, whereas the former includes only the land and that which is permanently attached to it.

**Recording:** The act of entering documents into a public registry or record. For the purposes of our course, we are especially interested in the process of entering those documents that convey interests in real estate. The process of recording—for any sort of document—is sometimes also legally referred to as "recordation."

**Subrogation:** This is a process in which a debtor is replaced with another, third party who pays the debtor's debt and thus acquires whatever rights and privileges might have originally been assigned to the debtor. This process allows a title insurance company to assume the rights of the original claimant to recover damages from anyone who is responsible for the claim.

**Title:** Legal evidence—often in the form of a written document—that an individual has legitimate ownership rights to a particular parcel of real estate. A title constitutes the most basic legal connection between a piece of land and the person who owns it.

**Title Insurance:** A kind of insurance that protects a policyholder from liabilities and hazards associated with his or her title to a particular parcel of real estate. For example, title insurance can help an owner to deal with mistakes in the public records relating to his or her property.

**Title Search:** This is an examination of the public records associated with the title to a particular parcel of real estate. In general, one of the main objectives of any title search is to ascertain that the person who claims to own the parcel genuinely possesses the legal right to sell and transfer ownership of the parcel. However, the title search is also concerned with establishing the chain of title and the absence of liens and other encumbrances. In short, a title search helps to ensure that a prospective buyer is getting what he or she believes, and that he or she is not acquiring any hidden legal liabilities in the process.
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Outline the general steps involved in recording.
- Distinguish between different types of public records.
- Explain the common methods of property conveyance.
- Describe the difference between constructive and actual notice.
- Identify evidence of titles.
- Explain title insurance and coverage.
- Describe the different types of property ownership.
- Differentiate between the various types of deeds.
LESSON ONE
PUBLIC RECORDS AND RECORDING

This lesson focuses on the following topics:

- Recording
- Public Records
- Prospective Buyer’s Responsibilities When Researching a Property

INTRODUCTION

“Recording” is the process of entering a document into the public record; for our purposes, we are primarily concerned with recording those documents related to the conveyance of real estate. This process is important because it provides prospective buyers with accessible, legally acceptable evidence of a clean and legitimately held title. This kind of evidence helps sellers to assure prospective buyers that any transaction that takes place between them will involve a valid title conveyance. This kind of assurance makes a transaction much more attractive than one in which this kind of evidence is not provided.

The location of these public records will vary from state to state (and can vary from one county to another), but often the county clerk keeps them or they are kept in an office that performs a similar regulatory role. This public record is usually made up of books called “libers,” which are frequently composed of photocopies of recorded documents such as deeds. This public record is where individuals can find documents pertaining to a particular parcel of real estate that will tell them about real estate interests, conveyances, liens, encumbrances and other issues that relate to the property. When people file various documents connected with a conveyance of ownership, this record is where they are entered.

This lesson will cover how public documents are recorded and why this process matters. In addition, it will discuss the priority that recorded documents hold, as well as the distinction between constructive notice and actual notice and the role played by each sort.

RECORDING

To record a document, an individual must submit the document to the proper state or county office. The specific location to which documents must be submitted will vary from state to state (and can vary from one county to another), but it is often a county clerk’s office or a similar regulatory office or body. Once the document has been submitted, it is reviewed to ensure that it conforms to all relevant state-specific statutes.
Once this conformity has been confirmed, the office accepting the document will collect fees and any necessary forms, and then the office will copy the document and enter it into the public record. The original document is generally returned to the person who presented it for recording.

Most states have laws requiring all parties involved in a real estate transaction to enter all of their formal real estate-related documents into the public record so that the facts contained in those documents are made available. This recording process is part of providing legal, public and constructive notice of ownership interests; we will discuss the role of notice and its various forms later in this lesson. The documents that are entered into the public record must also conform to a state’s statute of frauds.

**STATUTE OF FRAUDS**

A state’s statute of frauds is a state law that establishes the features of a valid contract. For example, a state’s statute of frauds will generally require that certain types of contracts—including real estate contracts—be set out in writing and that written contracts be signed by all the parties bound by the contract. Licensees should acquaint themselves with the specific requirements set out in their states’ statutes, because there are frequently subtle differences between one state’s statute of frauds and that of another state.

In general, however, most states’ statutes require the following contracts be in writing:

- Contracts which involve the sale or transfer of land
- Contracts in which one party assumes the obligations of another party
- Contracts which extend over a period of more than twelve months
- Contracts for the sale of goods

A written contract can generally be handwritten, typed, printed, photocopied or photographed. It may include letters, pictures, maps, memoranda and other documents.

**ACKNOWLEDGEMENT**

Before a document can be entered into the public record, it must be notarized. Signing a document before a notary public or authorized public officer amounts to a declaration that the person signing is doing so freely and voluntarily. Identifying oneself to the notary also provides evidence that the signature on the document is authentic; it amounts to a declaration that the individual signing the document is, in fact, the person he or she claims to be. These formal declarations are “acknowledgement.”
A notarized document will bear the notary’s seal and will include the expiration date of the notary’s commission. If a notary public is unavailable, there are often other authorized public officials who can accept the acknowledgements that play an important role in giving a document its proper legal authority. The specific individuals who can accept and document acknowledgements will vary from state to state (and can vary from one county to another), but they often include:

- Recording office clerks
- Commissioners of deeds
- Judges of court records
- Military officials
- Justices of the peace
- Foreign ministers
- Consular agents

TORRENS SYSTEM

As discussed briefly, the Torrens system is a method of recording or registering the titles to parcels of land. It is named after its creator, Sir Robert Torrens. This method gives special authority to a registered title: under this system, when a registered title is transferred, that title is absolute—it is backed by the authority of the state in which the title was registered. This system still influences the recording processes that most states follow today, though the specific processes that are required to establish clear title to a parcel of land will vary from state to state and can vary from one county to another.

Even though state and local systems will vary—both relative to one another and relative to the original Torrens system—we can still make some general points about the Torrens systems itself which will give us a sense of the general process involved. The Torrens system requires a landowner to record the title itself, not just evidence that he or she holds title to the parcel in question. The owner must, therefore, establish title to the property.

He or she must first obtain an abstract of title, which is a condensed history of the events that have affected the title to the property. The abstract will include the names of previous owners and will also note the existence of any liens or other encumbrances on the property. It may very well include a variety of other information—there is no standardized form or method for creating or presenting an abstract of title.

The landowner then applies to the appropriate local court for a certificate of title. Receiving a certificate of title often involves a hearing which presents an opportunity for all of the parties named in the abstract and any other parties who may have claims to the property to make their claims known. If no other party presents a valid claim overriding or otherwise abridging the applicant’s ownership claim, then the state’s registrar of titles (or some similar local authority) will
prepare a certificate of title. This certificate officially recognizes the applicant as the legal owner of the property and lists any liens or other encumbrances associated with the property.

Under the Torrens system, transfer or possession of a deed does not necessarily ensure land conveyance. When a property owner receives a deed, he or she must take the deed to the state’s registrar of titles (or another appropriate state authority). The registrar (or other state official) will then cancel the grantor’s certificate of title and issue a new certificate of title in the name of the grantee.

**PUBLIC RECORDS**

As we have discussed, real property records document official ownership and identify any liens and other encumbrances that may be associated with a property. Public records also generally include any records maintained by the general land office; local surveyors; city, county or district clerks; as well as the records of county assessors, collectors and treasurers. Documents concerning ordinances, zoning, leases, contracts, taxes or special assessments are usually part of a region’s public records as well.

These records therefore provide prospective buyers with access to a broad spectrum of information concerning a particular parcel of real estate, access which provides them with an opportunity to minimize any uncertainties that may arise regarding the parcel of real estate they are considering or the transfer of its ownership.

Public records thus provide constructive notice to the public regarding ownership interests and the various past events that may affect the title to a specific parcel of real estate. That is to say, these records make the facts about a title’s history and its current standing publicly available; therefore, individuals involved in a transaction that relies on a particular title can be presumed to have knowledge of the relevant historical facts affecting that title. Because public records make such a wealth of information available to prospective buyers, the burden of discovering defects in a property or its title generally falls on those prospective buyers.

Information, which may be contained in public records, includes documentation of the following entities:

- Mortgage liens
- Judgment liens
- Mechanic’s liens
- Pending lawsuits
- Easements
We will now discuss the details of these various entities and their relevance for real estate transactions.

**MORTGAGE LIENS**

When an individual fails to pay a debt, the creditor to whom that debt is owed can sometimes acquire a legal right to or interest in the debtor’s property. This right or interest is generally relinquished when the debt is paid. Such a right or interest, as you may recall, is called a “lien.”

A mortgage lien is a lien on the property that was purchased with money borrowed from a lender. The borrower uses the property as collateral and places it as security for a home equity loan. The lien then guarantees repayment to the lender if the borrower does not make the required payments on the mortgage loan, because this lien allows the lender to force the sale of a property to recover unpaid loan funds.

In other words, a mortgage allows the borrower to have full legal title to a property, but the lender has a lien on the property and can foreclose on the property (i.e., terminate the borrower’s ownership interest in the property) if the borrower does not make appropriate mortgage payments. Mortgage lenders generally require what is called a “preferred lien” (also known as a first mortgage lien), under which no other major liens against the property (other than real estate taxes) can take priority over the mortgage lien.

In some states, a deed of trust is used rather than a mortgage lien. A deed of trust conveys title to a trustee until the loan has been repaid.

**JUDGMENT LIENS**

A judgment lien reflects a court decision concerning the rights and claims of parties in a suit. For example, a creditor can sue to have a lien placed on a debtor’s property to guarantee the repayment of a debt. A judgment lien does not become effective until it is recorded. Once the borrower repays the debt on a property, the lender can release the property to the property owner. This release should also be recorded, so that the appropriate authorities can remove the judgment lien from the property’s public record.

**MECHANIC’S LIENS**

A mechanic’s lien establishes a claim against a property to secure payment for labor or materials used to improve that property. This lien protects contractors, laborers, subcontractors and other individuals who earn their living by supplying labor and materials by ensuring that they will be paid for any work they have completed. This type of lien allows them to file suit against any non-paying parties to recover damages. The existence of mechanic’s liens provides property
owners a strong incentive to pay these individuals their debts because a property cannot easily be sold when outstanding liens are associated with it.

**PENDING LAWSUITS**

The public record regarding a property will often include evidence of any pending lawsuits involving that property. Such a lawsuit may also be referred to as “lis pendens,” which is Latin for “suit pending” and is the formal legal term for this type of suit. Recording a pending lawsuit provides constructive notice to anyone investigating the property by making this fact publicly available, thereby, warning prospective buyers about future liens that may be associated with the property.

**EASEMENTS**

Easements are an interest in, or a right to use, another individual’s land or property, generally for a specific, limited purpose. For example, a right-of-way is a kind of easement in which an individual is allowed to travel across property owned by someone else. Property owners usually allow easements or setbacks for the placement of gas lines, electric lines, railroad tracks, phone lines, utility poles, trenches, sewer lines and the provision of other utilities.

It is important that easements are entered into the public record because they are, in effect, a kind of abridgement of full ownership rights. For example, if a property has an established public right-of-way running across it, prospective buyers of this property should be alerted of this fact because any established easements usually “come with” a property when someone chooses to buy it.

**ACTIVITY**

In this activity, you will be presented with a word bank containing the names of the various legal entities we have just discussed. Fill in all blanks appropriately.

**WORD BANK**

- Mortgage liens
- Judgment liens
- Mechanic’s liens
- Pending lawsuits
- Easements

1. _____ guarantee repayment to lenders by allowing them to force the sale of property if borrowers do not make their required loan payments.

2. Public records of _____ provide constructive notice that there is an incipient legal action involving the property.
3 _____ entitle individuals or groups to use property which they do not own for specific, limited purpose.

4 _____ reflect a court decision concerning individuals’ rights and claims to property.

5 _____ allow contractors, laborers and other suppliers to recover damages when clients do not pay for services they rendered to improve those clients’ properties.
ACTIVITY ANSWERS

1. _____ guarantee repayment to lenders by allowing them to force the sale of property if borrowers do not make their required loan payments. (Mortgage liens)

2. Public records of _____ provide constructive notice that there is an incipient legal action involving the property. (Pending lawsuits)

3. _____ entitle individuals or groups to use property which they do not own for specific, limited purpose. (Easements)

4. _____ reflect a court decision concerning individuals' rights and claims to property. (Judgment liens)

5. _____ allow contractors, laborers and other suppliers to recover damages when clients do not pay for services they rendered to improve those clients' properties. (Mechanic's liens)

ACCESSING AND USING PUBLIC RECORDS

When documents are entered into public record, copies of those documents are placed in chronological order with other related papers, and the set of papers is placed into a book (usually called a “liber”). This book is then made available for public viewing. Some states require that these records be converted to microfilm to make them more readily accessible. The specific process involved in gaining access to a set of public records can vary, depending on the specific state and county in which the records are located.

When searching for real property records, there are generally three basic locations in which an individual can look:

- The tract index
- The grantor index
- The grantee index
Whether any one of these indexes is available will vary from county to county. However, even when the index itself does not exist, there is often a different source (or set of sources) from which one can obtain the information. Similarly, the location of these indexes can vary widely, though the registrar of deeds, or a similar local office, often holds them. We will now discuss the details of these three indexes.

**Tract Index**

A tract index will generally record all of the legal transactions related to a particular parcel of land, all in one convenient location. In a tract index, each page is generally dedicated to a single tract of land, which is further broken down into plats, blocks and lots. Because the tract index simply notes these various transactions and does not provide a full record of them, tract index records also often include references to the location of the various complete records in the broader body of public records.

To search for a property, the user needs to have the legal land description—that is, he or she must have the description that reveals which tract, plat and block contain the lot that corresponds to the particular property being researched. One can also sometimes search for a property using its parcel identification number or its tax identification number. Once the user has the appropriate information needed to identify the property, he or she can then view the book in which the property’s record is located.

You can probably see how the tract index could be helpful when preparing an abstract of title. It provides the basic information needed to document a clear chain of title covering the time period from when a property was first owned (or at least from the date that its ownership was first entered into public record) up until the time that the abstract is created.

**Grantor Index**

The grantor index contains part of the information that one can find in a tract index. Specifically, the grantor index (which is sometimes called a “grantor’s index”) lists all the names of people who have transferred their ownership interest in a property. Most grantor indexes are made up of alphabetical collections, which are sometimes also divided by year.

Because this is the way these indexes are generally organized, an individual who is researching a property must know a grantor’s name in order to use the index. Once the researcher finds the grantor’s (seller’s) name in the grantor index, he or she can view the grantee’s (buyer’s) name (because the two parties will be listed as having engaged in the transaction together); the researcher will also usually find a note about where to find the conveyance document in public records, as well as a short description of the document. If the grantee’s name is not
mentioned in the entry for the grantor, the researcher can use this other information to find the recorded deed in public records. From that deed, he or she can determine the grantee’s name.

You will probably guess that the grantor index cannot help us in our research in the same way that the tract index could. Once I find a grantor and a grantee in the index, I cannot readily go further—I know that person X sold the property to person Y, but I cannot easily see what happened to the property after that transaction occurred. This is not especially helpful if, for example, I am trying to trace a chain of title.

However, we can combine the grantor index with another resource, and together they will allow us to trace the chain of title. This other resource is the grantee index.

**Grantee Index**

The grantee index (sometimes also called a “grantee’s index”) is created and organized in roughly the same manner as the grantor index. However, it is organized using the names of grantees—so this index tells us the names of individuals who accepted or purchased ownership interest in a given year. Entries are approximately the same as entries in the grantor index, which means that these entries will tell a researcher who sold or otherwise transferred ownership interest as well as who received it.

So, imagine that I am trying to trace a chain of title; this project will show us how to combine the grantor index and the grantee index into a helpful resource. To employ these indexes in this task, I begin by finding the current owner’s name. This information will not be in the grantor index, because the current owner has not yet transferred his or her ownership interest in the property. Instead, I will have to get this information from a local records office, generally from a place like the local registrar of deeds office, many of which maintain an index of current property owners.

Once I have the current owner’s name, I can look at the recorded deed and find the grantor—the person who sold the property to its current owner. Let’s call these people Owner A (the current owner) and Owner B (the previous owner). Now, I need to find Owner B’s name in the grantee index, that is, I need to find the transaction in which Owner B bought the property. When I find this information, I can find the name of Owner C, the person who sold the property to Owner B. Similarly, I can then seek out Owner C in the grantee index, to find the transaction in which he or she bought the property from Owner D.

I can follow this chain throughout the extant records for the property I am researching. The information I gather from the grantee index can be combined with that contained in the grantor index—once I have learned the various
grantor’s names, I can look them up in that index and find out additional details about the conveyance of the property. By combining these two resources, I can amass virtually the same information I could have gotten from the tract index, and I can certainly gather enough information to establish a chain of title.

**Example: Locating a Record in One of These Three Indexes**

Say the record of a conveyance contains the following information:

<table>
<thead>
<tr>
<th>THE DEED</th>
<th>County ABC, State DEF, Town Lot Book 54, p. 333</th>
</tr>
</thead>
<tbody>
<tr>
<td>DATE OF DOCUMENT</td>
<td>1 Oct 1955 Date of recording: 5 November 1955</td>
</tr>
<tr>
<td>GRANTORS (sellers)</td>
<td>Grantor A (husband) and Grantor AB (wife)</td>
</tr>
<tr>
<td>GRANTEE (buyer)</td>
<td>Grantee Q of County ABC, State DEF</td>
</tr>
<tr>
<td>PROPERTY</td>
<td>Lot No. 5 in Block Number 11 in XYZ's Third Addition to the city of GHI.</td>
</tr>
</tbody>
</table>

The record above could be indexed in one of the following three ways:

- It could be placed in the grantor index under either Grantor A’s name or Grantor AB’s name. In both cases, the entry is likely to be of the form “last name, first name”—thus, an alphabetical search in the grantor index should provide an entry for one or both of the grantors.
- It could be placed in the grantee index under Grantee Q’s name, again most likely in an entry of the form “last name, first name.” Likewise, an alphabetical search of the grantee index will produce an entry for the transaction in which Grantee Q received title to this property.
- It could be placed in the tract index, in an entry identifying it as “Lot No. 5, Block 11 in XYZ’s Third Addition to the city of GHI.” In this case, the researcher must first find the city of GHI in the index, then find XYZ’s third addition to that city in the index, and so on through the increasingly smaller land divisions until he or she finds lot number five, which should be the property in question.

**PROSPECTIVE BUYER’S RESPONSIBILITIES WHEN RESEARCHING A PROPERTY**

Whenever individuals are considering purchasing properties or acquiring partial ownership interest in properties, they should take care to investigate those properties’ backgrounds and titles. Prospective buyers are responsible for gathering information and satisfying their own concerns about the status of the properties’ title. Therefore, a prospective buyer should take the following steps:
He or she should perform a title search, in which the public record is examined to determine whether the person proposing to sell the property actually has the right to sell it, and to ensure that the title to the property is such that the prospective buyer would actually receive all of the ownership rights that he or she is expecting to receive as a result of the transaction.

- He or she should examine the abstract of title (or have such an abstract created, if one does not already exist).
- He or she should examine the chain of title.
- He or she should inspect the property to ensure that the property description in the title corresponds properly to the actual property.

By completing these steps, and conducting any other investigations he or she deems necessary, the prospective buyer takes responsibility for verifying just what it is that he or she will get when purchasing a property. As a result, the prospective buyer need not rely on the seller’s claims about the property—instead, he or she has independent, objective information about the title and the property. In brief, a prospective buyer who has taken these steps has followed the Latin adage “caveat emptor,” which means, “let the buyer beware.”

When someone is selling a property, the seller is only obligated to disclose latent defects to the prospective buyer—that is, the seller need only disclose defects or other problems with the property that are not readily apparent to someone inspecting the property. Something similar is true about the state of the property’s title: if the facts regarding the title have been entered into the public record, then none of these facts are considered to be undisclosed defects in the title—regardless of whether the prospective buyer has in fact researched the relevant public records.

Entering this information into the public record is considered making it publicly accessible—it renders the information “readily apparent” to prospective buyers. This is one reason that prospective buyers must investigate public records pertaining to the any property they are considering.

**CONSTRUCTIVE NOTICE**

We just noted that prospective buyers are effectively responsible for educating themselves regarding the publicly recorded information about any property they are considering. Publicly recording the facts about a property’s title shifts the burden from the seller onto the prospective buyer—by entering these facts into the public record, a seller is considered to have provided all prospective buyers with something called “constructive notice.” That is, the seller has placed this information in a public place accessible to all prospective buyers who may then act on their duty to investigate the publicly recorded facts about a property.
Because prospective buyers have a duty to look out for their own interests in any real estate transaction, they can be presumed to have any information that has been entered into the public record—that is, they can be presumed to have any information they might have found if they had followed through on their duty to look out for their own interests.

Prospective buyers are not liable for liens and encumbrances not filed in public record because this information is not readily available to them. However, they are responsible for any information for which the seller has provided constructive notice. That is to say, a buyer can be held liable—or a seller can be released from liability—if the information at issue has been entered into the public record.

**ACTUAL NOTICE**

Constructive notice can be contrasted with actual notice. When an individual receives actual notice, he or she has been directly notified of a fact—for example, if a seller tells a prospective buyer that there is a lien on a property, the prospective buyer has received actual notice of the existence of the lien. We can think of “actual notice” as meaning something like “direct knowledge.”

After an individual has researched a property through public records or personal inspection, he or she is considered to have direct knowledge (or to have received actual notice) of the information he or she acquired as a result of that research or inspection. We should note, however, that when an individual has received actual notice of a fact regarding a property, he or she should not use lack of constructive notice (such as unrecorded deeds) to validate or invalidate a claim.

**PRIORITY**

Disputes sometimes arise concerning who recorded a deed first, who first received constructive or actual notice of a transfer of ownership, or who took possession of a property first. Because of the possibility of this sort of dispute, it is important to note that—in terms of establishing ownership—taking possession of a parcel of land or property takes precedence over recording a deed. Priority, in this case, refers to the order of rights in relation to time. This means that if neither party has taken possession of the property, then whoever recorded the deed first has ownership rights.

**EXAMPLE:**
Seller A sells Buyer B a property and gives Buyer B a deed; however, Buyer B does not record the deed or take possession of the property. Two weeks later, Seller A sells the same property to Buyer C and also gives him a deed, which Buyer C records. In this case, even though Buyer B purchased the property first, Buyer C has ownership rights because he recorded the deed before Buyer B took possession of the property or recorded the deed.
SUMMARY

Individuals should enter all documents relating to conveyances—including evidence of property liens and other encumbrances—into their state or county’s public record. These public records allow all interested parties to have access to vital information regarding a property’s history; these records reveal the chain of ownership and often disclose problems associated with a property, such as liens or pending lawsuits. Before an individual can record a document, that document must satisfy a number of general legal requirements. When the document is submitted, local officials will review the document to ensure that it adheres to state laws. They will also make certain that it conforms to that state’s statute of frauds and that it has been properly notarized.

The systems of land registration that are used across the U.S. reflect the influence of the Torrens system. Land registration, as it is practiced here, allows individuals to document a property’s ownership history and also to identify any liens or other encumbrances that may be associated with a property. This land registration system creates a body of public records that make a variety of information readily available to prospective buyers. Entering facts about a property and its title into the public record effectively provides constructive notice of those facts to a prospective buyer. That is to say, entering these facts into the public record places the information in a readily accessible public sphere upon which prospective buyers can draw.

Because these detailed public records exist, prospective buyers have a responsibility to themselves to follow the Latin maxim “caveat emptor.” That is to say, prospective buyers have a responsibility to research the public records regarding any property they are considering. The burden is on prospective buyers to acquire any publicly recorded information about a property and its title. Individuals should use both public records and personal inspections, to ensure that they have direct knowledge of the physical condition of a property and any ownership interest held in it. In essence, a prospective buyer has a duty to acquire as much direct knowledge as he or she can about a property.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON TWO
TITLES

This lesson will focus on the following topics:

- Voluntary Alienation
- Involuntary Alienation
- Title History
- Evidence of Title
- Marketable Title

INTRODUCTION

As we will be using it here, the term “title” refers to the ownership rights to a parcel land or property—having or holding title means that one has or holds those rights. “Title” can also refer to documents that serve as evidence of ownership. In essence, a title represents an owner’s bundle of rights; evidence that one holds those rights legitimately can give the proof that allows an individual to re-acquire or sustain ownership of a property.

Each state has distinctive laws regulating the process of transferring of one’s title (or ownership interest) in real estate. However, it is generally true that titles may be transferred either through voluntary alienation (which is usually achieved via a deed) or through involuntary alienation.

This lesson will discuss the concept of title as we examine the ways in which a title can be transferred. The last sections of this lesson will go over evidence of title and what it means to hold marketable title.

VOLUNTARY ALIENATION

Voluntary alienation is the process or practice of willingly bequeathing property through sale or gift. In voluntary alienation, an individual freely separates the property from himself or herself, giving up all or part of whatever ownership interests he or she holds in the property. This process requires that the property owner use a valid method of title conveyance—that is, voluntary alienation requires that he or she convey ownership to another individual in such a way that the law will recognize that the ownership interest has been transferred. Valid transfer is usually achieved by employing either a deed or a will.
Deeds of conveyance must conform to state laws. In most cases, this means the deeds must:

- Comply with the state’s statute of frauds.
- Identify the grantor (seller or giver) and the grantee (buyer or receiver) by name.
- Include the signature of the grantor.
- Contain a granting clause, which is a statement of the grantor's intention to convey his or her ownership rights in a specific, identified property.
- Contain a habendum clause, which describes the extent of the ownership interest that is being conveyed by the transfer of the deed, as well as any conditions or limits that the grantor is imposing on the interest being transferred.
- Include a legal description of the property.
- List any liens or other encumbrances associated with the property.
- Be delivered to and accepted by the grantee.

Licensees should acquaint themselves with their states’ specific laws regulating conveyance, as well as the laws that describe the features that a deed must have if it is to be a valid instrument of conveyance. These laws vary from state to state, so any making of assumptions about a state's laws is imprudent. These assumptions could invalidate a transaction, which would be unfortunate for everyone involved; these assumptions may also expose the licensee to legal liability as well as endangering his or her professional reputation.

**PROPERTY CONVEYANCE BY WILL**

A will is another form of voluntary alienation, in which property owners specify the individuals to whom they wish to bequeath their property after they die. A will can thus serve as an instrument of conveyance. Again, states have their own laws regulating what makes a will valid and describing the features a will must have if it is to be a legally recognized instrument of conveyance. However, in general, wills must be:

- In writing.
- Signed by the testator (i.e., the person to whom the will belongs).
- Witnessed by two or more legally competent parties.
- Created by a testator who is sufficiently mentally competent to understand the effect and importance of his or her decisions.
- Drawn up voluntarily and freely.
There are numerous kinds of wills, but remember we are here concerned with three broad types of wills:

- **Formal or witnessed will:** This type of will is usually prepared by an attorney, either by creating an original will or by using a standardized form. Creating this sort of will requires that the testator sign the document before two or more legally-competent witnesses who are not parties named in the will.

- **Holographic will:** This type of will is handwritten and prepared entirely by the testator. It is generally dated and signed by the testator, but its creation does not involve an attorney and need not involve witnesses.

- **Nuncupative will:** An oral will given by an individual with an immediate fear of dying.

You will notice that these wills are listed in order of decreasing formality. An attorney creates a witnessed will; it is a formal written document signed before witnesses. A holographic will is created by the testator and need not be witnessed. Finally, a nuncupative will is simply a statement of bequest, made by an individual who has been seriously injured or otherwise fears incipient death.

The legal strength of these wills corresponds roughly to their formality. A witnessed will is—barring other defects in the will—generally a very strong legal document in all states. Most states will accept holographic wills, even if they are not witnessed. Most states will not accept nuncupative wills as binding legal entities; the states that do accept them place limits on the value and type of property that such a will can convey. In general, these limits mean that a nuncupative will cannot convey ownership interest in real estate.

**INVOLUNTARY ALIENATION**

Deeds and wills are the most common legally recognized way of transferring an owner’s interest in a property with that owner’s express consent. However, titles can also be transferred without the owner’s consent. The ways in which this kind of involuntary transfer can be achieved include:

- Intestate succession and escheat
- Descent
- Court order
- Adverse possession

**INTESTATE SUCCESSION AND ESCHEAT**

When a person dies without having made out a will, that person is said to have died *intestate*. State laws prescribe the specifics of how the dead person’s estate is managed in this kind of case. However, it is generally true that the dead person’s estate will first pass to his or her spouse. If there is no surviving
spouse, the estate will pass to other family members, such as children, parents, or siblings. The order in which these people are considered varies from state to state. In any of these cases, though, if the dead person’s ownership interest in real estate is transferred to a spouse or family member, then that property has been transferred without his or her consent, because the dead person did not bequeath the property to that individual.

In some cases, a person who dies intestate has no surviving spouse or other family members. In such a situation, ownership of that person’s estate often reverts to the state according to the legal doctrine of escheat. Via escheat, the dead person’s ownership interest in any property is transferred to the state, without his or her consent.

**DESCENT**

As we noted in our discussion of intestate succession, when an individual dies intestate, the title to any property transfers by descent. Because there is no valid will, a probate court will generally distribute any property to the dead person’s heirs by the statute of descent and distribution, which is a state statute specifying the basic process for allotting a decedent’s property.

Oftentimes, the probate court gives precedence of property distribution to the decedent’s blood relatives, a group that includes his or her surviving spouse, if any, and his or her children, parents and siblings. In all of these cases, the absence of a will means that property is transferred without the deceased owner’s consent. However, if the individual has a valid will when he or she dies, any allotment of property to the heirs will be done according to the stipulations of the will regardless of what other divisions might be stipulated in state laws.

**NOTE:**

In community property states, each spouse automatically owns one half of the property acquired during the marriage. These states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Wisconsin and Washington. This means that a valid will written in one of these states can only dispose of the dead person’s half of that community property and that if a person dies intestate, his or her surviving spouse automatically receives half of their community property regardless of any other claims that people may press against the dead person’s estate.

Even in cases in which a person dies with a valid will, conveyance by descent can come into play. If there are any disputes concerning the terms of a valid will or the state’s allotment of the dead person’s property, the disputing parties should arrange for probate proceedings. At a probate proceeding, the court determines a will’s legality and identifies the appropriate heirs if there are any discrepancies in the will. If there are no discrepancies, then the will is generally
carried out as written, presuming that the terms of the will do not violate any laws.

If disagreements arise concerning the state’s allotment of property according to the statute of descent and distribution, then the disputing parties may present proof of inheritance status at a probate proceeding. The courts will examine all of the evidence presented to them and will identify the rightful heirs to the property; they will then distribute the property accordingly.

**COURT ORDER**

The title to a property can also be conveyed without the owner’s consent by court order, according to state statutes and the precedents of common law. The most common forms of court action regarding property titles are:

- Action to quiet title
- Suit for partition
- Suit for condemnation
- Foreclosure

We will now discuss these various court actions in greater detail.

**Action to Quiet Title**

This court action intends to establish or settle an individual’s title to a particular property. In general, an action to quiet title occurs because there is a cloud on title, that is, a real or potential flaw in the title, created by a lien or other encumbrance associated with the property. The action to quiet title attempts to remove any clouds from a title and seeks to establish official ownership by holding hearings in which all parties who have any claim or interest in the property can present written or verbal evidence of their rights. The court will then evaluate the various competing claims regarding the property and reach a decision about how to assign the ownership rights.

**Suit for Partition**

When two or more parties who must split ownership interest in a property cannot divide the property successfully on their own, they can file a suit for partition. In this kind of suit, a court will make a decision about how the property should be divided. The court may call for the physical division of the property in a particular way or, if the matter cannot be resolved in a straightforward fashion, the court may force a sale of the property.
Suit for Condemnation

State and federal governments can claim private property for various public uses under their power of eminent domain. This property is generally claimed through condemnation. To exercise this power, the government's action must satisfy three conditions:

- The proposed use of the private property must benefit the public.
- The property owner must be fairly compensated for the property that is taken.
- The property owner’s rights must be protected by due process.

Foreclosure

When a borrower does not repay a lender or otherwise fails to meet the terms of a loan for which the borrower’s property serves as collateral, that lender can often foreclosure on the borrower’s property. When a lender forecloses on a property, this means that the lender can sell the property and repay the loan with the proceeds from the sale.

However, when foreclosure seems imminent, there are still several options open to the borrower, some of which may permit him or her to keep the property. He or she can:

- Ask for a special forbearance from the lender.
- Modify the terms of the mortgage.
- Make a partial claim.
- Have a pre-foreclosure sale.
- Obtain a deed-in-lieu of foreclosure.

We will now cover each of these options in greater detail.

Special Forbearance

If a lender grants a special forbearance, the lender can temporarily reduce or suspend payments on a loan, or arrange another payment plan for the borrower. Borrowers can sometimes qualify for a special forbearance if their income has been substantially reduced or they have had a significant increase in living expenses, and they can prove that they qualify for a new payment plan.

Mortgage Modification

If the lender is willing to modify the terms of the mortgage loan (through refinancing or an extension of the loan period), the borrower may be able to reduce his or her monthly payments to a manageable level. However, the
borrower must usually resolve the financial problems that led to the need for a mortgage modification and demonstrate that he or she is able to manage the terms of the new repayment plan.

**Partial Claim**

Under a partial claim, a lender helps a borrower who is behind on his or her loan payments to obtain an interest-free loan to bring the payments on the loan up to date. The lender can file a partial claim with the U.S. Department of Housing and Urban Development (HUD), which can use the FHA Insurance Fund to make a one-time payment to the lender to make the mortgage payments current. The borrower signs an interest-free promissory note, and a lien is placed on the property until the borrower repays this loan from HUD. However, borrowers can only qualify for this kind of assistance if certain conditions are met:

- The delinquent loan payments must be at least 4 months late but no more than 12 months late.
- Foreclosure proceedings against the borrower cannot already have begun.
- The borrower’s financial situation must be such that he or she can start to make full mortgage payments if the loan is brought up to date.

**Pre-foreclosure Sale**

To avoid foreclosure, a borrower can try to sell his or her property and pay the mortgage loan with the proceeds. A borrower may qualify for a pre-foreclosure sale if:

- Payments are at least two months behind on the date that the pre-foreclosure sale will close.
- The borrower can sell the property within three to five months, or within the period specified by the lender.
- The sale price of the property is an appropriate portion of the property’s appraised value, according to HUD program guidelines.

**Deed-in-Lieu of Foreclosure**

A borrower may also voluntarily return the property to the lender, to avoid the damage to his or her credit rating that would result from a foreclosure. This arrangement is referred to as “deed-in lieu of foreclosure.” To qualify for a deed-in-lieu of foreclosure, a borrower must:

- Be behind on his or her loan payments, but not qualify for a special forbearance, a mortgage modification, a partial claim or a pre-foreclosure sale.
- Have failed in any efforts to sell the property before foreclosure.
• Not have defaulted on another FHA mortgage loan.

**ADVERSE POSSESSION**

The final way in which title can be conveyed without the owner’s consent is through adverse possession. In some situations a person can develop legitimate ownership interests in a property through occupation, even if someone else owns the occupied property, and the occupant does not have the owner’s permission to use or occupy the property. Real property that is acquired through unauthorized occupation of another person’s property is secured through a process called “adverse possession.”

The adverse possessor *must* have some type of claim or right to the land. Most jurisdictions have laws that specify how this kind of claim can be established. For example, it might be the case that an uninterrupted, exclusive and open occupancy of a property for a specific period of time allows title to that property to pass to the occupant. So if, for example, an owner allows a squatter to occupy his or her property for a long enough period of time and does nothing to expel the squatting occupant, then the property can legally become the squatter’s.

Unlike conveyance through a deed, adverse possession is an example of involuntary conveyance. In essence, the owner whose rights are abridged by adverse possession gives up his or her property through inaction—the owner looses his or her rights to the property because he or she chose not to exercise them. Adverse possession laws thus encourage the efficient use of property and help discourage owners from abandoning property or letting it stand unused for long periods of time.

**TITLE HISTORY**

In the last lesson, we discussed the way in which public records will reflect the major legal actions that have occurred over a title’s history. This history will be made up of transfers of ownership (deeds), along with public records of judgment liens, mechanics’ liens and the like. Certain liens, such as real estate taxes and some inheritance and franchise taxes do not need to be recorded with public officials.

The availability of this relatively detailed history means that an individual who is interested in purchasing or otherwise investigating a property should perform title searches and obtain an abstract of title. He or she should also review the chain of title to identify the previous owners of the property and discover any liens or other encumbrances associated with the property. Research into the history of a title will reveal virtually all of the information that a prospective buyer or property owner needs to know to ensure the successful transfer of a property’s title.

**TITLE SEARCH**
Prospective buyers or mortgagees generally do not perform their own title searches. Instead, lawyers, trained title searchers or insurance companies usually carry out title searches on their behalf. When an individual performs a title search, he or she examines the available public records to ensure that there are no clouds on the title—that is, a title search helps an individual to ensure that there are no real or potential flaws in a title, created by liens or other encumbrances associated with the property. If a property’s title is free of clouds and is otherwise accurate, then it will usually be possible for the property owner to legally transfer ownership of that property.

A title search should begin with the present owner and trace the lineage of ownership back to the original owner (or grantor) or the earliest recorded owner. This provides the individual who is researching the property with an opportunity to examine each change of ownership in an effort to ensure that there are no encumbrances associated with the property, that no important documents are missing or suspicious and that no significant gaps in ownership exist.

**ABSTRACT OF TITLE**

An abstract of title is a brief history of the title to a particular parcel of real estate. It is a summary of the public records that exist regarding that parcel and presents a compressed listing of the various events and changes that have affected the title to that parcel over time. It chronicles any transfers in ownership as well as any divisions of ownership interest. It also records liens and other encumbrances that may be associated with the property. A certificate that identifies the period of time covered is included with most abstracts, but there are no standard forms or methods for presenting or creating an abstract.

An abstracter prepares an abstract by performing a title search, which will return a variety of information regarding the title’s history. From this information, the abstracter summarizes all of the legal events that have affected the title in the past, and makes careful note of any current liens or other encumbrances and their status. The abstracter will also attach a document to the abstract of title that lists the records that were used (or which the abstracter elected *not* to use) in creating the abstract.

The various documents that may be noted or discussed within, or in connection with, an abstract of title include:

- Records of easements
- Records of mortgages
- Records of wills
- Records of pending lawsuits
- Records of marriages
- Records of divorces
CHAIN OF TITLE

A chain of title is in some ways similar to an abstract of title, in that it conveys a concise picture of a property’s ownership history. However, a chain of title only includes the names of the property’s previous owners, a brief description of how the property came to belong to each owner and a notation regarding where the full record of each transaction can be found.

An individual can search for past grantors and grantees by using grantor and grantee indexes. As we discussed earlier, these records will display the names of all grantors and grantees alphabetically, according to year. A complete line of ownership can be usually be established by searching these indexes.

EXAMPLE:
A chain of title: (taken from Texas Real Estate Law, 5th ed., Jacobus)

<table>
<thead>
<tr>
<th>U.S. Government to Owner 1 by Homestead Act</th>
<th>Owner 1 to Owner 2 by warranty deed</th>
<th>Owner 2 to Owner 3 by warranty deed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recorded 6/5/1880, Bk. 40, pg. 21</td>
<td>Recorded 12/7/1915, Bk. 345, pg. 53</td>
<td>Recorded 3/9/1945, Bk. 911, pg. 33</td>
</tr>
</tbody>
</table>

When there is a gap in the chain of ownership—i.e., when ownership cannot be established through an unbroken chain—an individual who seeks to claim or establish ownership must sometimes press an action to quiet title. Generally, an action to quiet title presents an opportunity for any interested parties to assert their right or claim to the property. The ultimate aim of the action is to resolve legal difficulties created by the tension between the apparent or legally recognized owner’s claim to a property and the rights or interests in that property that may have been acquired by creditors or other parties who are not (presently) the recognized, legal owners of the property.

EVIDENCE OF TITLE

Understandably, most prospective buyers want to purchase properties that are free of liens and other encumbrances. However, the prospective purchaser cannot rely on the seller to disclose of all pertinent information about a property’s title, and a seller cannot use mere possession of a deed as evidence that he or she possesses legal title to the property.

Because prospective buyers cannot rely on the seller or possession of a deed to ensure that a title is free of encumbrances, they should instead rely on abstracts of title, title insurance policies and attorney’s evaluations of titles. These other
sources offer objective data from which prospective buyers can draw their own conclusions.

The reliability of this data is still not perfect, but is it considerably improved because it comes from someone who does not have a vested interest in how the prospective buyer evaluates the property’s title. Although title insurance polices often serve as the best form of evidence, abstracts and legal evaluations can provide important help in determining the status of the current title.

**TITLE INSURANCE**

Title insurance protects a policyholder from any events that occurred before the issuance of the policy. Its basic aim is to protect the policyholder against any losses that may arise from defects in the title or liens associated with the title. Despite the many precautions individuals can take to ensure a valid property conveyance, problems can still occur. For example, if a deed has been forged, or, say a minor executed a conveyance contract or if a person misrepresents his or her ownership interest in a property, all of these facts can affect the status of a property’s title and ownership. Property owners need title insurance to protect themselves from potential complications like these.

When an individual seeks title insurance, the title insurance company researches the history of the title in approximately the manner we have already discussed. They examine the public records relating to the property and trace the chain of title, in an effort to determine whether there are any existing liens, encumbrances or other problematic claims associated with the property.

This research process usually involves a title search performed by an abstracter, an attorney or a company employee. After the search is completed, the company attorney issues an opinion about which individuals, if any, have legitimate claims to the property. Once the insurance company feels they have explored all of the relevant public records, they issue a title commitment that commits the title insurance company to issuing a policy.

If the insurance company deems the title insurable based on their examination of public records, they will generally issue a policy which amounts to a contract in which they agree to compensate the policyholder for any losses he or she may suffer as a result of unidentified, pre-existing defects in the title. However, by agreeing to settle any claims for a policyholder, the insurance company generally assumes the right of subrogation, which allows the insurance company to assume the rights of the policyholder to recover any damages against those responsible for the claim(s) against the title.

Lenders generally require an extensive examination of the public records relating to a property before they will issue a loan for which that property is to serve as collateral. Lenders often consider title insurance to be the ideal form of evidence
of title because insurance companies research public records extensively before assuming the responsibilities created when they issue a policy.

**Title Commitment**

A title commitment is a promise or contract that commits a title insurance company to issuing a policy for a particular piece of property. It includes a statement of the terms and conditions under which the insurance company is willing to insure the property’s title, and notes any exclusions or aspects of the title that the company deems uninsurable. The title commitment also generally states the current condition of the property, lists the current property owner and identifies any mortgage loans that have not been fully paid.

**Types of Policies**

Title insurance companies offer various types of policies to accommodate the different types of customers who need insurance. The most common types of title insurance policies are:

- **A lender’s policy,** which assures lenders that they have a first lien against a property. It protects lenders from defects associated with a property’s title that might interfere with their ability to recover damages from an unpaid mortgage loan. This policy expires when the mortgage loan is paid.

- **An owner’s policy,** which protects property owners against defects in their titles and against liens and other encumbrances associated with their property. This policy only protects the owner against title problems that occurred prior to his or her taking ownership of the property—that is, if he or she enters into contracts or other relationships that affect the status of the title after taking ownership of the property, these are not covered by the title insurance policy. This kind of policy remains in effect as long as the insured individual retains ownership of the property.

- **Leasehold title insurance,** which assures lessees that they have a valid lease. For example, lessees can suffer substantial financial damages and other inconveniences if the landlord or owner does not have a valid title to the leased property or if there are easements that interfere with the lessee using the property in the ways permitted by the lease. Leasehold insurance protects lessees against these kinds of problems.

Standard title insurance policies can protect policyholders against damages arising from a variety of problems that can affect a property’s title. These include:

- Fraud
- Forgery
- Errors in an abstract of title
ATTORNEY’S OPINION OF TITLE

If a prospective borrower or buyer wants to use an attorney’s opinion of title as evidence of title, he or she must first hire an abstracter to prepare an abstract of title—the attorney’s opinion will be based on this abstract. Abstracters themselves do not give opinions concerning the condition of the title; they simply collect the data that makes up the abstract and create the abstract itself. Because abstracts play such a crucial role in evaluating the status of a property’s title, abstracters should be scrupulous about accuracy and completeness, making a special effort to record and convey all relevant information to avoid claims of negligence.

After the abstracter creates the abstract, the prospective buyer’s legal representative or the lender’s attorney inspects the abstract and evaluates the information it contains. He or she then prepares an attorney’s opinion of title, a formal document that describes his or her judgment regarding which individuals, if any, have legitimate ownership claims on a property.

Ideally, both the abstract and the attorney’s opinion are the result of careful, thoughtful work. However, the opinion can only be as good as the abstract upon which it is based, and there is no way to guarantee that an abstracter has reviewed every possible relevant document. Because this is true, neither the abstract nor the opinion can offer an absolute guarantee against defects in a title or liens and other encumbrances associated with a property (especially those not entered into public records).

MARKETABLE TITLE

The term “marketable title” refers to a title that appears to be without defects that would impair the market value or general marketability of a property, and which also covers the entirety of a property. A marketable title may have liens, encumbrances or clouds on it, as long as the buyer openly accepts those liens (etc.), as part of the purchase contract. A marketable title is one that permits an owner to sell or transfer a property freely, and it is a title that prospective buyers can or should accept without objection. When a buyer accepts a marketable title, he or she can generally feel secure in the purchase because a marketable title is one that the buyer will not have to defend against other claimants.

Many real estate transactions aim at exchanging a marketable title for a property’s purchase price, but as we have seen, it is not always easy to ensure that a title is actually marketable. A clear or marketable title can only be provided through the work of a seller’s attorney or title insurance company.
A marketable title, then:

- Allows the grantee to exercise ownership rights without having to defend those rights through litigation.
- Shows that the property can be sold or mortgaged at fair market value by a practical and knowledgeable individual.
- Does not have any defects that have not been openly accepted by the buyer.
- Does not have any liens or encumbrances that have not been openly accepted by the buyer.

**SUMMARY**

This lesson began by explaining how titles are conveyed through voluntary and involuntary alienation. Voluntary alienation involves the transfer of property with the explicit permission of the property owner; it is generally achieved through instruments of conveyance such as wills and deeds. Involuntary alienation involves the transfer of property without the owner’s consent, and commonly occurs by means of intestate succession and escheat, descent, court order or adverse possession.

To transfer the ownership of a property successfully, its title must be clean (i.e., marketable) and generally free of defects. Ensuring that a title is marketable requires research into the history of the title, often involving a title search and the preparation of an abstract of title if one does not already exist. Title searches provide prospective buyers or lenders with information regarding previous owners, as well as the liens and encumbrances that may be associated with the property; this information helps determine them to evaluate a title’s marketability.

Because even the best and most thorough research may not reveal all of the problems associated with a title, owners and lenders often purchase title insurance, which covers them against damages arising from the status of a property’s title. We should note, though, that title insurance only protects against problems with the title that existed before the person seeking the insurance acquired title to the property.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
TITLE TRANSFERS

This lesson will focus on the following topics:

- Types of Ownership
- Types of Deeds

INTRODUCTION

The previous lessons in this module have discussed various methods of identifying a property’s owner and the importance of securing a clean title. However, we have not yet talked about the various forms of ownership—that is, about the various kinds of ownership interests that an individual (or individuals) can have in a property. This lesson will cover the various types of ownership and how they can affect a property owner’s right to sell, use or distribute property.

We have also mentioned deeds as instruments of conveyance, though we have not discussed any of the particular features of deeds. In this lesson, we will discuss deeds in greater detail.

TYPES OF OWNERSHIP

For our purposes, there are three basic forms of ownership. Property can be owned individually; it can be co-owned or it can be held in trust. We will now discuss the details of these three forms of ownership.

INDIVIDUAL OWNERSHIP

Individual ownership occurs when one person is the owner of a property. He or she has absolute control over the distribution and use of the land as well as final say over any other decisions affecting the property (within the confines of the law). Individual ownership is also called “sole ownership”; property that is owned by a single individual is sometimes referred to as being “held in severalty.” The term "severalty" derives from the term "sever," which means to make separate or individual. When a property is held in severalty, it usually belongs to single or married individuals. It might also be held by a corporation, as a form of business having legal standing as an individual.

CO-OWNERSHIP

Co-ownership occurs when two or more persons have ownership rights to a property; under this type of ownership, these individuals become co-owners or concurrent owners. Co-owners may all have possession of a property at the
same time, or one owner may take possession while the others do not use the property but maintain their ownership interest(s). Similarly, co-owners may have equal ownership rights in a property, or the ownership interests may be divided in some other way; responsibilities to and liabilities regarding the property may be divided in a similar way. Some states have specific laws regulating the division of rights and responsibilities regarding a co-owned property.

There are four basic types of co-ownership:

- Tenancy in common
- Joint tenancy
- Community property
- Property held in partnership

We will now discuss these varieties of co-ownership in more detail.

**TENANCY IN COMMON**

When two or more parties own a property as a tenancy in common, each owner has a partial ownership interest and partial rights in a property. The ownership interests may be divided in various ways, but there is no actual physical division of the property. If the various ownership interests are not equal—that is, if each owner is not assigned the same percentage of ownership rights in the property—then the co-owners’ fractions of ownership interest are stated in the deed that created the tenancy in common. In the absence of any deed stating an unequal division, it is often assumed that all rights and obligations regarding the property are divided evenly.

In a tenancy in common, each co-owner of the property holds his or her individual portion of the ownership interest in severalty. This means that each individual co-owner can sell, transfer, mortgage or lease his or her interest in the property without the authorization of the other owners of the property, as long as that owner’s actions do not endanger or abridge the rights of the other owners. Each of the tenants-in-common has an equal right to enjoy the use of each part and the whole of property, but none of them has a right to possess any part of the property exclusively.

The co-owners, as a group, have sole rights to use and distribute the property as they wish, as long as their choices conform to state and federal laws. If one owner dies, distribution of his or her interest in a co-owned property is done according to the will or by the laws of descent and distribution if there is no will. It is important to note that there is no right of survivorship here—that is to say, it is not the case that when one co-owner dies, his or her ownership interest reverts to the surviving co-owners.
JOINT TENANCY

In a joint tenancy, two or more individuals share ownership of a property. Under this form of co-ownership, there is a right of survivorship; when a joint tenant dies, the surviving joint tenants inherit the deceased co-owner’s ownership interest in the property. The only way for a joint tenant to acquire an ownership interest that can be conveyed in a will is for that person to be the only surviving joint tenant. Otherwise, when any of the joint tenants dies his or her ownership interest reverts to the surviving joint tenants.

Because joint tenancy involves the right of survivorship, many states require co-owners who wish to own property in this way to create a written contract that specifies their intent to create a joint tenancy and identify the co-owners as joint tenants. Without a contract or conveyance that clearly identifies their relationship as a joint tenancy, it may be presumed to be a tenancy in common.

Joint tenancy is more explicitly an arrangement for sharing a property—and sharing it equally—than is a tenancy in common. Four unities distinguish a joint tenancy from other kinds of co-ownership, all of which must be present for the method of ownership to qualify as a joint tenancy:

- **Unity of interest**: All of the joint tenants’ ownership interests and rights must be equal in their extent, nature and duration.
- **Unity of time**: Joint tenants are required to acquire their property ownership or ownership interests at the same time. Thus, no additional joint tenants can be added to an established joint tenancy unless a contract is created defining a new joint tenancy arrangement.
- **Unity of title**: Joint tenants are required to acquire their property from the same transaction, and they must hold title under the same document, such as a deed or a will.
- **Unity of possession**: Each joint tenant has an equal right to enjoy the use of each part of the property as well as the whole of the property. However, no joint tenant has a right to possess any part of the property exclusively.

A joint tenant annuls a joint tenancy when any one of the four essential unities of joint tenancy is terminated. Bankruptcy, foreclosure and suits to partition the land can also cancel a joint tenancy. Having co-owned land legally partitioned by a court is a legitimate way to dissolve a co-ownership when the parties cannot or will not voluntarily agree to its termination. If a court cannot divide the land in a way that satisfies the co-owners, it will often force them to sell the land and divide the proceeds between the joint tenants.
COMMUNITY PROPERTY

Community property is property that held in common between a wife and a husband, in which each party holds half of the ownership interests in the property. This arrangement is generally created by community property laws, under which the ownership interests in any property that is acquired *during* the course of a marriage are automatically divided equally between the two spouses. Only the following states recognize community property laws: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin. They are often referred to as “community property states.”

Community property laws recognize ownership based on the spouses’ marriage agreement, rather than the actual holding of title. This means that all property acquired during a marriage belongs equally to *both* individuals, and will be equally divided if their marriage is dissolved. If one spouse dies, his or her portion of their community property will transfer to the surviving spouse.

These laws do not govern property that is received as an inheritance or a gift, and they do not apply to property acquired prior to the marriage; all such property is considered to be “separate property.” Prior to marriage, both parties can agree to convert their separate property into community property; they can also agree that none of their property will be considered community property, though this arrangement generally must be specified in writing.

PARTNERSHIPS

A partnership is created when two or more parties agree to combine their property and talents to create a for-profit business. Parties can create a variety of partnerships; we will discuss two common types of partnership here:

- General partnerships
- Limited partnerships

We will now discuss these partnerships in more detail.

**General Partnerships**

A general partnership combines two or more parties’ resources, assets and expertise into a business unit. The creation of this partnership also creates financial and legal responsibilities for all of the partners. Consequently, all partners can be held legally responsible for the other partners’ actions and commitments. Most states’ laws follow the Uniform Partnership Act (UPA), which is designed to bring various states’ partnership laws into accord. The UPA outlines the basic requirements of a partnership agreement, apart from any specific details that might be written into a particular partnership contract. Although the UPA provides a helpful general outline to follow while drafting a
partnership agreement, partners should create and define the key clauses that shape and regulate their unique partnerships.

**Limited Partnerships**

A limited partnership is an alternative to a general partnership. A limited partnership is made up of both limited and general partners. The general partners do the work of managing and overseeing the business; they usually accept unlimited personal liability. Limited partners function more as investors, supplying capital but playing no role in the day-to-day operation and management of the business. Limited partners' liability is generally limited to the amount of their investments in a business.

The relationship between limited and general partners must be set out in a written agreement if the partnership contract is to conform to the requirements of the Uniform Limited Partnership Act (ULPA), later amended to become the Revised Uniform Limited Partnership Act (RULPA). The majority of states follow the directives of the ULPA or the RULPA, which acknowledge the legality of a limited partnership.

**TRUSTS**

When a property is held in trust, an individual transfers ownership of that property to another individual who in turn manages that property for a third party. The transferor or creator of the trust is called the trustor; the individual who receives the trust is called the beneficiary; and the manager of the trust is called the trustee. The trustee carries out the trustor's wishes by holding title to the trust and performing according to the trustor's wishes concerning the property.

**EXAMPLE:**
Person X owns a condominium, and she wishes to place this property into a trust so that it will become her grandson's property in the future. Person X asks her Person Y to act as a trustee for this trust. If Person Y accepts this responsibility, this means that Person Y will need to manage the property according to the terms set out in the trust agreement, and that Person Y is responsible for delivering the property to the grandson in approximately the condition specified in the agreement.

In this case, Person X is the trustor, Person Y is the trustee and the grandson is the beneficiary.
TYPES OF DEEDS

A deed is a type of contract; it is a written document that conveys ownership interest from a grantor to a grantee. A deed does not itself represent ownership of a property and should not be confused with the actual title to the property. To convey property interest successfully, a deed must be legally valid. A legally valid deed satisfies the following conditions:

- The deed names the grantor and the grantee.
- The deed identifies the consideration exchanged in the transaction.
- The deed contains a legal description of the property.
- The deed specifically addresses the conveyance of the property.
- The deed is in writing.
- The deed bears the signature of the grantor.
- The deed has been delivered to the grantee.
- The deed has been accepted by the grantee.

There are various kinds of deeds; the six major types of deeds are as follows:

- General warranty deeds
- Special warranty deeds
- Bargain and sale deeds
- Quitclaim deeds
- Deeds of trust and trustee's deeds (Note that these are not the same kind of deed, but they are closely connected to one another.)
- Grant deeds

Each type of deed offers varying degrees of ownership interest and varying degrees of protection from defects in the title. We will now discuss these deeds in more detail.

GENERAL WARRANTY DEEDS

A general warranty deed is a deed in which the grantor agrees to protect the grantee against any other claim to title and attests to the absence of any title defects prior to and during the grantor’s ownership. With a general warranty deed, a grantor is promising that the title carries no limitations originating during or prior to the grantor’s possession. It is the greatest level of title assurance that a grantee can receive in a real estate transaction.

By agreeing to specific covenants and warranties, the grantor assures the grantee that the title is clear and free of any liens or other encumbrances. Most general warranty deeds contain at least the following five covenants:
Covenant of seisin: Under this covenant, the grantor guarantees that he or she owns the subject property and has the right to transfer the title to that property.

Covenant against encumbrances: Under this covenant, the grantor guarantees that there are no liens or other encumbrances associated with the property’s title other than those explicitly mentioned in the deed.

Covenant of quiet enjoyment: Under this covenant, the grantor guarantees that the grantee will not face litigation, eviction or experience any other disturbance arising from prior claims to the property’s title while in possession of the property. Via this covenant, the grantor essentially claims that the title is valid against any other claims to the property.

Covenant for further assurances: Under this covenant, the grantor guarantees that if the title turns out to have defects, he or she will take the necessary steps to make the title good.

Covenant of warranty: Under this covenant, the grantor guarantees that he or she will defend the grantee against any other legitimate claims to the property’s title. This covenant is similar to the covenant for quiet enjoyment.

SPECIAL WARRANTY DEEDS

In a special warranty deed, the grantor only warrants against encumbrances and defects that may have occurred during the grantor’s ownership of the property. A special warranty deed is the most common instrument of property conveyance because it makes the grantor responsible only for the history of the title under his or her tenure. Trustees often use this type of deed because their position makes them uniquely accountable for the condition of the property’s title while they are holding it in trust.

BARGAIN AND SALE DEEDS

A bargain and sale deed (also called a “deed without warranty”) is a deed that offers no warranty against defects in the title or encumbrances associated with the title. It generally meets only the minimum standards for a valid instrument of conveyance. A bargain and sale deed conveys all of a grantor’s interest to a grantee, but it gives the grantee no protection against real or potential defects in the title. This type of deed only acknowledges that the grantor has legal possession of the title and the property and may legally transfer that title.

QUITCLAIM DEED

Quitclaim deeds contain no covenants or warranties against real or potential defects in the title, or against encumbrances. In this respect, they are like bargain and sale deeds. However, quitclaim deeds also provide no assertion or
assurance that the title being conveyed is valid or legally held. Quitclaim deeds thus provide the least protection to the grantee.

A quitclaim deed conveys whatever interest a grantor may have in a property to a grantee, which means that whatever rights and possession a grantor has towards a property is given to the grantee. However, if the grantor has no real claims to the property, then the grantee receives nothing even if he or she has exchanged money or some other valuable commodity for the deed.

A quitclaim deed is not a very prudent way to acquire ownership interest. However, a quitclaim deed can be quite useful for relinquishing ownership interest. When, for example, partial or incomplete ownership claims arise due to inheritances, dowers, easements, community property rights or foreclosure, a cloud on the title occurs and is best remedied by a quitclaim deed.

DEED OF TRUST

A trustor uses a deed of trust as an instrument to convey a property’s title to a trustee, who in turn holds the property’s title for a beneficiary. Under this form of deed, the trustee has the authority to sell or mortgage the property as long as he or she acts within the instructions of the trustor. This kind of deed is often used to transfer a property’s title to a lender (trustee) to serve as security until a loan is repaid.

Deeds of Trust and Trustee’s Deeds

A deed of trust conveys property interest from an owner (called a trustor) to an independent third party (called a trustee) until the beneficiary (the party to receive the land) completes the action(s) stated in the deed of trust. For example, if a grandparent wishes to convey title in Parcel A to his granddaughter (the beneficiary) on her 21st birthday, then the grandparent (the trustor) could convey title of Parcel A to a title company (the trustee) until the granddaughter’s turns 21. On her 21st birthday, the title company would transfer title to her. A trustee (in our example, the title company) uses a trustee’s deed to convey title to the beneficiary (in our example, the granddaughter).

In short, deeds of trust put the property into a trusteeship, and trustee’s deeds take the property out of trusteeship.

GRANT DEEDS

A grant deed contains some, but not all, of the covenants that are usually included in a general warranty deed. Specifically, a grant deed is usually understood to imply that the grantor actually possesses legal title to a property, that he or she has not transferred this title to any other parties and that the title
has no other encumbrances beyond those addressed in the deed. This type of deed conveys full ownership rights to the grantee.

**SUMMARY**

This lesson discussed the transferal of titles by explaining the different types of property ownership and the various types of deeds that convey ownership.

There are basically three forms of property ownership. Property can owned independently (i.e., it can be held in severalty), it can be held in trust or it can be co-owned. When an individual holds a property in severalty, only one individual (or one married couple) has ownership rights to the property; this is also known as “sole ownership.” When property is held in trust, an individual (the trustee) temporarily holds title to a property that is later to be transferred to another person (the beneficiary) according to terms set out by the person who made the trust (the trustor).

In co-ownership, two or more parties have ownership rights to the property. Co-ownership of a property can take the form of a tenancy in common, a joint tenancy, community property or a property held in partnership. When co-owners own property as a tenancy in common, each owner decides what fraction of interest he or she wishes to have in a property. There is no physical division of the property, only a division of the interest vested in the property. Tenants in common may pass their portion of ownership rights in a will; they may also sell, lease or otherwise dispose of their ownership interest in any way that does not compromise the interests of the other co-owners.

In a joint tenancy relationship, the co-owners’ ownership rights are subject to the right of survivorship, under which the surviving joint tenants inherent a deceased co-owner’s interest in the property. Joint tenants may not pass their ownership interests in a will, nor can they otherwise transfer their ownership rights to anyone else in such a way that the new owner becomes a joint tenant. To add new joint tenants, a new joint tenancy agreement must be created. A joint tenancy arrangement must satisfy certain requirements; in particular, joint tenancies are distinguished by four unities: the unity of time, the unity of title, the unity of interest and the unity of possession.

In states that recognize community property laws, all property acquired by a couple during the course of their marriage that is not a gift or an inheritance is referred to as “community property.” Under these laws, each spouse has an equal ownership interest in property acquired during the marriage.

When two or more parties agree to combine their capital and talents in order to create a for-profit business, they have created a partnership. Partners can be co-owners of various kinds of property, including real estate. In this lesson, we discussed two kinds of partnerships, the general partnership and the limited
partnership. A general partnership requires all partners to take responsibility for the actions of all other partners. In a limited partnership, on the other hand, the general partners who see to the management and daily operations of the business assume full liability, while the limited partners (who function primarily as investors and are not involved in the day-to-day operations of the business) assume only limited liability.

Deeds are written instruments that convey a property’s title from a grantor to a grantee. There are essentially six types of deeds: general warranty deeds, special warranty deeds, bargain and sale deeds, quitclaim deeds, deeds in trust (and the related trustee’s deeds) and grant deeds.

General warranty deeds provide grantees with the most protection against defects to a title that occurred prior to the grantee’s possession of the title, because they include various covenants in which the grantor promises to protect the grantee against the problems that can be created by a defective or clouded title. Special warranty deeds only warrant against problems with the title that may have been created during the grantor’s possession and ownership of the title.

Bargain and sale deeds do not provide protection or warranties against any encumbrances or defects in the title; they only guarantee that the grantor holds the title legally and has possession of the property. Quitclaim deeds offer a grantee the least protection against a problematic title, because they do not guarantee against any defects in the title nor do they guarantee that the grantor actually has legal possession of the title. A deed in trust transfers the title to a property from the trustor to the trustee (sometimes a party who holds the title as a security for a loan); a trustee can then use a trustee’s deed to transfer a property’s title to a beneficiary. In short, deeds of trust put the property into a trusteeship, and trustee’s deeds take the property out of trusteeship.

Return to your on-line course player to take the Lesson Quiz.
LESSON FOUR
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Activity
- Insight into Titles and Records
- Field Application of Titles and Records Information

INTRODUCTION

This module has covered a lot of specific information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided in this module, using a series of exercises and case studies. The first half of this lesson presents an activity, along with comprehensive questions and dilemmas. The second half presents case studies that examine the principles and ideas presented in this module. Upon completion, the student will have a better understanding of the real-world applications of the information he or she has been studying.

ACTIVITY

The following activity will test your comprehension of some of the material presented in this module by asking you to apply your knowledge. In this activity, you are presented with a deed form from which some important facts have been omitted. A word bank contains the words and phrases that you will use to fill in this missing information. Some words and phrases will not need to be used at all.

<table>
<thead>
<tr>
<th>WORD BANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>$250,000</td>
</tr>
<tr>
<td>Two Hundred and Fifty Thousand dollars ($250,000)</td>
</tr>
<tr>
<td>Grantee(s)</td>
</tr>
<tr>
<td>Freely convey</td>
</tr>
<tr>
<td>Convey, grant and deed</td>
</tr>
<tr>
<td>PERSON A 123 Main Street, Anytown, USA</td>
</tr>
<tr>
<td>Remise, release and quitclaim</td>
</tr>
<tr>
<td>Beneficiary</td>
</tr>
<tr>
<td>Trustor</td>
</tr>
</tbody>
</table>
RECORDING REQUESTED BY
AND WHEN RECORDED MAILED TO:

________________

Consideration: ____________
Property Transfer Tax: ____________
Assessor's Parcel Number: 

GRANT DEED

PERSON A, an unmarried person, and COMPANY 123, a Limited Liability Company, as Grantor(s), for the consideration of ________________, hereby ________________ to COMPANY ABC, a Limited Partnership, as ________________, the real property located in the County of Y, Anytown, commonly known as 123 Main Street, Anytown, USA and more specifically described as set forth in EXHIBIT “C” to this Grant Deed, which is attached hereto and incorporated herein by reference.

On this 5th day of November, 2003, in the County of Y, Anytown, I/we herewith sign this Grant Deed.

PERSON A SIGNATURE                    PERSON B (MANAGING MEMBER)
ACTIVITY ANSWERS

RECORDING REQUESTED BY
AND WHEN RECORDED MAILED TO:

____________________(PERSON A 123 Main Street Anytown, USA)___________

Consideration: ___($250,000)__________
Property Transfer Tax:
Assessor's Parcel Number:

GRANT DEED

PERSON A, an unmarried person, and COMPANY 123, a Limited Liability Company, as Grantor(s), for the consideration of ________ (Two Hundred and Fifty Thousand dollars ($250,000))__________, hereby ________ (convey, grant and deed) ____________ to COMPANY ABC, a Limited Partnership, as ________ (Grantee(s))_______, the real property located in the County of Y, Anytown, commonly known as 123 Main Street, Anytown, USA and more specifically described as set forth in EXHIBIT “C” to this Grant Deed, which is attached hereto and incorporated herein by reference.

On this 5th day of November, 2003, in the County of Y, Anytown, I/we herewith sign this Grant Deed.

PERSON A SIGNATURE                    PERSON B (MANAGING MEMBER)

INSIGHT INTO TITLES AND RECORDS

Q1: What basic steps occur in the process of recording, and why should documents related to real estate transaction be publicly recorded?

Q2: How does an individual have a document acknowledged, and why is acknowledgement necessary?

Q3: What is the connection between public records and a prospective buyer’s duty to follow the maxim “caveat emptor”?

Q4: How can a title conveyance occur involuntarily by court order?

Q5: Why is title insurance generally thought to be necessary?
INSIGHT INTO TITLES AND RECORDS ANSWERS

A1: The prospective buyer or titleholder must submit the document (deed, mortgage, etc.) to the appropriate county office, where it is reviewed to ensure that the document conforms to relevant state laws. After the document has been reviewed, the office will collect any necessary fees, complete the proper forms and then copy the document and enter it into the public record. Titleholders and prospective buyers should record all property-related documents to give the public constructive notice of their interest in a property and any alterations that are made to its title.

A2: To have a document acknowledged, a titleholder or prospective buyer should take the document to a notary public or another public official who is authorized to notarize documents. The notary public will verify that the signature on the document belongs to the titleholder or prospective buyer, and will show this verification by marking the document with his or her seal. Acknowledgement is necessary because the acknowledgement process helps to ensure that the signature on the document is authentic and that anyone signing the documents is doing so voluntarily.

A3: The maxim “caveat emptor” means, “let the buyer beware.” This means that it is the buyer’s responsibility to seek out publicly available information regarding any property in which he or she is interested. Therefore, the buyer needs to research the property actively. While a seller is legally required to make some disclosures regarding a property, he or she does not have to disclose information that has been entered into the public records regarding a property. Thus, it is the buyer’s duty to discover what information is actually contained in the public records.

A4: Four forms of court order may force the conveyance of a property: an action to quiet title, a suit for partition, a suit for condemnation and a foreclosure action.

When a court calls for an action to quiet title, it holds a hearing in which all parties who believe they might have a claim to the property may appear and plead their case. The court then examines all evidence to determine legal ownership and clear any cloud on title.

In a suit for partition, the court orders the physical division of a disputed property or sale of that property. In a suit for condemnation, the court can order a private owner to surrender his or her real estate to the state or federal government if the government can prove that the use of the property will benefit the public, show fair compensation to the property owner and assures that the owner will receive due process. Finally, foreclosure occurs when a borrower cannot repay a loan for which his or her property serves as security. In such a case, the court generally requires that the property be sold to repay the debt.
A5: Although prospective buyers and titleholders may take many precautions to ensure that a title has no defects or encumbrances, even the most careful research cannot ensure that a title is absolutely without defects or encumbrances. Title insurance protects the titleholder from any undiscovered problems with the title that occurred before he or she took possession of the title. The title insurance company offers compensation for any damages that the titleholder suffers as a result of these defects. However, we should note that the title insurance company assumes the right of subrogation and can sue the party responsible for the claim against the title.

FIELD APPLICATION OF TITLES AND RECORDS INFORMATION

Please consider the following case studies. After reading the situations, decide on how one could resolve the dilemma or complication. Keep in mind that land use legislation protects the public’s welfare, so your response must not only serve the individual(s) involved in the given situation—it must look out for the larger community as well.

CASE STUDY ONE

A grandfather promised his granddaughter that she would inherit his entire estate upon his death. The grandfather contacted an attorney to draw up a will that specified that all his assets—real estate, money and personal property—would transfer to his granddaughter upon his death. The grandfather died the following day without signing the will, and the court distributed the grandfather’s property according to the statute of descent and distribution. The court allotted a fraction of the estate to each of the man’s family members. His granddaughter claimed that she had rights to the entire estate, even though her grandfather did not sign the will. Is she right?
CASE STUDY ONE RESPONSE

Although the grandfather drew up a will, because it was unsigned it most likely does not meet the conditions of a valid will. To be a legally binding document, a will must be a written document signed by the testator (the grandfather). By having the will prepared by an attorney and witnessed by two or more parties not named in it, the will is legally strengthened. In this case, the granddaughter can argue the matter in probate court but is unlikely to win the case because there is no legitimate will, which means her grandfather died intestate. Therefore, the probate court is likely to stand by the decision to distribute the estate according to the descent statutes, which generally give priority of inheritance to a spouse or other close blood relatives, such as children, parents, siblings, aunts and uncles.

CASE STUDY TWO

Buyer A wishes to learn about Seller Y’s property, so she calls him and asks about the property’s title. She wants to know if the title has a clean history—specifically, she wants to know whether there are any liens or encumbrances associated with the title and whether Seller Y knew or knows the past owners of the title. Seller Y assures Buyer A that no defects, liens or other encumbrances have been associated with the title during the time he has had possession of the title. Feeling reassured after talking to Seller Y, Buyer A decides to purchase the property without title insurance. Seller Y gives Buyer A a bargain and sale deed, which she records at the county clerk’s office.

Three months later, Buyer A receives a foreclosure notice from the court calling for the sale of the property to repay debts owed to lenders by Seller G, the individual who sold the property to Seller Y. Is Buyer A responsible for the financial damages she may suffer in this case?
CASE STUDY TWO RESPONSE

Buyer A is responsible for any damages she may suffer in this case. Even though she spoke with Seller Y about the property's history, Buyer A did not make any effort to secure independent, objective information about the property’s title—that is, she did not follow the “caveat emptor” maxim. She chose to rely upon Seller Y’s incomplete (and perhaps biased) understanding of the property’s title.

Buyer A’s responsibility is increased because of the type of deed she accepted. Each type of deed offers varying degrees of protection against title defects, and a bargain and sale deed only acknowledges the grantor’s possession of the title. It offers no warranties against liens and other encumbrances associated with the title.

We should note that Seller Y did not deceive Buyer A. He specifically told her that he was not responsible for any defects in the property’s title. The foreclosure claim is not being pressed because of any of Seller Y’s debts, so the foreclosure does not invalidate anything he told Buyer A. To discover encumbrances and liens like the one she is facing now, Buyer A would need to have researched (or hired someone to research) the public records regarding Seller Y’s property. Buyer A should have hired a qualified person to perform a title search, had an attorney review an abstract of the property’s title and she should have purchased title insurance.

CASE STUDY THREE

A and B want to get married. However, A wants to keep all of her property separate from B’s. B informs A that she has no choice in this matter because they live in a community property state, and in such states community property laws dictate that once a couple gets married, all of the property acquired during the course of the marriage becomes community property, regardless of either individual’s wishes. A disagrees with B and says that each of them can keep some or all of his or her property separate if they both make a written agreement consenting to do so. Who is correct?
CASE STUDY THREE RESPONSE

A is correct. The term "separate property" refers to any property the spouse owned prior to the marriage. It includes all property the spouse acquired by gift or inheritance and property purchased with separate funds or personal injury settlements received during the marriage. Under community property laws, all separate property belongs only to one spouse. All property acquired during the course of their marriage belongs equally to each spouse unless they have written agreements stipulating another arrangement. Therefore, if both spouses choose to keep any portion of the property acquired during their marriage separate, they must have a written contract that specifies this arrangement. Otherwise, all property acquired during the marriage is community property.

CASE STUDY FOUR

A prospective buyer is seeking to purchase a home. Having found a neighborhood that he likes, he researches current selling prices and the conditions of the homes available in the area. Finally, after examining the neighborhood extensively, he finds a home that he likes. The prospective buyer hires a company to perform a title search on the property and generate an abstract of title.

The company examines the public records regarding the property and compiles an abstract for the prospective buyer. A representative of the company reports to the prospective buyer that the title to the property has several liens associated with it, and that she is thus unsure whether the seller actually holds legal title to the property. She recommends that the prospective buyer not purchase the property.

What should the prospective buyer do in this case?
CASE STUDY FOUR RESPONSE
The prospective buyer A should take the abstract of title to an attorney and get the attorney’s opinion of the title. Abstracters and others who perform research into a title’s condition are generally not fully qualified to give recommendations about property purchases or to make judgments regarding a title’s legal condition. The researcher’s main job is to ensure the abstract contains accurate information, because the attorney’s opinion of the title relies on the abstract and the integrity of the information it contains. While an attorney’s opinion cannot guarantee against defects and other title problems not found on the abstract, an attorney is generally better qualified to evaluate a title’s condition. The prospective buyer should not rely solely on the researcher’s opinion.

CASE STUDY FIVE
A and B agree to own property in a joint tenancy arrangement. They both draw up an agreement specifying the terms of their ownership. However, three months later, A dies. A’s wife tells B that A left her his ownership interest in A and B’s property in his will. B explains to A’s wife that he and A had a joint tenancy relationship, which entails that deceased joint tenants’ ownership rights revert to the surviving tenants.

Who has rights to A’s ownership interest?
CASE STUDY FIVE RESPONSE

B is legally entitled to A’s ownership interest in the property because they had a joint tenancy relationship supported by a written contract defining their relationship. In a joint tenancy, the right of survivorship determines how a deceased joint tenant’s ownership interest is distributed by assigning it to the surviving joint tenant(s). Even if A did leave a valid will assigning his ownership interests to his wife, those ownership interests still legally belong to B—A cannot bequeath them to anyone other than another joint tenant.

CASE STUDY SIX

Buyer A purchases a house from Seller X and receives a quitclaim deed, which he immediately records at the county clerk’s office; Buyer A does not take possession of the property at this time. One week later, Seller X sells the same property to Buyer B, who also receives a quitclaim deed. Buyer B records the deed and moves in, taking possession of the property. A few days later, Buyer B receives a call from Buyer A, who claims that he has ownership of the property because he recorded his deed first. Buyer B explains to Buyer A that since he took possession of the property first, it does not matter who recorded a deed first. After his discussion with Buyer A, Buyer B receives a phone call from Person F, who informs Buyer B that Seller X has never had any legitimate ownership claim or rights to the property and that the property actually belongs to Person F.

Given the information here, which party most likely has legal rights to the property?
CASE STUDY SIX RESPONSE

Person F probably has legal ownership rights to the property, if he or she can produce appropriate documents to serve as evidence of title and prove ownership, such as title insurance, an abstract of title or an attorney’s opinion of title. If Person F really does own the property, then Seller X cannot have conveyed any kind of ownership rights to Buyer A or Buyer B. Neither Buyer A nor Buyer B paid sufficient attention to the type of deed they received. A quitclaim deed relinquishes all of the grantor’s interests, if any, in a property. Therefore, if the grantor has no rights, the grantee receives nothing regardless of when he or she registered the deed or when he or she took possession of the property.

CASE STUDY SEVEN

G decides he wants to place a parcel of real estate into a trust for P. G asks D to be the trustee for the trust. Five months later, G passes away. The terms of the trust stipulate that D can lease the property out or make investments using the property as security if the investments are secure AND the use of the property benefits P. D decides that she wishes to use the property as a security for a large home improvement loan to build a swimming pool and extensive greenhouses in her own backyard. She transfers the property’s title to a lender to obtain these funds. During construction, D suffers an unexpected drop in her personal income, preventing her from paying the loan. Unable to come to an agreement with the lender about her loan payments, D defaults on the loan. What will most likely happen in this case?
CASE STUDY SEVEN RESPONSE
The lender will most likely demand sale of the entrusted property to repay the loan for which it is serving as security. D will probably have to sell the property to repay the debt. P may take suit against D claiming D did not make a safe and reliable investment, thereby breaking the terms of the trust. D also failed to act in P’s best interests because D’s home improvements offered no benefit to P.

CASE STUDY EIGHT
A receives a foreclosure notice from his lender. He realizes that he has not made any mortgage payments in the last five months but he is starting a new job soon and will soon be able to make his mortgage payments again. What should A do if he would like to keep his home?
CASE STUDY EIGHT RESPONSE
A should discuss his situation with his lender. A may be able to arrange a special forbearance, or a modification of the terms of his mortgage. He also meets the conditions required to make a partial claim. A person can make a partial claim when his or her payments are at least four months late but less than 12 months late. He or she must also be able to resume making full mortgage payments as soon as the mortgage is brought up to date. The lender may be able to file a partial claim with HUD, which can then use the FHA Insurance Fund in order to make a one-time payment for A to make his mortgage current. A will be required to sign a promissory note confirming his intent to repay the loan from HUD.
# Texas Principles of Real Estate
## Module 10: Liens, Taxes and Foreclosures

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**Total Time:** 210 minutes (3.5 Hours)
INTRODUCTION

This module discusses liens, taxes and foreclosures. There are many types of liens, as well as several kinds of taxes, that can attach to a parcel of real estate. When borrowers default on a debt, foreclosure is the process by which lien holders collect the unpaid portion of a debt. Because liens represent an interest in real property, it is crucial that real estate licensees develop an in-depth understanding of liens and lien-related issues. Such knowledge also helps licensees to better advise buyers and sellers.

The first lesson presents a general overview of liens. It explains the classification of liens and discusses the types of non-tax liens. Lesson two discusses taxes and tax issues, including \textit{ad valorem} taxes, real estate tax computation, special assessments, real estate transfer taxes, federal income taxes, capital gains taxes and tax shelters for homeowners and investors. It also discusses the priority of liens. Lesson three addresses: methods of foreclosure, redemptions, deficiency judgments, checklist tips for homeowners facing foreclosure and fraudulent behaviors related to foreclosure.

The conclusion of this module presents real world dilemmas and applications of the information presented. As the student completes the module, he or she should try to paint a big picture of the issues surrounding liens, taxes and foreclosures, which the module addresses with comprehensive questions, activities and case studies.

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KEY TERMS

Ad Valorem Taxes: General real estate taxes, calculated according to the assessed value of individual properties. The term *ad valorem* is Latin for "according to value."

Adjusted Basis: The purchase price of real estate plus the cost of improvements, less depreciation.

Appropriation: The actual method by which a district imposes a real estate tax.

Assessment Roll: A public record that provides information on properties in a specific area or district, including legal descriptions, owners and assessment values.

Basis: A taxpayer’s costs (used for tax purposes) for obtaining and maintaining a property, less depreciation. "Basis" (also called “tax basis”) is essentially the taxpayer’s investment in his or her property.

Capital Asset: A usually long-term asset used in the regular course of business; for income tax purposes, capital assets are all property except what a taxpayer holds for regular sale to consumers.

Capital Gains: The capital an investor receives when he or she sells or exchanges an asset, equal to the sale price of the property less the investor’s costs for obtaining and maintaining that asset (i.e., less his or her basis).

Deduction: An amount of money subtracted from income when calculating federal income tax.

Deficiency Judgment: A judgment against a debtor that pays off the remaining balance of a defaulted loan, plus accrued interest and expenses, if a foreclosure sale does not generate enough money to pay off a loan.

Depreciation: A method of allocating the cost of an aging asset over its estimated useful life. For income tax purposes, depreciation is a provision for the estimated wear and tear of an asset. Depreciation deductions can be claimed as a tax deduction on real estate improvements, not land, regardless of whether the market indicates an increase or decrease in the value of the property.

Encumbrance: A claim against a property that affects its title or use.

Equalization Factor: A number by which assessed values of real estate are multiplied; used to distribute taxes more equitably.
**Equitable Lien**: A lien created by courts and derived from common law, which is enforceable only in terms of equity.

**Equity Skimming**: A fraudulent action in which a person offers to take over a delinquent mortgage loan and pay the owner a sum of money when the property is sold; typically, the fraudulent person collects rents and allows the lender to foreclose.

**Foreclosure**: A legal procedure by which the real property used to secure a debt can be sold to satisfy the debt.

**General Lien**: A lien affecting all of the property an individual or institution owns, including both real and personal property.

**Holding Period**: The amount of time between the day a property is bought and the day it is sold.

**Improvement**: A permanent or nonpermanent addition to real property that usually increases its value.

**Involuntary Lien**: A lien that goes into effect without the owner taking any action to initiate it.

**IRS Tax Lien**: A general lien imposed by the Internal Revenue Service when a person fails to pay federal income tax.

**Lien**: When an individual fails to pay a debt, the creditor to whom that debt is owed can sometimes acquire a legal right to or interest in the debtor’s property. This right or interest is generally relinquished when the debt is paid. Such a right or interest is called a “lien.”

**Lien Theory**: The theory whereby borrowers are considered the owners of mortgaged land, and lenders obtain a lien on the property.

**Lienholder**: A person or entity that holds a lien; also called a “lienor.”

**Long-term Capital Gain**: A gain taxed according to federal capital gains tax rates, with a holding period longer than one year.

**Modified Lien Theory**: Under modified lien theory borrowers hold title to mortgaged property, but lenders can take immediate possession of the title in the event of default.
Mortgage Modification: An alternative to foreclosure in which homeowners refinance their mortgage loans or extend the term of their loans in order to reduce the monthly payments.

Mortgagor: The party that borrows money from another party (the mortgagee) in a transaction that uses a mortgage as security for the loan: often referred to as the borrower.

Offer in Compromise: An agreement between a delinquent taxpayer and the IRS in which the latter will accept a lesser amount of money to remove the IRS tax lien.

Partial Claim: A one-time-only interest-free loan that brings a borrower’s mortgage payments up to date, financed by the FHA insurance fund.

Pre-foreclosure Sale: Sale in which a homeowner/mortgagor sells a property in order to satisfy the mortgage before foreclosure, despite the fact that the amount may be less than what is owed.

Proration: Proration is a means of calculating partial costs owed (or benefits due) so that they are distributed proportionately between two or more parties. For example, if a buyer purchases a home in the middle of the tax year, it would be unfair for that buyer to pay all of the year’s property taxes when he or she only occupied the property for part of that year. In this case, proration would be used to determine what proportion of the property tax the buyer should pay for that year. In this course, the term “proration” will be used to describe the process of dividing prepaid items or accrued items (such as utility bills) between a buyer and a seller.

Real Estate Transfer Tax: Taxes on the transfer of real estate, imposed by some states and municipalities.

Redemption: The payment of a mortgage or loan in default by a borrower. Redemption must usually occur before a foreclosure sale; also known as “equitable redemption.”

Short-term Capital Gain: Gain taxed as normal income, with a holding period of one year or less.

Special Assessments: Taxes levied for public improvements; they may be voluntary or involuntary; also termed “assessment for benefits.”

Special Forbearance: The establishment of a repayment plan, a temporary reduction in payments or a temporary suspension in payments as an alternative to foreclosure for those who meet certain requirements: the owner must occupy the property, experience an increase in basic living expenses or a decrease in income and be able to pay the terms of the agreement.
Specific Lien: A lien against a specific parcel of real estate.

Statutory Lien: A lien established by state or federal law (statute) for a specific set of circumstances.

Subordination Agreements: An agreement wherein a lienholder who has a lien of higher priority than a second lienholder agrees to subordinate his or her lien to the second party (that is, to accept a position of lower priority).

Tax: A charge imposed by a governmental institution on individuals, organizations or property in order to produce revenue for its operation.

Tax Lien: A lien imposed by a governmental institution on property for nonpayment of taxes.

Tax Lien Certificate: When a state sells a tax lien by auction, the winner receives a tax lien certificate; it provides a yield that must be paid by the delinquent taxpayer upon redemption or title to the property after a specified period of time.

Tax Sale: A sale of property resulting from unpaid taxes.

Tax Shelter: A legal investment used to defer or reduce income-tax payments.

Title Theory: Under title theory, lenders are considered the owners of mortgaged land until the borrower can pay the full amount of the mortgage.

Voluntary Lien: A lien placed on a property voluntarily by an owner. A mortgage lien is an example of a voluntary lien.

**LEARNING OBJECTIVES**

Upon completion of this module, the student will be able to:

- Define the terms *lien* and *tax lien* and understand their operations.
- Recognize the different types of liens and know how their priority is established.
- Identify and describe types of non-tax liens.
- Understand how *ad valorem* taxes and special assessments are levied.
- Know how homeowners and investors can save on federal income taxes and capital gains taxes through the use of tax shelters.
- Describe and list different types of foreclosures.
- Recognize alternatives to foreclosure and common scams related to foreclosure.
LESSON ONE
LIENS

This lesson focuses on the following topics:

- Lien Defined
- Mortgage Theories
- Lien Classifications
- Types of Non-Tax Liens

INTRODUCTION

When homebuyers obtain a mortgage, the property they have just purchased typically becomes security for the loan, and the lender obtains a lien against the property. This lesson will explain the meaning of a lien, and how liens impact an owner's interest in property. Exactly how a lien affects a property depends upon if the state the owner lives in is a title theory state, a lien theory state or a modified lien theory state. The following sections will address the meaning and difference between these three legal approaches, as well as the different classifications of liens.

LIEN DEFINED

Liens are legal claims or rights to a debtor's property that serve as security for obligations or debt. A key element of liens is that they provide an almost immediate right for lienholders to liquidate property upon default of a debtor. Unlike lenders that obtain liens, lenders of unsecured loans must file a lawsuit to gain access to a borrower's property. In some cases, liens can still be enforced in the event of bankruptcy.

Real estate liens “attach” to a specific piece of property; thus, a debtor cannot sell his or her property without the lien accompanying it. A lien represents a superior claim to a piece of property even after it has been sold. So, in order to sell a property, the owner likely will have to take steps to clear the land of its liens. Although a person who has bought a property that has liens is not responsible for paying off the associated debts, the lienholders can still take legal action to gain control of the property. Which lienholder is entitled to property in what order depends upon the priority of the liens. This module discusses the priority of liens in Lesson Two.

ENCUMBRANCES

Liens are a type of encumbrance. The term encumbrance refers to any claim against a property that affects its clear title or use. Because liens are creditors'
claims that impact title, they are all considered encumbrances. This does not mean, however, that all encumbrances are liens. For example, easements, encroachments and restrictions are all encumbrances as well because they influence use and title. Nevertheless, they are not claims held by creditors and, consequently, are not liens. Instead, easements refer to the right to use a section of another person's property for some particular reason; and an encroachment is a physical intrusion on someone else's property without direct permission.

MORTGAGE THEORIES

As previously stated, the interest that a debtor holds in a particular property, as well as when and how the debtor may seize property upon default, depends upon the state in which the owner lives. There are three different approaches to liens: title theory, lien theory and modified lien theory. As the following sections explain, it is easiest for a debtor to seize property upon default in title theory states. This is because the debtor actually holds title in the property until the debt is paid in full.

TITLE THEORY

In some states, lenders are considered the owners of mortgaged land and hold legal title, while the borrower has equitable title. These states are called title theory states. Legal title is transferred to the borrower only when the mortgage has been paid in full. In the event of default, the lender can take immediate control over the mortgaged property.

LIEN THEORY

Other states are lien theory states because they consider borrowers to be the owners of mortgaged property—lenders only have a lien on property with no right of possession. When the loan is paid in full, the lien is removed. In the event of default, the lender can foreclose on the mortgaged property after notice is given and enough time has passed in order to obtain the balance due on the loan. Some states allow a statutory redemption period after foreclosure when debtors may redeem their property; a detailed discussion of foreclosure follows in Lesson Three.

MODIFIED LIEN THEORY

Some states are considered modified lien theory, or intermediary theory, states. In intermediary states, borrowers hold title to the mortgaged property during the mortgage term. If the borrower defaults on payments, the lenders may take back title and assume possession of the property.
LIEN CLASSIFICATIONS

Liens are classified in a variety of ways. They can be general or specific, voluntary or involuntary, statutory or equitable, and tax or non-tax. We will briefly discuss each category, including types of non-tax liens in this lesson, followed by a more extensive description of tax liens in the next lesson.

GENERAL LIENS

*General liens* affect any property an individual or institution owns, including both real and personal property. This includes many kinds of taxes, such as IRS and inheritance. Exceptions to general liens are discussed in Lesson Two.

SPECIFIC LIENS

*Specific liens* are claims against particular parcels of real estate; they do not affect any other property. Examples of specific liens are vendor’s liens, execution liens, vendee’s liens, surety bail bond liens, mechanic’s liens, mortgages, special assessments, property taxes and attachments.

VOLUNTARY LIENS

When a person takes some action that places a lien on his or her own property, the lien is *voluntary*. That is, they choose to initiate a lien that would not otherwise exist. Lenders usually require security for a loan, so borrowers often provide real estate as security. A common example is a mortgage. With a mortgage a debtor voluntarily offers the property for which he or she needs a loan as security for that loan.

INVOLUNTARY LIENS

Liens are *involuntary* when a property owner does not take any action to initiate them; they are either statutory or equitable. Real estate tax liens and judgment liens are examples of involuntary liens.

Statutory Liens

State or federal law often establishes liens for a specific set of circumstances. Because the liens are imposed through statute, they are called “statutory” liens. They include federal tax liens, mechanic’s liens, *ad valorem* tax liens and judgment liens.
Equitable Liens

An equitable lien is a right that exists only in equity, with one party charging his or her property as security for a debt or loan. Equitable liens are created by courts and derived from common law. A vendor's lien is an example of an equitable lien. When a buyer does not pay in full, for example, a seller might obtain a vendor's lien on the property. Equitable liens also occur when a tenant for life, joint owner or occupant makes alterations to land that increase its value.

TYPES OF NON-TAX LIENS

It is important to note that tax liens generally take precedence over non-tax liens. In the event of default or delinquency on payments for the lien, this means that the state or federal tax liens will typically be addressed first.

MORTGAGE LIENS

Typically, when a person buys a home, the home itself becomes collateral for the loan, so the lender obtains a mortgage lien. Because the owner creates the lien, a mortgage lien is considered voluntary. Lenders may also require a preferred lien, which means that no other liens can take priority. Mortgage liens can also be deed of trust liens. Under a deed of trust (or trust deed), a trustee holds title as security for a debt until the lien is paid.

MECHANIC'S LIENS

Mechanic's liens protect suppliers, contractors, architects, engineers, surveyors, and other parties whose labor has improved the value of real property. Mechanic's liens are based on the enhancement of value theory: the parties who performed the labor have increased the value of the real estate, and thus have an interest in the property; the property itself becomes security for money owed. Mechanic's liens are specific, involuntary, statutory liens.

Mechanic's liens are a crucial means for people to ensure payment for the work they perform. For example, a homeowner might hire a contractor to add an additional room to his home. If the homeowner refuses to pay after the work is completed, the contractor may enforce a mechanic's lien against the property. A court can force the homeowner to sell his home to satisfy the debt. When the home is sold, the contractor will receive compensation.

To obtain a mechanic's lien, parties must work under contract (including implied contracts) with the owner of a property or the owner's representative. Parties usually have a limited period of time to file a lien after work has been performed, or they may not receive compensation. This time period varies from state to state, as does the point in time when a lien attaches to a piece of real estate (this
may have an effect on lien priority, which is discussed later). States might establish one of the following points in time for lien attachment:

- The time a contract is signed
- The time an individual’s or contractor’s work ends
- The time construction begins
- The time a lien is recorded

**JUDGMENT LIENS**

*Judgments* are decrees given by courts. When judgments specify the amount of money owed, they are called *money judgments*. *Judgment liens* are general, involuntary liens, so they apply to both real and personal property. The written court decree is called an *abstract of judgment*; it takes effect only after it has been recorded in the county clerk’s office. The lien applies to property currently owned or acquired in that county.

A court can issue a *writ of execution* to force payment of monies owed from a judgment when a debtor does not pay. It gives court officers the right to confiscate and sell the debtor’s property to satisfy the debt. The writ of execution is itself an involuntary lien, called an *execution lien*. It attaches to the property until it is sold.

**Federal Judgment Liens**

The government can file a *federal judgment lien* for failure to pay certain debts, such as student loans. These liens are filed in the county where real property is held.

**Lis Pendens Notice**

A notice called a *lis pendens* is used to notify the public when a lawsuit is filed that affects a specific piece of real estate. This informs the public and any interested parties of the potential claim on the property. A *lis pendens* notice is often useful because a considerable time period may elapse between the time a lawsuit is filed and the time a judgment is rendered.

**ATTACHMENT LIENS**

Plaintiffs in a lawsuit may seek a *writ of attachment*, in which the court seizes property until it reaches a judgment. This protects creditors from a conveyance of title before a judgment is rendered. A writ of attachment is also called an attachment lien.
Creditors must post a surety bond or deposit large enough to cover any potential losses the defendant might suffer in order to obtain a writ of attachment. This protects debtors if the court decides in their favor.

**Exempt Property**

Certain kinds of property are exempt from attachments and executions. Exemptions are often limited to a certain value; they vary from state to state but might include items such as:

- Tools used for a trade or business
- Social Security
- Basic household appliances and furniture
- School books
- Money owed to debtors for child support or injury
- Prescription health supports
- Basic wages
- Cemetery lots

**VENDOR’S LIENS**

A vendor’s lien is a specific, involuntary lien on a property as security for the purchase price that arises when a seller has not yet received full payment for property. When a seller does not finance a loan, the lender holds the vendor’s lien. By filing suit to have the property sold, vendor’s liens are enforced.

**VENDEE’S LIENS**

When a seller fails to deliver title to a parcel of real estate and/or when the buyer has satisfied all terms of the contract for a sale, a *vendee’s lien* applies to the property to ensure the repayment of what the buyer paid in. It is a specific, involuntary lien that protects buyers.

**BAIL BOND LIENS**

Bail bonds can be put up in the form of real estate in lieu of cash when a property owner is accused of a crime. This creates a *bail bond lien*—a specific, statutory, involuntary lien enforceable by a court officer or the sheriff if the accused property owner does not appear in court.

**MUNICIPAL UTILITY LIENS**

If a property owner refuses to pay bills for municipal utilities, the municipality can obtain a *municipal utility lien* on the property. It is a specific, involuntary lien.
SUMMARY

Liens are legal claims or rights to property that serve as security for obligations or debt. A lien does not usually constitute ownership of a property, but it does represent a claim against the property. Lienholders can take legal action to enforce a lien if necessary. Liens are particularly useful in the event of default because they provide a relatively immediate means to liquidate a property to satisfy the debt. Liens in real estate are usually attached to a specific parcel; although property with a lien can be sold, the lien will accompany it. Liens are a type of encumbrance, a term referring to any claim against a property that affects its title or use. Not all encumbrances are liens, but all liens are encumbrances.

Liens are classified as general or specific, voluntary or involuntary, statutory or equitable, and tax or non-tax. General liens affect all the property a person owns, both real and personal, whereas specific liens attach to an individual piece of property. State law often specifies exemptions to general liens. Voluntary liens go into effect because an owner takes a specific action, whereas involuntary liens affect owners’ land without any action on their part. Involuntary liens are either statutory, which means they are created by statute, or equitable, which means that they derive from common law.

This lesson covered non-tax liens, which includes mortgage liens, mechanic’s liens, judgment liens, federal judgment liens, attachment liens, vendor’s and vendee’s liens, bail bond liens and municipal utility liens. With mortgage liens, the property is itself security for a loan. Mechanic’s liens protect parties whose labor improved a parcel of real estate when an owner refuses to pay; however, parties must have an express or implied contract with the owner or the owner’s representative. Judgment liens apply to both real and personal property. A court can issue a writ of execution to force payment of monies owed from a judgment when necessary. A lis pendens notice is often given before a judgment is rendered to notify interested parties of the potential future claim on a parcel of real estate. Lastly, an attachment lien or writ of attachment protects creditors from a conveyance of title before a judgment is rendered; the court retains custody of the property pending a decision.

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LESSON TWO
TAXES

This lesson focuses on the following topics:

- Tax Classifications
- Ad Valorem Taxes
- Special Assessments
- Lien Priority
- Real Estate Transfer Taxes
- Federal Taxes
- Tax Liens

INTRODUCTION

In order to raise revenue for the local community and government agencies, state and municipal governments impose taxes on real estate. Governments typically levy two types of taxes on real estate: special assessments (also called improvement taxes) and ad valorem taxes, which are assessed real estate taxes. Both types of taxes are specific, involuntary, statutory liens on a taxpayer’s real estate.

This lesson discusses special assessment and ad valorem taxes, and other taxes that relate to real estate, including: real estate transfer taxes and federal taxes on income and capital gains. A tax lien is a statutory lien that is imposed against real property if the property owner becomes delinquent in the payment of taxes. It is important to note that real estate professionals are not expected to be nor should they be treated as tax experts. However, they should be familiar with the following tax issues, and should direct a client to an accountant or tax advisor if he or she requires specific tax information.

TAX CLASSIFICATIONS

Taxes are generally classified as progressive, regressive or proportional.

- Progressive taxes—A greater percentage of an individual’s income is taxed as the income level increases, the higher the income, the higher the tax rate.
- Regressive taxes—A greater percentage of an individual’s income is taxed as the income level decreases, the lower the income, the higher the tax rate.
- Proportional taxes—An individual pays taxes that are proportional to the amount of income at a fixed tax rate. For example, if the tax rate is 20%, someone who earns $100,000 will pay $20,000 in taxes. If that person’s
income increases to $150,000, the tax rate is still 20%, and he or she will pay $30,000 in taxes.

It is generally understood that the U.S. Income Tax is a type of progressive tax, and sales tax is a regressive tax. Income tax is a progressive tax because as an individual's income increases, the percentage of money that is taxed increases as well; high-income earners pay a higher income tax rate. Sales tax is a regressive tax, because the percentage of money that is taxed increases as income decreases. As a result, low-income earners pay a higher regressive tax rate than high-income earners. To understand the effects of regressive tax, consider the following example:

**Example:** Person A has $100,000 and Person B has $1,000, and they both want to purchase a stereo that costs $500.00. The sales tax rate in their state is 8%.

First, we calculate the tax owed on the stereo.

Eight percent equals .08. We can multiply this amount by the cost of the stereo to find out how much tax must be paid on the purchase:

\[
.08 \times 500.00 = 40.00
\]

Second, we must calculate what percentage of each person's income goes to sales tax if they purchase the stereo. We will first calculate Person A and then Person B.

**Person A:**

\[
\frac{40.00}{100,000} \times 100 = \frac{X}{100}\%
\]

\[
100,000 \times X = 100 \times 40.00
\]

\[
X = \frac{100 \times 40.00}{100,000}
\]

\[
X = 0.04\%
\]

This means that if Person A buys the stereo, then 0.04% of her income goes to sales taxes. Now, let's compare that tax rate with that of Person B.

**Person B:**

\[
\frac{40.00}{1,000} \times 100 = \frac{X}{100}\%
\]
$1,000 \times X = 100 \times $40.00

X = \frac{100 \times $40.00}{1,000}

X = 4\%

This means that if Person B buys the stereo, then 4% of his income goes to taxes.

This is a significant difference in tax rates, even though Person A and Person B are buying the same stereo. If Person A buys the stereo, then only 0.04% of her income will be taxed. When Person B buys the same object, he will be taxed 4% of his income. This regressive tax rate will continue to increase as the amount of income decreases.

**AD VALOREM TAXES**

*Ad valorem* taxes are general real estate taxes. The term *ad valorem* is Latin for "according to value." It follows, then, that the amount of an *ad valorem* tax is determined according to the appraised value of the property to be taxed. Many governmental bodies have the authority to levy *ad valorem* taxes, including the following:

- Counties
- Cities
- Towns
- Districts containing parks or preserved forests
- Hospital districts
- Water districts
- School districts

Governmental bodies impose *ad valorem* taxes to support state and local agencies. *Ad valorem* taxes are specific, involuntary, statutory liens.

**REAL ESTATE VALUATION**

Local assessors, whose methods of appraisal may vary from state to state, assess the value of an individual parcel of property for tax purposes. Assessments are based on the market value of the property; the value of the land upon which the property is situated is usually appraised separately. Assessed values are then listed in the local *tax roll*. Homeowners may object to the appraised assessment of their property, but must take their appeals to court.
Equalization Factor

Value assessments for properties may vary substantially according to their location in a particular taxing district. This creates an inequity in tax assessments, and would result in an unfair distribution of statewide taxes. So, in order to equalize tax assessments throughout the state, the assessed values of properties are equalized using an equalization factor—that is, by multiplying the assessed value of a property. Taxes are then levied against the adjusted assessments, and all property owners in the state pay an equal share of the state tax.

In an area with a low tax assessment, an equalization factor greater than 100 percent is applied. For example, if the tax assessment for an area is 20% lower than the state average assessment, an equalization factor of 120% is multiplied by the assessed value of each property in that area. In an area with a high tax assessment, an equalization factor of less than 100 percent is used. Ad valorem taxes are then calculated according to the adjusted assessments.

Example: A certain county’s assessments are found to be 10 percent lower than other counties in the state. The state decides to apply an equalization factor to the assessments in this county. What factor should be used, and what would the new assessment for a home previously assessed at $120,000 in the affected area be?

Let A = the adjusted assessment of a home. So, 90 percent of A is equal to the original price of the home. To find the equalization factor, we must determine the adjusted price of the home expressed as a percentage of the original price:

$$\frac{A}{0.9A} = \frac{1}{0.9} = 111\%$$ equalization factor

To find the new assessment value of the $120,000 home, we multiply the equalization factor by the original assessment:

$$111\% \times \$120,000 = \$133,200$$

TAX RATE CALCULATION

When a taxing district creates a budget for a fiscal year, it must determine the total expected expenses, as well as the expected revenues from sources like revenue sharing and fees. The difference between total expenses and total revenue is equal to the amount of money that the district must raise from the collection of real estate taxes. So, if a district expects to raise $40 million in
revenues and expects to spend $50 million in a given year, then the district must raise $10 million in real estate taxes.

To determine the tax rate applied to each property owner, the district divides the total amount to be raised from real estate taxes by the total assessed value of all real estate in the district.

Example: A district’s fiscal budget indicates that expected expenses are $68 million and expected revenues from fees and other sources total $66 million. If the total assessed value of real estate in the district is $50 million, what will the real estate tax rate be?

The total amount that needs to be raised is:

$68 million – $66 million = $2 million

Now we can express this figure as a percentage of the total assessed value of real estate:

$2 million / $50 million = 4% (tax rate)

Tax rates are usually expressed in terms of mills. One mill is equal to one thousandth of a dollar (1/1000\(^{th}\) of $1.00, or $0.001). So, in the previous example, the tax rate could be expressed as $4 per $100 of the assessed value, which is also $40 per $1,000. A tax rate of $40 per $1,000 equals 40 mills.

TAX BILL CALCULATION

To determine an individual property owner’s tax bill, the tax rate is simply applied to the assessed value (or, adjusted assessment if an equalization factor was applied) of the property. Sometimes, the bills from different taxing districts are combined into a single tax bill, and sometimes bills are given out separately. Districts may also have different ends for their fiscal years; in such cases taxes must be paid at different times.

Example: The assessed value of a home is $85,000. If the tax rate for that taxing district is 15 mills, what is the total amount of taxes the property owner must pay?

If the tax rate is 15 mills, then the owner must pay $15 for every $1,000 of the assessed value of the property.

Therefore, $15 x 85 (which is $85,000 / $1,000) = $1,275

The tax rate of 15 mills may also be expressed as $1.50 for every $100.
Therefore,

$85,000 \times \frac{1.50}{100} = $1,275

**Example:** Owner A has two properties with assessed values of $90,000 and $120,000. If the tax rate is 1.5%, what will Owner A’s tax bill total?

Total assessed value for Owner A’s property:

$90,000 + $120,000 = $210,000

Total tax bill:

1.5% \times $210,000 = .015 \times 210,000 = $3,150

**APPROPRIATION**

The actual method by which a district imposes a tax is called *appropriation*. A district passes a law or ordinance that states the details of the proposed tax, and the district obtains authority to collect needed funds for the proposed expenditures. Finally, the district officially imposes the tax, an action called a *tax levy*.

**REAL ESTATE TAX DUE DATES**

Due dates for real estate taxes vary from state to state and are regulated by statute. Some states require payment the same year the tax is levied, and others require payment the following year. In some cases payments can be made in installments, and only a portion of the tax bill is due during the year the tax is levied. A knowledge of local due dates, also called *penalty dates*, is especially important for the proration of taxes when a property is sold.

**EXEMPTIONS FROM AD VALOREM TAXES**

Many properties are exempt by state governments because the properties are used for tax-exempt purposes. Examples of properties commonly exempted include the following:

- Hospitals
- School property
- Property owned by religious organizations
- Property owned by non-profit organizations
- Property owned by municipalities, cities and counties
State and local governments also may reduce general real estate taxes for senior citizens, on land used for agricultural purposes or for certain industries. Other possible reductions include homesteads and reductions for persons with disabilities.

**INVESTMENT IN TAX LIENS**

When a taxpayer fails to pay their real estate taxes, some states impose a tax lien on the property, and sell the tax lien at a tax sale. The highest bidder on the tax lien may purchase the lien. The buyer receives a *tax lien certificate* that entitles him to one of the following:

- A yield from the lien that must be paid by the defaulting taxpayer upon redemption (redemption is discussed later).
- Title to the property after a specified period of time.

It is important to note that the buyer does not purchase the property, only the tax lien on the property. However, these provisions make tax lien sales a lucrative opportunity for investment. They are somewhat risky, however, because in some states if the delinquent taxpayer declares bankruptcy, IRS liens or liens from lenders may take priority, rendering the tax lien certificate worthless. Another risk associated with tax lien sales is that they are often sold with little opportunity to inspect the property; the purchaser may discover problems after obtaining the tax lien certificate.

**SPECIAL ASSESSMENTS**

Special assessments, also called improvement taxes, are taxes levied on property to pay for public improvements. Homeowners whose property is near or adjacent to the improvement bear the expense of these improvements, but only if the owner benefits from the improvement.

Special assessments can be voluntary or involuntary. For example, a city may decide to improve the curb in a neighborhood without seeking approval or consent from the homeowners. In this case a tax lien will be placed on the affected homeowners’ property whether or not they wanted the improvement themselves. Sometimes, however, members of a neighborhood might petition the city for a public improvement such as a sidewalk. They agree to pay for the improvement, so the special assessment is voluntary. All special assessments are statutory and specific, and are held against the affected homeowners’ properties until paid. If the assessment is not paid, a lien may be placed on the defaulting owner’s property.
Special assessments are levied for common improvements, such as:

- Gutters
- Street lights
- Curb improvements
- Street paving
- Sidewalks

Depending on the type of improvement, property owners can share the cost of improvements on an equal or prorated basis. For example, several homeowners might equally share the cost of a street lamp, but the cost of a new sidewalk might be prorated according to the length of sidewalk built on each individual property.

**SPECIAL ASSESSMENTS PROCEDURE**

By implementing the following general procedure, special assessments may be imposed:

1. A local government body submits a proposal for an improvement, or affected property owners petition the city for an improvement. Both submissions must indicate the need for or desirability of the improvement.
2. The proper authority holds hearings on the improvement after the affected property owners have been notified of the proposal or petition.
3. An ordinance is passed that describes the improvement, the cost of the project and the area affected.
4. The amount to be assessed is calculated against all assessable properties in an *assessment roll*. The assessment roll indicates how the cost will be divided, usually according to front footage or estimated individual benefit.
5. Public hearings are held to confirm the assessment roll. Community members can raise objections at this time; a local court then decides on the proposal.
6. The special assessment becomes a lien on the affected owners’ properties.
7. Local authorities issue a *warrant* after the improvement is completed that allows a local collector to issue bills to begin collecting the special assessment.

Special assessments become liens on affected homeowners’ properties after the warrant and bills are issued. Special assessments may be prepaid in full to avoid interest charges or taxpayers may pay the special assessments in installments. Some taxpayers may be eligible for special assessment deferral. Types of special assessment deferrals may be used by senior citizens and disabled persons with hardship status, and for assessments levied on unimproved land.
LIEN PRIORITY

A lien on a specific parcel of property evidences an owner’s debt and obligation to pay the debt. If a person defaults on the lien and fails to make payments on that debt, the governing body may foreclose on the property. The property is usually sold at a public auction, and proceeds from the sale are used to satisfy the owner’s debt. This money is used to pay any outstanding liens, in order of their priority.

The priority of liens is generally determined by the date when the lien was recorded in the county clerk’s office. For example, a mechanic’s lien that was recorded on March 1, 2004 has priority over a judgment lien that was recorded on May 31st of the same year. It is important to note, however, that special assessments and state property taxes have highest priority over all other liens, regardless of when they were recorded. However, state law may change the order of lien priority; in some states mechanic’s liens have priority over other liens.

Consider the following example:

A parcel of property is foreclosed and sold by a court to satisfy all of the owner’s outstanding debts. This debt includes a second mortgage lien that was recorded in June 2002. The first mortgage on the same property was recorded in May 1997. The property owner never paid a contractor for improvements performed in September 2000, for which a mechanic’s lien took effect in January 2001. A special assessment was levied for curb improvement on the property in August 2003. The order of payment from the proceeds of the sale would be as follows:

1. The special assessment for the curb improvement, along with any outstanding general property taxes, is paid first.
2. The first mortgage lien is then paid, because it was recorded earliest.
3. Next, the contractor is paid to satisfy the mechanic’s lien that took effect in 2001.
4. The lender for the second mortgage then receives payment.
5. Finally, if there are any proceeds left over from the sale, the property owner receives the remainder.

SUBORDINATION AGREEMENTS

Subordination agreements are written compromises between lienholders to change the priority of their liens. When buyers obtain a mortgage loan to purchase a property, lenders often require a highest-priority lien. In that case, a seller might agree to have a subordinate lien in order to sell the property, if the full price will not be paid.
REAL ESTATE TRANSFER TAXES

Many states and municipalities have passed laws that impose a tax on the conveyance of real estate from one party to another. A real estate transfer tax must be paid when the property is sold, and the seller usually bears this expense. The amount of transfer tax is set by the state; a common transfer tax rate is $0.55 per $500 of the final sale price. The money collected from this tax may be divided between the county and state. For example, Michigan’s real estate transfer tax is $4.30 per $500 of the sale price of a single property. $0.55 of that rate goes to the county, and $3.75 goes to the state.

Real estate transfer taxes are usually paid by purchasing tax stamps, which are affixed to a deed at the time of recording at the county clerk’s office. Some states also require that both buyers and sellers sign a declaration form that indicates the type of transfer being affected, the address and legal description of the property and the type of deed being used to transfer title.

Some property transfers are exempt from transfer taxes. Common examples include the following:

- Transfers between governmental bodies
- Transfers by educational or religious institutions
- Transfers of real estate as security for a loan
- Real estate gifts

FEDERAL TAXES

IRS TAX LIENS

When a person does not pay Internal Revenue Service (IRS) taxes, such as the federal income tax, the IRS may obtain an IRS lien, which is a general, involuntary, statutory lien that is held against all of the defaulting taxpayer’s property. The IRS will first assess the taxpayer’s liability and then send a Notice and Demand for Payment to the taxpayer. If the taxpayer does not respond within ten days after receiving this notice, the IRS may then create a lien for the amount of the debt. The lien creates a claim on the taxpayer’s real and personal property, including any property purchased after the lien is filed.

An IRS tax lien may be released if the taxpayer satisfies the debt within 30 days by paying the amount due or by submitting a bond that guarantees payment of the debt.

Homeowners and investors must pay federal income tax on profit made from the sale or use of real estate. However, both homeowners and investors can reduce these taxes through the use of tax shelters.
TAX DEDUCTIONS

Federal income tax is assessed according to an individual’s net income. Deductions are ordinary expenses that a person pays in a taxable year that may be subtracted from his or her taxable income, thus reducing the tax liability on that income. Common deductions for homeowners include:

- Real estate taxes levied on primary residences.
- Interest on mortgage payments for primary residences.
- Other costs associated with a mortgage, such as prepayment penalties, fees and discount points.

Homeowners may not deduct the following expenses from taxable income:

- The principal portion of a mortgage payment.
- Depreciation expenses on a primary residence.
- Insurance premiums.
- Escrow payments.
- Utility expenses.

Deductions can greatly benefit an individual by lowering his or her tax liability. However, many of these deductions apply only to individuals who own and pay property taxes on a home. Consider the following example illustrating how a tax deduction can make owning a home more lucrative than renting.

**Example:** Assume that a homeowner and a renter each make $50,000 a year. The renter pays $900 a month to rent a house, but he cannot deduct any portion of rent payments for tax purposes. The homebuyer, on the other hand, can deduct both the interest on her mortgage payment and property taxes.

Assume the homeowner owns a $100,000 home, the monthly payment on which is $1,000 dollars. Assume that the amortization period is twenty years and the principal portion of the payment is $417, so the interest portion is $583 a month. The homeowner pays a total of $6,996 in interest each year.

Assume that both the renter and the homeowner are in the 28 percent income tax bracket. However, after the homeowner applies her deductions, she pays less tax than the renter. The renter pays $900 a month, which comes to $10,800 a year to live in a rented house. He pays the following federal income tax:

\[
28\% \times \$50,000 = \$14,000 \text{ (federal income tax)}
\]
The homeowner pays $12,000 a year in mortgage payments, plus $1,000 in real estate tax, for a total of $13,000 per year to live in her home. She can deduct the interest portion of her mortgage payment, which equals $6,996, as well as the real estate tax, so she pays the following federal income tax:

\[ (50,000 - (6,996 + 1,000)) \times 28\% = 42,004 \times 0.28 = 11,761 \text{ (federal income tax)} \]

The renter pays a total of $24,800 in rent and federal income tax; the homeowner pays a total of $24,761 in mortgage payments and federal income tax. Even though the homeowner’s monthly mortgage payment is $100 more than the renter’s monthly rent payment, they spend almost the same amount of money to live and pay taxes in this example. If their monthly payments had been the same, the homeowner would effectively have had much lower monthly payments, after deductions were taken into account. The homeowner’s benefits are greater still when we consider that in this case she also generated the following equity:

\[ 417 \text{ (principal portion of mortgage payment)} \times 12 \text{ months} = 5004 \text{ (amount of the principal paid off)} \]

**TAXES ON CAPITAL GAINS**

Capital gain refers to the profit received from selling a capital asset. Conversely, capital loss refers to the loss incurred from selling a capital asset. Capital assets include all of taxpayer’s tangible property, such as real estate, investment properties and equipment, but do not include property that is held for regular sale to consumers. The IRS imposes a tax on all forms of capital gains. In real estate, capital gain typically can be calculated using the following equation:

\[ \text{Sale price} - (\text{purchase price} + \text{cost of improvements}) + \text{total depreciation} - \text{expenses} = \text{gain} \]

The purchase price may be replaced by the price of the lot plus construction costs. It is important to note that residential properties do not depreciate; this part of the equation must be omitted when calculating gain on the sale of a primary residence. We will cover why and discuss depreciation in detail later in this lesson.

**Holding Period**

Whether a capital gain is taxed as a short-term or long-term gain is determined by the length of time the property is held (the amount of time between the day a property is bought and the day it is sold), called the *holding period*. If the holding period was shorter than one year, then the capital gain is short-term; if the
holding period was greater than or equal to one year, the capital gain is considered a long-term gain.

**Short-Term Capital Gains**

Short-term capital gains are taxed as normal income, according to federal income tax rates. This means that in most cases short-term gains are taxed at a much higher rate than long-term gains.

**Long-Term Capital Gains**

Long-term capital gains are currently taxed at 5 percent, 15 percent, 25 percent, 28 percent or a combination of these rates. The income level of the individual taxpayer determines the tax rate at which the gain will be taxed. For individuals in the top four federal income tax brackets, a tax rate of 15 percent applies. Most people claiming capital gains fall into this category. However, capital gains are taxed at 5 percent for those in the 10 percent and 15 percent income tax brackets. If the capital gain would push these individuals into one of the top four income tax brackets, then the portion of the capital gain below the minimum for the lowest of these brackets is taxed at five percent, while the rest is taxed at 15 percent.

These rates went into effect in May 2003. Previously, rates were five percent higher for most people: 20 percent for those in the top four income tax brackets, and 10 percent for those in lower tax brackets. The new rates are effective until the end of 2008. If lawmakers do not pass any new laws pertaining to these capital gains rates, the old rates will go back into effect.

The 25 percent rate listed above applies to depreciated properties, which are discussed later in this lesson. The tax rate is higher because investors received previous tax benefits by depreciating a property over its useful life; this helps the federal government to recapture money.

The 15 and 28 percent capital gains tax rate applies to gains from the sale of small business stock and collectibles. Examples of collectibles are antiques, gems, expensive wine collections and works of art.

**Homeowner Tax Benefits when Selling Principal Residences**

The Taxpayer Relief Act of 1997 created certain exclusions from capital gains taxes for homeowners. Under the universal exclusion, married homeowners may exclude up to $500,000 on the sale of a primary residence and single homeowners may exclude up to $250,000. This exclusion is reusable every two years after the sale.
Taxpayers must meet ownership and use requirements to be eligible for the exclusion. The taxpayer must have owned and occupied the home as a principal residence for at least two of the five years preceding the sale. However, the two years may be an aggregate amount of time, and need not be continuous.

For married couples, both spouses must have occupied the residence for at least two years out of the prior five years. However, only one spouse needs to have owned the property for at least two out of five years. Some use and time requirements may be modified or waived for certain individuals who cannot meet them due to incapacitation, divorce or death of a spouse. For example, if homeowners are forced to sell their homes as a result of a change in employment or health, they can exclude a fraction of $250,000, or $500,000 for joint filers, which is proportionate to the fraction of two years they spent at the residence.

### Exceptions

Exceptions to the two-year use requirement also include the following:

- Property acquired in rollover transactions, which are transfers of funds to investments of the same type, used to defer the payment of taxes (i.e. 1031 exchanges)
- Property transferred by a spouse
- Property owned by a spouse, former spouse or deceased spouse
- Owners who have received care from a nursing home

Exceptions may only be made once every two years, again unless the sale is a result of a change in health or employment.

When homes are sold for under $250,000 (or under $500,000 for joint filers) the owners do not have to file an information return reporting the sale of their principal residence.

For principal residence sales occurring after May 6, 1997, sellers are required to provide to the government a written assurance containing the following two items:

- A statement that the entire gain made from the sale can be excluded.
- A statement that the property is the owner’s principal residence.

The 1997 law allows most people to avoid any taxes from gains on the sale of their primary residences because the exclusion can be used frequently. However, these benefits do not apply to investment properties.
Application of Previous Rules

Previous rules addressing the postponement of gain and $125,000 exclusion for individuals older than 55 years do not apply to sales after May 6, 1997. However, taxpayers may choose to have the old rules apply if a sale occurred:

- On or before August 5, 1997
- On or after August 5, 1997, pursuant to a contract that was binding on August 5, 1997; or
- On or after August 5, 1997, if, under the old rollover transaction rules, gain would not have been recognized because a replacement residence was acquired (or pursuant to a binding contract) on or before August 5, 1997.

INVESTORS

Real estate investors can also benefit from tax shelters. When an investor sells a parcel of real estate, gain is determined by the basis and the adjusted basis. The term basis typically refers to the purchase price of real estate, and the adjusted basis is the purchase price plus the cost of improvements less the depreciation. The gain is the difference between the selling price (minus expenses) and the adjusted basis.

Depreciation

Investors can use depreciation, sometimes called cost recovery, as a tax shelter on investment property to recover costs. The term depreciation generally refers to the decline in the value of an asset or property due to use, wear or obsolescence. Depreciation may also refer to the allocation of the cost of an asset over its useful life. Only improvements to a parcel of real estate depreciate—the land itself is considered indestructible and, therefore, does not. An improvement, such as the construction of a home on unimproved land, only depreciates and can therefore be deducted from the taxpayer’s income when the property is used to generate income, such as a rental house. Improvements may be depreciated regardless of the physical damage and deterioration the property suffers. Tax deductions from depreciation lower the adjusted tax basis of a property.

Capital Gains on Depreciated Properties

When investors claim depreciation deductions for a piece of property, the depreciated portion of the gain is taxed at a rate of 25 percent, and the rest is taxed at the usual rate of 15 percent (or five percent).

Example: An investor sells a building for $700,000. The building has depreciated $100,000 in value, and was originally purchased for $500,000. What will the capital gains taxes be for this sale (assume the seller is in one of the top four income tax brackets)?
Because the building has depreciated by $100,000, the gain is $300,000. The $100,000 portion is taxed at 25 percent, and the remaining $200,000 of the gain is taxed at 15 percent. So, the total tax paid will be equal to the following:

$$25\% \times $100,000 + 15\% \times $200,000 = $25,000 + $30,000 = $55,000 \text{ (total capital gains tax)}$$

**REMOVAL OF IRS TAX LIENS**

The following are examples of ways to remove IRS tax liens:

- Tax liens can be removed when such an action benefits both the IRS and the individual.
- Tax liens can be removed if they are not in agreement with established procedures.
- The IRS can remove a tax lien if the taxpayer enters into an installment agreement, which involves periodic payment of the tax debt.
- If the IRS mistakenly imposed a tax lien, it can be sued for the removal.
- Taxpayers can appeal tax liens.
- If taxes are not collected within the period of time set forth in the statute of limitations, IRS tax liens are removed (usually they will be removed in 10 years).
- Tax liens can be removed if they are imposed prematurely.
- Tax liens can be removed if written notice of the lien is not issued within five business days of the day of filing; the notice must specify the amount as well as inform the recipient of the right to appeal the lien within 30 days of the notice’s issuance.
- Tax liens can be removed if they are not based on an assessment that adheres to the requirements of valid assessments.
- Tax liens can be removed if the National Taxpayer Advocate determines that removal is in the best interest of the taxpayer.

**Offer in Compromise**

If taxpayers are unable to pay their tax debt in full, and payments in the installment program is not a viable option, the IRS may accept an offer in compromise from the taxpayer. An offer in compromise allows the taxpayer to pay the IRS an amount that is less than the amount of delinquent taxes under certain circumstances. Requests for offers in compromise might be granted in the following situations:

- A doubt exists that the amount for assessed taxes the taxpayer owes is correct.
• The taxpayer is unable to pay the full amount; all assets are considered for ability to pay that are in excess of the amount needed for basic living expenses.
• An individual suffers a hardship, and the collection of the tax would be inequitable or unfair.

After a request for an offer in compromise has been accepted, the IRS may not pursue collection action until the request is accepted or rejected. If it is rejected, the request may be appealed. Requests often take about one year to process, but may take longer if the tax liability is greater than $50,000. If an offer in compromise is accepted, the IRS has 30 days to remove the tax lien.

LEARN MORE ABOUT:
Offers in compromise, here:

TAX LIENS

There are other tax liens that we have not covered. For example, liens can be enforced when state inheritance or federal estate taxes, as well as corporate franchise taxes, fall delinquent. State inheritance taxes and federal estate taxes are general, involuntary liens created by statute that apply to deceased persons' property; the taxes are normally paid in probate court. Some states require corporations to pay a franchise tax to conduct business in the state. Failure to pay such a tax can result in a corporation franchise tax lien, a general, involuntary lien that may operate as a priority lien on all corporate property.

As previously noted, not all taxing districts have the same tax liens and often there are multiple taxing authorities that govern a particular parcel of real estate. To know all of the tax liens that affect a particular property you must consult all local, state and federal tax authorities.

SUMMARY

The two main taxes affecting real estate are ad valorem taxes and special assessments. Other taxes that might affect real estate are real estate transfer taxes, federal income taxes and capital gains taxes. Taxes can be generally classified as progressive, regressive or proportional.

Ad valorem taxes are general real estate taxes that can be levied by many types of governmental bodies. Some parcels of real estate are exempt from these taxes, such as nonprofit organizations. Real estate is typically appraised, or assessed, for tax purposes by local assessors; if particular districts are appraised below or above surrounding districts, the state may apply an equalization factor to make the distribution of the tax burden fair.
Districts calculate real estate taxes as follows: total estimated expenses – total expected revenue from other sources such as fees = total money needed; the total amount that needs to be raised is distributed as a tax burden proportionally to each parcel of real estate. The method by which a district officially imposes taxes is called *appropriation*. Due dates for *ad valorem* taxes vary from state to state. Individuals can invest in tax liens; they can be highly lucrative but are somewhat risky.

Special assessments are taxes levied for public improvements and can be voluntary or involuntary; they attach specifically to those parcels of real estate whose owners benefit from the improvement. Special assessments are always statutory, specific liens.

When a court sale of a parcel of real estate occurs, money is paid out according to the established priority of liens. *Ad valorem* taxes and special assessments generally have priority over all liens. Other liens are usually paid off in the order they took effect, which in most cases means the order in which they were recorded. Subordination agreements allow the priority of liens to change.

Some states impose real estate transfer taxes that take effect whenever a parcel of real estate changes title. These taxes are typically very low.

This lesson discussed federal income taxes and several tax shelters that homeowners and investors can use to save money on the purchase or sale of real estate. Mortgagors can deduct real estate taxes and the interest portion of mortgage payments from federal income tax, effectively lowering their monthly payments. Homeowners who sell their primary residences are now exempt from capital gains tax for gains of up to $250,000 (for single filers), if they have lived in the dwelling for two of the previous five years. Short-term gains are taxed as regular income, whereas long-term gains (sales of property held for longer than one year) are taxed as capital gains; investors can save money by owning property on a long-term basis. Investors can also save money through depreciation, also called cost recovery, which can be deducted from income.

Federal income tax liens can be removed in special cases, such as when removal benefits both the government and the individual. The IRS is also sometimes willing to accept an offer in compromise, under which the IRS will accept a lower amount of money to satisfy a tax lien.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
FORECLOSURE

This lesson focuses on the following topics:

- Lien Priority and Foreclosure
- Types of Foreclosure
- Redemption
- Deficiency Judgments
- Tax Lien Enforcement
- Tips for Homeowners Facing Foreclosure
- Foreclosure Alternatives
- Foreclosure and Fraud

INTRODUCTION

Foreclosure is the legal procedure by which a parcel of real estate that has been used to secure a debt is reclaimed by a lender upon borrower default. The lender, or lienholder, institutes the foreclosure to either gain title or force a sale of the property to satisfy the debt. Foreclosures usually occur when a borrower fails to make payments on a mortgage, or fails to satisfy other requirements of the mortgage or deed of trust. Governments may also foreclose on property for failure to pay property or income taxes.

This lesson will cover foreclosure proceedings by explaining the types of foreclosure, rights of redemption, and deficiency judgments. In addition, this lesson will describe alternatives to foreclosure, and offer tips for homeowners on how to avoid fraudulent promises and transactions when facing foreclosure.

LIEN PRIORITY AND FORECLOSURE

When a property is foreclosed, title may transfer directly to the lender or public authority, or to a buyer upon a foreclosure sale. The proceeds from the sale are used to satisfy the borrower’s debt, and liens are paid in the order of their priority. If the funds are not sufficient to pay all the liens, the liens will remain attached to the property. Consider the following example, which demonstrates lien attachment after a foreclosure sale.

Example: A home serves as security for three mortgages, recorded in July of 1997, June of 2001 and August of 2003. The mortgagor had improvements made on the property for which a mechanic’s lien was filed in January of 2002. Real estate taxes were not paid, and represent an outstanding lien as of December 2003. If the mortgagee (lender) whose lien was recorded in June of 2001 forecloses on the property and holds a
sale, what liens will remain with the property after it goes to the purchaser?

Because the mechanic’s lien and the last mortgage were recorded after the foreclosing mortgagee’s lien, they are removed by the foreclosure proceedings. Although the real estate tax lien took effect after the foreclosing mortgagee’s lien, it remains with the property—recall that real estate taxes and special assessments generally have priority over all other liens. The first mortgage remains with the property as well.

PROTECTING LIENS OF LESSER PRIORITY

In order to protect their interests, lienholders with lower priority can make payments on liens of greater priority and foreclose on a property. After the foreclosure proceeding, the lienholder can obtain possession of the property, subject to liens of greater priority. This method protects junior liens from being removed in the procedure explained above.

TYPES OF FORECLOSURE

There are two types of foreclosure: judicial and nonjudicial. Strict foreclosure and deed in lieu of foreclosure are two other methods of foreclosure that may be used in certain circumstances. However, it is important to note that foreclosure proceedings may vary from state to state.

JUDICIAL FORECLOSURE

A lender may foreclose on a property through judicial foreclosure by bringing a lawsuit in court against the defaulting borrower with the intent of obtaining a judgment order for the amount of the borrower’s debt. Proceedings for judicial foreclosures are executed in the following order:

1. The lender provides public notice of foreclosure.
2. The lender may choose to accelerate the due date for all remaining payments on the loan, which means that the entire remaining balance of the loan will be due.
3. The lender files a foreclosure suit against the defaulting borrower.
4. A court hears the case and may issue a judgment order in favor of the lender.
5. The court issues an execution order instructing the sheriff to take possession of the foreclosed property.
6. The sheriff sells the property at a public auction to the highest bidder.
7. Title to the foreclosed property transfers to the buyer by a sheriff’s deed.
NONJUDICIAL FORECLOSURE

If a lender wants to avoid oftentimes complicated and long court hearings, a property may be foreclosed by nonjudicial foreclosure. However, the original loan document must have a *power-of-sale clause* written into the agreement for such foreclosures to occur. Some states prohibit the inclusion of this clause.

Nonjudicial disclosure may also be called foreclosure under the power of sale. States usually require notice of the default to be filed in the county recorder’s office. The notice must specify the amount of time a debtor has to make a payment, and avoid foreclosure. If the debt is not satisfied, the mortagee (lender) or trustee advertises the sale of the property in the county courthouse for a period of time determined by state statute. The mortagee or trustee must also advertise the sale in a local newspaper to inform the public of the sale. A sheriff conducts the sale, and title transfers to the buyer by a sheriff’s deed.

STRict Foreclosure

Although this proceeding is uncommon today, creditors and lenders may perform *strict foreclosures* in certain circumstances. Under strict foreclosure, a lender must first provide notice to the debtor of default, and file the appropriate paperwork. After a court-specified time, if the debtor has not paid the portion of the debt in default, the lender obtains full title to the property. Under strict foreclosure, there is no court hearing or foreclosure sale.

DEED IN LIEU OF FORECLOSURE

Lenders may also accept a deed in lieu of foreclosure in the event of borrower default to avoid foreclosure proceedings. In this case, the borrower transfers title directly to the lender. The primary advantage of this type of foreclosure is that court costs and attorney fees are avoided, and there is no record of foreclosure. The disadvantage of this method is that all liens of lesser priority accompany the property, and lenders may be held liable for payment of these liens. An additional disadvantage is the borrower’s loss of rights associated with private mortgage insurance, Veteran’s Administration (VA) guarantees and Federal Housing Administration (FHA) insurance. Homeowner issues related to deeds in lieu of foreclosures are discussed later in this lesson.

REDEMPTION

Most states allow debtors to *redeem* (regain possession of) their property after default, and in some cases, after a foreclosure sale. There are two types of redemption: equitable redemption and statutory redemption.
EQUITABLE REDEMPTION

Equitable redemption occurs after the borrower has defaulted on payment, but before the sale of the property. Equitable redemption allows defaulting debtors to pay the balance due on the debt (as well as any costs the lender incurred and any accrued interest) in order to prevent a foreclosure sale. After payment, the lender will reinstate the mortgage. However, if the lender has accelerated the loan, the principal amount of the loan, with any costs, fees and interest, is due.

STATUTORY REDEMPTION

Statutory redemption allows debtors to recover their property after a foreclosure sale by paying all of the outstanding debt, accrued interest and all charges associated with the foreclosure sale. Debtors have a specific and limited amount of time to recover the property, called the statutory redemption period. During this time, the court may appoint someone to take control of the property. The purchaser at the foreclosure sale usually has the right to collect rents until the property is redeemed, but must return the property to the owner when the debt is paid.

DEFICIENCY JUDGMENTS

Lenders sometimes seek a deficiency judgment against a defaulted borrower if a foreclosure sale does not generate enough money to pay off the balance due on the loan. Deficiency judgments pay off the remaining balance, accrued interest and foreclosure expenses; any remaining money is given to the borrower. It is important to note that if a lender accepts a deed in lieu of foreclosure from a defaulting borrower, that lender may not obtain a deficiency judgment.

Some states do not allow deficiency judgments, and others strictly limit them. The following are examples of situations in which deficiency judgments are usually prohibited:

- Nonjudicial foreclosures of trust deeds.
- When the foreclosing lender buys the property at a sale for less than the fair market value.
- When the seller buys back the property at the sale.

When deficiency judgments are not allowed, the debt is called non-recourse financing. Borrowers who obtain non-recourse financing are not personally liable for the loan. In the event of default, the only way for lenders to collect the remaining balance of a loan is by foreclosure.

In states that do allow deficiency judgments, the foreclosed mortgagor loses not only the property, but also must pay additional money to clear his or her debt.
TAX LIEN ENFORCEMENT

Remember that real estate tax liens and special assessments generally have priority over all other types of liens. But to be enforced, tax liens first must be valid, which means they must satisfy the following criteria:

- They must be for a legal purpose.
- They must be levied properly.
- They must be applied to all property equitably.

Statute specifies a length of time during which property taxes may be paid. After this time period has expired, by conducting a tax sale, taxes on specific properties are collected; this is also called a tax foreclosure.

TAX SALES

Once a taxing authority has placed a tax lien on a property, the owner of that property has until the date of the tax sale to pay the assessed taxes. If, at that time, the owner has not paid his or her debt, the property may be sold at a tax sale. Although states may employ different methods of conducting tax sales, a tax collector usually conducts these events annually.

At least one month prior to the tax sale, a list of all properties for sale, with each owner’s name and unpaid tax amount on record, is advertised in local newspapers. At the sale, bidding starts at the amount the delinquent taxpayer owes on the property, and increases in increments. The winning bidder obtains a certificate of purchase, which is a document that officially verifies a successful bid. It is important to note that it is the responsibility of the bidder to inspect the property before the sale to avoid future liabilities.

Redemption

Because delinquent taxpayers have a right to redeem their property (by paying delinquent taxes, fees and interest), at many tax sales, bidding is based upon the percentage that the delinquent taxpayer would pay to the bidder if it were redeemed, with the lowest interest rate winning the auction.

Redemption can occur at any time before the tax sale and, in most states, within a specified length of time (waiting period) after the tax sale. It is during this time that other lienholders may also redeem property. If the owner and lienholders do not redeem the property within the waiting period, the bidder can obtain a tax deed, a title whose nature varies from state to state. At that time, the purchaser is responsible for paying any taxes, assessments, penalties, fees and costs assessed against the property.
In many states if no one bids high enough at a tax sale, the property is forfeited to the state; if the redemption period expires, the state can either use the land or sell it.

**TIPS FOR HOMEOWNERS FACING FORECLOSURE**

The following information is adapted from HUD’s Website, which contains advice for homeowners facing foreclosure proceedings. The information applies to FHA-insured loans, but may or may not be applicable to mortgagors with unconventional loans or Veteran’s Administration (VA) loans, over which HUD does not have loss mitigation oversight. Homeowners should always contact their lenders and housing counseling agencies when facing foreclosure, in order to minimize risks and to find alternatives to foreclosure.


Homeowners should take any measure possible to avoid foreclosure because not only will they be without a home, but also such action will seriously impede their ability to obtain credit in the future. Furthermore, as discussed earlier in this lesson, if a foreclosure sale does not generate enough money to pay off the mortgage, the mortgagee may seek a deficiency judgment for the remainder of the mortgage, which also can have detrimental effects on a person’s ability to obtain credit.

HUD strongly advises homeowners not to avoid letters from their lenders. As soon as mortgagors know they are going to have problems making a payment, they should write to their mortgagor’s loss mitigation department. The term *loss mitigation* refers to a process for avoiding foreclosure, in which a lender may help a mortgagor who cannot make payments to avoid defaulting on the loan. Homeowners generally must provide specific personal financial information for the loss mitigation department to be able to help. However, the lender may be sympathetic to individual situations that arise and inhibit a mortgagor's ability to pay.

When facing foreclosure, mortgagors should make sure to stay in their homes, because if they abandon their property, they may not qualify for assistance from their lenders.

Housing counseling agencies offer a variety of services free of charge. They often offer credit counseling, have information on government programs that may assist mortgagors and provide information on community or private organizations that can help. For more information on these agencies, please visit [http://www.hud.gov/offices/hsg/sfh/hcc/hccprof14.cfm](http://www.hud.gov/offices/hsg/sfh/hcc/hccprof14.cfm).
FORECLOSURE ALTERNATIVES

PRE-FORECLOSURE SALE

Homeowners can sometimes sell their properties for less than the remaining balance of the loan in a pre-foreclosure sale, in order to avoid the foreclosure process. The following criteria must generally be satisfied to engage in a pre-foreclosure sale:

- The loan must be at least two months delinquent.
- The house must be sold within three to five months.
- The lender must obtain a new appraisal of the property showing that the home’s value adheres to the Department of Housing and Urban Development (HUD) program guidelines.

PARTIAL CLAIM

Homeowners who have defaulted on their mortgage for the first time, but will be able to make full payments in the future, may qualify for a partial claim that is financed by the FHA insurance fund. A partial claim is a one-time-only payment that brings a mortgage up to date. To qualify for a partial claim, the mortgage must be at least four months delinquent but no more than 12 months delinquent.

When the lender qualifies for a partial claim, HUD will pay the delinquent balance of the loan. The borrower is then required to execute a promissory note for the amount of the claim, and a lien is placed on the property until the promissory note is paid in full. However, this note is interest free, and is due after the mortgage is paid in full or when the home is sold.

MORTGAGE MODIFICATION

In some cases, homeowners may refinance their mortgage loans or extend the term of their loans in order to lower the monthly payments. Mortgage modification works best for individuals who have encountered temporary financial problems, have since recovered, and are now capable of paying the new mortgage payment.

SPECIAL FORBEARANCE

Homeowners who experience an increase in basic living expenses or a decrease in income may qualify with their lenders for one of the following:

- Repayment plan
- Temporary reduction of payments
- Temporary suspension of payments
Mortgagors must provide information to their lenders that indicates their ability to satisfy the requirements of a new mortgage payment plan.

MORTGAGORS AND DEEDS IN LIEU OF FORECLOSURES

A mortgagor can offer a lender a deed in lieu of foreclosure, but should only do so as a last resort. If the following criteria are met, however, a mortgagor may need to consider this as an option:

- The mortgagor has defaulted, and none of the previously discussed alternatives to foreclosure is possible.
- The mortgagor does not have another FHA-insured loan in default.
- A pre-foreclosure sale was unsuccessful.

Although the mortgagor loses his or her property, foreclosure is more damaging to a person’s credit. Keep in mind that lenders may not accept a deed in lieu of foreclosure, because of the method’s disadvantages such as the continued attachment of junior liens.

FORECLOSURE AND FRAUD

HUD warns homeowners that they should be wary of fraudulent promises used by people to take advantage of others in difficult situations. When homeowners sell their homes without professional assistance, they should be careful of buyers who seem overly eager to complete the sale and should question any deal that seems too good to be true.

The following precautions can help protect homeowners from fraudulent promises:

- Homeowners should never sign any document that they do not completely understand.
- Any verbal promises should be obtained in writing.
- Before entering into an agreement involving their homes, mortgagors should consult a lawyer or mortgage company.
- Homeowners should be careful of contract of sale and loan assumptions in which mortgagors are not released from liability for their loans.

Homeowners should be particularly aware of the following two types of scams: phony counseling agencies and equity scams.

PHONY COUNSELING AGENCIES

Homeowners facing foreclosure are sometimes approached by people claiming to represent counseling agencies. These individuals usually offer to provide
services, such as negotiating a pre-foreclosure sale or a repayment plan with the
lender, in exchange for a fee; however, these are actions that mortgagors can
take themselves for free. When homeowners have doubts about paying for a
service like those listed, they should contact another counseling agency that they
know is legitimate.

One means by which homeowners can be sure to avoid this type of deceptive
assistance is by using only HUD-approved counseling agencies. Homeowners
can easily locate such an agency by calling (800) 569-4287.

**EQUITY SKIMMING**

In another kind of fraudulent transaction that HUD identifies as *equity skimming*,
a buyer may approach a mortgagor facing foreclosure and offer to pay off the
mortgage and then give the mortgagor a certain amount of money when the
property is sold. In these cases, the mortgagor is usually asked to sign a
quitclaim deed that transfers ownership of the property from the mortgagor to the
buyer. The mortgagor usually stays in the home, and the buyer collects rent.

However, the buyer very rarely makes any mortgage payment to the seller. The
buyer possesses title to the property, but the mortgagor is still held liable for the
mortgage payments. If no payments are made, the lender may foreclose on the
property. Upon foreclosure, the mortgagor loses not only his or her home, but
also any equity he or she may have had in it.

Mortgagors must watch for potentially fraudulent buyers. When a mortgagor is
going to sell a home to avoid foreclosure, the mortgagor should investigate a
buyer's history. Mortgagors can determine if any complaints have been filed
against a buyer by contacting the state real estate commission, the state attorney
general or the local district attorney's consumer fraud unit.

**SUMMARY**

Foreclosure is the legal procedure by which a parcel of real estate used to
secure a debt is sold to satisfy the debt. Foreclosures can occur when a debtor
fails to make payments or fails to satisfy other requirements of a mortgage or
deed of trust. The proceeds from a foreclosure sale are used to satisfy the debt
created by liens; liens with the highest priority will be paid off first. If the sale
proceeds are not sufficient to satisfy all of the borrower's debt, liens may remain
with the property. To protect their interests, junior lienholders can make
payments on debts secured by liens of greater priority and perform a foreclosure
sale.

The three types of foreclosure are judicial foreclosure, nonjudicial foreclosure
and strict foreclosure. Judicial foreclosure is ordered by a court after a lender
files suit against a delinquent borrower and obtains a judgment order. In states
that recognize deeds of trust, foreclosures can sometimes be performed without a court order and are called nonjudicial foreclosures. In rare cases, strict foreclosure can occur, which allows lenders to obtain full title in fee simple estate to a property after a debtor has been delinquent in making payments for a specific period of time. Lenders can also accept deeds in lieu of foreclosure, but there are several disadvantages for the lender, such as the continued attachment of junior liens. Most states allow a mortgagor redemption rights to reclaim property that has been foreclosed. Redemption can occur before a foreclosure sale, called equitable redemption, or in some cases after the foreclosure sale, called statutory redemption.

If a foreclosure sale is not sufficient to pay off a loan, the lender may seek a deficiency judgment against the debtor for the remaining balance of the loan. Lenders who accept a deed in lieu of foreclosure cannot seek deficiency judgments. Deficiency judgments are prohibited in some states; debts in this case are often called non-recourse financing because the only way for lenders to obtain the remaining balance of a loan, in the event of default, is through foreclosure.

Federal income taxes are generally enforced through tax sales (sales of property resulting from unpaid taxes). Before a tax sale occurs, owners have the right to redeem their property by paying the delinquent taxes. In many cases, they also have the right to redeem a property after a sale has occurred.

HUD strongly advises homeowners to take any possible steps to avoid foreclosure, because it seriously impedes their future ability to obtain credit. HUD advises defaulting mortgagors to stay in their homes, respond to lenders’ letters and contact their lender’s loss mitigation department.

Several alternatives to foreclosure exist, such as pre-foreclosure sales, partial claims, mortgage modification and special forbearance. Pre-foreclosure sales allow borrowers to sell their home before a lender forecloses, but owners have only a limited time to do so. Some lenders may qualify for partial claims, which are one-time-only payments from HUD that bring mortgages up-to-date and are paid after the remaining loan balance is due. With mortgage modification, borrowers can either refinance or extend the term of a loan. Mortgagors who suffer a change in wage or basic living expenses may be eligible for special forbearance allowing for a repayment plan, or temporary suspension or alteration of payments.

Homeowners facing foreclosure should be careful of false promises and fraudulent transactions. They generally should not sign anything they do not fully understand. Two common deceptive practices involve phony counseling agencies and equity skimming.

Return to your on-line course player to take the Lesson Quiz.
LESSON FOUR
REAL WORLD PRACTICE

This lesson focuses on the following topics:

- Insight into Liens, Taxes and Foreclosures
- Field Applications of Liens, Taxes and Foreclosures

INTRODUCTION

This module has covered many specifics over a relatively short period of time. To ensure a comprehensive understanding of this material, we will review the information by completing a matching exercise and a series of case studies. The first half of this lesson presents a list of liens that must be matched with appropriate explanations. The second half presents brief case studies that illustrate principles and ideas presented in this module.

INSIGHT INTO LIENS, TAXES AND FORECLOSURES

The following exercise contains a list of liens and corresponding descriptions. Match each type of lien with its proper description.

**WORD BANK**

Vendor's liens
Mechanic's liens
Federal judgment liens
Writs of attachment
Judgments

1
These are decrees ordered by courts. They are general, involuntary liens, so they apply to both an individual’s real and personal property. They take effect only after they have been recorded in the county clerk’s office, and apply to property currently owned or acquired in that county.

2
The government might file this type of lien for failure to pay certain debts such as student loans. These liens are filed in the county where real property is held.

3
This is a specific, involuntary lien created by statute in some states that arises when a seller has not yet received full payment for a property. The lien constitutes security for a debt. When the seller does not finance the loan, the lien is transferred to the lender. By filing suit to have the property sold, these liens are enforced.
4
This type of lien protects suppliers, contractors, architects, engineers, surveyors and other parties whose labor has improved the value of real property. They are based on the *enhancement of value theory*: the parties who performed the labor have increased the value of the real estate and thus have an interest in it; the property itself becomes security for money owed.

5
Plaintiffs in a lawsuit may seek this; a court maintains custody of property until it reaches a judgment. It protects creditors from a conveyance of title before a judgment is rendered.
INSIGHT INTO LIENS, TAXES AND FORECLOSURES
ANSWERS

1
These are decrees ordered by courts. They are general, involuntary liens, so they apply to both an individual’s real and personal property. They take effect only after they have been recorded in the county clerk’s office, and apply to property currently owned or acquired in that county. (Judgments)

2
The government might file this type of lien for failure to pay certain debts such as student loans. These liens are filed in the county where real property is held. (Federal judgment liens)

3
This is a specific, involuntary lien created by statute in some states that arises when a seller has not yet received full payment for a property. The lien constitutes security for a debt. When the seller does not finance the loan, the lien is transferred to the lender. By filing suit to have the property sold, these liens are enforced. (Vendor’s liens)

4
This type of lien protects suppliers, contractors, architects, engineers, surveyors and other parties whose labor has improved the value of real property. They are based on the enhancement of value theory: the parties who performed the labor have increased the value of the real estate and thus have an interest in it; the property itself becomes security for money owed. (Mechanic’s liens)

5
Plaintiffs in a lawsuit may seek this; a court maintains custody of property until it reaches a judgment. It protects creditors from a conveyance of title before a judgment is rendered. (Writs of attachment)
FIELD APPLICATIONS OF LIENS, TAXES AND FORECLOSURES

CASE STUDY ONE

A city decides to install streetlights within a certain neighborhood and wishes to levy a special assessment to pay for the improvement. In what order would the following steps need to be taken in the special assessment procedure? Number each step in the order it would occur in real time:

Local authorities issue a warrant that allows a local collector to issue bills to begin collecting the special assessment.

Hearings are held to confirm the assessment roll. Community members can raise objections at this time; a local court then decides on the proposal.

The proper authority holds hearings on the improvement after the affected property owners have been notified of the proposal.

The special assessment becomes a lien.

The city puts forth a proposal for the improvement.

The assessment is spread over the properties that are affected in what is called the assessment roll. This stage determines how the cost for the streetlights will be divided.

An ordinance is passed that describes the improvement itself, the cost involved and the area affected.
CASE STUDY ONE RESPONSE

Local authorities issue a warrant that allows a local collector to issue bills to begin collecting the special assessment. (7)

Hearings are held to confirm the assessment roll. Community members can raise objections at this time; a local court then decides on the proposal. (5)

The proper authority holds hearings on the improvement after the affected property owners have been notified of the proposal. (2)

The special assessment becomes a lien. (6)

The city puts forth a proposal for the improvement. (1)

The assessment is spread over the properties that are affected in what is called the assessment roll. This stage determines how the cost for the streetlights will be divided. (4)

An ordinance is passed that describes the improvement itself, the cost involved and the area affected. (3)

CASE STUDY TWO PART ONE

Creditor A files suit against Debtor B for failure to repay a loan. The creditor is worried that Debtor B may decide to convey title to the real estate he owns, and give his valuable personal possessions to a family member, thus preventing Creditor A from obtaining payment. Creditor A decides to seek a writ of attachment. Which of the following statements are true about writs of attachment? Check all applicable options.

Under a writ of attachment, the court maintains custody of the property until a judgment is rendered.

Debtor B has no means for recovering lost money from the writ of attachment.

A writ of attachment will protect Creditor A from a title conveyance of Debtor B’s real property.

If Debtor B does not wish to have all the property he owns attached, then he can request to have certain property exempted from the writ of attachment.

A writ of attachment is also referred to as a writ of certiorari.
CASE STUDY TWO PART ONE RESPONSE

Under a writ of attachment, the court maintains custody of the property until a judgment is rendered.  
(Correct)

Debtor B has no means for recovering lost money from the writ of attachment.  
(Incorrect.  Creditor A is required to post a surety bond or deposit great enough to cover any potential losses the defendant might suffer.)

A writ of attachment will protect Creditor A from a title conveyance of Debtor B’s real property.  
(Correct)

If Debtor B does not wish to have all the property he owns attached, then he can request to have certain property exempted from the writ of attachment.  
(Correct)

A writ of attachment is also referred to as a writ of certiorari.  
(Incorrect.  A writ of attachment is also called an attachment lien)

CASE STUDY TWO PART TWO

As previously noted, certain property may be exempted. Which of the following items are likely to be exempted from the writ of attachment? Check all applicable options.

Investment properties
Tools used for a trade or business
Vehicles
Social Security
Jewelry
Household Appliances and furniture
Schoolbooks
Share of stock in a business partnership
Lots in cemeteries
CASE STUDY TWO PART TWO RESPONSE

Correct responses appear in **BOLD ITALICS**.

Investment properties
*Tools used for a trade or business*
Vehicles
*Social Security*
Jewelry
*Household Appliances and furniture*
*Schoolbooks*
Share of stock in a business partnership
*Lots in cemeteries*

CASE STUDY THREE

A state has determined that a particular county’s tax assessments are unusually high. Homes appraised at $80,000 in other jurisdictions were compared with similar homes in this area that were appraised at $100,000. The state decides to apply an equalization factor to the county to make the real estate tax burden more fairly distributed. What equalization factor must the state apply?

To determine the equalization factor, we must express the price of homes in other counties as a percentage of the area in question.

$$\frac{80,000}{100,000} = 80\% \text{ equalization factor}$$

We can check our work by applying the equalization factor:

$$80\% \times 100,000 = 0.8 \times 100,000 = 80,000$$

Now we apply the equalization factor to another home in the equalized jurisdiction with an originally assessed value of $540,000. What would that amount be?
CASE STUDY THREE RESPONSE

\[ 80\% \times \$540,000 = 0.8 \times \$540,000 = \$432,000 \]

CASE STUDY FOUR

This case study has two parts. First, you will determine the likely priority of liens against a property. Then, once the liens’ order is established, examine who is likely to receive payment and how much each party would receive.

Lien Priority

A parcel of real estate that is encumbered by several liens is sold in a court sale. Given the following information, determine the likely priority of liens in order to determine how they will be paid off.

A Subject Property has two mortgages. The first was recorded in January 1997, and the second in June 2002. A contractor installed a swimming pool on the property but was never paid for the work. The contract was signed in December 2001. Work began in February 2002 and was completed in July 2002. Thus, a mechanic’s lien was recorded in January 2002. Also, the city completed a new sidewalk on the property. Construction began in February 2002, and was completed in May 2002. Thereafter, a special assessment lien attached to Subject Property as of December 2002.

What would the priority of the following liens be? Number them in that order.

First mortgage
Second mortgage
Mechanic's lien
Special assessment
CASE STUDY FOUR RESPONSE
Lien Priority

First mortgage (Second)
Second mortgage (Third)
Mechanic’s lien (Fourth)
Special assessment (First)

The special assessment must be paid first, even though it took effect last because special assessments and real estate taxes generally have priority over all other liens. Next to be paid is the first mortgage because it was recorded earliest. After that comes the second mortgage, and finally the mechanic’s lien, because the contractor’s work was completed a month after the second mortgage was recorded.

Payment of Liens

We now know that the swimming pool contractor’s lien is fourth in line behind the special assessment lien, the first mortgage and the second mortgage. Using the following information on the owner’s debts, determine whether or not the swimming pool contractor can expect to receive payment and, if so, how much would that be? Assume that the state requires that mechanic’s liens take effect when construction finishes.

- First mortgage unpaid balance: $150,000
- Second mortgage unpaid balance: $40,000
- Mechanic’s lien: $30,000
- Special assessment: $10,000
- Court sale price: $190,000
CASE STUDY FOUR RESPONSE
Payment of Liens

To determine the answer to this question, first arrange the liens according to priority:

1. Special assessment: $10,000  
2. First mortgage: $150,000  
3. Second mortgage: $40,000  
4. Mechanic’s lien: $30,000

The home was sold for $190,000, so we must subtract the debts according to priority.

$190,000 - $10,000 (special assessment) = $180,000  
$180,000 - $150,000 (first mortgage) = $30,000

The remaining $30,000 will be used to pay off the majority of the second mortgage, so (unfortunately) no money will be left over to pay the contractor. In this case, money from the state Recovery Fund may be used to pay the contractor, if such a fund exists.

CASE STUDY FIVE

A taxing district’s fiscal budget outlines the following information:

- The total expected expenses for the district are $50,000,000.
- The expected revenues from fees and other sources (excluding real estate taxes) are $47,000,000.
- The total assessed value of real estate in the district is $120,000,000.

What will the real estate tax rate be for the year, and what will the tax bill be for an owner whose property is assessed at $220,000?

The district needs to raise the following amount of money in real estate taxes:

$50,000,000 - $47,000,000 = $3,000,000

To determine the tax rate, we must express the needed money as a percentage of the total assessed value of real estate in the district:

$3,000,000 / $120,000,000 = 3 / 120 = .025 = 2.5%

What is the tax rate expressed in mills?
One mill is equal to $1 / 1,000^{th}$ of one dollar. To convert the percentage to mills, we must express the tax rate as a decimal and multiply by 1,000:

\[ .025 \times 1,000 = 25 \text{ mills} \]

Now determine the tax bill for the property owner whose real property was assessed at $220,000. What would that amount be?
CASE STUDY FIVE RESPONSE

2.5% x $220,000 = .025 x $220,000 = $5,500

CASE STUDY SIX

Homeowner A purchased a home a year ago, and now is trying to calculate her federal income taxes. Use the following information to calculate Homeowner A’s federal income tax bill after deductions:

- Homeowner A makes $80,000 a year.
- Homeowner A’s income tax rate is 25 percent.
- Homeowner’s monthly mortgage payment is $2,000.
- The principal portion of Homeowner A’s mortgage payment is $800.
- Homeowner A pays insurance premiums of $200 a month.
- Homeowner A’s utility expenses for the year totaled $1,200.
- Homeowner A’s real estate taxes for this property are $2,500.
- Homeowner A paid $500 in deductible mortgage fees during the year.

Homeowner A must first determine her federal income tax deductions for the year. Of the listed items, the following are deductible:

- The interest portion of the mortgage payment
- Real estate taxes
- Mortgage fees

Homeowners typically cannot deduct insurance premiums, utility expenses and the principal portion of interest payments.

She can now calculate her total deductions:

\[ \$2,000 \text{ (total mortgage payment)} - \$800 \text{ (principal portion of payment)} = \$1,200 \text{ interest portion of payment} \]

\[ \$1,200 \text{ (monthly interest payment)} \times 12 \text{ months} = \$14,400 \text{ total interest payment for the year} \]

\[ \$14,400 \text{ (total interest)} + \$2,500 \text{ (real estate tax)} + \$500 \text{ (mortgage fees)} = \$17,400 \text{ total deduction} \]

\[ \$80,000 \text{ (yearly income)} - \$17,400 \text{ (deductions)} = \$62,600 \text{ taxable income} \]
Homeowner A’s tax rate is 25%, so she must pay the following amount in income taxes:

$$25\% \times $62,600 = $15,650$$

After deductions are taken into account, what are Homeowner A’s effective monthly savings on her mortgage payment?
CASE STUDY SIX RESPONSE

If Homeowner A were renting, she would receive no tax deductions, so all of her income would be taxed:

\[ 25\% \times \$80,000 = \$20,000 \]

Her monthly savings, then, is the following:

\[ \$20,000 - \$15,650 = \$4,350 \]
\[ \$4,350 / 12 \text{ months} = \$362.50 \text{ (monthly savings)} \]
\[ \$2,000 - \$362.50 = \$1637.50 \text{ (effective monthly payment)} \]

CASE STUDY SEVEN

PART ONE

Mortgagor A has recently defaulted on his loan and wishes to avoid foreclosure. What are his options? Use the following information to determine your answers.

- Mortgagor A defaulted four months ago.
- Mortgagor A lives in a state with a statutory redemption period.
- Mortgagor A recently experienced financial difficulties that caused him to default but does not expect to have these difficulties in the future.
- Mortgagor A previously obtained a partial claim.
- Mortgagor A recently experienced an increase in basic living expenses.

1. Can Mortgagor A obtain a partial claim to catch up with his mortgage payments?
   - Yes or No?

2. Is Mortgagor A eligible for special forbearance?
   - Yes or No?
CASE STUDY SEVEN PART ONE RESPONSES

1
No

Because Mortgagor A does not expect future financial difficulties, and his mortgage is between 4 and 12 months delinquent, a partial claim would be a good option to bring his mortgage up-to-date. However, partial claims are granted on a one-time-only basis. Mortgagor A has already obtained a partial claim, so he cannot obtain another one.

2
Yes

Because he recently experienced an increase in basic living expenses, Mortgagor A may be considered for special forbearance.

PART TWO
Which of the following are possible solutions to Mortgagor A’s problem under special forbearance? Check all applicable options.

- Repayment plan
- Permanent reduction of payments
- Temporary reduction of payments
- Redemption
- Temporary suspension of payments
CASE STUDY SEVEN PART TWO RESPONSES

Correct choices appear in **BOLD ITALICS**.

*Repayment plan*
Permanent reduction of payments
*Temporary reduction of payments*
Redemption
*Temporary suspension of payments*

Mortgagor A must demonstrate an ability to make future payments to qualify for special forbearance.

**PART THREE**

1. Could Mortgagor A possibly conduct a pre-foreclosure sale?
   
   Yes or No?

2. Could Mortgagor A offer a deed in lieu of foreclosure?
   
   Yes or No?

3. Will Mortgagor A have a chance to reinstate his mortgage after a foreclosure sale has taken place?
   
   Yes or No?
PART THREE RESPONSES

1  
Yes  
Because Mortgagor A’s mortgage is at least two months delinquent, he may be allowed to conduct a pre-foreclosure sale. The lender may require that the home be sold within three to five months.

2  
Yes  
Mortgagor A can offer a deed in lieu of foreclosure but should do so only as a last resort. If a pre-foreclosure sale is unsuccessful, Mortgagor A may wish to consider this option because foreclosure will be more damaging to his credit.

3  
Yes  
Because the state allows a statutory redemption period, he can redeem the property after the sale.

Mortgagor A may also wish to consider mortgage modification to refinance the loan and lower monthly payments.

CASE STUDY EIGHT

Mortgagor A has defaulted on her loan, so Lender B has decided to take action. Which of the following might Lender B pursue? Check all applicable options.

Judicial foreclosure
Nonjudicial foreclosure
Strict foreclosure
Non-strict foreclosure
Lenient foreclosure
Deed in lieu of foreclosure
Deed in lieu of liens
CASE STUDY EIGHT RESPONSE

Correct choices are shown in **BOLD ITALICS**.

**Judicial foreclosure**

**Nonjudicial foreclosure**

**Strict foreclosure**

Non-strict foreclosure

Lenient foreclosure

**Deed in lieu of foreclosure**

Deed in lieu of liens

In order to perform a judicial foreclosure, Lender B must provide public notice and file a foreclosure suit. The lender has the option to accelerate the loan. If the court decides in favor of Lender B, the property may be sold in a public sale.

If the state recognizes deeds of trust, Lender B may be allowed to conduct a nonjudicial foreclosure under a power-of-sale clause in the mortgage contract. The state may require notice of the default to be filed in the county recorder’s office, and will specify an amount of time a debtor has to make a payment and avoid foreclosure. Lender B might place an advertisement in the newspaper in addition to the initial notice to inform the public of the sale. Some states prohibit nonjudicial foreclosure.

Lender B may be able to perform a strict foreclosure, although most states prohibit them. After filing the appropriate paperwork and after a court-specified period of time has ended, the lender may obtain full title to the property.

Lender B can also accept a deed in lieu of foreclosure. The primary advantage of this method is that court costs and attorney fees are avoided. However, Lender B might avoid this method because all liens of lesser priority accompany the property, whereas foreclosure proceedings eliminate junior liens. An additional disadvantage is the loss of rights associated with private mortgage insurance, VA guarantees and FHA insurance.

CASE STUDY NINE

PART ONE

Mortgagor A has defaulted on her mortgage. She is worried that her lender might foreclose on the property. Her state does not allow a statutory redemption period, and her financial difficulties may not allow her to recover the property in the event of foreclosure. She has recently heard about various deceptive and fraudulent practices that people use to take advantage of mortgagors in similar situations. Mortgagor A approaches Licensee B and asks for her advice. Which
of the following pieces of advice might Licensee B offer? Check all the suggestions that would truly help prevent people from taking advantage of Mortgagor A’s situation:

Make sure to obtain at least a verbal promise from buyers for actions they say they will take.

When time is of the essence, you may need to sign a contract on the spot to avoid a buyer backing out.

You should consult a lawyer or mortgage company before entering into any kind of agreement.

If approached by a person offering to negotiate a pre-foreclosure sale, your best option is to engage the person’s services because pre-foreclosure sales are extremely difficult to conduct yourself.

Be wary of contract of sale loan assumptions that may not release you from liability for the loan.
CASE STUDY NINE PART ONE RESPONSE

Correct choices are shown in **BOLD ITALICS**.

Make sure to obtain at least a verbal promise from buyers for actions they say they will take.

When time is of the essence, you may need to sign a contract on the spot to avoid a buyer backing out.

*You should consult a lawyer or mortgage company before entering into any kind of agreement.*

If approached by a person offering to negotiate a pre-foreclosure sale, your best option is to engage the person’s services because pre-foreclosure sales are extremely difficult to conduct yourself.

*Be wary of contract of sale loan assumptions that may not release you from liability for the loan.*

Because a verbal promise may not stand up in court, all promises should be obtained in writing. Mortgagor A should not rush through the process of finding a buyer and signing a contract. She should first make sure that she fully understands all the provisions of a contract, and she should be careful of buyers who seem overly eager to sign a contract. Mortgagor A should not employ the services of a person offering to negotiate a pre-foreclosure sale because she could probably perform it herself for free.

**PART TWO**

**Finding a Buyer for Mortgagor A**

Assume that Buyer C approaches Mortgagor A, offers to pay off the mortgage and give Mortgagor A some portion of the money after selling the property. The buyer stipulates, however, that Mortgagor A must sign a quitclaim deed that transfers title to him and move out of the house immediately. Should Mortgagor A accept the offer?

Yes or No?
CASE STUDY NINE PART TWO RESPONSE
Finding a Buyer for Mortgagor A

No

This is likely a fraudulent offer, so Mortgagor A should not accept it. Buyer C may not truly be interested in buying the property. With the arrangements he stipulates, he could potentially not make any mortgage payments but still collect rent on the property, causing the lender to eventually foreclose on the property. This type of fraudulent transaction is referred to as equity skimming.

CASE STUDY TEN

Homeowner A has just sold her primary residence. Property values have gone up considerably over the years: she originally bought the property for $180,000, but she was able to sell the home for $400,000. She has lived in the home for the past 10 years. Assume that the capital gains tax rate is 15 percent and that she is in the 28 percent federal income tax bracket. What is the total amount of tax that Homeowner A must pay for the sale of her home? Choose the correct letter response from the following options.

A: $33,000
B: $61,600
C: She does not have to pay any tax on the gain.
CASE STUDY TEN RESPONSE ONE

The correct option is C.

*She does not have to pay any tax on the gain.*

According to a 1997 tax law, sales of principal residences are exempt from capital gains taxes for gains up to $250,000, or $500,000 for those filing jointly ($250,000 for each spouse). To be exempt from capital gains taxes, homeowners must have lived in their primary residence for two of the previous five years before the sale, so the sale of Homeowner A’s home is exempt from capital gains taxes.

Now, which one of the following choices applies to the gain on the sale of an investment property that was bought 9 months prior? Mark your response.

Federal income tax
Capital gains tax
CASE STUDY TEN RESPONSE TWO

*Federal income tax*

Because the investor owned the property for less than one year, the gain is taxed as normal income. The investor would most likely save money if she had waited to sell the property and generated a long-term gain instead of a short-term gain.
LESSON FIVE
LIENS, TAXES AND FORECLOSURES IN TEXAS

This lesson focuses on the following topics:

- Mechanic’s Liens
- Vendor’s Liens
- Lien Theory
- Exemptions from Ad Valorem Taxes
- Real Estate Valuation
- Special Assessments
- Foreclosure Sales
- Non-judicial Foreclosures
- Redemption
- Deficiency Judgments

MECHANIC’S LIENS

In Texas, mechanic’s liens generally take effect when construction begins or when materials are delivered to a site. Mechanic’s liens also have priority over other liens, including mortgage liens. An affidavit may be filed no later than 30 days after the commencement of construction or delivery of materials. Mechanic’s liens must be foreclosed within two years of filing or within one year of completion of the work. Residential foreclosures must occur within one year of the lien affidavit’s filing.

After work has been completed, landowners are required by sections 53.101 of the Texas Property Code to retain 10% of the construction bill until 30 days after construction is completed. To protect landowners from liens imposed by subcontractors, the general contractor must provide an affidavit stating that the final bills have been paid, after the landowner makes the final payment. Issues relating to mechanic’s liens in Texas are very complex, so expert counsel is recommended.

VENDOR’S LIENS

Vendor’s liens are established by statute in Texas.

LIEN THEORY

A state that interprets mortgage as creating a lien on property while the borrower retains title (ownership rights) uses lien theory. Then, once the borrower completes all loan payments, the mortgage lender's lien is removed. Texas is a lien theory state.
EXEMPTIONS FROM AD VALOREM TAXES

Reductions of appraised value, called exemptions, may be made in Texas according to the Texas Property Tax Code. Reductions in appraised value result in lower property taxes.

HOMESTEADS

Homesteads are parcels of real estate owned and occupied by families. They are designated to protect the interests of homeowners. Homesteads generally cannot undergo a forced sale by creditors. Exceptions include sales resulting from unpaid taxes, mortgages and mechanic’s liens. Families do not need to take any specific action to officially establish homesteads: they are created by default. Because homesteads derive from the Texas Constitution, this right cannot be waived.

Owners of homesteads can apply with the central appraisal district for a $15,000 exemption from school district taxes. Homeowners should check with their tax assessors to determine the homestead exemptions offered in other taxing districts.

DISABLED HOMEOWNERS

Persons with disabilities can obtain a $10,000 deduction from school district taxes. They are also allowed to pay real estate taxes in four installments without penalties or interest. However, the disability deduction and a senior citizen deduction may not be taken simultaneously.

SENIOR CITIZENS

School taxing districts must also grant a $10,000 exemption to senior citizens, who are allowed to pay ad valorem taxes in four installments. To qualify for the exemption, homeowners must be over age 65 and occupy a homestead.

Seniors can also defer delinquent taxes until they stop living at the same property. However, an interest rate of 8% a year applies.

REAL ESTATE VALUATION

In Texas, real estate must be appraised according to the fair market value at least every three years. However, the appraised value may not increase more than 10% every year. Ad Valorem taxes become liens on January 1 for the year of the tax and are delinquent beginning February of the following year. Penalties are applied after the delinquent date, but discounts are allowed in varying amounts for payment before the delinquent date.
VALUATION OF AGRICULTURAL LAND

When the primary source of income from a parcel of real estate is agriculture, the land may be considered agricultural land for the purposes of appraisal. Such appraisals are based on agricultural value instead of market value. However, when agriculturally assessed property is sold or its use is changed, the taxes for the previous three years that would have been levied at market value are recovered by the taxing district, plus interest.

OPEN-SPACE LAND

Texas law preserves and promotes open-space land by taxing land “devoted to farm, ranch, or wildlife management purposes” on the basis of its productive capacity.

SPECIAL ASSESSMENTS

Special assessments are paid in annual installments over five or ten years. Interest for the unpaid balance of the special assessment is paid along with the assessment; however, homeowners can avoid interest by prepayment.

FORECLOSURE SALES

Lenders must follow strict guidelines to obtain the maximum purchase price for foreclosure sales. They do not have to obtain fair market value, but this may impact a lender’s ability to receive a deficiency judgment. Foreclosure sales occur in Texas on the first Tuesday of every month between 10 a.m. and 4 p.m. Lenders must allow 20 days before accelerating a loan. The statute of limitations for foreclosure is four years.

NON-JUDICIAL FORECLOSURES

Texas allows non-judicial foreclosures to occur under power-of-sale clauses in deeds of trust. Foreclosing lenders must provide 21-day advance notice as follows:

- They must post a notice at the door of the county courthouse.
- They must send notice by certified mail to debtors.
- They must file in the county clerk’s office.

Purchasers at foreclosure sales receive a trustee’s deed, which provides the same title the delinquent borrower had, but free of the debt in default.
REDEMPTION

When a property will be foreclosed to satisfy a tax debt, an equitable redemption period is allowed before a tax sale occurs, and a statutory redemption of six months, or two years for homesteads and agricultural properties, is also allowed. To redeem the property the owner must pay the amount paid at the tax sale and interest plus any other charges.

When a lender foreclosure occurs, an equitable redemption period is allowed before the foreclosure sale, but Texas does not allow a statutory redemption period.

DEFICIENCY JUDGMENTS

If a foreclosure sale conducted under a power-of-sale clause does not generate enough money to pay off the remaining balance of a loan, the lender may obtain a deficiency judgment. Lenders have two years to file suit for deficiency judgments in Texas.

Return to your on-line course player to take the Lesson Quiz.
# Texas Principles of Real Estate

## Module 11: Listing Agreements

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| Total Lesson Time: | 270 minutes (4.5 Hours) |
INTRODUCTION

One of the main ways that real estate licensees profit from real estate transactions is through listing agreements, or written contractual agreements between property owners and real estate licensees in which the licensee markets a property on behalf of an owner. Consequently, understanding the different types of listing agreements, what makes a listing agreement valid and who may enter into listing agreements with consumers is of specific importance to all licensees.

In accordance with TREC rules Sections 535.71 and 535.72D, this module will help the student become familiar with the basic legal concepts and forms used in listing real property and the different types of listing agreements available. In addition, it presents an overview of the listing process through a step-by-step review of the basic listing form and contents.

Although listing agreements vary from broker-to-broker and state-to-state, the underlying core content, form and most of the legal implications associated with them, remain the same. It is these core concepts that this course will address; and, consequently, upon completion of this course, the student will know how to successfully obtain listings (through prospecting and other means), how to maintain listings through quality representation and how to retain loyal clientele and gain referrals for future business.

The conclusion of this module presents real world dilemmas and applications of the information presented. As you complete this module, try to keep in mind how it will impact your role in the field as a real estate licensee, and how you assist consumers.
KEY TERMS

**Closing Costs:** (also called “transaction costs”) Various fees and expenses payable by the seller and buyer at the time of a real estate closing, set out in the settlement statement.

**Comparative Market Analysis (CMA):** (sometimes also called a “competitive market analysis”) An informal system for establishing the value of real property which works by comparing the prices of recently sold, pending and currently-for-sale homes that are similar in size and features to the subject property (the property listed for sale). A CMA is prepared by a real estate professional prior to (or in conjunction with) obtaining a listing, as part of helping a seller determine an initial asking price for a property.

**Exclusive Agency Listing Agreement:** An employment contract that gives one broker the exclusive right to sell a particular property and earn a fee or commission when the seller accepts an offer; this kind of contract defines a specific period of time during which the agent has this exclusive right. Exclusive listings still allow the property owner to sell directly to a buyer and not pay a commission unless otherwise stipulated in the contract. In this situation, the seller would only be obligated to pay a fixed amount to compensate the broker for his or her efforts in providing services such as placing signage, running advertisements, producing brochures and listing the property with an MLS.

**Exclusive Right-to-Sell Listing Agreement:** An employment contract giving one broker the exclusive right to collect a commission on the sale of a property if the owner, listing broker or anyone else sells the property during the term stated in the listing agreement.

**Expiration of Listing Period:** The end of the time period covered by a listing agreement or the clause in a listing agreement that defines when the broker employment contract expires. All legally enforceable listing agreements must have a clause establishing the period during which the conditions of the agreement apply.

**Fiduciary:** A person who has been entrusted to act for another person’s benefit or who accepts responsibility for looking after another person’s interests. A fiduciary thus stands in a special relationship of trust with the person for whom he or she acts, and often has the authority to make decisions for that person.

**Fiduciary Relationship:** A broker under contract stands in a fiduciary relationship with the party (or parties) who contract for the broker’s services. This is a special relationship of trust that imposes fiduciary duties on the broker. Most states’ license laws impose some version of the duties of obedience, loyalty, disclosure, confidentiality, accountability and reasonable care. A real
estate professional owes his or her complete fiduciary loyalty to the principal, though the specifics of the licensee’s duties will vary depending on whether the contract is with a seller or a buyer. However, a broker must always treat all parties to a transaction fairly and honestly, regardless of whether he or she has contractual or fiduciary duties to those individuals.

**Legal Description:** (sometimes also called a “legal land description” or a “property description”) The full description of the real property and details of any associated personal property improvements, either attached or having their own separate title, that will be included in a sale. This description can usually be found in the recorded document that conveyed the property to the individual who is now the seller, as well as in the county appraisal district records where the property is located. Identifying a property by its legal description is considered to be more accurate and binding than identifying it by its physical address.

**Listing Agreement:** A written contractual agreement between a property owner (or owners) and the real estate broker who will market that property; this agreement establishes the contractual terms and conditions of the listing. The agreement covers the marketing of the property and defines any fees or commissions that a licensee is to receive if he or she procures a buyer during the term of the listing agreement.

**Listing Broker:** A licensee that establishes a written listing agreement with a property owner (or owners) under which property will be sold or leased; listings are often obtained by a salesperson working for the individual who becomes the listing broker.

**Multiple Listing Service (MLS):** A marketing service which is usually run exclusively for members of a board of REALTORS®, and sometimes owned by it as well. Through an MLS, all member-brokers pool their listings to share information among the membership and publish commissions that are offered to other agents who bring possible buyers for a property. Members generally establish the procedures for sharing commissions, the standards for required information and other regulatory conventions. Multiple listing services usually require property owners to sign an exclusive agency agreement or an exclusive right-to-sell listing agreement with participating brokers before the owners can have their properties listed with the service.

**Net Listing Agreement:** An employment contract by which the seller agrees to pay any amount over the listing price as set forth in the contract as commission. Net listings are illegal in some states and not recommended in many others because they tend to create tensions between a licensee’s own interests and his or her obligations to serve clients’ best interests.

**Open Listing Agreement:** (also known as a “simple listing” or a “general listing”) A type of listing agreement in which more than one broker may be employed to
sell the property, but only the broker who is the procuring cause of the sale receives a commission. Additionally, the owner is not obligated to pay anyone a commission if the owner sells the property himself or herself—i.e., if no broker is the procuring cause of the sale. Builders and developers often use open listings, by which they agree to pay a sales commission to any broker who procures a buyer for a house or lot in a designated subdivision.

**Principal:** Principals are the contracting parties involved in a contract or the individuals who are making an exchange in a transaction. For example, in a listing agreement, the seller is the principal who hires the broker (the other principal in the listing contract) to represent him or her in the sale or lease of his or her property. In a real estate transaction, the seller and buyer are the principals in the exchange. Though the examples just mentioned involve only two principals, there can be more than two principals associated with a contract or a transaction.

**Property Owner(s):** The generic term used to represent an individual, group of individuals (including married couples) or any other form of partnership, company, trust or legal entity capable of owning title that does in fact own the title to real property.

**Property Address:** The address of a property, usually posted on that property. Sometimes a property has two different addresses, a 911 emergency address and a U.S. Post Office mailing address—when one property has multiple addresses, this can lead to legal difficulties in documents that do not also include a legal description. Like the legal description, property addresses can usually be found in the appraisal district records for the county in which the property is located.

**Seller’s Disclosure Notice:** A notice that provides information about a property’s condition. This information, usually in the form of a disclosure statement, outlines the general facts regarding a property and any of its known latent defects. The disclosure notice will also describe any personal property that is set to transfer with the sale of real estate, such as refrigerators or stoves. There are state and federal laws governing the specific content that is required in a disclosure notice.
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Describe the broker/owner relationship.
- Outline the legal aspects of the broker/owner relationship and other responsibilities created by listing agreements.
- Identify various types of listing agreements and explain the differences they make in a business relationship.
- Explain the listing process and the basic marketing strategies needed to obtain listings.
- Describe the basic concept of Comparative Market Analysis (CMA) and the process involved in preparing one.
- State the basic content and form of a listing agreement.
- Name the other forms typically executed along with a listing agreement, including forms required by federal law and others required by most states.
- Describe marketing strategies needed to obtain a buyer while maintaining customer loyalty.
LESSON ONE
LISTING AGREEMENTS

This lesson focuses on the following topics:

- The Relationship Created by the Listing Agreement
- The Roles of Brokers and Salespeople in Listing Agreements
- Essential Features of a Legally Binding Listing Agreement
- Terminating a Listing Agreement

INTRODUCTION

A listing agreement is an employment contract to market real property. A listing agreement is thus different from a contract to transfer real estate, and creating a listing agreement is distinct from entering into a contract to purchase or sell real estate. A listing agreement is a contract in which a seller hires a real estate broker to assist with the sale of real property.

In most states, a listing agreement must be put in writing if it is to be legally enforceable. Most brokers and multiple listing services produce their own forms for listing agreements. Even though listing agreement forms come from a variety of sources, the basic components of all listing agreements are essentially the same. It is also generally true that all listing agreements must comply with state law and, when applicable, MLS standards.

The following sections outline the general features that are shared by most listing agreements and the role that these agreements play in a real estate career. The lesson begins by covering the responsibilities and authority that listing agreements create for brokers and the different roles brokers and salespeople play in listing real property. We will then discuss how listing agreements are terminated. Later lessons will cover the other documents that often accompany listing agreements.

RELATIONSHIP CREATED BY THE LISTING AGREEMENT

A listing agreement creates a legal employee-employer relationship between a licensee and the owner(s) of the property to be listed. This relationship creates special responsibilities for the licensee because it makes him or her a fiduciary. This means that the licensee has been entrusted to act for another person’s benefit and that he or she has accepted responsibility for looking after the owner’s interests. A fiduciary thus stands in a special relationship of trust with the person for whom he or she acts, and he or she often has the authority to make decisions for that person.
When they have entered into a listing agreement, then, the broker and any salespeople working on the broker’s behalf thus have a legally binding relationship with the seller. As long as the listing agreement remains in effect, brokers and salespeople bound by the agreement owe their complete allegiance to the seller or landlord with whom they made the agreement.

There are generally eight basic duties that a broker and any salespeople affiliated with that broker owe to a principal; these obligations are often reflected in a state’s license laws. These fiduciary duties are as follows:

- Loyalty
- Confidentiality
- Obedience
- Full disclosure
- Skill
- Care
- Diligence
- Accountability for all funds that the broker handles during the listing period

**THE ROLES OF BROKERS AND SALESPEOPLE IN LISTING AGREEMENTS**

Listing or employment agreements are always created between a broker and a seller or landlord—that is to say, sellers and landlords do not create listing agreements with salespeople. Thus, the fiduciary relationship created by a listing agreement exists between a seller and a broker, not between a seller and a salesperson. The broker is, therefore, primarily responsible for carrying out the fiduciary duties we just discussed; even if salespeople act on the broker’s behalf, the ultimate responsibility for seeing that these duties are fulfilled lies with the broker. This is true even though salespeople are often sellers’ primary or only contact that the seller has with the brokerage firm.

A listing agreement authorizes a broker to act in one, specific capacity on behalf of the principal—specifically, the broker is authorized to do what he or she feels is necessary to sell or lease the principal’s property. Of course, the broker’s actions must be compatible with the fiduciary duties that he or she owes to the client.

Because the broker’s authority is limited in this way—i.e., because he or she cannot act on the principal’s behalf in all of the principal’s affairs—the broker is what is often called a “special agent” for the seller in those states that recognize agency relationships. A special agent is to be distinguished from a general agent, whose authority is much broader and generally extends over a longer period of time. For example, property managers are usually general agents for property
owners. In addition, when brokers employ salespeople, a general agency relationship usually exists between the broker and salesperson—i.e., they usually have broad authority to act on the broker’s behalf.

In states that recognize agency relationships, then, this means that:

- The broker is the principal’s special agent (i.e., the broker is a special agent for the seller or landlord).
- The salesperson is a general agent for the broker.

Because salespeople are general agents for brokers, they may assist principals on the broker’s behalf. However, salespeople who assist principals can only do so in the broker’s name and under the broker’s supervision.

Even though salespeople are not directly involved in creating the fiduciary relationship associated with a listing agreement, this does not mean that they are relieved of fiduciary obligations. Salespeople still owe fiduciary duties to sellers that are created by the salespeople’s relationships with their respective brokers.

Real estate professionals should consult their states’ laws for specifics about the different roles and responsibilities that brokers and salespeople are permitted to assume. In general, salespeople should ensure that their sponsoring brokers review their transactions, and they should give their brokers an opportunity to review all agreements to assure that the agreements conform to their brokers’ policies. This is especially true for agreements regarding commission amounts.

**ESSENTIAL FEATURES OF A LEGALLY BINDING LISTING AGREEMENT**

As we noted earlier, brokerage firms and multiple listing services often create their own listing agreement forms. This means that there is some variation in form and content among listing agreements. However, even though they vary in this way, there are still general legal standards that define a valid listing agreement. These standards are as follows:

- The listing agreement must contain a legal description of the property that is to be listed.
- Both the broker and the owner(s) must sign the listing agreement.
- The listing agreement must specify a definite termination date.
- The listing agreement must be put in writing.
- A seller who is of sound mind and of legal age must have issued the listing agreement.

We will now discuss these requirements in greater detail.
LEGAL DESCRIPTION

The legal description of the property is a description of the property that identifies it uniquely, distinguishing it from properties that may share its street address, for example. A legal description generally reflects specific information gathered by a surveyor or a developer, and commonly includes the subdivision, plat, lot and block in which the property is located. This information is typically recorded in most states’ public records, often filed with a clerk in the county or general region in which the real property is situated.

If the property is not in a typical subdivision—for example, if it is on raw or undeveloped land—then the legal description generally consists of the field notes prepared in conjunction with a survey, which notes are also typically recorded with a local governmental authority. In all cases, the owner(s) who are creating the listing agreement should either have access to a copy of the legal description or be able to provide information that will enable someone to obtain proper records from local authorities.

BROKER’S SIGNATURE AND OWNER’S SIGNATURE

All legal owners of the property being listed must sign the listing agreement. If the property is owned by a married couple, for example, then both spouses’ names and signatures should be included as part of the listing agreement—even if the property in question is the separate property of one spouse. Requirements in this regard may vary from state to state, so it would be prudent to check specific state statutes rather than making assumptions.

Failing to satisfy the signature requirement can have serious ramifications. For example, suppose that a married couple has separated and is preparing to divorce. You are working with one spouse; the two of you create a listing agreement and you proceed with marketing, procuring a contract acceptable to the one spouse with whom you have been dealing. When you subsequently ask for the other spouse's signature on the contract, you find that the he or she does not want to sell, did not give permission to sell and hoped to get the listed property in the impending divorce. In this case you have misled a buyer and stated that a property was for sale, when in fact it was not. This could lead the buyer to take legal action against you and leaves you vulnerable to disciplinary action from your licensing entity.

The broker’s name needs to be included along with the broker’s signature. The salesperson can sign the broker’s name only if authorized to do so by the broker. Salespeople must consult their brokers on this issue.
TERMINATION DATE

The listing agreement must specify a period of time during which the broker will work for the principal. This specified period must include both the beginning date of employment and the date that the agreement will terminate. An agreement that does not include clearly defined dates will be void in most states. However, some states allow for automatic extension periods; consult your specific state’s requirements to determine what information you must include in order to insure the validity of your agreement.

WRITTEN AGREEMENTS

Most states require that listing agreements be made in writing. Regardless of a particular state’s requirements, putting agreements in writing is a good general practice for all real estate practitioners to adopt. When agreements are clearly set out in writing, documentation exists that can help resolve misunderstandings and prevent litigation.

SELLER COMPETENCY

The seller(s) or landlord(s) must be of sound mind and of legal age to create a legally binding contract. Determining whether an individual is of legal age is a relatively simple matter in most cases. Only a court of law can determine that someone is not mentally competent. The issue of mental competency rarely arises in everyday real estate activity, but real estate professionals should remember that a mentally unsound person should never be bound by a contract.

When there are significant doubts about a principal’s mental competence, it is generally preferable for listing agreements to be made on that person’s behalf by someone who has a signed specific power of attorney that permits him or her to address the sale or leasing of the real property involved. This function can also be performed by someone who has what is sometimes called a “durable power of attorney,” i.e., a document created by the principal giving another individual broad power of attorney in the event that the principal can no longer competently handle his or her own affairs.

TERMINATING A LISTING AGREEMENT

All listing agreements terminate when they reach their pre-established expiration dates. However, a listing agreement may be terminated for a number of other reasons, as well:

- A listing agreement can be terminated when there is unilateral revocation by the owner or by the broker for just cause. For example, a broker might revoke an agreement because a seller will not cooperate with showings; a seller might revoke an agreement due to lack of activity or apparent
abandonment by the broker. When there is any type of falling out between the seller and the listing broker, it is usually preferable to terminate the listing agreement rather than exacerbate hard feelings or, worse, risk ending up in litigation.

- A listing agreement can be terminated if the seller goes bankrupt. When this occurs, a bankruptcy court has the right to block a sale. For the sale to proceed, usually a trustee for the bankruptcy estate must be assigned or approved by a court to assist with the sale, automatically staying any further action by law.
- A listing agreement can be terminated if the seller or broker dies or becomes incapacitated in a way that prevents him or her from playing his or her proper role in the transaction.
- A listing agreement can be terminated if outside forces change the permissible use of the listed property. For example, a shift in zoning regulations that changes what had been a residence into commercial property might create this kind of change. Because the broker in this case was initially retained to sell the property as a residential transaction, this change makes it impossible to execute the initial contract.

**SUMMARY**

This lesson introduced the basic purpose of a listing agreement and described how it establishes legal relationships between brokers (and their affiliated salespeople) and the seller(s) or landlord(s) who create the listing agreements. Only a broker is legally permitted to list, sell or lease property on behalf of clients—salespeople cannot perform this function. A salesperson may be a client’s sole contact with a brokerage firm, but all of a salesperson’s work on a transaction is always undertaken in the supervising broker’s name. It is that broker’s ultimate responsibility to govern the affiliated salespeople’s actions and to ensure that all fiduciary obligations to the client are carried out and met.

Multiple listing services and brokerage firms often create their own forms for listing agreements, and thus, the form and content of these agreements may vary somewhat. However, all listing agreements must meet the same basic conditions if they are to be legally valid contracts. These general requirements are as follows:
The listing agreement must contain a legal description of the property that is to be listed.
Both the broker and the owner(s) must sign the listing agreement.
The listing agreement must specify a definite termination date.
The listing agreement must be in writing.
A seller who is of sound mind and of legal age must have issued the listing agreement.

As with other contracts, listing agreements may be terminated for a variety of reasons, including those that follow:

- Unilateral revocation by the owner or by the broker for just cause
- Seller bankruptcy
- Irreparable damage to, or destruction of, the listed property
- Fulfillment of the listing agreement’s terms and conditions
- Death or incapacity of the seller or broker
- Mutual agreement
- Changes to the permitted use of the property as imposed by outside forces

Return to your on-line course player to take the Lesson Quiz.
LESSON TWO
TYPES OF LISTING AGREEMENTS

This lesson focuses on the following topics:

• Open Listing Agreements
• Exclusive Right-to-Sell Listing Agreements
• Exclusive Agency Listing Agreements
• Net Listing Agreements
• The Multiple Listing Service (MLS)

INTRODUCTION

This lesson discusses the various types of listing agreements and the features that distinguish each one. Although the names of these agreements may vary from state to state, their basic shape and their legal implications are generally comparatively uniform. Each of these agreements creates a slightly different fiduciary relationship between the seller and broker, depending on the specific terms of the agreement. This lesson will first outline the exclusive right-to-sell listing, the exclusive agency listing, the open listing and the net listing. We will then discuss multiple listing services (MLSs) and their effects on listing agreements.

An MLS is a database—it is not a type of listing agreement. However, in practice many exclusive right-to-sell listings fall under MLS regulation and organization. Consequently, the student will need a working understanding of both concepts to understand each of them fully.

OPEN LISTING AGREEMENTS

Open listings allow a seller to list his or her property concurrently with any number of competing brokers; among these various brokers, the broker who is the procuring cause of the sale is the one who is entitled to receive a commission. Under this sort of agreement, the seller can also sell the property on his or her own without being required to pay commission. Open listing agreements are most commonly seen among builders and developers who work with a broad range of brokers in the sale of new homes and lots.

As in virtually all listing agreements, a seller working under an open listing agreement offers to pay a broker a commission if he or she brings about the sale by presenting the listed property to a ready, willing and able buyer. Some sellers believe this type of listing works in their favor because more listings mean more prospects; many sellers are also attracted by the fact that they will not be locked into paying a commission if the property is sold as a result of their own initiative.
In addition, an open listing policy releases the seller from any obligation to inform the other listing brokers when the property goes under contract or is closed. The sale of the property under such an agreement essentially cancels all outstanding listings.

Real estate licensees, on the other hand, generally avoid open listing agreements, primarily because it can be difficult to determine who is entitled to the commission payment when multiple brokers are involved. Furthermore, brokers often do not feel this type of agreement serves them well because a licensee who diligently advertises a property may not be rewarded for his or her efforts if another licensee happens to secure the sale of the property. In general, only the individual who closes the sale earns the commission, regardless of whether he or she benefits from others’ marketing efforts.

**EXCLUSIVE RIGHT-TO-SELL LISTING AGREEMENTS**

Real estate professionals generally prefer exclusive right-to-sell listings to other listing agreements. This type of agreement states that as long as the property is sold within the time frame stipulated in the contract, the listing broker named in the contract will receive a commission for his or her role in bringing the transaction about. It does not matter who secures the sale—it can be the named listing agent, another agent or the owner may find a buyer without the listing agent's assistance. Regardless, a commission must be paid to the listing agent because an exclusive right-to-sell contract grants the licensee exclusive rights to the commission.

When comparing these terms with those of an open listing agreement, it is clear why real estate licensees would favor the exclusive right-to-sell approach. From the licensee’s perspective, holding an exclusive right to a commission provides one with protection from the possibility of dedicating time and effort to a sale only to have the commission go to another party. For similar reasons, licensees generally encourage sellers to favor exclusive right-to-sell listings. They argue that when an agent has a vested interest in a property, he or she is more willing to expend time, effort and money on diligently marketing the property. Because the listing agent has a secure hold on the commission, he or she can spend more time and energy finding a qualified buyer. This stands in opposition to an open listing agreement, in which brokers may expend less effort promoting a property and may settle for an offer below the property’s market value, for fear that another broker may secure the sale of the property and consequently receive the commission.

**EXCLUSIVE AGENCY LISTING AGREEMENTS**

Exclusive agency listings combine elements of open listing agreements and exclusive right-to-sell agreements. As with open listings, exclusive agency listings release the owner from any obligation to pay a commission in the event
that the owner secures the sale of the property. And as with an exclusive right-to-sell listing, the seller agrees to list the property with only one broker during a specified listing term. The distinguishing characteristic of exclusive agency listings is that the named listing broker is owed the commission only if someone other than the owner sells the property.

However, this feature of the agreement can lead to problems on occasion. For example, an owner who is bound by an exclusive agency listing agreement might conspire with the broker’s prospective buyer to execute the sale of the property after the listing agreement expires so as to avoid paying a commission to the listing broker. In this case, the listing broker can only collect commission by proving that he or she was the procuring cause of the sale. That is, the agent must demonstrate that he or she was the individual who found a ready, willing and able buyer and that these actions put the sale into motion.

**NET LISTING AGREEMENTS**

In a net listing, the broker’s commission is the *net difference* between the sales proceeds and the net amount desired by the seller. In other words, these are listing agreements in which the seller pays as commission any amount over the list price set in the contract (generally less closing costs).

A seller may choose to enter into a net listing agreement for a variety of reasons—for example, he or she may have established a set price that he or she will accept for the property and not wish to negotiate other offers with prospective buyers. Net listings can work in conjunction with open listings, exclusive right-to-sell listings and exclusive agency listings.

Consider the following scenario:

Seller X has a parcel of land that he has been trying to sell on his own for quite some time. Tired of trying to market the property but unwilling to accept the low offers he has received in the past, he calls upon Licensee Y to secure the sale of the lot for no less than $100,000. Seller X agrees that in exchange for relieving him of the problems associated with the details of the real estate transaction, Licensee Y will receive as commission the difference between the actual sale price and the seller’s desired net price. Shortly thereafter, Licensee Y secures the sale of the property for $110,000 and walks away with a 10% commission.

In many states, net listings are illegal because of the potential risk to both the seller and the licensee. Even in states that permit net listings, real estate professionals often advise against them such that they are not commonly used. They are unpopular because they create an unavoidable tension between the licensee’s best interests and the best interests of his or her clients.
Think back to the previous example of the parcel of land that was sold for $110,000 with a 10% commission. At first glance it may seem that a licensee would be willing to dedicate a lot of time and effort to the marketing of this property because of the opportunity to secure such a high commission rate. Although this may indeed be true in some cases, it is not guaranteed. The following two examples suggest ways that net listings can work to the disadvantage of either the licensee or the principal.

The interaction between Seller X and Licensee Y might have worked out much differently for Licensee Y…

Again, Seller X sets a net price of $100,000 for the parcel of land, allowing Licensee Y to accept as commission any difference between this amount and the actual sale price. Licensee Y, hoping to receive a higher-than-usual commission, puts a lot of time, energy and money into promoting the property, which she lists for $110,000. After Licensee Y has spent a few hundred dollars and a number of hours on marketing the property, a prospective buyer makes an offer. However, the offer is only for $100,000. Because Licensee Y must honor the interests of her client, she must communicate this offer to Seller X, who is pleased that he’ll receive the desired amount for the land and accepts the offer. In this scenario, Licensee Y walks away with nothing except lost time, energy and money.

The interaction between Seller X and Licensee Y might just as easily have worked out differently for Seller X …

Seller X again seeks $100,000 for the sale of his property. Choosing not to disclose to Seller X that the actual market value of the property is substantially higher than this desired net amount, Licensee Y lists the property for $130,000. Shortly after putting the property on the market, a buyer agrees to buy the property for the list price, thereby Licensee Y secures a 30% commission for herself. In this situation, Licensee Y did not disclose the fair market value of the property to Seller X and could be held liable for withholding information and knowingly misleading her client.

**THE MULTIPLE LISTING SERVICE (MLS)**

A multiple listing service (MLS) is an arrangement in which brokers agree to share their listings with other brokers by pooling their information into a single database in exchange for a share in the commission earned by the licensees closing the transactions. Commonly, brokers who are members of a group (such as a Board of REALTORS®) may form an MLS.

Most MLSs create their own listing forms, which their members may—and sometimes must—use. These MLS listing agreement forms often include a stipulation clause authorizing and obligating the listing broker to share the listing with other broker-members by submitting the property information on the MLS.
These agreement forms generally also provide an option under which individual sellers may opt out of having their properties listed on the MLS. MLS systems also have rules established by their member-brokers regarding how quickly a broker must enter the property listing into the system, thereby keeping brokers honest from attempting to “hide” listings from other member-brokers. Other rules are also set by each MLS to create an environment of fairness and equity among members.

As part of advertising a listed property in the MLS System, the listing broker usually advertises a fee or commission that will be paid to a “cooperating” broker in a sales transaction. A cooperating broker is the other broker or salesperson who shows the listed property to a prospective buyer who subsequently purchases the property; the important role this individual plays in securing the sale entitles this cooperating broker to a fee or commission, because he or she is properly the “procuring cause” of the sale.

The amount offered to a cooperating broker is left to the discretion of the listing broker. If the cooperating broker or salesperson represents a prospective buyer—i.e., if that cooperating broker has been retained as the buyer’s agent—then the listing agent must receive authorization from the seller to share a part of the commission. This possibility is generally covered on the original MLS listing agreement form.

An MLS offers advantages to the owner (or seller), as well as to brokers and prospective buyers. Properties that are listed with MLSs generally receive greater public exposure through the MLS system, and the property is shown by a larger number of brokers and salespeople to a larger audience of prospective buyers as a result. This increased exposure means that more prospects see the seller’s property, increasing the chance of a rapid sale at something near the seller’s desired price. The property’s additional exposure also gives the broker more opportunities to sell the property, often resulting in better commissions and prospective buyers benefiting from varied choices and purchase options.

**SUMMARY**

There are four basic types of listing agreement contracts:

- The open listing agreement
- The exclusive-right-to-sell listing agreement
- The exclusive agency agreement
- The net listing agreement

Each of these agreement contracts creates a different relationship between the listing broker and the person listing the property for sale.
An open listing agreement allows a seller to list his or her property concurrently with any number of competing brokers; among these various brokers, the broker who is the procuring cause of the sale is the one who will receive a commission. Under his sort of agreement, the seller can also sell the property on his or her own without facing liability for a commission payment.

An exclusive-right-to-sell listing agreement states that as long as the property is sold within the timeframe stipulated in the contract, the listing broker named in the contract will receive a commission for his or her role as agent in the real estate transaction. It does not matter how the sale is secured, whether by the named listing agent, through another agent or as a result of the owner finding a buyer without the listing agent’s assistance. Regardless, a commission must be paid to the listing agent who holds exclusive rights to the commission. Exclusive right-to-sell agreements are the most commonly used type of listing agreement and are generally considered the most desirable for a broker. This is because these agreements assure the broker that he or she will receive a commission if the property sells.

Exclusive agency listings combine elements of open listing agreements and exclusive right-to-sell agreements. As with open listings, exclusive agency listings release the owner from any obligation to pay a commission in the event that the owner secures the sale of the property. As with an exclusive right-to-sell listing, the seller agrees to list the property with only one broker during a specified listing term. The distinguishing characteristic of exclusive agency listings is that the named listing broker is owed commission only if someone other than the owner sells the property.

In a net listing, the broker’s commission is the net difference between the sales proceeds and the net amount desired by the seller. In other words, these are listing agreements in which the seller pays, as commission, any amount over the list price set in the contract (generally less closing costs). Net listings are generally discouraged (to the extent of their being outlawed in many states) because they create an unavoidable tension between the licensee’s best interest and the best interest of his or her client(s).

A Multiple Listing Service (MLS) is a system in which a group of broker-members pool their listings, thus allowing other brokers opportunities to show and sell any of the pooled listings. When another broker secures a buyer for a property for which he or she is not the listing broker, that broker becomes known as the “cooperating broker” and is often entitled to a fee or commission set by the listing broker. This system is advantageous for brokers, sellers and prospective buyers because it gives each of them greater exposure in the marketplace.

Return to your on-line course player to take the Lesson Quiz.
LESSON THREE
THE LISTING PROCESS

This lesson focuses on the following topics:

- Initiating the Listing Process
- Comparative Market Analysis
- Seller’s Costs and Seller’s Net
- Information Needed for a Listing Agreement
- Disclosures
- Information Typically Included in a Listing Agreement

INTRODUCTION

This lesson examines the process of creating a listing agreement that is acceptable to both the broker and the seller. We will look at the details of this process, including the initial contact, the pricing process, the specific information that a listing agreement should contain and the disclosures that are required to protect both the broker and the seller. We will also discuss how to conduct the final meeting with a seller, in which one presents one’s research and services in the hope of securing a listing contract.

INITIATING THE LISTING PROCESS

BROKERAGE POLICIES

Before obtaining a listing, it is helpful to review the brokerage firm’s policies on taking listings so that you know what aspects of the listing agreement can be negotiated and have clearly identified those parts of the agreement, if any, that cannot be negotiated. A firm’s policies can cover many elements of an agreement, including:

- Permissible commission rates
- Minimum listing periods
- Non-negotiable terms

Setting Commission Charges

Commission rates are not fixed by any state or federal regulatory agency. Instead, individual brokerages set their own rates. Salespeople must understand their brokerage’s commission standards and follow their sponsoring broker’s instructions closely. Each real estate firm should set its own rates without consulting other firms; when firms set their rates as a group, this can lead to the
appearance of price-fixing. Price-fixing is illegal and any activities that suggest it should be avoided.

**Minimum Listing Periods**

Brokerages should establish minimum listing periods. A minimum listing period is a preset, minimum period of time in which a brokerage is authorized to market a property under a particular listing agreement. The broker determines this period, ensuring that the listing agreement permits sufficient time for marketing efforts to take effect. If the listing agreement does not grant an adequate minimum time period for marketing the property, the brokerage’s marketing efforts can be wasted or they can end up benefiting another brokerage company or enabling the seller to procure a buyer on his or her own. Both of these outcomes mean wasted resources for a brokerage.

**Non-negotiable Terms**

Non-negotiable terms are those terms and conditions of a listing agreement that are mandatory in a particular brokerage firm. For example, a firm could require that all listed properties be offered on an MLS, even though a seller typically has the right to opt out of having his or her property marketed through this service. A brokerage might also require that a sign be placed on all properties that the firm markets. Whatever non-negotiable terms a brokerage chooses to set (if any), it is important that all salespeople understand those terms and how they are properly satisfied.

**THE INITIAL MEETING**

The first step to obtaining a listing is an initial meeting with the seller and an inspection of the property that will be offered for sale. You should prepare yourself for this meeting. In particular, you should bring:

- An initial contact form
- A sign for the yard
- A lockbox (if appropriate)
- Copies of current advertising on the Internet and in various publications, to illustrate the brokerage’s approach to marketing

**Initial Contact Form**

Some states’ license laws require licensees to present sellers with an initial contact form when they first meet with these clients. This form generally describes the different types of relationships that a licensee can have with the seller. The permissible relationships vary from state to state, but this sort of form will generally explain that a licensee can represent a seller exclusively, represent a buyer exclusively, or represent both parties in the same transaction with or
without the appointment of a third party intermediary. The seller must usually acknowledge receipt of this form in writing. A licensee should consult his or her state’s license law to clarify his or her obligations in this respect.

**Sign for Yard**

You never know! Bringing a sign shows initiative and enthusiasm. Having a sign on hand also allows you to begin marketing immediately if this first meeting results in the creation of a listing agreement.

**Lockbox**

A lockbox is a device that allows other agents to have access to a listed property when representatives from your firm cannot meet a prospective buyer to show the property. A lockbox is often a small box attached to the doorknob that encloses a key to the property; the box can generally be opened with a combination or other means of access granted to properly authorized licensees. Lockboxes can be advantageous, because they increase a property’s accessibility to prospective buyers who may want to view a property with little, if any, notice. However, some owners understandably do not want to authorize the use of lockboxes on their properties; so, be sure to check with your client about his or her preferences in this respect.

**Advertisements**

Bringing current advertisements from properties that are listed with your brokerage firm is a great way to show a prospective seller that his or her property will be marketed effectively in major publications.

**NOTE:**

Again, salespeople should know their brokers’ specific guidelines on advertising before they discuss this issue with clients. For example, what would you say if a seller asks for assurance that his or her property will actually appear in a specific advertisement? The proper answer depends upon your brokerage’s policies.

**CONSULTATION**

The next step in creating a listing agreement is talking with the seller to identify his or her marketing needs and expectations regarding the relationship with the listing broker. This conversation might take place during the initial meeting with the seller, or it could be part of a later meeting. **When** you choose to have this conversation is not as important as the fact that you have it, and that you have it before creating the listing agreement.
The main point of this discussion is to clarify what the seller wants and needs from the broker and from the transaction. The specific content of this conversation will vary from client to client, but there are general points that will be relevant to virtually every client. These include:

- The seller’s expected sale price for the property
- The time frame within which the seller hopes to close the transaction
- The seller’s motivation to sell the property

Licensees need to know sellers’ wants, needs and motivations in order to best serve their clients. For example, if your seller is in no special hurry to sell his or her property, you might be able to set a higher price for the property than you could if the seller wants to sell in a hurry because you would have more time to find an able and willing buyer.

After identifying the seller’s basic needs and desires, the salesperson should explain the services that his or her real estate firm offers. In describing these services, it is generally helpful to present examples of the firm’s advertising and give an overview of the entire listing and marketing process. It is also worth taking the time to discuss the fiduciary relationships created by a listing agreement and the transaction process itself, from contract to closing. The real estate professional should remember that while some sellers may have extensive experience in real estate transactions, many others may be conducting their first sale. A licensee should be prepared to deal with both inexperienced and very knowledgeable sellers, as well as sellers whose experience falls between these two extremes.

After the licensee has met with the seller and educated him- or herself about the seller’s hopes and goals, the real estate professional should prepare the documents needed to create a listing agreement. He or she should make sure that these documents—and the manner in which they are completed—conform to state laws. Before making a presentation to the client and finalizing the listing agreement, the licensee must collect a variety of information about the property and the costs associated with marketing and selling.

As a first step in collecting this information, the licensee should take a tour of the property to become familiar with its major features and to look for any problems or defects that could affect its price or the way in which it should be marketed. The real estate professional can help win the seller over by listening to what the seller considers to be the significant features of the property. These features might be the ones to advertise to attract buyers.

This tour will also allow the salesperson to gather vital information that he or she needs to complete the comparative market analysis, which is the next step in the listing process.
COMPARATIVE MARKET ANALYSIS

A comparative market analysis (often simply called a CMA) is an informal system for establishing the value of real property which works by comparing the prices of recently sold, pending and currently-for-sale homes that are similar in size and features to the subject property (the property listed for sale). These similar properties are generally called “comparables.” This information can be very useful in helping a seller determine an appropriate initial asking price for his or her property.

Licensees must understand the fundamentals of valuation to compile the market data that is necessary for creating a CMA. However, a CMA is neither as comprehensive nor as technical as an appraisal and it should not be presented as one. Most states require that you include language in the report informing the seller that the report was not prepared using the standards of a regular appraisal and should not be used in lieu of obtaining an appraisal from a licensed real estate appraiser.

A CMA is generally prepared by collecting data on recent sales, pending sales (if available) and active listings that are in the same marketing area and have features similar to those of the subject property, including, but not limited to:

- Square footage
- Age
- Construction
- Size
- Location

Recent sales in the area are the most important factor in developing an accurate value range for a particular property. These sales represent the actual market in that they are factual evidence of what a ready, willing and able buyer would pay for similar properties in the area; these sales also provide evidence of the prices that sellers who were not under duress were willing to accept.

The information that a salesperson uses to compile the data used in a CMA can come from various sources. Typically, the local multiple listing service is a good source of data regarding comparable properties. MLS members often share information on sold listings to facilitate the process of assembling CMAs. This shared information usually includes the price at which properties were actually sold (as opposed to their listing price), as well as information about the amount of time it took to sell each property.

There is often data available regarding the special features or defects of each property that might have affected its price, as well as information about closing costs, repairs or decorator allowances that the seller may have paid on the
buyer’s behalf. Seller expenses of this sort need to be added to or subtracted from the selling price to make the comparisons fair.

Another good source of information is the local county appraisal district. The county recorder sends questionnaires to both sellers and buyers requesting that they submit the final selling prices of the properties in their transactions. Individuals are not legally required to return the questionnaire in most states, but most people comply voluntarily. Because the information is self-reported, there is no guarantee that it is accurate, but public deed records state loan amounts, so sale prices can be estimated with relative accuracy. Most residential real estate loans are for 95 percent, 90 percent or 80 percent of a property’s selling price.

**BASIC POINTS OF COMPARISON BETWEEN PROPERTIES**

While no two properties are exactly alike, a real estate professional should still be able to determine a likely range of selling prices for a subject property by comparing properties that have similar features and which are of similar size, location and condition. The major pieces of information relevant to real property comparisons are the following:

- Sale price
- Sale date
- Square footage
- The property’s age
- Type of construction
- The property’s size and location

We will now discuss each of these points in more detail.

**Sale Price**

The sale price is the price for which the property actually sold. It is important not to confuse a property’s sale price with its list price, that is, we should distinguish a property’s selling price from its asking price. There can be a large difference between a property’s asking price and the price at which it actually sells. Licensees can evaluate selling prices more fairly if they know whether a particular sale was a cash sale or a financed sale, since cash sale usually means a slightly lower price.

**Sale Date**

The sale date is the date on which the property sold. This date is important because the real estate market shifts and fluctuates constantly; a sale more than six months old likely occurred under significantly different market conditions and thus is probably too old to use in generating an accurate CMA.
Appraisers, too, tend to limit their comparables to properties sold within the preceding six months. The closer in time a comparable sale is to the one your client is considering, the more likely that comparable is to reflect facts about the market that can be usefully applied to your client’s situation. In addition to considering a comparable’s sale date, it may also be important to consider how long it took to sell the property before using that particular comparable in your CMA.

**Square Footage**

A property’s square footage is generally understood to be the floor area of the heated and air-conditioned sections of the property. Square footage is one of the most important aspects of a comparative analysis, and thus it is essential to have an accurate representation of the square footage of your client’s property.

Relying on square footage figures from appraisers, other agents, or even blueprints can be risky, because it can leave a licensee vulnerable to legal liability if those figures are not accurate. If a licensee chooses to rely on square footage figures derived from another source, he or she should be certain to point that fact out to prospective buyers in a clear way—probably in writing. To be fully confident that square footage figures are accurate, a licensee might choose to measure the property. However, once a licensee introduces his or her own measurements into the transaction, he or she is responsible for the accuracy of those numbers—a liability that some licensees would prefer not to accept. Licensees must decide for themselves how to handle this issue.

In some states, the real estate commission or another regulatory agency may offer guidelines for measuring square footage. Licensees should determine whether their states have such guidelines and adhere to those instructions if they exist. If your state does not have measuring guidelines and you feel the need to measure a property’s square footage, the most prudent approach is to seek guidance from an appraiser or other professional who has experience with projects of this sort.

**The Property’s Age**

It stands to reason that a property’s age is determined by counting the number of years since the property was first constructed. Improvements and remodeling can have ages that differ from the property as a whole, however, because they are made after the property was constructed—for example, the kitchen of a 100-year-old house may have been remodeled just three years ago.

A property’s age is important because property depreciates over time. The likely sale price of an older property should be compared with the depreciated sale prices of newer properties. Older properties are more likely to require
expenditures on the part of a buyer—for example, an older property may be more likely to require a new roof, exterior and interior painting or remodeling. All of these “needs” create costs that detract from an older property’s value when it is compared to newer properties. Since an actual depreciation figure may be difficult to come by, comparative market analyses should involve houses of roughly the same age whenever possible.

**Type of Construction**

The way in which a home is made affects its value. Home type (i.e., mobile home, duplex, single-family), foundation type, construction materials (e.g., wood, brick), siding and roof type (metal, shingle) can all have an impact on a property’s value. These factors can influence price significantly; for example, it costs a good deal more to construct a home with a brick exterior than it does to construct a home with a wood exterior; there are also differences in the costs associated with the maintenance of each type of exterior and the longevity of each construction. A brick home is probably at least 20 percent more expensive to construct than a wood-sided home. This difference would be noted and the price “adjusted” in an actual appraisal; a CMA is best created using very similar properties—that is, a CMA would be better if comparing a brick home to other brick homes, rather than trying to compare broadly disparate home types.

**The Property’s Size and Location**

A property’s location (its place in a subdivision and whether it occupies a corner lot) and size (the lot’s square footage, as opposed to the house’s footage) affect its value as well. The idea that the whole value of real estate is “location, location, location” is not far from the truth. For example, a property located in the downtown area of a prosperous city is worth more than a similar property on the outskirts of that city. Similarly, properties located in an affluent area of course often sell at higher prices than property located in low-income areas, and a property on a lake’s waterfront would be worth a good bit more than a water-view lot across the street from the lake.

Location is critical in determining a property’s value, as is its square footage. For instance, a half-acre tract might actually be worth more per square foot than a one-acre tract, just as the smaller area may be more affordable and more manageable. To obtain location and square footage information, a licensee should ask the seller for a plat map or a survey of the property; the seller should generally have received some version of this information when the lot was purchased. Either a plat or a survey should give a square footage figure for the lot; it will at least provide the lot’s dimensions, from which the footage can be computed. Another source for this information is the county appraisal district, which normally keeps plats of subdivided acreage tracts and formally filed subdivision plats.
Final Considerations Regarding Points of Comparison between Properties

We have now discussed common points of comparison between properties used in creating a CMA: sale price, sale date, square footage, age, construction, size and location. These six factors are not exhaustive, but they are the primary factors that a real estate professional should consider when compiling information for a CMA. Licensees should make some effort to tailor the information contained in the CMA, so that it reflects the details of the particular listed property.

This tailoring—as well as the depth and thoroughness of the CMA itself—will be affected by client’s needs and the amount of time a licensee has to prepare the CMA. For example, a market-conscious seller who is already familiar with real estate pricing may want a CMA simply to confirm his or her suspicions about price ranges. In a case like this, a licensee might use a minimum of data for the comparative analysis, such as the property’s address, its sale price, its sale date, its square footage and the price per square foot. When working with clients who want greater detail about the local market, more information will probably be necessary.

In the end, real estate professionals should be sure that they know enough about the local market to appear knowledgeable about their clients’ properties and enough to be able to assess an accurate price range for those properties. When the licensee has this information, he or she can then help the seller make an informed decision about pricing the property. The process of creating a CMA should educate both parties and help reinforce the client’s view of the real estate professional as trustworthy, confident and well informed.

COMPLETING A CMA

Once the proper data has been gathered, the licensee preparing the CMA should select three or four properties that fall under each of the following headings:

- Available on the market
- Under contract
- Sold in the past three months

After properties of these various sorts have been selected, the licensee must calculate the price range of the listed property by accounting for the differences between it and the properties to which it is being compared. To do so, we must correct for significant differences between the listed property and the other properties such that variables are properly reflected in their respective prices.

This means that we need to assess the features of the listed property, and see what features each comparable has that the listed property lacks. All of these
features will add value to the comparable property, making it worth more than the listed property. To compare properties accurately, we must imagine that their features are as similar as possible.

Thus, for any valuable feature a comparable possesses, which is missing from the listed property, we should subtract the value that that feature contributes to the comparable’s sale price. In this way, we bring the comparable’s price more properly in line with the listed property—that is, we can compare them more exactly because the value of non-comparable features is no longer distorting the comparable’s sale price. Naturally, for every valuable feature the listed property possesses, which is missing from a comparable property, we should add the value of that feature to the sale price of the comparable.

For example, if the comparable properties are all on similar lots without pools, while the listed property has an in-ground pool, then the licensee preparing the CMA would have to account for this difference by adding the value of the pool to the selling price of the comparables.

Licensees should be careful not to over-inflate the values that are added or subtracted when they are making these adjustments. The amount that a specific feature contributes to a property’s value is not directly related to that feature’s original cost, and may not be related to original cost at all. For example, swimming pools vary greatly in their adjustment values due to age, design, and their suitability for the property to which they are added. In some markets, the pool might add no value at all; in others, it might actually detract from the value, regardless of the fact that it was expensive to build. If the licensee preparing the CMA does not know how to value a feature, then he or she should consult an experienced broker or refer to publications that give standardized valuations.

CMAs provide an informal value range for a listed property—they do not give an actual appraised value for the property. For this reason, some states require a bold-faced statement in the CMA report to advise recipients that the CMA is not an appraisal, and does not reflect the true appraised value of the property. When presenting your CMA to a client, remind the seller (and anyone else with whom you share the CMA) that you are not an appraiser.

The CMA should be easy to read and understand. Larger brokerage firms often develop their own CMA worksheets, which are then filled out by individual licensees. Some real estate boards also have their own CMA forms. There is no standard or required CMA format; you may want to create one specifically for a seller’s listing.

A chart or table format is often a good format to use. For example, if you are using a row of columns, you can create a CMA report in the following way: beginning at the left, you should identify the seller’s listed property with an address column and, below it, the addresses or names of the other properties
being considered, divided into three categories of sold, under contract and available.

The column to the right of this should contain the sale price (or list price, for the unsold properties) figures for each comparable property, with the “price” field for the subject property, of course, left blank. Continuing to the right, record in successive columns:

- The square footage of each property (i.e., its functional living space)
- A price per square foot for each property (this figure is equal to the number of square feet divided by the selling price of the property)
- The age of each structure
- The type of construction used for each property
- Land differences (if applicable)
- The size of each property (i.e., the size of the lot)

Finally, add a comments column, in which you can briefly note specific differences in the properties that are not covered in these more general categories. Once you have filled in all of the fields, you can determine averages for the comparable sold properties, the comparable properties that are under contract and the comparable properties that are still available. Once you finish the CMA, you are almost ready to present the CMA data to your client.

Even though a CMA is not an appraisal, it still serves as a good and generally reliable tool for establishing a price range for a listed property. Unfortunately, some sellers will ask a real estate professional to create a CMA when they have no intention of listing the property with the licensee, instead meaning to go on to place the property for sale themselves after getting the CMA data. For this reason, it is often prudent to convey the findings to the seller without leaving a copy of the CMA.

It can sometimes be useful to have an actual appraisal performed, beyond any CMA research that is done. For example, an appraisal might be desirable and even advisable if a property is unusual; an appraisal may be the only way to get accurate valuation information if there are no recent or comparable sales available to evaluate. In addition, a seller may sometimes disagree with the results of a CMA and think that his or her property is more valuable than the CMA suggests.

In cases like these, it is often prudent to advise your seller to retain the services of a professional licensed appraiser. Referring your client to an appraiser does not make you look incapable; instead, it shows that you are aware that a specialist can help to facilitate your client’s transaction. This can help to boost your credibility and ensure that you get the listing. An official appraisal is also a useful marketing tool that inspires confidence in both the seller and prospective buyers.
Ideally, a property will be listed at or below its appraised value. Buyers entering into a contract may also reuse appraisals; for instance, if the buyer’s loan is obtained within 90 days of the appraisal date, the buyer can often use an appraisal obtained by the seller. Sometimes a seller, aided by the real estate licensee, can negotiate with the appraiser to provide an updated appraisal after 90 days for a discounted price.

Homes that have not been appraised are likely to have overpriced listing prices. Listings of this sort can cost the brokerage more than they are worth in time, money and future business. In practice, it is always preferable not to take on an overpriced listing.

**SELLER’S COSTS AND SELLER’S NET**

When making a listing presentation, the licensee must be able to quote a net proceeds figure to the seller. That is, the licensee must be able to tell the seller approximately the amount of money that he or she will end up with at the closing table after all of the customary costs are subtracted from the selling price in the purchase contract.

Licensees should take care to inform sellers that any computations of net proceeds are just educated estimates and that the figures are not binding on the brokerage in any way. Many features of a purchase contract are negotiable and others are set by the lender for certain types of loans; this means that any estimate a licensee provides prior to the existence of a signed purchase contract will at best be only an approximation of the transaction’s actual outcome.

An in-depth treatment of the seller’s costs is beyond the scope of this course. However, a brief overview is necessary because some discussion of these costs often plays an important part in the listing process.

There are basic expenses that are almost always paid by the seller. As such, they should generally be viewed as deductions from the selling price, otherwise known as the gross proceeds. The specific amounts that a seller pays for each of these items will, of course, vary with each transaction, but the principles involved remain the same. Properly understood, then, the selling price represents the money due to the seller after subtracting the following items:

- The broker’s commission
- Closing fee(s)
- Costs associated with title search, examination and insurance binder
- Costs for document preparations and attorney’s fees
- Recording fees
- Loan fees
- Appraisal fees
- Survey fees
• Pest inspection fees
• Taxes and dues

The various costs associated with real estate transactions are typically referred to as “settlement charges” or “closing costs” and most are negotiable between the principals involved in the transaction.

Depending on the type of loan a buyer obtains, the law may also dictate that other expenses accrue to the seller. For example, VA loans do not permit the buyer to pay any portion of the escrow fees, whereas under FHA and conventional loans, the fee is usually split among the principals (unless otherwise negotiated).

With the exception of laws regulating specific loans, the contracting parties are normally free to negotiate who will pay the various closing costs. In some instances, for example, a seller might agree to pay all of a buyer’s closing costs in exchange for some benefit.

Title companies normally have closing cost charts with approximate amounts for each item; often the companies make these charts available to the public and to real estate professionals. Having a copy of a chart like this as well as a title policy insurance rate chart (if rates are set in the state where you practice) can greatly assist you in the process of determining settlement costs for your client. When a closing is done through a title company, a HUD-1 Settlement Statement is often used, which provides an itemization of various settlement costs. A sample HUD-1 Settlement Statement is included for your review. It has been provided for educational purposes only.
## Settlement Charges

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<th>Item Description</th>
<th>Amount</th>
<th>Payable at Settlement</th>
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<td>Government Recording and Transfer Charges</td>
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<td>Additional Settlement Charges</td>
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<td>Total Settlement Charges (enter on lines 103, Section J and 502, Section K)</td>
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It is worth noting that any discussion of costs will be simplified if you always remember to carry a calculator that can do basic real estate finance computations, including fractions, percentages, and amortizations.

We will now discuss the various settlement costs in greater detail.

**THE BROKER’S COMMISSION**

The broker’s commission is the amount of compensation that the broker has negotiated to receive from the seller as part of the listing agreement. If a broker is to qualify for a commission, a number of general conditions must be met:

- The listing agreement must state the amount of commission in writing.
- The broker must hold an active real estate license at the time of entering into the listing agreement and must have an active license up until the time that the sale actually closes.
- The broker must have been the procuring cause of the sale.

If all of these preconditions are met, then the negotiated amount is paid to the broker when the sale is completed. A title company generally issues a check for the broker’s commission, paid from the seller’s funds.

**CLOSING FEE**

The closing fee (sometimes also called an “escrow fee”) is the amount that the title company or other closing entity charges for facilitating the closing.

**NOTE:**
In VA loan transactions, the **seller** (not the buyer) must pay this fee—this point is not negotiable for these loans. FHA and conventional loans generally allow this fee to be divided between the seller and the buyer, unless other arrangements have been made in their contract.

**COSTS ASSOCIATED WITH TITLE SEARCH, EXAMINATION AND INSURANCE BINDER**

Title companies charge fees to research public records, to examine titles and to issue title insurance policies to ensure that sellers are conveying good titles to buyers. This kind of evidence that a title is good often plays an important role in real estate transactions, because it assures prospective buyers that they are receiving titles free of encumbrances, liens, judgments, bankruptcies and other suits that may affect title (other than those mentioned explicitly in a deed). This kind of research can also help resolve or preclude discrepancies in legal descriptions or acreage being conveyed when a survey is provided.
In some states, the amount that these companies can charge is regulated along with other types of insurance; in these cases, a licensee should obtain a policy rate chart to determine how much the company will charge.

In general, the amount of these fees is based on the contract sale price. There can also be significant costs associated with a separate “mortgagee’s title policy” that is issued to a lender to guarantee the title’s status for the lender—a secondary binder usually paid at a fixed amount by the borrower as part of obtaining a loan. You should check with a local title company if you are uncertain about these rates.

**COSTS FOR DOCUMENT PREPARATION AND ATTORNEY’S FEES**

An attorney will usually charge for preparing the legal documents necessary for the sale. Usually this document preparation process includes transferring the property’s deed to the buyer and releasing any current lien(s) held by the seller to be paid off upon resale. If the property is held in the name of a corporation, partnership or other business entity—or is part of an estate—then, there may be additional legal documentation required to successfully transfer title.

**RECORDING FEES**

Recording fees are fees paid to a county’s record-keeping authority, in exchange for filing the deed and release of current lien in public records. You can usually call the county recording office to learn the cost of filing. These fees are generally assessed on a per page basis, with an additional fee for document preservation. You may have to estimate this figure based on average document length.

**LOAN FEES**

Although loan fees rarely constitute an expense for the seller, there can sometimes be discount points or other fees that a seller may be required to pay. In addition, the seller’s lender may charge a fee if the seller uses the proceeds of the sale to pay a loan off early; this fee is called a “pre-payment penalty.”

**APPRAISAL FEES**

Appraisal fees are the costs associated with having a property professionally appraised. These fees are usually connected with a lender-required appraisal and are paid by the buyer (i.e., the borrower) to reimburse the lender who orders it. However, appraisal fees might become seller expenses if the seller and the buyer negotiate this arrangement. For VA loans, the seller *must* pay the appraisal fee, unless the appraisal is ordered directly by the buyer.
SURVEY FEES

For various reasons, a transaction might require a survey to verify the official boundaries of a property. Survey fees are usually connected with the buyer’s loan. However, sometimes a seller already has a survey, and the buyer may negotiate for the seller to pay for an update so that the survey can be used again.

State laws govern how long an existing survey remains valid, though lenders may have more stringent requirements. Surveys may also need to be updated to reflect improvements to a property. If the property being sold is acreage, then a survey may be required to sell the property because lots are normally priced on a per-acre basis. In such cases, the real estate professional should recommend a survey when listing, so that the seller will know the size of the tract for pricing purposes. Regardless of whether you expect that a particular transaction will involve a survey, you should at least contact a surveyor so that you will have a clear idea of the range of prices for these services.

PEST INSPECTION FEES

Some lenders require a pest inspection, especially if the appraiser notes evidence of infestations or damages due to pests. Pest inspections may also be required under some states’ laws. A seller might also want to provide the inspection voluntarily, since a lender could deny a loan without one. Local pest inspection companies should be able to give you price schedules for these services.

TAXES AND DUES

The seller is responsible for all property taxes, homeowner’s dues, property owner’s association dues and any additional dues in condominium and town home complexes to or through the date of closing, as stipulated. Because it is unlikely that a sale will coincide with the exact date on which any or all of these are due, each of them is normally prorated, or divided proportionately, from the beginning of the calendar year (or other fiscal year involved) to or through the date of closing.

Property taxes are normally paid in arrears, i.e. for the previous year, while other dues are paid in advance. To give the seller an idea of net, you should estimate closing at 90 to 120 days in the future when calculating figures for each of these taxes and dues. Remember that items paid in arrears are to be subtracted from the seller’s net, while those paid in advance should be credited to the seller for the remainder of the period already paid.

When you are creating a listing agreement with a seller, that client is likely to have many questions regarding the sale of the property, many of which will revolve around the projected selling price, how long the entire process is
expected to take and what services the broker will provide. During the listing presentation, the licensee should go over the services his or her brokerage can provide and present the completed CMA. In addition, the licensee must make certain that a seller is aware of the closing costs likely to be incurred in the transaction. If the licensee provides clear information about appropriate selling prices and settlement costs, sellers will develop a realistic picture of their expected net proceeds.

INFORMATION NEEDED FOR A LISTING AGREEMENT

Once the broker and the seller have agreed on a listing price and created a contract defining their employment relationship, the broker will need to gather additional detailed information about the listed property. This information will allow the broker to provide correct information to prospective buyers and to other brokers through an MLS (if that service will be used in marketing the property).

Obtaining this array of detailed information early in the listing process will also help to prepare the licensee to answer most of the typical questions that prospective buyers will ask, eliminating the need to contact the seller with frequent questions. By becoming familiar with the listed property, the licensee will be able to gain the confidence of both the seller and of prospective buyers.

The information needed for a listing agreement typically includes:

- The names and legal relationships of the owners, as well as those of any tenants on the property.
- Proof of both ownership interest and authority to sell.
- The complete legal description and street address of the property; if the property is a mobile home or other trailer that is conveyed with a certificate of title, complete information will be needed for that as well.
- Descriptions of any fixtures (personal property that has been permanently attached to real property) that will not be conveyed with the property and descriptions of any personal property (for instance, a major appliance) that is to be conveyed with the property, as well as clear identification of personal property that will not be included in the sale. The listing agreement, any offers and the final contract all must specify these items because the listing agreement does not bind a prospective buyer.
- Descriptions of construction improvements, including the age, size and type of construction, along with descriptions of any remodeling done.
- Descriptions of construction defects or structural defects, such as a cracked foundation or leaking roof, as well as descriptions of anything that might permanently affect health conditions on the property, or otherwise impair its safety or functionality.
- The dimensions of the lot (length and width), or boundary markers on acreage tracts, along with square footage. Obtaining a plat or survey is often helpful in determining dimensions.
• The number, type and size of each room in a structure.
• Existing mortgage loan information, including the name and address of all lenders, along with all current mortgage liens, loan balances, monthly payments, loan numbers, interest rates, the assumability conditions (if applicable) for the loan and whether the loan may be pre-paid without penalty.
• The seller’s willingness to offer special financing, and if so, on what terms.
• Any outstanding special assessments or tax rollbacks, along with their documentation and whether the seller or the buyer will pay them.
• The current property tax amount and assessed value per the appropriate taxing authority. You should request a copy of the most recent tax receipt for this so you have the tax identification numbers needed to close later.
• The current zoning classification and any pending zoning changes. Zoning should be documented. You should be prepared to explain all relevant zoning classifications to prospective buyers.
• Information about any possible future annexation by a municipality and available documentation of any pending changes.
• Any unusual covenants or deed restrictions.
• Neighborhood, association or area amenities and any required dues. The respective organizations should have written copies of this information available.
• Proximity to schools, churches, parks and public transportation. If the seller does not know this information, then the licensee should obtain it elsewhere.
• Local school districts and the applicable state rankings of schools in close proximity.
• Any special features or additional information that would make the property more desirable.
• Any required disclosures concerning agency relationships or property conditions.

DISCLOSURES

Most states require some form of disclosure regarding property condition and representation relationships. In addition, many states require a broker or salesperson to inform all parties involved in a real estate transaction of which party the broker or salesperson legally represents.

Property disclosures protect buyers, sellers and brokers from misunderstandings and erroneous assumptions concerning a property’s known condition. Most states and real estate associations have developed disclosure forms that are to be filled out and completed by the seller. These usually cover such things as mandatory homeowners’ association membership and dues, additional tax liabilities that may be incurred by a change in land use after the sale and subsurface disclosures that inform parties about underground pipelines for potentially hazardous materials like natural gas.
The federal government requires additional disclosures regarding the presence of hazardous substances such as asbestos and lead-based paints; the particular sort of disclosure that is appropriate for your client will often depend on the age of his or her property and whether it is intended for residential or commercial use. It is important for sellers to fill out these forms themselves; if the licensee completes the form, even based on information obtained from the seller, then the licensee could be held liable for any errors or omissions on the form.

Even when a seller’s disclosure is provided, it is advisable for a prospective buyer to have the property inspected by a licensed inspector. This is a prudent strategy because the seller may be unaware of significant latent defects or potential problems. This inspection provides additional protection for a prospective buyer and may allow a buyer to negotiate a better price if the inspection reveals defects of which the seller was unaware.

INFORMATION TYPICALLY INCLUDED IN A LISTING AGREEMENT

As we noted earlier, listing agreement forms can vary widely depending on who drafted them. Most real estate associations, especially ones that have MLSs, develop their own forms to ensure uniformity and compliance. Some brokers who do not participate in an MLS have attorneys draft their listing agreements, to ensure that their forms comply with state agency regulations and to be certain that their forms contain the proper elements and language so as to be legally binding. Finally, some brokers use forms drafted by their state’s real estate licensing authorities (the state real estate commission), although this is somewhat rare.

Even though listing agreement forms come from a variety of sources, all of these aim to serve the same fundamental purpose: to create a legally binding contract for marketing real estate. Because this is so, all listing agreement forms tend to share a roughly similar form in that they strive to meet approximately similar standards. All listing agreements typically include the following information:

- The type of listing agreement that the contract is meant to create.
- The names of all parties to the contract.
- The name of the individual who has been retained to market the property, and the name of the firm by which he or she is employed as well as the name of the supervising broker if the person listing the property works under a broker.
- A description of the property.
- A description of any real property that is not included as part of the sale, as well as a description of any personal property (such as appliances) that will be included as part of the sale. It is generally prudent to identify
important personal property that will not be included as part of the sale, too.

- The listing price that the seller has established.
- The time period during which the listing agreement is valid.
- A description of the broker’s authority and responsibilities.
- A commission agreement.
- A broker protection clause.
- The seller’s representations and warranties.
- Lockbox arrangements.
- IRS Information.
- Special provisions.
- Indemnification.
- Antitrust declaration.
- Non-discrimination clause.
- Lead-based paint notice.
- Signatures.

We will now go over these points in greater detail.

**THE TYPE OF LISTING AGREEMENT**

Earlier lessons discussed the different types of listing agreements, including open listing agreements, exclusive right-to-sell listing agreements, exclusive agency listing agreements and net listing agreements. The type of listing that the contract creates will determine the extent and nature of the broker’s authority on behalf of a seller, as well as the conditions under which the broker is owed a commission.

**THE NAMES OF ALL PARTIES TO THE CONTRACT**

All of the individuals who have an ownership interest in the listed property must be named in the listing agreement and the agreement must bear their signatures. If one or more of the owners are married, then their spouses should also be named and their signatures included on the agreement as well.

If part or all of a property is leased to a tenant (or tenants), this is a material fact that should be disclosed; the terms of the lease should also be provided to prospective buyers. In these cases, there is also usually a separate addendum attached to the listing agreement in which sellers consent to show the property when the tenant is not present or place a lockbox allowing licensees access when this is the case.
THE REAL ESTATE BROKER OR FIRM

The listing agreement must also include the listing salesperson’s name, as well as his or her supervising broker’s name and the name of the company employing them. It is important to make sure that the contract clearly identifies the listing licensee because a written agreement with a seller is required if the licensee is to be entitled to a commission or fee.

THE DESCRIPTION OF THE PROPERTY

The listing agreement should include the property’s legal description as well as its street address. If the property is an acreage tract and your seller does not have a good legal description of the property, then you may have to research the county deed records and obtain a copy of the original deed. The original deed may be especially helpful if the property does not face a public street; it can help to confirm that the property is legally accessible, which is something most title companies require.

REAL PROPERTY AND PERSONAL PROPERTY ASSOCIATED WITH THE SALE

Any items of real property that will be removed by the seller prior to closing must be specifically addressed in the listing agreement. This includes fixtures—that is, personal property that is permanently attached to real property.

The listing agreement should also address any personal property that the seller intends to leave with the property. These items may become points of negotiation in the final sale contract and must be specified again there because a buyer is not bound by a listing agreement. Personal property included as part of a sale could include: refrigerators, washers, dryers, fireplace accessories, window treatments, pool equipment and storage sheds.

Licensees often advise the seller to remove or replace anything the seller wants to keep so that a prospective buyer will not assume that it is included as part of the sale price. For example, if a seller has an antique chandelier in the dining room that will not be included as part of the sale, then he or she should be advised to remove it and replace it with another fixture before showing the property. This eliminates significant potential for confusion and simplifies the licensee’s task.

Leased Equipment

Leased equipment is another matter that should also be covered when identifying the property that will transfer in a sale. Water softeners, cable television boxes and security systems are some examples of items that may be leased by a seller; when leased, these items do not belong to the seller, who generally has only
limited rights with respect to transferring or disposing of these items in a sale. The listing agreement should address the length of the leasing agreement for these items as well as the cost for leasing them; it should also address whether or not the items have transferability.

**Residential Service Contract**

Residential service contracts are also often relevant to the personal property that will transfer in a real estate transaction. A residential service contract (also called a “home warranty” or sometimes a “homeowner warranty”) is an insurance policy covering the major appliances in a house, such as an air conditioner, heater, water heater and garage door opener. These policies can also cover systems such as plumbing or heating, or other structural components of the property; what is covered will depend upon the specific provisions contained in a particular policy.

Residential service contracts address the current condition of the property and the potential for future problems. If the property itself is old, or if the functionality of some of its significant systems obsolete, a buyer may be reluctant to purchase the property because of worries about future repairs or replacement costs. Thus, by offering a homeowner warranty, the seller inspires more confidence in prospective buyers.

When residential service contracts are discussed in a listing agreement, it is generally the case that they are presented as an option—that is, the seller is not required to provide this kind of warranty, although he or she should be told about the benefits such a warranty can create. Nationwide companies now commonly offer forms for residential service contracts, which are regulated by the various states.

**THE LISTING PRICE**

The listing price is the *expected* gross sale price. The seller’s net proceeds are determined by taking the gross sale price and subtracting any unpaid real estate taxes, closing costs, remaining mortgage balances and any other liens or outstanding debts secured by the property. The listing price is merely the initial asking price, *not* the price for which the property ends up selling—thus, any figures that are determined using the listing price can only be estimates which may be altered if the selling price differs from the listing price.

**TIME PERIOD DURING WHICH THE LISTING AGREEMENT IS VALID**

The listing agreement stipulates the time during which the contract is in force, naming specific dates for the contract’s beginning and its termination. This is probably one of the most vital portions of a listing agreement, because it
establishes the period during which the seller and the broker are legally obligated to respect the terms and conditions of their agreement. If a licensee is to be entitled to the negotiated fee or commission set in the contract, then an acceptable offer that results in a contract must be obtained during the time period set forth in the contract (this period is also called the “listing term”).

**BROKER’S AUTHORITY AND RESPONSIBILITIES**

Generally, the listing agreement also describes the scope of the broker’s authority and his or her responsibilities with respect to the seller and the listed property. This includes the broker’s authority to advertise the property and may include stipulations about where it can be advertised. In addition, this part of the agreement would include the seller’s permission to place a “For Sale” sign on the property and the broker’s authority to work with other brokers through an MLS. This part of the listing agreement will also cover other marketing issues such as when and how showings are to take place.

**COMMISSION AGREEMENT**

The listing agreement also addresses the commission that a broker is to receive if the listed property is sold and secures the seller’s agreement to this arrangement. The commission agreement should specify the conditions under which a commission will be paid. Typically, a broker qualifies to receive a commission if he or she is the “procuring cause” of a sale and obtains a buyer who is “ready, willing, and able to buy.”

This section of the listing agreement also addresses whether the commission will be paid as a flat fee or as a percentage of the selling price, as well as how it must be earned, when it will be paid and whether the seller will pay it separately or from escrow at closing.

**THE BROKER PROTECTION CLAUSE**

This clause allows for the broker to receive a commission after the termination of the listing agreement if he or she is the procuring cause of a sale that does not close until after the listing agreement terminates. For example, this could happen if the broker shows the property to an interested buyer who sees the property while it is listed, but for some reason waits to make an offer until after the listing agreement has expired. If the seller accepts this offer, a good case could be made that the broker was the procuring cause of the sale.

The broker protection clause establishes a time period within which offers remain “attached” to the broker’s marketing efforts and showings, and thus make him or her eligible for commission even if the listing agreement is no longer in force. Typically, the protection clause rescinds this protection if another broker re-lists the property. Sometimes the clause stipulates that a broker may compose a list
of interested buyers, and if any of these people purchase the property within a specified number of days, then the broker receives a commission on the resulting sale.

SELLER’S REPRESENTATIONS AND WARRANTIES

In this part of the listing agreement, the seller informs the broker that:

- He or she has title to and peaceable possession of the real property and any improvements thereon. For a property like a mobile home with a separate title, the licensee should not rely on the seller’s warranty but should instead actually investigate public records to confirm that the seller is indeed the owner. If there is a discrepancy regarding title, ask for proof by requesting a copy of the deed or other legal conveyance document; failing to do so could cause you to misrepresent the property to other brokers and to prospective buyers.
- He or she has the legal capacity to convey the property and enter into a listing agreement authorizing the selling or leasing of the property. This also should be confirmed to prevent misrepresentation.
- He or she is not currently a party to any other listing agreement with another broker and will not contract with another broker during the term of the listing.
- There is no person or entity with any current claim or later right to acquire title or any other legal interest in the property that is being offered for lease or sale in the listing agreement.
- Any improvements on the property comply with current building codes and the structure itself was built following proper permitting procedures; in addition, the seller warrants that the property is properly zoned for the purposes for which it is being offered for sale or lease.
- If there are any repairs or defects known to the seller at the time of listing, then the items will be properly disclosed or repaired prior to closing.
- The seller is not currently in default or delinquent on any note or mortgage associated with the property (that is, the seller warrants that the property is not being foreclosed upon). A licensee can still market the property even if the seller is in default as long as this fact is conveyed to all prospective buyers, as it would be in a pre-foreclosure sale.
- There are no judgment liens or other legal issues concerning the property currently before a court of law.
- He or she has available copies of all rental contracts covering all or any leased portion of the property and will get permission from the agent before creating or renewing any rentals during the listing term.
- He or she agrees to furnish a title insurance policy to a prospective buyer at his or her own expense.
LOCKBOX ARRANGEMENTS

This section of the listing agreement addresses how and whether a lockbox will be used on the seller’s property, as well as how this information will appear in most listings, especially if there is an affiliated MLS involved. If the seller agrees to use a lockbox, then this portion of the listing agreement generally involves the seller giving the agent permission to place a lockbox that contains a key via which other licensees can gain access when the seller is not at home to show the property.

It is critical to get the lockbox arrangements in writing because this part of the listing contract involves the seller agreeing to indemnify the broker and hold him or her harmless for any damages or claims that arise as a result of the lockbox’s use, such as unauthorized entry or theft.

Most of the lockboxes now used include safeguards that involve the insertion of an electronic key and a provide record of who made the last entry. The agent should realistically present the benefits and disadvantages of lockboxes, making sure the seller understands that a lockbox is optional. If tenants are present on the property, then the licensee should also get written permission from each tenant agreeing to the use of the lockbox, since tenants also have a property interest.

IRS INFORMATION

This section of the agreement contract primarily provides information. It states that the Internal Revenue Service requires escrow officers to report gross selling price and the seller’s tax identification number; it also states that a percentage of the selling price will be withheld if the seller is not a U.S. citizen. A seller’s nationality must usually be confirmed by affidavit; the seller should indicate whether he or she is a citizen on the listing agreement, thereby documenting this fact for the broker’s protection.

SPECIAL PROVISIONS

This is a blank section in most listing agreements that gives the seller or the licensee a chance to write in other items that need to be addressed in the contract but are not covered in the conventional sections of the agreement. For example, this section might include referral by another licensee, special instructions for showing, a move-out timeframe, or a reduced commission structure that could not be written in full in the agreement section. If you need to attach another page for special provisions, then label it and place it so that it is properly incorporated into the contract.
INDEMNIFICATION

This section of the agreement states that the seller and broker will not hold one another responsible and will not pursue litigation in the event that one supplies incorrect information to the other. This misinformation can be either intentional or unintentional (although we should note that this section does not grant either party the freedom to commit fraud).

ANTITRUST DECLARATION

Federal and state statutes prohibit brokers from participating in price fixing with regard to their services and commissions. The listing agreement should therefore state that the commission and service costs in the contract were negotiated by the seller and broker for the purposes of this particular transaction and not set by any trade association or organization.

NON-DISCRIMINATION CLAUSE

In compliance with federal fair housing laws, a seller who lists his or her property through a licensee must permit that property to be shown to or purchased by any buyer regardless of that buyer’s race, color, national origin, familial status, sex, handicap or religion. State laws may add other groups to this list of protected classes. The broker should be aware of both the federal and state laws regarding protected classes because penalties for violating anti-discrimination laws can be severe. As a rule, licensees should refuse listings from sellers who do not wish to comply with these laws.

LEAD-BASED PAINT NOTICE

If the listed property includes structures or improvements that were built before 1978, federal law requires the seller to:

- Provide an EPA lead hazard information pamphlet.
- Disclose the presence of any known lead-based paint or other related hazards and provide any previously obtained testing reports.
- Permit buyers to conduct risk assessments regarding, or inspections for, the presence of lead-based paint hazards.

Federal law requires any contracts for the sale of properties built before 1978 to contain a prescribed Lead Warning Statement to the buyer.

LEARN MORE:
For more information, see HUD’s Office of Healthy Homes and Lead hazard Control at www.hud.gov/lea/leadhelp.html.
SIGNATURES OF ALL PARTIES HAVING OWNERSHIP INTEREST

All parties who have a legal ownership interest in the property must sign the listing contract. Most listing agreements also require social security numbers (or tax identification numbers), so that this information is readily available when it is needed for closing. However, it is not essential that the listing agreement include these numbers (although it *must* bear the owner or owners’ signatures); if you do not have these numbers when the listing contract is being created, they can be obtained later.

SELLER’S DISCLOSURE NOTICE

A seller’s disclosure notice is a separate document that a seller fills out; it is not truly part of the listing agreement, although the information it supplies represents important information for the licensee who has been employed to market the property. In the seller’s disclosure, the seller describes all visible or latent (invisible) defects affecting the property, to the best of his or her knowledge. The seller also generally has a duty to disclose any significant change that may occur during the listing period that would materially affect the property.

Most states have laws that outline the specific information that must be included in a disclosure notice within a particular state. Some states also have standardized disclosure forms that must be completed for real estate transactions executed within the state.

The National Association of REALTORS® has established its own disclosure form (and its own listing agreement). These forms are used by most of its affiliated state associations—that is to say, member-brokers and member-salespeople agree to use these forms in their transactions. We have provided an example of the seller’s disclosure notice required by Texas law, to illustrate one such form. This form is provided for educational purposes only.
## SELLER'S DISCLOSURE OF PROPERTY CONDITION

(SECTION 5.008, TEXAS PROPERTY CODE)

CONCERNING THE PROPERTY AT ______________________________

(Street Address and City)

THIS NOTICE IS A DISCLOSURE OF SELLER'S KNOWLEDGE OF THE CONDITION OF THE PROPERTY AS OF THE DATE SIGNED BY SELLER AND IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THE PURCHASER MAY WISH TO OBTAIN. IT IS NOT A WARRANTY OF ANY KIND BY SELLER OR SELLER'S AGENTS.

Seller ☐ is ☐ is not occupying the Property. If unoccupied, how long since Seller has occupied the Property? 

1. The Property has the items checked below [Write Yes (Y), No (N), or Unknown (U)]:

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<td>Fireplace(s) &amp; Chimney(Woodburning)</td>
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<td>Gas Fixtures</td>
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<td>Garage Door Opener(s):</td>
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<td>Water Heater</td>
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<td>Age: (approx)</td>
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Are you (Seller) aware of any of the above items that are not in working condition, that have known defects, or that are in need of repair? ☐ Yes ☐ No ☐ Unknown. If yes, then describe. (Attach additional sheets if necessary):

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2. Are you (Seller) aware of any known defects/infestations in any of the following? Write Yes (Y) if you are aware, write No (N) if you are not aware.

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<tr>
<th>Item</th>
<th>Yes</th>
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<td>Interior Walls</td>
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<td>Exterior Walls</td>
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<td>Other Structural Components (Describe)</td>
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01A 

TREC No. 09-H
We have now reviewed all of the basic portions of the listing agreement contract itself as well as those items the real estate professional should prepare (such as the CMA) and bring to the listing presentation.
SUMMARY

Before licensees create listing agreements, they must familiarize themselves with their brokerages' policies regarding this sort of contract. Brokerage firms usually have set standards for commission rates and the minimum length a listing agreement should be. Firms also generally have rules regarding which contract terms are non-negotiable, although the specific conditions that are not negotiable may vary from firm to firm.

At the initial meeting with the seller, the licensee should identify what sale price the seller expects, the expected timeframe for finding a buyer and the seller’s motivation to sell. The licensee should tour the property and gather information about it. He or she should also collect information for a comparative market analysis (CMA). A CMA is a means of determining a property’s approximate market value by comparing it with similar properties that are for sale or which have sold recently in the same market.

The information needed for a CMA can be collected from a multiple listing service (MLS) or from the local appraisal district. When determining similarity and comparing properties, licensees should evaluate at least the following features:

- Price (either the listing price or the price for which the property sold)
- Date of sale
- Square footage
- Age
- Type of construction
- Size and location

Ideally, the licensee should collect information on three or four properties that have sold in the past three months, three or four properties that are under contract and three or four properties that are for sale. It may be necessary or desirable (though it may not be essential in some cases) to have the property appraised, to secure more specific valuation data than that provided by a CMA.

Once the licensee has created a CMA, he or she should be prepared to present the seller with a brief overview of the analysis, as well as an estimate of net profit (i.e., net proceeds from the sale). By taking the property’s expected sale price and subtracting all closing fees, an estimation of the seller’s net proceeds can be determined. These closing fees (also called “settlement fees”) can include fees for appraisals, surveys, inspections and document preparation, as well as taxes and fees associated with loans.

After collecting all of the necessary information and discussing a seller’s hopes and needs regarding the transaction, the licensee should draw up a listing agreement with the seller. The brokerage firm or the MLS to which a licensee belongs usually creates the listing agreement forms. Though the specific details
of these forms can vary because they come from a variety of sources, most listing agreements cover the same basic information. This data includes the following:

- Proof of the seller’s ownership and legal capacity to sell
- A legal description of the property
- A description of the type and size of each room
- Loan, tax and zoning information
- Required disclosures

Sellers are required by law to disclose material facts about the property, that is, to disclose facts that one would reasonably expect could influence a prudent buyer’s decisions regarding the property. These facts include information about the presence of asbestos and lead-based paint, subsurface pipelines containing hazardous materials and mandatory homeowner’s dues.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON FOUR
THE LEGAL ISSUES SURROUNDING A LISTING AGREEMENT

This lesson will focus on the following topics:

- Legal Obligations of Sellers and Licensees
- Receiving Commissions
- Splitting Commissions
- Breach of Contract

INTRODUCTION

The previous lessons have covered the process of obtaining a listing, as well as the documentation that is needed to create into a listing agreement. This lesson will review the legal issues surrounding a listing itself. Our discussion will outline the legal obligations imposed on both sellers and licensees when they work together under a listing agreement. We will also cover the conditions under which a commission is rightfully owed and the lawful disbursement of such funds.

LEGAL OBLIGATIONS OF SELLERS AND LICENSEES

The successful execution of a listing agreement requires that all parties involved in the contract understand the obligations that the agreement imposes. Each state’s license law creates specific legal obligations for the parties that create a listing contract (and licensees should familiarize themselves with their state’s unique requirements). However, many states’ license laws impose broadly similar obligations, which we will now discuss.

THE SELLER’S OBLIGATIONS

When a seller agrees to list his or her property for sale with a licensee, he or she makes a written claim that he or she owns the property and has the legal capacity to enter into a listing agreement for it. This declaration includes the seller stating that he or she:

- Is of legal age.
- Is not already party to another listing agreement.
- Does not currently have a purchase contract for the property (or a lease contract that has not already been disclosed to the licensee).
In addition, the seller generally must state:

- Whether there are any current loans or other encumbrances affecting the property (other than those that are disclosed in the agreement).
- That there are no pending court proceedings involving the property and no legal judgments against the property.
- That he or she has fully disclosed all material facts about the property.

These are the basic representations that a seller makes to a broker as consideration for a listing agreement. We will now examine what the broker represents in return.

THE BROKER’S OBLIGATIONS

Under a listing agreement, a broker (and any other licensees legally authorized to act on the broker’s behalf) must make reasonable efforts and act diligently to sell the property. A listing agreement usually goes on to explain what these efforts and acts will include. The broker is generally granted permission to:

- Advertise the property in ways that comply with federal and state laws regarding discrimination, fair housing laws and disclosure laws to insure that the advertisements are equitable and not deceptive in any way.
- Place a “for sale” sign on the property.
- Prepare information about the property and distribute this information to other brokers and their licensees, so that they can assist in the process of finding a buyer for the property.
- Place the property on a multiple listing service (or on multiple MLSs) within a specified number of days so that other brokers, their licensees and (in some cases) the general public can access information about the property being marketed. Licensees should familiarize themselves with all MLS rules and regulations governing the marketing of properties and ensure that their work complies with these standards.
- Remove any other brokers’ signage from the property, and any signage placed by the seller, so that the broker is clearly the only one offering the property for sale (unless otherwise stipulated in the listing agreement).
- Provide buyers, other brokers and their associates, home inspectors, appraisers and any seller-authorized repairmen with access to the property as part of general effort to obtain a purchaser and complete the sale of the property.
- Obtain all pertinent information about any notes, liens or encumbrances on the property and provide this information to a prospective purchaser, if required. (Some lenders require written advance notice of intent to sell and obtain payoff information, as well.)
- Accept earnest money in conjunction with obtaining an earnest money contract with an offer to purchase the seller’s property. The licensee is also generally authorized to deposit accepted earnest money in trust as
governed by the terms of the listing contract. This deposit process normally involves placing the funds with a title company or other designated escrow officer.

The licensee is thus granted broad authority over many matters related to marketing the property. The broker is not, however, authorized to execute any document in the name of or on behalf of the seller with respect to the property. The penalties for doing so may include losing one’s license and being held legally accountable in both civil and criminal proceedings.

The various acts that a listing broker is authorized to carry out make up the broad obligations that real estate professionals owe to clients with whom they have created listing agreements, though there may be more or fewer depending on the particular terms that a licensee and a seller negotiate for in their listing contract. As always, the written contract establishes the rights and duties of the parties involved, so it should be followed strictly.

In most states, there are laws establishing the priority of written documents over verbal representations made between contracting parties, so the written listing agreement will usually supersede any verbal understandings. Thus, any verbal agreements should be written into the listing agreement. Having all contractual terms and conditions in writing benefits everyone involved.

Now, we will turn to what is probably the most important contractual term written into a listing agreement: the language that establishes when a commission or fee has been earned.

**RECEIVING COMMISSIONS**

A commission or fee is earned only after satisfying the conditions set out in the listing agreement. Generally, the contract will require that at least one of several events occur during the term of the listing before a licensee is entitled to a fee or a commission. To ensure that all parties understand the agreement and to make the agreement legally enforceable, these events as the condition of receiving a fee or commission should be clearly spelled out in the listing agreement.

Although there is some variation between states based on their laws, it is generally true that a licensee will receive a commission or fee only if:

- A broker within the company marketing the property, or working with a cooperating broker from another firm, procures one of the following during the listing term:
  - A buyer who contracts to purchase the seller’s property.
  - A buyer ready, willing, and able to buy the property at listing price and on the terms established in the listing agreement.
o A buyer ready, willing, and able to buy at some other price, or on other terms, acceptable to the seller.
- The seller breaches the listing agreement.
- A seller bound by an exclusive right-to-sell listing agreement sells, exchanges, agrees to sell or agrees to exchange the property to or with anyone at any price and on any terms.

In addition, most states require that the broker or salesperson be actively licensed at the time of entering into a listing agreement and at the time of closing if he or she is to be entitled to a commission or fee. If an individual’s license is inactive at the time of closing, this will usually cause the escrow officer or title company to hold the funds until the license is reactivated or other legal steps are taken. If a title company disperses funds to an unlicensed broker or salespeople, then the title company is legally liable for paying commissions to an individual who cannot legally receive this kind of payment.

**BREACH OF CONTRACT**

The listing agreement should also spell out the conditions under which a seller is understood to have breached the listing contract. A seller is generally considered to have breached this contract if he or she:

- Is unwilling to complete the sale of the property after contracting to do so.
- Subsequently proves to lack the legal authority to sell the property because of legal inability to enter into a contract or because he or she no longer holds an ownership interest in the property.

A buyer might also default on his or her contract with the seller. In such a case, the broker is usually entitled to a contractually established portion of any amount collected. If the seller collects by lawsuit, compromise, settlement or any other means, the selling price or other damages from a buyer who breached an accepted contract, then the broker generally receives a portion of these funds as his or her commission.

We will discuss breach of contract further in a later section.

**PROTECTION PERIOD**

The protection period is a period of time negotiated in the listing agreement that establishes when and whether a licensee is entitled to a commission or fee after the listing contract has been terminated (regardless of how the listing was terminated). This period is closely connected to the “broker protection clause” discussed earlier.

During the protection period, the execution of any sale or exchange for which the licensee was demonstrably the procuring cause entitles that licensee to the
commission or fee set out in the listing contract—even if that contract is no longer in force. That is to say, if—during this period—the seller enters into a sales contract for the property or sells, exchanges or otherwise transfers any interest in the property with a buyer with whom the broker registered the seller, during the term of the listing or within a set number of days after the termination occurs, then the broker still earns the commission or fee.

However, if the seller re-lists the property with another broker, then this protection will generally not apply. The real estate professional should be familiar with this portion of the listing agreement and follow it to ensure that he or she receives the commissions or fees from transactions produced by his or her efforts.

**PAYMENT**

Commissions are usually paid at the closing of a sale. In a typical purchase scenario, the title company or other escrow officer in charge of the transaction distributes the funds. If this proves impossible—as would be true if the seller refused to sell the property or breached the listing contract—the commission due would have to be paid immediately. However, the listing contract may establish some other mutually acceptable arrangement for paying a commission.

There are a limited number of circumstances in which a commission shall not be due, including:

- Cases in which the seller is unable to deliver a title policy to the buyer due to title issues that are not his or her fault.
- Cases in which there is an unanticipated foreclosure or other legal proceeding resulting in involuntary loss of the seller’s ownership rights.
- Cases in which there is a casualty loss (e.g., the property is damaged by fire or flooding) and the seller cannot reasonably be expected to restore the property to its prior condition by the closing date set for the transaction to take place.

**SPLITTING COMMISSIONS**

Once a commission is earned, it must often be split between two or more parties. Commissions can be split between real estate professionals and between principals and licensees. The following sections will discuss the legal frameworks that guide real estate brokers, cooperating brokers and salespeople in dividing commissions amongst themselves. We will also cover when and how licensees and principals may split commissions.

**SPLITTING COMMISSION BETWEEN REAL ESTATE PROFESSIONALS**
In most states, there are two main types of real estate professionals: real estate brokers and real estate salespeople. Under most states’ license laws, only a broker or a brokerage firm with a sponsoring broker is entitled to receive commissions or fees in real estate transactions. In general, a real estate professional must begin his or her career as a salesperson sponsored by a broker, working in a kind of apprenticeship for a statutory period before he or she can become a broker.

Salespeople can sometimes share in commission or fees resulting from their work on behalf of their sponsoring brokers. Their sponsorial relationship must be established by a contract between the salesperson and broker for a salesperson to be legally entitled to share in the fee or commission received.

**Sponsoring Brokers, Salespeople and Cooperating Brokers**

Because only the broker is legally entitled to a commission or fee, a sponsored salesperson that is the procuring cause of a sale for a listed property must have a written agreement with the broker to receive any part of the commission. This is true regardless of whether that salesperson’s work is on behalf of the buyer or seller.

Most broker-salesperson contracts involve either a flat fee or a percentage-of-fee arrangement; this latter arrangement might be such that, for example, there is a 50 percent “split” with the broker, in which the salesperson receives half of the commission and the broker receives the other half. Any contract to divide fees or commissions is negotiated separately from the listing agreement with the seller and separately from the purchase contract for the property. License laws generally forbid salespeople to accept commissions or fees directly from principals, so the commission must first go to the broker, who will then divide it according to any contractual arrangements.

If another broker or salesperson is involved, in addition to the two parties just discussed, then the division of the commission or fee must be done at two levels: first between the two brokers and then between each broker and their individual salespeople. Normally, the title company or another escrow officer issues commissions to the appropriate brokers who, in turn, issue funds to their respective representatives.

**Buyer-Brokers and Seller-Brokers**

A seller-broker and a buyer-broker will generally divide funds in accordance with the earnest money contract to which the sponsoring brokers have agreed. In some states this contract is referred to as a broker information and ratification of fee agreement. It usually states that the listing broker agrees to pay the broker representing the buyer a percentage or set portion of the selling price. It is
executed as a separate written agreement between the brokers involved. All of these fees are negotiable (as is their division) and are usually governed solely by the separate listing agreements and sponsorship agreements that the brokers have established.

SPLITTING COMMISSIONS WITH PRINCIPALS

Unless prohibited by federal or state law, a broker is usually free to negotiate a contract in which he or she agrees to return or pay a portion of the commission or fee to a principal. In a transaction involving an FHA-insured loan, however, the buyer’s and seller’s representatives are forbidden to return funds to principals; the representatives must state in writing that they have not assisted the buyer directly or indirectly with the closing costs or down payment associated with the purchase.

If the transaction is one in which a broker is permitted to return funds to a principal, it is left to the broker to decide whether the funds will be returned before or after the broker divides the commission with his or her salespeople. Unless forbidden by law, the seller’s broker may pay a portion of the commission or fee toward the buyer’s closing costs or simply return it as a cash rebate at closing. In lieu of funds, a broker might also offer fees, services or repairs.

For example, a seller and a buyer may have created a purchase contract, but say the buyer lacks sufficient funds to close. Rather than lose the buyer, the buyer’s broker and the seller’s broker might agree to contribute a portion of their expected fees to the buyer’s closing costs, reasoning that a reduced commission is better than none at all. The escrow officer or title company involved then simply subtracts the agreed-upon portion from their fees and records this on the HUD-1 Settlement Statement. Again, licensees should always check state and federal laws to confirm the legality of any arrangement to share funds with a principal. They should also carefully document the entire agreement, to prevent misunderstandings and possible legal complications.

SPLITTING COMMISSION WITH THIRD PARTIES

A licensee cannot split fees with third parties unless those parties are licensed real estate professionals or principals with whom the licensee has a direct contractual relationship. For example, a licensee could not agree to pay part of his or her commission to a repairperson for repairs to the property because this would involve splitting fees with an unlicensed third party. However, an arrangement could be made in which the seller agrees to pay the repairperson out of the closing proceeds of a sale if, in turn, the broker agrees to reduce his fee by the cost of the repairs. This arrangement has the same ultimate effect as if the broker paid the repairperson directly, but this arrangement is legal because the funds are being “paid” to the principal (seller) and not to the unlicensed third
party. A licensee should always consult his or her state’s laws to assess the legality of splitting fees with third parties.

**BREACH OF CONTRACT**

Both licensees and sellers can face serious penalties for breaching a listing agreement contract. The punishments for breaching a listing agreement are determined by specific state laws and rules, as well as by the rules of any Board of REALTORS® with which the licensee is affiliated. Though some states have distinctive laws in this regard, most states share many common laws governing contractual obligations with which a licensee should be familiar.

When either party breaches the listing agreement, there is what’s known as a “breach of contract.” The listing agreement should delineate what actions or events will constitute a breach of contract, as well as the remedies that are available if a breach occurs. Because the listing agreement contract is in writing and signed by all the parties, the remedies spelled out in the document will determine how a breach of contract is handled, unless superseded by state laws.

**SELLER DEFAULT**

A listing agreement is a legally binding contract between the seller(s) and the broker. Many listing agreement forms include language to this effect, perhaps including something like: “This is intended to be a legally binding agreement. Read it carefully. If you do not understand the legal effects of this listing agreement, consult your attorney before signing.” Violating a signed contract is known as **defaulting** on that contract.

For example, consider the following situation: A seller and a broker create an exclusive right-to-sell agreement. The seller sells the property on his or her own and does not pay the listing broker a commission, even though their contract requires this commission to be paid. This seller is, thus, in default because he or she has failed to honor the terms of the listing agreement.

A seller who fails (or refuses) to fill out the seller’s disclosure notice completely and correctly can be held liable for misrepresentation and fraud, along with the listing broker. A prudent broker will therefore rescind any listing agreement that relies on an incorrect or incomplete disclosure because this kind of error in the way the property is being represented can allow prospective buyers the right to back out of purchase contracts at any time and file suit against the broker and seller. Similarly, if a broker lists a property and later determines that there are defects in the property that the seller knowingly concealed, the broker should rescind the listing agreement. Listing agreements should generally be rescinded if a broker is asked to withhold information about property defects, as well.
Many listing agreements include language stipulating that the broker is entitled to the amount that would have been paid as commission if the seller defaults on the listing contract.

**BROKER DEFAULT**

If the broker breaches the listing agreement, then he or she will receive no commission or fee. Depending on the type of breach, the broker may suffer harsher penalties than a simple lost commission or fee. Most listing agreements include a paragraph dealing with the attorney’s fees and court costs that parties in default must pay. Agreements also usually include language that explains mediation—it is generally the case that the contract will require the parties to explore mediation and split the mediation costs before either of them pursues litigation.

The actions of a broker who defaults on a contract may also violate specific laws that stipulate their own remedies, beyond those addressed in the listing agreement contract. If a broker violates fair housing laws, there are specific penalties set out in federal and state acts for such action; for example, if an administrative law judge determines that a fair housing violation has occurred, then the broker can receive a maximum penalty of $11,000 for a first offense.

The federal law requiring the disclosure of possible lead-based paint hazards also includes an explicit penalty: damages for a violation are assessed in an amount not to exceed $10,000. Sellers can also be held liable and fined under these laws, although they apply differently to sellers who are not working with a licensee.

On top of contractual damage awards, there are other remedies that can be pursued through judicial action that can prove quite costly for a licensee. For example, if a licensee breaches a listing agreement and costs the seller a potential sale as a result, the seller can seek damages in the amount of the profit lost on the sale. He or she may also be able to pursue other damages incurred as a result of continued ownership of the property, such as loan interest, taxes, funds lost on the contract (e.g., if the seller paid out any funds for an anticipated closing).

Greater punitive damages may be an option if it is found that the broker committed fraud in the course of the transaction. In some states, the broker may face damages that are doubled or tripled under a deceptive trade practices action if the following conditions exist:

- The licensee misrepresented material facts.
- The licensee was aware that he or she was making misrepresentative statements, at the time the statements were made.
• The buyer suffered damages (financial or otherwise) as a result of the licensee’s misrepresentations.
• The misrepresentations caused the buyer to do something he or she would not have done, had he or she known the truth.

An all-too-common example of this sort of problem is a broker’s failure to disclose foundation problems, even when the seller has disclosed these problems to the broker. Since these defects are not usually visible, misinformed buyers often proceed with the purchase, only to be faced with a major problem sometime after closing when the defect becomes apparent. In a case like this, a broker who committed fraud could get sued for the difference between the price of the house as represented and the value of the house given its actual condition—a figure which can be quite substantial. Some states’ laws will allow a judge or jury to double or triple this figure if the broker is found to have knowingly misrepresented the material facts regarding the property.

A prudent real estate professional will be honest and truthful in all of his or her professional dealings and will avoid sellers who request that defects not be disclosed. Likewise, licensees should not abet a buyer in misleading a seller. For example, a licensee should not attempt to convince a seller that there is a defect in a property when there is not, in an effort to get the seller to lower his or her price. When a licensee takes gross advantage of another party’s ignorance, he or she is committing a form of fraud.

In most states, license laws contain provisions specifically addressing payment from a state-established “recovery fund” if a judgment is obtained against a licensee and the licensee is unable to pay. If a licensee is involved in a judgment that draws on this sort of state fund, that licensee will generally have his or her license suspended, pending repayment of all money paid out from the fund on his or her behalf.

**SUMMARY**

Listing contracts give the licensee permission to make genuine efforts toward selling a property. These efforts generally include advertising the property, obtaining material information about the property’s condition and owners and accepting earnest money for a purchase contract, among other activities. Licensees are granted broad authority over many matters related to marketing the property, but they *may not* execute documents in the seller’s name.

Listing agreements should stipulate the specific conditions that must be met before a broker is entitled to the commission set forth in the contract. Generally, a broker earns the commission specified in the listing agreement when he or she (or an authorized representative) is the procuring cause of the property’s sale. It is also true that a broker is generally entitled to a commission if the property is
sold by anyone under an exclusive right-to-sell agreement, or if the seller breaches the listing agreement.

A seller is generally understood to have breached the listing agreement if he or she proves *unwilling* to sell the property after contracting to do so despite being *able* to complete the sale, or proves to be *unable* to do so due to legal incapability or loss of his or her ownership interest. Listing agreements usually provide a period of time after the term of the agreement during which the broker will still receive a commission if he or she is the procuring cause of the sale; this period is called the “protection period.” However, regardless of any arrangements made in a listing contract a broker generally receives no commission when a property is foreclosed or when an owner suffers a casualty loss.

Commissions must be paid directly to the broker; most states’ license laws forbid paying commissions to salespeople. The broker may split his or her fees with his or her salespeople, with other brokers and with the principals involved in the contract. However, a broker cannot share a commission with an unlicensed third party.

A broker will not receive a commission if he or she breaches the listing agreement. Brokers in default may face civil proceedings brought by sellers for lost profits and expenses, in addition to disciplinary actions brought by professional organizations like the National Association of REALTORS®. Misrepresenting a property to a prospective buyer can also result in lawsuits; willful misrepresentation—i.e., fraud—can result in a licensee facing penalties that are considerably steeper. Financial awards that a licensee cannot pay on his or her own will be paid from a recovery fund in many states, and an individual’s license can be suspended until the fines he or she incurred are fully paid.

*Return to your on-line course player to take the Lesson Quiz.*
LES S S F I Wo N T I N G T H E L I S T I N G

This lesson focuses on the following topics:

- Marketing
- Showing the Listing
- Keeping the Seller Happy

INTRODUCTION

The previous lessons have covered the legal issues surrounding listing agreements, the basic standards that determine when a licensee is owed a commission. We also discussed how commission funds could be divided among brokers, cooperating brokers and salespeople, as well as how commissions can be shared between licensees and principals. However, knowing the law is not, by itself, enough to ensure that you will handle a listing successfully.

This lesson will outline how to manage a listing once you have established a listing agreement. We will discuss the general issues involved in marketing a property, and how to provide a level of service that will help you to build positive fiduciary relationships that lead to valuable personal referrals.

We will begin by explaining the marketing process and the importance of honesty in all fiduciary relationships. We will then outline the importance of customer service, methods for keeping sellers happy and for providing responsive service to prospective buyers—techniques that will help you get referrals from past clients.

MARKETING

As a real estate professional, one of your main duties is marketing sellers’ properties. Earlier, we talked about the process of gathering background information on the property and coming up with an initial price range by preparing a CMA; these are the first steps in marketing a property—this collection of information will form the foundation of your marketing program. However, the initial process of gathering of this information is aimed at securing a listing agreement. Once you have created a listing agreement with a client, you must redirect your efforts toward selling the property.

Real estate professionals should try to improve their rapport with sellers throughout the marketing process; from the time a seller signs a listing agreement to the time a sale closes, you can be building and improving your relationship with the client. You can begin building good relationships by being honest with your seller from the outset. You may lose some listings to brokers
who make false promises, but a truthful approach will lead to repeat business and customer satisfaction in the long run. Being honest will also help you avoid legal issues in the future, because serious liability concerns can be created by dishonesty, even if it is well intentioned.

Licensees who do not have a great deal of marketing experience should consult their brokers and talk with other licensees who sell in the area in which the listed property is located. Your CMA should provide significant information about the overall local economy and similar properties that have sold or gone under contract recently; you are likely to need some further figures as well, including the total number of similar properties that have been sold or marketed recently. You will need to know these things before discussing the seller’s property with the seller, in order to properly advise him or her about the prospects of marketing the property.

Once a licensee has an accurate picture of the local real estate market and the potential demand associated with a particular property, he or she should find a way to present this information to the seller clearly and concisely. Many real estate licensees use a ranking system, such as a one-to-ten scale or one-to-one-hundred scale. Using this sort of scale, licensees assign numbers to properties depending on their estimated marketability; for example, on a one-to-ten scale, a “ten” ranking would generally be associated with a highly marketable property, while a “one” ranking reflects a property unlikely to generate much interest.

To use this type of ranking system successfully, you should develop a consistent means of assigning a particular rank. For example, you might give properties a certain number of points that reflect their various positive features and the desirability of their respective locations. Your ultimate goal in using this sort of system is to convey a clear and accurate picture of the market and the place of the listed property within that market, so that the seller does not expect more activity than is warranted.

When presenting this information to clients, many licensees choose to remind the clients that these rankings are part of an overall picture of the market that should be kept largely confidential and not indiscriminately shared with other licensees or prospective buyers. It is also prudent to make certain that clients understand that any information conveyed by this sort of ranking system is only an estimate.

After explaining your estimate of the property’s marketing potential to the seller, you should help him or her prepare the listed property so that it looks its best for prospective buyers. Little things like trimming the lawn, using a pressure washer on the home’s exterior surface, painting its interior walls and shampooing carpets can make a big difference. You should guide your client here, with the goal of improving a prospective buyer’s first impression of the property. If there are things that would improve the property’s appearance without tremendous expense, recommend that they be done as soon as possible. Acting on this
advice may create a short delay before marketing the property, but if the alterations or repairs make the property more desirable to prospective buyers, this delay can help both you and your client.

If more extensive work is needed to make the property marketable, you may want to discuss having an allowance built into the purchase price. An allowance is an amount allotted for repairs. Generally, this amount is deducted from the sale price or refunded to the buyer at closing, so that the buyer can finance the necessary repairs.

You should also place a “For Sale” sign on the property, as long as this is acceptable to your client. You will recall that a listing agreement should offer a seller the chance to provide a written statement that he or she does not want a sign on the listed property. If a seller does not want a sign, you would typically note this under the “special provisions” section of a listing agreement. A yard sign is one of the most effective marketing tools; if a client will not permit you to place a sign on the listed property, then you may want to reconsider taking the listing—especially if the listed property is not a “prime property,” and will thus need the added marketing boost that a sign can provide.

In addition, if the property is a condominium or town home, a licensee should make sure the regulations and covenants governing the property allow you to place signage in front of the property. For example, sometimes deed restrictions prohibit placing signs. You should also familiarize yourself with relevant city, county and state laws governing signage, as this legislation often regulates permissible advertisement and its placement. For example, many jurisdictions do not allow private signage to be placed on public roadways for more than a short period of time, and fines are sometimes levied for non-compliance. Once you have secured the seller’s permission to place a sign and confirmed that yours and its placement conform to the relevant laws, you should get the sign up as soon as possible.

In creating your CMA and assessing the listed property itself, you should have already gathered detailed information about the property that can be used in your marketing efforts. If you have not, now is the time to collect this data. As a brief review, the following checklist should be your guide to the information you will need:

- Obtain a copy of a recent survey or plat of the property, preferably showing any improvements placed on the real property along with fences, creeks, ponds, etc. This legal property description should also note any contingent circumstances that affect the property, as required by lenders (e.g., the fact that the property is located on a flood plain).
- Obtain a current copy of the public appraisal district records. In most states, relying on public records for square footage, age and other essential facts about the property will relieve you of liability to a buyer if
this information later proves to be wrong. An appraisal done for refinancing or for the seller’s purchase can also be a good source for this information, though you (and the seller) must be aware that the market may have changed since the appraisal was performed.

- Obtain a current copy of the tax billing that shows how much was paid or is owed on the property. You should also note the tax and school districts in which the property is situated, and, as a matter of confirmation, who owns the property.
- Obtain measurements of interior rooms, especially the bedrooms and living areas, because buyers often want to know if their furniture will fit. Most MLSs provide spaces on their forms for this information; some services require it.
- Take detailed notes regarding the property, including the details of its construction, wall and floor coverings, special features, storage areas, etc.
- Photograph the front of the property from the street since this type of image can be used to help prospective buyers locate the property, especially if they have seen it on an MLS service and are driving past to assess the property before contacting a licensee.
- Photograph the sides and back of the property; these images may show other positive features of the property, and can thus entice a drive-by shopper with parts of the property that cannot be seen from the road.
- Photograph the interior of the property. Make sure to highlight the selling points and not the dirty clothes in the corner!
- Write down directions to the property from major thoroughfares and nearby cities. Most MLSs require this sort of information; it is also helpful for a prospective buyer who may want to drive by the property. Include street names and other pertinent landmarks, distances and any address or other identifying marks on the property itself. This is especially important for rural listings, which can be difficult to locate unless one is familiar with the area.
- As soon as you have collected the information you need, enter the pertinent facts into the MLS, so others can immediately see that the property is for sale. If the MLS you use permits photographs, upload as many as possible. However, whether or not you use photographs, be as thorough as possible in describing the property, accentuating its attractive features and, if necessary, noting its defects. Place the property in your brokerage’s upcoming advertisements. Timeframes for listing will vary depending on the listed property’s type and the advertising you agreed to offer (newspaper, magazine, etc.).

**SHOWING THE LISTING**

Prospective buyers will almost always want to see a property before they consider purchasing it. Showing a listing is your time to shine. Make sure that you have previewed the property and that you know how to get there **before** you attempt to show it to any prospective buyers. It may also be useful to require
prospective buyers to be pre-qualified by a lender. This will ensure that you and the prospective buyers focus on homes that are in their pre-qualified price range.

You should maintain a “safety-first” attitude at all showings. To be safe, don’t meet prospective buyers alone at the property. Meet them in your office first, make a copy of any prospective buyer’s driver’s license and take down his or her license plate number. An office’s safety policy should be consistently applied by treating all prospective buyers equally.

Make sure you pay attention to the prospective buyer’s desires. Be alert to his or her verbal and nonverbal signals when showing properties, and use these to determine how you can present a property and best serve the prospect. Emphasize the good points of a listing, but don’t pressure clients. Also, it is usually best to limit the number of homes you show a client in one day; if you show a buyer too many houses in a short period of time, it may be difficult for the client to keep the properties separate in his or her mind. Throughout the showing process, maintain a professional appearance and an upbeat attitude.

It is also important that you not make assumptions about what properties a prospective buyer will want to see, or should want to see. You should never show a prospective buyer houses that he or she has not asked to see, based on your assumptions about what would suit someone of the buyer’s race, color, religion, national origin, familial status or sex. This practice is called “steering”; it is both unethical and illegal. Licensees may not do this even if a prospective buyer asks to be shown properties based on these criteria. When a buyer makes this sort of request, you should inform him or her that Fair Housing laws prevent you from satisfying this request.

**KEEPING THE SELLER HAPPY**

When you have taken the listing agreement and begun the marketing process, your hope is that prospective buyers will come to see the listed property. However, days or even weeks may pass with little or no activity, which can be upsetting and frustrating for both the licensee and the seller. Your job is to keep the seller happy and try to remedy the situation as best you can.

**KEEPING THE SELLER INFORMED**

The most important part of keeping the seller happy is keeping the seller informed. Even if you have no news—no showings, no offers, nor feedback (positive or negative)—you should still call the seller and inform him or her of these facts. Keeping the seller informed helps to make it clear that the lack of activity is not due to inaction on your part. Make sure to discuss your concerns about the level of activity and describe what you plan to do to increase interest in the property. You might want to provide details about current market conditions and explain any changes that may have occurred since the listing was created.
Providing this information can be especially effective when the market takes a downward turn, perhaps due to major world events or the end of an area’s “sales season.”

**IMPROVING THE LISTED PROPERTY’S IMAGE**

You should be frank and direct with your seller—keeping the seller informed means giving him or her accurate information. Explain any issues that may be further reasons for the slump in activity, perhaps dividing these into problems the two of you can work to solve and problems that must be waited out. There are some problems that must simply be accepted as factors that will make it more difficult to generate interest in a property. For example, it might be that the listed property lacks curb appeal, but correcting this problem would involve a total and costly replacement of the front façade—a course of action that is unlikely to appeal to the seller. The problem might be inside; for example, the listed property might have an unusual floor plan to which few, if any, buyers are attracted, such as a four-bedroom house with only one bathroom. Adding at least one more bath would be a desirable improvement to the plan, but this improvement would come at the price of a substantial expense that is not likely to be recouped in the sale.

The real estate professional should be ready to explain a plan of action to the seller that can help overcome these hurdles. Some of the responsibility for helping to sell the property lies with the seller, and the plan could require the seller’s participation, either financially or through work to modify the property. For example, the listed property may be painted a rather unpopular color, like purple. Many people like purple, but almost no one wants a purple house. In a case like this, you should ask your seller to consider repainting the property in a more neutral color to improve its marketability. Repainting would require the seller to contribute resources, but the property would be more likely to sell as a result.

Sometimes a seller is unwilling to make improvements to the listed property, either because he or she lacks the funds or because the seller believes that these problems are not serious issues. In these cases, the real estate professional should try to convince the seller to make concessions, either by lowering the price of the property so that its cost realistically reflects these deficiencies or by offering a repair allowance to prospective buyers so that the cost of correcting the problems can be deducted or financed with a rebate at closing.

**INCREASING ACTIVITY**

Calling the seller every time you make an appointment to show the property can help to show at least the appearance of activity and evidence of your diligence in marketing the property. Even when a prospective buyer does not show up for a
showing, the seller will often still feel that something is happening that is connected to selling the property. If the showing does occur, you should try to get feedback about the property from the prospective buyer or from his or her representative; you should share this information with your seller as soon as possible. You may, for example, want to have a simple survey ready for prospective buyers or their representatives to fill out, so that you have written comments that the seller can easily review.

Another technique that is especially popular in larger real estate companies is to have other salespeople in your brokerage firm preview the property. This previewing familiarizes them with the company’s listing inventory, but it also gives you a risk-free opportunity to collect feedback for your seller client. You can collect this feedback with a written survey, just as you would from prospective buyers, and obtain a collection of feedback at the start of the marketing process. This feedback allows you to learn what other real estate professionals think of the property’s price and condition, as well as what improvements they would suggest. Convey these results to the seller, and then start formulating a marketing plan that incorporates your colleagues’ ideas and your own to increase your chances of finding a buyer.

To promote attendance at this sort of event, you might want to have a contest in which licensees are asked to guess the eventual selling price and offer a prize to the person whose guess is closest. You could also simply offer a prize drawing for the licensees who attend the showing and fill out the survey.

A third technique that works in some instances is to hold an open house. To conduct an open house, the licensee puts out signs and advertising to let people know that he or she will be at the seller's property during set hours on a specific day. During the time that the house is open to the public, prospective buyers or other licensees may preview the property. It is usually a good idea to have the seller clean the property beforehand and leave the property during the open house, so that prospective buyers can feel more at ease. It is important to prepare a sign-in sheet that attendees are required to sign; this sheet gives the seller another visible reflection of market activity and can help to show that the efforts required for an open house are worthwhile.

A fourth technique that is well suited to properties that need repairs or improvements is to request that the seller pay for a licensed real estate inspector to inspect the property and write a report. This inspection achieves several things:

- It takes the pressure off the licensee to uncover and disclose the property’s defects and deficiencies.
- A professional inspector’s report gives the seller objective, professional information about what needs to be done to the property.
The inspection report can be presented to prospective buyers, reassuring them about the property’s condition and providing a clearer picture about the problems that a buyer might confront if he or she purchased the property.

The inspection results can help you convince a seller to adjust his or her asking price or to address some of the property’s problems. Then, proof of repairs can be provided to prospective buyers, along with the inspection report.

**EDUCATING SELLERS ABOUT THE MARKET**

Finally, it can be helpful to educate your sellers about the market. For example, many licensees will take their clients to view competing properties. Either at the time of listing or at the first sign of inactivity, you should take some time to ensure that your seller understands the competition. Most prospective buyers look at ten or more properties before making a final decision. Prospective buyers are understandably cautious, because a residential real-estate purchase is often the biggest purchase a person will ever make.

Sellers’ sentimental attachment to their homes can make it difficult for them to see and judge their properties objectively. Patiently offering market information is a good way to build trust and help sellers form realistic expectations about prices and the rapidity with which their properties may sell. If a seller seems unusually unrealistic and is unwilling to be persuaded that his or her view needs to change, then you might want to reconsider representing the listing.

**SUMMARY**

This lesson described the basic issues involved in managing a listing after it has been obtained. We discussed general marketing concerns, as well as the fundamentals of conducting effective showings and how to keep your seller realistic and in good spirits even when there is not a great deal of interest in his or her property.

The most important part of marketing a listing successfully is being honest and direct with the seller. Keep the seller informed about all factors that may affect the property’s marketing, selling time and sale price. Place a “For Sale” sign in front of the property if you are permitted to do so. Gather all the relevant information about the property and place it on the MLS along with several photographs displaying different views of the house.

The licensee should identify any improvements that are needed to make the property marketable, and develop a plan of action under which either the seller agrees to make those improvements or agrees to provide concessions in the contract to make the property more appealing to prospective buyers. When a property needs repairs, it is often helpful if the seller will pay for a licensed real
estate inspector to inspect the property and write a report. This report gives the seller objective data about the property’s problems. You can also use the information, surveys and reports you have gathered to convince reluctant sellers that your plan for marketing and improvements is appropriate.

To keep the seller happy, make sure to keep him or her informed. Even if you do not have news, stay in touch with the seller and express your concerns about the lack of activity as well as your plans for remedying the problem. Be certain that a lack of activity on the listing is not confused with a lack of effort on your part. Get feedback about the property from prospective buyers and from other licensees; use this information to shape your marketing plan and as a source of data to share with your client.

You can often stimulate interest in a listing by holding an open house. If you prepare a sign-in sheet for attendees and a survey for everyone to fill out, you can use the open house as another chance to collect information that will help you gauge interest in the property, as well as helping you to decide whether your marketing approach is the right one. Through your honesty and diligence, you will earn the confidence and respect of the sellers you represent.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON SIX
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Activity
- Case Studies

INTRODUCTION

This module has covered a lot of specific information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided in this module, using a series of exercises and case studies. The first half of this lesson uses a matching exercise to explore your knowledge of a listing agreement’s basic parts. The second half presents case studies that examine the principles and ideas presented in this module. Upon completion, the student will have a better understanding of the real-world applications of the information he or she has been studying in this module.

ACTIVITY

THE PARTS OF A LISTING AGREEMENT

In this exercise, the student will demonstrate his or her knowledge of listing agreements by matching, for each of the parts of a listing agreement described, where in the agreement this description would be found. Indicate location by writing the appropriate term after each description.

<table>
<thead>
<tr>
<th>Type of Agreement</th>
<th>Term</th>
<th>IRS Information</th>
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<tbody>
<tr>
<td>Names of All Sellers</td>
<td>Broker’s Authority</td>
<td>Special Provisions</td>
</tr>
<tr>
<td>Real Estate Firm</td>
<td>Commission Agreement</td>
<td>Indemnification</td>
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<tr>
<td>Legal Description</td>
<td>Broker Protection Clause</td>
<td>Antitrust Declaration</td>
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<tr>
<td>Listing Price</td>
<td>Seller Representations</td>
<td>Nondiscrimination Clause</td>
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<td>Wording</td>
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<td>Wording</td>
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</table>

(1) This Listing begins on 12 March 2005 and ends on 12 September 2005.

(2) If, after termination of the listing, but during the period stated above, the seller agrees to sell the property to a party whom the broker has identified, then the broker is entitled to receive commission for the sale of the property.
(3) The commission and services determined by this agreement were negotiated by the seller and the broker and were not set by any trade association or organization.

(4) Seller: Mr. & Mrs. Z.

(5) Lot 7 in Block 2 of the Curfew Sound Subdivision, City of Gray, Elegy County, [STATE].

(6) The sellers certify that they are natural-born citizens of the United States of America.

(7) Bronson, Bronson & Tweed, Brokers.

(8) This property is to be shown to and may be purchased by any genuinely interested party, regardless of race, creed, color, national origin, family status, sex, handicap or religious preference.

(9) The seller instructs the broker to list the property at the following selling price: $116,000.

(10) The seller agrees to fully and truthfully complete the disclosure(s) required by state and national law.

(11) The broker is hereby granted the authority to place a “For Sale” sign on the property and remove any and all other signs offering the property for sale.

(12) In the event that the fee is earned and payable, the seller will pay the broker 10 percent of the property’s gross selling price.

(13) The seller instructs the broker to show the property only after 3:00 PM, Monday through Saturday.

(14) The broker is granted an exclusive right to sell the property.

(15) The broker and seller agree to hold each other harmless in the event that one supplies incorrect information to the other, including both intentional and unintentional misinformation.
THE PARTS OF A LISTING AGREEMENT ANSWERS

(1) This Listing begins on 12 March 2005 and ends on 12 September 2005. **Term**

(2) If, after termination of the listing, but during the period stated above, the seller agrees to sell the property to a party whom the broker has identified, then the broker is entitled to receive commission for the sale of the property. **Broker Protection Clause**

(3) The commission and services determined by this agreement were negotiated by the seller and the broker and were not set by any trade association or organization. **Antitrust Declaration**

(4) Seller: Mr. & Mrs. Z. **Names of All Sellers**

(5) Lot 7 in Block 2 of the Curfew Sound Subdivision, City of Gray, Elegy County, [STATE]. **Legal Description**

(6) The sellers certify that they are natural-born citizens of the United States of America. **IRS Information**

(7) Bronson, Bronson & Tweed, Brokers. **Real Estate Firm**

(8) This property is to be shown to and may be purchased by any genuinely interested party, regardless of race, creed, color, national origin, family status, sex, handicap or religious preference. **Nondiscrimination Clause**

(9) The seller instructs the broker to list the property at the following selling price: $116,000. **Listing Price**

(10) The seller agrees to fully and truthfully complete the disclosure(s) required by state and national law. **Seller Representations**

(11) The broker is hereby granted the authority to place a “For Sale” sign on the property and remove any and all other signs offering the property for sale. **Broker’s Authority**

(12) In the event that the fee is earned and payable, the seller will pay the broker 10 percent of the property’s gross selling price. **Commission**

(13) The seller instructs the broker to show the property only after 3:00 PM, Monday through Saturday. **Special Provisions**

(14) The broker is granted an exclusive right to sell the property. **Type of Agreement**
(15) The broker and seller agree to hold each other harmless in the event that one supplies incorrect information to the other, including both intentional and unintentional misinformation. **Indemnification**

**CASE STUDIES**

**CASE STUDY ONE**

The purchase agreement is a form that is sometimes executed along with a listing agreement. The purchase agreement is a document detailing the purchase price and conditions of the transaction. What happens when a purchase agreement is entered into during the term of the listing agreement, but closed after the expiration of the listing agreement? Does that transaction generate a commission for the listing broker?
CASE STUDY ONE RESPONSE
According to one recent court case in the State of Minnesota, the answer was no! The court found that the broker was not due a commission because the listing agreement did not specify that the broker as entitled to a commission after the listing agreement had expired. Situations like the one described in this case study are usually complicated, and are best resolved with the help of an attorney. This kind of case does illustrate, however, why many brokerages will only list with an exclusive right-to-sell listing agreement and why many brokers require that protection periods be written into their listing agreements.

CASE STUDY TWO
The statements below pertain to the creation and execution of a listing agreement. Some of the sentences contain errors—that is, they do not accurately describe any step involved in creating or executing a valid listing agreement because the situation described in the statement violates the law or violates the professional conventions surrounding listing agreements. Read each bulleted item and check any sentence you think contains errors.

- Seller A hires Salesperson S to help sell his house.
- Salesperson S signs a listing agreement with Seller A.
- Salesperson S manages Seller A’s contact and communications with the brokerage firm—that is, Seller A has no direct contact with a broker.
- Broker B is hired to find a ready, willing and able buyer to purchase the seller’s property.
- Broker B may only perform these duties in the name of, and under the supervision of, Salesperson S.
- Salesperson S is a general agent of Broker B and has a fiduciary duty to Seller A created by the salesperson’s relationship with the broker.
- Salesperson S should ensure that any prospective sales transaction is reviewed by Seller A.
- Salesperson S should ensure that Broker B is kept informed about any agreements he or she makes, so that the broker can ensure that that these conform to relevant laws and firm policies.
## CASE STUDY TWO RESPONSE

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<td>▪ Seller A hires Salesperson S to help sell his house.</td>
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<td>X</td>
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## CASE STUDY THREE

In the Pennsylvania Superior Court case *Knoblauch, Inc. v. Singer*, the court held that a written agreement for the marketing of several properties, signed by both a broker and a seller, was not invalidated simply because it lacked a specific termination date not subject to prior notice [No. 229 M.D.A 2001 (Pa. Super. Ct., April 9, 2002)]. This memorandum overturned a previous trial court decision in which it was concluded that the broker was not entitled to a commission.

The broker in this case, Knoblauch, had drafted a letter stating that if any of the four listed properties were sold, Singer (the seller) would pay Knoblauch a five percent commission. Both parties signed the letter and more than a year later several of the properties were sold. At this time, Singer refused to pay Knoblauch the five percent commission, appealing to the fact that the letter did not contain a definite termination date not subject to prior notice, which listing agreements are required to have under Pennsylvania’s Real Estate and Licensing and Registration Act (RELRA).

Knoblauch argued that the commission was nevertheless due to him, as the letter was not a listing agreement, only a “finder’s letter.” This claim complicated matters in the trial, because the RELRA does not establish any sort of standards that this sort of letter must meet. The trial court ultimately concluded that Singer was *not* required to pay the commission, because the commission arrangement
was based on a legally invalid listing agreement. However, the appeals court overturned this ruling, holding that while the letter failed to meet the standards of a listing agreement (because it failed to state the price and terms of the commission agreement and did not require that Knoblauch be the procuring cause of sale), it nonetheless created a contractual relationship between Knoblauch and Singer and obligated Singer to pay Knoblauch the commission they had negotiated.

**SOURCE:** “Some Commission Agreements Escape Requirement for ‘Listing Agreements’ Under Licensing Act” by Harris Ominsky

We should not interpret this result to mean that a licensee need not include termination dates in a listing agreement or that a licensee can omit price and terms from an agreement contract and still prevail in court. It is true that this might happen, but it is much more prudent to create listing agreements that meet professional standards of practice.

It is also essential that a licensee’s listing agreements conform to his or her state’s license laws. **Note** that if Knoblauch’s document had been judged to be a listing agreement, he would not have been entitled to a commission because his agreement did not meet the standards established in the Pennsylvania license laws. He only obtained a commission because the Superior Court concluded the document was not, in fact, a listing agreement.

**CASE STUDY FOUR**

In September of 1997, the Hubbell Commercial Brokers, L.C. (doing business as CB Richard Ellis/Hubbell Commercial) sued another brokerage firm and a real estate partnership (Fountain Three, a partnership, and R & R Investors, Ltd.) for violating a mutual agreement.

The Fountain Three partnership owned a retail development in West Des Moines, called “The Shoppes at Three Fountains.” R & R Investors, Ltd. was one of Fountain Three’s partners; they were also a licensed real estate brokerage in Iowa. Hubbell Commercial Brokers, L.C., was also a licensed real estate brokerage in Iowa, doing business as CB Richard Ellis/Hubbell Commercial.

A company called Golf Galaxy enlisted Hubbell’s services (i.e., the services of CB Commercial Real Estate Group, Inc.) to find retail space for golf stores in Iowa. After extensive negotiation, Hubbell arranged a lease through a second brokerage firm, R & R Investors, Ltd., creating an agreement to share commissions from the transaction. One of the terms of the written lease agreement made Fountain Three responsible for any commission. When the
transaction was concluded, Fountain Three and R & R Investors, Ltd. refused to pay commission to Hubbell, claiming that the contract did not comply with the Iowa Real Estate Commission’s rules governing listing agreements. Hubbell sued, seeking payment of the commission and claiming breach of contract, among other issues.

A jury found that Hubbell had satisfactorily proved the existence and terms of a contract, the performance of all the terms, breach of the contract, and damages. The parties stipulated that the amount of the disputed commission was $69,000. The jury returned a verdict against Fountain Three and R & R Investors, Ltd. on both theories of recovery for $69,000.

This case was appealed in 2002 before the Iowa Supreme Court, which once again found for Hubbell. Fountain Three and R & R Investors, Ltd. once again claimed that the contract which was the subject of the case was unenforceable because it did not conform to the IREC’s rules and regulations. The court concluded that the IREC’s rules and the state laws regarding real estate listing agreements were written to protect clients from the practices of brokers, and do not apply to an agreement made between two brokers. Fountain Three was ordered to pay the contested commission plus damages to Hubbell.

CASE STUDY FIVE

Broker X represents Seller F. Shortly after the expiration of their listing agreement, Seller F successfully sells his property to Buyer X. Even though the listing agreement expired, Seller F still had to pay Broker X a commission.

Can you think of a relevant reason why this might have been the case?
CASE STUDY FIVE RESPONSE
There could be a variety of special circumstances that could lead to this. However, more than likely, Broker X and Seller F’s listing agreement contained a protection period. This means that Broker X probably gave Seller F a list of prospective buyers. If any of those buyers purchased the property within the protection period, then Broker X would still receive a commission.
## Texas Principles of Real Estate
### Module 12: Closing and Settlement Costs

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<th>Section</th>
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<td><strong>Lesson 1: Real Estate Closings</strong></td>
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<td>• Pre-Closing Requirements</td>
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<td>• Real Estate Settlement Procedures Act (RESPA)</td>
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<td><strong>Lesson 2: Expenses</strong></td>
<td>40 minutes</td>
</tr>
<tr>
<td>• Allocating Expenses</td>
<td></td>
</tr>
<tr>
<td>• Credits and Debits</td>
<td></td>
</tr>
<tr>
<td>• Prorating Expenses</td>
<td></td>
</tr>
<tr>
<td><strong>Lesson 3: The HUD-1 Settlement Statement</strong></td>
<td>90 minutes</td>
</tr>
<tr>
<td>• General Guidelines for the HUD-1 Settlement Statement Form</td>
<td></td>
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<tr>
<td>• Settlement Charges</td>
<td></td>
</tr>
<tr>
<td>• Summary of Borrower’s Transaction</td>
<td></td>
</tr>
<tr>
<td>• Summary of Seller’s Transaction</td>
<td></td>
</tr>
<tr>
<td><strong>Lesson 4: Real World Practice</strong></td>
<td>40 minutes</td>
</tr>
<tr>
<td>• Field Application of Settlement Statement Knowledge</td>
<td></td>
</tr>
<tr>
<td>• Insight into Closings and Settlement Costs</td>
<td></td>
</tr>
<tr>
<td><strong>Lesson 5: Texas State Laws and Regulations on Closings and Settlement Costs</strong></td>
<td>10 minutes</td>
</tr>
<tr>
<td>• Closing a Transaction in Texas</td>
<td></td>
</tr>
<tr>
<td>• Texas Guidelines for Calculating Settlement Expenses</td>
<td></td>
</tr>
</tbody>
</table>

**Total Lesson Time:** 240 minutes (4 Hours)
INTRODUCTION

Some real estate licensees believe that their job ends when the purchase and sales contract is signed, and in fact, in many states, the licensee has no official duties throughout the closing process. However, transactions can and do fall apart during the closing stage. Licensees who are familiar with closing procedures and settlement costs can stay involved and make sure that their transactions meet the desired end.

In accordance with TREC rules Sections 535.71 and 535.72D, this module covers the buyer’s and the seller’s concerns at closing, the required documents to close a transaction and the rules and regulations of the closing process. It covers a broad range of issues related to closing and settlement. To help the student learn ways to help clients through this at times complicated process, it includes the following lessons:

- Real Estate Closings
- Expenses
- The HUD-1 Settlement Statement

In addition, this module includes a final practice lesson. This concluding lesson presents real-world dilemmas and concrete applications of the information presented in the rest of the course. As the student completes this module, he or she should try to develop a broad picture of closing and settlement and how they fit into the larger practice of real estate. The last lesson will help with this project by presenting comprehensive content questions, practice problems and case studies.
KEY TERMS

**Accrued Item:** Seller expenses that are treated in a particular way at closing. Accrued items are prorated costs that a seller owes (such as real estate taxes in states where these are not prepaid), but which will ultimately be paid by a buyer after he or she receives title to a property. That is to say, these expenses have been (or are being) incurred, but need not be paid at the time the sale closes. In an effort to ensure that these expenses are handled fairly, the seller generally pays the buyer for these items through credits at closing. For example, a seller might credit a buyer for the proportion of annual real estate taxes that were charged during the part of the year that the seller occupied the property.

**Affidavit of Title:** A legal guarantee regarding the condition of a property’s title. In this affidavit, the seller swears to his or her legal identity and marital status; the seller also testifies that he or she has had no, bankruptcies, divorces or legal judgments made against him or her since the date of the title examination—i.e., that the title is in the same condition as it was at the time of the examination. The affidavit also generally entails that that there are no unrecorded deeds or contracts for the property and that the owner has paid for all repairs and improvements that have been made recently or that were stipulated as part of the sale.

**Banking Year:** A 360-day year (or 12 months of 30 days each) that is often used in banking and other financial practices.

**Closing Date:** (also sometimes called the “settlement date”) The closing date is the culmination of a real estate transaction; it is date on which a seller delivers the deed to a property (transferring title to the buyer) and the buyer pays for the property. This date is generally specified in the purchase and sales agreement.

**Closing Statement:** (also sometimes called a “settlement statement”) The closing statement is a detailed, comprehensive document that summarizes each party’s debits and credits, as well as the funds that each party has contributed to the transaction thus far. This document is also often used to calculate the total amount that the buyer must bring to the settlement.

**Credit:** A credit is a positive balance or a positive amount. For our purposes, it is a figure entered in a party’s favor when determining the overall costs associated with a transaction. On closing statements, credits reflect expenses that have been paid by a particular individual or expenses that are owed to that individual. Credits stand in contrast to debits.

**Debit:** A debit is a negative balance or a negative amount. For our purposes, it is an amount due from or owed by a particular individual when determining the overall costs associated with a transaction. On closing statements, debits reflect
charges made to the parties involved in the transaction. Debits stand in contrast to credits.

**Escrow:** An agreement between two or more parties which establishes that certain instruments, funds or property are to be placed with a third party for safekeeping, pending the fulfillment of certain conditions or the performance of specific acts.

**Escrow Closing:** The term “escrow closing” describes a closing transaction in which a disinterested third party (often an escrow agent) presides over the closing. This disinterested third party generally acts according to escrow instructions that have been created by the principals involved in a transaction. It is usually the case that this third party is entrusted with funds and many of the important documents that are involved in a real estate transaction; paperwork is often handled through this third party, and the other parties might not be present at the closing.

**First User Loan:** The Department of Housing and Urban Development (HUD) defines a first user loan as “a loan to finance construction of a new structure or purchase of manufactured home where the structure was constructed for sale or the manufactured home was purchased for purposes of resale and the loan is used as or converted to a loan to finance purchase by the first user.”

**Mortgage Reduction Certificate:** (sometimes called a “reduction certificate” or a “payoff statement”) A document issued by a mortgage lender (i.e., a mortgagee) that records the amount owed on a mortgage loan as of a certain date. A mortgage reduction certificate is issued in some cases when the buyer takes over the seller’s mortgage loan. However, this document can be useful in nearly all transactions, as it is both the seller and the buyer’s best interests to have a clear legal picture of a property’s mortgage.

**Payoff Statement:** (sometimes called a “reduction certificate” or a “mortgage reduction certificate”) A document issued by a mortgage lender (i.e., a mortgagee) that shows the exact amount required to pay an existing loan. This document can be useful in nearly all transactions, as it is both the seller and the buyer’s best interests to have a clear legal picture of a property’s mortgage.

**Passing Papers:** The phrase “passing papers” describes a closing transaction in which the principals meet face-to-face and exchange documents. This phrase is sometimes also used informally to refer to closing in general, but it most accurately describes a closing in which the principals meet to exchange documents.

**Principal:** For our purposes, a “principal” is one of the primary parties involved in a real estate transaction. For example, in a standard two-party sale, the buyer and the seller are the principals to the transaction.
**Prepaid Item:** The term "prepaid items" refers to certain seller’s expenses on a closing statement. A prepaid item is an item that has been paid for ahead of time, generally by the seller. For example, a seller might have prepaid an insurance policy that is required by the local homeowner’s association. A buyer must then generally “purchase” this item from the seller at the time of the sale, either with cash, credits or in some other way that the principals have negotiated.

**Proration:** Proration is a means of calculating partial costs owed (or benefits due) so that they are distributed proportionately between two or more parties. For example, if a buyer purchases a home in the middle of the tax year, it would be unfair for that buyer to pay all of the year’s property taxes when he or she only occupied the property for part of the year. In this case, proration would be used to determine what proportion of the property tax the buyer should pay for that year. In this course, the term “proration” will be used to describe the process of dividing prepaid items or accrued items (such as utility bills) between a buyer and a seller.

**Settlement:** The division of expenses and funds between a buyer and a seller. This term is sometimes used interchangeably with “closing,” but it more accurately describes the process that occurs as a buyer and a seller settle their costs and payments with one another.

**Settlement Statement:** (also commonly called a “closing statement”) The settlement statement is a detailed, comprehensive document that summarizes each party’s debits and credits, as well as the funds that each party has contributed to the transaction thus far. This document is also often used to calculate the total amount that the buyer must bring to the settlement.

**Survey:** A survey is a detailed legal description of a property that is created through surveying, which is the process of measuring a property’s exact boundaries. There are a variety of legitimate survey methods that are documented in different ways. The sort of property at issue usually determines the most appropriate survey method.

**Title Evidence:** Title evidence is documentation regarding the current condition of a property’s title. This evidence generally includes the abstract of title as well as the attorney’s opinion of the title, the title insurance and the certificate of title. This evidence may include other documentation, such as a title commitment or a title report; the overarching objective of assembling title evidence is to collect all relevant information about the documents, records, judgments, liens, and other public records data pertaining to the history and current condition of a property’s title.
LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Outline the primary concerns that arise throughout the closing process, for both the buyer and the seller.
- Describe what both the buyer and the seller must do to prepare for the closing date.
- List the documents that the buyer and the seller must complete to close a typical real estate transaction.
- Explain a licensee’s responsibility with respect to IRS Form 1099-S and HUD’s “Notice to the Homebuyer” form.
- Name and distinguish the different types of closings.
- Describe the licensee’s role in the closing process.
- Outline the basic requirements and regulations imposed by the Real Estate Settlement Procedures Act (RESPA).
- Identify which party is responsible for each expense in a typical closing transaction.
- Explain the concept of credit and the concept of debit.
- Prorate prepaid items and accrued expenses.
LESSON ONE
REAL ESTATE CLOSINGS

This lesson focuses on the following topics:

- Pre-Closing Requirements
- Closing Procedures
- Required Documents
- Reporting Transactions to the IRS
- Licensee’s Role
- Real Estate Settlement Procedures Act (RESPA)

INTRODUCTION

In many states, a real estate licensee’s official, legal responsibilities to the principals involved in a real estate transaction end with the signing of the sales contract. Even though a licensee may not have any legal obligation to provide services throughout the closing process (the final stage of the real estate transaction), it is not prudent simply to walk away from a transaction after the sales contract has been signed. Deals can and do fall apart during the closing process, and when a transaction fails to close this can mean unsatisfied clients and no commission. Real estate professionals who understand closing procedures and regulations can stay involved right up to the end of a transaction, helping to ensure that their principals’ transactions close appropriately.

NOTE: Most real estate licensees are not lawyers; unless a real estate professional is also a licensed attorney, he or she does not have the authority to give legal advice and can face liability and punishment for the unauthorized practice of law. If the buyers and sellers with whom you work need legal advice, or if they ask you for legal advice, you should recommend that they consult real estate attorneys before signing any legally binding documents.

PRE-CLOSING REQUIREMENTS

The closing process is the culmination of a real estate transaction, in which a buyer pays a seller to transfer the property’s title to the buyer. This process will proceed more smoothly if both the buyer and the seller have made the appropriate preparations beforehand.

SELLERS’ CONCERNS

In most transactions, a seller is primarily concerned with getting as much as possible of his or her requested purchase price. Therefore, a seller should verify
that a prospective buyer has the necessary funds or has obtained appropriate financing before agreeing to close a real estate transaction. To prevent any delays, a seller should also make certain that he or she has complied with all of the prospective buyer’s requirements, such as making repairs to the property or having the property inspected for rodents and insects.

Though price is an important consideration for most sellers, each transaction will present its own unique issues that will be determined by a seller’s specific goals and desires. Regardless of a transaction’s distinctive features, sellers should be discouraged from becoming so focused on price that they neglect other significant concerns.

BUYER’S CONCERNS

As we noted, a seller will generally be quite concerned about a prospective buyer’s ability to pay for the property. Before closing, then, a prospective buyer must do everything he or she can to demonstrate that he or she will be able to complete the transaction that has been negotiated with the seller. The specific things that a particular buyer must do to demonstrate this will vary from case to case, but licensees can be of great help by providing general guidance about financing and directing prospective buyers to financial professionals who can help them with funding and documentation.

Once a buyer has secured funding for the transaction, he or she is generally primarily concerned with getting a marketable title from a seller—that is to say, most buyers are focused on obtaining a title that is apparently complete and otherwise in proper order. This does not mean that it is in fact free of defects or other inaccuracies, only that it seems to cover the subject property in its entirety and to be otherwise complete.

A marketable title need not be perfect; it may have liens, encumbrances or other defects as long as the buyer openly accepts these as part of the purchase contract. A marketable title is one that permits an owner to sell or transfer a property freely, and it is generally understood to be a title that prospective buyers can or should accept without objection. When a buyer accepts a marketable title, he or she can usually feel secure in the purchase because a marketable title is one that the buyer will not have to defend against other claimants.

A marketable title, then:

- Allows the recipient of the title to exercise ownership rights without having to defend those rights through litigation.
- Shows that the property can be sold or mortgaged at fair market value by a practical and knowledgeable individual.
- Does not have any defects that have not been openly accepted by the buyer.
• Does not have any liens or encumbrances that have not been openly accepted by the buyer.

Many real estate transactions aim at exchanging a marketable title for a property’s purchase price, but it is not always easy to ensure that a title is actually marketable. A clear or marketable title can only be provided through the work of a seller’s attorney or title insurance company.

Before closing, a buyer will want to do the following things to help ensure that he or she receives a marketable title:

• Ensure that the proper professionals (e.g., title abstracters or title insurance agents) examine all records and paperwork associated with the title, including public records, current and past leases, evidence of title, the deed and any documents connected with liens or other encumbrances.
• Make certain that the property survey is accurate, perhaps by asking an independent surveyor to examine it.
• Conduct a final inspection (or walk-through) with a professional inspector to ensure that the property is as the seller has represented it to be.

PRE-CLOSING RESPONSIBILITIES REGARDING FHA-INSURED MORTGAGES

When working with borrowers on transactions that rely on FHA-insured mortgages, lenders are required to give buyers the one-page Notice to the Homebuyer form. This form was created as part of NAR® and HUD’s joint Homebuyer Protection Initiative; it explains the difference between an appraisal and a home inspection and recommends that buyers obtain an inspection. We have provided a copy of this form here for educational purposes only.
**NOTICE TO THE HOMEOWNER**

Read Carefully

As part of our job insuring the mortgage for the lender, the FHA requires the lender to conduct an appraisal to:

- estimate the value of your potential new home
- ensure it meets minimal FHA standards
- ensure it will be marketable

Appraisals are different from home inspections. Home inspections give more detailed information about your potential new home.

This report is a summary of the observations of an appraiser who visited the property. If there was a problem, the appraiser answered "YES" under "Problem".

<table>
<thead>
<tr>
<th>Physical Condition</th>
<th>Problem (Y)</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Site Hazards</td>
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<td></td>
</tr>
<tr>
<td>Soil Conditions</td>
<td>□</td>
<td></td>
</tr>
<tr>
<td>Grading and Drainage Problems</td>
<td>□</td>
<td></td>
</tr>
<tr>
<td>Well, Individual Water Supply and Septic Problems</td>
<td>□</td>
<td></td>
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<tr>
<td>Wood Destroying Insects</td>
<td>□</td>
<td></td>
</tr>
<tr>
<td>Private Road Access and Maintenance Problems</td>
<td>□</td>
<td></td>
</tr>
<tr>
<td>Structural Deficiencies</td>
<td>□</td>
<td></td>
</tr>
</tbody>
</table>

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FSS HUD-92504-MS (Part 3: Homebuyer Summary) Page 1 of 2 Modified 1/1/2006
CLOSING PROCEDURES

Let’s assume that Broker A, Seller B and Buyer C have arrived at an agreement about the sale of Seller B’s condominium. The principals have settled on a price and taken all the necessary steps to ensure a smooth sale: they have hired
professionals to research and insure the title; they have had the property professionally appraised and inspected; and the buyer has secured appropriate financing. It is now time to transfer the title from Seller B to Buyer C and sign all of the important documents associated with the sale.

The first step in closing the property is to make sure that all principals understand the terms and conditions of the purchase contract, as well as any addenda. One or both parties may wish to consult an attorney before signing the sale paperwork; licensees should encourage those who desire legal advice (or any other guidance that falls outside the licensee’s field(s) of expertise) to enlist the help of a professional. Once the parties are sure they understand everything to which they are agreeing, there are a variety of ways the contract and the other essential paperwork associated with the closing process can be completed.

**FACE-TO-FACE CLOSING**

Some closings are aptly described by the phrase “passing papers”—a process in which principals and their representatives meet face-to-face and exchange documents required to close the sale.

Face-to-face closings can be held in a variety of locations, including a broker’s office, the buyer’s attorney’s office, the seller’s attorney’s office, a title company office, lending institution office or at the offices of the county clerk or recorder or at the escrow company. A face-to-face closing involves the principals to the transaction, but it frequently involves other individuals as well. For example, buyers and sellers may have their attorneys and brokers present, if they wish. In addition, representatives from lending institutions and the title insurance companies may attend closings.

Usually one person presides over the closing, such as a broker, the buyer’s or the seller’s attorney, a representative from the lending institution or a title company representative. He or she is responsible for calculating the settlement, that is, for calculating the division of expenses and funds between the buyer and the seller.

**ESCROW CLOSING**

The term “escrow closing” describes a closing transaction in which a disinterested third party (often an escrow agent) presides over the closing. This third party has no personal interest in the transaction and does not represent either of the principals.

One of the parties selects a company or individual to serve as the escrow agent (or escrow holder); this might be the escrow department of a bank or other lending institution, an attorney, a title company, a trust company or an escrow company. This disinterested third party generally acts according to escrow
instructions that have been created by the principals involved in a transaction. It is usually the case that this third party is entrusted with funds and many of the important documents that are involved in a real estate transaction; paperwork is often handled through this third party, and the other parties might not be present at the closing. If one or both of the principals is absent from the closing meeting, copies of the settlement statement should be mailed or delivered to the absent parties immediately after closing.

**NOTE:** Some states have laws or regulations specifying which party (or parties) may choose the escrow agent. Otherwise, the parties negotiate to decide which party gets to choose or to select an escrow agent together.

In an escrow closing, the buyer and the seller first sign the sales contract, and then the broker gives the earnest money to the escrow agent to deposit in a trust account; this money is described as being held in escrow. Before the closing date, the buyer and seller must give the escrow agent all of the completed, legally valid documents that will be needed to complete the closing.

**REQUIRED DOCUMENTS**

Diverse individuals have an interest in the outcome of any real estate transaction; these varied interests are reflected in the documentation that is required for a real estate sale. For example, the lender that is helping to finance the purchase has an interest in the property and will want assurance that its title is marketable, that the property’s taxes and insurance are maintained and that the lender’s mortgage lien will have priority over any other liens. Before closing, a lender may require the following items:

- A title insurance policy
- A fire and hazard insurance policy
- A survey
- A pest inspection certificate
- A reserve account for property taxes and insurance

These documents help lenders to identify and evaluate the property for which the loan is intended, and to determine whether the risks associated with that loan are ones they want to assume. Lenders may require other documents as well; the list above is only meant to convey a general idea of the kind of supporting paperwork that is likely to be required.

Beyond these documents, the buyer and seller will have to supply additional paperwork to complete the transaction. If the closing will be face-to-face, they can bring the documents with them. If an escrow agent is conducting the closing, the buyer and seller will need to give the documents to the escrow agent before the closing date.
The documents that the seller must supply include:

- Title evidence (legal documentation regarding the current condition of a property’s title)
- The deed
- Hazard insurance policies
- Any affidavits of title or other documents needed to clear the title
- Any payoff statements or mortgage reduction certificates (documents issued by a mortgage lender that show the exact amount required to pay an existing loan)

The documents that the buyer must supply include:

- Evidence that he or she has secured a loan
- Property insurance policies
- The agreed-upon amount of cash (usually in the form of a cashier’s check) needed to close on the property
- Any other documents required by the title company

The particular features and requirements of a transaction determine the specific documents necessary in any given transaction. The documents listed here are only intended to give a general picture of the paperwork that is often involved in a typical real estate sale.

**REPORTING TRANSACTIONS TO THE IRS**

**FORM 1099-S**

Licensees need to be aware that the sale of stock in cooperative housing corporations, as well as sales of land, condominium units and permanent structures, including residential, commercial and industrial buildings, must be reported to the Internal Revenue Service (IRS). Usually the closing agent or the mortgage lender will fill out the Form 1099-S for this type of transaction, but any licensees involved in the transaction could be held liable if the IRS is not properly notified.

Various parties can be designated as the person responsible for filing the 1099-S, including the transferor’s attorney, the transferee’s attorney and the disbursing title or the escrow company. The IRS provides extensive guidelines about who can be held responsible for filling this form, and in what circumstances.

**LEARN MORE:** IRS instructions for Form 1099-S can be found online at: [http://www.irs.gov/instructions/i1099s/ar02.html#d0e189](http://www.irs.gov/instructions/i1099s/ar02.html#d0e189).

**FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT**
If a transaction is subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), then the person who is buying or receiving property must determine whether the individual who is selling or transferring property is a citizen of the United States. If the seller is not a citizen, then the buyer (or his or her representative) must withhold 10 percent of the sale proceeds and send it to the IRS within 10 days of closing. A comprehensive purchase and sale agreement should include a paragraph that explains this act, to ensure that all parties are advised of their responsibilities in this regard.

There are exceptions to FIRPTA. One of the most common exceptions to FIRPTA releases a transferee (i.e., a purchaser or a buyer) from the obligation to withhold tax in cases in which the buyer purchases real estate for use as his or her home and the purchase price is not more than $300,000. Residential property transactions that meet these conditions are thus often exempt from FIRPTA’s requirements. Licensees should encourage principals to consult with tax attorneys on this point, however, and should not advise people about whether FIRPTA applies to their transaction.


Of special interest for our purposes is the section of Publication 515 that discusses U.S. real property interest; this section can be found online at: [http://www.irs.gov/publications/p515/ar02.html#d0e5964](http://www.irs.gov/publications/p515/ar02.html#d0e5964).

You may also write to receive advice and information on FIRPTA from the IRS at:
Director, Philadelphia Service Center
P.O. Box 21086
Drop Point N-423 FIRPTA Unit
Philadelphia, PA 19114–0586
Licensee’s Role

As we noted earlier, a licensee’s official responsibilities in the closing process vary from state to state. However, all licensees can do things that can help to make sure a transaction goes smoothly, regardless of what their state-mandated responsibilities may be.

Licensees can help to facilitate transactions in a variety of ways, including the following:

- When working with buyers, communicate with their lenders. Find out exactly which documents are required, and the date by which they must be submitted.
- When working with sellers, make sure that they comply with all requirements imposed by the buyer and the lender.
- Regardless of whether your client is a buyer or a seller, ensure that the client is meeting important deadlines.
- Communicate with the other party’s broker.
- Stay involved!

Use the following checklist to keep track of all of the details in the closing process.
## Closing Checklist

**Name of Client:**

<table>
<thead>
<tr>
<th>Loan Information:</th>
<th>Additional Information:</th>
</tr>
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<tbody>
<tr>
<td>Type</td>
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</tr>
<tr>
<td>Amount</td>
<td>________________</td>
</tr>
<tr>
<td>Down payment</td>
<td>________________</td>
</tr>
<tr>
<td>Interest rate</td>
<td>________________</td>
</tr>
<tr>
<td>Loan fee</td>
<td>________________</td>
</tr>
<tr>
<td>Points</td>
<td>________________</td>
</tr>
</tbody>
</table>

### Processing

<table>
<thead>
<tr>
<th></th>
<th>Due Date</th>
<th>Completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust account deposit</td>
<td>_____</td>
<td>_____</td>
</tr>
<tr>
<td>Loan application completed</td>
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<td>_____</td>
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<tr>
<td>Appraisal ordered</td>
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<td>_____</td>
</tr>
<tr>
<td>Credit report ordered</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Income &amp; funds verified</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Loan approved</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>All parties notified of approval</td>
<td>_____</td>
<td>_____</td>
</tr>
<tr>
<td>Termite inspection completed</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Other work completed</td>
<td>_____</td>
<td>_____</td>
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<td>--------------------------------------</td>
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<td>-----------</td>
</tr>
<tr>
<td>Buyer’s hazard insurance</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Loan documents signed</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Arrange possession date</td>
<td>_____</td>
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</tr>
<tr>
<td>Loan funded</td>
<td>_____</td>
<td>_____</td>
</tr>
<tr>
<td>Loan funds disbursed</td>
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<td>_____</td>
</tr>
<tr>
<td>Keys to buyer</td>
<td>_____</td>
<td>_____</td>
</tr>
<tr>
<td>Remove sold sign &amp; lock box</td>
<td>_____</td>
<td>_____</td>
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<tr>
<td>Other ________________</td>
<td>_____</td>
<td>_____</td>
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<td>Other ________________</td>
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<td>_____</td>
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<tr>
<td>Other ________________</td>
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</tbody>
</table>
REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)

The Real Estate Settlement Procedures Act (RESPA) was enacted in 1974 by the U.S. Department of Housing and Urban Development (HUD). RESPA is a consumer protection statute that aims to help educate consumers about closing and settlement services. One important goal of RESPA is to provide information that will teach consumers to be savvy judges of these services’ proper cost, and thus eliminate referral fees and other questionable tacked-on fees that can unnecessarily increase the cost of closing and settlement services. HUD’s Office of RESPA and Interstate Land Sales enforces RESPA.

RESPA applies to most loans secured by a mortgage lien placed on one- to four-family residential properties. These loans include most purchase loans, assumptions and property improvement loans; they also generally include refinancing loans and equity lines of credit. The primary condition for a loan’s falling under RESPA is that it be what is called a “federally related mortgage loan,” defined broadly in RESPA as a loan that is directly or indirectly supported by federal regulation, insurance, guarantees, supplements or assistance. This term also covers loans that the originating lender intends to sell to a federal program, such as Fannie Mae. This range of loans covers the majority of loans that are secured for home purchases.

When a borrower applies for a loan that is covered by RESPA, the Act requires that the lender or mortgage broker provide the borrower with a variety of disclosure information, including the following:

- A Special Information Booklet, containing consumer information about real estate transactions and real estate settlement services. To view or print the 1997 version of this booklet, entitled Buying Your Home: Settlement Costs and Helpful Information, visit this link: [http://www.hud.gov/offices/hsq/sfh/res/stcosts.pdf](http://www.hud.gov/offices/hsq/sfh/res/stcosts.pdf). A Good Faith Estimate (GFE) of closing and settlement costs. This estimate of the amount the borrower is likely to pay at closing should include origination fees, points and the maximum amount to be collected at closing. This GFE is merely an estimate; actual settlement costs may vary considerably. If the lender or mortgage broker requires the borrower to use a particular settlement services provider, that requirement must be disclosed in the GFE.
- A Mortgage Servicing Disclosure Statement. This statement tells the borrower whether the lender will service the loan or transfer it to another. It also gives information about complaint resolution.

Ideally, the lender will provide this disclosure information at the time of application. If the lender does not give the borrower this information at that time, it must be mailed within three business days of receiving the loan application. If
the loan is declined within three days, the lender is not obligated to provide these disclosures.

RESPA also requires that both the borrower (i.e., the buyer) and the seller receive the HUD-1 Settlement Statement at closing. The HUD-1 Settlement Statement is a standardized form that shows all of the borrower’s and seller’s charges arising from the settlement of their real estate transaction. We will discuss this form in greater detail in Lesson Three.

**NOTE:** Some states require that licensees give their clients an estimate of the expenses involved in closing the transaction at the time the purchase contract is signed. The HUD-1 Settlement Statement can be used to figure these estimates, as can the Good Faith Estimate form.

Some of RESPA’s regulations—such as its disclosure requirements—apply only to lenders. However, RESPA includes sections that impose regulations that also apply to licensees. For example, one section of RESPA is specifically concerned with reducing the unnecessary and ethically dubious charges that can sometimes be associated with settlement and closing services. This part of RESPA explicitly “prohibits anyone from giving or accepting a fee, kickback or any thing of value in exchange for referrals of settlement service business involving a federally related mortgage loan.” This means, for example, that licensees cannot accept payment of any sort for referring clients to a bank. Licensees who provide computerized loan origination services also need to comply with RESPA regulations.

Violations of RESPA regulations can lead to serious penalties for both licensees and lending institution employees. Fines of up to $10,000 can be assessed, as can prison terms for up to a year. Further details about penalties can be found in Section 8 of RESPA.

**LEARN MORE:** You can read more about RESPA on HUD’s Website at: [http://www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm](http://www.hud.gov/offices/hsg/sfh/res/respa_hm.cfm). Specific details about the requirements imposed by the RESPA statutes can be found at: [http://www.hud.gov/offices/hsg/sfh/res/respa_st.cfm](http://www.hud.gov/offices/hsg/sfh/res/respa_st.cfm).

**SUMMARY**

Licensees’ responsibilities vary from state to state, and in many areas, their official legal responsibilities end with the signing of the purchase contract. However, when a licensee understands the closing process, he or she can stay involved in a transaction after the purchase contract is signed. Licensees who remain involved can use their professional expertise to ensure that their hard work culminates in a transaction that closes smoothly.
Before closing a real estate transaction, buyers and sellers should ensure that their interests in the transaction are secure. The buyer should hire professionals (e.g., title abstracters) to examine all relevant documentation related to the property; he or she should also hire an inspector to conduct a final inspection of the property. The seller should make sure that he or she has satisfied all of the buyer’s requirements and that the buyer has obtained appropriate financing. Both parties must work to ensure that all of the preliminary conditions imposed on their transaction have been met; once they agree that this is the case, the licensee needs to work with the buyer and seller to ensure that they completely understand the purchase contract.

Though licensees are unlikely to be held legally responsible for these issues, they should still help to ensure that principals receive proper loan disclosures retain appropriate withholding for sales that fall under FIRPTA withholding requirements. Buyers with FHA-insured mortgages should receive the one-page Notice to the Homebuyer form. The Real Estate Settlement Procedures Act (RESPA) requires that borrowers who apply for federally related mortgage loans receive the following disclosures:

- A Special Information Booklet containing consumer information about real estate transactions and real estate settlement services.
- A Good Faith Estimate (GFE) of closing and settlement costs.
- A Mortgage Servicing Disclosure Statement.

Once the principals have judged all documentation and funding to be satisfactory and the licensee and other professionals overseeing the transaction believe everything is in order, the transaction can move toward closing. Closing can be conducted through a face-to-face meeting between the principals and their representatives; the closing process can also be overseen and conducted by an escrow agent. In all cases, the documents that the seller must supply include:

- Title evidence (legal documentation regarding the current condition of a property’s title)
- The deed
- Hazard insurance policies
- Any affidavits of title or other documents needed to clear the title
- Any payoff statements or mortgage reduction certificates (documents issued by a mortgage lender that show the exact amount required to pay an existing loan)

The documents that the buyer must supply include:

- Evidence that he or she has secured a loan
- Property insurance policies
- The agreed-upon amount of cash (usually in the form of a cashier’s check) needed to close on the property
• Any other documents required by the title company

The lender may also require additional documents before approving the loan for the transaction. The particular features and requirements of the transaction determine the specific documents that are necessary. The documents listed here are only intended to give a general picture of the paperwork that is often involved in a typical real estate sale.

RESPA is a consumer protection statute that aims to help educate consumers about closing and settlement services. One important goal of RESPA is to provide information that will teach consumers to be savvy judges of these services’ proper cost, and thus eliminate referral fees and other questionable tacked-on fees that can unnecessarily increase the cost of closing and settlement services. HUD’s Office of RESPA and Interstate Land Sales enforce RESPA.

Although some of RESPA’s regulations (such as its disclosure requirements) apply only to lending institutions, licensees need to be aware that the act also prohibits licensees from accepting fees, kickbacks or any kind of payment in exchange for their referrals of settlement service business involving a federally related mortgage loan. Specific information about these prohibited payments can be found in the RESPA statutes.

Return to your on-line course player to take the Lesson Quiz.
LESSON TWO
EXPENSES

This lesson focuses on the following topics:

- Allocating Expenses
- Credits and Debits
- Prorating Expenses

INTRODUCTION

The closing statement (also called a “settlement statement) is a document that provides a detailed list of each party’s expenses as well as how much he or she has already contributed to the transaction thus far. This statement also provides an accounting of the final amount that the buyer must bring to the closing. To complete a closing or settlement statement properly, one must know which principal is responsible for each transaction expense. A licensee must also have a clear understanding of credits and debits and should know how to prorate expenses that must be divided between the principals.

ALLOCATING EXPENSES

There are a variety of expenses associated with any real estate transaction. For example, brokers’ commissions must be paid and loans often come with significant fees. These expenses can be divided in various ways between the principals involved in the transaction; their legal responsibility varies from state to state, and many expenses can be negotiated between the principals. These variables mean that there is no single set of general guidelines that can teach a licensee how these expenses are divided between principals.

Nonetheless, there are conventions that often determine the way these expenses are allocated in a typical real estate transaction. The following table illustrates the general guidelines for allocating expenses.
<table>
<thead>
<tr>
<th>ITEM</th>
<th>PAID BY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brokers’ Commissions</td>
<td>Either party or both, by agreement</td>
</tr>
<tr>
<td>Attorneys’ Fees</td>
<td>Either party or both, by agreement</td>
</tr>
<tr>
<td>Title Expenses</td>
<td>Both parties responsible for different</td>
</tr>
<tr>
<td></td>
<td>title expenses</td>
</tr>
<tr>
<td>Transfer Tax</td>
<td>Seller</td>
</tr>
<tr>
<td>Recording Expenses</td>
<td>Both parties responsible for different</td>
</tr>
<tr>
<td></td>
<td>recording expenses</td>
</tr>
<tr>
<td>Loan Fees</td>
<td>Both parties responsible for different</td>
</tr>
<tr>
<td></td>
<td>loan fees</td>
</tr>
<tr>
<td>Appraisal Fees</td>
<td>Either party or both, by agreement</td>
</tr>
<tr>
<td>Survey Fees</td>
<td>Both parties responsible for different</td>
</tr>
<tr>
<td></td>
<td>survey fees</td>
</tr>
<tr>
<td>Tax and Insurance Reserves</td>
<td>Buyer</td>
</tr>
</tbody>
</table>

**Brokers’ Commissions:** A seller usually pays the commission for any broker who has been hired to represent the seller. If a broker represents the buyer or if each party has a broker of his or her own, each party may pay some part of the total cost of commission(s).

**Attorneys’ Fees:** If a buyer and a seller are paying their attorneys out of their own pockets, then the attorneys’ fees are often omitted from the closing statement. However, if one or more attorneys’ fees are to be deducted from the proceeds in the closing, then the party who hired the attorney as his or her representative will generally be debited for the attorney’s fees.

**Title Expenses:** Generally, a seller is required to pay for the title search. However, if a buyer conducts another search of his or her own, then he or she usually pays for that additional research. The buyer also usually pays for title insurance policies.

**Transfer Tax:** Transfer taxes are usually a seller’s responsibility.

**Recording Expenses:** A seller is generally responsible for recording expenses (i.e., filing fees and other similar costs) related to clearing defects from the property’s title, such as recording satisfactions of liens, affidavits and quitclaim deeds. A buyer is usually responsible for the recording expenses associated with the title transfer, such as the costs associated with publicly recording the deed that gives him or her title.

**Loan Fees:** A buyer is usually responsible for paying loan origination fees for a new loan, and for paying assumption fees if he or she assumes the seller’s existing loan. If a seller is paying off a mortgage before its due date, he or she may be required to pay a prepayment fee.
Appraisal Fees: The party that ordered the appraisal usually pays the fees associated with it.

Survey Fees: A buyer usually pays property survey fees, especially if he or she obtains a new mortgage.

Tax and Insurance Reserves: A buyer is often required to open an escrow account to cover real estate taxes that are assessed during the time the transaction is taking place. In this case, he or she generally deposits at least enough in the account to pay for the taxes through the end of the month of closing. However, a seller is debited and a buyer is credited for any of the seller’s unpaid taxes. A buyer often also pays at least the first year’s premium on fire or hazard insurance at closing.

It is worth repeating that state laws may stipulate arrangements other than those described above, as may the regulations associated with certain types of financing. In addition, many transactions leave substantial leeway for the principals to negotiate about how expenses are allocated. In all of these cases, the final division of fees may look considerably different than the general example given previously. Purchase contracts should reflect all negotiated and stipulated agreements regarding the allocation of expenses.

ADDITIONAL TRANSACTION FEES

Certain kinds of financing can result in additional transaction costs. These expenses include the following stipulations:

- If a loan has private mortgage insurance, then a buyer generally pays for one year’s premium at or before the time of closing.
- If a loan is FHA-insured, a buyer is usually debited for the mortgage insurance premium unless it is financed with the loan.
- If a loan is a Veterans Affairs loan, the buyer is debited for a funding fee to the VA.

CREDITS AND DEBITS

A closing statement provides a detailed accounting of each party’s debits and credits. A credit is a positive balance or a positive amount. For our purposes, it is a figure entered in a party’s favor when determining the overall costs associated with a transaction. On closing statements, credits reflect expenses that have been paid by a particular individual or expenses that are owed to that individual. Credits stand in contrast to debits.

A debit is a negative balance or a negative amount. For the purposes of our discussion, it is an amount due from or owed by a particular individual when
determining the overall costs associated with a transaction. On closing statements, debits reflect charges made to the parties involved in the transaction.

The actual amount that a buyer is to pay at closing is calculated by subtracting the buyer’s total credits (such as prepaid earnest money or the balance of a loan that the buyer will assume from the seller) from the buyer’s total debits (such as the purchase price). The remaining total is the amount that the buyer must bring to the closing to complete the transaction.

To determine how much money a seller will receive from a transaction, we subtract the seller’s total debits (such as the balance of a mortgage loan) from the seller’s total credits (such as the purchase price). The remaining total is the amount that the seller will receive.

In most cases, when we are tallying up credits and debits, it will be clear which party is responsible for a given transaction expense. However, some expenses cannot be allocated so easily. Many items that are prepaid or paid after a certain amount of time has passed, such as taxes, need to be divided proportionately between a buyer and a seller. The process of making this proportional division is called “proration.”

**PRORATING EXPENSES**

For our purposes, the proration process is a method of dividing accrued items and prepaid items between a seller and a buyer. Accrued items are costs that a seller owes (such as real estate taxes in a state where these are not prepaid), but which will ultimately be paid by a buyer after he or she receives title to a property. That is to say, these expenses have been (or are being) incurred at the time of sale, but need not be paid at the time the sale closes. In an effort to ensure that these expenses are handled fairly, the seller generally pays the buyer for these items through credits at closing. For example, a seller might credit a buyer for the proportion of annual real estate taxes that were charged during the part of the year that the seller occupied the property.

A prepaid item of course is an item that has been paid for ahead of time, generally by the seller. For example, a seller might have prepaid an insurance policy that is required by the local homeowner’s association. A buyer must then generally “purchase” this item from the seller at the time of the sale, either with cash, credits or in some other way that the principals have negotiated.
The following table shows examples of prepaid items and accrued items.

<table>
<thead>
<tr>
<th>PREPAID</th>
<th>ACCRUED</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Fuel oil on hand</td>
<td>• Interest on an existing mortgage assumed by the buyer</td>
</tr>
<tr>
<td>• Insurance and tax reserves for the mortgage</td>
<td>• Unpaid water charges and other utility bills</td>
</tr>
<tr>
<td>• Prepaid water charges and other utility bills</td>
<td>• Unpaid taxes</td>
</tr>
<tr>
<td>• General real estate taxes in a state where these are prepaid</td>
<td>• General real estate taxes in a state where these are not prepaid</td>
</tr>
</tbody>
</table>

Accrued items are generally debited to the seller and credited to the buyer, and prepaid items are credited to the seller and debited to the buyer.

**CALCULATING PRORATED EXPENSES**

Federal and state laws, as well as the negotiated terms of a particular purchase agreement, may dictate whether certain expenses can be prorated or how they should be prorated. The following guidelines for calculating a prorated expense are provided for educational purposes and may not reflect the actual procedures that are required in a specific case. A prudent licensee will not make assumptions about prorated expenses. Instead, familiarize yourself with relevant state laws and check with local lenders to identify the procedures they generally follow when prorating property taxes, insurance and interest.

When calculating prorated expenses, the first step is determining an annual charge for the item being prorated. To calculate the monthly charge for the item, then divide by 12. It may be necessary to go further and calculate a daily charge for the item. In this case, there are two methods commonly used to calculate daily charges:

- **A 360-day year**: The 360-day year is known as the “banking year”; it is commonly used in banking and other financial calculations, and is divided into 12 months of 30 days each. To figure daily charges using a 360-day year, you can divide the yearly charge by 360 or divide the monthly charge by 30.

- **A 365-day year**: The 365-day year is sometimes also called the “conventional calendar year,” because its divisions reflect the actual months of the calendar that most of us use. To calculate the daily charge for an item using the conventional calendar year, divide the yearly charge by 365 (366 in a leap year).
The actual number of days or months in the period for which you are calculating the prorated expense is then multiplied by the monthly or daily charge (whichever is appropriate) to determine the accrued amount or prepaid amount for the item.

Before you begin calculating prorations, then, you will need to answer the following three questions:

- What kind of item is being prorated? Is the charge for the item assessed daily, monthly, annually or according to some other schedule?
- Is this item accrued or prepaid?
- Which calculation method should be used?

**NOTE:** Throughout this module, we will use the 360-day year. However, regulations in your area may require that you use the 365-day year. Also, in our calculations we will assume that the seller is responsible for expenses incurred on the closing date. However, state laws determine whether the seller is in fact legally responsible for charges incurred on this date; these laws vary and you should confirm the standard used in your state before finalizing your calculations.

Now let’s look at some examples.

**PRORATING AN ACCRUED ITEM**

A sale is to be closed on the second of July. The property’s water bill for the entire year has been estimated at $300. Assuming that the seller is responsible for expenses on the day of closing, the accrued period is six months (January through June) and two days (July first and second). This is the amount of time for which the seller should be held responsible for the property’s water bills, because he or she occupied or was otherwise responsible for the property during this time. Let’s calculate the monthly and daily prorated costs for the water bill, using a 360-day year:

Monthly charge: $300 ÷ 12 months = $25  
Daily charge: $25 ÷ 30 days = $0.833

Now we will multiply the monthly and daily charge by the number of months and days in the period:

$25 × 6 months = $150  
$0.833 × 2 days = $1.666

Finally, we add the two amounts together:

$150 + $1.666 = $151.666
We can then round this figure to the second decimal place, giving us a total of $151.67. This is the amount that should be credited to the buyer and debited to the seller as we calculate the various settlement expenses associated with the transaction.

**PRORATING A PREPAID ITEM**

When calculating prorated expenses for a prepaid item, it is first necessary to determine the period of time for which the expense has been prepaid. For example, let’s assume that a seller lives in a state in which real estate taxes are prepaid. He or she has prepaid all real estate taxes for the year 2005, up to and including December 31; the total amount of prepaid taxes is $2000. The sale’s closing date is October 5, 2005. Using a 360-day year, we can calculate the number of prepaid months and days beyond the closing date as follows:

<table>
<thead>
<tr>
<th>Months</th>
<th>Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 months</td>
<td>25 days</td>
</tr>
<tr>
<td>Amount paid to Dec. 31</td>
<td>12</td>
</tr>
<tr>
<td>Closing date = Oct. 5</td>
<td>-10</td>
</tr>
<tr>
<td>Prepaid period</td>
<td></td>
</tr>
</tbody>
</table>

As we noted above, the total paid was $2,000. Now that we know the number of prepaid months and days beyond the closing date, we can calculate the amount that will be credited to the seller and debited to the buyer using the following formulas:

- Total amount ÷ 12 months = Monthly charge
  - $2,000 ÷ 12 months = $166.666

- Monthly charge ÷ 30 days = Daily charge
  - $166.666 ÷ 30 days = $5.555

- Monthly charge × Number of months in period = Monthly amount
  - $166.666 × 2 months = $333.332

- Daily charge × Number of days in period = Daily amount
  - $5.555 × 25 days = $138.875

- Monthly amount + Daily amount = Total
  - $333.332 + $138.875 = $472.207

We can then round this figure to the second decimal place, giving us a total of $472.21. This is the total amount that the seller has prepaid beyond the closing date—that is, the seller has paid $472.21 in taxes for a period during which the buyer should be held responsible for these charges. This amount will be credited to the seller and debited to the buyer as we calculate the various settlement expenses associated with the transaction.
ADDITIONAL GUIDELINES FOR CALCULATING PRORATED EXPENSES

- In many states, the seller is held responsible for any expenses incurred on the closing date. However, some states specify that the buyer owns the property as of the closing date, and he or she is therefore held responsible for any expenses incurred on that date. Check your state regulations to determine the specific standard used in your state.
- Estimates of utility charges and other similar expenses are often based on the most recent bill.
- Rents are usually prorated using a 365-day year, which reflects the actual amount of days for which rent is collected. The seller generally receives rents that are due as of the closing date, but again, you should check your state laws to be certain of the regulations in your state.
- Security deposits are usually transferred from the seller to the buyer; these funds are held in trust for tenants, and are not properly understood to be either the seller or the buyer's property.
- The way in which one is to calculate prorated real estate taxes varies from state to state. Check the rules for your state before finalizing any calculations.
- Expenses like water and other utilities, mortgage interest and real estate taxes are frequently prorated using the 360-day banking year. However, some areas require that the 365-day year be used. Familiarize yourself with local laws, and contact local lenders to determine the standards they use when calculating prorated expenses.
- Some special assessments are billed in installments (such as assessments for sewer improvements). When a transaction involves expenses of this sort, the buyer often assumes all future payments with interest. This amount is not generally prorated at closing.

SUMMARY

There are a variety of expenses associated with any real estate transaction. For example, brokers’ commissions must be paid and loans often come with significant fees. These expenses can be divided in various ways between the principals involved in the transaction; their legal responsibility varies from state to state, and many expenses can be negotiated between the principals. These variables mean that there is no single set of general guidelines that can teach a licensee how these expenses are divided between principals.

Dividing the various expenses associated with a transaction is essential in the preparation of a closing statement (also called a “settlement statement”). The details of this preparation process are the topic of our next lesson; for now, it is enough for us to know that a closing statement provides a detailed accounting of each party’s debits and credits. A credit is a positive balance or a positive
amount. For our purposes, it is a figure entered in a party’s favor when determining the overall costs associated with a transaction. On closing statements, credits reflect expenses that have been paid by a particular individual or expenses that are owed to that individual. Credits stand in contrast to debits.

A debit is a negative balance or a negative amount. For the purposes of our discussion, it is an amount due from or owed by a particular individual when determining the overall costs associated with a transaction. On closing statements, debits reflect charges made to the parties involved in the transaction. A careful accounting of credits and debits will allow a licensee to determine exactly how much a buyer must pay to complete a transaction, as well as the amount that a seller will actually take away from a sale, which is rarely the same amount as the purchase price.

Some of the expenses associated with a real estate transaction, such as transaction fees, are clearly the responsibility of either the buyer or the seller. State laws and the negotiated terms of the purchase contract will offer further guidelines that help a licensee determine which party is properly held responsible for a given expense. Other expenses must be divided proportionally between the parties, so that the charges to each party properly reflect the amount of money he or she owes or has prepaid. We call these “prorated expenses,” and the process by which we calculate them is called “proration.”

For our purposes, the proration process is a method of dividing accrued items and prepaid items between a seller and a buyer. Accrued items are costs that a seller owes (such as real estate taxes), but which will ultimately be paid by a buyer after he or she receives title to a property. That is to say, these expenses have been (or are being) incurred, but need not be paid at the time the sale closes. In an effort to ensure that these expenses are handled fairly, the seller generally pays the buyer for these items through credits at closing. For example, a seller might credit a buyer for the proportion of annual real estate taxes that were charged during the part of the year that the seller occupied the property.

A prepaid item is an item that has been paid for ahead of time, generally by the seller. For example, a seller might have prepaid an insurance policy that is required by the local homeowner’s association. A buyer must then generally “purchase” this item from the seller at the time of the sale, either with cash, credits or in some other way that the principals have negotiated.

When calculating prorated expenses, the first step is determining a yearly charge for the item. To calculate the monthly charge for the item, divide the amount by 12. It may be necessary to go further and calculate a daily charge for the item. In this case, there are two methods commonly used to calculate daily charges: the 360-day banking year and the 365-day conventional calendar year; which one is appropriate in a particular case will depend on your state’s laws and
regulations in this regard. Once you have determined the daily or monthly charge for the item, you can multiply it by the number of days or months in the period for which the prorated expense is being calculated.

The next lesson will discuss preparing pre-settlement estimates of closing costs and settlement statements.

*Return to your on-line course player to take the Lesson Quiz.*
LESSON THREE
HUD-1 SETTLEMENT STATEMENT

This lesson focuses on the following topics:

- General Guidelines for the HUD-1 Settlement Statement Form
- Settlement Charges
- Summary of Borrower’s Transaction
- Summary of Seller’s Transaction

INTRODUCTION

As we discussed in the previous lesson, the settlement statement (also called a “closing statement”) is a detailed, comprehensive document that summarizes each party’s debits and credits, as well as the funds that each party has contributed to the transaction thus far. This document is also often used to calculate the total amount that the buyer must bring to the settlement. There is no generally accepted format that all settlement statements must follow.

However, all transactions that fall under RESPA regulation are required to use the HUD-1 Settlement Statement form. This means that all transactions involving a federally related loan used to purchase a one- to four-family home must use the HUD-1 Settlement Statement form; this in turn means that nearly all residential purchase transactions will require this form. Therefore, the HUD-1 Settlement Statement is the most commonly used form for settlement statements, and all licensees who deal in residential property should be familiar with it.

NOTE: The HUD-1 Settlement Statement may also be used for transactions that are not covered by RESPA regulations—that is to say, there are no prohibitions against using it for sales that fall outside of RESPA’s domain.

There are many details to consider when filling out a HUD-1 Settlement Statement. The settlement agent is responsible for this task; in some states, licensees may act as settlement agents. Regardless of who acts as a settlement agent, that individual must be careful and accurate. The material in this lesson will familiarize you with this common form and educate you about how to complete it properly.
GENERAL GUIDELINES FOR THE HUD-1 SETTLEMENT STATEMENT FORM

In most states, the settlement agent completes the HUD-1 Settlement Statement. Current RESPA regulations do not define the term “settlement agent,” but previous definitions suggest that we should understand this term to mean “the individual who is conducting or handling the settlement of the transaction.” If the lender and the principals have not designated a particular individual as the settlement agent, then the lender is often considered to be the settlement agent.

However, licensees should familiarize themselves with the requirements imposed by the states in which they live. State laws may require that this form be completed by a particular party, or may stipulate that only certain individuals can serve as settlement agents. These sorts of details cannot be left to chance, and a prudent licensee will do everything that he or she can to ensure that all transactions go as smoothly as possible.

As we have already noted, the settlement statement provides a detailed accounting of the principals’ debits and credits; this is true of the HUD-1 form as well. However, some of the settlement information may not be available until the last minute; there is no legal requirement that the form be fully completed before closing. The buyer may request to receive a copy of the HUD-1 Settlement Statement one day before closing, but even at this late stage, some important expenses or credits may remain unknown. In such cases, the settlement agent should complete the settlement statement to the best of his or her knowledge and ensure that all parties are aware that at least some of the costs given at that point are only estimates.

At closing, the settlement agent should ensure that both the buyer and the seller receive a copy of the settlement statement. Some sections of the form allow for the seller’s information to be omitted from the buyer’s copy of the statement, and vice versa, thus protecting each party’s privacy (see, for example, Section J, which is discussed in detail later in this lesson). However, each principal should receive a copy of the form that has been adequately completed, so that they may use it to draw conclusions about their transaction. In addition, the settlement agent should retain a copy of the settlement form that includes any omitted information for both principals, to provide the fullest possible accounting of the closing transaction.

For escrow closings in which the buyer, the seller or both principals are absent, the settlement statement should be mailed or delivered immediately after closing. In all types of closings, the buyer and the seller should carefully review the settlement statement with their attorneys and brokers to ensure that all of the information it contains is accurate.
The settlement statement must be completed in a clear and legible fashion, though it may be handwritten, typed or completed on a computer. If any of the expenses mentioned on the form have been paid outside of the settlement, their respective lines should be marked “P.O.C.,” indicating that they were paid outside of closing. Additional pages may be attached to the statement to include information required by local or state laws, or to make sure that the purchase contract’s settlement provisions are thoroughly explained in the statement.

We will now examine the HUD-1 form in greater detail.

**GENERAL GUIDELINES FOR ENTERING BASIC TRANSACTION INFORMATION ON THE HUD-1 FORM**

Let’s assume that Seller A’s property is located at 100 Olive Street, Smallville, Texas 78702; Seller A currently resides at this address. The home is listed with Pro Real Estate, which is located at 550 Congress Street, Smallville, Texas 78702. Buyer B (who lives at 325 W. Mary St., Smallville, Texas, 78702) and Seller A have agreed that Buyer B will purchase the house for $115,000, and that the transaction will be closed on July 10, 2005, at the Pro Real Estate office. Buyer B has obtained a new conventional loan through Your Bank, which is located at 100 Main Street, Smallville, Texas 78702, and Buyer B did not need to buy insurance for the loan because the loan-to-value ratio is less than 80 percent. The file number and loan number are not available at this point.

How would we enter this information into the blank HUD-1 Settlement Statement form?

### A. U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT SETTLEMENT STATEMENT

<table>
<thead>
<tr>
<th>B. TYPE OF LOAN</th>
<th>1. □ FHA</th>
<th>2. □ FmHA</th>
<th>6. File Number</th>
<th>7. Loan Number</th>
</tr>
</thead>
</table>

**C. NOTE:** This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

<table>
<thead>
<tr>
<th>D. NAME AND ADDRESS OF BORROWER:</th>
<th>E. NAME AND ADDRESS OF SELLER:</th>
<th>F. NAME AND ADDRESS OF LENDER:</th>
</tr>
</thead>
<tbody>
<tr>
<td>G. PROPERTY LOCATION:</td>
<td>H. SETTLEMENT AGENT:</td>
<td>I. SETTLEMENT DATE:</td>
</tr>
</tbody>
</table>

PLACE OF SETTLEMENT:

Section A. Do not enter any information here.

Section B. Check the appropriate loan type and then enter the specific loan information in spaces 6, 7 and 8.
Section C. No entry required.

Section D. Enter the full legal name of the borrower (buyer), along with his or her current mailing address and zip code. If there is more than one buyer, enter complete information for all of them. Use an additional page if necessary.

Section E. Enter the full legal name of the seller, along with his or her current mailing address and zip code. If there is more than one seller, enter complete information for all of them. Use an additional page if necessary.

Section F. Enter the name, current mailing address and zip code of the lender.

Section G. Enter the street address and zip code of the property. If no street address is available, you may enter a legal description instead, but the zip code must still be entered.

Section H. Enter the full legal name of the settlement agent, current mailing address and zip code. Enter the address and zip code of the place of settlement.

Section I. Enter the date of settlement.

Now, recalling the information from our example, let's look at the completed form for this situation.

| A. U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT SETTLEMENT STATEMENT |
| B. TYPE OF LOAN | 1. □ FHA | 2. □ FmHA | 6. File Number | 7. Loan Number |

C. NOTE: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

| D. NAME AND ADDRESS OF BORROWER: | E. NAME AND ADDRESS OF SELLER: | F. NAME AND ADDRESS OF LENDER: |
| Buyer B | Seller A | Your Bank |
| 325 W. Mary St. Smallville, TX 78702 | 100 Olive St. Smallville, TX 78702 | 100 Main St. Smallville, TX 78702 |

| G. PROPERTY LOCATION: | H. SETTLEMENT AGENT: | I. SETTLEMENT DATE: |
| 100 Olive St. Smallville, TX 78702 | Pro Real Estate | July 10, 2005 |

| PLACE OF SETTLEMENT: | |
| 550 Congress Street Smallville, TX 78702 |
This, then, is the preliminary part of the HUD-1 Settlement Statement, which identifies the principals involved in the transaction as well as the property being transferred. This part of the form also specifies what kind of funding will be used in the sale, and designates a settlement agent. We will now look in detail at the body of the HUD-1 form. The main part of this form is divided into three major sections:

- Summary of Borrower's Transaction (Section J)
- Summary of Seller's Transaction (Section K)
- Settlement Charges (Section L)

Although the Settlement Charges section (Section L) is the final section of the form, you will probably want to fill out this section first because the totals from this section are needed for calculations in other sections of the form.
### A. Settlement Statement

#### B. Type of Loan

- FHA
- FedHFA
- Conv. Unins.

#### C. Note:

This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(g.o.c.)" were paid outside closing; they are shown here for informational purposes and are not included in the totals.

#### E. Name & Address of Borrower

<table>
<thead>
<tr>
<th>Name &amp; Address of Borrower</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

#### F. Name & Address of Seller

<table>
<thead>
<tr>
<th>Name &amp; Address of Seller</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

#### G. Property Location

<table>
<thead>
<tr>
<th>Property Location</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

#### H. Settlement Agent

<table>
<thead>
<tr>
<th>Name of Settlement Agent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Place of Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Settlement Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
</tbody>
</table>

#### J. Summary of Borrower's Transaction

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### K. Summary of Seller's Transaction

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 20. Gross Amount Due From Borrower

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 210. Amounts Paid By Or In Behalf Of Borrower

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 210. Deposit or earnest money

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Notes:

Section 5 of the Real Estate Settlement Procedures Act (RESPA) requires the following:

- HUD must develop a financial information booklet to help persons borrowing money to finance the purchase of residential real estate to better understand the nature and costs of real estate settlement services.
- Each lender must provide the booklet to all applicants from whom it receives or for whom it prepares a written application to borrow money to finance the purchase of residential real estate. Lenders must prepare and distribute the booklet a Good Faith Estimate of the settlement costs that the borrower is likely to incur in connection with the settlement. These disclosures are mandatory.

Section 4(a) of RESPA mandates that HUD develop and prescribe this standard form to be used at the time of loan settlement to provide full disclosure of all charges imposed upon the borrower and seller. Those are third-party disclosures that are designed to provide the borrower with pertinent information during the settlement process in order to do a better shopper.

The Public Reporting Burden for this collection of information is estimated to average one hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information.

This agency may not collect this information, and you are not required to complete this form, unless it displays a currently valid OMB control number. The information requested does not lend itself to confidentiality.

Previous editions are obsolete

Page 1 of 2

Form HUD-1 (3/36)

Ref. Handbook 4905.2
### L. Settlement Charges

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>760.</td>
<td>Total Sales/Broker's Commission based on price $</td>
<td>@ % =</td>
<td>Borrowers Funds at Settlement</td>
<td>Seller's Funds at Settlement</td>
</tr>
<tr>
<td>761.</td>
<td></td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>762.</td>
<td></td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>763.</td>
<td>Commission paid at Settlement</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 800. Items Payable In Connection With Loan

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>801.</td>
<td>Loan Origination Fee</td>
<td>@%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>802.</td>
<td>Loan Discount</td>
<td>@%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>803.</td>
<td>Appraisal Fee</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>804.</td>
<td>Credit Report</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>805.</td>
<td>Lender's Inspection Fee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>806.</td>
<td>Mortgage Insurance Application Fee</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>807.</td>
<td>Assumption Fee</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 900. Items Required By Lender To Be Paid In Advance

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>901.</td>
<td>Interest from</td>
<td>to $/day</td>
<td></td>
<td></td>
</tr>
<tr>
<td>902.</td>
<td>Mortgage Insurance Premium for months</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>903.</td>
<td>Hazard Insurance Premium for years</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>904.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 1000. Reserves Deposited With Lender

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>1001.</td>
<td>Hazard insurance per month</td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1002.</td>
<td>Mortgage insurance per month</td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1003.</td>
<td>City property taxes per month</td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1004.</td>
<td>County property taxes per month</td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1005.</td>
<td>Annual assessments per month</td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1006.</td>
<td></td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1007.</td>
<td></td>
<td>months $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1008.</td>
<td></td>
<td>months $</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 1100. Title Charges

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>1101.</td>
<td>Settlement or closing fee</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1102.</td>
<td>Abstract or title search</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1103.</td>
<td>Title examination</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1104.</td>
<td>Title insurance binder</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1105.</td>
<td>Document preparation</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1106.</td>
<td>Notary fees</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1107.</td>
<td>Attorney's fees</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1108.</td>
<td>Title insurance</td>
<td>to</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 1200. Government Recording and Transfer Charges

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>1201.</td>
<td>Recording fees: Deed $ ; Mortgage $ ; Releases $</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1202.</td>
<td>City/county tax/stamps: Deed $ ; Mortgage $</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1203.</td>
<td>State tax/stamps: Deed $ ; Mortgage $</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1204.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 1300. Additional Settlement Charges

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Formula</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
<tbody>
<tr>
<td>1301.</td>
<td>Survey</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1302.</td>
<td>Pest inspection</td>
<td>to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1303.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1304.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1305.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### 1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)
We will now discuss each of the HUD-1 form’s three sections in greater detail.

**SETTLEMENT CHARGES**

As we noted earlier, the settlement charges section of the HUD-1 (Section L) is actually the section of the form. However, information contained there is needed to complete the earlier sections, so we will treat this section of the form first. The first portion of the settlement charges section (Line 700–704) deals with the brokers’ commissions. Read the text below for an explanation of how that line should be completed.

<table>
<thead>
<tr>
<th>L. SETTLEMENT CHARGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>700. <strong>TOTAL SALES/BROKER’S COMMISSION based on price</strong> $ ________ @ __% = ________</td>
</tr>
</tbody>
</table>

*Division of Commission (line 700) as follows:*

- 701. $ to
- 702. $ to
- 703. Commission paid at Settlement
- 704. 

Line 700: Enter the commission charged by the licensee. If the commission is a percentage of the purchase, enter the property’s selling price, the percentage of the commission and the dollar amount of the total commission paid by the seller.

Lines 701 and 702: If the commission is being split between two or more licensees, or between a licensee and some other third party who is legally permitted to receive commissions, enter the respective dollar amounts that these parties will receive on these lines.

Line 703: Enter the amount of the sales commission to be paid at settlement. If the licensee is keeping part of the earnest money to pay for all or part of his or her commission, list only the commission being paid at settlement and note the amount of the earnest money deposit being kept by the broker on line 704 with a P.O.C. note.

Line 704: Enter any additional charges imposed by the licensee, as well as any commission being charged to the buyer that is to be paid out by the settlement agent.

Lines 800 through 811 detail the items payable in connection with the loan(s). Each loan fee and charge needs to be itemized. These lines of the form are fairly self-explanatory; the person completing the form simply needs to fill in the information requested, which should be readily available from the borrower or
from the lender. Lines 808 through 811 should be used to note any additional loan charges. As we discussed in Lesson Two, most loan fees and charges will generally be charged to the buyer (i.e., the borrower), but make certain that the completed settlement form reflects any negotiated arrangements between the seller and the buyer with respect to loan charges.

<table>
<thead>
<tr>
<th>800. ITEMS PAYABLE IN CONNECTION WITH LOAN</th>
<th>PAID FROM BORROWER’S FUNDS AT SETTLEMENT</th>
<th>PAID FROM SELLER’S FUNDS AT SETTLEMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>801. Loan Origination Fee %</td>
<td></td>
<td></td>
</tr>
<tr>
<td>802. Loan Discount %</td>
<td></td>
<td></td>
</tr>
<tr>
<td>803. Appraisal Fee to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>804. Credit Report to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>805. Lender’s Inspection Fee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>806. Mortgage Insurance Application Fee to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>807. Assumption Fee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>808.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>809.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>810.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>811.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Lines 900 through 905 list items that the lender stipulates must be paid at closing (except for the reserves, which are listed on lines 1000 through 1008). Note, however, that these charges are not necessarily paid to the lender. Generally, the buyer is responsible for these expenses. Read the text below for an explanation of how that line should be completed.

<table>
<thead>
<tr>
<th>900. ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>901. Interest from ______ to_______ @ $ ____/day</td>
<td></td>
<td></td>
</tr>
<tr>
<td>902. Mortgage Insurance Premium for ______ months to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>903. Hazard Insurance Premium for _____ years to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>904. years to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>905.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Line 900: Do not enter any information on this line.
Line 901: Enter any interest that is being collected at closing for part of a month or part of a payment period that occurs between settlement and the time of the first monthly payment. Include any per diem charges. Do not enter any amount on this line if interest will not be collected until the first monthly payment.

Line 902: Enter mortgage insurance premiums that are due at closing (not including any reserves collected by the lender, which will be recorded elsewhere). If the buyer is paying a lump sum mortgage insurance premium, record that total on this line with a note indicating that this premium covers the life of the loan.

Line 903: Enter hazard insurance premiums that are due at closing (again, not including any reserves collected by the lender, which will be recorded elsewhere).

Lines 904 and 905: Enter any additional items required by the lender (e.g., flood insurance). You should also use these lines to enter here any amounts paid at closing for other insurance not required by the lender. As with the other 900-series lines, do not include reserves in the figures you record here.

As we mentioned earlier, lines 1000 through 1008 detail the reserves that have been or need to be deposited with the lender. Read the text below to see a brief explanation of how that line should be completed.

**IMPORTANT NOTE:** This section requires a different type of accounting than the rest of the settlement sheet. HUD offers the following guidance in this regard:

> “After itemizing individual deposits in the 1000 series using single-item accounting, the servicer shall make an adjustment based on aggregate accounting. This adjustment equals the difference between the deposit required under aggregate accounting and the sum of the deposits required under single-item accounting. The computation steps for both accounting methods are set out in 3500.17(d). The adjustment will always be a negative number or zero (-0-). The settlement agent shall enter the aggregate adjustment amount on a final line in the 1000 series of the HUD-1 or HUD-1A statements.

> During the phase-in period, as defined in 3500.17(b), an alternative procedure is available. If a servicer has not yet conducted the escrow account analysis to determine the aggregate accounting starting balance, the settlement agent may initially calculate the 1000 series deposits for the HUD-1 and HUD-1A settlement statement using single-item analysis with a one-month cushion (unless the mortgage loan documents indicate a smaller amount). In the escrow account analysis conducted within 45 days of settlement, the servicer shall adjust the escrow account to reflect the aggregate accounting balance.”
These instructions are taken from HUD’s instructions for completing the HUD-1 Settlement Statement (HUD RESPA Final Regulations, Appendix A), which can be found online at [http://www.hud.gov:80/offices/hsg/sfh/res/resappa.cfm](http://www.hud.gov:80/offices/hsg/sfh/res/resappa.cfm).

Sections 3500.17(b) and 3500.17(d), mentioned in these instructions, can be found in the HUD RESPA Final Regulations, Appendix B, which is online at [http://www.hud.gov/offices/hsg/sfh/res/resappb.cfm](http://www.hud.gov/offices/hsg/sfh/res/resappb.cfm).

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>RESERVES DEPOSITED WITH LENDER</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1001</td>
<td>Hazard Insurance _____ months @ $ ____ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1002</td>
<td>Mortgage insurance _____ months @ $ ___ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1003</td>
<td>City property taxes ____ months @ $ ___ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1004</td>
<td>County property taxes ___ months @ ___$ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1005</td>
<td>Annual assessments _____ months @ $___ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1006</td>
<td>_____ Months @ $____ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1007</td>
<td>_____ Months @ $____ per month</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1008</td>
<td>Aggregate Adjustment ____ months @ $___ per month</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Line 1000: This line requires no entry.

Lines 1001 through 1007: Enter amounts collected by the lender and held in escrow or trust for making future payments. Record these amounts as monthly payments of specific amounts, with a total in either the “borrower’s funds” column or the “seller’s funds” column. Lines 1006 and 1007 can be used to account for items other than those listed; for example, a lender might require reserves to cover flood insurance.

Line 1008: Enter the aggregate adjustment amount, per HUD’s accounting instructions, outlined in the earlier note. Remember that HUD’s instructions can be found in HUD RESPA Final Regulations, Appendix A, which is online at [http://www.hud.gov:80/offices/hsg/sfh/res/resappa.cfm](http://www.hud.gov:80/offices/hsg/sfh/res/resappa.cfm); further details can be found in Appendix B, which is online at [http://www.hud.gov/offices/hsg/sfh/res/resappb.cfm](http://www.hud.gov/offices/hsg/sfh/res/resappb.cfm).

Lines 1100 through 1113 list title charges and attorneys’ fees associated with the transaction. Read the text below to see an explanation of how each line should be completed.

**NOTE:** In some transactions, a single individual or company performs more than one of the services listed on lines 1101 through 1106, for a single aggregate fee. For example, an attorney might perform notary duties, execute a title examination and prepare documents. In cases like these, that individual’s aggregate fee
should be entered on line 1107 (if the individual is an attorney) or on line 1108 (for title companies). Under lines 1107 and 1108, space is provided in which you should give the line item number of each service performed by that individual or company. If you do this, you need not itemize each service individually in the “borrower’s” and “seller’s” columns.

If more than one individual performs any single service and each person or company charges a fee, their separate fees must be accounted for in this section. You should show the total paid in either the “borrower’s” or the “seller’s” column and list their individual charges on the line following the word “to.” This is true for all services listed on lines 1101 through 1106.

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1100</td>
<td><strong>TITLE CHARGES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1101</td>
<td>Settlement or closing fee          to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1102</td>
<td>Abstract or title search           to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1103</td>
<td>Title examination                  to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1104</td>
<td>Title insurance binder             to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1105</td>
<td>Document preparation               to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1106</td>
<td>Notary fees                        to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1107</td>
<td>Attorney’s fees                    to</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(includes above items numbers; )

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1108</td>
<td>Title Insurance                      to</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(includes above items numbers; )

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1109</td>
<td>Lender’s coverage $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1110</td>
<td>Owner’s coverage $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1111</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1112</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Line 1100: Do not enter any information on this line.

Line 1101: Enter the settlement agent’s fee.

Line 1102: Enter the fee for the abstract or title search. Remember that if this is part of an aggregate fee charged by a title company or an attorney for a variety of services, you can enter that aggregate fee on line 1108 and provide the line item numbers of the services that were performed for this transaction. This is true for all services listed on lines 1101 through 1106.
Remember, too, that if multiple individuals are paid for the same service, their separate fees must be properly accounted for here.

Line 1103: Enter the title examination fee. If the same person or company performs the abstract or title search and the examination and charges a single fee for both procedures, one fee could be entered on this line. This is only true if that single person or company is not a title company or an attorney; if a title company or attorney performs these or any other services for an aggregate fee, that amount should be entered using lines 1107 and 1108.

Line 1104: Enter the title insurance binder fee; this is sometimes also called a "commitment to insure."

Line 1105: Enter the document preparation fee.

Line 1106: Enter notary fees charged to ensure the authenticity of closing documents.

Line 1107: Enter attorney’s fees. If a transaction involves multiple attorneys, one attorney’s fees should be entered on line 1107, and the others’ fees should be accounted for on line 1111, 1112 or 1113.

Line 1108: Enter total charge for title insurance. If an attorney is also acting as the title agent, note on line 1107 which services are included in the attorney’s fee, and note on line 1113 which services are included in the insurance commission.

Lines 1109 and 1110: Enter the separate charges for the lender’s and owner’s title insurance policies. Do not enter these amounts in the “borrower’s” column or the “seller’s” column, because the total title insurance charges have already been entered on line 1108.

Lines 1111 through 1113: Enter any title fees or charges that have not been accounted for in lines 1101-1110. For example, if one party must pay a public records office for a certificate of title, that charge would be entered here.

Lines 1200 through 1205 itemize government recording and transfer charges associated with the transaction. This is another fairly self-explanatory part of the form; the settlement agent need only list the recording fees on line 1201, the city/county tax/stamps on line 1202 and the state tax/stamps on line 1203. Lines 1204 through 1205 are to be used for any additional charges that are related to government recording and transfer.
Any other settlement charges that have not already been itemized should be listed on Lines 1300 through 1305. Enter survey costs on Line 1301 and pest or other inspection charges on Line 1302; other inspection charges may be entered here as well, such as hazard inspections (e.g., radon or lead-based paint). Lines 1303 through 1305 are for additional charges not associated with surveys, hazard inspections, or any of the other categories listed in Section L, such as structural inspections or fees for warranty coverage. Do not use lines 1303 through 1305 to list the seller’s obligatory payoffs, such as liens. These are covered in Section K.

<table>
<thead>
<tr>
<th>1300. ADDITIONAL SETTLEMENT CHARGES</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1301. Survey to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1302. Pest inspection to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1303.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1304.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1305.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

When all information has been verified and entered in Section L of the form, add up the charges in the “borrower’s funds” column and calculate a similar total for the “seller’s funds” column. Enter these totals on Line 1400. These totals will also be entered in Sections J and K, on lines 103 and 502, respectively.

<table>
<thead>
<tr>
<th>1400. TOTAL SETTLEMENT CHARGES (enter on lines 103, Section J and 502, Section K)</th>
<th>Borrower’s Funds</th>
<th>Seller’s Funds</th>
</tr>
</thead>
</table>

SUMMARY OF BORROWER’S TRANSACTION

Having discussed the “Settlement Charges” section of the HUD-1 form, we will now turn to the part of the form that outlines the buyer’s (i.e., the borrower’s) costs associated with the transaction. Section J of the HUD-1 form lists the
buyer’s expenses. Line 100 through 120 details the gross amount due from the buyer—that is to say, these lines provide us with a detailed explanation of the buyer’s debits. Section J can be left blank on the copy of the HUD-1 form provided to the seller, just as Section K (which details the seller’s debits) can be left blank on the copy of the form provided to the buyer. The settlement agent, however, should retain a copy of the form fully filled out with information for both principals.

Read the text that follows to see an explanation of how these lines should be completed.

### J. SUMMARY OF BORROWER’S TRANSACTION

<table>
<thead>
<tr>
<th>Line 100. GROSS AMOUNT DUE FROM BORROWER:</th>
</tr>
</thead>
<tbody>
<tr>
<td>101. Contract sale price</td>
</tr>
<tr>
<td>102. Personal property</td>
</tr>
<tr>
<td>103. Settlement charges to buyer</td>
</tr>
<tr>
<td>104.</td>
</tr>
<tr>
<td>105.</td>
</tr>
<tr>
<td>Adjustments for items paid by seller in</td>
</tr>
<tr>
<td>advance</td>
</tr>
<tr>
<td>106. City/town taxes</td>
</tr>
<tr>
<td>107. County taxes</td>
</tr>
<tr>
<td>108. Assessments</td>
</tr>
<tr>
<td>109.</td>
</tr>
<tr>
<td>110.</td>
</tr>
<tr>
<td>111.</td>
</tr>
<tr>
<td>112.</td>
</tr>
<tr>
<td>120. GROSS AMOUNT DUE FROM BORROWER</td>
</tr>
</tbody>
</table>

**Line 100:** Do not enter any information in this line.

**Line 101:** Enter the property’s gross sale price. If the buyer and seller have agreed to separate prices for any personal property being exchanged (such as carpets or appliances), do not include these in the sale price. These separately priced items will be recorded on line 102.

**Line 102:** Enter the gross sale price of any items of tangible personal property exchanged between the seller and the buyer, such as carpets or appliances. The
specifics regarding what counts as personal property vary from state to state; therefore, settlement agents should consult their states’ guidelines about what items are correctly considered to be personal property.

Line 103: Enter the total settlement charges to the buyer. We determined this figure in our discussion of Section L. If the settlement agent has already completed Section L, this amount can be found on line 1400.

Lines 104 and 105: Enter any additional amounts that the buyer owes or amounts for which the buyer is reimbursing the seller (such as security deposits). Also, if the buyer is financing construction on the property or is purchasing a manufactured home and has obtained a loan other than a first user loan, the purchase price of the land must be entered on line 104, and the construction costs or price of the manufactured home being placed there must be entered on Line 105. When buyers are financing construction, line 101 is left blank.

Lines 106 through 108: Enter any city taxes, town taxes, county taxes or assessments that the seller has prepaid and for which the buyer must reimburse the seller.

Lines 109 through 112: Enter any additional prepaid amounts for which the buyer must reimburse the seller.

Line 120: Add the figures from lines 101 through 112, and enter that amount here. This is the buyer’s total debit.

Lines 200 through 220 in Section J identify the amounts paid by or on behalf of the buyer (that is to say, this section outlines the buyer’s credits). Read the text below for an explanation of how these lines should be completed.

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>200.</td>
<td><strong>AMOUNTS PAID BY OR IN BEHALF OF BORROWER:</strong></td>
</tr>
<tr>
<td>201.</td>
<td>Deposit of earnest money</td>
</tr>
<tr>
<td>202.</td>
<td>Principal amount of new loan(s)</td>
</tr>
<tr>
<td>203.</td>
<td>Existing loan(s) taken subject to</td>
</tr>
<tr>
<td>204.</td>
<td></td>
</tr>
<tr>
<td>205.</td>
<td></td>
</tr>
<tr>
<td>206.</td>
<td></td>
</tr>
<tr>
<td>207.</td>
<td></td>
</tr>
<tr>
<td>208.</td>
<td></td>
</tr>
<tr>
<td>209.</td>
<td>Adjustments for items unpaid by seller</td>
</tr>
<tr>
<td>Line 210</td>
<td>City/town taxes _____ to</td>
</tr>
<tr>
<td>Line 211</td>
<td>County taxes _____ to</td>
</tr>
<tr>
<td>Line 212</td>
<td>Assessments _____ to</td>
</tr>
<tr>
<td>Line 213</td>
<td></td>
</tr>
<tr>
<td>Line 214</td>
<td></td>
</tr>
<tr>
<td>Line 215</td>
<td></td>
</tr>
<tr>
<td>Line 216</td>
<td></td>
</tr>
<tr>
<td>Line 217</td>
<td></td>
</tr>
<tr>
<td>Line 218</td>
<td></td>
</tr>
<tr>
<td>Line 219</td>
<td></td>
</tr>
<tr>
<td>Line 220</td>
<td><strong>TOTAL PAID BY/FOR BORROWER</strong></td>
</tr>
</tbody>
</table>

Line 200: Do not enter any information on this line.

Line 201: Enter the amount of earnest money or any other money paid against the purchase price before closing.

Line 202: Enter the amount of the new loan(s) made by the lender or first user loan(s), if applicable. Throughout the remainder of the form, the settlement agent should be certain that his or her calculations reflect any known adjustments or charges associated with temporary or permanent financing.

Line 203: Enter the amount of any loan the buyer is assuming, or the amounts of any other liens and encumbrances to which the buyer’s title is subject, if applicable.

Lines 204 through 209: Enter any other items that have been paid for by the buyer or paid on the buyer’s behalf which have not yet been entered in this part of the form. For example, the settlement agent should use these lines to account for cases in which the seller accepts a note from the buyer for all or part of the purchase price, cases in which the seller accepts other property as trade and cases in which the seller gives the buyer an allowance to make specific repairs or improvements to the property.

Lines 210 through 212: Enter any accrued city taxes, town taxes, county taxes or assessments that date from a period prior to closing but which have not yet been paid. Generally, the seller is understood to owe the buyer for these expenses unless they have negotiated another arrangement.

Lines 213 through 219: Enter any additional accrued items dating from a period prior to settlement that have not yet been paid but which will come due to the buyer (such as utilities used but not yet paid for). Again, the seller is generally
understood to owe the buyer for these expenses, unless they have negotiated another arrangement.

Line 220: Add the figures from lines 201 through 219, and enter that amount here. This is the buyer’s total credit.

Line 300 should be left blank, but lines 301 through 303 are used to calculate the amount of cash due from the buyer or the amount of cash due to the buyer at closing. On line 301, enter the gross amount due from the buyer, which can be found on line 120. On line 302, enter the buyer’s total credit from line 220. Subtract line 302 (the buyer’s credit) from line 301 (the gross amount due) to determine the total cash due from the buyer (i.e., the borrower) or due to the buyer. Enter this amount on line 303. The settlement agent should make certain to avoid confusion by checking the appropriate box on the HUD-1 form to indicate whether the figure on line 303 represents cash due to the buyer or cash due from the buyer.

<table>
<thead>
<tr>
<th>300. CASH AT SETTLEMENT FROM/TO BORROWER</th>
</tr>
</thead>
<tbody>
<tr>
<td>301. Gross amount due from borrower(line 120)</td>
</tr>
<tr>
<td>302. Less amounts paid by/for borrower(line 220)</td>
</tr>
<tr>
<td>303. CASH □ FROM □ TO BORROWER</td>
</tr>
</tbody>
</table>

It may seem odd that cash would be due to a buyer in a real estate transaction. However, one occasionally encounters situations in which the buyer’s credit is larger than his or her debit, and in these cases the buyer would receive cash at closing. However, in most transactions the amount entered on line 303 will reflect cash owed by the buyer.

**SUMMARY OF SELLER’S TRANSACTION**

Now we turn to the third part of the HUD-1 form, which is much like Section J except that now we are concerned with the seller, not the buyer. Section K details the seller’s expenses associated with the transaction. As we noted before, there is no obligation to share this part of the form with the buyer; Section K can be left blank on the seller’s copy of the form, though the settlement agent should retain a copy of the form fully filled out with information for both principals.

Lines 400 through 420 list the amounts due to the seller (that is, these lines list the seller’s credits). Read the text below to see an explanation of how these lines should be completed.
## K. SUMMARY OF SELLER’S TRANSACTION

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>400.</td>
<td>GROSS AMOUNT DUE TO SELLER:</td>
<td></td>
</tr>
<tr>
<td>401.</td>
<td>Contract sale price</td>
<td></td>
</tr>
<tr>
<td>402.</td>
<td>Personal property</td>
<td></td>
</tr>
<tr>
<td>403.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>404.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>405.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Adjustments for items paid by seller in advance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>406.</td>
<td>City/town taxes _____ to</td>
<td></td>
</tr>
<tr>
<td>407.</td>
<td>County taxes _____ to</td>
<td></td>
</tr>
<tr>
<td>408.</td>
<td>Assessments _____ to</td>
<td></td>
</tr>
<tr>
<td>409.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>410.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>411.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>412.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>420.</td>
<td>GROSS AMOUNT DUE TO SELLER</td>
<td></td>
</tr>
</tbody>
</table>

**Line 400:** Do not enter any information on this line.

**Line 401:** Enter the property’s gross sale price. If the buyer and seller have agreed to separate prices for any personal property being exchanged (such as carpets or appliances), do not include these in the sale price. These separately priced items will be recorded on line 402.

**Line 402:** Enter the gross sale price of any items of tangible personal property exchanged between the seller and the buyer, such as carpets or appliances. The specifics regarding what counts as personal property vary from state to state; therefore, settlement agents should consult their states’ guidelines about what items are correctly considered to be personal property.

**Lines 403 through 405:** Enter any additional amounts that the seller is owed. Also, if the buyer is financing construction on the property or is purchasing a manufactured home and has obtained a loan other than a first user loan, the purchase price of the land must be entered on line 404, and the construction costs or price of the manufactured home being placed there must be entered on Line 405. When buyers are financing construction, line 401 is left blank.

**Lines 406 through 408:** Enter any prepaid city taxes, town taxes, county taxes or assessments that the seller has prepaid and for which the buyer must reimburse the seller.
Lines 409 through 412: Enter any additional prepaid amounts for which the buyer must reimburse the seller.

Line 420: Add the figures from lines 401 through 412, and enter that amount here. This is the seller’s total credit.

Lines 500 through 520 identify amounts that the seller must pay and other reductions in the amount due to the seller (that is to say, this section outlines the seller’s debits). Read the text below to see an explanation of how these lines should be completed.

<table>
<thead>
<tr>
<th>500. REDUCTIONS IN AMOUNT DUE TO SELLER:</th>
</tr>
</thead>
<tbody>
<tr>
<td>501. Excess deposit (see instructions)</td>
</tr>
<tr>
<td>502. Settlement charges to seller (line 1400)</td>
</tr>
<tr>
<td>503. Existing loan(s) taken subject to</td>
</tr>
<tr>
<td>504. Payoff of first mortgage loan</td>
</tr>
<tr>
<td>505. Payoff of second mortgage loan</td>
</tr>
<tr>
<td>506.</td>
</tr>
<tr>
<td>507.</td>
</tr>
<tr>
<td>508.</td>
</tr>
<tr>
<td>509. Adjustments for items unpaid by seller</td>
</tr>
<tr>
<td>510. City/town taxes _____ to</td>
</tr>
<tr>
<td>511. County taxes _____ to</td>
</tr>
<tr>
<td>512. Assessments _____ to</td>
</tr>
<tr>
<td>513.</td>
</tr>
<tr>
<td>514.</td>
</tr>
<tr>
<td>515.</td>
</tr>
<tr>
<td>516.</td>
</tr>
<tr>
<td>517.</td>
</tr>
<tr>
<td>518.</td>
</tr>
<tr>
<td>519.</td>
</tr>
<tr>
<td>520. TOTAL REDUCTION AMOUNT DUE SELLER</td>
</tr>
</tbody>
</table>

Line 500: Do not enter any information on this line.
Line 501: This line is only used in particular circumstances. Specifically, it is for use when someone besides the settlement agent (e.g., the seller’s broker) holds an amount of earnest money that exceeds his or her commission and the excess amount is to be returned directly to the seller rather than passed through the settlement agent. In these cases, the settlement agent should enter the amount of the excess deposit on this line. The total amount of the deposit, including commissions, should be entered on line 201.

Line 502: Enter the total settlement charges to the seller. We determined this figure in our discussion of Section L. If the settlement agent has already completed Section L, this amount can be found on line 1400.

Line 503: If the buyer is assuming any of the seller’s loans or receiving a title subject to other liens or encumbrances, the settlement agent should enter that amount here.

Lines 504 and 505: If any first or second mortgage loans are to be paid off as part of the closing process, the settlement agent should enter those amounts here (including the loans’ accrued interest).

Lines 506 and 507: On line 506, enter deposits that the buyer has paid to the seller (or to another party who is not the settlement agent) and which were not entered on line 501. Sometimes the seller (or other party who is not the settlement agent) turns over part or all of the deposit to the settlement agent. In these cases, the settlement agent should use line 507 to enter in parentheses the amount of the deposit that is being distributed as proceeds, and enter on line 506 any amount of the deposit that the seller or other party still holds. Also any time the settlement agent holds the deposit, he or she should make a note on line 507 indicating that it will be distributed as proceeds.

Lines 508 and 509: These lines can be used for a variety of purposes. They might be used to list any liens that the seller must pay off to clear the title. Lines 506 and 507 can be used to list other items that the seller is obligated to pay off (i.e., items that are not liens). Do not use lines 1301 through 1305 to list the seller’s obligatory payoffs. These lines might also be used to detail funds held by the settlement agent for the payment of bills that cannot be prorated at closing due to a lack of information. Any amounts that were entered on lines 204 through 209 (covering general items that have been paid for by the buyer or paid on the buyer’s behalf) should be entered here, including seller-financing arrangements.

Lines 510 through 512: Enter any accrued city taxes, town taxes, county taxes or assessments that date from a period prior to closing but which have not yet been paid. Generally, the seller is understood to owe the buyer for these expenses unless they have negotiated another arrangement.
Lines 513 through 519: Enter any additional accrued items dating from a period prior to settlement that have not yet been paid but which will come due to the buyer (such as utilities used but not yet paid for). Again, the seller is generally understood to owe the buyer for these expenses, unless they have negotiated another arrangement.

Line 520: Add the figures from lines 501 through 519, and enter that amount here. This is the seller’s total debit.

Line 600 should be left blank, but lines 601 through 603 are used to calculate the amount of cash due to the seller or due from the seller at closing. On line 601, enter the total amount due to the seller, which is the total entered earlier on line 420. Then, enter the seller’s total debit on line 602; this amount is found on line 520. Subtract line 602 (the seller’s debit) from Line 601 (the total amount due to the seller) to determine the total cash due to the seller or due from the seller and enter that amount on line 603. The settlement agent should make certain to avoid confusion by checking the appropriate box on the HUD-1 form to indicate whether the figure on line 303 represents cash due to the buyer or cash due from the buyer.

<table>
<thead>
<tr>
<th>600. CASH AT SETTLEMENT TO/FROM SELLER</th>
</tr>
</thead>
<tbody>
<tr>
<td>601. Gross amount due to seller (line 420)</td>
</tr>
<tr>
<td>602. Less reductions in amount due seller (line 520)</td>
</tr>
<tr>
<td>603. CASH □ TO □ FROM SELLER</td>
</tr>
</tbody>
</table>

It may seem odd that cash would be due from a seller in a real estate transaction. However, one occasionally encounters situations in which the buyer’s credit is larger than his or her debit, and in these cases the buyer would receive cash at closing. However, in most transactions the amount entered on line 603 will reflect cash owed to the seller.

**SUMMARY**

Settlement statements give a detailed accounting of each principal’s expenses associated with a real estate transaction; as a result, these statements also generally reveal the amount that a buyer must bring to the closing. There is no generally accepted format that all settlement statements must follow.

However, all transactions that fall under RESPA regulation are required to use the HUD-1 Settlement Statement form. This means that all transactions involving a federally related loan used to purchase a one- to four-family home must use the HUD-1 Settlement Statement form; this, in turn, means that nearly all
residential purchase transactions will require this form. Therefore, the HUD-1 Settlement Statement is the most commonly used form for settlement statements, and all licensees who deal in residential property should be familiar with it. We should note that even transactions that do not fall under RESPA regulations are permitted to use the HUD-1 form as a settlement statement.

The preliminary part of the HUD-1 Settlement Statement identifies the principals involved in the transaction as well as the property being transferred. This part of the form also specifies what kind of funding will be used in the sale, and designates a settlement agent. The body of the HUD-1 form is divided into three major sections:

- Summary of Borrower’s Transaction (Section J)
- Summary of Seller’s Transaction (Section K)
- Settlement Charges (Section L)

Although the Settlement Charges section (Section L) is the final section of the form, it is often best to complete this section first because the totals from this section are needed for calculations in the other sections of the form.

Sections J and K provide summaries of the borrower’s side of the transaction and the seller’s side of the transaction, itemizing each party’s debits and credits to determine the amount of cash to be exchanged at closing.

Some of the settlement information may not be available until the last minute; there is no legal requirement that the form be fully completed before closing. The buyer may request to receive a copy of the HUD-1 Settlement Statement one day before closing, but even at this late stage, some important expenses or credits may remain unknown. In such cases, the settlement agent should complete the settlement statement to the best of his or her knowledge and ensure that all parties are aware that at least some of the costs given at that point are only estimates.

At closing, the settlement agent should ensure that both the buyer and the seller receive a copy of the settlement statement. Some sections of the form allow for the seller’s information to be omitted from the buyer’s copy of the statement, and vice versa, thus protecting each party’s privacy (see, for example, Section J). However, each principal should receive a copy of the form that has been adequately completed, so that they may use it to draw conclusions about their transaction. In addition, the settlement agent should retain a copy of the settlement form that includes any omitted information for both principals, to provide the fullest possible accounting of the closing transaction.

For escrow closings in which the buyer, the seller or both principals are absent, the settlement statement should be mailed or delivered immediately after closing. In all types of closings, the buyer and the seller should carefully review the
settlement statement with their attorneys and brokers to ensure that all of the information it contains is accurate.

There are many details to consider when filling out a HUD-1 Settlement Statement. The settlement agent is responsible for this task; in some states, licensees may act as settlement agents. Regardless of who acts as a settlement agent, that individual must be careful and accurate. In the next lesson, you will practice filling out a Settlement Statement to increase your understanding of this complex topic.

*Return to your online course player to take the Lesson Quiz.*
LESSON FOUR
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Field Application of Settlement Statement Knowledge
- Insight into Closings and Settlement Costs

INTRODUCTION

This module has covered a lot of specific information over a relatively short period of time. To ensure a comprehensive understanding of these details, we will now integrate the information provided, using a series of exercises and case studies. The first part of this lesson will describe the closing costs in an imaginary transaction, and you will be required to fill out the HUD-1 Settlement Statement calculating the final costs to the buyer and seller. The second part presents case studies—some drawn from real life situations and others created just for the purposes of this course—illustrating the regulations and concepts covered in the module. Upon completion, you should have a better sense of real-world applications of the information you have been studying.

FIELD APPLICATION OF SETTLEMENT STATEMENT KNOWLEDGE

It is likely that as a real estate licensee, you will never be asked to fill out the HUD-1 Settlement Statement. However, if you plan to stay involved in the closings of clients’ transactions, you will need to be able to explain expenses, debits and credits to buyers and sellers. These parties may wish to negotiate the terms of the settlement statement, and you may assist in that process. Also, you will probably give buyers and sellers estimates of the costs involved in closing, and knowing how to fill out the HUD-1 Settlement Statement will prepare you for this task.
### Settlement Statement

#### B. Type of Loan

|-------|------|----------------|---------------|

#### C. Notes:

- "This form is designed to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "P.O.C." were paid outside the closing, they are shown here for informational purposes and are not included in the total.

#### D. Name & Address of Borrower:

#### E. Name & Address of Seller:

#### F. Name & Address of Lender:

#### G. Property Location:

#### H. Settlement Agent:

#### I. Settlement Date:

#### J. Summary of Borrower’s Transaction

| Line | Description | Amount
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>199.</td>
<td>Gross Amount Due From Borrower</td>
<td>400. Gross Amount Due to Seller</td>
</tr>
<tr>
<td>201.</td>
<td>Down payment</td>
<td>402. Personal property</td>
</tr>
<tr>
<td>202.</td>
<td>Adjustments for items paid by the seller in advance</td>
<td>403. Adjustments for items paid by the seller in advance</td>
</tr>
<tr>
<td>203.</td>
<td>Adjustments for items unpaid by the seller</td>
<td>404. Adjustments for items unpaid by the seller</td>
</tr>
</tbody>
</table>

#### K. Summary of Seller’s Transaction

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>400.</td>
<td>Gross Amount Due From Borrower</td>
<td>400. Gross Amount Due to Seller</td>
</tr>
<tr>
<td>403.</td>
<td>Adjustments for items paid by the seller in advance</td>
<td>404. Adjustments for items paid by the seller in advance</td>
</tr>
<tr>
<td>405.</td>
<td>Adjustments for items unpaid by the seller</td>
<td>406. Adjustments for items unpaid by the seller</td>
</tr>
</tbody>
</table>

#### L. Total Paid By/Tor For Borrower

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>520.</td>
<td>Total Sale Amount Due Seller</td>
<td>521. Total Sale Amount Due Borrower</td>
</tr>
</tbody>
</table>

#### M. Notes:

Section 5 of the Real Estate Settlement Procedures Act (RESPA) requires the following:

- HUD must develop a special information booklet to help persons obtaining money to finance the purchase of residential real estate to better understand the nature and costs of real estate settlement services.
- Each lender must provide the borrower with a Good Faith Estimate of the settlement costs that the borrower will likely incur in connection with the settlement.

These disclosures are mandatory. Section 5 of RESPA mandates that HUD develop and pre-print the standard form to be used at the time of loan settlement to provide full disclosure of all charges imposed upon the borrower and seller. These are third party disclosures that are designed to provide the borrower with settlement information during the settlement process in order to be a better shopper.

The Public Reporting Burden for this collection of information is estimated to average one hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information.

This agency may not collect this information, and you are not required to complete this form, unless it displays a currently valid OMB control number.
## L. Settlement Charges

### 730. Total Sales/Broker’s Commission based on price $ \% =

<table>
<thead>
<tr>
<th>Division of Commission (line 730) as follows</th>
<th>Paid From Buyers’ Proceeds</th>
<th>Paid From Seller’s Proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>731. $ to $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>732. $ to $</td>
<td></td>
<td></td>
</tr>
<tr>
<td>733. Commission paid at Settlement</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 800. Items Payable In Connection With Loan

| 801. Loan Origination Fee %            |                           |                             |
| 802. Loan Discount %                   |                           |                             |
| 803. Appraisal Fee to                  |                           |                             |
| 804. Credit Report to                  |                           |                             |
| 805. Lender’s Inspection Fee to        |                           |                             |
| 806. Mortgage Insurance Application Fee |                           |                             |
| 807. Assumption Fee                    |                           |                             |

### 900. Items Required By Lender To Be Paid In Advance

<table>
<thead>
<tr>
<th>901. Interest from to $</th>
<th>$</th>
<th>$</th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>902. Mortgage Insurance Premium for months to</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>903. Hazard Insurance Premium for years to</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>904.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 1000. Reserve Deposited With Lender

| 1001. Hazard insurance | months | $ | $ | per month |
| 1002. Mortgage insurance | months | $ | $ | per month |
| 1003. City property taxes | months | $ | $ | per month |
| 1004. County property taxes | months | $ | $ | per month |
| 1005. Annual assessments | months | $ | $ | per month |
| 1006. | months | $ | $ | per month |
| 1007. | months | $ | $ | per month |
| 1008. | months | $ | $ | per month |

### 1100. Title Charges

| 1101. Settlement or closing fee to | | | |
| 1102. Abstract or title search to | | | |
| 1103. Title examination to | | | |
| 1104. Title insurance binder to | | | |
| 1105. Document preparation to | | | |
| 1106. Notary fees to | | | |
| 1107. Attorney’s fees to | | | |
| 1108. Title insurance | | | |

### 1200. Government Recording and Transfer Charges

| 1201. Recording fees: deed $ | $ | $ |
| 1202. Recodification fees: $ | $ | $ |
| 1203. State transfer tax: deed $ | $ | $ |
| 1204. | $ | $ | $ |

### 1300. Additional Settlement Charges

| 1301. Survey to | | |
| 1302. Pas inspection to | | |
| 1303. | | |
| 1304. | | |
| 1305. | | |

### 1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)
We will now go through a sample closing transaction and note expenses incurred. Enter this information on the correct lines of the HUD-1 form. Once we have gone over the necessary information, you will be asked to make calculations and provide totals. If your totals do not match the correct answers given below, please try again.

**NOTE:** The amounts and percentages used in the example do not necessarily reflect standard rates or even rates used in your area.

Buyer B has decided to purchase Seller A’s home for $115,000. Buyer B secures a loan for $90,000 from Quality Loans, which charges a loan origination fee of 1 percent and a loan discount fee of 2 percent. Buyer B also pays $400 for appraisal fees and $35 for a credit report, but these expenses were paid outside of closing. Buyer B’s lender requires that he purchase one year of hazard insurance for $400 and that he deposit the following amounts in escrow:

- For hazard insurance, two monthly payments at $30 per month;
- For county property taxes, two monthly payments at $150 per month.

In this transaction, Seller A pays $20 for the title search and $20 for the title insurance binder. Seller A must also pay her attorney $600 for legal representation, document preparation and notary services. Buyer B’s title charges include $600 for title insurance and $250 paid to his attorney for legal representation and title examination.

Buyer B is charged a total of $40 for recording fees ($20 for the deed and $20 for the mortgage). Seller A is charged $40 to record two documents to clear title, $20 to record the release of title and $150 in state transfer taxes. In this transaction the buyer is responsible for survey charges of $100, and the seller pays a $150 termite inspection charge.

Finally, there is the matter of brokers’ commissions. In this transaction, only Seller A has a broker, so the commission will not be split. Seller A’s broker charges 5 percent of the sale price, so the total commission is $5,750.

Now calculate Buyer B’s and Seller A’s settlement charges.

**NOTE:** Remember that you can find detailed instructions about how to fill out the HUD-1 form at [http://www.hud.gov/offices/hsg/sfh/res/resappa.cfm](http://www.hud.gov/offices/hsg/sfh/res/resappa.cfm).

**What are the buyer’s total settlement charges?**

**What are the seller’s total settlement charges?**
Feedback:

Buyer’s total settlement charges: $4,450.00  
Seller’s total settlement charges: $6,750.00

As mentioned previously, the purchase price of the property is $115,000. Buyer B paid $25,000 as a deposit, and the remainder of the purchase price is covered by the $90,000 loan he obtained. We already calculated the settlement charges, which are $4,450 to Buyer B and $6,750 to Seller A. Seller A also needs to pay off the remaining $45,920.30 from her first mortgage loan.

Seller A prepaid the real estate taxes on this property for the entire year, which totaled $1,200. The date of closing is July 10. For this transaction, prorations should be calculated using a 360-day year.

Now figure the total cash due to the buyer or due from the buyer, as well as the total cash due to the seller and due from the seller (that is to say, do the calculations that are necessary to complete line 303 and line 603).

NOTE: 
Once again, remember that you can find detailed instructions about how to complete the HUD-1 form at http://www.hud.gov/offices/hsg/sfh/res/resappa.cfm.

1) Is cash due to the buyer or due from the buyer?

2) What is the total amount of cash due from the buyer at closing?

Remember that you can figure the amount of days in the prorated period in the following way:

<table>
<thead>
<tr>
<th>Months</th>
<th>Days</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment period = full year</td>
<td>12</td>
</tr>
<tr>
<td>Closing date = July 10</td>
<td>-7</td>
</tr>
<tr>
<td>Prepaid period =</td>
<td>5 months</td>
</tr>
</tbody>
</table>

3) Is cash due to the seller or due from the seller?

4) What is the total amount of cash due to the seller at closing? 
Remember, you should subtract the total on line 520 from the total on line 420.
FEEDBACK:

1) Cash is due from the buyer.
2) $5,016.67
3) Cash is due to the seller.
4) $62,896.37

INSIGHT INTO CLOSINGS AND SETTLEMENT COSTS

This section presents 10 case studies addressing the concepts we have covered in the module. The first five case studies are built around fictional scenarios that put regulations and principles you have learned into practice. You will be asked to draw on your knowledge of closings and settlement costs to answer a question about each of these five situations. The remaining five cases are presentations of actual settlement cases involving RESPA regulations. You will be asked to consider the facts of the case and anticipate the outcome.

CASE STUDY ONE

In 2001, Broker A assisted her client, Seller X, in the sale of his commercial strip mall. Broker A stayed involved in every step of the transaction and saw the deal through to closing. However, Broker A forgot one important detail, and in 2002, the Internal Revenue Service (IRS) sent Broker A notice about this issue. What could Broker A have forgotten that would have caused the IRS to get involved?

Broker A probably forgot to give her client the one-page Notice to the Homebuyer disclosure form.

Broker A probably forgot to make sure that the closing agent or lender had filed Form 1099-S.

Broker A probably forgot to send a certified copy of the HUD-1 Settlement Statement to the IRS.

Broker A probably forgot to file the affidavit of title with the Department of Licensing.
Feedback:
Broker A probably forgot to make sure that the closing agent or lender filed Form 1099-S. This is the only one of the issues listed above that would concern the IRS. Licensees need to be aware that the sale of stock in cooperative housing corporations, as well as sales of land, condominium units and permanent structures, including residential, commercial and industrial buildings, must be reported to the Internal Revenue Service (IRS). Usually the closing agent or the mortgage lender will fill out the Form 1099-S for this type of transaction, but any licensees involved in the transaction could be held liable if the IRS is not properly notified.

CASE STUDY TWO

Broker B represents Seller Q. Broker B has just finished negotiating a purchase and sale agreement with Buyer A for the sale of Seller Q’s condominium unit. The state in which they live requires that all real estate transactions be closed through escrow, so Seller Q, per the purchase and sale agreement, selects Escrow Agent D to preside over the closing. On the date of closing, who must be present?

- Only Escrow Agent D
- Seller Q, Buyer A and Escrow Agent D
- Seller Q’s attorney, Buyer A’s attorney and Escrow Agent D
- Broker B and Escrow Agent D
Feedback:
Only Escrow Agent D must be present. In most states, the only person who is required to attend an escrow closing is the individual presiding over that closing process. In this transaction, Seller Q and Buyer A will send all necessary paperwork to Escrow Agent D before closing; after closing she can send a completed settlement statement to Buyer A and Seller Q if they choose not to attend the closing.

CASE STUDY THREE

Buyer Z applied for a federal loan for a one-family home through Lender B. To comply with RESPA requirements, Lender B gave Buyer Z HUD’s Special Information booklet (containing consumer information about real estate transactions and real estate settlement services) and a Mortgage Servicing Disclosure Statement. What else must Lender B provide to the borrower before closing?

A completed HUD-1 Settlement Statement

A Notice to the Homebuyer Form

A Good Faith Estimate of closing and settlement costs

A copy of IRS Form 1099-S
Feedback:
Buyer Z applied for a loan that falls under RESPA regulations. Therefore, within three business days of receiving Buyer Z’s loan application Lender B must send Buyer Z a **Good Faith Estimate** of the closing and settlement costs, in addition to the HUD Special Information booklet and the Mortgage Servicing Disclosure Statement.

**CASE STUDY FOUR**

Buyer X has agreed to purchase Seller M’s home for $150,000. Buyer X puts down a deposit of $15,000 and has secured a loan for 80 percent of the total purchase price. Excluding any settlement costs and other debits or credits, how much will Buyer X need to bring to the closing?

$10,000  
$15,000  
$20,000  
$50,000
Feedback:
Buyer X will need to bring an additional $15,000 to the closing to cover the rest of the purchase price. This amount may change, depending upon Buyer X’s other settlement costs, debits and credits.

CASE STUDY FIVE

Settlement Agent A is filling out a HUD-1 Settlement Statement, but he is having trouble itemizing the title charges in Section L (Settlement Charges). The documents associated with the transaction state that the seller’s title examination fee was $30, the seller’s document preparation fee was $20 and the seller’s attorney fees were $400. However, the seller has included evidence that the attorney conducted the title examination and prepared documents, and that the attorney's $400 fee included these fees. What should Settlement Agent A do?

Enter the title examination fee of $30, the document preparation fee of $20 and an attorney’s fee of $400, as given.

Enter an attorney’s fee of $450 and do not enter the other fees.

Enter the title examination fee of $30, the document preparation fee of $20 and an attorney’s fee of $350.

Enter the attorney’s fee of $400 as given and do not enter the other fees.
Feedback:
Because the attorney’s fee includes the title examination fee and the document preparation fee, the settlement agent must account for these fees on the HUD-1 in such a way that they are not charged twice. Therefore, settlement Agent A should enter the attorney’s fee of $400 as given and not enter the other fees individually. This figure should be entered on line 1107 of the HUD-1 form; the settlement agent should also include the line numbers of the items that are covered in this overall fee.

CASE STUDY SIX

The U.S. Department of Housing and Urban Development (HUD) and World Savings Bank, FSB, entered into a settlement on July 2, 2003. This settlement was the result of HUD’s investigation into World Savings Bank’s “For Services Rendered” program. HUD determined that through this program, the bank “solicit[ed] and compensat[ed] real estate agents (“Agents”) for assisting prospective borrowers in the completion and submission of mortgage loan applications” through a Website run by the Bank.

HUD found that the World Savings Bank was thus giving a “thing of value” to real estate licensees in exchange for their referral of business; conduct which violates Section 8 of RESPA. This section of the Act states that “No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.” World Savings Bank contested this judgment but agreed to the settlement, which is not interpreted as an admission of guilt.

Using your knowledge of RESPA, what do you think the World Savings Bank was required to do to fulfill the settlement? Write your thoughts below and then compare your answer with ours.
Feedback:
Violations of RESPA regulations can lead to serious penalties for both licensees and lending institutions employees. Fines of up to $10,000 can be assessed, as can prison terms of up to a year. Further details about penalties can be found in Section 8 of RESPA. According to the terms of this particular settlement, World Savings Bank was required to discontinue their “For Services Rendered” program and pay $7,557 to the U.S. Treasury. The settlement allows World Savings Bank to reinstate the program, but if they do so the program must not pay licensees for referring loan applicants; any consideration granted to licensees must be “reasonably related” to goods, services or facilities that those licensees actually furnish or perform. Any reinstated program must follow all RESPA regulations and other relevant HUD policies.

CASE STUDY SEVEN

After an investigation into the business practices of ARVIDA/JMB Partners (a large builder and realty services company in Florida), HUD alleged that ARVIDA was in violation of RESPA regulations in section 8(b) and section 9 that prohibit the “giving or receiving of any portion, split or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a federally related mortgage loan other than for services actually performed.”

HUD found that ARVIDA was charging buyers a percentage of the purchase price of their homes as closing costs; in many cases, this entire percentage fee was not actually used to pay closing costs. The remaining portion of the percentage fee was retained by ARVIDA and not specifically accounted for. ARVIDA also imposed an additional $300 charge on buyers who elected not to work with ARVIDA’s affiliated title company and instead used independent title agents. ARVIDA denied that these practices violated RESPA but agreed to enter into a settlement with HUD on September 17, 2001.

Using your knowledge of RESPA regulations, what did ARVIDA/JMB Partners do wrong? Write your thoughts below and then compare your answer with ours.
Feedback:
Buyers have the right to use any title company they choose; lending institutions
and other realty service providers are not allowed to assess additional fees to
penalize individuals who elect not to use title companies affiliated with the service
provider. In addition, closing costs must be itemized and properly accounted for,
not calculated as a percentage of the sale.

The settlement with HUD required that ARVIDA begin itemizing closing costs,
stop imposing extra charges on buyers for using independent title companies and
send refund checks to buyers who were charged for using independent title
companies within the time period addressed by the settlement. The settlement
allowed ARVIDA and its affiliates to continue offering packages of settlement
services, as well as discounts and rebates. However, all of ARVIDA’s conduct in
this regard must follow RESPA regulations and other relevant HUD policies.

CASE STUDY EIGHT

HUD investigated the business practices of Fidelity Financial, Inc., Fidelity
National Title Insurance Company, Fidelity National Flood Insurance Company,
Fidelity National Tax Service Company, Inc., and their affiliates and employees
(FNF). HUD concluded that FNF had violated section 8(a) RESPA by “enter[ing]
into contracts with lenders (banks, credit unions and mortgage companies) that
contained provisions for free review of existing loan portfolios in exchange for
future referrals of business.”

Why is this sort of behavior against RESPA regulations? Write your thoughts
below and then compare your answer with ours.

Feedback:
As discussed in the first case study, RESPA forbids realty service companies to
give things of value in exchange for referrals. HUD determined that a free review
of loan portfolios counts as a thing of value.

FNF denied that these practices violated RESPA, but the two parties entered into
a settlement on February 28, 2002. This settlement required that FNF abandon
this practice, begin charging reasonable fees for all such service, notify existing
customers of the change and pay hefty fines.

CASE STUDY NINE
After an investigation into the business practices of TitleVentures.com and its owners, Jerry D. Holmes, Jr., and Jerry D. Holmes, Sr., HUD declared that TitleVentures.com was in violation of Sections 8(a) and 8(b) of RESPA, which have both been quoted in previous case studies.

One of HUD’s findings was that TitleVentures.com had created “preferred attorney” lists. TitleVentures.com referred clients only to attorneys on the list, and attorneys were placed on that list only if they agreed to use TitleVentures.com for any title work generated by the referral, which violates RESPA regulations for referrals. TitleVentures.com and HUD entered into a settlement on July 10, 2003, which required that TitleVentures.com terminate its preferred attorney lists and programs, terminate the operations of 29 title agencies controlled by the company, hold interest in no more than 12 title agencies for three years after the date of the settlement, operate all title agencies in accordance with guidelines established in the settlement and pay a fine of $7,750.

If TitleVentures.com wanted to continue to refer its clients to attorneys, how could this be done in compliance with RESPA regulations? Write your thoughts below and then compare your answer with ours.

**Feedback:**
RESPA does not allow companies to give or accept payment or any other “thing of value” in exchange for referrals. TitleVentures.com could refer clients to attorneys as long as there is no pre-established compensation arrangement between the title company and the attorneys, such as their previous agreement that the attorneys will reciprocate for referrals by giving title work back to TitleVentures.com. In addition, TitleVentures.com could not require that their clients use one of the recommended attorneys.

**CASE STUDY TEN**

According to HUD’s investigation, Coldwell Banker United, Realtors®, was found to have violated RESPA regulations. HUD asserted that Coldwell was accepting “virtual tours” for free or below cost from various title companies (“virtual tours” are a service which allows a person to use the Internet to find photographs and information about properties for sale, as well as interior and exterior views of those properties). HUD deemed such virtual tours to be “things of value.” Coldwell denied that this practice violated RESPA, but the two parties entered into a settlement on July 22, 2003. The settlement required that Coldwell pay reasonable fees for virtual tours and not accept any tour for free. Coldwell was also required to pay $5,200 in fines and to notify all of its real estate licensees about the settlement agreement.
Why does RESPA prohibit real estate professionals from accepting virtual tours for free from title companies? Write your thoughts below and then compare your answer with ours.

Feedback:
Real estate professionals are not allowed to accept payment or any other “thing of value” from a title company, lending institution or other business in exchange for referring clients. Although in this situation there was no direct arrangement between the real estate firm and the title companies, accepting things of value could create an implied relationship. RESPA regulations require that appropriate compensation be paid for services and goods received.
LESSON FIVE
TEXAS STATE LAWS AND REGULATIONS ON CLOSINGS AND SETTLEMENT COSTS

This lesson will focus on:

- Closing a Transaction in Texas
- Texas Guidelines for Calculating Settlement Expenses

CLOSING A TRANSACTION IN TEXAS

Closings may take place at the office of the title company, the lending institution, the buyer’s or the seller’s attorney or the buyer’s or seller’s broker. However, in the state of Texas, it is customary for real estate transactions to close in escrow at the title company office. Usually, the buyer’s attorney, the seller’s attorney or a representative of the title company may preside over the closing (brokers and licensees do not usually conduct closing proceedings), but it is important to know that the title company itself may not prepare a legal document. In Texas, preparing legal documents is considered practicing law, and only an attorney may do this. The title company may employ an attorney who handles this task.

A licensee may fill in the forms and contracts that have been created by the Texas Real Estate Commission (TREC). All TREC contracts state that all parties should consult their attorneys before signing. TREC purchase and sale contracts also include relevant information to the transaction, including instructions for the escrow agent and details for the transaction.

Procedures for proving title are similar to the general procedures. The seller must provide evidence of title through a current abstract or title commitment. The Texas Real Estate License Act requires that if a seller submits only an abstract, the broker must advise the buyer (in writing before or on the date of closing) to have an attorney examine the abstract or obtain a title insurance policy. If the buyer’s attorney examines the abstract, he or she will issue an opinion of title that gives the status of the title with all liens and restrictions.

As is general practice, the seller must submit an affidavit of debts and liens, in which the seller states that, to his or her knowledge, there are no unpaid repairs or improvements and no defects in the title. In Texas, the title insurance company requires this form before giving the buyer an owner’s policy. Also, if the amount due at closing is equal to or greater than $1,500, the Good Funds Rule of the Texas State Board of Insurance states that the title company must require the buyer to pay with a cashier’s check or certified personal check.
TEXAS GUIDELINES FOR CALCULATING SETTLEMENT EXPENSES

TITLE EXPENSES

In some states, the seller is charged for the first search of public records for title evidence, but in Texas, it is prohibited to charge for this search. In Texas, the only charges allowed for title insurance are the lender’s and the owner’s policies.

The seller pays to have the abstract prepared or brought up to date, and the buyer pays for his or her attorney to examine the title and issue an opinion of title. Either party may pay for the title policy and the Texas State Board of Insurance set premiums.

RECORDING FEES

In Texas, recording fees are set by each county, although they range from $3-$8 for the first page and $2-$3 for each page thereafter.

CALCULATING EXPENSES

The seller owns the property on the day of closing and therefore pays any expenses incurred and receives income for that day. For prorating mortgage interest, real estate taxes, utilities and insurance premiums in Texas, the 360-day year is generally used. However, the specific contract may provide for calculations based upon a 365-day year (or 366 days in a leap year).

SUMMARY

The closing process in Texas is similar to the general process used throughout the United States, but some details vary from other states. For example, it is customary in Texas to close transactions at the title company office, whereas in other areas, most closings might take place at the broker’s or an attorney’s office.

One important piece of legislation in Texas that deals with closings and settlement costs is the Texas Real Estate License Act, which requires a broker to advise buyers in writing before or on the date of closing to have an attorney examine the title abstract or obtain a title insurance policy. Other specific regulations include the Good Funds Rule of Texas State Board Insurance, which requires that a buyer pay with a cashier’s or certified personal check if the amount due at closing is $1,500 or greater, and the rule that only an attorney may create contracts, but licensees may fill in the TREC contracts, which include a statement advising all parties to consult attorneys before signing the contract. Finally, Texas regulations include details about specific settlement costs and methods for calculating the expenses, including the fact that the seller owns the
property on the day of closing and the 360-day year is generally used for calculating prorations.

Return to your online course player to take the Lesson Quiz.
# Texas Principles of Real Estate
## Module 13: Real Estate Appraisal

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**Lesson 1: The Role of an Appraiser**
- Characteristics of a Reliable Appraiser
- Qualifications of an Appraiser
- Appraisal Employment and Job Functions

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**Lesson 2: Federal Legislation and National Agencies**
- The Appraisal Foundation
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**Lesson 3: Overview of Basic Value Principles**
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- Cost
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**Lesson 4: The Dynamics of the Real Estate Market**
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**Lesson 5: Approaches to Appraisal**
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**Lesson 6: The Appraisal Process**
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**Lesson 7: Real Estate Practice**
- Exercise: Completing a Residential Appraisal
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**Total Time**

| 210 minutes (3.5 Hours) |
INTRODUCTION

In order to own and convey property in a market economy it is necessary for that property to be assigned a specific monetary value. This process, unlike, say, that of assigning value to durable goods—which have specific materials, production and marketing costs—can be somewhat more involved. With property, the fixed costs—building materials and labor costs—are always accompanied by more esoteric factors that go to make property more (or less) valuable. Becoming a member of the group that understands and applies these factors is a bit more complex than simply being able to understand a balance sheet.

This course covers the theories, rules, duties and activities that guide the real estate appraisal process. An appraiser must also conduct him- or herself professionally, ethically and honestly. There are guidelines regarding professionally and ethically correct behavior of appraisers as well that are also covered by this course. The entire appraisal process should be carried out in the best possible way for consumers and licensees as well as the real estate market.

As well as touching upon general standards by which the value of property should be established, this module is broken down into separate lessons that cover:

- The Role of a Real Estate Appraiser
- Federal Legislation and National Agencies Governing the Industry
- An Overview of Basic Value Principles
- The Dynamics of the Real Estate Market
- Three Approaches to Appraisal
- The Appraisal Process

After finishing this course the student will be familiar with the basic rules of appraisal, the ways to carry out a real estate appraisal, the different types of licenses and certificates an appraiser can get, the different types of appraisals and the type of certificate or license which corresponds to types of appraisal. The course also looks at the effects of appraisal on housing needs and supply in the market as well as the overall economy. The last lesson of this course is a real world practice lesson in which the students can apply and test their acquired knowledge with examples and case studies.
KEY TERMS

**Appraisal:** The act or process of developing an opinion of value as of a specific date.

**Appraisal Report:** An appraiser’s written or oral estimate of value submitted to a client based on a specified definition of value for the subject property as of a specific date, giving all details of the data utilized in the appraisal process.

**Appraised Value:** An estimate by an appraiser of the amount of a particular value, such as market value, assessed value, or insurable value, based on the given assignment.

**Appraiser:** A person who engages in the procedure of estimating the value of real property or personal property.

**Balance:** The appraisal principle that states that the highest property values are realized when improvements are proportional to one another and to the land in size and type.

**Capitalization Rate:** The percentage used in the income capitalization approach to appraisal that represents an annual rate of return on one's investment. \( V = \frac{I}{R} \) where: \( V \) = Value, \( I \) = Net Operating Income and \( R \) = Capitalization Rate.

**Comparables:** These are the properties which are the same in many ways as the property being appraised, that is, the subject property. They can therefore be used to estimate the value of the subject property.

**Cost Approach:** A method of appraising property based on the depreciated reproduction cost (new) of all improvements, plus the market value of the site.

**Cost of Credit:** The amount one pays on borrowed money; an interest rate.

**Depreciation (Accounting):** A method of allocating the cost of an aging asset over its estimated useful life. For income tax purposes, depreciation is a provision for the estimated wear and tear of an asset. Depreciation deductions can be claimed as a tax deduction on real estate improvements, not land, regardless of whether the market indicates an increase or decrease in the value of the property.

**Depreciation (Real Estate):** A loss in value from wear, use or obsolescence (disuse).

**External Obsolescence:** The decrease in the value of a property because of factors not related to the physical characteristics of the property, for example...
environmental, social or political aspects. External obsolescence is also called economic depreciation and it is usually not under the owner’s control to prevent their property from going through it.

**Equity (Equity Buildup):** The money applied towards the principal amount of a loan, as opposed to the loan interest, plus any increase in the value of the property because of appreciation.

**(Preferred) Functional Depreciation:** The decrease in the value of a structure because of new trends in market preferences, consumer tastes and technological advances, etc. The issue that causes the decrease in value may be fixable, for example, lights not being bright enough in a building; or unfixable, for example, rooms in a house being too small, depending on how the cost of making the changes compares to the potential benefit of the repairs.

**Highest and Best Use:** The one most profitable and efficient use of any given tract of land that is also be legal, financially viable, productive and physically plausible.

**Income Capitalization Approach:** A method of estimating the present value of the property’s anticipated income benefits.

**Leverage:** The use of loaned funds to finance an investment.

**Market:** A particular geographic region or demographic section in which there may be a demand for certain goods or services; for our purposes, the goods demanded would be realty.

**Market Value:** In a normal and fair real estate market, this is the price that will most likely result in a sale and be deemed acceptable by both buyer and seller alike.

**Physical Depreciation:** A decrease in the value of a property or its improvements due to the deterioration of its physical condition. The reason for this can be due to weather or usage, etc.

**Price:** The amount of money requested or exchanged for a piece of property.

**Real Property:** The tangible and intangible rights associated with the ownership of real estate.

**Sales Comparison Approach:** A means of estimating value by comparing recent sales of comparable properties to the subject property after making appropriate adjustments for any differences. This method is effective in an active market in which sales comparables can be identified and information collected.
and verified. The comparable properties selected should be substantially similar to the subject property and should be “arms length” transactions.

**USPAP (Uniform Standards of Professional Appraisal Practice):** An annual publication printed by the Appraisal Foundation that defines key appraisal terminology and offers guidelines for completing non-biased and accurate appraisals.

**URAR (Uniform Residential Appraisal Report):** A form used for VA, FNMA, HUD, FHLMC and FMHA loans in estimating property value.

**Value:** The power of a good or service to command other goods or services in exchange, or, the present worth of future rights to income and benefits arising from ownership.

### LEARNING OBJECTIVES

Upon completion of this module, the student will be able to:

- Understand the basics of and common terms relating to real estate value estimation and appraisal.
- List the traits that a qualified appraiser must possess.
- Identify the value principles applied in the appraisal of property.
- Employ the value theories in the appraisal process to calculate the price at which property should be traded.
- Identify the characteristics that a real estate market should have to promote trade of property.
- Discuss the three value approach in detail.
- Pursue the eight steps of real estate appraisal to reach a purchase price for a property.
- Understand an appraisal report.
- Know the difference between an appraisal certificate and license.
LESSON ONE
ROLE OF AN APPRAISER

This lesson focuses on the following topics:

- Characteristics of a Reliable Appraiser
- Qualifications of an Appraiser
- Appraisal Employment and Job Functions

INTRODUCTION

According to the USPAP (Uniform Standards of Professional Appraisal Practice), an appraisal is “the act or process of developing an opinion of value.” It is not a report about how marketable a home is as that is a BMA (broker’s market analysis) or a CMA (market analysis). An appraisal report presents an approximation or a judgment of fixed value and is an objective and autonomous report.

An appraiser who has been certified or licensed by the state should determine the worth of a property. An appraiser is a specially trained examiner who, by considering all aspects of a property, produces a report detailing value. The property must be examined thoroughly, from physical aspects, such as structure and fittings, to non-physical aspects, like appeal and facilities.

The appraiser plays an important role when someone lists a property and demands a certain value for it. The owner should have an idea of the market worth of the property. Insurance companies, as well as parties that will potentially be buying, selling and lending are required to know the market value of listed property. If the property title is considered worthless, lenders will not be willing to lend money for its mortgage since they could not expect to get their finances back if the borrower defaults.

CHARACTERISTICS OF A RELIABLE APPRAISER

An appraiser who has been licensed or certified is the only professional who is officially qualified and formally trained for this purpose and whose estimate is accurate and reliable. Appraisers must employ their professional education, experience in the field and work with neutrality. They should have also fulfilled the state and federal licensing requirements.

A CMA (Comparative Market Analysis) is an informal estimate of the value of a property and can be made by other real estate professionals who hold licenses, such as real estate brokers. A CMA should not, however, be given as much importance as a formal real estate appraisal.
FORMAL EDUCATION

It is very important for the individuals who enter the field to receive formal education in the discipline of appraising. There are many institutions that impart instruction in this field; the process can start in high schools, which provide beginning appraisal education, and continue later in colleges, distance education, professional organizations, private schools and higher education institutions. An appraiser has a very specifically defined job; thorough and broad-ranging education must therefore be obtained because the work is precise and requires accurate training. An appraiser must be learned in diverse fields ranging from economics and statistics to social sciences and geography; in order to accurately appraise real property, he or she must also keep up with developments in real estate and architectural trends along with city planning.

An individual who wishes to obtain an appraisal license must take at least 90 hours of coursework, and one who wishes to gain certification must take at least 120–135 hours of courses. These requirements, set by the Appraisal Foundation (the organization that oversees educational requirements for all appraisal certifications and licenses), were modified in 2004; by 2006, these requirements are to increase between 35% to 60%, bringing the required hours of education up to 140 for appraisal licenses and 200 for appraisal certification with an associate’s degree.

FIELD EXPERIENCE

An individual working toward becoming a professional appraiser usually gathers some field experience before formally entering the profession. It is often only after years of experience that the work of an appraiser new to the profession commands respect and whose reports are given due importance. This experience is obtained either by working under an appraiser who is already established in the field or by doing internships in appraisal companies. Schools that offer appraisal programs, along with some states, require their students to take an internship. Students seeking internships may obtain these positions at certain appraisal companies; internships often involve work in the field and research.

OBJECTIVITY

If an appraiser has a personal stake in a transaction, the credibility of the appraisal is affected. An appraiser should evaluate a property with impartiality and make an objective and logical assessment. Those practicing professional objectivity can improve their reputation among other licensees and clients and, in turn, increase their earnings. If an appraiser holds a personal interest in a property, they must maintain honesty about the matter from the beginning and disclose their interests to all involved parties.
In situations where the appraiser has a personal interest (e.g., an appraisal fee that depends on the worth of the property, a personal relation to an involved party or a property ownership in the neighborhood of the property being appraised), there is a risk that the appraiser might not make an objective decision. Appraisers should not take up appraisal cases involving such circumstances; in fact, it is required by most professional appraisal organizations, including USPAP, that if such an interest is held, the appraiser must state so in the appraisal report. Practically speaking, any appraiser should avoid work in which he or she has a personal stake; moreover, it is of utmost importance that an appraiser’s fee is never dependent on a final estimate.

COMPETENCY

An appraiser’s worth is proportionate to his or her professional competence. To improve status among fellow professionals and potential clients, an appraiser can:

- Become licensed or certified.
- Gain new experience by appraising various types of property.
- Examine appraisal cases in advance to identify problems that could arise.
- Anticipate potential problems and thus avert them.
- Be a part of an organization that necessitates continuing education.
- Strive to improve his or her skills, even if not required by law.
- Avoid any and all work where any personal stake is at claim.
- Never accept a fee dependent on an appraisal’s value.

QUALIFICATIONS OF AN APPRAISER

The level of qualification among appraisers is not the same, even with respect to state licensing and certification programs. To continue their education and improve their qualifications, appraisers often become members of independent appraisal organizations.

PROFESSIONAL DESIGNATIONS

In the past, an appraiser’s qualifications were judged according to his or her professional designation, which was often mistakenly assumed to be a government-mandated license of sorts. Industry standards came from professional appraisal organizations, many of which have existed for many years, and government certification and licensing qualifications.

An appraiser who wants to be a member of a professional appraisal organization must usually clear at least one written exam, submit samples of appraisal work to demonstrate that they are capable of creating an appraisal report and exhibit real experience in the field. The aims of a professional appraisal organization include
increasing professional skills among member appraisers, establishing the reputation in the market that they are well-qualified and encouraging members to conform to ethics and moral principles in their work practices.

State and federal laws have already established standards regarding ethical behavior and professional qualifications that appraisers need meet. If an appraisal organization has requirements stricter than those, it means it is a reliable and solid organization. This is a good criterion in deciding how good an organization is. The NAIFA (National Association of Independent Fee Appraisers) is such an organization, having higher standards than state and federal law.

PROFESSIONAL SOCIETIES

An appraiser can become a member of a professional appraisal organization if they meet certain requirements set by the appraisal organization, such as field experience and extra education. Different appraisal organizations set different requirements for joining, some more demanding than others; good appraisal organizations have requirements in excess of what is required by the Appraisal Foundation. Appraisal organizations offer courses and conferences and hold meetings and seminars, all of which can be effective in keeping members abreast of industry trends and maintaining professional expertise. An appraiser should contemplate the advantages of becoming part of a particular organization before joining.

The following are some appraisal organizations:

Accredited Review Appraisers Council
http://arac.lincoln-grad.org
Publisher of The Review Appraiser
Member designation: AAR (Accredited in Appraisal Review)

American Association of Certified Appraisers, Inc., Cincinnati, Ohio
Member designations:
Non-certified: Affiliate and R-1 (Residential-First Level);
Certified: CA-R (Certified Appraiser-Residential), CA-S (Certified Appraiser- Senior), and CA-C (Certified Appraiser-Consultant)

American Society of Appraisers
www.appraisers.org
Publisher of Technical Valuation, a professional journal, and the Appraisal and Valuation Manual
Member designations: ASA (Senior Member), ASR (Senior Residential Member) and FASA (Fellow)

American Society of Farm Managers and Rural Appraisers, Inc., Denver,
Colo.
www.asfmra.org
Member designations: AFM (Accredited Farm Manager) and ARA (Accredited Rural Appraiser)

American Society of Professional Appraisers, Atlanta, Ga.
Member designations: CRRA (Certified Residential Real Estate Appraiser) and CCRA (Certified Commercial Real Estate Appraiser)

American Society of Real Estate Appraisers, Atlanta, Ga.
Member designations: RSA (Residential Senior Appraiser) and CSA (Commercial Senior Appraiser)

Appraisal Institute
www.appraisalinstitute.org
Publisher of The Appraisal Journal and Valuation Insights and Perspectives, as well as a number of special reports and books
Member designations: MA1 (Member of the Appraisal Institute) and SRA (Senior Residential Appraiser)

The Appraisal Institute was created in 1990 by the merger of the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers. Appraisal Institute members who were members of one of the earlier organizations also may have one of the following designations, although these are no longer issued by the Appraisal Institute: RM (Residential Member), SRPA (Senior Real Property Appraiser) and SREA (Senior Real Estate Analyst).

Appraisal Institute of Canada
www.aicanada.org
Publisher of The Canadian Appraiser, a technical journal, and Appraisal Institute DIGEST, a newsletter
Member designations: CRA (Canadian Residential Appraiser) and AACI (Accredited Appraiser Canadian Institute)

Foundation of Real Estate Appraisers
www.frea.com
Publisher of Communicator magazine

International Association of Assessing Officers
www.iaao.org
Publisher of The International Assessor and the Assessors Journal, as well as many specialized booklets and manuals
Member designations: CPE (Certified Personality Evaluator), AAE (Accredited Assessment Evaluator), CAE (Certified Assessment Evaluator) and RES (Residential Evaluation Specialist)
APPRAISAL EMPLOYMENT AND JOB FUNCTIONS

An appraiser carries out many tasks while evaluating a property, ranging from appraisal report preparation to managing finances and accounts to the tasks of a surveyor. An appraiser can perform all tasks allowed by their license or certification and about which they have been provided training, but nothing beyond that. The main task of an appraiser is to estimate the value of a property by examining it in detail and preparing an “appraisal report” to present the findings. The appraisal can be requested by anyone (a company or an individual) and for many different reasons, including calculating insurance coverage for a property or calculating figures for a loan.
EMPLOYMENT OPPORTUNITIES

Concerning the many companies and organizations which appraisers can join, what follows is a sampling of the employment opportunities provided by various groups.

Federal Agencies

Appraisers are needed in all agencies involved in building or maintaining roads. The FHA (Federal Housing Administration) and the VA (Veteran’s Administration), which evaluate the worth of real estate before assigning mortgage or insuring it, also need good appraisers.

Large Businesses and Corporations

When large businesses and corporations wish to open new offices or start new projects or ventures, they need to find out whether a particular property is economically sound and will want to know if the land can be utilized in a cost-effective manner. A qualified, experienced appraiser, capable of undertaking all relevant matters and making the necessary calculations for such a comprehensive report, which can be lengthy and complex, is hired for this purpose.

Appraisal Companies

When a company or an individual wants to hire an appraiser for their own purposes, they can contact an appraisal company. Appraisal companies, sometimes quite large, exist all over the country and hire licensed and certified appraisers to complete their own tasks as well as providing appraisers to other outside companies and individuals.

Self-Employment

Typically, when an appraisal is necessary, single-family residential homeowners will contact self-employed local appraisers for this type of work.

COMPENSATION

An appraiser is paid a fee by a buyer or buyer’s lender when he or she makes an appraisal of property owned by a single family. This fee should never be based on a final estimate of a property as that would conflict with an appraiser’s job of making an objective, accurate appraisal of a property. The appraisal fee is negotiable and should be commensurate to the amount of time spent on the appraisal process and how complicated the task of appraising is for the property.
External issues such as market competition and expenses incurred also affect an appraiser's fee.

**SUMMARY**

According to the USPAP (Uniform Standards of Professional Appraisal Practice), an appraisal is the act or process of developing an opinion of value, which may be requested for a variety of reasons, such as refinancing, mortgaging, insuring, and buying real property. Only a state licensed or certified appraiser (addressed in subsequent lessons) with adequate education, experience in the field and complete objectivity can render an accurate and reliable appraisal.

The employment opportunities for an experienced appraiser, in both the private and public sector, are numerous. Most often, self-employed appraisers complete single-family appraisals, for which the hiring party (most likely the home buyer or lender) pays compensation. While there are many ethical issues relating to home appraisal, this lesson raises one very important point: whatever the decided appraisal fee, it cannot relate to or depend on the final value estimate.

*Return to your online course player to take the Lesson Quiz.*
LESSON TWO
FEDERAL REGULATIONS AND NATIONAL AGENCIES

This lesson covers the following topics:

- The Appraisal Foundation
- FIRREA
- USPAP

INTRODUCTION

The Appraisal Foundation, FIRREA and USPAP jointly regulate and make the laws in the appraisal industry. The need for laws to control the appraisal industry was felt after the 1980’s when the real estate market went through a financial crisis caused by relaxed bank insurance policies, overvalued appraisals of real estate and lax supervision of the savings and loans industry. The federal laws created as a result of this helped counterbalance these problems.

THE APPRAISAL FOUNDATION

The Appraisal Foundation is a non-profit, non-governmental organization founded in 1987. The FIRREA act, passed by Congress in 1989, requires all states to conform to the guidelines of the Appraisal Foundation. The ASB (Appraisal Standards Board) and the AQB (Appraiser Qualifications Board) are the two bodies that constitute the Appraisal Foundation.

For more information about the Appraisal Foundation, visit the Website at: http://www.appraisalfoundation.org.

THE APPRAISAL STANDARDS BOARD (ASB)

The Appraisal Standards Board (ASB) creates the professional rules and regulations that appraisers must follow when appraising a property and making an appraisal report. The Uniform Standards of Professional Appraisal Practice (USPAP), which contains the professional and ethical guidelines for real estate appraisal, is enforced by the ASB.

THE APPRAISER QUALIFICATIONS BOARD (AQB)

The AQB (Appraiser Qualifications Board) decides the necessary conditions that appraisers throughout the country must meet to be licensed, certified and recertified. It also sets the minimum requirements that state agencies should have for appraisers to whom they grant licenses and certification.
FIRREA

FIRREA (Financial Institutions Reform, Recovery and Enforcement Act) is an act that Congress passed after the economic recession of the 1980’s. This slump occurred in part due to the deregulation of loans and the savings industry; thereafter, organizations dealing with loans and savings started buying and building private real estate. In the wake of this buying and building frenzy, appraisers, who were at the time not subject to state or federal laws, were pressured to appraise real estate at high values and many complied with this demand.

Because there was a need to regulate these harmful activities, FIRREA was passed. FIRREA ensured that, among other things, appraisers would not come under unfair influence and that federally insured banks would be protected from specious or faulty appraisals. FIRREA’s reach extended outside the appraisal industry as well.

The following are provisions of FIRREA:

- Bank regulators must adopt policies concerning the performance and operation of appraisals.
- All states must create and enforce a program for the licensing and certification of appraisers.
- By August 1990, lawmakers in federal banks must have enforced individual regulations, also referred to as the final rule by appraisers and lenders.
- Appraisals made for banks must come from certified or licensed individuals.
- A nationwide list of all certified and licensed appraisers must be made available to lending institutions.

LICENSING VS. CERTIFICATION

A licensed appraiser is different from a certified appraiser in job as well as qualification and FIRREA elucidates this difference:

- A licensed appraiser may complete an appraisal of most non-residential properties or residential properties of one to four units whose value is less than $250,000.
- Only a certified appraiser can evaluate residential properties of one to four units whose value is above $250,000 and any properties whose value is above one million dollars.
- A certified appraiser should take up the appraisal of a property deemed particularly difficult or large by a licensed appraiser.
The 1980s proved that precise appraisals are crucial to both the real estate industry as well as the economy as a whole. Because of this, FIRREA mandates that all state licensing and certification standards meet or exceed those set forth by the Appraisal Foundation's two sub-organizations, the Appraisal Standards Board (ASB) and the Appraiser Qualifications Board (AQB).

**USPAP**

The Uniform Standards of Professional Appraisal Practice (USPAP) is the set of guidelines, created by the Appraisal Standards Board, to follow throughout an appraisal process. The Appraisal Foundation accepted and adopted USPAP in January 1989, and, shortly after the passage of FIRREA was implemented by all states as the basic set of requirements that licensed and certified appraisers must meet.

Updated annually to incorporate all changes, whether large or small, USPAP deals with the following issues:

- Personal/real property appraisal and reporting
- Business appraisal and reporting
- Review appraisal and reporting
- Real estate/property consulting
- Supplemental standards and statements
- Rules and jurisdictional exceptions
- Competency
- Ethics

**SUMMARY**

The formation of the Appraisal Foundation (a national, non-profit regulatory body) in 1987 marked the beginning of appraisal regulation. Although the society began publishing ethical and professional standards in 1987, federal law did not require adherence to the society's standards until 1989 with the enactment of FIRREA. Two boards form the Appraisal Foundation: the ASB (The Appraisals Standards Board) and the AQB (the Appraiser Qualifications Board). The ASB publishes the USPAP (the Uniform Standards of Professional Appraisal Practice) annually. This publication details the guidelines for impartial, accurate appraisals, offers definitions of key terminology and explains the process for compiling an appraisal report. The AQB establishes the minimum standards that all states must now either meet or exceed in the education, training, licensing and certifying of appraisers.

The *Financial Institutions Reform, Recovery and Enforcement Act*, or FIRREA changed more than just the appraisal industry; but for our purposes, FIRREA sought to end unscrupulous lending practices and regulate the appraisal
business. Initially, it required that states develop and maintain a system of licensure and certification for appraisers that met or exceeded those set by the AQB. It provided that the bank regulators adopt policies regarding the performance and utilization of appraisals. In addition, it stated that federal bank regulators needed to institute individual regulations by August 1990. (These regulations are commonly known as the final rule by lenders and appraisers.) Lastly, FIRREA required, and still does, that a national list of all licensed and certified appraisers be made available to lending institutions.

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LESSON THREE
VALUE PRINCIPLES

This lesson focuses on the following topics:

• Price
• Cost
• Value
• Value Principles and Theories

INTRODUCTION

Thus far we’ve discussed the role of an appraiser and with which agencies and laws he or she works. In this lesson we cover more explicitly the process of appraisal, including the main methods used to appraise real estate, the theories and principles that affect the value of land and how they are related to each other.

PRICE

The price of a property is the actual amount for which a property is sold and that which has been agreed upon and written into a contract. It can also be looked upon as the transaction charge. These may not be the same but usually there is a connection between the price of a property and its calculated value, such as the insurable value, investment value, market value, etc. There are, however, reasons for which a property may not sell for its estimated worth; for example, if the buyer is a friend or relative, or if the seller is urgent to sell, then the seller may accept a lower price. However, the market value is often the same as or greater than the purchase price of a property.

COST OF CREDIT

Upon the closing of a real estate transaction, the purchaser often chooses not to pay the full amount in cash; most purchasers pay only part of the cost up front and then the remainder later. This remaining amount is thus a long-term loan. And like all loans, interest is charged on it. This interest paid on such a long-term loan is referred to as the cost of credit. If the cost of credit is high, meaning interest rates are high, fewer people purchase homes on account of the significant increase in overall money spent.

Loans tend to fall into one of two categories: short-term or long-term. Short-term loans can be obtained from the money market in such forms as certificates of deposit, notes and securities, U.S. Treasury bills and even Euros, whereas long-term loans are obtained from the capital market through the likes of deeds of
trust, stocks, bonds and mortgages. All the organizations that lend funds for property purchases are part of the capital market. These organizations are actually investing money when they approve a loan as a result of earning a profit from the interest they charge.

Concerning investors, there are two basic types: equity and debt. Equity investors loan money without security, but with a very high interest rate; this is referred to as venture capital. Debt investors, on the other hand, are the more conservative lenders; they keep a share in the property for which they are lending as security for their loan.

**COST**

Cost is the money spent to obtain a good or service. As an example, imagine the process of building a new home; cost is the term used to reference the total amount spent on all goods and services employed, including the price of the land, the material used in building the home and labor costs of the homebuilders. This cost may differ significantly from an assessed value.

**VALUE**

Value is defined as an assessment of worth at a specific time, with respect to various factors or indicators like inflation and cost of credit. Since value can change, an appraiser should include the date and the type of value when making an appraisal of real property, like a home.

There are many types of value that an appraiser may be required to assess by a lending institution or by an individual, including:

- Appraised Value
- Assessed Value
- Book Value
- Capitalization Value
- Cash Value
- Depreciated Value
- Exchange Value
- Going-Concern Value
- Improved Value
- Inheritance Tax Value
- Insurable Value
- Investment Value
- Leased Fee Value
- Leasehold Value
- Liquidation Value
- Market Value
• Mortgage Loan Value
• Rental Value
• Replacement Value
• Salvage Value
• Value in Use

Market value is the most common type, to which we usually refer when we use the term.

TYPES OF VALUE

We will now look at some of the more common types of value assessments, namely market value, value in use, assessed value and insurable value.

Market Value

Market value helps greatly in determining the price for which a property may be sold. Of the many valuations of real property that brokers and salesperson may encounter, market value is referenced most frequently. USPAP defines market value as:

“The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.”

Implicit in this definition are the conditions whereby:

• Buyer and seller are typically motivated.
• Both parties are well informed or well advised, and acting in what they consider their best interests.
• A reasonable time is allowed for exposure in the open market.
• Payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto.
• The price represents the normal consideration for the property sold and unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Value in Use

The value in use principle is most applicable to commercial properties. One thing that appraisers should keep in mind is that not all value is tangible. The value in use of a property is a measure of how well a property is fulfilling its intended purpose. For example, two properties might be exactly the same in certain physical ways, that is to say, same builder, neighboring location and identical
amenities; however, one might have a higher value in use than another because it has a more popular commercial reputation.

**Assessed Value**

The assessed value of a land is an estimate of its worth that local taxing authorities make in order to calculate ad valorem taxes on the land. The local authorities levy ad valorem taxes, which are a percentage of the property value, through property taxes. Licensees are not expected to have a thorough knowledge about taxation, although property taxes do significantly affect the process of purchasing a home.

If an appraisal licensee can understand and convey the consequences of how the assessed value of real estate affects taxes, they will effectively be a notch above their fellow licensees, as this is not a required job function but a supplemental skill.

**Insurable Value**

Insurable value is the value for which an insurance company will insure a property. It is used specially to assist with financing of property since property insurance and insurable statements are required for many loans. Insurable value takes into consideration only additional improvements that are made to a piece of land, not the land itself. For example, if there is a piece of land on which a new structure is built, then the insurable value will relate only to the new structure, not to any pre-existing ones.

**VALUE PRINCIPLES AND THEORIES**

There are certain factors, principles, trends and theories that affect the value of real estate; these are all interrelated and impact property value in different ways and to different extents. The degree of effect on the value of a property also depends on the approach that an appraiser takes. An appraiser should be well aware of these theories and principles and be able to utilize such knowledge so as to analyze any property and estimate its value accordingly.

**ANTICIPATION**

According to the principle of anticipation, the value of real estate can fluctuate due to certain events that are expected to happen. The value of real estate usually appreciates, that is increases, but that is not always the case.

Different people related in some capacity to real property stand to gain or lose from this association. For example, if a school is built in a locality where there were previously no schools, then the people living in the houses nearest the school might feel a lack of privacy and notice an increase in noise levels, and
consequentially anticipate the value of their houses diminishing, whereas people who are a few blocks away might anticipate a rise in the value of their homes because they now have a school in the neighborhood.

Anticipation is closely related to change, competition and supply and demand.

**BALANCE**

According to the principle of balance, when there is a congruous relationship between all factors that play a significant role in the market, the value of real estate increases. These factors include consumers and producers, supply and demand, land, manpower, capital and management. A strong and healthy economy gives a boost to the value of real estate, while a weak economy brings the value of property down. Real estate is most valuable when supply and demand is near equal. This happens when there are several providers in the market and a matching number of buyers, as well as sufficient real estate, laborers, money and people to administer and manage the properties.

Balance is closely tied to these other principles: conformity, contribution, surplus productivity, and the four agents of production.

**CHANGE**

According to the principle of change the value of an item in the market does not always remain the same but keeps changing because of natural factors as well as the needs of the market. Due to this real estate appraisers must be well experienced. Although they cannot predict natural and weather-related events or calamities, they can identify the associated consequences.

The three other principles which change is tied in with are anticipation, inclining and declining periods, and supply and demand.

**COMPETITION**

The principle of competition holds that the value of a property will be affected with respect to the availability of similar properties in a similar area. For example, if many properties of a similar nature are all available in a local area, the value of those properties will decrease. Inversely, a scarcity of a particular kind of property in a local area will increase value. For appraisers who evaluate single-family houses, the principle of competition is significant because a common method of calculating market value is by comparing properties that are available and similar to the subject property.

The two other principles to which competition is tied are anticipation and supply and demand.
CONFORMITY

According to the principle of conformity if all residences in a locality are similar in structure, age and size, and are maintained in the same way and have comparable market appeal, their value increases. The principle of conformity entails progression and regression.

Progression

When houses in an area are similar to each other, their values increase; this is called progression. For example, if a house is built in an area where it is initially the only house, its value will increase when other houses with similar characteristics and market value are built in the neighboring locale.

Regression

When houses in a certain area lack conformity, their values decrease; this is called regression. For example, if a house is built in an area where it is the only new and modern house in the midst of older, shabby and rundown houses, its value will be less than that of a similar house in a different location, one that is surrounded by new and modern houses with the latest facilities and amenities.

The principle of conformity is related to balance.

CONTRIBUTION

According to the principle of contribution, when an improvement is made to a property, its value is directly equivalent to its increase in market value, regardless of the cost of the improvement. Because of this, when an appraiser estimates the value of an improvement, he or she looks at how much it has contributed to the property’s value, not the cost to obtain and apply it. There is no rule such that the value of land depends entirely on its cost. For example, plants and greenery can be grown next to a property at a low cost but they might increase the value of the property to a much greater extent.

The four other principles to which contribution is tied with are balance, the four agents of production, substitution and conformity.

EXTERNALITIES

According to the principle of externalities, external factors such as stock market trends, the socio-political climate, money exchange rates, government facilities and regulation and tax laws; are all examples of external factors that can affect property. These are present at various levels ranging from city, county and state to school districts and on up to the national level.
The other principles to which the principle of externalities is tied are inclining and declining periods and supply and demand.

**INCLINING AND DECLINING PERIODS**

You may recall that, according to the principle of change discussed earlier, the value of an item in the market does not always remain constant but keeps changing because of natural factors and demands made on the market. This gives rise to the three phases through which a market commodity commonly travels: inclining and diminishing periods of growth, stability and decline. This is not a rule for every single property but a general trend that can be observed among properties that offer sound structure and design and have decent market values.

**Growth**

When a property is new, it typically corresponds to current trends and preferences in the market. Because new homes on the market are generally few in number, their value, assuming no inherent design flaws, will tend to increase for a certain period of time. The period of time during which a new property's relatively scarce supply drives its demand, and as a consequence its value, is called the period of growth.

**Stabilization**

When the value of a property stops increasing, levels off and becomes steady, it is said to be in a stabilization phase. This is usually due to ordinary occurrences like natural depreciation or changing market trends and needs. Changes in market strength are inevitable.

**Decline**

The third and last stage of this real estate life cycle is the that of decline. This is when demand for a property decreases whereas the cost to maintain it increases. While a well built home will last for a long time, no physical structure is eternal; the period of decline is perhaps the most natural one.

The inclining and declining periods are tied to the principles of change and externalities.

**THEORY OF INCREASING AND DECREASING RETURNS**

According to the theory of increasing and decreasing returns, until the cost of property maintenance becomes greater than property value, an owner is justified
in contributing to the upkeep of the property. From this point of view, the life cycle of a property is divided into two phases, the periods of increasing and decreasing returns.

**Increasing Returns**

The law of increasing returns is in effect what happens when an improvement made on real estate gives rise to a profit that is equal to or greater than the cost of the improvement. This means that the improvement made to the property was a worthwhile investment.

**Decreasing Returns**

The law of decreasing returns is in effect when money spent on an improvement or the maintenance of an existing improvement does not give rise to positive earnings or a value increase on the land. This means that, costwise, it was not worthwhile to have spent the money on making or maintaining the improvement.

The three principles to which the theory of increasing and decreasing returns is tied are change, inclining and declining periods, and opportunity cost.

**OPPORTUNITY COST**

Opportunity cost refers to the time and money sacrificed to complete a task. For example, if a person is going to college, then the opportunity cost is not just cost incurred on related expenses such as books, school fees and other supplies, but also the amount of money that could have been earned by working somewhere while attending college.

The principle of opportunity cost is applied in the appraisal process when properties that generate income are being appraised. Then, the rate of return for the property being examined is compared to the rates of return for similar properties.

The four principles to which opportunity cost is tied are competition, the four agents of production, substitution and supply and demand.

**SUBSTITUTION**

According to the principle of substitution, a purchaser will only pay the amount of money to purchase a property for which he or she could buy another similar property.

While this theory is practiced throughout the appraisal profession, it is particularly pertinent to the appraising of residential housing. In evaluating a home’s worth, a
proper appraisal will take into account the selling price of recently sold, similar housing in the neighborhood. And while an owner sets the asking price, it is fitting that the appraiser relates such information to the owner before his or her final decision.

Substitution is related to the principle of contribution.

**SUPPLY AND DEMAND**

The supply and demand of a property relates to its availability and scarcity in the area where it is located. The price of a property depends on the demand for and supply of such a property in the market. When the demand goes up or supply goes down, the value of the property increases, and vice versa.

The theory of supply and demand is tied to the principles of change and substitution.

**SURPLUS PRODUCTIVITY**

The four agents of production are land, labor, capital and management, and all are acquired at a cost-to-generate profit. For example, while land is acquired at a set price and taxes then have to be paid on it, there may also be a return on land in the form of rent.

The expenditure relevant to the cost of owning land—like spent wages, management labor, taxes and maintenance costs—must be subtracted from net income to calculate the entrepreneurial incentive or surplus productivity of an income-generating property.

The value of a commercial property depends on how much income it can generate, a measure of which is its surplus productivity. Appraisers utilize this method in the income capitalization approach to appraisal.

The three principles to which surplus productivity relate are balance, contribution and the four agents of production.

**HIGHEST AND BEST USE**

The highest and best use principle is the most important value principle for land value appraisal; according to this principle, there is one particular way a plot of land can be used most efficiently so as to generate the highest possible income. The highest and best use of land must be legal, financially viable, productive and physically plausible, and the land should be developed with its highest and best use in mind.
The highest and best use of a plot of land does not always remain constant, but rather changes with time. The way a plot of land is currently being used may not be considered its highest and best use. To determine the highest and best use, the current earnings are compared with possible alternate earning scenarios; this evaluation of the land is conducted differently depending on whether it is currently undeveloped or improved.

**Highest and Best Use Study on an Improved Lot**

There are several methods that can be employed to determine the highest and best use of real estate which has been improved, and thus to compare a possible future application against other probable ones, as well as with the land's current usage.

One method is to look at the income the current use of the property is generating, and to compare that with income that could be generated from any alternate application of the property, provided the current use meets the requirements for an alternate application.

Another method is to subtract the cost of renovating the current structure from a potential income of an alternate application and compare the resultant amount with the current income being generated.

One other method is to assume that the land is currently vacated and subtract the cost of destroying and removing the current structure from the potential incomes of alternate uses and compare the resultant amount with the income being generated currently.

**SUMMARY**

Initially, this lesson differentiates between cost, purchase price and value. Although these amounts are often related, they are not the same. *Purchase price* is the transaction charge, or the value at which the property actually sells. This price is heavily influenced by the cost of credit. *Cost* is the money paid for goods or services supplied. *Value* refers to the worth of an item relative to some function or indicator at a given date. There are different types of value. This module concerns itself primarily with *market value*—"the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, [with] the buyer and seller each acting prudently and knowledgeably, and assuming [that] the price is not affected by undue stimulus" (USPAP).

Many factors (or principles) influence value. This lesson introduces those factors that an experienced appraiser uses as he or she constructs a report. Anticipation, balance, change, competition, conformity, contribution, externalities, progression and regression, inclining and declining periods, the law of increasing and
decreasing returns, opportunity cost, substitution, supply and demand, surplus productivity, and the highest and best use all influence value statements. Their importance depends on a job's particularities; however, it will be useful to remember the following in the continuing discussion of appraisal approaches: highest and best use, supply and demand, the principle of substitution and also contribution.

The principle of highest and best use states that there is usually one most productive use for any given property, which determines the utility of a current improvement. The highest and best use of a property is not necessarily its current use. An appraiser must decide if there is a better use for a tract of land before he or she can confidently state the value of the given property.

A home's value relates to the economic interaction of supply and demand at the time of the appraisal. Price varies directly with demand and inversely with supply. For example, if supply is low, then price is high; if demand is high, then price is high. For our purposes supply and demand relate to the local real estate market, such as within a certain neighborhood.

The principle of contribution states that an improvement on a property is only as valuable as the difference it causes in the property's overall value. The contribution of a particular improvement is not necessarily how much the improvement was to add. For example, if an owner landscapes a property, then the contributing amount may be significant even though the cost of the contribution made was quite small.

The principle of substitution, particularly important to the sales comparison approach in real estate appraisal, states that a buyer only pays as much as he or she would have paid for a comparable house in a comparable area. For example, if two houses that are very similar to the subject house sell for $120,000, then it is likely that the home in question will sell for around that same amount. If two houses are alike in almost every way, then a potential buyer will usually purchase the less expensive home.

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LESSON FOUR
THE DYNAMICS OF THE REAL ESTATE MARKET

This lesson focuses on the following topics:

- Market Influences
- Value Criteria
- Combining Market Influences with Value Determinants

INTRODUCTION

A market is a place where people buy and sell commodities. Thus, a real estate market is where people buy and sell real estate in a local setting. However, even though the purchase and sale of land may be done locally, the effects of the transaction are felt far and wide, or locally to nationally.

The value of a property—its demand, utility, scarcity and transferability—is affected by certain characteristics prevalent in the market relating to applicable economic, social, governmental or physical aspects. This lesson addresses these factors.

MARKET INFLUENCES

Appraisers look at certain aspects of real estate to collect information and analyze the value of a property; specifically this includes financial, legal and social factors, such as the cost of credit, city infrastructure and employment trends. The main groups into which all these factors fall will be discussed first.

PHYSICAL

Before ascertaining its value, an appraiser must look at the actual physical location of a property and other related physical characteristics, such as its condition and surroundings, how old it is and the climate of the area.

SOCIAL

The social aspect of a property involves trends among the people that live in the area; their ages, the number of members in their families, their preferences, etc.

GOVERNMENTAL

The government applies laws to a property at the local, state and national levels to set limits on the way the property can be used and distributed, for example
zoning, rent regularization and tax-related laws. These laws affect the worth of a property and should be taken into account during the appraisal process.

ECONOMIC

The economic factors affecting the value of a property are relevant to the local property market and beyond. The cost of credit significantly affects a property’s worth, as do the accessibility of funds, interest rates as well as average earnings.

VALUE CRITERIA

The factors that we have discussed up until now affect the value of a property. We will now see ways in which an appraiser determines how and to what extent these factors affect the value of a property through their relationship with the demand, utility, scarcity and transferability of a property.

Demand: The wish and ability to buy an item. Something that is of value is necessarily in demand.

Utility: The use to which an item can be put. An item must have some use for it to be of some value.
  • Homes are usually useful unless they are made in a way, or situated in a place, which makes them inconvenient to live in.

Scarcity: The scarcity of an item refers to the lack of it being present in the market. Items that are of greater value are usually available in limited quantities.
  • If there are few of a certain type of homestead in a locality, people will usually want to buy those over the houses that are plentiful, assuming quality among the houses is otherwise the same.

Transferability: The transferability of an item is the ease with which its ownership can be changed. The easier it is to transfer ownership of an item, the greater the transferability (and thus usually value).
  • The title of a house must be easy to transfer. If there are issues with a house such that the title cannot be easily transferred under the buyer’s name, then people will not want to buy it.

In general, the higher the demand, utility, scarcity and transferability of a property, the higher its value. All these qualities should be examined before drawing any conclusions about a property’s value.
COMBINING MARKET CHARACTERISTICS WITH VALUE DETERMINANTS

Thus far, we have covered market characteristics and elements that determine value; we shall now discuss the relationship between these. Because trends in the market affect demand, utility, scarcity and transferability, they thereby influence the value of property.

RELATIONSHIP CHARTS

Through some examples, we will now explore how market influences affect property value.

1.

<table>
<thead>
<tr>
<th>Market Influence</th>
<th>Element that creates value</th>
<th>Effect on Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Physical</strong></td>
<td><strong>Demand</strong></td>
<td><strong>Value</strong></td>
</tr>
<tr>
<td>(The location of property is downtown.)</td>
<td>(There is a high demand for properties in the downtown area.)</td>
<td>(Value of property increases.)</td>
</tr>
<tr>
<td><strong>Scarcity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Downtown properties are scarce.)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The physical location of a property is downtown. Such properties are scarce since there are not many downtown properties being sold. This property is in high demand. Thus, its value increases.

2.

<table>
<thead>
<tr>
<th>Market Influence</th>
<th>Element that creates value</th>
<th>Effect on Value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governmental</strong></td>
<td><strong>Transferability</strong></td>
<td><strong>Value</strong></td>
</tr>
<tr>
<td>(An outstanding lien exists on the property.)</td>
<td>(The transferability of the property decreases because of the lien.)</td>
<td>(The value of property decreases.)</td>
</tr>
</tbody>
</table>

When there is an outstanding lien against a property, which causes difficulty in changing the ownership of the property, the value of the property decreases. In
turn, this decreases the transferability of the property and, thus, decreases the value of the property as well.

**MARKET READING**

We will now look at a real life scenario and try to see how market influences affect value determinants—the elements that create value. Of course, in real life there are many other factors affecting a situation, so things may not be so simple; but it is still useful to look at the main workings of cause and effect in a practical real life setting.

**Market Description**

Say there is a new residential area—Happy Homes—being built near an industrial complex within close driving distance of a busy city center. The residential area is still under development so most community centers, such as parks and libraries, have not yet been built. However, quite a few houses have been constructed and the nearby industrial complex provides an excellent source of jobs for the local population. The houses are all new with good fittings and facilities, and there are no liens or other liabilities attached to these homes.

**Value Criteria**

We will now look at how the description above applies to our value determinates:

**Demand:** All characteristics of a property should be examined for their affect on demand, but let us focus on just a few: the property is located near the city center which makes access to markets easier for the residents. Proximity to the industrial complex ensures that the residents can find employment. This increases the demand for the property and, consequentially, the value.

**Utility:** The houses are well built and in a good area. Their utility is high which thus increases their value.

**Scarcity:** We have to observe how scarce the property is with respect to its immediate location and surroundings; because quite a few houses have been built, scarcity is low and this decreases value.

**Transferability:** There are no outstanding liens on the property, thus titles of property are clean and houses can be transferred easily. Transferability is high so the value again increases.
Property Value Summation

The demand, utility and transferability of the houses are high and cause an increase in value. However, the scarcity of the houses is low and causes a decrease in value. Even so, overall, the value of the property increases.

SUMMARY

This lesson introduces the idea of a market, which is a place for buying and selling commodities; for our purposes, the commodity is real estate and the market refers to the local real estate market. The value principles described in the previous lesson play out in any number of ways within this sphere. This lesson introduces two market characteristics and value criterions.

An appraiser gathers information on market characteristics or conditions. These characteristics represent one of four types: social, physical, economic or governmental. Social characteristics relate to the local real estate market's demographics: its population, average age, family size, consumer preference, etc. The physical characteristics relate to the area's climate and the property's age, size and condition. Economic characteristics include the cost of credit, the availability of financing and interest rates. Governmental controls also influence value. These controls include all applicable taxation and zoning laws.

An appraiser applies these characteristics to the four value criterions: demand, utility, scarcity and transferability, to discover how they affect value. For example, if a home were located near a lake, then the appraiser would note this particular physical characteristic. He or she would then apply this to the value criterion of demand. Properties near lakes are in high demand, and thus usually have increased value. One would then apply the characteristic to scarcity. Generally speaking, lake properties are scarce. Consequently, value increases.

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LESSON FIVE
APPROACHES TO APPRAISAL

This lesson focuses on the following topics:

- Land Value Approaches
- Relationship between the Approaches

INTRODUCTION

This lesson discusses three different ways to appraise a property. None are mutually exclusive, and in fact they are often used concurrently. They are as follows:

- Sales comparison approach
- Cost approach
- Income capitalization approach

LAND VALUE APPROACHES

We will now look at the three approaches in further detail, with respect to land value.

SALES COMPARISON APPROACH

Comparable Property $\pm$ Adjustments = Subject Property Value

Purchase Price

Recall covering the two value principles of substitution and contribution in Lesson Three? The value principle of substitution states that someone will pay only that amount of money to purchase a property for which they could buy another similar property.

The value principle of contribution states that when an improvement is made to a property, its value is equivalent to its increase in market value, regardless of the cost of the improvement.

An appraiser must know the prices for which properties comparable to the one being examined have recently sold. This is called the sales comparison approach or the market data approach and it operates on the principle of substitution, explained earlier. The property being appraised is called the subject property while similar properties are referred to as comparables. The appraiser must calculate the difference in the value, called the contributing value or adjustment,
and then apply the following calculation to devise the value of the property being appraised. Residential properties and empty pieces of real estate are often appraised using this method.

Adjustments are always made to the price of the comparable, not to the subject property. For example, if a garden is present in the comparable property but not in the subject property, the contributing value of the garden must be subtracted from the purchase price of the comparable property. On the other hand, if a garden is present in the subject property but not in the comparable property, the contributing value of the garden must be added to the purchase price of the comparable property.

**Types of Adjustments**

The appraiser can adjust the purchase price of the comparable for many different reasons; we divide these into three main groups:

- On-site features
- Off-site features
- Sale conditions

On-site features refer to the actual physical features of the property. The appraiser must take into account the different physical features of the comparable and subject properties, such as different number or size of rooms, windows, doors, bathroom and kitchen fixtures, etc. Off-site features refer to the area where the property is located. Being located in a place with facilities for residents such as schools, supermarkets or centers of employment would be considered off-site features. Sale conditions are those under which the comparable property was sold that could have been factored in its price; for example, whether or not the property was bought using creative financing.
Adjustment Examples

Please complete the following exercises using the sales comparison approach to appraisal.

On-Site Differences

Appraiser A wants to find the value for Home B. He finds out that Home C recently sold up the street for $120,000. The houses are very similar except that Home C has an extra half-bath with a contributing value of $500.

1. Which home is the subject property? _________________
2. Which home is the comparable property? _________________
3. Using the sales comparison approach to appraisal, fill in the appropriate home in the appropriate spot.

_________ – Contributing Value = ___________
ANSWER KEY:
1: The subject property is the home the appraiser is currently appraising. *(Home B)*
2: A similar, recently sold home that an appraiser uses to estimate the value of the subject property. *(Home C)*
3: The comparable (Home C) has a bath with a contributing value of $500. Subtract this amount from the purchase price to compensate for the difference and arrive at the subject property *(Home B)*’s value.

\[ \$120,000 - \$500 = \$119,500 \]

Off-Site Differences

Appraiser B is currently appraising several homes within a five-mile radius of a park. She wants to establish the contributing value of park’s proximity, so she takes two otherwise identical homes: Home A, within a mile radius, and Home B five miles away from the park. Home A sold for $100,000. Home B sold for $95,000. What is the park’s contributing value?
FEEDBACK: Take the difference between the two homes. $100,000 – X = $95,000. So, the contributing value is $5,000.

Sale Condition Differences

Subject Property W is 10 years old. Appraiser Y finds a comparable property that is also 10 years old, which sold for $80,000 six months earlier. She knows that changes in the market affect purchase price and determines that, for various reasons, property values increased 5% over the past six months. Using the sales comparison approach to appraisal, what is the value of Subject Property W?
FEEDBACK:
First, multiply $80,000 by .05. This results in $4,000. If you add that to the comparable value, the subject property’s value is $84,000.

Appraising Vacant Land

Empty pieces of land are also usually appraised through the sales comparison approach. The method that the appraiser follows is to find comparable properties and make the appropriate on-site, off-site and sale conditions adjustments. Soil integrity, land surface and dimensions, zoning laws, physical location and the availability of facilities are some examples of causes for adjustment.

Arm's-Length Transaction

Although the appraiser adjusts for subtle differences in a property, he or she must carefully examine the condition of sale. If the appraiser finds that the sale did not occur at arm's-length, then he or she should pick a different property. An arm's-length transaction refers to a transaction in which neither the seller nor buyer act under undue duress. Only an experienced appraiser can absolutely separate those sales conditions that he or she can adjust from and those that provide undue duress; however, consider the following exercise illustrating those transactions that pose undue duress.

Circle those conditions that may prevent an arm's-length sale:

1. The seller's company transferred her to a new city and she must move immediately.
   Yes           No
2. The home is put up for sale for tax delinquency.
   Yes           No
3. The city recently zoned a landfill near the home.
   Yes           No
4. The seller failed to disclose the untreated mold growth in the bathroom.
   Yes           No
5. The buyer is the seller's son-in-law.
   Yes           No
FEEDBACK:
Numbers 1, 2, 4 and 5 are not conducted at arm's-length. In the first sale, the seller needs to sell the home as quickly as possible. This means that the home may not remain on the market long enough to fetch the property’s market price. In this case, the appraiser should probably choose another property. In example 2, time is also a key factor. Without adequate marketing time, the sale condition is not at an arm's-length. In example 4, the seller failed to disclose pertinent information and this pushed undue stress onto the buyer. The fifth example may be the simplest example of an arm’s-length complication. When there is a direct relationship between a buyer and a seller other than in the terms of a sale, the sale is probably not at arm's-length.

There are certain situations that may occur in a transaction that would effectively negate an arm’s length description. These include circumstances where the principal parties of a transaction already know each other; where there is no (or a very small) initial payment for a purchase and the entire payment is made through creative financing; and where the sale is forced, for example in the case of a liquidation, tax sale or foreclosure.

COST APPROACH

Several steps are involved in the cost approach to appraisal:

1. The value of the site is calculated, usually through the sales comparison approach.
2. The value of all the improvements that have been applied to land is calculated by looking at how much it will cost to replace those improvements or construct them again according to present market prices.
3. The value of the depreciation on those improvements is subtracted from the calculated value of constructing them.
4. This figure is added to the value of the site.

The following equation sums up the cost approach:

\[
\text{Reproduction Cost of Improvement} - \text{Improvement's Depreciation} + \text{Site Value} = \text{Property Value}
\]

Depreciation

As an item wears out over time, or a new law is enacted that affects the usage of an item, or even as new trends come about in society, depreciation is at work. All commodities suffer depreciation, including real estate. Depreciation of real estate
occurs as a result of obsolescence, either external or functional, and deterioration. External obsolescence is when the best and highest use of a property changes, there is a new demand supply situation or zoning regulations have been introduced. Functional obsolescence is a result of an antiquated structure or look of a property. Deterioration of a property is a result of usage, weather, etc.

**Steps in the Cost Approach to Appraisal**

The following are the steps that an appraiser must follow in the cost approach to appraisal:

1. Determine how much it will cost to get the improvements made on the property redone with respect to prices in the present market.
2. Calculate in dollars the value of the depreciation on those improvements.
3. Find out what a comparable piece of real estate costs.
4. Apply the needed adjustments to the comparable land.
5. Apply the cost approach equation to the values calculated from above.
6. Calculate the value of the property.

**Cost Approach Examples**

Please complete the following exercise using the cost approach to appraisal.

Appraiser Y wants to find the value of Office Building A. Office Building A would cost $400,000 to construct today. In light of this, Appraiser Y concludes that the building has depreciated by 20%. In addition, he finds a vacant and nearly identical parcel nearby that sold for $100,000 early in the year. The comparable land has a small hill, which makes it more valuable than the subject property. Appraiser Y estimates this difference at $1,000. What is the value of the subject property, Office Building A? For the answer, complete the following steps:

This problem has two parts, the sales comparison steps for land valuation and the cost steps for improvement valuation. Begin with cost.

**Step 1:** Cost approach steps

1. Establish the reproduction cost of Office Building A.

   __________

2. Find the depreciation in dollars.

   ____________ x _____________ = _______________
Step 2: Establish site value using the sales comparison approach.

1. Establish the value of the comparable parcel.

   ___________

2. Subtract the adjustment to establish site value.

   ___________ – ______________ = ______________

Step 3: Combine the information in the cost approach equation

   ___________ – ______________ + ______________ = ______________

2. What is the property value of Office Building A?

   ___________
ANSWER KEY:

Step 1:
1. $400,000 (Cost to construct today)
2. $400,000 (Reproduction cost) x 20% (Depreciation extent) = $80,000 (Depreciation loss)

Step 2:
1. $100,000 (Comparable parcel cost)
2. $100,000 (Comparable) - $1,000 (Contributing value) = $99,000 (Site value)

Step 3:
1. $400,000 - $80,000 + $99,000 = Property value
2. $419,000

INCOME CAPITALIZATION APPROACH

The income capitalization approach calculates property value in relation to the profit that an owner expects from a property over the course of his or her investment. Value then equals the net income a property will produce over its remaining economic life, or the profit the property will generate before it diminishes due to obsolescence or deterioration. Before continuing on to the income capitalization approach, please review the following terms:

1. **Net Operating Income**: An annual representation of realized profit (gross income minus operating expenses).

2. **Effective Gross Income**: All the sources of income, including rent, minus vacancy and collection expenses (i.e., non-payment, late payment, etc.).

3. **Operating Expenses**: All the costs associated with maintaining and running the property.

4. **Potential Gross Income**: A property's maximum profit opportunity providing for no vacancies or collection losses.

5. **Rate of Return**: An investor's percentage yield based on a property's income.

With these terms in mind, the value of the property equals the net operating income—or the difference between the effective gross income and all operating expenses—divided by the rate of return. To arrive at an adequate net operating income, an appraiser must utilize a thorough calculation of income and expenses. In essence, there are four steps to calculating value using the income capitalization approach:
1. Estimate the potential gross income, which is the profit assuming no vacancies or collection losses.

2. Establish the effective gross income by subtracting vacancies and collection losses from the potential gross income.

3. Determine the annual net operating income by subtracting all annual operating expenses from the effective gross income.

4. Divide the net operating income by the rate of return, also called the capitalization rate.

Once an appraiser has the potential gross income, he or she utilizes the following equations, illustrating the steps given above.

**Equation 1: Effective Gross Income**

\[
\text{Potential Gross Income} - \text{Vacancies and Collection Losses} = \text{Effective Gross Income}
\]

**Equation 2: Net Operating Income**

\[
\text{Effective Gross Income} - \text{Operating Expenses} = \text{Net Operating Income}
\]

**Equation 3: Property Value**

\[
\frac{\text{Net Operating Income}}{\text{Capitalization Rate}} = \text{Property Value}
\]

**Income Capitalization Approach Examples**

Please complete the following exercise using the income capitalization approach to appraisal.

Investment Property X yields a net annual rental income of $50,000. The investors expect a 20% return on their various investments. The investors wish to sell Investment Property X. What should their asking price be (in other words, what is the market value of Investment Property X)?
Uses for Income Capitalization Approach

The income capitalization approach is used to appraise properties that generate income, for example commercial or investment properties. Single-family residences are appraised using the cost and sales comparison appraisal approaches. The income capitalization approach does not work with them because they do not generate income.

RELATIONSHIP BETWEEN THE APPROACHES

You have now studied the three approaches to appraisal, all of which are interrelated. Think of how the sales comparison approach is used in the cost approach equation. The appraiser has to figure out which of the three appraisal approaches to apply to each particular appraisal case.

CHOOSING AN APPROACH

All three approaches to appraisal require different information. For example, to use the cost approach, the appraiser must receive construction costs. To use the sales comparison approach, an appraiser must have access to the purchase prices of comparable properties. To use the income capitalization approach, an appraiser must know a property's investment return and figures relating to personal investment amounts. Depending on the particular job, sometimes this information might be unavailable. The availability of information influences which appraisal approach an appraiser ultimately uses.

A property's use also influences this decision. Previously the lesson explained that the income capitalization approach is overly complex and often inaccurate when applied to single-family residential homes. An appraiser considers the nature and use of a particular property before deciding upon a particular approach over another. In general, an appraiser asks the following questions. After reviewing the questions, we provide a series of answers. Depending upon the answer and given the information within this lesson, pick the most appropriate approach to appraisal.

- Is the property a commercial property?
- Is the property a single-family residence?
• Is there access to information on the purchase prices of comparable properties?
• What information is the appraiser unable to access?

A building's use is the single most important factor to consider when deciding which approach to use. In light of this, think about the following situations.

Name the approach that would formulate the basis of your appraisal if you were the appraiser and the property in question is a residential home near a similar home that sold for $100,000 earlier that same month.

What approach to appraisal are you likely to use?
FEEDBACK:
Sales Comparison: The sales comparison approach to appraisal is most commonly used for residential homes. Provided that the appraiser has access to comparable properties, it will almost always formulate the basis of his or her value estimate.

If the property in question is a large office building downtown with an investment return of 10%, then what approach to appraisal is an appraiser likely to use?
FEEDBACK:
Income Capitalization: More than likely an appraiser will calculate the purchase price relative to the profit the building will yield as an investment over the course of its economic life.)

Given the previous information and exercises, you may have arrived at the conclusion, which some other appraisers also hold, that although these rules formulate the basis for appraisal, an appraiser will often combine approaches within a single job and that some properties—as will be the case with those introduced on subsequent pages—do not fall neatly into any one type. Nevertheless, in general:

- The sales comparison approach is most reliable for single-family homes.
- The cost approach is usually most reliable for non-income-producing properties other than single-family residencies.
- The income capitalization approach is most reliable for commercial or income-producing properties.

COMBINING APPROACHES

A mixture of the defined approaches can also be used if the value of the improvement and the land itself need to be calculated separately. For example, in the cost approach to appraisal or tax valuation, the value of the land and the improvement must be differentiated.

COMPLICATED BUILDING USES

We said that investment properties use the income capitalization approach and residences occupied by single families use the sales comparison approach; however, there are properties that cannot be divided into these categories, such as governmental and public property, for instance schools and hospitals. Such properties must be examined separately one by one.

Examine the following example, which illustrates how an appraiser might handle appraising a schoolhouse, which would constitute a complicated building use valuation.

If a 30-year-old schoolhouse were sold, which of the appraisal approaches would be used? Which of the approaches discussed would best form the basis of the valuation?

Schoolhouses are sold very rarely. Due to this, there will probably be no comparable properties. Without any comparable properties, the sales comparison approach does not work. The income capitalization approach might work, if the schoolhouse could easily convert into offices or another standard
commercial usage. Without these important pieces of information, however, the cost approach would likely be the most useful way to form the basis of this particular appraisal. More than likely, the high cost of reproducing such a building today would constitute the building's major selling point.

Consider an example:

What would Mr. A. Prayser do if he had to appraise an old school? The sales comparison approach cannot be employed as schools are infrequently sold and so there are no comparable properties. If the school can be transformed into a property with some commercial value, the income capitalization approach can be used. If this information is not currently available, the cost approach could be used to appraise the school. The biggest incentive for a potential buyer in the present market would be that to reproduce such a building today would be very expensive.

**SUMMARY**

This lesson covers the three most common approaches to property valuation: the cost approach, the sales comparison approach and the income capitalization approach. These appraisal methods are not mutually exclusive. Often, an appraiser uses more than one technique on a single project. In particular, the cost approach to appraisal necessitates the use of the sales comparison approach to appraisal, as illustrated below.

Using the sales comparison approach, an appraiser equates the subject property's value to the purchase price of a comparable property plus or minus adjustments for the contributing value of on-site, off-site or sale condition differences. This method is used almost exclusively for single-family residencies, vacant lots and site valuation in the cost approach. It employs the following equation:

\[
\text{Comparable's Purchase Price} \pm \text{Adjustments} = \text{Property Value}
\]

Using the cost approach, the appraiser estimates value equal to an improvement's reproduction cost at current market prices minus depreciation. The appraiser adds this amount to the estimated site value, usually found through the sales comparison approach. The cost approach is most commonly used to appraise non-income-producing properties that are not single-family homes. It uses the following equation:

\[
\text{Reproduction Cost of Improvements} - \text{Improvement's Depreciation} + \text{Site Value} = \text{Property Value}
\]
Using the income capitalization approach, appraisers estimate the value of a property by the amount of income it can be expected to produce over the course of its economic life. The value of the property is equal to the net operating income—or the difference between the effective gross income and all operating expenses—divided by the rate of return. This is used exclusively for income producing properties and utilizes the following equation.

\[
\text{Net Operating Income} \quad \frac{\text{Return (Capitalization) Rate}}{\text{Property Value}}
\]

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LESSON SIX
THE APPRAISAL PROCESS

This lesson focuses on the following topics:

• Eight Steps of the Appraisal Process

INTRODUCTION

This lesson covers the steps that are involved in appraising a property. USPAP defines the procedures and rules that appraisers must follow to appraise a property.

EIGHT STEPS OF THE APPRAISAL PROCESS

There are eight steps that an appraiser needs to follow to appraise a property. Each of them is covered in detail below.

STEP 1: STATE THE PROBLEM

The first thing that an appraiser must do is to carefully outline the tasks that are to be achieved and the purpose of the appraisal. All logistical details needed to identify the property being appraised and the appraisal project should also be stated, such as the location and legal description of the property and the date of the appraisal. The type of property rights to be appraised must be identified. From the beginning it should be clear whether it is the full ownership that needs to be evaluated or partial ownership, such as tenant’s ownership, etc. Further, any limitations need to be elucidated for the appraiser’s protection.

STEP 2: LISTING NECESSARY DATA AND ITS SOURCES

The appraiser must first decide which appraisal approach he or she is going to follow and collect the required data accordingly. Once the best approach has been decided, the appraiser will need to figure out exactly what further information is necessary. It is imperative that appraisers be knowledgeable about information sources from which they can retrieve data.

STEP 3: GATHERING, RECORDING AND VERIFYING DATA

In this step the appraiser must gather, verify, document and confirm the information that is needed to appraise the subject property.

Information about the physical features and location of the subject and comparable properties must be collected so that they can be compared properly.
The way this is done will be different depending on different approaches as well as type and worth of property.

Appraisers take pictures of the property to justify and provide documentation for their appraisal. For example, if a property has already been appraised at a certain value and then gets damaged, its value will naturally decrease; the appraiser can justify the previous high appraisal figure if he or she has pictures to show the former state of the property. Pictures of the property in an appraisal report also lend an air of professionalism.

**STEP 4: DETERMINING THE HIGHEST AND BEST USE**

The value principle of the highest and best use of land states that there is only one way to use a piece of land which brings about the greatest profit and utilizes the land in the best way. While it is not necessary that a property was formerly being utilized at its highest and best use, it is up to the appraiser to examine the land to determine what the highest and best use of the land is and to estimate a value for the land accordingly by using data collected about its physical features, financial condition and any government laws or regulations concerning it, and finally, to comparing this information to the current demands of the market.

**STEP 5: ESTIMATING THE LAND VALUE**

In this step the appraiser uses the sales comparison approach to locate real estate similar to the land parcel being appraised. This done by comparing the similar parcels to the subject property the appraiser makes the required adjustments. Remember the subject land parcel is evaluated separately from the improvements made on it.

**STEP 6: ESTIMATING VALUE WITH EACH OF THREE APPROACHES**

As we discussed earlier in the course, the three approaches to appraisal are the sales comparison, cost and income capitalization approaches; these are applied to the land depending on the type and use of the property. However, it is not necessary that a property appraisal necessarily use only one of these approaches, nor is it necessary for the appraiser to follow a certain approach for a certain type of property.

**STEP 7: RECONCILIATION OF THE FINAL VALUE ESTIMATE**

If an appraiser has used several approaches in appraising a property, he or she needs to combine the findings for the final report; this process is referred to as reconciliation. The results of their findings from the varied approaches are not just averaged, but rather the findings that are most applicable to the property.
being appraised are given the greatest importance and coverage in the final report.

STEP 8: WRITING AND PRESENTING THE VALUE REPORT

In this the last step of the appraisal process, the appraiser completes the appraisal report in accordance with the guidelines provided by USPAP. The appraiser can then submit either a written or oral report to the client. Both are allowed by USPAP, although a written report is more common.

SUMMARY

The appraisal process begins with the assignment of a particular project. An appraiser should always state the purpose of his or her appraisal in the report because it may not always be just for the sale of property. For example, perhaps a client needs a valuation statement for a home mortgage, for refinancing or for insurance purposes.

In all, there are eight steps in the appraisal process: to define the appraisal problem, plan the appraisal, collect and analyze the data, determine the highest and best use of the property, estimate the value of the site, estimate the value of the property, reconcile all data for a final estimate of value and prepare and present the appraisal report. The Appraisal Standards Board sets the guidelines for compiling an appraisal report, which are attainable annually in the USPAP (Uniform Standards of Professional Appraisal Practice).

To report an appraisal, an appraiser must reconcile all collected data, while keeping in mind that he or she may not simply estimate or average together any such figures. The appraisal must be as precise as possible with any limitations adequately stated. That is to say that the appraiser must state the scope and the date of the appraisal so that in the future interested parties will have a frame of reference in which to place the report. For example, to clarify intent, status, and scope, the appraiser may state that the appraisal has been made in terms of the property: as improved, as is, as subject to, or as purposed/based upon some other hypothetical. The actual report may be oral or written, although written reports are the industry standard.

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LESSEON SEVEN
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

- Completing a Residential Appraisal
- Field Applications of Appraisal Material

INTRODUCTION

This module has covered many specifics over a relatively short period of time. To ensure a comprehensive understanding, we have integrated the information provided in the module through an appraisal exercise and case studies. The first half of this lesson presents the student the opportunity to appraise an example home. Follow the directions given to establish the value of the single-family residency using the sales comparison approach to appraisal. The second half presents brief case studies that illustrate principles and ideas presented in this module.

COMPLETING A RESIDENTIAL APPRAISAL

During its discussion of appraisal approaches, this module explained how an appraiser accounts for the contributing value of the physical differences between a subject property and a comparable property.

Imagine that a client hires you to appraise Subject Home A. You decide to use Comparable House B, which recently sold for $100,000, as a comparable property.

<table>
<thead>
<tr>
<th>Subject Home A</th>
<th>Comparable Home B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pool</strong> (contributing value: $1500)</td>
<td><strong>Bay window</strong> (contributing value: $200)</td>
</tr>
<tr>
<td><strong>Covered deck</strong> (contributing value: $300)</td>
<td></td>
</tr>
</tbody>
</table>
This module used a pool several times as an example. Appraisers often adjust for physical differences such as an in-ground pool, which can contribute to a property’s overall value. Please note, however, that an above-ground pool usually has no contributing value. Consider the relationship between cost and contributing value. An above-ground pool may cost a good sum, but because it does not contribute to a property’s value, an appraiser does not consider it. The contributing value of this in-ground swimming pool is $1,500.

1. Do you want to add or subtract this value from Comparable Home B’s purchase price?

This module utilized a large bay window as an example. This type of improvement is especially popular located, as illustrated, near the dining room or breakfast nook. These windows and their installation may not cost a lot, but they do contribute to the property's overall appeal and value. The contributing value of the bay window is $200.

2. Do you want to add or subtract this value from Comparable Home B’s purchase price?
This module discussed the contributing value of covered decks. Often, deck work is something owners will complete, which means the cost of such a project may not be extensive. Nevertheless, a covered deck does appeal to consumer preferences as it allows an owner or renter the ability to enjoy his or her backyard more completely. Consequently, an appraiser would likely consider this deck and add or subtract accordingly for its contributing value. The contributing value of the covered deck is $300.

3. Do you want to add or subtract this value from Comparable Home B's purchase price?
We will now apply these numbers to the sales comparison approach equation.

We know that Comparable Home B’s Purchase Price was $100,000. Given your choices, we will adjust this price to account for Contributing Values:

\[
\begin{array}{c}
$100,000 \\
\text{Purchase Price of B} \\
\hline
(300+1500-200) \\
\text{Adjustments} \\
\hline
$101,600 \\
\text{Subject A’s Value}
\end{array}
\]

“Therefore, the purchase price of Comparable House B plus and minus the adjustments we’ve found equals Subject Home A’s Value of $101,600.”

**FIELD APPLICATIONS OF APPRAISAL MATERIAL**

Please consider the following case studies. After reading the situations, decide on how one could resolve the dilemma or complication.

**CASE STUDY ONE**

Seller A decides to sell her home and contracts Licensee B to represent her. Seller A asks Licensee B, “How much do you think I should ask for the home?” Licensee B has been a broker for 10 years, is pretty good at estimating market value and offers to prepare a CMA to determine a suitable list price; however, he tells Seller A that although he can offer her a good estimate, when Seller A receives and accepts a contract for sale, the buyer still needs to hire a licensed appraiser to determine loan value. Did Licensee B respond appropriately?
**CASE STUDY ONE RESPONSE**

Yes, Licensee B responded correctly. For all practical purposes, a real estate broker or agent prepares a CMA (Comparative Market Analysis) using the sales comparison approach to determine the list price. Once a seller and buyer agree to and accept a contract, the buyer or buyer’s lender sends an appraiser out to determine an appropriate value for a loan amount. One would employ a certified appraiser for expensive or very complex projects. The case study does not specifically state that the project is complex or the property very expensive. The student may recall from Lesson Two that FIRREA set the following standards:

A **certified appraiser must** complete a report involving:
- A property worth **over** $1 million.
- A one-unit to four-unit residential complex with a value **over** $250,000.

A **licensed appraiser may** complete any report involving:
- A one-unit to four-unit residential complex/dwelling worth **less** than $250,000.
- Most non-residential property worth **less** than $250,000.

If a **licensed** appraiser finds that a property is particularly large or that the appraisal report is particularly difficult, then a **certified** appraiser should assume the project.

**CASE STUDY TWO**

Appraiser A is appraising Subject Property X, a single-family residency. She decides to base the majority of her evaluation on the sales comparison approach to appraisal. She finds a comparable property up the street that recently sold for $100,000. She researches the property and the condition of sale to find any differences for which she may make adjustments. She finds out that the buyer placed no down payment when he purchased the house. She decides not to use the home as a comparable. Did she make the correct decision?
CASE STUDY TWO RESPONSE
Yes, Licensee A responded correctly. While an appraiser can adjust for the terms of a sale, if the sale did not occur at arm's length, then the appraiser should probably choose a different property. The student may recall the following rules for an arm's-length transaction from Lesson Six:

- Forced sales are (foreclosure, tax sale, estate liquidation, etc.) not at arm's-length.
- If the principals know each other outside the sales transaction, then it is not at arm's-length.
- Extremely creative financing and/or little or no down payment may compromise an arm's-length sale.

CASE STUDY THREE
Potential Client A walks into Licensee B's real estate office. She explains that an appraiser appraised her property at $150,000 and now she is looking for representation in the listing/selling of her home. During negotiations, she mentions that the appraiser compared her house to three other homes to arrive at a good asking price. Offhand, she asks Licensee B how that appraiser used the other homes in appraising her home and why the appraiser used this method. Licensee B seizes this opportunity to separate herself from other interviewees with whom Potential Client A may have spoken. What did Licensee B probably say?
CASE STUDY THREE RESPONSE
Licensee B probably explained the value principle of substitution, which comprises one of the single most important considerations when appraising any property, especially single-family residences. She may have recited the information presented in Lesson Three, which explains the principle of substitution as claiming that the price someone is willing to pay for a property is only as high as the amount that would acquire a similar or comparable property. More than likely, the comparable properties sold for around $150,000, which is the price that her home is likely to sell for as well.

CASE STUDY FOUR
Appraiser Z attempts to find the market value of Commercial Unit Y. After collecting all her data, she finds the following information true: the building produces $40,000 in net operating income. Based on an investor receiving a 5% return rate on his or her investment, what is a good market value estimate, or purchase price, for Commercial Unit Y?

As stated in Lesson 5, Appraiser Z will use the income capitalization rate for the basis of her value estimate. To establish a sound purchase price, she will use the following equation:

\[
\text{Net Operating Income} \div \text{Return (Capitalization) Rate} = \text{Property Value}
\]
CASE STUDY FOUR RESPONSE

Plugging the number in the above example into this equation:

\[
\frac{40,000}{5\%} = 800,000
\]

A good purchase price is $800,000.

CASE STUDY FIVE

Appraiser C, a certified appraiser, is asked to appraise Non-Profit Hospital Building A. How should he go about appraising this difficult case?
CASE STUDY FIVE RESPONSE
Being a non-profit hospital, there is likely no net operating income to consider. As well, because sales of such properties are extremely rare, Appraiser C will probably be unable to find an adequate comparable property. This leaves the cost approach. In such cases, as illustrated in a previous example in Lesson 5, the cost approach will form the basis for the appraiser's value estimate. Appraiser C will find the cost of duplicating such a building today and subtract from the actual building's depreciation. He will find the land value according to the sales comparison approach and add this site value onto the value of the improvement.

If you were representing, as either a salesperson or a broker, the hospital seller, then you might find that the main selling point of such a property is the high cost of reproducing the building at current prices.

CASE STUDY SIX
Property taxes can play a big role in the decision to purchase a particular home. Licensee A, generally familiar with local taxing laws, mentions property taxes and how they can impact the cost of a home to her client, Potential Buyer Y. In order to help Potential Buyer Y incorporate tax assessment into his buying decision, what type of value must Licensee A acquire?
CASE STUDY SIX RESPONSE
As indicated in Lesson Three, assessed value refers to the value determined by the local taxing authority, which it uses for ad valorem taxation. Usually a local authority levies ad valorem taxes through property taxes.

There are other types of value, which Lesson Three lists. A familiarity with the differences between these will help a licensee distinguish him- or herself from the competition. As the real estate market becomes increasingly competitive, licensees, like Licensee A who offer well rounded and complete/competent and impartial advice will continue to stand out in the crowd.

CASE STUDY SEVEN
Home Seller X walks into Licensee W's real estate office. He explains to Licensee W that he wants to sell his home, but has come across the following complication: recently his home was appraised for below what he expected, and less than what an appraisal estimated just three years before. He explains that there is not any significant damage to the house and that he can see no reason for the larger than expected value decline. Licensee W knows that there are factors that Home Seller X is not considering. He does not want to lose a potential client, but feels that he must explain the characteristics that X may not have taken into consideration. In addition, Licensee W knows that homes whose asking prices do not reflect the current market value often sell for less than market value. Assuming, for the sake of this example, that both appraisals are accurate, how could Licensee W respond sensitively while explaining the complex nature of the market?
CASE STUDY SEVEN RESPONSE
Initially, Licensee W could state that he understands Home Seller X's point of view, that without significant physical damage or wear, one might expect a home to retain its value. Nevertheless, physical characteristics are not the only factors to consider. As illustrated in Lesson Four, an appraiser examines four characteristic categories: physical, social, governmental and economic. Changes in legislation affecting the national economy may even have caused the change in value. Licensee W may have access to current market indicators or economic statistics that could help explain this.

Next, Licensee W should emphasize that the owner/seller, not an appraiser, always sets the final purchase price. Consequently, if employed, he might list property according to whatever purchase price Home Seller X desires; however, he should probably mention that, statistically, homes that ask a price above market value usually sell for less than the listed price.

CASE STUDY EIGHT
Licensee X represents Seller B. Licensee X has been a broker for the past 10 years. In his experience, he has found that it is not a good idea to locate appraisers for a particular client, as endorsing one appraiser over another may lead to an untrue (and therefore, indictable) belief about a particular appraiser. In addition, to protect his own unbiased professional opinion, he feels that choosing an appraiser is a decision that Seller B must make for herself. Nevertheless, Seller B asks Licensee X what she should look for in an appraiser. Understanding that Licensee X's opinions about divulging specific information about varying appraisers is a bad idea and that keeping himself professionally removed from the decision a good one, what advice could he give Seller B?
CASE STUDY EIGHT RESPONSE
The best advice Licensee X could give to Seller B, as listed in Lesson One of this module, is to look for a formally educated, experienced and licensed or certified appraiser. He could mention that many appraisers join professional organizations to prove their competency and experience. He might tell Seller B to check the appraiser's resume for membership in an appraisal association whose standards exceed those set by the Appraisal Foundation. It is a good idea that he mention that Seller B must weigh membership in such an organization on its own merits and that information pertaining to various associations is usually available online. This means that, if Seller B finds a particular association listed on a resume, then she could find information pertaining to membership qualifications there.

CASE STUDY NINE
Commercial Developer X wants to build a storage facility. He asks Broker Y to find a suitable location. After Broker Y finds a series of sites that all meet Commercial Developer X's needs, how can Broker Y help Commercial Developer X decide upon the best site?
CASE STUDY NINE RESPONSE
Broker Y should probably recommend that Commercial Developer X conduct a highest and best use study, also referred to as a feasibility study. Often, appraisers who conduct these kinds of studies belong to appraisal companies. Whomever Commercial Developer X decides to employ will need to establish the following conditions for each potential site:

- Legality
- Financially Viable
- Productivity
- Physical Plausibility

Broker Y may be able to provide insight into some of these areas. For example, if he is familiar with local zoning laws, then he could comment on the likely legality of such a development for particular locations.

CASE STUDY TEN
Broker A is helping Home Buyer B buy a home. Home Buyer B comes across the cost of credit and wonders how big a difference this will make in the overall price of a home. Broker A represents Buyer B and would like to offer the most complete answer possible. What could she say without engaging the sometimes-complex particulars of certain rates and values?
CASE STUDY TEN RESPONSE
Broker A is not a loan officer or underwriter; however, as she represents Home Buyer B, she could offer the following information to give her client a general understanding of the term, as discussed in Lesson Three of this module. However, it is important that Broker A does not cross over into areas where she is not an expert. She must also explain to Home Buyer B that he should direct particular questions to his loan processors.

The *cost of credit* refers to the expense associated with borrowing money, or the interest paid on a long-term loan. When the market is very tight and the cost of credit very high (that is to say, interest rates are very high), the cost of credit increases the cost of a home. When interest rates are low, the price of a home decreases because the cost of borrowing money decreases. The cost of credit's effect on a home's purchase price depends on whether the cost of credit at the time is high or low, and how high or low the rate is.
# Texas Principles of Real Estate

## Module 14: Real Estate Finance

### Introduction
- Learning Objectives
- Key Terms

### Lesson 1: Introduction to Real Estate Finance
- Promissory Notes
- Secured vs. Unsecured Notes
- Default
- Amortization
- Assumption
- Escrow Accounts
- Self-Acceleration
- Loan Payments
- Types of Loans
- Qualifying the Buyer
- Loan Application Checklist
- Underwriting Guidelines and Process

### Lesson 2: Conventional Loans
- Conventional Financing
- Conventional Loan Guidelines
- FNMA/FHLMC Underwriting Guidelines

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- Qualifiers
- Income Qualifications
- Mortgage Insurance Premium
- Underwriting Guidelines
- Down Payment Requirements
- Minimum Investment
- FHA Appraisal
- Direct Endorsement
- Additional Facts about FHA Loans
- Programs
- Advantages and Disadvantages
- Practice

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- VA Loan Entitlements
- VA Eligibility Requirements
- Use of Veterans Entitlement
- Assuming VA Loans
- Closing Costs

15 minutes

50 minutes

25 minutes

30 minutes

25 minutes
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<th>Lesson 5: The Basics of Real Estate Financing</th>
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<td>• Certificate of Reasonable Value</td>
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<td>• Qualifying the Buyer</td>
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<td>• Practice</td>
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<td>• Loan Payment Plans</td>
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<td>• Additional Loan Payment Plans</td>
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<td>• Closing Real Estate Loans</td>
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<tr>
<td>• Introduction to Closing Costs</td>
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<th>Lesson 6: Case Studies and Practice</th>
<th>35 minutes</th>
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<td>• Practice Problems</td>
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<td>• Case Studies</td>
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<th>Total Lesson Time:</th>
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INTRODUCTION

This course provides an introduction to residential real estate finance, including information on how to underwrite FHA, VA, FNMA and FHLMC loans. Understanding this information will help the student assist his or her buyer- and seller-clients from the initial meeting, through the closing proceedings with basic financing and loan-qualification questions.

In accordance with TREC rules Sections 535.71 and 535.72D, in this course, you will learn the basics of the different types of loans available, loan applications, appraisals, escrow, titles and credit reports, including qualifying for loan amounts and verifying income and assets.

Upon completion of this module, the student will know how to calculate loan amounts, estimate monthly payments, property taxes, hazard and mortgage insurance (for conventional, FHA and VA loans) and qualifying ratios and income.
KEY TERMS

**Acceleration Clause:** (also called an "alienation clause") A clause in the mortgage document that, if enforced, makes the entire balance of the mortgage due to the lender immediately upon default.

**Amortization:** The paying down of the principal of a loan over time; a loan that is so paid down is said to be *amortized*; the period of time it takes for such a loan to be paid off is called the *amortization period*.

**Appraisal:** The process by which the value of a piece of real estate is determined; any value so determined is called the *appraisal value*.

**Assumption:** Taking over the obligation or commitment of another, as in a loan, insurance policy, etc.

**Closing:** The finalizing steps of a real estate transaction, when the real property is turned over to the purchaser on the *closing date*.

**Escrow Account:** An account held by the lending institution into which the borrower pays taxes, insurance and special assessments and from which the lender pays these sums as they become due.

**Expense-to-Income ratio:** The ratio of the housing expense of a borrower, or PITI (Principal + Interest + Taxes + Insurance), to the net income of the borrower.

**FHA:** Federal Housing Authority; the Federal Housing Administration, which operates under the Department of Housing and Urban Development, administers the government home loan insurance program. This program allows prospective homebuyers to get a loan in order to finance their home by removing the risk from the lender.

**FHLMC:** Federal Home Loan Mortgage Corporation, also known as *Freddie Mac*, purchases first mortgages on residences.

**FNMA:** Federal National Mortgage Association, also known as *Fannie Mae*, supplies home mortgage funds through a congressionally chartered, shareholder company.

**Loan Discount:** An amount paid to the lender to lower the lending rate; loan discounts are expressed in points, where one point equals one percent of the loan; eight points is equivalent to a one percent interest rate reduction.
Loan-to-Value (LTV) ratio: The ratio of the amount of a loan to the value of the property to be purchased; it is used in determining such things as buyer payment restrictions and veteran eligibility.

Mortgage: A document wherein a borrower gives a lien against or title to his or her property to a lender as collateral for the loan amount.

Mortgage Insurance Premium (MIP): The amount paid by the borrower for private mortgage insurance, which insures the lender against loss in the event of borrower default.

PITI: Principal, Interest, Taxes and Insurance.

Principal: The unpaid amount of a loan, not counting interest.

Private Mortgage Insurance (PMI): Insures the lender against loss in the event of borrower default; the insurance is paid for by the borrower through the mortgage insurance provider.

Promissory Note: A note wherein the borrower acknowledges his or her debt and agrees to pay the lender according to the terms of the loan.

Secured Loan: A loan that places a lien or title against a property as security for the loan amount; opposite of an unsecured loan.

Underwriting Process: The process by which an applicant is qualified for and then receives a loan.

Unsecured Loan: A loan where there is no collateral pledged for the loan, and it is backed only by the borrower’s signature.

VA: The Veterans Administration is responsible for providing federal benefits for veterans and their dependents.

Veterans Entitlement: The amount of money a veteran is entitled to under the VA loan program, based on his or her service record and the amount of entitlement currently being used.
LEARNING OBJECTIVES

Upon completion of this module, the student will:

- Understand the basic concepts and key terms of real estate financing and the key terms.
- Know how to qualify a buyer for the most common types of loans.
- Be familiar with the use and function of escrow accounts.
- Know what a mortgage insurance premium is.
- Know the process of underwriting and its guidelines.
- Be familiar with the three most common types of loans: conventional, FHA and VA.
- Know the advantages and disadvantages of conventional loans.
- Know how to use conventional qualifying ratios.
- Know the advantages and disadvantages of FHA loans.
- Know about the differing FHA qualification ratios.
- Know the advantages and disadvantages of VA loans.
- Be familiar with VA eligibility and qualification periods.
- Be able to calculate the amount of VA entitlement used.
- Be able to calculate VA loan amounts and required down payments.
- Know the process and qualifications for assuming VA and FHA loans.
- Be familiar with other types of loans available.
- Know how to underwrite and close loans.
LESSON ONE  
INTRODUCTION TO REAL ESTATE FINANCE

This lesson focuses on the following topics:

- Promissory Notes
- Secured vs. Unsecured Notes
- Default
- Amortization
- Assumption
- Escrow Accounts
- Self-Acceleration
- Loan Payments
- Types of Loans
- Qualifying the Buyer
- Loan Application Checklist
- Underwriting Guidelines

INTRODUCTION

As you read through this lesson, and the course, keep in mind that real estate financing focuses on these basic questions:

- How does one pay for real property?
- Should we pay cash or borrow?
- Should we pay now or later?

Most residential real estate financial transactions involve a loan; real estate is one of the few assets that can be purchased without full payment in advance. The group of investors that consumers borrow money from are known as primary lenders. These lenders accept and process loan applications, underwrite loans and make loans upon approval. Every loan made by a primary lender requires the borrower to sign a promissory note.

PROMISSORY NOTES

The promissory note is the common document for all loans, not just the ones commonly referred to as a “mortgage.” It is an agreement between the obligor, maker or payor (borrower), and the obligee, or payee (lender), and is the written agreement of the borrower’s personal promise to repay the lender. In the note, the borrower acknowledges the debt, and the agreement provides for all of the terms of repayment.
The promissory note, commonly referred to simply as a “note”, begins with an acknowledgment of the borrower's debt to the lender and the borrower's promise to repay the debt, either to the lender named in the note or to anyone who later holds the note.

The note is a negotiable instrument that can be sold to another investor or lender. It specifies the amount of the debt, the rate of interest and date on which interest charges are to begin and the amount and terms of repayment. It is the complete contract or agreement of the loan terms between the borrower and the lender.

**SECURED VS. UNSECURED NOTES**

Promissory notes can be secured or unsecured. A *secured note* refers to a mortgage that pledges rights (a lien or title, depending on state law) against a property as security for the debt. An *unsecured note* has no collateral pledged for the loan; rather, it is a promise backed only by the signature of the borrower. This is often referred to as a *signature loan*. The note will, when applicable, refer to the *mortgage* or *deed of trust* that is security for it.

A mortgage is a document that creates a lien, a claim that the mortgage holder has on the property. A deed of trust is a document that actually conveys title to the property to a trustee, who holds the title until the debt has been cleared. If it is secured by a mortgage or deed of trust in favor of the lender, that document will also refer to the note for which it is security. Without mention of security, the note is an unsecured loan. Either type of note will require the signature(s) of the borrower(s), who are required to sign the note to agree that he, she or they owe the money. It is not required for the lender to sign the note, as notes are transferable.

What most people commonly refer to as a mortgage loan actually includes two documents: a mortgage and a promissory note. The mortgage is a document in which the borrower, known as the mortgagor, gives a lien against (or title to) his or her real estate as collateral for the loan to the lender, also known as the mortgagee. Whether the form used is a lien against the property or actually transfers the title until the loan is repaid depends on state law. In any case, the mortgage document makes reference to the promissory note that secures it.

**DEFAULT**

Usually included in a promissory note is an acceleration clause. It gives the lender the right upon any default by the borrower(s) to make the entire balance plus accrued interest immediately due and payable. This clause is important because it gives the lender the right to foreclose on the property if the entire loan balance is not then paid. Without this clause, the lender would have to sue for each individual late payment. The acceleration clause allows him or her to make
the remaining balance due and payable immediately after the borrower is declared in default and given required notice. The lender can then sue to foreclose on the whole amount.

Although non-payment is the most common form of default, there are other reasons that could cause default and the execution of the acceleration clause. The borrower’s failure to comply with any terms of the loan agreement, such as the requirement to pay taxes or insurance or failure to maintain the condition of the property could also be considered a default.

AMORTIZATION

A loan will usually be paid off in portions over time or amortized. The word amortization is a Latin term that means “killing off slowly over time.” If the note is to be amortized, there will be equal monthly payments that contribute to both principal and interest until the entire loan is paid. The payments will be credited when due first to interest, then any remainder credited to principal. In addition, there will usually be a statement providing a grace period for each payment and a penalty to be added to any payments made after the expiration of the grace period.

If the payment being made is not sufficient to cover the interest due for any payment period, then the unpaid interest is added to the principal balance. This is known as negative amortization or deferred interest.

Payments on amortized loans are calculated by using mortgage constant factors. Mortgage constant factors can be obtained from amortization tables, financial calculators or financial programs accessed on personal computers.

ASSUMPTION

Sometimes it is advantageous to a buyer to take over an existing loan when purchasing a property. The interest rate may be less than prevailing rates or other terms may be more favorable.

In an assumption of a mortgage, the purchaser signs an agreement to assume the obligation of the original mortgage. This makes the buyer equally responsible to the lender. If the buyer defaults, then both the buyer and the seller may be responsible for any deficiency.

Most modern mortgages have clauses prohibiting an assumption without the prior written permission of the lender. If the buyer must qualify and the seller is given a release of liability—is no longer part of the loan agreement—then the correct term for this would be novation (terminating one agreement by replacing it with another, usually including a new party or parties).
A buyer can also purchase the property *subject to any encumbrances*, as an alternative to assuming the loan. In this way, the buyer would not be personally responsible for the repayment of the loan, and the lender could not sue him or her in the event of default. The drawback to purchasing a property with a lien on it and not at the same time assuming the responsibility of repaying the debt is that the property could be foreclosed through no fault of the owner.

**ESCROW ACCOUNTS**

Escrow accounts are accounts held by the lending institution to which the borrower pays monthly installments for property taxes, insurance and special assessments. Lenders also disburse these sums as they become due from these accounts. When a LTV loan that is greater than 80 percent is made, these accounts are required on all loans, regardless of whether conventional, FHA or VA.

Escrow accounts generally contain the following payments:

- Taxes
- Hazard Insurance
- Private Mortgage Insurance
- One-time PMI Premium

**TAXES**

All property owners will be taxed by a variety of taxing authorities such as state, county, city, school, MUD (municipal utility district—set up for a subdivision to retire the bonds issued to pay for installation of the water and sewer facilities), fire district and/or FM roads. Lenders will generally estimate taxes on new home construction at 2.5 percent of the sale price (unless the home is in a MUD district, then the lender uses 2.75 percent). For resale homes, lenders will obtain a tax certificate showing actual taxes paid on the property.

**HAZARD INSURANCE**

Insurance premiums may be calculated in the field using a rate sheet provided by an insurance company. Annual premiums are given based on the replacement value for frame or brick construction, factoring in depreciation, proximity of property to nearest fire station and/or fire hydrant and the physical location of the property (i.e. within the city limits or on the fringe).

**NOTE:**
The insurance covers the improvements and contents only if a person chooses to add them, but does not cover land value.
PRIVATE MORTGAGE INSURANCE

The purpose of PMI is to insure lenders against losses due to non-repayment of low down payment conventional mortgages. Loan limits above a loan-to-value (LTV) ratio of 80 percent require PMI, but the full amount of PMI payments is tax deductible. Not all lenders require the same PMI coverage. One of the determining factors is the type of loan being sought. The other is the loan-to-value ratio (LTV). When a loan is paid off so that the remaining balance is less than 80 percent LTV, the insurance may be cancelled. Now let’s cover how PMI is computed.

Monthly PMI

The monthly PMI is figured on the loan amount. There is no up-front PMI premium paid. The PMI is as follows for various loan percentages:

<table>
<thead>
<tr>
<th>Loan %</th>
<th>PMI</th>
</tr>
</thead>
<tbody>
<tr>
<td>95%</td>
<td>(Loan amount x 0.0078) / 12</td>
</tr>
<tr>
<td>90%</td>
<td>(Loan amount x 0.0052) / 12</td>
</tr>
<tr>
<td>85%</td>
<td>(Loan amount x 0.0033) / 12</td>
</tr>
</tbody>
</table>

This monthly premium amount is then added into the PITI payment (principal, interest, taxes and insurance).

One-Time PMI Premium—(Optional Arrangement)

Some private mortgage companies have introduced a program called ZOMP (Zero Option Monthly Premium), which allows the buyer to incorporate the PMI into the monthly payment. This has been an alternative to the traditional practice of charging an initial premium plus renewal premiums. Under this program, the initial premium and renewal premiums are combined into a single, one-time premium that is financed over the loan term rather than paid as a lump sum. The amount of the one-time premium is simply added to the mortgage amount before calculating the monthly payment. This program has advantages and disadvantages for borrowers:

Advantages of the one-time premium:

- There is no cash requirement at closing.
- The mortgage payments including the monthly portion of the amortized one-time premium are usually smaller than the mortgage payments including a share of the traditional renewal premium.
- The policy is self-canceling when the home is sold.
Disadvantages:

- The one-time premium cannot be cancelled after LTV drops below 80 percent.
- The premium has an amortizing MIP (Mortgage Insurance Premium) over 30 years.

**SELF-ACCELERATION**

Self-acceleration happens when a borrower pre-pays principal amounts of the loan before they are due, thus, shortening the life of the loan. Some notes include a pre-payment penalty that charges a borrower who makes pre-payments. This is to make up lost profit from interest if a loan amortizes more quickly than normal.

**LOAN PAYMENTS**

Here is an example of a partial loan payment schedule, including the amount of monthly payments, monthly interest, paid principal and the balance remaining on a $100,000 year, fixed rate loan amortizing over 30 years.

<table>
<thead>
<tr>
<th>No.</th>
<th>Pmt Amt</th>
<th>Interest</th>
<th>Principal</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>877.57</td>
<td>833.33</td>
<td>44.24</td>
<td>99,955.76</td>
</tr>
<tr>
<td>2</td>
<td>877.57</td>
<td>832.96</td>
<td>44.61</td>
<td>99,911.15</td>
</tr>
<tr>
<td>3</td>
<td>877.57</td>
<td>832.59</td>
<td>44.98</td>
<td>99,866.17</td>
</tr>
<tr>
<td>4</td>
<td>877.57</td>
<td>832.22</td>
<td>45.35</td>
<td>99,820.82</td>
</tr>
<tr>
<td>5</td>
<td>877.57</td>
<td>831.84</td>
<td>45.73</td>
<td>99,775.09</td>
</tr>
<tr>
<td>6</td>
<td>877.57</td>
<td>831.46</td>
<td>46.11</td>
<td>99,728.98</td>
</tr>
<tr>
<td>61</td>
<td>877.57</td>
<td>804.79</td>
<td>72.78</td>
<td>96,501.63</td>
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<tr>
<td>62</td>
<td>877.57</td>
<td>804.18</td>
<td>73.39</td>
<td>96,428.24</td>
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<tr>
<td>63</td>
<td>877.57</td>
<td>803.57</td>
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<td>121</td>
<td>877.57</td>
<td>757.82</td>
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<tr>
<td>122</td>
<td>877.57</td>
<td>756.82</td>
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<tr>
<td>123</td>
<td>877.57</td>
<td>755.82</td>
<td>121.75</td>
<td>90,576.10</td>
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This schedule shows how, as time goes by, payments on interest decrease and payments on principal increase. Thus, at the 123rd payment, the loan principal is decreased by almost three times that of the 1st payment.
INTEREST RATES

Interest is the rent paid on money. Interest rates are determined by the market—the individual lenders—but are influenced by the Federal Reserve System’s open market activities and its primary lending discount rate (the interest rate the Fed charges to other banks). They are also limited by usury laws, which prohibit lenders from charging excessive interest on a loan.

Interest rates are inversely correlated with property values. That is, rising interest rates cause falling property values, and falling rates cause property values to increase.

TYPES OF LOANS

The three most common types of loans are conventional loans, FHA loans and VA loans. Conventional loans meet the Fannie Mae and Freddie Mac requirements for sale on the secondary loan market. FHA (Federal Housing Authority) loans are partially guaranteed by the federal government. VA loans are loans for veterans and are fully guaranteed by the government. We will discuss these three types of loans in detail, as well as the less-common varieties, in later lessons.

QUALIFYING THE BUYER

Before deciding whether a buyer can obtain a real estate loan or not, a underwriter analyzes two things:

1. The borrower’s overall financial condition, and
2. The value of the property for which the loan is being sought (often referred to as collateral for the loan).

The primary concern of the lender is determining the degree of risk. Most lenders use FNMA/FHLMC underwriting standards (discussed later) for conventional loans and FHA and VA standards for FHA/VA loans. With this in mind, we will first turn to qualifying the buyer.

There are five major areas of concern when qualifying the buyer, all of which must be verified by the lender:

- Income
- Credit
- Net Worth
- Source of Funds
- Debts
INCOME

The three tests of the borrower’s income are quantity, quality and durability: how much, how well and how long income can be expected to last.

Quantity

The applicant’s income must be sufficient to repay both the mortgage loan and all other recurring installment debts. Part-time income, overtime income, pensions, retirement benefits and income from second jobs can be considered. Military allowances are counted provided they can be verified. Income from rental property is also considered. With the latter, the lender usually requires copies of signed leases, and only a percentage of any net income counts towards qualifying because of possible future vacancies. Alimony and/or child support is counted, provided it is court-ordered and a history of payments can be verified, and only a percentage of this income is counted, depending on the length of time it is expected to continue.

Any negative cash flow, such as car payments or losses on rental property, is counted as long-term debt and subtracted from net income.

Quality

All income reported by the applicant is verified by the lender. If the borrower is an employee, then the lender sends a Verification of Employment Form to the employer requesting information regarding the length of employment, gross salary and other income and the likelihood of continued employment.

If the applicant’s sole income is in the form of commissions, then it must be verified by the past two-year’s tax returns. If only part of the total income is commissions, W-2 forms and a verification of employment are also considered as proof of income. A two-year history is usually required if the income is to be counted.

If the borrower applicant is self-employed, the lender will usually want to review federal income tax returns for the previous two or three years, profit and loss statements, business credit reports, business plans and the borrower’s current financial statement.

Durability

Income is considered sufficient if consistent working patterns are established and there is a reasonable expectation that the income will continue. As a general rule, a two-year job history must be verified.
CREDIT

The credit history of the applicant is provided through a credit report from a reputable credit reporting service, which indicates a 10-year record of past and current credit accounts, the amount of credit involved and the pattern of repayment. Letters of explanation may be submitted with regard to credit problems. These should be submitted to the lender at the time of application to avoid any misunderstandings further into the underwriting process.

NET WORTH

The applicant's current assets, including the source of funds being used for any down payment and settlement costs, will be verified. Also, a borrower's net worth oftentimes has an important effect on the lender's final loan decision. A lender counts only demonstrable net worth on other real estate owned by the borrower.

SOURCE OF FUNDS

Verification of the source of the borrower's down payment and settlement costs is made through the Request for Verification of Deposit Form. The two primary figures on this form that the underwriter is concerned with are:

(1) Current balance on deposit
(2) Average balance for the previous two months, although this varies by lender

DEBTS

All debts, regardless of the number of payments remaining, must be included on the loan application. For conventional loans, installment debts that cannot be paid off by paying the minimum payments in 12 months or less will be included in the applicant's total long-term debt ratio. For FHA and VA loans, debts with six or more payments remaining will be included in the applicant's total long-term debt ratio.

These are simply guidelines; lenders may impose their own standards, which may actually be more stringent. This could include counting all debts without regard to the number of payments remaining or even factoring in the maximum possible payments on credit cards or other lines of credit that do not currently have balances.

LOAN APPLICATION CHECKLIST

Quick turn around time begins with a complete loan application. Although this topic will be dealt with later in more detail, a brief overview is essential for all real
estate licensees. Essential loan application information that borrowers should have ready includes:

- Name and phone number of all landlords for the past two years
- Copies of 30 days’ worth of most recent pay stubs (or original pay stubs on VA loans)
- Previous two years of W-2s (or 1099s if self employed)
- All Bond Programs require three years of tax returns, W-2s and residency information
- Most recent two months’ bank and investment statements for all accounts; these will require updating through approval
- Copy of recorded divorce decree (all pages; if applicable)
- Settlement statements from all real estate sold in the past two years
- Copies of lease agreements on any rental property owned and proof of rental income for the past two years
- Copy of DD214, Statement of Service or Certificate of Eligibility (VA loans only)
- Copies of car titles to any vehicle(s) owned free and clear, less than four years old
- Warranty deeds on any free and clear real property

Next, we turn to a brief overview of underwriting guidelines and the underwriting process so that you will understand further what is involved in obtaining real estate financing.

**UNDERWRITING GUIDELINES AND PROCESS**

**WHAT FACTORS DO UNDERWRITERS CONSIDER?**

Underwriters approve or deny a mortgage loan application based on an evaluation of the following:

- Income and assets, which help determine the borrower’s ability to pay a loan.
- Credit, which shows the borrower’s current credit use, how the borrower treated obligations in the past and helps determine the borrower’s credit worthiness and willingness to repay a loan.
- Property, which determines whether or not the property is adequate collateral for the loan.

Underwriters base their decision on a combination or layering of these three factors.
HOW DO LAYERS OF RISK AFFECT HOMEOWNERSHIP?

The presence of individual risk factors does not necessarily threaten a borrower’s ability to maintain homeownership. However, when layers of risk—a number of interrelated high-risk characteristics—are present without sufficient offset, their cumulative effect dramatically increases the likelihood of default and foreclosure.

To help borrowers maintain long-term homeownership, underwriters work to understand borrowers’ needs and to manage the present risks in their loans.

INCOME ANALYSIS

Once a lender determines how much stable income the loan applicant has, he or she must decide whether or not the amount of stable income is adequate to cover the proposed monthly mortgage payment. The lender must also consider at this time the income ratios including the purchaser’s debt. In addition to lender ratios, a purchaser’s credit score affects the ability to obtain a loan.

Real estate professionals should be able to qualify prospective buyers before showing them homes. Qualifying prospects up front gives licensees an idea of the maximum monthly mortgage payment their income will support and helps to determine which properties to show them.

Once the maximum monthly payment is established, the real estate licensee can determine the maximum sale price the buyer can afford. And in a similar manner, if a licensee knows what the monthly payment on a particular property is, he or she can determine the monthly income necessary to qualify for the loan.

HOUSING EXPENSE-TO-INCOME RATIO

The housing expense-to-income ratio is the percent of net income that goes toward paying for the property. High percentages are a risk factor, and lenders usually set limits on the ratio. For example, for conventional loans, the proposed housing expense (principal, interest, taxes and insurance) should not exceed 28 percent of the borrower’s stable monthly income. Lenders of conventional loans will consider compensating factors in the qualifying process. Some of these factors include:

- A large down payment
- Cash reserve
- Upward mobility
- Military benefits
- Company benefits
- Temporary income
- Nominal increase in housing expenses
TOTAL DEBT SERVICE RATIO

Conventional lenders consider a borrower’s income adequate for a loan if the total debt service—i.e., the proposed total housing expense (including principal, interest, taxes, hazard insurance and mortgage insurance, if applicable) plus any other recurring liabilities—does not exceed 36 percent of his or her stable monthly income.

A borrower’s recurring liabilities can be broken down into three categories: installment, revolving and other.

- Installment debts have a fixed beginning and ending date. An example would be a car loan. An installment debt will be included in the total debt ratio if there are more than six months remaining.
- Revolving debts involve an open-end line of credit with minimum monthly payments. Examples would be credit cards and department charge cards. The lender uses the most recent required minimum monthly payment in their debt calculation.
- The “other” category includes alimony, child support and other similar ongoing obligations. At the current time, neither FNMA nor FHLMC take into account childcare expenses as a recurring liability.

The following example illustrates the process of loan qualification. Create a Conventional Loan Analysis and calculate an estimated monthly payment using the following information.

A house sells for $100,000. The borrower receives a 90 percent LTV loan at 8 percent interest for 30 years. The monthly payment required to amortize a $1,000 loan over 30 years at 8 percent is $7.34.

<table>
<thead>
<tr>
<th>Sale price: $100,000</th>
<th>Gross monthly income: $4,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>LTV Ratio: 90%</td>
<td>Long term debts: $325/ mo.</td>
</tr>
<tr>
<td>Interest Rate: 8%</td>
<td>Taxes: $200/ mo.</td>
</tr>
<tr>
<td>Term: 30 year fixed rate</td>
<td>Insurance: $48/ mo.</td>
</tr>
<tr>
<td>Qualifying ratios: 28% / 36%</td>
<td>Homeowners fee: $35/ mo.</td>
</tr>
<tr>
<td>PMI: 0.0052 annually</td>
<td></td>
</tr>
</tbody>
</table>

Estimated Monthly Payment (Conventional Loan)

<table>
<thead>
<tr>
<th>Mortgage payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and Interest $ _____</td>
</tr>
<tr>
<td>Taxes $ _____</td>
</tr>
<tr>
<td>Insurance $ _____</td>
</tr>
<tr>
<td>PMI $ _____</td>
</tr>
<tr>
<td>Homeowner's fee $ _____</td>
</tr>
</tbody>
</table>
To fill in the estimated monthly payment chart, we must first calculate the amount of the loan. A 90 percent LTV on a house whose value is $100,000 will be 0.90 x $100,000 = $90,000.

Then, calculate the principal and interest payment. If a $1,000 loan takes a $7.34 monthly payment to fully amortize in 30 years, then a $90,000 loan will take a 90 x $7.34 = $660.60 monthly payment over the same term.

For the rows labeled “Taxes,” “Insurance” and “Homeowner’s Fee,” simply record the monthly figures given in their respective places.

To calculate the monthly PMI charge, we must divide the annual percentage by 12 (the number of months) and multiply the figure by the amount of the loan. So (0.0052 x $90,000)/ 12 = $39.00.

The total monthly payment is the sum of all the figures in the right column.

<table>
<thead>
<tr>
<th>Mortgage Payment</th>
<th>$ 660.60</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and Interest</td>
<td>$ 660.60</td>
</tr>
<tr>
<td>Taxes</td>
<td>$ 200</td>
</tr>
<tr>
<td>Insurance</td>
<td>$ 48</td>
</tr>
<tr>
<td>PMI</td>
<td>$ 39</td>
</tr>
<tr>
<td>Homeowner's fee</td>
<td>$ 35</td>
</tr>
<tr>
<td>Total Mortgage Payment</td>
<td>$ 982.60</td>
</tr>
</tbody>
</table>

To fill out our conventional loan analysis, we take our previously calculated PITI = $982.60, and divide it by the borrower’s stable monthly income of $4,500 to find the housing expense ratio. Since 21.84 percent is less than the maximum ratio of 28 percent, this is a housing expense the borrower can be expected to handle.

To calculate the total debt service ratio, add the monthly long-term debt payment to the PITI payment: $982.60 + $325 = $1307.60 and divide this number by the borrower’s stable monthly income. This ratio, too, is below the maximum amount, and the borrower should qualify for a conventional loan.
Conventional Loan Analysis

1<sup>st</sup> Ratio = \( \frac{982.60}{4500} = 21.84\% \)
Should Not Exceed 28\%

2<sup>nd</sup> Ratio = \( \frac{(982.60 + 325)}{4500} = 29.06\% \)
Should Not Exceed 36\%

**SUMMARY**

To purchase residential real estate, individuals usually take out loans. Most loans are fully amortized, meaning they are paid off in equal monthly installments reducing the principal over time. The process by which borrowers are considered for loans and, if qualified, receive them is called underwriting.

Underwriters consider the quality, quantity and durability of a borrower’s income, and his or her credit, net worth, source of funds and debt. Borrowers qualify for loans on the basis of two ratios: the housing expense-to-income ratio and the total debt service ratio.

*Return to your online course player to take the Lesson Quiz.*
LESSON TWO
CONVENTIONAL LOANS

This lesson focuses on the following topics:

- Conventional Financing
- Qualifying the Buyer
- Underwriting Guidelines

INTRODUCTION

Now that the student has a basic understanding of real estate finance, the next three lessons detail each of the different kinds of loans: conventional, FHA and VA. This lesson covers conventional loans. This lesson also discusses the meaning and use of conventional financing and then states the differences between the types of lenders, including: commercial banks and credit unions, savings and loans associations and mortgage banks. It will then go over the details of qualifying buyers and the underwriting process, as well as the sale of conventional home loans on the secondary market.

CONVENTIONAL FINANCING

A conventional loan is defined as a loan that is neither federally insured (such as an FHA loan) nor federally guaranteed (like a VA loan). Primary lenders such as commercial banks and credit unions, savings and loans associations and mortgage banks offer them. In general, they are divided into two categories: conforming and non-conforming.

CONFORMING AND NON-CONFORMING LOANS

The Federal National Mortgage Association, or Fannie Mae and the Federal Home Loan Mortgage Corporation, or Freddie Mac, have developed a set of loan guidelines to regulate and homogenize the conventional loans offered on the primary market that they subsequently purchase on the secondary market. Conventional loans that adhere to these guidelines are referred to as conforming, while those that do not are referred to as non-conforming, or jumbo loans.

Most conventional primary lenders follow these set limits on the amount of money they will lend for two main reasons: first, because the limits are meant to decrease the risk of default, and, second, because primary lenders look to sell conventional loans on the secondary market to secondary lenders, such as Freddie Mac or Fannie Mae. Freddie Mac and Fannie Mae are two of the largest purchasers of home loans on the secondary market. Consequently, one could see why primary lenders would be interested in adhering to the guidelines by which Freddie Mac and Fannie Mae purchase.
CONVENTIONAL LOAN REQUIREMENTS

Each lender has its own requirements as to the type of property he or she will finance, as well as different procedures for qualifying potential borrowers. These loans may be assumed with the permission of the lender. In general, most conventional lenders use the same basic underwriting guidelines covered in this course. Nevertheless, real estate practitioners should always check with each lender for their specific underwriting guidelines to be sure.

PRIMARY LENDERS FOR HOME LOANS

Commercial Banks and Credit Unions

Commercial banks are called commercial, because they originally specialized in short-term capital loans for business and construction. Today, these banks have expanded into the home-loan market. Most of the mortgages created by commercial banks are sold to buyers on the secondary market.

Credit unions are more recent and less common than commercial banks, though they offer most of the same services. They are financial institutions that are controlled by their members, usually all of a certain group (for example, teachers, union members or the employees of a certain military base). Many credit unions focus on home equity loans, short-term loans based on the portion of a home the borrower has already paid off (his or her equity).

Savings and Loan Associations

Savings and Loan Associations (S&Ls), otherwise known as thrift lenders, were originally established by the government for the purpose of offering long-term, single-family home loans. For a long time S&Ls dominated the home loan market, but in the 1980’s, deregulation led to a savings and loan crisis. Today, S&Ls are much like commercial banks, and offer a wide variety of financial services. However, S&Ls are chartered by the government and must meet the qualified thrift lender (QTL) test to retain that charter and receive benefits from the Federal Home Loan Bank System. At least 70 percent of an S&L’s assets must be housing-related (for example, home mortgages, home equity loans and mortgage-backed securities) for it to meet the QTL test.

Mortgage Bankers

Mortgage banks control the greatest share of the primary lending market. They manage capital, not from personal deposits, but from large investors like insurance companies and retirement funds. Mortgage companies also borrow money from commercial banks to finance loans. All of these loans are then sold on the secondary market, as mortgage companies do not hold loans in portfolio. Some mortgage companies operate entirely from the proceeds of secondary-
market sales, selling their loans to insurance companies and retirement funds, and to buyers like Fannie Mae and Freddie Mac (discussed shortly).

**SECONDARY MARKET**

The secondary market is where real estate loans are bought and sold. A lender is willing to advance funds to a borrower in exchange for periodic interest payments for the use of those funds; for the same reason, an investor is willing to purchase a promissory note from a lender. These notes sell at present values determined by using discounted cash flow analyses, as will be discussed later. The idea is to give the note a relative worth, based on alternative investment opportunities open to the purchaser. If the investor could earn seven percent annual returns in the stock market, the net present value of the note is the value of the future cash flows from interest, discounted at a rate of seven percent.

Levels of risk are important as well. Investments with high risk and low returns are of little interest to investors. To ensure the level of risk associated with loans in the secondary market does not run too high, the largest buyers in the secondary market have established guidelines to which loans must conform, if they are to be traded in the secondary market.

These conforming guidelines have a further benefit to the secondary market, in making loans easy to value and compare. These guidelines are established by three government-sponsored agencies, the chief operators in the secondary market: the Federal National Mortgage Association (FNMA or Fannie Mae), the Federal Home Loan Mortgage Company (FHLMC or Freddie Mac), and the Government National Mortgage Association (GNMA or Ginnie Mae).

**Fannie Mae**

Originally created by the government to provide a secondary market for FHA-insured loans (discussed in a later lesson), Fannie Mae is now a privately owned purchaser of FHA, VA, and conventional loans. Mortgages are purchased on an administered price system. That is, the required yields (the money each loan returns per unit of present value) are set daily. Lenders can check these requirements and place an order to sell by phone.

In addition to the purchase and sale of loans, Fannie Mae issues what are known as mortgaged-backed securities. These are investment instruments like stocks, which pay returns to their holders. They differ from stocks in having as collateral a pool of mortgages the issuing institution (in this case, Fannie Mae) owns. Fannie Mae does not necessarily own or sell the securities; a lender brings a mortgage package to Fannie Mae, and Fannie Mae exchanges the guaranteed securities with the lender for the mortgages.
These securities are attractive to investors for two reasons: first, they cost less than purchasing an entire loan and are more easily liquidated; and second, they are guaranteed. That is, the holder of the security receives the full payment from it, whether or not the borrowers of the mortgages held as collateral pay their loans in full. For this guarantee, investors take slightly lower profits from the mortgages than if they held them themselves, through the payment of a guarantee fee.

For more info, visit Fannie Mae online: http://www.fanniemae.com.

**Freddie Mac**

Freddie Mac was created to provide a secondary market for conventional loans during the Savings and Loan crisis of the 80's. The success of the secondary market in ameliorating the losses in the primary market illustrates an important dynamic. Lenders are willing to lend large sums of money deposited in their institutions to borrowers because they receive cash flows from the interest. But until they receive this interest, they are lacking in funds to lend out. By selling the loans on the secondary market, lenders receive the present value of those interest cash flows, which they can immediately lend out to other borrowers, continuing the process. In addition, the primary market is stabilized by mortgage-backed securities—liquid assets—issued by secondary market purchasers.

Freddie Mac's secondary market activities are, in part, what bailed out S&Ls. Securities sold by Freddie Mac are known as participation certificates (or PCs), but they work in the same way as Fannie Mae’s mortgage-backed securities (MBSs). Freddie Mac buys VA, FHA, conventional and adjustable rate loans that meet its underwriting criteria.

For more info, visit Freddie Mac online: http://www.freddiemac.com.

**Ginnie Mae**

Unlike Fannie Mae and Freddie Mac, the federal government wholly owns Ginnie Mae. Its activities are under the direct supervision of the Department of Housing and Urban Development, otherwise known as HUD. Ginnie Mae plays an important role in the primary market, by offering loans to housing projects of interest to HUD’s purposes, but not easily financed through private loans. However, Ginnie Mae’s role in the secondary market, as the largest issuer of mortgage-backed securities, and the only issuer of government guaranteed securities, is of greater importance. The government guarantee allows the type of special assistance and residential mortgage loans that Ginnie Mae deals with to rival other securities in the secondary market.

For more info, visit Ginnie Mae online: http://www.ginniemae.gov.
## CONVENTIONAL LOAN GUIDELINES

### CONVENTIONAL LOAN QUALIFYING WORKSHEET

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyer</td>
<td>Agent</td>
<td>Date</td>
</tr>
</tbody>
</table>

1. Combined Gross Monthly Income: $_______
2. Multiply By .36 to Determine Maximum Debt $_______ \( \times .36 \)
3. Total Allowable Housing and Debt Expense $_______
4. LESS: Installment Debts: Car Note $_______
5. Car/Boat/Loan $_______
6. Student Loan $_______
7. Alimony/Child Support $_______
8. Finance Company $_______
9. Other $_______
10. Other $_______
11. Revolving Debt: Credit Card $_______
12. Credit Card $_______
13. Credit Card $_______
14. Other $_______
15. Total Installment and Revolving Debt: (Lines 4-14) $_______
16. Total Allowable Housing Expense $_______
17. LESS: Property Tax (monthly) $_______
18. Fire Insurance (monthly) $_______
19. Flood Insurance (monthly) $________
20. P.M.I. (monthly) $________
21. Other $________
22. Total Lines 17 through 21 $________
23. Remainder is Maximum Allowable Principle & Interest $________

SECOND CALCULATION

24. Combined Gross Monthly Income $________
25. Multiply By .28 to Determine Maximum Housing Expense _______ X .28
26. Equals Maximum Housing Expense = $________
27. LESS: Escrows Total from Line 22 -$________
28. Equals Maximum Allowable Principle & Interest =$________

FINAL CALCULATION

29. Take the Lower of Line 23 or 28 $________
   (MAXIMUM P&I PAYMENT)
30. Divide by the Mortgage Factor for (INT. RATE) %________
31. Equals Maximum Mortgage Amount $________
32. Add down payment + $________
33. Maximum sales price $________
The amount limits set forth by Fannie Mae for conforming loans are listed in the chart below.
CONFORMING LOAN LIMITS FOR 2005

<table>
<thead>
<tr>
<th>Type</th>
<th>Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single-family</td>
<td>$359,650</td>
</tr>
<tr>
<td>Two-family</td>
<td>$460,400</td>
</tr>
<tr>
<td>Three-family</td>
<td>$556,500</td>
</tr>
<tr>
<td>Four-family</td>
<td>$691,600</td>
</tr>
</tbody>
</table>

These new limits are effective for loans closed on or after January 1, 2005.

A fully amortized loan is repaid within a certain period of time (usually 15 or 30 years) by means of regular payments (usually monthly) including a portion for principal and a portion for interest, often referred to as P/I. As each payment is made, the appropriate amount of principal is deducted from the debt and the remainder of the payment, which represents the interest, is retained by the lender as earnings or profit.

With each payment, the amount of the debt is reduced and the interest due with the next payment recalculated based on the lower balance. The total monthly payment remains the same throughout the term of the loan. However, every month, the interest portion of the payment is reduced, and the principal portion is increased.

The final payment settles the loan completely, including any remaining interest owed through that time. The principal balance is zero and no further interest is due. Not all conventional loans are fully amortized—some are paid off with a balloon payment, where the remaining amount due on the loan is paid after a specified period of time in a single lump sum.

FNMA/FHLMC UNDERWRITING GUIDELINES

The largest buyers of conventional mortgages in the secondary market are the Federal National Mortgage Association, commonly called Fannie Mae, and the Federal Home Loan Mortgage Corporation, commonly called Freddie Mac. All mortgage loans purchased by FNMA and FHLMC must meet their guidelines, and applications must be submitted using documents developed and approved by each organization.

Another entity in the mortgage loan process is private mortgage guaranty insurers. Along with having to meet FNMA and FHLMC guidelines, mortgage loans with an 80 percent or greater loan-to-value (LTV) ratio must be insured by additional guidelines established by each mortgage guaranty insurer.
GENERAL FANNIE MAE UNDERWRITING GUIDELINES

The Fannie Mae underwriting guidelines divide loans by Loan-to-Value ratio. Consider the following guidelines for 98-percent and 90-percent LTV loans.

Characteristic of 98-percent loans:

- Three percent limit on seller contribution toward buyer closing costs
- Three months’ mortgage payments in reserve escrow account
- Flawless credit
- No buydowns of the interest rate allowed
- Gifts allowed to help buyer with down payment
- Qualifying ratios of 33 percent and 40 percent (more on this later)
- Co-borrowers must also take title to collateral property

Characteristic of 90-percent loans:

- Three percent limit on seller contribution (up to six percent below 90 percent)
- Two months mortgage payments in reserve escrow account
- Gift letters for five percent of the down payment must be matched with five percent cash from borrower
- Co-borrower must be a member of the immediate family and take title to the collateral property

98-percent LTV loans are riskier because the borrower has less equity in the house and thus less to lose in the event of default. For this reason a 98-percent loan requires a borrower to have flawless credit, whereas a lender would be more likely to give a 90-percent loan to sub-prime borrowers, i.e. those with less than perfect credit.

For similar reasons, a borrower who receives a 90-percent loan is only required to keep two months’ mortgage payments in an escrow account, while a 98-percent borrower must have three. For loans less than 80-percent LTV, no escrow account is required. The qualifying ratios, as well, increase with the LTV—for the 98-percent loans, the ratios are 33 and 40 percent, well above the typical nonconforming ratios of 28 and 36.

SUMMARY

A conventional loan is not guaranteed or insured by the federal government. Conventional loans either conform to the Federal National Mortgage Association (Fannie Mae) guidelines or they do not. The latter is called non-conforming or jumbo loans.
Conventional loans are typically fully amortized loans, which have the same monthly payment and reduce the principal gradually over time. They generally have a 28-percent/36-percent (housing expense to income/total debt service ratio) ratio requirement, but these ratios can be higher for sub-prime borrowers. Fannie Mae underwriting guidelines are designed to decrease the risk of default by increasing restrictions on higher LTV loans.

Return to your online course player to take the Lesson Quiz.
LESSON THREE
FHA LOANS

This lesson focuses on the following topics:

- Qualifiers
- Income Qualifications
- Mortgage Insurance Premiums
- Underwriting Guidelines
- Down Payment Requirements
- Minimum Investment
- FHA Appraisal
- Direct Endorsement
- Additional Facts
- Programs
- Advantages and Disadvantages
- Practice

INTRODUCTION

The Federal Housing Authority (FHA), was established in 1934 as a government agency and part of the Department of Housing and Urban Development (HUD). The FHA does not make loans directly, but insures lenders against loss in case of buyer default with mortgage insurance so that lenders are willing to lend money with a very low down payment required from the borrower.

The FHA program was designed to encourage home ownership. If a borrower defaults, then the lender forecloses as with any other loan. After the foreclosure sale, if the lender suffers a loss, the FHA would make-up the loss to the lender up to 25 percent of the original value. FHA loans are insured loans and therefore, viewed by lenders as less risky. The underwriting guidelines on these loans are, thus, less stringent than on conventional loans.

The borrower pays the FHA for insurance coverage on the loan. In turn, this insurance helps to stabilize the mortgage market and creates an active national secondary market for FHA insured mortgage loans.
# FHA Loan Qualifying Worksheet

**Buyer:**

**Agent:**

**Date:**

1. Combined Gross Monthly Income: _____________________________

2. Multiply by .41 to Determine Maximum Debt: _____________________________ X .41

3. Total Allowable Housing and Debt Expense: _____________________________

4. **LESS:** Installment Debts:
   - Car Note $__________
   - Car/Boat/Loan $__________
   - Student Loan $__________
   - Alimony/Child Support $__________
   - Finance Company $__________
   - Child Care $__________
   - Other $__________

5. Revolving Debt:
   - Credit Card $__________
   - Credit Card $__________
   - Credit Card $__________
   - Other $__________

6. Total Installment and Revolving Debt (Lines 4-14): _____________________________

7. Total Allowable Housing Expense: _____________________________

8. **LESS:**
   - Property Tax (/12) (one month) $__________
   - Fire Insurance (/12) (one month) $__________
   - Flood Insurance (/12) (one month) $__________
   - Other $__________
   - Other $__________

9. Total Lines 17 through 21: _____________________________

10. Remainder is Maximum Allowable Principle & Interest: _____________________________

**SECOND CALCULATION**

11. Combined Gross Monthly Income: _____________________________

12. Multiply by .29 to Determine Maximum Housing Expense: _____________________________ X .29

13. Equals Maximum Housing Expense: _____________________________

14. **LESS:** Escrows Total from Line 22: _____________________________

15. Equals Maximum Allowable Principle & Interest: _____________________________

**FINAL CALCULATION**

16. Take the Lower of Line 23 or 28: _____________________________

17. Divide by the Mortgage Factor for ____%: □ ________

18. Equals Maximum Total Loan (Line 5 of Closing Cost Calculation): _____________________________

19. Multiply by Factor To Remove MIP (.015%): _____________________________

20. Equals Maximum Base Loan (Line 3 on Closing Cost Calculation): _____________________________
QUALIFIERS

Being of legal age and having either proof of U.S. citizenship or possessing a green card are the only two qualifications for an FHA-insured loan.

INCOME QUALIFICATIONS

AN FHA loan requires a housing expense-to-income ratio not in excess of 29 percent. Housing expenses include PITI (principal, interest, taxes and insurance).

It also requires a total debt service ratio of 41 percent. Debts paid in full within nine months are generally not included, but long-term debts, including installment debts exceeding nine months to pay in full and all revolving debts are included. Alimony and child support payments are deducted from monthly gross income before calculating the qualifying ratio.

FHA also considers compensating factors, if the ratios are exceeded.

MORTGAGE INSURANCE PREMIUM (MIP)

FHA loans are insured loans. In addition to the monthly PITI payment, the FHA borrower will have to pay a one-time Mortgage Insurance Premium (MIP) at closing (1.5 percent of the sale price since 2001), as well as, a monthly MIP premium payment. The annual renewal premium is .5 percent for any loan longer than 15 years, and .25 percent for 15 years or less with 10 percent or less down. With more than 10 percent down for a loan of 15 years or less, there is no annual premium.

The insurance coverage provided by the FHA to the lender is paid for by the borrower to safeguard the lender against a loan default. The insurance amount is called Mortgage Insurance Premium (MIP).

These premiums go into a fund administered by HUD to reimburse lenders that suffer losses on these loans. The annual premium can be deleted when the loan-to-value ratio reaches 78 percent based on the original sale price.

With a $100,000 FHA-insured 30-year loan, the borrower would pay a $1,500 MIP at closing or finance ($100,000 x 0.015 = $1,500), plus $41.66 per month ($100,000 x 0.005 = $500/12 = $41.66).

UNDERWRITING GUIDELINES

The Housing Authority sets limits on the maximum amount of loans it insures. Below is a table of the maximum loan amounts from 2005.
### 2005 FHA MAXIMUM LOAN LIMITS

<table>
<thead>
<tr>
<th>Type of Property</th>
<th>High Cost Area*</th>
<th>Non-High Cost Area*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single-family</td>
<td>$290,319</td>
<td>$160,176</td>
</tr>
<tr>
<td>Duplex</td>
<td>$371,621</td>
<td>$205,032</td>
</tr>
<tr>
<td>Triplex</td>
<td>$449,181</td>
<td>$247,824</td>
</tr>
<tr>
<td>Four-unit dwelling</td>
<td>$558,236</td>
<td>$307,992</td>
</tr>
</tbody>
</table>

The FHA high-cost loan limits for Alaska, Guam, Hawaii and the Virgin Islands may be adjusted up to 150 percent of the new ceilings.


### DOWN PAYMENT REQUIREMENTS

For properties with value/sale price equal to or less than $50,000, a 1.25 percent down payment is required.

For properties with value/sale price in excess of $50,000, a 2.25 percent down payment is required. For example:

If sale price is $50,000, then the down payment is:

\[
50,000 \times 0.0125 = $625
\]

If sale price is $115,200, then the down payment is:

\[
115,200 \times 0.0225 = $2592
\]

### MINIMUM INVESTMENT

In addition to maximum loan limits and the down payment requirements, the FHA has established certain criteria of minimum investment for all insured loans.

- Borrowers must have at minimum three percent cash investment in the property.
- The investment cannot consist of discount points (monies paid to buydown the rate of a loan upfront) or pre-paid expenses (items paid in advance at closing).
- The difference of the 2.25 percent down payment requirement and the three percent investment may consist of some portion of the buyer’s allowable closing costs.
- The seller can pay the balance of the buyer’s closing costs, all prepaid and discount/origination points up to a maximum contribution of six percent (three percent if the loan amount is 90 percent or above).
- No origination fee (an amount of money, usually one percent of the loan amount, collected upfront to initiate the loan) is required as part of the closing costs.
- Existing credit policies remain intact for those transactions not previously eligible for high LTV (loan-to-value ratio) financing.

**FHA APPRAISAL**

The FHA has no requirement for the property to sell at or below the appraised value. The sale price can be any price agreed upon by the buyer and seller. However, maximum insurable loan amounts are computed on the FHA appraised value of the property or sale price, whichever is less, and the difference between actual sale price and maximum loan amount must be paid in cash by the borrower as a down payment at closing, or the borrower can choose not to buy the home.

An FHA appraisal is usually a little higher than a conventional appraisal, since the appraiser must be FHA-approved and is also given a checklist of items to inspect for the lender. FHA appraisals are not regular property appraisals, which the purchaser should still have conducted. The FHA accepts VA appraisals with some restrictions, provided the appraisal is less than 90 days old.

The FHA requires that a builder’s plans meet both state and local building codes in addition to 17 provisions not found in such codes. The property must also be adjacent to a publicly maintained street.

**DIRECT ENDORSEMENT**

Some lenders have the authority to approve FHA loans in-house without submitting the file to the FHA regional office for prior approval. This will save 10-14 days in processing time.

**NOTE:**
Before filling out a final purchase contract, check with each lender for more exact timelines so that sufficient days are negotiated to close the transaction without falling into default.

**ADDITIONAL FACTS ABOUT FHA LOANS**

- An individual may hold more than one FHA loan. If the buyer has sold a home on which the FHA loan was assumed within the past year, that loan must be current. If the loan was assumed, it must be current and the buyer must be an owner-occupant OR the loan must be reduced to 75 percent of
the maximum loan available to the owner-occupant under 203b, according to a new appraisal.

- Do not specify non-realty items on the contract; use a separate agreement. If they are specified on the contract, FHA will assign a value to each item and reduce the appraised value of the property accordingly. (Note to agent: if a Non-Realty Items Addendum is part of the contract, do NOT submit it with the loan application. This reduces any confusion by the lender and is a legally binding document on its own.)

- Qualifying assumption of FHA loans (non-qualifying before 1986) allow for a release of liability of seller if:
  - The buyer assuming the loan is pre-approved by the lender, and
  - The transaction has been consummated to the then applicable FHA standards.

- Escrow of taxes and insurance is required by FHA.
- Discount points may be charged, payable by either the buyer or seller.
- FHA requires a larger down payment than a VA loan, which requires none.
- Anyone of legal age and otherwise legally capable of owning property, may obtain an FHA loan. The borrower does not need to be a citizen of the U.S. (green card is sufficient).
- Any gift does not have to come from an immediate family member, although no direct business relationship with the borrower can exist.

**PROGRAMS**

There are 14 major FHA programs under the National Housing Act. These include:

<table>
<thead>
<tr>
<th>Name of Program</th>
<th>Area of coverage / Loan available for</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Title I</strong></td>
<td>Home improvements</td>
</tr>
<tr>
<td><strong>2. Title 11(Section 202)</strong></td>
<td>Rental or cooperative housing for the elderly or handicapped</td>
</tr>
<tr>
<td><strong>3. Section 203(b)</strong></td>
<td>Fixed interest rate loans for single-family owner-occupied homes</td>
</tr>
<tr>
<td><strong>4. Section 203(k)</strong></td>
<td>Rehabilitation loans for existing homes and refinancing existing debt</td>
</tr>
<tr>
<td><strong>5. Section 203(v)</strong></td>
<td>Eligible veterans</td>
</tr>
<tr>
<td><strong>6. Section 221(d)(2)</strong></td>
<td>Low-income to moderate-income families</td>
</tr>
<tr>
<td><strong>7. Section 221(d)(3)</strong></td>
<td>Commercial projects for multifamily rental housing for moderate-income families</td>
</tr>
<tr>
<td><strong>8. Section 221(d)(4)</strong></td>
<td>Commercial projects with 90% loans for rental housing for moderate-income families</td>
</tr>
<tr>
<td><strong>9. Section 223(e)</strong></td>
<td>Declining neighborhoods where normal underwriting requirements cannot be met</td>
</tr>
<tr>
<td><strong>10. Section 223(f)</strong></td>
<td>Purchase or refinancing of existing apartment buildings, which are at least three years old</td>
</tr>
</tbody>
</table>
## ADVANTAGES AND DISADVANTAGES

### ADVANTAGES OF FHA LOANS

FHA loans have several advantages over conventional loans. They typically have a lower down payment and there is never a pre-payment penalty charged for making loan payments earlier than they are due. Other borrowers can assume FHA loans; however, since 1986, the assumptor has had to go through the same underwriting process—verifying debts and income, etc.—as the original borrower to prove his or her creditworthiness. Sellers can be held liable for an FHA loan if the person to whom they have sold the house assumes the loan without a test of creditworthiness. Another important advantage of FHA loans is that mortgages can be made on a graduated payment schedule, with low monthly payments that increase over time.

### DISADVANTAGES OF FHA LOANS

FHA loans also have several disadvantages when compared to conventional loans. First, processing an FHA loan takes between 15 and 30 days longer than processing a conventional loan. Second, there is a maximum loan amount on FHA loans and this can be limiting. For example, in 2002, in certain areas, the maximum loan amount was $101,500 plus MIP. Third, the mortgage insurance premiums must either be paid upfront at closing or be financed. Finally, the FHA loan program does not insure loans to investors, only to homeowners.

### PRACTICE

What follows is a breakdown of an FHA loan applicant’s monthly income and expenditures and the loan for which he is applying. Determine his housing expense to income and total debt service ratios. Assuming that the applicant intends to pay the minimum allowable down payment and borrow the upfront MIP charge, does he qualify for the loan?

To determine principal and interest payments, it is best to use a mortgage loan calculator like the one found here: [http://www.webmath.com/amort.html](http://www.webmath.com/amort.html).
As an example let’s calculate a mortgage loan of $1,000 at 10-percent interest over 15 years.

Using the calculator at the above link, we find that the monthly payment will be $10.75, and we are also provided a chart that shows the monthly breakdown of principal vs. interest payments: 
http://www.webmath.com/cgi-bin/amort.cgi?amount=1000&years=15&period=12&rate=10&extra=0.

So, let’s see if the applicant qualifies for the FHA loan using the following information.

<table>
<thead>
<tr>
<th>Sale Price</th>
<th>$82,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>10%</td>
</tr>
<tr>
<td>Terms</td>
<td>15-year loan</td>
</tr>
<tr>
<td>Gross Monthly Income</td>
<td>$3850 combined</td>
</tr>
<tr>
<td>Long Term Debts</td>
<td>$75</td>
</tr>
<tr>
<td>Child Care</td>
<td>$150</td>
</tr>
<tr>
<td>Taxes</td>
<td>$155</td>
</tr>
<tr>
<td>Insurance</td>
<td>$30</td>
</tr>
</tbody>
</table>

**FHA QUALIFYING WORKSHEET**

The total loan amount is calculated by subtracting the down payment from the sale price. Since the sale price is in excess of $50,000, the down payment must be at least 2.25% of the sale price.

The qualifying loan amount is calculated by adding the MIP to the loan amount. (Remember, with a $100,000 FHA-insured 15-year loan, the borrower would pay a $1,500 MIP at closing ($100,000 x 0.015 = $1,500), plus $20.83 per month ($100,000 x 0.0025 = $250/12 = $20.83). Bearing this in mind and using the Fast Fact information, complete the following:

Sale price $_______ – Down Payment $_______ = Loan Amount $_______

Loan Amount $_______ + MIP (2.25%) $_______ = Loan Amount for Qualifying $_______

Using what we know (remembering the mortgage calculator at http://www.webmath.com/amort.html and knowing that the annual MIP renewal premium is .5 percent for any loan longer than 15 years, and .25 percent for 15 years or less with 10 percent or less down) and the monthly breakdown chart, fill in the appropriate information in the spaces provided.
Gross Monthly Income = $________ (A)

<table>
<thead>
<tr>
<th>Monthly Housing Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and Interest (PI)</td>
<td>$</td>
</tr>
<tr>
<td>Taxes (T)</td>
<td>+</td>
</tr>
<tr>
<td>Hazard Insurance (I)</td>
<td>+</td>
</tr>
<tr>
<td>Monthly MIP</td>
<td>+</td>
</tr>
<tr>
<td>Total Housing Expenses</td>
<td>$_______(B)</td>
</tr>
</tbody>
</table>

Housing Expense to Income Ratio:

\[
\frac{B}{A} = ____\% \text{ (should not exceed 29\%)}
\]

Using what we know (remembering the mortgage calculator at [http://www.webmath.com/amort.html](http://www.webmath.com/amort.html) and that the annual MIP renewal premium is .5 percent for any loan longer than 15 years, and .25 percent for 15 years or less with 10 percent or less down) and the monthly breakdown chart, fill in the appropriate information in the spaces provided. When finished, compare your answers with our solution.

<table>
<thead>
<tr>
<th>Total Housing Expenses</th>
<th>$ (B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Child Care</td>
<td>+</td>
</tr>
<tr>
<td>Long Term Debts</td>
<td>+</td>
</tr>
<tr>
<td>Total Living Expense</td>
<td>$ (C)</td>
</tr>
</tbody>
</table>

Total Debt Service Ratio:

\[
\frac{C}{A} = ___\% \text{ (should not exceed 41\%)}
\]
Solution

The sale price of the property in question is in excess of $50,000. Therefore, the down payment must be at least 2.25% of its amount:

$$82,000 \times 2.25\% = 1,845$$

The loan amount can be calculated by subtracting the down payment from the sale price:

$$82,000 - 1,845 = 80,155$$

Now, the upfront mortgage premium can be calculated by multiplying the required percentage of down payment, 1.5%, by the loan amount.

$$1.5\% \times 80,155.00 = 1,202.33 \text{ Mortgage Premium}$$

The total loan amount for qualifying will then be:

$$80,155.00 + 1,202.33 = 81,357.33$$

Using a mortgage calculator, monthly principal and interest payments will be:

$$874.27 / \text{month}$$

To fill out the required table, we just recopy the tax and insurance figures from the applicant’s expense chart. The monthly MIP charge at .25% per year is

$$($81,357.33 \times 0.0025) / 12 \text{ months} = 16.95 / \text{month}.$$ The total housing expense then is the sum of all dollar amounts in the right column:

<table>
<thead>
<tr>
<th>Monthly Housing Expenses:</th>
<th>$874.27</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle and Interest (PI)</td>
<td>+155</td>
</tr>
<tr>
<td>Taxes (T)</td>
<td>+30</td>
</tr>
<tr>
<td>Hazard Insurance (I)</td>
<td>+16.95</td>
</tr>
<tr>
<td>Total Housing Expenses</td>
<td>$1,076.22 (B)</td>
</tr>
</tbody>
</table>

Remembering that gross monthly income is $3,850 (A), we find the housing expense to income ratio by dividing (B) by (A).

Therefore, the housing expense to income ratio equals $1,076.22 / $3,850 = 0.2795, or 27.95%.

To determine the total debt service (total living expense) we add long-term debts and child care to the total housing expense:

<p>| Total Housing Expenses | $1,076.22 (B) |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Child Care</td>
<td>+ 150</td>
</tr>
<tr>
<td>Long Term Debts</td>
<td>+ 75</td>
</tr>
<tr>
<td>Total Living Expense</td>
<td><strong>$1,301.22</strong> (C)</td>
</tr>
</tbody>
</table>

The total debt service ratio is calculated by dividing the total living expense (C) by gross monthly income (A): $1,308.12 / $3,850 = 0.3379, or **33.79%**.

Recalling that the total housing expense to income ration should not exceed 29%, and that the total debt service ratio should not exceed 41%, our numbers of 27.95% and 33.79% respectively indicate that this borrower would be eligible for an FHA loan.

**SUMMARY**

FHA loans are loans insured by the Federal Housing Authority, which Congress created as part of the U.S. Department of Housing and Urban Development. The FHA program was designed to encourage homeownership and anyone who is a U.S. citizen or who holds a valid green card may apply. The cost of the insured loan is the Mortgage Insurance Premium: 2.25 percent of the loan amount upfront and an additional 0.5 percent or 0.25 percent annual payment for 30- and 15-year terms respectively. The FHA sets certain limits on the loans it insures, including the stipulation of a maximum loan limit, down payment, minimum investment requirements and income qualifications for borrowers. Borrowers must have a three percent total investment and may not have a housing expense to income ratio exceeding 29 percent or a total debt service ratio exceeding 41 percent.

*Return to your online course player to take the Lesson Quiz.*
INTRODUCTION

VA loans constitute a federally regulated program administered by the Veterans Administration to assist eligible military personnel in obtaining home loans with interest rates set by VA and no down payment required (in most cases). VA loans are only available to eligible veterans and to a select group of other applicants. Unlike other loans, VA loans are guaranteed loans and, therefore, viewed as less risky by lenders since they have a risk partner: namely, the federal government. These loans may be made for owner-occupied purchases only, and at the time of closing, the buyer must sign a statement attesting that he or she intends to live on the property.

VA loans vary greatly from both conventional and FHA insured loans. This lesson will outline how VA loans differ, how guaranteed amounts are determined and how entitlement is established. In addition, this lesson will touch on the Veteran's Benefits Improvement Act and explain how it affects VA entitlement.

VA LOAN ENTITLEMENTS

There is no VA limit on the amount of loan a veteran can obtain; the lender determines this. However, the VA does set a limit on the amount of the loan it will guarantee. The VA also sets guidelines to be adhered to by the borrower to ensure that lenders are making prudent loans, and it may refuse to guarantee loans issued by certain lenders who have previously failed to meet VA requirements.

The VA guarantees the lender against loss, although the maximum amount of the guarantee changes every few years to keep up with home prices. As of December 10, 2004, the basic entitlement guaranteed loans up to $359,650. In general, a lender would lend up to four times the veteran’s eligibility. Therefore, if
the veteran qualified, he or she could borrow up to four times $359,650 under VA guidelines.

The VA does not insure loans like the FHA, and there is no mortgage insurance premium charged to the veteran for a VA loan; however, the veteran does pay a one-time upfront funding fee as the cost of receiving the guaranteed loan.

The concept of the VA program is to guarantee a portion of the loan against potential loss by a veteran purchaser's default in a fashion similar to that of the FHA program. In the event of a loss on a transaction by the lender, and after the loan has been foreclosed and the property sold at auction, the Veteran's Administration would make-up the loss suffered by the lender up to its applicable guarantee limit, which would normally be a sufficient amount.

As another benefit of this program, the seller is allowed to pay all of the buyer-veteran's settlement charges, including the prepaid items to establish the escrow account. Since October 27, 1995, however, veterans have been able to pay their own points, but these points may not be financed in the loan as with some other types of loans.

When lending no more than four times a borrower's eligibility, the lender is never more than 75 percent LTV at risk on a VA loan. The underwriting guidelines on these loans are, in turn, also less stringent than that on conventional loans. For instance, there is only one qualifying ratio for housing expense and total long-term debt—that is, 41 percent of gross income.

**VA ELIGIBILITY REQUIREMENTS**

The eligibility requirements for VA loans are many and detailed. We will only be concerned with an overview of these requirements. The full, detailed list is provided in the link that follows.

VA Eligibility Requirements:  
http://www.military.com/Finance/Content?file=Home_Loans_Eligibility.htm&area=Content

**OVERVIEW**

Veterans who served during World War II, the Korean War, Vietnam, the Gulf War or peacetime efforts following these wars are eligible for VA loans, if:

They have 90 days of wartime service, OR  
181 days of continuous peacetime service.

In both instances, the veteran must have been discharged under other than “dishonorable” circumstances. If a veteran’s service time was cut short by an
injury or for some other reason beyond his or her control, such as an “involuntary reduction in force,” then he or she may still be eligible.

Certain other persons who are not wartime veterans can also be eligible for VA guaranteed loans. Selected Reservists or National Guard members who have served at least six years are also eligible, as well as the spouses of veterans killed or missing in action or who were prisoners of war. In addition, U.S. citizens who served in the armed forces of a government allied with the U.S. in World War II may also be eligible.

Additionally, VA stipulations allow several veterans to purchase one- to four-family unit homes together, even if they are not married or related, provided they intend to occupy the property. However, a veteran and a non-veteran or a veteran and a non-veteran unmarried partner cannot be co-borrowers on a loan. On the other hand, an exceptionally well-qualified non-veteran may be a co-signer for a veteran, but the non-veteran would not hold title to the property. Naturally, in this case, the non-veteran co-signer would have liability for the repayment of the loan.

CERTIFICATES OF ELIGIBILITY

The Veterans Administration issues and updates Certificates of Eligibility. These certificates establish a veteran’s eligibility in writing and can be obtained with the following forms:

- DD-214 (discharge form)
- VA Form 26-1 880 (application form)
- DD-13 (statement of service, if the veteran is still on active duty)
- DD-1747 (unavailability of base housing)

USE OF VETERANS ENTITLEMENT

VA GUARANTY HISTORY

Since its inception, from time to time Congress has raised the loan guaranty amount; consequently, it has been raised from its original amount of $2,000 to $359,650.

CALCULATING AMOUNT OF ENTITLEMENT USED

There are two methods for calculating the amount of eligibility used by a veteran in a transaction. The reason this is important is because if the veteran has remaining entitlement, he or she can obtain another VA loan while retaining ownership of his or her present property, or with the original VA loan still in effect.
The 60 Percent Rule

The amount of eligibility used can be 60 percent of the loan, or the total eligibility available, whichever is less. This method was utilized for all loans originating before 01/31/88.

Sliding Scale

This method is used for all loans originating after 01/31/88 is as follows.

<table>
<thead>
<tr>
<th>LOAN AMOUNT</th>
<th>GUARANTEE USED</th>
</tr>
</thead>
<tbody>
<tr>
<td>$44,999 OR LESS</td>
<td>50% of the loan amount</td>
</tr>
<tr>
<td>$45,000 – $56,250</td>
<td>$22,500</td>
</tr>
<tr>
<td>$56,251 – $144,000</td>
<td>40% of the loan amount to a maximum of $36,000</td>
</tr>
<tr>
<td>$144,000 and above</td>
<td>25% of the loan amount to a maximum of $359,650</td>
</tr>
</tbody>
</table>

When calculating partial entitlement under either of these methods, use the $36,000 entitlement figure instead of the $359,650 entitlement figure if the resulting loan amount will be under $144,000.

RE-USING ENTITLEMENT

Once a veteran uses his or her entitlement, it cannot be reused until:

- The original loan is paid off in full.
- The VA is notified of the fact that it has been paid off by the original lender.
- The house is disposed of (no longer owned by the veteran).

There is an exception to this rule, however.

The Veteran's Benefit Improvements Act of 1994, signed in November by President Clinton, changed a number of veteran programs and benefits. In addition to recognizing and offering medical assistance for the previously “undiagnosable” Gulf War Syndrome, it also allows veterans a one-time exception to the “disposal of original house” rule. If a veteran pays off his or her original loan in full and the original lender of the note acknowledges the payment, then the veteran may gain VA entitlement once again without disposing of his or her home. This is true for one time only.

In addition to re-gaining entitlement, veterans may substitute entitlement when assuming an existing VA loan. To substitute entitlement, the purchaser must meet the following qualifications:

- Be a veteran
- Have at least as much entitlement as the original mortgagor
Agree in writing to substitute his or her entitlement
Qualify for the assumption

ASSUMING VA LOANS

Anyone, veteran or non-veteran, may assume a VA loan, and there is no limit to the number of VA loans an individual may assume. VA loans originated prior to 03/01/88 are fully assumable with no qualifying and no change in terms. VA loans originated after 03/01/88 are assumable only with a full qualification process approving the borrower, although the terms of the loan itself will not change. This provision holds true for the life of the loan. The borrower assuming loans closed after this date also assumes the obligation of the veteran to the VA.

A 0.5 percent funding fee will be charged on all assumptions of VA loans originated after 03/01/88. A lender's processing fee of up to $500 will also be charged. And, the person assuming the loan may be either an owner-occupant or an investor.

CLOSING COSTS

The VA sets limits on allowable costs at closing. Thus, the “no prepayment penalty” provision applies to all VA loans.

At one time, the seller might pay any or all of the veteran’s closing costs, including the loan origination fee. However, the VA now puts a four percent limit on any seller contribution.

Normal discount points and closing costs, which are customarily paid by the seller, or closing costs equally likely to be paid by either the buyer or seller, will not be considered as concession for the purposes of determining if the total concessions are within the established limit.

VA ALLOWABLE CLOSING COSTS

- Either the buyer or the seller can paid discount points.
- Origination fee is to be one percent of the loan amount.
- A credit report fee is to be the actual charge.
- An appraisal fee is $275, plus mileage the appraiser travels to the property.
- Any survey fee is to be the actual charge.
- Recording fees are to be actual charges.
- The mortgagee’s title policy is $70 (versus $125 for a conventional loan).
- For VA funding fee: see the preceding information.
- Tax and insurance escrow is the amount required by lender.
Should any amounts exceed these, the seller not the buyer must pay the overage.

**THE FUNDING FEE**

The funding fee is the cost of receiving a VA guarantee. It takes the place of the Mortgage Insurance Premium in FHA loans. As of 10/01/93, the VA funding fee is a graduated schedule based on the amount of the borrower's down payment (DP):

- 2.00% = Funding Fee with less than 5% DP.
- 1.50% = Funding Fee with at least a 5% DP but less than a 10% DP.
- 1.25% = Funding Fee with 10% or more DP.
- 3.00% = Funding Fee on all subsequent loans.

**REQUIRED DOWN PAYMENTS**

There is no required down payment on VA loans up to $203,000, provided the sale price and the VA appraisal (known as the Certified Reasonable Value) amounts are equal and the veteran has full entitlement.

If the appraisal is lower than the sale price, the veteran must pay the difference between the appraisal value and the contract price as a down payment. Provided the appraisal value (CRV) is equal to or greater than the agreed to contract price, the veteran may borrow the funds for the down payment, as long as he or she qualifies for both payments. Gifts for down payment or closing costs are acceptable if obtained from relatives or from someone with a close, personal relationship to the borrower. However, a gift letter and verification of the donor's ability to make the gift is required.

**CERTIFICATE OF REASONABLE VALUE**

A VA Certificate of Reasonable Value includes an appraised value of the home and an expiration date after which the Certificate is no longer usable. Loans on property less than one year old may be made only if that property meets VA standards for construction and general acceptability. Also, builders of new homes must furnish veterans with certain construction warranties before the VA will guarantee a loan. The VA has established certain property requirements, which the appraiser will evaluate to determine if a loan can be VA guaranteed. Properties considered must:

- Be structurally sound.
- Not be in close proximity to hazardous or noxious influences.
• Have adequate public or on-site utilities (water well and septic systems are acceptable when inspected by the County Health Department).
• Not be engulfed by commercial or industrial properties.
• Have a required termite inspection performed.
• Be located on a publicly maintained road.
• Be clear of any contingencies.

The Veterans Administration may refuse to appraise properties built by certain builders who have previously failed to meet VA standards.

QUALIFYING THE BUYER

Here is a VA Loan Qualifying Worksheet:
The VA uses one ratio to qualify buyers: a debt-to-income ratio of 41 percent. However, it will also consider residual income and compensating factors for ratios over 41 percent.

---

<table>
<thead>
<tr>
<th>V.A. LOAN QUALIFYING WORKSHEET</th>
</tr>
</thead>
<tbody>
<tr>
<td>The VA uses one ratio instead of two. The system is simple if you follow the following chart:</td>
</tr>
</tbody>
</table>

1. Combined Gross Monthly Income  $________
2. LESS: Federal Income Tax (____ in Family)  $________
3. Social Security (Line 1 x .0751)  $________
4. State Income Tax  $________
5. TOTAL Taxes Withheld  $________
6. Installment & Revolving Debt  $________
7. Child Support, Alimony  $________
8. Child Care  $________
9. Monthly Property Taxes  $________
10. Monthly Homeowner’s Insurance  $________
11. Monthly Flood Insurance  $________
12. TOTAL Installment & Other Charges  $________
13. Monthly Utilities  $________
14. Monthly Maintenance  $________
15. TOTAL Deductions from Income (Line 5, 12, 13, 14)  $________
17. LESS: VA Required Amount Remaining for Family Support  $________
18. EQUALS: Total Amount of Principle & Interest Allowed  $________

---

**SECOND CALCULATION**

19. Gross Income (Line 1)  $________
20. MULTIPLY By Maximum VA Qualifying Ratio (%)  $____ x .41
21. EQUALS Ratio Amount  $________
22. SUBTRACT Line 12  $________
23. Maximum Principle & Interest Allowed  $________

**FINAL CALCULATION**

24. Take the lower of Line 18 or Line 23  $________
25. DIVIDE by Mortgage Factor for ____%  $________
26. EQUALS Maximum Loan Amount  $________

---

The VA uses one ratio to qualify buyers: a debt-to-income ratio of 41 percent. However, it will also consider residual income and compensating factors for ratios over 41 percent.
PRACTICE

Use the chart below to determine whether or not this veteran meets the VA debt service ratio requirement to receive a guaranteed loan. To do this, you will need to use the amortization calculator that was used in the previous lesson, found at: [http://www.webmath.com/amort.html](http://www.webmath.com/amort.html).

<table>
<thead>
<tr>
<th>Sale price</th>
<th>$79,900</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes</td>
<td>$105</td>
</tr>
<tr>
<td>Insurance</td>
<td>$30</td>
</tr>
<tr>
<td>Interest rate</td>
<td>10.5%</td>
</tr>
<tr>
<td>Term</td>
<td>30 years</td>
</tr>
<tr>
<td>Gross monthly income</td>
<td>$3,200 (A)</td>
</tr>
<tr>
<td>Long-term debts</td>
<td>$320</td>
</tr>
</tbody>
</table>

Using the previous chart, determine whether or not this veteran meets the VA debt service ratio requirement to receive a guaranteed loan. Don’t forget to use the amortization calculator that was used in the previous lesson, found here: [http://www.webmath.com/amort.html](http://www.webmath.com/amort.html).

**VA Qualifying Worksheet**

Combined Gross Monthly Income = $___________ (A)

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle and Interest (PI)</td>
<td>$</td>
</tr>
<tr>
<td>Taxes (T)</td>
<td>+</td>
</tr>
<tr>
<td>Hazard Insurance (I)</td>
<td>+</td>
</tr>
<tr>
<td>Long Term Debts</td>
<td>+</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$_______(B)</td>
</tr>
</tbody>
</table>

B / A = ____% (not to be in excess of 41%)
SOLUTION:

Using the amortization calculator (http://www.webmath.com/amort.html) we find that the amount and term of the loan results in a monthly payment of $730.88.

Follow this link to see the calculations and amortization chart: http://www.webmath.com/cgi-bin/amort.cgi?amount=79900&years=30&period=12&rate=10.5&extra=0

Now, using the information given in the first chart we can complete the VA qualifying worksheet.

<table>
<thead>
<tr>
<th>Expenses:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal and Interest (PI)</td>
<td>$730.88</td>
</tr>
<tr>
<td>Taxes (T)</td>
<td>+105.00</td>
</tr>
<tr>
<td>Hazard Insurance (I)</td>
<td>+30.00</td>
</tr>
<tr>
<td>Long Term Debts</td>
<td>+320.00</td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td><strong>$1185.88 (B)</strong></td>
</tr>
</tbody>
</table>

You can now calculate the total debt service ratio by dividing the borrower’s total expenses (B) by gross monthly income (A):

\[
\frac{1,185.88}{3200.00} = 0.3705 \text{ or } 37.05\%
\]

This percentage, less than the required 41%, shows that this buyer would be qualified for a VA loan.

**SUMMARY**

VA loans are loans guaranteed by the Veterans Administration and the federal government. They are only for veterans of foreign wars, current servicemen and women and a select group of others, and may only be used for owner-occupied one-to-four family properties. The VA reimburses lenders for loss up to $60,000 in the event of default by a borrower. The cost of this guarantee is a one-time funding fee, which varies inversely as a function of the borrower’s down payment. The VA sets limits on the allowable closing costs and requires that sellers pay any overages at closing. It also requires that properties be appraised by the VA and receive a Certificate of Reasonable Value. Any amount of the sale price of a property that exceeds the appraisal value must be paid as a down payment. VA
loans are fully assumable but only by purchasers who also meet the eligibility requirements of the Administration.

Return to your online course player to take the Lesson Quiz.
LESSON FIVE
BASICS OF REAL ESTATE FINANCING

This lesson focuses on the following topics:

- Loan Payment Plans
- Additional Loan Payment Plans
- Closing Real Estate Loans
- Introduction to Closing Costs
- Closing Costs

INTRODUCTION

In the past three lessons we covered the three most common types of loans: FHA, VA and conventional loans, and who may receive them. While these are the three most common types, they are not the only types. It is important that real estate professionals are familiar with other, less common types of loans as well so they can assist their clients in the best possible way.

This lesson will cover those types of financing that we have not yet touched upon. In addition, it will place the previously covered loans as well as these new loans in context to help the student formulate a "big picture" of real estate finance. In particular, this lesson will go over payment plans, discuss how real estate loans are finally closed and explain the costs and finance activities associated with closing a property sale.

LOAN PAYMENT PLANS

There are many different loan payment plans available in today's complex mortgage market. This lesson will expose the real estate practitioner to various alternatives that can be offered a borrower. Because financing is key to a successful transaction, knowing these could mean the difference in making or not making a sale. We will discuss the advantages and disadvantages of each plan, as well as any other pertinent details or features.

LOAN PAYMENT PLANS

The first matter of business will be different loan payment plans and their requirements:

- Conventional Fixed Rate Mortgage
- FHA Insured Mortgage
- VA Guaranteed Mortgage
- Adjustable Rate Mortgage (ARM)
- Graduated Payment Mortgage (GPM)
- Growth Equity Mortgage (GEM)
- Permanent Buydown
- Temporary Buydown

**Conventional Fixed Rate Mortgage**

Recall that the primary advantage of this most common type of mortgage is the stability of the monthly payment. The main disadvantage is that the borrower will not be able to take advantage of a drop in interest rates without refinancing.

![Fixed Mortgage Rates](image)

**FHA Insured Mortgage**

FHA’s mortgage insurance programs help low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. The main advantage of an FHA loan is that it requires lower down payments than conventional loans. The disadvantages include the expense of the mortgage insurance premium paid by the borrower and low limits on the loan amount.
VA Guaranteed Mortgage

Because VA loans are guaranteed, they have no insurance fee. And usually no down payment is required. However, the major disadvantage is that these loans are limited to veterans only. Furthermore, the borrower must pay a funding fee to receive the guarantee and the guarantee is only partial, affecting the amount of a loan a veteran can usually take, even though there are no legal limits.

Adjustable Rate Mortgage (ARM)

This loan is specifically tied to an economic indicator outside the lender’s control.

It is customary for lenders to make mortgage and deed of trust loans at an interest rate that remains constant over the life of the loan; however, in recent years adjustable-rate loans have become increasingly popular among lenders.

Adjustable-rate mortgages (ARMs) are amortized loans that allow for interest rate changes or “adjustments” at pre-determined periods, usually annually. Because the interest on a mortgagor’s loan may fluctuate up or down, during the loan term in relation to some agreed upon economic indicator, the mortgagor’s loan payments fluctuate as well. The movement of some government index, such as Treasury notes or bills, governs the amount of the interest-rate adjustment.

Furthermore, the amount and frequency of adjustment are limited by the terms of the note itself. All of these factors can be either favorable or unfavorable for the borrower, depending on the market.

All adjustable rate mortgages have four basic features:

1. Initial Interest Rate
2. Adjustment Interval
3. Index
4. Margin

Initial Interest Rate

This is the beginning rate on the ARM. It will stay the same until it is adjusted either up or down on the adjustment date specified in the mortgage. The initial rate usually is lower than the interest rate charged for a long-term, fixed-rate mortgage.
Adjustment Interval

This is the period of time between changes in either the interest rate and/or the monthly payment. The interest rate on most ARMs may change after one, three or five years, although other adjustment intervals may be negotiated with the lender.

Index

The index is a published measure of interest rates on certain types of investments. For example, the interest the government pays on bonds. An index for an ARM is always based on external, economic factors that the lender does not control. Thus, the rate of an ARM increases or decreases independently of either the lender’s or borrower’s desires or intentions.

Margin

This is an additional amount the lender adds to the index to account for business expenses. This amount usually remains the same throughout the lifetime of the loan and is added to the margin every adjustment period. For example, if the index is five percent at one adjustment period and the margin two percent, then the interest rate on the loan for that period is seven percent.

Are ARMs a Good or a Bad Choice for Borrowers?

Whether ARMs are a good or bad choice generally depends on the borrower’s financial situation. ARMs can be a good choice for financing a home under certain conditions, such as:

1 Rising income expectations: If the purchaser expects his or her income to increase each year and does not expect to accumulate extraordinary debts, then he or she is a good candidate for an ARM.

2 High interest rates: When interest rates rise, they threaten to squeeze potential homebuyers out of the housing market because fewer people can qualify for loans at the higher rates. ARMs have beginning interest rates typically as much as one to three percentage points below those of fixed-rate mortgages. Many lenders will make loans to homebuyers by qualifying them with the lower initial interest rates available on ARMs, even though the same borrowers could not qualify at the higher interest rates on a fixed-rate mortgage.

3 Short-term homeownership: If a borrower expects to move within a relatively short time because of a temporary job assignment or a transfer, an ARM makes
sense because the borrower gains the advantages of homeownership with a lower interest rate and lower monthly payments. This is especially important in such a situation because the build-up of home equity will probably be minimal and minimizing cash output helps make up for this, in that, the borrower will not have to pay a disproportionate amount of interest on a home he or she does not own.

The following questionnaire will help give you a clearer picture of what is involved with an ARM.

**Adjustable Rate Mortgage (ARM) Lender Questionnaire**

- What index are you currently using?
- Can the index change during the loan term?
- What is the margin?
- Does your margin change during the life of the loan?
- Does index plus margin equal rate every year of the loan?
- Is there a prepayment penalty assessed for early payments?
- What is the penalty and how long is it imposed?
- What are the interest rate caps, i.e. the maximum allowed interest rate?
  - Per Adjustment Period?
  - Over the life of the loan?
- What is the interest rate adjustment period?
- Are there any payment caps, i.e., limits on the amount of payments?
  - Per Adjustment Period?
  - Over the life of the loan?
- What is the payment adjustment period?
- Is there a possibility of negative amortization?
- Is there a negative amortization cap?
- Does this loan contain a conversion option, allowing the borrower to switch over to a fixed-rate loan?
- When can the borrower exercise this conversion option?
- Are there any cash costs to the borrower at the time of the conversion?
- What interest rate will the borrower get at the time of the conversion?

Another skill the real estate practitioner will want to develop is being able to show a borrower a worst-case scenario. In the case of recommending whether or not a buyer should consider an ARM, there are two ways to demonstrate the disadvantages of an ARM:

1. In the form of unfavorable interest rate fluctuations, and
2. In the form of payment fluctuations.

Interest rate is the simplest and easiest for most people to understand.
EXAMPLE:

For a loan amount of $100,000 upon which there would be a fixed interest rate of 10% for 30 years, an ARM of 6% with adjustment caps of 2 points annually (or 6 points over the life of the loan) would appear, at first glance, to be advantageous. However, should the index fluctuate as follows, the ARM would prove to have been an unwise choice.

<table>
<thead>
<tr>
<th>Pmt Year</th>
<th>Fixed Interest</th>
<th>ARM Index Interest</th>
<th>+/-</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10</td>
<td>6</td>
<td>+4</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>8</td>
<td>+2</td>
</tr>
<tr>
<td>3</td>
<td>10</td>
<td>10</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>10</td>
<td>12</td>
<td>-2</td>
</tr>
<tr>
<td>5</td>
<td>10</td>
<td>12</td>
<td>-2</td>
</tr>
<tr>
<td>6</td>
<td>10</td>
<td>12</td>
<td>-2</td>
</tr>
</tbody>
</table>

Advantages of an ARM

1. Low initial payments, and
2. The borrower is most often qualified on the basis of the lower initial payments.

Disadvantages of an ARM

1. The potential of negative amortization, and
2. Potentially higher payments in the future

Alternatives to an ARM

The following alternatives to an adjustable rate mortgage will be discussed in the following sections:

1. Temporary buydown
2. Permanent buydown
3. Equity participation mortgages

Graduated Payment Mortgage (GPM)

These loans are not readily available in today's mortgage market; however, a salesperson needs to be aware of their existence when attempting to list a property for sale. These loans were designed to negatively amortize and are sometimes referred to as negative amortization loans. The initial payments are not high enough to pay even the interest due, and the payments increase
(graduate) over the next five years until they level off at a sufficient amount that fully amortizes the loan over the remaining term.

Advantages of a GPM

The borrower qualifies on the basis of the lower initial payments, resulting in more potential qualifying purchasers.

Disadvantages of a GPM

The principal balance due on the loan increases instead of decreases in the first few years, so resale during this period could result in a loss to the seller. And, the increased payments may become impossible for the borrower to continue making since the rise can be substantial.

Growth Equity Mortgage (GEM)

These loans take on many different forms in today's competitive financial arena. The interest rate on these loans is fixed and available at an average of one full percent below the thirty year fixed mortgage rate in any given market. The payment increases annually by a pre-determined amount with all of the increase being applied to principal reduction. This causes a GEM loan to be paid off in an average of twelve to seventeen years, depending on the amount of increase in the payments, which are typically three percent, five percent, or 7.5 percent per year.

Advantages of a GEM Loan

A GEM is much like a fixed-rate loan that the borrower self-accelerates, but with two differences: there is never a pre-payment penalty (as GEM “prepayments” are just the regular, increased monthly payments) and the structure of the loan makes acceleration mandatory, rather than optional. It also has the following benefits:

- Lower initial interest rate
- Simplicity of the loan
- Known/predictable payments
- Equity that builds up quickly
- Reduced interest costs
- No chance of negative amortization

Disadvantages of a GEM Loan

The monthly payment increases over time. The borrower must determine up front if he or she will be able to make the payments as they increase over some years.
Permanent Buydown

Another name for a permanent buydown is simply *discount point*, or sometimes, just *point*. Points are what lenders charge borrowers for providing a loan. Because a lender will want to charge more for making higher loans and because when a potential borrower first approaches a lender the exact amount of the potential loan is unknown, lenders express their loan charges in percentages—that is, points—rather than absolute dollar figures. One point is one percent of a loan amount. For example, if a loan amount were $100,000, then the discount point would be $1,000.

When a potential borrower first approaches a lender, he or she will be told upfront the amount of discount points that a lender charges.

There are two different perspectives that a professional real estate person should be familiar with when it comes to discount points. There is the cash at closing side, with which most brokers are already familiar, as well as the "increased yield to the investor" side of discount points.

If a broker is familiar with the yield side of points, then the broker is better able to negotiate transactions for buyers and sellers than is his or her competition.

Since we are most often working with 30 year loans, the rule of thumb we are dealing with is most often called the Rule of Eights: eight points increases the investor's yield by one percent.

In other words, for every point the lender charges, he or she is increasing his or her profit by one-eighth of a percent on the loan. If a lender were to charge four points, yield would increase by four-eighths or one-half of a percent.

Temporary Buydown

These loans are an alternative to the adjustable rate mortgage and/or graduated payment mortgage. They provide the borrower with the temporary help he or she needs without any chance of negative amortization and with a predictable payment structure. The disadvantage is that there is a higher loan fee for this type of loan.

Under a buydown plan, the subsidizing party—the borrower, seller, builder, etc.—establishes a *buydown fund*, which is collected in cash at closing. The required portion of the payment, every payment period, is paid from the *buydown fund*. The borrower then makes payments at the *bought down* effective rate, which are lower than at the actual lending rate. When the temporary buydown period is over, the lending rate returns to normal.
The lender is collecting a level payment for the entire term of the loan, and any amortization schedule should be calculated as such. To the lender, this is a level payment fixed rate loan. To the borrower, however, this is a *stair step* or graduated payment loan.

A typical 3-2-1 temporary buydown would be calculated as follows:

<table>
<thead>
<tr>
<th>Note Rate</th>
<th>Buydown %</th>
<th>Eff Rate</th>
<th>Pmt @ Note Rate</th>
<th>Pmt @ Eff Rate</th>
<th>Mo Subs</th>
<th>Ann Subs</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>3</td>
<td>7</td>
<td>877.57</td>
<td>665.30</td>
<td>212.27</td>
<td>2547</td>
</tr>
<tr>
<td>10</td>
<td>2</td>
<td>8</td>
<td>877.57</td>
<td>733.76</td>
<td>143.81</td>
<td>1726</td>
</tr>
<tr>
<td>10</td>
<td>1</td>
<td>9</td>
<td>877.57</td>
<td>804.62</td>
<td>72.95</td>
<td>875</td>
</tr>
<tr>
<td>10</td>
<td>-0-</td>
<td>10</td>
<td>877.57</td>
<td>877.57</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td></td>
<td><strong>877.57</strong></td>
<td><strong>877.57</strong></td>
<td><strong>2547</strong></td>
<td><strong>5148</strong></td>
</tr>
</tbody>
</table>

Here, the effective rate is the difference between the note rate and the buydown percentage, and the monthly subsidy required is the difference between the payment that would be collected at the note rate and the payment actually collected at the effective rate. To establish the above buydown at three graduated steps over three years would take a buydown fund of $5,148—the total amount of subsidy required to be paid out over the years.

**Advantages of a Temporary Buydown**

1. Low initial payments, and
2. The borrower is most often qualified on the basis of these.

**Disadvantages of a Temporary Buydown**

There are two disadvantages of a temporary buydown:

1. Buydown plans are typically expensive and require a large payment at closing.
2. A buydown is only temporary, and the borrower will have increased monthly payments that may be difficult to afford.

**ADDITIONAL LOAN PAYMENT PLANS**

The following pages will outline additional loan payment plans, including:

- FHA 203K Property Rehabilitation Program
- Equity Participation Mortgage
- Seller Financing
- Blanket Mortgage
- Open-End Mortgage
• Construction Loan
• Reverse Annuity Mortgage
• Wraparound Mortgage
• Purchase Money Mortgage
• Sale-Leaseback

As with any real estate transaction, the real estate licensee should advise both the buyer and seller to seek legal counsel for guidance.

FHA 203K PROPERTY REHABILITATION PROGRAM

Essentially, this program is a government loan designed to preserve the nation's existing housing stock by facilitating renovation and restoration. It features down payments of as little as three percent and can involve loan amounts up to 110 percent of the home's after-improved value.

EQUITY PARTICIPATION MORTGAGE

An equity participation mortgage is a mortgage loan wherein the lender has a partial equity interest in the property or receives a portion of the income from the property during ownership (if an income producing property).

SELLER FINANCING

This occurs when the seller of the real estate provides financing for the sale by taking back a secured note in the form of a mortgage, land contract or deed of trust. Although risky for the seller, this also allows the seller to make the interest income that the lender would normally make. A real estate sales professional should advise BOTH the buyer and seller to seek legal counsel before agreeing to this type of financing arrangement since terms can be added that can be detrimental to one or the other party.

BLANKET MORTGAGE

A blanket mortgage is a mortgage on more than one property. When getting a blanket mortgage, it is important to ensure the agreement includes a release clause that permits one or more of the properties to be released from the obligation of the mortgage upon repayment of a determined amount of the mortgage balance. This type of loan is commonly used for subdivision developers who need a loan covering the whole subdivision with releases as each lot is sold.
OPEN-END MORTGAGE

Open-end mortgages are called such because they allow the mortgagor to borrow additional funds at a later date on top of the original loan amount. This is useful, for example, to a new homebuyer who wishes to buy furniture or a washer and dryer, etc., after the home purchase. Thus, the borrower may receive more money without the necessity of refinancing. To pay off the new debts incurred, the monthly payment or the loan term (sometimes both) will be increased, often with a concurrent change in the interest rate. One important type of open-end mortgage is the construction mortgage.

CONSTRUCTION LOAN

Also known as interim financing, this loan is used by lenders for the purpose of financing new construction or for renovating existing improvements. A long-term mortgage requires the home to already be constructed before it can be used as security. The borrower typically would get approved for a long-term mortgage first, and then a bank will agree (based on a loan take out letter of guarantee from the long-term mortgage lender) to lend up to that amount on a construction loan.

A construction loan is designed to be short-term in nature (six months to two years), with the funds advanced in stages as construction occurs. Repayment of this loan is usually made from the permanent (long-term) mortgage loan carrier when construction is completed. Commercial banks generally make this loan with a slightly higher interest rate than the permanent long-term financing. Some banks also offer one-time closing loans where they provide both the interim and permanent loan—allowing the borrower to save the costs of closing two separate loans, but in some cases, involving more costs and other procedures and provisions that end up costing the borrower more in the long run. (The prudent real estate professional will have the borrower check with the lenders carefully when considering this One-Time Closing arrangement.)

REVERSE ANNUITY MORTGAGE

A reverse annuity mortgage is a very rarely used mortgage, but one with which the real estate professional should be familiar. Under the terms of a regular amortized loan, the mortgagor borrows a lump sum repaid in monthly payments. Simply stated, a reverse mortgage works exactly as it sounds: in reverse. The lender makes monthly payments to the borrower up to a pre-determined maximum amount. Interest is charged only on the balance received by the mortgagor. The loan is repaid upon the sale of the property or the death of the owner(s).

This type of loan is particularly valuable for couples who do not want to sell their home, but whose retirement income is not quite enough to make ends meet. The
maximum loan amount is based upon the equity in the home and the lender's actuarial tables. These tables attempt to determine, based upon a person's current health, age, health habits, zip code, etc., how long they are likely to live and compute a payment plan based on this chart.

**WRAPAROUND MORTGAGE**

A wraparound mortgage is a second loan that encompasses a pre-existing loan, along with additional funds. A wraparound mortgage can be between a buyer and seller, or a consumer and a third-party lender. The following example illustrates one use of a wraparound mortgage that real estate licensees are likely to come across.

A Seller owns said Property. A Buyer is interested in purchasing the Property. The Seller still holds an outstanding loan for the Property with a Lender. Rather than assume the Seller's existing loan, the Seller and Buyer create a wraparound mortgage in which the Seller "loans" the Buyer the money directly—the Buyer pays the Seller a monthly amount slightly over the Seller's mortgage payment. In essence, the Buyer makes payments to the Seller under a wraparound mortgage, and the Seller, in turn, pays the Lender. The wraparound mortgage between the Seller and the Buyer is subordinate to the first loan between the Seller and the Lender.

With some wraparound mortgages, like our example wrap, the seller takes on the risk of buyer default. The wraparound mortgage creates a lien on the property, but it is a lien *subordinate to* the lien created by the seller's mortgage. Thus, if the seller cannot pay back his lender because of buyer default, the lender's right to recover damages supersedes the seller's. The profit that the seller stands to receive after he or she makes his or her mortgage payments is what the seller buys with this risk.

Sometimes a third-party lender holds the wraparound loan. This party loans funds to the buyer and uses them to pay back the original mortgage of the seller, while keeping the difference. Often, it is the lender of the first mortgage who issues the wraparound. These types of loans could occur for a variety of reasons. For example, if a homeowner wanted to improve upon a property, he or she could take out money for the project, and then combine the previous mortgage with the new improvement loan under a wraparound.

**PURCHASE-MONEY MORTGAGE**

A purchase-money mortgage, like a wraparound mortgage, involves the buyer receiving funds from the seller in the form of a mortgage loan to purchase the property. In a purchase-money mortgage, however, there is no encumbrance from an original mortgage remaining on the property.
SALE-LEASEBACK

In a sale-leaseback, the owner of a parcel of real estate sells it and immediately leases it back. Commercial investors who desire to turn their liquid real estate into cash without losing the use of the asset use this type of arrangement. In addition, an investor can claim a tax deduction for rent paid on property he or she uses for business. The selling investor will often reserve the right to repurchase the property at the end of the lease period.

The sale-leaseback is beneficial to the purchasing party because (a) the party receives a steady stream of rental income, more or less guaranteed, and (b) the party profits by reselling the property to its original owner at its new market price. If the sellback price were set at the beginning of the lease, the purchase price would be considered a loan for tax purposes, and the selling party would lose many of the tax benefits of the arrangement.

CLOSING REAL ESTATE LOANS

Settlement (or closing) is the formal process by which ownership of real property passes from seller to buyer. It is the end of the home buying process and the time when title to the property is transferred from the seller to the buyer. This is also sometimes referred to as vesting title in the buyer.

Residential real estate transactions (one- to four-family properties) that require an institutional or non-institutional loan must normally be settled under the provisions of the Federal Act known as RESPA (Real Estate Settlement Procedures Act) as set out by HUD (the U.S. Department of Housing and Urban Development) guidelines. RESPA requires use of the following consumer protections:

- Upon written application for a loan, or within three business days thereafter, the lender must provide the prospective purchaser with:
  - A good faith estimate of settlement costs
  - Copy of the booklet Settlement Costs and You (a HUD guide for homebuyers)
- The lender is required, usually within three days of receiving the application, to deliver in person or place in the mail a Truth-In-Lending Statement, which will disclose the “annual percentage rate” (APR) on the loan. (The real interest rate being charged not just the posted initial rate.)
- The Federal Fair Credit Reporting Act states that if the terms of the financing have been adversely affected by a potential purchaser’s credit report, the potential purchaser has the right to inspect the summary of the credit report provided to the institution free of charge. After receipt of the report, the individual affected is also given procedures to challenge any errors visible in the report to correct it for future publications.
The federally enacted Equal Credit Opportunity Act (ECOA) must be adhered to as follows:
  o At least one business day before closing, the person conducting the closing (called the escrow officer—usually an employee of a title company or law firm) must allow the purchaser to see the HUD-1 Settlement Statement detailing the closing costs and prepaid items.
  o At closing, the completed HUD-1 Settlement Statement must be given to both the purchaser and seller to review and sign to acknowledge its accuracy.
  o Purchasers have the right to file a complaint if they feel that they have been treated unfairly.

A copy of a HUD-1 Settlement Statement is included here.
A. Settlement Statement

B. Type of Loan

1. FHA
2. FmHA
3. Conv. Loans
4. VA
5. Conv. Ins.

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to us by the settlement agent are shown. Items marked with a * were paid outside the closing; they are shown here for informational purposes and are not included in the totals.

D. Home & Address of Borrower:

E. Home & Address of Seller:

F. Home & Address of Lender:

G. Property Location:

H. Settlement Agent:

J. Summary of Borrower's Transaction

K. Summary of Seller's Transaction

L. Adjustments for items paid by seller in advance

M. Adjustments for items paid by seller in advance

N. Gross Amount Due From Borrower

O. Gross Amount Due To Seller

P. Amounts Paid By Or In Behalf Of Borrower

Q. Reductions In Amount Due To Seller

R. Deposit or earnest money

S. Escrow deposit (see instructions)

T. Principal amount of new loans

U. Settlement charges to seller (line 1400)

V. Existing loans taken subject to

W. Payments of first mortgage loan

X. Payments of second mortgage loan

Y. Adjustments for items unpaid by seller

Z. Adjustments for items unpaid by seller

AA. Total Paid By/Fee Borrower

BB. Total Reduction Amount Due Seller

CC. Cash At Settlement From To Borrower

DD. Gross amount due to seller (line 129)

EE. Less amounts paid by/borrower (line 220)

FF. Less reductions in settlement due to seller (line 229)

GG. Cash From To Borrower

HH. Cash To Borrower

Section 5 of the Real Estate Settlement Procedures Act (RESPA) mandates the following: HUD must develop a Special Information Booklet to help purchasers of residential real estate to better understand the nature and costs of real estate settlement services.

- Each lender must provide the booklet to all applicants from whom it receives or for whom it prepares a written application for a loan mortgage to finance the purchase of residential real estate. The lender must provide a written application for a loan mortgage to finance the purchase of residential real estate.

- Lenders must prepare and distribute the booklet. Good Faith Estimate of the settlement costs that the borrower is likely to incur in connection with the settlement. These disclosures are mandatory.

Section 6 of RESPA requires HUD to develop and prescribe the standard form to be used at the time of loan settlement to provide full disclosure of all charges imposed upon the borrower and seller. The form is used to disclose the charges that are expected to be paid by the borrower and the charges that are expected to be paid by the seller.

The Public Reporting Burden for this collection of information is estimated to average one hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information.

This agency may not collect this information, and you are not required to complete this form unless it displays a currently valid OMB control number.

The information requested does not lend itself to confidentiality.
## Settlement Charges

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>Amount</th>
<th>Paid From</th>
<th>Paid From</th>
</tr>
</thead>
</table>
| 700. Total Sales/Broker's Commission based on price $                |                                                                             | $            | P
| 701. $                                                               |                                                                             | $            | P
| 702. Commission paid at Settlement                                   |                                                                             | $            | P
| 800. Items Payable In Connection With Loan                          |                                                                             |              |                |                |
| 801. Loan Origination Fee                                            | %                                                                           |              |                |                |
| 802. Loan Discount                                                   | %                                                                           |              |                |                |
| 803. Prepayment                                                   |                                                                             |              |                |                |
| 804. Credit Report                                                  |                                                                             |              |                |                |
| 805. Lender's Inspection Fee                                         |                                                                             |              |                |                |
| 806. Mortgage Insurance Application Fee                             |                                                                             |              |                |                |
| 807. Assumption Fee                                                 |                                                                             |              |                |                |
| 810. Items Required By Lender To Be Paid In Advance                 |                                                                             |              |                |                |
| 901. Interest from to $                                              |                                                                             | $            |                |                |
| 902. Mortgage Insurance Premium for months to                       |                                                                             | $            |                |                |
| 903. Hazard Insurance Premium for years to                          |                                                                             | $            |                |                |
| 904. Hazard Insurance Premium                                       |                                                                             | $            |                |                |
| 1000. Reserves Deposited With Lender                                |                                                                             |              |                |                |
| 1001. Hazard insurance                                              | $ per month                                                                 |              |                |                |
| 1002. Mortgage insurance                                            | $ per month                                                                 |              |                |                |
| 1003. City property taxes                                           | $ per month                                                                 |              |                |                |
| 1004. County property taxes                                         | $ per month                                                                 |              |                |                |
| 1005. Annual assessments                                            | $ per month                                                                 |              |                |                |
| 1006. Property taxes                                                | $ per month                                                                 |              |                |                |
| 1007. Mortgage insurance                                            | $ per month                                                                 |              |                |                |
| 1008. Title insurance                                               | $ per month                                                                 |              |                |                |
| 1100. Title Charges                                                 |                                                                             |              |                |                |
| 1101. Settlement or closing fee                                      |                                                                             | $            |                |                |
| 1102. Abstract or title search                                      |                                                                             | $            |                |                |
| 1103. Title examination                                             |                                                                             | $            |                |                |
| 1104. Title insurance                                               |                                                                             | $            |                |                |
| 1105. Document preparation                                          |                                                                             | $            |                |                |
| 1106. Notary fees                                                  |                                                                             | $            |                |                |
| 1107. Attorney's fees                                              |                                                                             | $            |                |                |
| 1108. Title insurance                                               |                                                                             | $            |                |                |
| 1200. Government Recording and Transfer Charges                     |                                                                             |              |                |                |
| 1201. Recording fees: Dred $, Mortgage $                            |                                                                             | $            |                |                |
| 1202. City county tax/stamps: Dred $, Mortgage $                     |                                                                             | $            |                |                |
| 1300. Additional Settlement Charges                                 |                                                                             |              |                |                |
| 1301. Survey                                                        |                                                                             | $            |                |                |
| 1302. Pest inspection                                              |                                                                             | $            |                |                |
| 1400. Total Settlement Charges [enter on lines 100, Section J and 502, Section K] |                                                                             |              |                |                |
INTRODUCTION TO CLOSING COSTS

We have reviewed the process involved in closing a real estate loan. It is helpful for the real estate practitioner to know all the different closing costs involved in a financed real estate transaction. For this course, we have again tried to cover those closing costs typically associated with the three most common types of loans—conventional, FHA and VA—but fees and costs can vary per lender and type of specific loan involved. The prudent real estate professional should advise clients to review the good faith estimate of closing costs provided by the lender upon initial application for the loan and compare it to the HUD-1 Settlement Statement prior to closing so any questions regarding discrepancies can be addressed with the lender.

Next, we will turn to an in depth look at closing costs so that you, as a real estate professional, can better understand what each is for and be able to explain the information to your buyer and/or seller. This information will keep you honest and knowledgeable and, consequently, capable of winning the trust of your clients.

CLOSING COSTS

NON-RECURRING CLOSING COSTS NOT ASSOCIATED WITH THE LENDER

Upon selling a property there are many small fees not associated with the lender that will need to be paid. Familiarity with these fees is important for all real estate professionals. The following pages will outline many of these common, one-time closing fees.

Closing/Escrow/Settlement Fee: A fee paid to the settlement agent or escrow holder.

Title Insurance: Assurance to the potential homeowner that he or she is receiving clear title to the property being purchased—free of liens and encumbrances, and, if a survey was done, discrepancies in boundaries and area.

Legal or Document Preparation Fee: Fee paid to lawyer or law firm for preparation of legal documents for transaction and lender required forms.

Notary Fees: Fee for forms that must be attested to, or notarized.

Recording Fees: Fee for recording legal documents with local county recorder.

Pest Inspection/Treatment: Fee for inspection and/or treatment and repairs of pest infestations, wood rot and water damage (that a lender may require as a pre-condition of procuring the loan).
**Home Inspection:** Fee if a homebuyer has his or her home inspected and has not prepaid when the inspection was completed.

**Home Warranty:** Optional fee paid for an insurance policy covering items such as major appliances, etc., not to be confused with a warranty provided by the builder of a new home that would cover the structure itself.

**Courier Fee:** Deals with the costs associated with delivering documents to the buyer, seller, lender or title company, law firm, county recorder, etc. to facilitate the closing process.

**Homeowner's Association Transfer Fee:** The fee charged by a Homeowner’s Association for transferring all ownership documents to the new owner.

**Option Fee:** A negotiated fee paid by the potential purchaser at the time of contracting for an option to terminate the contract within a stated amount of days, as outlined in the earnest money contract.

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**NON-RECURRING CLOSING COSTS ASSOCIATED WITH LENDER**

The following costs are only collected at closing and do not continue to be collected during the loan period (non-recurring). The exact amount of each fee should appear on the original good faith estimate provided by the lender to the borrower at loan application. As a real estate professional, you should assist the borrower in reviewing and explaining each of these fees prior to closing. Also, compare the good faith estimate with the HUD-1 Settlement Statement for any discrepancies, and if any are found, contact your lender immediately for an explanation.

**Loan Origination Fee:** As previously stated, the loan origination fee is often referred to as *points*. On an FHA loan, the loan origination fee is one point. On a VA loan, the individual lender sets the loan origination fee. Anything in addition to one point (on government loans) is called *discount points*. A point is equal to one percent of the whole loan amount. This amount is paid directly to the lender as a fee to set up the loan.

**Appraisal Fee:** Fee paid to a licensed real estate appraiser, usually by the lender, to appraise the value of the property. The appraisal fee varies, depending on the value of the home and the difficulty involved in justifying value. Appraisal fees on VA and FHA loans are higher than on conventional loans because they require the appraiser to inspect items not strictly associated with value (but such inspections are NOT for the borrower and should not be substituted for an independent inspection done for a borrower prior to purchase—if the borrower so
chooses). This fee is usually negotiated directly with the lender, who orders the appraisal.

**Credit Report Fee:** Fee paid to a credit reporting service for reviewing the borrower’s credit history.

**Mortgage Broker Fee:** Broker processing fees. Borrowers should direct questions about broker processing fees to the broker directly. As the student probably knows, these fees are negotiable and set by the broker.

**Tax Service Fee:** Fee for a service that checks to make sure property tax payments are made or have been made.

**Flood Certification Fee:** Fee for a service to determine whether or not a property is located in a federally designated flood zone.

**Flood Monitoring Fee:** Fee paid for a service monitoring whether or not a re-mapping affects the flood zone designation status of a property (i.e., makes it so that a property previously outside a flood zone is now within a flood zone, or makes it so that a previously flood-zoned property is no longer flood-zoned).

**Escrow Waiver Fee:** Fee paid on loans made when an escrow account is not established to cover the cost of a service monitoring the payment of taxes and insurance on behalf of a lender over the course of the loan. It is possible to avoid an escrow account in loans less than 80 percent of the sale price.

Some fees are not consistently charged. The following list outlines fees applying to certain transactions. These should be listed on the Hud-1 Settlement Statement.

- Underwriting Fee: Fee sometimes charged by a lender reselling the loan in the secondary market.
- Administration Fee: Additional fee sometimes charged by a lender to establish the loan.
- Appraisal Review Fee: Fee sometimes charged by lender for a second appraiser to review the original appraisal when findings are considered questionable.
- Wire Transfer Fee: Fee charged if funds are wire transferred at closing for a buyer or seller.
- Warehousing Fee: Fee charged by lender as an additional amount for establishing loan.
SUMMARY

In addition to the three most common types of loans, VA, FHA and conventional fixed-rate loans, there are several other loan payment plans available. One important loan type of this sort is the adjustable rate mortgage or ARM. ARMs have an initial interest rate generally below conventional rate loans that is adjusted periodically in relation to some economic indicator, an index, stipulated in the loan. To the index a lender adds the margin, which is charged to cover business expenses. The margin amount usually stays the same over the life of the loan. ARMs typically have either a rate cap or a payment cap for either the adjustment period, the term of the loan, or both.

Other loan payment plans are often variations on the conventional loan and can have increased payments over time as with a graduated payment mortgage or a temporary buydown; an increasing interest rate, as with a growth equity mortgage; or a decreased rate, as with a permanent buydown. The loan and purchase process is governed by several government acts, including the Real Estate Settlement Procedures Act (RESPA), the Federal Fair Credit Reporting Act and the Equal Credit Opportunity Act (ECOA). A real estate professional must be familiar with the provisions of these acts in order to avoid violating the law.

The formal process by which ownership of real property passes from seller to buyer is known as "closing." There are costs at closing associated with the lender and other professionals and professional services. For example, upon closing a real estate transaction, fees must be paid to lawyers, couriers, homeowners’ associations, insurers, inspectors and appraisers. Lenders typically charge a fee for originating a loan, a mortgage broker fee for processing, a credit report fee for obtaining the information, a tax service fee to ensure that a property’s taxes are current and other fees for services in the course of closing.

Return to your online course player to take the Lesson Quiz.
LESSON SIX
CASE STUDIES AND PRACTICE

This lesson focuses on the following topics:

- Practice Problems
- Activity
- Case Studies

INTRODUCTION

This module has covered many specifics over a relatively short period of time. To ensure a comprehensive understanding of the material, we have integrated the information provided in the module into a series of questions and case studies.

The first half of this lesson presents several comprehensive questions and dilemmas. Please consider your response and then circle the answer choice that seems best to you. Then, read the corresponding feedback. The second half presents brief case studies illustrating the principles and ideas presented in this course.

PRACTICE PROBLEMS

How is loan qualifying ratio used to determine the maximum monthly payment a borrower can make, with respect to the borrower’s gross monthly income and long-term debt?

Which do you think is correct?

1. The borrower’s total housing expense ratio is multiplied by the borrower’s gross monthly income to find the maximum allowable housing expense with respect to housing costs. Then, the total debt service ratio is multiplied by the difference between gross monthly income and long-term debt to find the maximum allowable housing expense with respect to the borrower’s debt. The greater of the two maximum expenses is the maximum allowable housing expense.

2. The borrower’s total housing expense ratio is multiplied by the borrower’s gross monthly income to find the maximum allowable housing expense with respect to housing costs. Then, the total debt service ratio is multiplied by the difference between gross monthly income and long-term debt to find the maximum allowable housing expense with respect to the borrower’s debt. The lesser of the two maximum expenses is the maximum allowable housing expense.
**ANSWERS:**

1. Incorrect. Choosing the greater expense would exceed the limit placed by the lower expense. We should never have a housing expense figure that exceeds either of these limits, since the maximum allowable housing expense is an upper limit on housing costs, greater than which borrowers should not pay.

2. Correct. Choosing the lesser expense gives us a figure less than or equal to both maximum housing expense figures, not in excess of either. We should never have a housing expense figure that exceeds either of these limits, since the maximum allowable housing expense is an upper limit on housing costs, greater than which borrowers should not pay.

**QUESTION TWO**

In which of the following situations should a veteran’s remaining entitlement be calculated?

Which do you think is correct?

1. If a veteran who has paid a VA loan in full wants to buy a second home with the intention of leasing the property, the veteran’s remaining entitlement must be calculated in order to determine what loan amount the veteran can get to purchase the property.

2. If a veteran sells his or her home to another party who does not assume the VA loan, it is important to calculate the veteran’s remaining entitlement in order to determine what loan amount the veteran can get to purchase a new home.
ANSWERS:

1. Incorrect. VA loans are available to veterans who intend to occupy the property, not for investment or rental purposes. This veteran is not eligible for a VA loan; therefore, entitlement need not be calculated.

2. Correct. A veteran may obtain a second VA loan while the first VA loan is still in effect. However, the veteran’s entitlement must be calculated to determine how much of a loan he or she is eligible to receive. When the first VA loan is paid off, the veteran is eligible to receive the maximum entitlement.

CASE STUDIES

CASE STUDY ONE

Conventional Loans

A customer wants to buy a house that is listed at its appraised value of $90,000. He makes a salary of $39,000 a year but he is worried he will not be able to qualify for the 30-year loan he wants because he is currently paying off his new truck and his daughter’s college education. Annual taxes on the property are 2.4 percent of the appraised value; insurance is 0.75 percent; and the homeowner’s fee is $30/month. If the current interest rate is 7.35 percent, can we qualify him for a loan?

We sit him down with a conventional loan qualifying worksheet. His gross monthly income is $39,000 annually, or $3,250 a month. We must determine whether or not his total housing expense is less than 28 percent of $3,250 and if his total debt service is less than 36 percent of $3,250.

To determine total housing expense, we calculate the PITI payment. Since the loan to value ratio is 100 percent, which in turn is higher than 80 percent, Customer A must purchase private mortgage insurance, which at its cheapest we find is 0.5 percent annually. Since principal, interest, taxes and insurance are all given in percentages, it is best to calculate the amortization payments on a loan relative to one rate, the sum of all the others.

\[
7.35\text{% interest} + 2.4\text{% taxes} + 0.75\text{% hazard insurance} + 0.5\text{% PMI} = 11\text{% total rate}
\]

The amortization schedule—http://www.webmath.com/amort.html—indicates that a 30-year loan of $90,000 at 11 percent takes a monthly payment of $9.52 to fully amortize. With a monthly income of $3,250.00:
1: What is the monthly payment required for an 11%, 30-year loan of $90,000?

- $765.90
- $857.09
- $876.70

2: Now, add the $30/month homeowner’s fee to the monthly payment to calculate the total housing expense.

- $795.90
- $887.09
- $906.70

3: What is the borrower’s housing expense to income ratio?

- 28%
- 26.33%
- 27.29%

4: Based on this, does the borrower automatically qualify for the loan?

- Yes
- No
Answer Key:

1: $857.09. A $90,000 30-year loan takes monthly payments of $857.09 to fully amortize.

2: $887.09. $857.09 + $30 = $887.09 total housing expense.

3: 27.29%. The borrower’s housing expense to income ratio is: $887.09 / $3,250 = 27.29%, just less than the qualifying ratio of 28 percent.

4: No, the borrower does not automatically qualify for the loan. His total debt service ratio must also be calculated.

Calculate the borrower’s total debt service ratio. He is currently paying $3,000 a year for his daughter’s college education and $220 a month for his vehicle. That’s $470 a month. His total debts add up to $470 + $887.09 = $1357.09 a month.

1. What is the borrower’s total debt service ratio?

42.78%
41.75%
36.21%

2: Does the borrower qualify for the loan?

Yes
No
Answer Key:

1: **41.75%**. The total debt service ratio is calculated by dividing total debts by monthly income. Therefore, $1357.09 / $3,250 = 0.4175, or 41.75%.

2: **No**, the borrower does not qualify for a loan. His total debt ratio is 41.75%, well over the required 36%.

CASE STUDY TWO

Adjustable Rate Mortgages

Perhaps we can still help this customer. His daughter graduates in three more years and his truck only has 12 months more of payments. The goal would be to get him a loan with low initial payments and increased later payments. We know a few lenders who are willing to offer an adjustable rate mortgage, but these are worrisome because the rate may fluctuate too high for him to pay. Remember: he is well over the minimum required total debt service ratio.

The best ARM we find offered has an initial interest rate of 4.35 percent, three whole percentage points below the going rate for 30-year conventional loans. The total rate on the loan will be eight percent (4.35% interest + 2.4% taxes + 0.75% hazard + 0.5% PMI). At this rate, according to our schedule, the loan will require monthly payments of $660.39 to fully amortize in 30 years at eight percent. To this we add our $30 homeowner’s fee and the $470 truck and college payment to get the total debt service: $1,160.39. This is only 35.7 percent of his $3,250 gross monthly income and would qualify him for the loan.

But in some cases, qualifying isn’t enough. We have to consider the worst-case scenario. The margin on this loan is 0.35 percent and the rate adjusts annually, capped at two percent per interval. The index is U.S. Treasury Bonds, currently paying four percent. If the rate increases by the full two percent next year, this customer will have paid off his truck, but the effective rate he’ll be paying is 10 percent. This requires payments of $789.81, and a total debt service of $789.81 + $30 homeowner’s fee + $250 college payment = $1,069.81, only 32.92 percent.

However, suppose the interest rate went up yet again over the next two years, say, only one percent per year. Then the interest rate would be 12 percent and the total debt service payments, $1,205.75. This would be 1.1 percent in excess of the minimum ratio requirement and this customer might be at a high risk of default. And, this is only at a one percent per year increase: the cap is two points per year.
While it's unlikely this worst-case scenario will come to pass, it's still possible. We, as real estate licensees must explain the situation to our customer and make a decision as to whether or not the both of us are willing to take the risk. Remember: it is our risk too—the default of one of our client’s reflects a bad judgment on our part.

CASE STUDY THREE

Graduated Payment Mortgages

Another loan we might consider finding for Customer A is the graduated payment mortgage or GPM. These are not loans readily available in today’s market, but suppose that we know a lender who is willing to offer one at our request. The graduated payments are $400 the first year, $550 the second year, $700 the third year, $850 the fourth and $950 the fifth.

The payments of interest to us are those in the first year, right before the truck is paid off, the third year, right before his daughter leaves college and the fifth year, when the monthly payments are highest. Customer A should meet the required ratios at each of these critical points before he decides to take the loan. We fill out the following chart:

<table>
<thead>
<tr>
<th>Year</th>
<th>Monthly Loan Payment</th>
<th>Long Term Debt</th>
<th>Total Monthly Payments</th>
<th>Total Debt Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$400</td>
<td>$500</td>
<td>$1,173.75</td>
<td>36.12%</td>
</tr>
<tr>
<td>Year 3</td>
<td>$700</td>
<td>$280</td>
<td>$1,259.72</td>
<td>38.76%</td>
</tr>
<tr>
<td>Year 5</td>
<td>$950</td>
<td>$30</td>
<td>$1,243.90</td>
<td>38.27%</td>
</tr>
</tbody>
</table>

To find the total monthly payments we must calculate the taxes and insurance for each year. These calculations are tedious because we do not have the use of an amortization schedule (a GPM is often called a negative amortization loan). In essence, we multiply the interest rate by the first year’s principal, as well as the tax and insurance rate. Since the taxes and insurance are paid month to month, they aren’t considered in calculating the next year’s principal. By adding the interest and subtracting 12 times the monthly loan payment for the year, figure principal. Then the figures are calculated on the next year’s principal, and so on. Here is the result:

<table>
<thead>
<tr>
<th>Year</th>
<th>Principal</th>
<th>Interest (at 7.35%)</th>
<th>Taxes and Insurance</th>
<th>Mo. Payment x 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$90,000.00</td>
<td>$6,615.00</td>
<td>$3,285.00</td>
<td>$4,800</td>
</tr>
<tr>
<td>2</td>
<td>$91,815.00</td>
<td>$6,748.40</td>
<td>$3,351.25</td>
<td>$6,600</td>
</tr>
<tr>
<td>3</td>
<td>$91,963.40</td>
<td>$6,759.31</td>
<td>$3,356.66</td>
<td>$8,400</td>
</tr>
<tr>
<td>4</td>
<td>$90,322.71</td>
<td>$6,638.72</td>
<td>$3,296.79</td>
<td>$10,200</td>
</tr>
<tr>
<td>5</td>
<td>$86,761.43</td>
<td>$6,376.97</td>
<td>$3,166.79</td>
<td>$12,000</td>
</tr>
</tbody>
</table>
Notice how in the first few years the principal increases, as is to be expected with a GPM. The tax and insurance payments are divided by twelve to find the monthly tax and insurance payments, and added to the monthly loan payment and long-term debt payment to find the total monthly payment.

Since the total debt service exceeds 36 percent for years one, three and five, this customer does not qualify for this loan. However, the numbers are not excessively far off. If the customer could cut some of his long-term expenses or increase his income slightly, then he might be able to make the payments.

CASE STUDY FOUR

FHA Loans

Of course, the best solution may be an insured loan. When a loan is insured, the risk involved to the lender is less and thus the minimum requirements on the borrower less stringent.

The problem with an FHA loan may be the cash required to get it. For a customer’s desired $90,000 home, he has to pay 2.25 percent down—only part of his total three percent cash investment—and a mortgage insurance premium of 2.25 percent. This could conceivably run our client:

$$5.25\% \times \$90,000 = \$4,725 \text{ upfront}$$

Although this figure could be reduced by financing the MIP and paying it out over the term of the loan, making our client’s investment only $2,700—a more manageable figure.

But can he qualify for the loan? The financed MIP will run him 0.075 percent a year (2.25 percent/30 years) plus the annual mortgage insurance premium of 0.5 percent, and remember he also has to pay taxes of 2.4 percent, insurance of 0.75 percent and a homeowner’s fee of $30 a month. At an interest rate of 7.35 percent, the PITI rate is 11.075 percent. At this rate, monthly payments would need to be $862.20 plus the $30 homeowner’s fee for the loan to fully amortize. Since the borrower barely made the qualifying ratio for the conventional loan, we have cause to worry. Luckily his housing expense ratio turns out to be 27.47 percent, about a point and a half less than the 29 percent qualifying ratio for FHA loans.

However, his total debt service ratio was 41.75 percent of his gross monthly income before, and we’d expect this number to go up, as we’ve added the 0.075% financed MIP. This ratio is required by the FHA to be less than 41 percent, and it appears again as though this customer does not qualify.
Since the ratio is so close, this customer has two options. He could wait three months until his truck payment only had nine months remaining, and therefore would not be counted in his long-term debts by the FHA (compared to six with conventional loans). On the other hand, the FHA considers compensating factors—such as a cash reserve—in cases where the ratios are close. Pursuing either of these options might lose the borrower valuable time and the house may go off the market before then; however, if he does indeed have significant cash reserves, a permanent buydown may be the answer.

**CASE STUDY FIVE**

**Permanent Buydown**

A permanent buydown or discount point is an amount of a loan that the borrower pays in cash to “buydown” the interest rate over the life of the loan. The lender does not lose profit: he just gets it earlier. In a thirty-year loan we use the “Rule of Eights”: that is, every discount point (one percent of the loan amount) is worth a one-eighth reduction in the interest rate. How many discount points does a customer need to buy in order to qualify for his FHA loan?

One point reduces the PITI rate from 11.075% to 10.95%. The monthly payment is then $853.69 + $30 homeowner’s fee + $220 truck payment + $250 college tuition = $1,353.69. This is 41.65% of the loan amount.

Two points reduce the rate to 10.825%. The payment is then $845.21 + $30 + $220 + $250 = $1,345.21. This is 41.39% of the loan amount.

Three points reduce the rate to 10.7%. The payment is then $836.75 + $30 + $220 + $250 = $1,336.75. This is 41.13% of the loan amount.

Four points reduce the rate by half a point to 10.575%. The payment then is $828.32 + $30 + $220 + $250 = $1,328.32. This is 40.87% of the loan amount and thus, qualifies the buyer for the loan.

Four discount points constitute four percent of the loan amount and thus cost 0.04 x $90,000 or $3,600. The seller can pay these points, but only up to a three percent contribution, since the loan-to-value ratio is greater than 90 percent. The buyer would then have to contribute $900 plus the minimum investment requirement of $2,700, totaling $3,600 once again (remember discount points do not count toward the minimum investment required in an FHA loan). If a customer has this money on hand, he can buy the points and qualify for the loan.
CASE STUDY SIX

Closing

Let's suppose a customer has $5,825 to put toward the down payment and closing costs. Assuming the seller is paying for three loan discount points, this customer still must pay $900 for the fourth point, leaving him with $4,925. The required down payment is 2.25 percent as the property is greater than $50,000 in value. 0.025 x $90,000 = $2,250. This leaves the borrower with only $2,675 for closing. Since FHA loans require a three percent cash investment, he must use at least $675 more for closing—either to pay fees or to put more money down.

The lender in this case typically charges a one percent origination fee on the loan. FHA regulations, however, stipulate no origination fee is to be charged; and, since the seller has contributed the maximum amount toward the buyer's closing, the lender must waive the fee.

The FHA does, however, require that the house be appraised. The FHA-approved appraiser that our lender uses charges $275 and appraises the house at $89,400. This is $600 shy of the $90,000 price tag on the house and Customer A will have to pay this amount with the down payment. The $275 appraisal fee and the $600 down payment leave our buyer with $1,800.

Various fees for notary services, preparing legal documents and recording them with the county recorder, inspecting the home, transferring the homeowner's association's owner's documents and obtaining a credit report add up, in this case, to $1,000.

The closing date is March 20th and the contract stipulates prorated items are to run through the day of closing, meaning the buyer pays for them starting the day after closing. There is a flood insurance policy on the house running through June 15th that the buyer would like to assume. It is $3,500 a year. The insurance policy costs $3,500/365 days = $9.59 per day. Since the buyer would assume the policy on the 21st, he pays: meaning, the 11 remaining days of March, 30 days in April, 31 days in May, and 15 days in June, totaling 87 days. At the daily rate this would run him $834.33. This exceeds the $800 he has remaining after paying for all the fees, and he is forced not to assume the policy.

CASE STUDY SEVEN

VA Loans

A veteran is interested in purchasing a new home. He served in the Korean War and meets all the qualifications for a loan guaranteed by the Veterans
Administration. What he wants to know is whether he is better off getting a VA Loan or a conventionally financed loan.

Because the government fixes the interest rate on VA loans, it doesn’t change as often as the market rate. The VA rate is now 8.5 percent compared to the 7.35 percent market rate. The closing costs for both loans are essentially the same, with the following exceptions: the origination fee on the VA loan is one percent and on the conventional loan, 1.5 percent. Also, the VA charges a two percent funding fee in addition to other closing costs, and the VA appraisal is $75 more than the lender’s usual appraisal. However, the conventional loan requires private mortgage insurance because the LTV is below 80 percent, and the cost of this insurance is 0.75 percent annually.

The house this veteran is interested in buying costs $65,000. He wants to put 10 percent down. Assume a 30-year term and answer the following questions.

1. Which loan will cost him more per month?
2. Which loan will cost him more over time?

**The VA Loan**

The VA Loan costs him one percent origination fee and a two percent funding fee up front. The Rule of Eights tells us every discount point is worth one-eighth of a reduction in the interest rate. So, the lender’s profit from interest is essentially eight times the interest rate multiplied by the original loan amount.

\[
8 \times 0.085 = 0.68 = 68\%.
\]

The loan will cost the veteran \(1 + 0.1 + 0.2 + 0.68 = 1.71\) times the loan amount over its lifetime, plus the $75 extra for the appraisal.

The loan amount is 90 percent of $65,000 (the portion of the selling price not paid upfront), or $58,500. This loan will take a payment of $449.81 to amortize over 30 years at the VA rate. It will cost the veteran \((1.71 \times 58,500) + 75 = 100,110\) total.

**The Conventional Loan**

The conventional loan costs the veteran a 1.5 percent origination fee and an annual rate of 7.35 percent interest + 0.75% PMI. By the Rule of Eights the interest rate is equivalent to \(8 \times (0.0735 + 0.0075) = 0.648\) or 64.8 percent of the loan amount. Thus, the total cost of the loan is 166.3 percent of $58,500 or $97,285.50—plus 1.5 percent of $58,500, for a grand total of $98,163, which is less than the cost of the VA loan.

Moreover, the monthly payments are less too. The interest plus the insurance rate is 8.1 percent, which requires a payment of $433.34 to fully amortize over 30
years. It seems as though the veteran would be better off taking out a conventional loan, even though he qualifies for a VA-guaranteed one.

CASE STUDY EIGHT

Entitlement

A veteran who has purchased a home requiring a VA loan of $60,000 desires to sell it at that price and buy a new home for $180,000. He is selling to a non-veteran who cannot assume his original loan. If he wishes to take out a second VA loan for the new home, can he get it?

To answer this question we must determine how much entitlement the veteran currently has, and what the amount of the loan is that he can get with that entitlement.

The entitlement used for a loan between $56,251 and $144,000 based on the sliding scale is 40 percent of the loan amount. So, the veteran is currently using 40% x $60,000 = $24,000 of his entitlement. Thus his current entitlement is $60,000 (the amount that VA guarantees) – $24,000 = $36,000.

He needs to take out a loan to pay the difference of the sale price on his original house and the sale price of the house he is purchasing, or $180,000 – $60,000 = $120,000. Since lenders will typically loan up four times the amount of a veteran’s entitlement, the veteran can likely get a loan of 4 x $36,000 = $144,000.

This amount is enough to cover the $120,000 he needs.

CASE STUDY NINE

Income

A customer enters our office looking to purchase a home. She wants a 30-year loan and the current market interest rate is eight percent. She has no idea what price range is available to her, but she gives us the following information:

She works two jobs. Her primary job at a salary of $72,000 a year and a secondary job that she works for approximately 20 hours a week at $15 an hour. She has had the first job for 10 years now, but has only been working the second for 18 months.

On average, she keeps $7,000 in her checking and savings accounts combined.
She has two credit cards, each with limits of $5,000, which have required payments of at least 10 percent of the monthly balance with a 10-dollar minimum payment.

She is paying for her car at $300 a month plus $150 a month for insurance. She has 32 months remaining on the car. She is also paying off a washer, dryer and refrigerator at $48 a month for all three.

Assuming all these figures are roughly correct, we calculate her income as follows: gross monthly income is dependent only on her primary job, as she does not have a two-year history with the second job. This pays:

$72,000/12 = $6,000 a month

We know the lenders we deal with typically calculate worst-case credit card payments, as though the cards a borrower owned were maxed out. This gives her a payment of:

($5,000 x 0.10 x 2) = $1,000

We add to this $450 for her car payment and insurance and $48 for her other long-term debts and arrive at a total debt service of $1,498.

We know for a conventional loan:

Maximum monthly housing expense = 0.28 x gross monthly income
= 0.28 x $6,000
= $1,680

Or, if it is less:

Maximum monthly housing expense = 0.36 x (GMI − Total Debt Service)
= 0.36 x ($6,000 − $1,498)
= 0.36 x $4,502
= $1,620.72

So, the maximum payment this customer can make a month cannot exceed $1,620.72.

Looking at our amortization charts, we see that $1,620.72 per month will amortize a 30-year loan at eight percent interest whose principal is $220,877.38. The houses we will consider are those that range from $160,000 to $220,000 in value.
CASE STUDY TEN
Principal and Interest

A 30-year loan of $50,000 at six percent interest takes monthly payments of $299.78 to fully amortize. After three years, what percentage of the monthly payment is going toward interest and what toward principal?

The initial loan amount is $50,000 and the monthly interest is (0.06 / 12 months) = 0.005 or 0.5 percent. So the interest this first month is $50,000 x 0.5% = $250, which is 83.39 percent of the monthly payment.

The principal in the second month is the initial principal, less the monthly payment amount that went directly to the principal: $50,000 − ($299.78 − $250.00) = $50,000 − 49.78 = ____________.

$49,750.00
$49,950.22
$49,700.22
ANSWER:
The interest is $49,950.22 \times 0.5\% = $249.75, or 83.31 percent of the monthly payment.

As you can see, very little of the monthly payment is applied to the principal at the outset of the loan. The deeper into the loan the payer gets, the more of each payment goes toward the principal, and less toward the interest. This is the nature of amortization.

Formulas, equations, spreadsheets, and calculators exist to calculate these amounts, but, as you have seen in this course, the simplest method to delineating these amounts is the use of mortgage calculating software, many examples of which can be found on the web. This one was used in this course—http://www.webmath.com/amort.html—but most financial institutions provide this service online.

Using the one we have been using, we find that after 36 months only $59.57 is going to the principal, whereas the remainder of the $299.78 monthly payment—or $240.21—is still going to interest. It is not until the 223 month that more of each monthly payment is going to principal than to interest.
# Texas Principles of Real Estate

## Module 15: Real Estate Math

### Introduction
- Learning Objectives
- Key Terms

10 minutes

### Lesson 1: The Language of Math
- Fractions
- Decimals
- Percentages

25 minutes

### Lesson 2: Measurement of Dimensions in Real Estate
- Linear Measurement
- Area
- Volume

25 minutes

### Lesson 3: Financial Math
- Interest and Percentage Calculations
- Amortization
- Rate
- Prorations

30 minutes

### Lesson 4: Valuation Math
- Loan Discount
- Appreciation and Depreciation
- Value for Income-Producing Properties
- Percentage Leases
- Profit and Loss

50 minutes

### Lesson 5: Real Estate Practice
- Insight into Practical Applications of Real Estate Math
- Case Studies

40 minutes

Total Lesson Time: 180 minutes (3 Hours)
INTRODUCTION

This module is a 3-hour course designed to refresh real estate professionals with the mathematics skills used in their trade. It is important that licensees understand the mathematical concepts presented here in order to be competent in the practice of real estate.

The module includes fractions, decimals and percentages: the mathematical language used to express many aspects of real estate practice. Area and volume will be discussed so that the licensee will be able to determine and express the amount of commodity in a particular parcel of realty. While not a real estate finance course, this module will review concepts of interest, amortization and loan rate and discount. These concepts must be understood fully so that the licensee may grasp the essential elements used in the purchase of and financing for real property. Additionally, the principle of prorating will depict the importance of time in the transfer of realty.

The conclusion of this module offers real world examples and applications of the information presented. Upon completion of this module the student will comprehend the language and principles of mathematics necessary to successfully function in the practice of real estate.
**KEY TERMS**

**Amortization:** The repayment of a financial obligation over a period of time in a series of periodic installments. Specifically, it is the payback of the principal owed to the lender. Each payment should cover the interest accrued over the time period for which payment is made and a portion of the principal. The interest portion is tax deductible, whereas the amortization is not.

**Amortization Rate:** The percentage of a periodic payment that is applied to the reduction of the principal; in a level-payment mortgage this corresponds to the sinking fund factor.

**Amortization Term:** The time period over which the principal amount would be retired on the basis of the periodic installments paid.

**Amortized Loan:** A financial obligation repaid over a period of time in a series of periodic payments.

**Appreciation:** An increase in the value or worth of something due to economic or related causes such as supply and demand, which may prove to be either permanent or temporary. It is the opposite of depreciation.

**Area:** The surface size of a two-dimensional figure such as a triangle or rectangle, expressed in terms of square units, i.e., square feet or square yards. It is formulated by the equation: length x width = area for rectangles; one-half base x height = area for triangles; pi x radius squared = area for circles, etc.

**Banker’s Year:** An evenly based system used for calculations that assumes twelve calendar months, each containing thirty days, for a total of a 360-day year. It is also known as a *statutory year*.

**Calendar Year:** The standard practice of measuring a year based on twelve months with an unequal number of days in each, totaling 365 days or 366 in a leap year.

**Cost:** The money provided for materials, labor, land and profits necessary to bring a property into existence.

**Cubic:** A three-dimensional measurement based on the total volume of an object.

**Depreciation:** In real estate, this is a loss in value from wear, use or obsolescence (disuse).

**Discount:** The amount of money paid up front to acquire a loan. This amount is deducted from the principal at the time the loan is made and thus represents
interest paid in advance. The discount is normally stated in terms of points or percentages.

**Interest:** A charge made for the use of money over a period of time.

**Net Price:** The amount a seller receives after deducting sale expenses.

**Percentage Lease:** A lease in which the rent structure is based on a percentage of the income brought in by the lessee’s business. It usually stipulates that the rent will be a minimum rental amount plus a percentage of the tenant’s sales and is regularly used for tenants who are retailers.

**Profit:** The amount received after something is sold minus the original price and sale expenses, i.e., net price minus original price.

**Prorate:** To allocate between seller and buyer their proportionate share of an obligation paid or due—for example, to prorate real property taxes or insurance.

**Rate:** The cost per unit of something such as taxes, insurance or interest.

**Rate of Return:** The percentage relationship between the earnings on and the cost of an investment.

**Sale Price:** The actual amount received for the transfer of ownership as opposed to the list price or asking price.

**Volume:** This is the size of a three dimensional figure such as a cube. Measurements are typically represented in terms of cubic units—i.e., cubic feet or cubic yards.

**LEARNING OBJECTIVES**

Upon completion of this module, the student will be able to:

- Name key terms used in real estate math problems.
- Apply fractions, decimals and percentages.
- Translate fractions into decimal and percentage forms.
- Determine the area and volume of a given object or parcel.
- Manipulate the principles involved in rate calculations.
- Grasp the concept of amortization.
- Comprehend the principles of prorating and how to apply them.
- Understand and solve for appreciation and depreciation.
- Identify and apply calculation formulas to determine value and profit.
- Apply interest rates and loan discount rates.
- Use equations to calculate interest.
[Immediate text content starts here]

LESSON ONE
THE LANGUAGE OF MATH

This lesson focuses on the following topics:

- Fractions
- Decimals
- Percentages

INTRODUCTION

Fractions, decimals and percentages are all different ways of expressing a portion of a whole. For example, one half of a whole can be represented mathematically as ½, .50 and 50%.

FRACTIONS

Fractions have two parts called the denominator and the numerator. The denominator shows the number of equal parts in the total or whole. The numerator shows the number of parts of the total or whole that is being considered. In the example below, the total or whole has been divided into 10 equal parts, and you have eight of these equal parts:

\[ \frac{8}{10} \] (Read: “eight-tenths”)

8 is the Numerator

10 is the Denominator

PROPER FRACTIONS

This could be a way of expressing eight pennies as being eight-tenths of a dime. 8/10 is an example of a proper fraction. A proper fraction is a portion less than the whole or total. The whole or total can be expressed as 1. In the previous example, the dime is the total or whole, as in 1 dime equals 10 cents.

IMPROPER FRACTIONS

12/10 is an example of an improper fraction or a number larger than 1. It is improper because 12 is greater than 10. 12/10 can also be expressed as a mixed number: 1 and 2/10. A mixed number is a whole number plus a fraction. In the previous example, this would be the same as saying 1 dime and 2 pennies.
Some fractions can be reduced to make it easier to solve the problem. To reduce a fraction, determine the largest number by which both the numerator and the denominator can be evenly divided, then divide each by that number.

\[
\frac{50}{100} \text{ is equal to } \frac{1}{2} \quad \text{because both 50 and 100 are divisible by 50}
\]

### DECIMALS

Decimals are a way of expressing fractions in a form that is compatible with the use of calculators and computers. This form is derived by the use of a decimal point. The numbers to the right of the decimal point indicate what portion of the whole is being considered. The numbered spaces consecutively to the right of the decimal point represent tenths, hundredths, thousandths and so on.

### FRACTIONS TO DECIMALS

Fractions can be converted to equivalent decimals by dividing the numerator by the denominator. Thus, if using a calculator, fractions are represented in decimal form as follows:

\[
\frac{8}{10} = 8 \div 10 = .8 \\
\frac{12}{10} = 12 \div 10 = 1.2
\]

### ADDITION AND SUBTRACTION OF DECIMALS

To add or subtract decimals simply line them up by the decimal point.

\[
\begin{array}{c}
0.8 \\
+1.2 \\
\hline
2.0
\end{array}
\quad
\begin{array}{c}
1.2 \\
-0.8 \\
\hline
0.4
\end{array}
\]

### MULTIPLICATION OF DECIMALS

To multiply decimals, simply multiply the numbers as if they did not contain decimal points, then count the number of decimal places in each number and move the decimal point that total number of decimal places to the left in the answer.

\[
0.4 \\
\times 0.65
\]

1. \(4 \times 65 = 260\)
2. Now move the decimal three places to the left (because the .4, .6, and .5 mean there are three decimal places) and the answer is .260 or .26.
DIVISION OF DECIMALS

To divide decimals, consider the following diagram and terms:

\[
\text{Dividend} \div \text{Divisor} = \text{Quotient}
\]

The dividend is the number that is being divided. The divisor is the number the dividend is being divided by. The quotient is the answer. If the divisor does not contain a decimal but the dividend does, then the decimal can be carried straight up into the quotient as shown in the following example, where .64 is divided by 8:

\[
\begin{array}{c}
.08 \\
\hline
8 \quad .64 \\
\end{array}
\]

In the next example when we divide .64 by .008, there is now a decimal in the divisor as well as the dividend. In this case, we eliminate the decimals in both the divisor and dividend by shifting the decimals three places to the right.

\[
\begin{array}{c}
\text{quotient} \\
.008 \\
\hline
.640 \\
\end{array}
\]

Thus, when we move the decimal point up into the quotient, we find we are effectively dividing 640 by 8, which yields a result of 80 as shown below.

\[
\begin{array}{c}
80.0 \\
.008 \\
\hline
.640 \\
\end{array}
\]

PERCENTAGES

A percentage represents a portion of a whole. A whole is expressed as 100%. Percent means *per hundred*. Most real estate calculations are based on the calculation of percentages. For example, 40% means 40 parts out of the 100 parts. Percentages greater than 100% contain more than one whole unit. Thus, 175% is one whole plus 75 parts of another whole.
CONVERSION OF A PERCENTAGE TO A DECIMAL

To solve problems involving percentages, first convert them to either a decimal or a fraction. To convert a percentage to a decimal, you divide the percentage by 100, which is the same as moving the decimal point two places to the left and removing the percent sign.

- 50% = 0.5
- 2% = 0.02
- 175% = 1.75

CONVERSION OF A PERCENTAGE TO A FRACTION

To change a percentage to a fraction, place the percentage over 100. Then, if possible, reduce the fraction.

- 50% = 50/100 = 1/2
- 2% = 2/100 = 1/50
- 175% = 175/100 = 7/4

T-METHOD

Percentage problems follow the T-Method and solve for part, total, or rate. (Just remember that the Part and the Total are never in the same part of the T.)

<table>
<thead>
<tr>
<th>Part</th>
<th>T-top</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td></td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Total × Rate</th>
<th>T-bottom</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To determine a specific percentage of a whole, multiply the percentage by the total. This is shown in the following formula:

\[ \text{Total X Rate} = \text{Part} \]

\[ 100 \times 20\% = 20 \]

For example: If a broker is to receive a 5% commission on the sale of a $100,000 house ($100,000 is the total sale price), what will the broker’s commission be?

\[ \text{Total Sale price} \times \text{Commission rate} = \text{Broker’s commission} \]

\[ $100,000 \times 0.05 = $5,000 \]
Rule One

If we are given two numbers at the bottom of the T (the total and the rate; or as in the previous example, sale price and commission rate), then the mathematical operation used to solve for the result (the part; or the broker’s commission) is multiplication.

\[ \$100,000 \times 0.05 = \$5,000 \]

This is the formula used in calculating mortgage loan interest, broker’s commissions, loan origination fees, discount points, earnest money deposits and income on capital investments.

Rule Two

When given the part (at the top of the T) and the rate (at the bottom), the mathematical function to find the whole is solved with division: divide the part by the rate. Visualize this rule by remembering that because the part is on top of the T, it is always on top of the division sign. So, given the rate and the part, put the part on top and divide by the rate.

Example:
If a seller nets $100,000 on the sale of his or her house after paying a 5% commission to the broker, what was the sale price of the property?

Here, it is possible to get confused. Is $100,000 a total or a part? Since the seller receives (nets) only a percentage of the sale price, rather than all of it, it is a part. So, we put $100,000 on the top of the T. We know that it is equal to 95% of the selling price (100% minus 5% commission paid, or 95%), so 95% goes in the lower right hand area of the T.

\[ \$100,000 / 95\% = \$105,263.16 \]

Rule Three

When given the part (at the top of the T) and the total (at the bottom), the mathematical function to find the rate is, as above, division.

Let’s continue the previous example, but let’s assume that we know that the broker received $5,000 in commission and that the selling price was $100,000. What was the commission rate of the broker?

Because $5,000 is the part, it belongs at the top of the T. $100,000 is the sale price (or total) and goes in the bottom left. Thus, \( \frac{5,000}{100,000} = .05 \) or 5%. 

1140 of 1190
Collectively, the three rules of the T-method allow us to find any one of the three variables (part, total, and rate) when the other two are known.

**Example:** The realty company received a $2,000 commission for the sale of a house. The broker’s commission was 2% of the total sale price. What was the total sale price of the house?

$2,000 is the commission portion of the entire sale price of the house. It is a part, so it belongs on top. 2% is the commission or rate, so it goes to the bottom right.

\[
\frac{2,000}{0.02} = \$100,000
\]

**SALE PRICE VS. NET PRICE**

A variation of this technique is used to compute the sale price of a property if the owner wants to net a certain amount, say $100,000 after expenses. The first step is to estimate the sale expenses and express them as a percentage of the sale price. For example, if the sale commission is 5.5% and the seller’s other costs amount to .5%, the total expense is (5.5 + .5) or 6%.

Further, if the sale price is 100% with expenses estimated at 6%, this means that the seller’s net of $100,000 is 94% (100 – 6) of the sale price, or

\[
\$100,000 = 0.94 \times \text{Sale price}
\]

To solve for the sale price, divide both sides by 0.94:

\[
\frac{\$100,000}{0.94} = \frac{(.94 \times \text{Sale price})}{0.94}
\]

Notice that .94 / .94 = 1. Therefore, these can be canceled, which gives us the following:

\[
\$100,000 / 0.94 = \text{Sale price} = \$106,382.98
\]

To check your work, take 6% of this amount using the T-method with the two bottom elements, total and rate:

\[
\$106382.98 \times 0.06 = \$6382.98
\]

When subtracted from the sale price of $106,382.98, this leaves the seller’s desired net price of $100,000.
SUMMARY

Knowledge of the language of math is essential for success in real estate. Fractions, decimals and percentages are different means of expressing parts of a total or whole. The T-method can help us solve problems involving wholes, parts and rates. The T is a math device that places the part in the top and the rate and the whole in the bottom. The T-rules are: multiply two bottoms to find the top and divide the top by any bottom to find the other bottom. By understanding and mastering this method, a licensee can translate information pertaining to real estate into a functional format.

Return to your online course player to take the Lesson Quiz.
LESSON TWO
MEASUREMENT OF DIMENSIONS IN REAL ESTATE

This lesson focuses on the following topics:

- Linear Measurement
- Area
- Volume

INTRODUCTION

This lesson covers dimensional mathematics including linear measurements, area and volume. Linear measurements are used to express the length, width and height of objects in terms of inches, feet, yards and miles. This lesson shows how to convert from one unit of measurement to another. Area is the two-dimensional surface space of an object. It is expressed in square units such as square inches, square feet and square yards. Volume is the three-dimensional measurement of an enclosed space. Volume is expressed in cubic units: i.e., cubic inches, cubic feet and cubic yards. An understanding of linear measures and the ability to manipulate area and volume are among the tools essential to real estate professionals.

LINEAR MEASUREMENT

Linear measurement is used to determine the length of an object. The object may be in the form of a straight, curved or crooked line. The measurements are expressed as inches, feet, yards, meters or miles. In real estate, the terms per foot, per linear foot, per running foot and per front foot refer to the total length of an object. Per foot means for each foot, so a lot might be priced $10 per foot. Per front foot refers to the frontage of a lot. It could refer to street frontage or water frontage and is important to the value of the lot, depending on the amount of usable frontage. When two dimensions are given for a lot, the first dimension represents frontage, unless otherwise specified.

At times it may be necessary to convert linear measurements of one form to another. The following are standard conversions used in real estate.

\[
\begin{align*}
12 \text{ inches} &= 1 \text{ foot} \\
\text{Inches divided by 12} &= \text{feet} \\
\text{Feet multiplied by 12} &= \text{inches} \\
36 \text{ inches} &= 1 \text{ yard} \\
\text{Inches divided by 36} &= \text{yards}
\end{align*}
\]
Yards multiplied by 36 = inches

3 feet = 1 yard
Feet divided by 3 = yards
Yards multiplied by 3 = feet

5,280 feet = 1 mile
Feet divided by 5,280 = miles
Miles multiplied by 5,280 = feet

Example:
Determine the cost of a fence to enclose a lot at $5 per linear running foot of fence.

Because fences are priced per linear (running) foot, it is necessary to first determine the total amount of linear running feet of the lot. Next, you should multiply this amount by the cost of fencing each linear (running) foot. For example, if the lot were 75 feet by 125 feet the problem would be solved as follows:

\[
75' + 75' + 125' + 125' = 400 \text{ linear/running feet}
\]

\[
400 \text{ linear/running feet} \times $5.00 \text{ (cost of fence per linear/running foot)} = $2,000
\]

In general, the formula for determining the perimeter (the length around) of a rectangle is:

\[
2 \times (\text{Length} + \text{Width})
\]

We could have solved by using this formula: where length = 75’ and width = 125’. This achieves the same result:

\[
\text{Perimeter} = 2 \times (75' + 125') = 2 \times (200') = 400'
\]
(You should use the method with which you are the most comfortable.)

**Example:**
A tract of land is for sale for $3,000 per front foot. How much will it cost to purchase the property if the tract is 200 by 175 feet?

200 feet is the frontage because it is the first measure given.

200 front feet x $3,000 = $600,000 (Cost to purchase)

**AREA**

*Area* refers to the two-dimensional surface space of an object. It is measured in square units such as square inches, square feet, square yards or acres. Areas may be any shape, but typically in real estate, area involves rectangles, squares and triangles.

**CONVERSION OF AREA**

At times it may be necessary to convert area measurements from one form to another. The following are standard area conversions used in real estate:

- 144 square inches = 1 square foot
  - Square inches divided by 144 = square feet
  - Square feet multiplied by 144 = square inches
- 1,296 square inches = 1 square yard
  - Square inches divided by 1,296 = square yards
  - Square yards x 1,296 = square inches
- 9 square feet = 1 square yard
  - Square feet divided by 9 = square yards
  - Square yards multiplied by 9 = square feet
- 43,560 square feet = 1 acre
  - Square feet divided by 43,560 = acres
  - Acres multiplied by 43,560 = square feet

**AREA OF SQUARES AND RECTANGLES**

The area of a square or a rectangle is the length multiplied by the width.

\[ \text{Length} \times \text{Width} = \text{Area of a square or rectangle} \]
**Example:** If the length of a lot is 100 feet and the width is 100 feet, what is the area of the lot?

\[100 \times 100 = 10,000 \text{ square feet}\]

**Example:** How many acres are there in a tract of land that measures 225 feet x 400 feet?

\[225' \times 400' = 90,000 \text{ square feet divided by } 43,560 = 2.066 \text{ acres}\]

**Example:** If hardwood floors cost $15.00 per square foot to install, how much would it cost to install hardwood floors in a room that is 18 feet by 23 feet?

\[18 \times 23 = 414 \text{ square feet multiplied by } $15.00 = $6,210\]

At times, the area to be measured is not a perfect square or rectangle. For example, the area may be in an *L* shape. In this instance, measure the two sections of the shape, calculate them individually and add them together. Don’t include the area of overlap of the two sections.

**Example:** What is the area of the following *L*-shaped floor plan?

First measure the vertical section of 23 feet. This is the length of the first rectangle. To find its width, take the horizontal section of 18 feet minus 10 feet. So the width is 8 feet. Multiply length times width to find the area 23’ x 8’ = 184 square feet.

Second, find the area of the second rectangle. Its length is 7 feet and its width is 10 feet, so multiply the length and width: 10’ x 7’ = 70 square feet.
Finally, add the two results: $184 + 70 = 254$ square feet, the total area of the floor plan.

**AREA OF A TRIANGLE**

Triangles are encountered in real estate because of tapering property lines and roofs. By multiplying the base by the height and dividing the answer by two, one can find the area of a triangle. The base is the bottom of the triangle. The height is the imaginary straight line extending from the base to the point (corner) opposite. This line creates a 90-degree angle with the base (in other words, height is perpendicular to the base).

\[
\frac{\text{Base} \times \text{Height}}{2} = \text{Area of a triangle}
\]

**Example:** How many square feet are contained in a triangular lot that is 350 feet at the base and is 200 feet high?

\[
350 \text{ feet} \times 200 \text{ feet} = 70,000 \text{ square feet divided by 2} = 35,000 \text{ square feet}
\]

**AREA OF A CIRCLE**

To calculate the area of a circle we use the formula:

\[
3.142 \times \text{Radius squared}
\]

The linear distance around a circle, the circumference, is given by the formula $2 \pi \times \text{radius}$.

3.142 is an approximation of the number π (read: pi), which is the ratio of a circle’s circumference (the length around the circle) to its diameter (the length of
any line segment that passes through the circle’s origin, or center, and whose endpoints lie on the circle). The radius of the circle is one half of the diameter, i.e., a line segment starting at the origin of the circle and ending at any point along the circle.

Example: Calculate the area of a circle with a radius of 10 feet.

\[
\text{Area} = \pi r^2 = 3.142 \times 10^2 = 3.142 \times 100 = 314.2 \text{ square feet}
\]

**VOLUME**

Volume is the cubic capacity of an enclosed space. Volume is used to describe the amount of space in any three-dimensional area and is expressed in cubic units.

The formula for computing cubic or rectangular volume is:

\[
\text{Volume} = \text{Length} \times \text{Width} \times \text{Height}
\]

Example:
The living room of a condo is 15 feet long, 6 feet wide and has a ceiling height of 10 feet. What is the volume of the living room?
Volume = 15' x 6' x 10'
Volume = 900 cubic feet

There is another way to calculate volume if the solid is a triangular prism (think roofs).

Volume = \( \frac{1}{2} \times \text{Base} \times \text{Height} \times \text{Width} \)

**Example:**
Calculate the volume of the house shown below.

Here we first divide the house into two solids, a rectangular prism (the “box” part of the house) and a triangular one (the roof part). The triangular prism at the top of the house has a height of 10 feet, a base of 30 feet and a width of 50 feet. Thus, we know:

Volume = \( \frac{1}{2} \times (10' \times 30' \times 50') \)
Volume = 7,500 cubic feet
The next step is to calculate the volume of the rectangular prism. It shares two dimensions with the top: the triangle’s base is the width of the rectangle and the triangular prism’s width is the length of the rectangle. The rectangle is 14 feet high, so:

\[
\text{Volume} = 30' \times 50' \times 14'
\]
\[
\text{Volume} = 21,000 \text{ cubic feet}
\]

The total volume of the two solids is their sum:

\[
7,500 + 21,000 = 28,500 \text{ cubic feet of airspace}
\]

Finally, the formula for computing the volume of a cylinder is expressed below.

\[
\text{Volume} = \pi \times \text{Radius squared} \times \text{Depth}
\]

**Example:**
What is the approximate volume of a straight tube that is 30 feet long and 10 feet wide? Remember to use 3.142 to represent \(\pi\).

First determine the radius of the tube, which is 1/2 the diameter. The diameter is 10 feet, so the radius is 5 feet. We know the tube is 30 feet long, so using the formula:

\[
\text{Volume} = 3.142 \times 5 \text{ feet squared} \times 30 \text{ feet}
\]
\[
\text{Volume} = 3.142 \times 25 \times 30 = 2356.5 \text{ cubic feet}
\]

Cubic measurements of volume are used to compute the construction costs per cubic foot of a building or the heating and cooling requirements for a building.

Keep in mind that when calculating the area or the volume, all dimensions used must be given in the same unit of measure. For example, the student should not multiply feet by inches, but instead feet by feet and inches by inches.
SUMMARY

This lesson covers dimensional mathematics including linear measurements, area and volume. Linear measurements are used to express the length, width and height of objects in terms of inches, feet, yards and miles. This lesson shows how to convert from one unit of measurement to another. Area is the two-dimensional surface space of an object. It is expressed in square units such as square inches, square feet and square yards. Volume is the three-dimensional measurement of an enclosed space. Volume is expressed in cubic units: i.e., cubic inches, cubic feet and cubic yards. An understanding of linear measures and the ability to manipulate area and volume are among the tools essential to real estate professionals.

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LESSON THREE
FINANCIAL MATH

This lesson focuses on the following topics:

- Interest and Percentage Calculations
- Amortization
- Rate
- Prorating

INTRODUCTION

This lesson covers several aspects of financial math. These include the topics of interest, amortization, rate and proration. Interest is the cost incurred for the use of money over a period of time. Amortization is the repayment of a financial debt over a period of time in a series of payments. Rate is a cost per unit that is charged to an assessed value. Prorations involve the debits and credits charged to buyers and sellers based on their proportionate ownership of the property at the time of closing on real estate transactions.

INTEREST AND PERCENTAGE CALCULATIONS

Interest is the cost incurred for borrowing money. The amount of interest paid is determined by the annual interest rate, the amount of money borrowed (the principal) and the amount of time the money is loaned. The formulas for percentage calculations also are used for interest computations.

Principal x Annual interest rate (a percentage) x Time (in years) = Interest payment

For example, presuming that the principal doesn’t change, what is the annual interest on a $10,000 loan, which has an interest rate of 10%?

$10,000 x 0.10 x 1 year = $1,000 interest

Annual interest is the interest for an entire year. If we want the interest for just one month we have to divide the annual interest by 12 (number of months in a year).

$1,000 / 12 = $83.33 monthly

All the above calculations are based on simple interest. Now compare that with compound interest. The difference between the two is that compound interest has each period’s interest added to the principal before the next interest payment
is figured, so compound interest will be a higher amount (which is great if the
money is in a retirement fund, but not so great if it’s a mortgage payment).

**Example:**
If $100,000 is placed in an account bearing 10% *simple interest*, what
would the account balance be after three years?

\[
\begin{align*}
\text{\$100,000 X .10} & = \text{\$10,000 yearly interest} \\
\text{\$10,000 X 3 years} & = \text{\$30,000 total simple interest} \\
\text{\$30,000 (total simple interest) + \$100,000 (principal) = \$130,000 account balance}
\end{align*}
\]

If this amount were calculated with *compound interest* (yearly
compounding), instead of simple interest, we would have to make sure to
compound the interest of each year’s principal:

\[
\text{\$100,000 \times 0.10 = 10,000 \text{ first year’s interest}}
\]

\[
\begin{align*}
\text{\$100,000 (1st year’s principal) + \$10,000 (interest) = \$110,000 (new} \\
\text{principal)} \\
\text{110,000 \times 0.10 = \$11,000 second year’s compound interest}
\end{align*}
\]

\[
\begin{align*}
\text{\$110,000 (2nd year’s principal) + \$11,000 (interest) = \$121,000 (new} \\
\text{principal)} \\
\text{121,000 \times 0.10 = \$12,100 third year’s compound interest}
\end{align*}
\]

\[
\begin{align*}
\text{\$121,000 (3rd year’s principal) + \$12,100 (compound interest) = \$133,100} \\
\text{account balance}
\end{align*}
\]

As you can see, compound interest yields $3,100 more than simple
interest.

**AMORTIZATION**

The repayment of a financial obligation over a specific period of time in a series
of periodic installments is known as *amortization*. Specifically, it is the payback of
the principal owed to the lender. Each payment should cover the interest accrued
over the time period for which payment is made and a portion of the principal.
The interest portion is tax deductible, whereas the amortization portion is not.

The payment is first applied to the accrued interest with the remaining balance
applied to the principal.

**Example:** What would the balance be on a 30-year loan for $150,000 with
a 10% annual interest rate after the first two monthly payments of $1,500
each?
To solve this problem, begin by calculating balances from the first to the second payment. Remember that the rate of interest for a month will be one-twelfth the annual rate. So, solve for this in the following way:

Monthly interest rate = \( \frac{.10}{12} = \frac{1}{120} = 0.008333 = 10/12 \% \)

Thus, the interest due the first month is the monthly interest rate times the loan principal for that month:

\[
$150,000 \text{ loan principal} \times 10/12 \% \text{ monthly interest rate} = $1,250
\]

The payment on the principal for the first month is the monthly payment less the first month’s interest:

\[
$1500 \text{ monthly payment} – $1250 \text{ interest} = $250 \text{ payment on loan principal}
\]

So, the loan balance after the first monthly payment is shown below.

\[
$150,000 – $250 = $149,750
\]

Our second month figures are as follows:

Monthly interest is $149,750 loan principal x 10/12 % monthly interest rate = $1,247.92 interest

Payment on loan principal is $1500 monthly payment – $1,247.92 = $252.08 principal payment

New balance = $149,750 (previous balance) – $252.08 (monthly payment on principal) = $149,497.92

**RATE**

A rate is a cost per unit. Insurance premiums, interest and property taxes are usually expressed as rates. The formula for computing premiums, interest, etc. from rates is:

\[
\text{Rate of interest (premium, tax, etc.)} = \frac{\text{Interest (premium, tax, etc.)}}{\text{Total value}}
\]

This is another application of the T-method:
Example: Suppose we want to calculate the yearly tax on a house that has been appraised at $100,000 and is taxed at an annual rate of $2.00 per $100 of appraised value. We can express this rate as a percentage with the following formula:

\[
\frac{\$2 \text{ (tax)}}{\$100 \text{ (total)}} = \text{tax rate} = .02 = 2%
\]

We now have the two bottom parts of the T-diagram: the total value of the house ($100,000) and the tax rate (2%). We know that we can multiply the two bottom parts and come up with the portion that will go to taxes:

\[
\$100,000 \times 2\% = \$2,000 \text{ yearly tax}
\]

**PRORATION**

To *prorate* means to divide proportionately. Prorating typically takes place at real estate closing and involves the equitable division of money-owed obligations between the buyer and seller. These obligations vary depending on the details of the property transfer. Typically the items that may be prorated are real estate property taxes, interest on a loan, homeowner’s insurance and rent on income-producing property. Accurate proration calculations are necessary to ensure that expenses are divided fairly between the seller and the buyer.

**BANKER’S YEAR vs. CALENDAR YEAR**

The number of days owed is of primary importance in the proration process. There are two ways people in the real estate business measure the days in a year. The first is called a *banker’s year* or *statutory year*. A banker’s (statutory) year assumes that there are 360 days in a year (30 days in each month).

The second is the *calendar year*, which contains 12 months with 28 to 31 days in the months. The total number of days in a calendar year is 365 days or 366 if it falls on a leap year. Be sure to use the appropriate measure when making calculations. For example, a 30-day month and 360-day statutory year is required on sales involving Fannie Mae and Freddie Mac.
TO vs. THROUGH

Aside from the number of days, the difference between prorating through the day of closing or to the day of closing must be considered. When prorating through the day of closing the seller is responsible for the day of closing. When prorating to the day of closing, the buyer is responsible for the day of closing. The “seller is through, the buyer is to.” Go ahead, say it out loud: The seller is through; the buyer is to.

The steps in the proration process are as follows:

- Firstly, the actual number of days in the prorated period is determined by taking into consideration whether the agreement specifies to or through the closing day.
- If a yearly charge is considered, the amount to be prorated is divided by 360 days for a banker’s (statutory) year or by 365 days for a calendar year to arrive at the daily rate.
- The actual number of days is then multiplied by the daily rate to determine the prorated figure.

CATEGORIES OF PRORATED ITEMS

Two categories of prorated items are accrued items and prepaid items. Explanations for each follow.

Accrued Items

An accrued item is an expense that has accumulated on a purchase and will have to be paid by the buyer. For example, if the buyer assumes a loan with monthly interest from the seller, the buyer will have to pay this interest at the end of the payment period even if he or she has not held the loan for a full payment cycle. With accrued items, the seller pays the buyer the amount owed up to or through the closing. The seller is through; the buyer is to.

Prepaid Items

A prepaid item is an expenditure that, because the seller has already paid it, becomes part of the buyer’s purchase. For example, if the buyer is purchasing a home in year 10 of a 40-year prepaid flood insurance policy, because 30-years still remain effective on the policy, the unused portion is prorated and the buyer pays the seller for it.
PREPAID ITEMS EXAMPLES

EXAMPLE ONE

Mr. A has a home loan with a current balance of $150,000 (with 10-percent interest that he pays down at $1500 a month). Ms. B is going to buy Mr. A's house and assume the rest of the loan. The closing date for the transaction is to be August 15, and it is decided that proration will occur through the day of closing. Interest on home mortgage loans is paid for the month before the pay month—that is, an August 1st payment covers the interest for the month of July. Thus, at the time Ms. B assumes the loan, it will have accrued about a half a month's worth of interest, due after the closing date, which Mr. A will pay her for in advance on the closing date. What is the amount of interest Mr. A will have to pay, assuming a statutory year?

The monthly interest rate is once again
\[ \frac{0.10}{12} = 10/12 \% \]

So the interest for the entire month of August will be:
\[ $150,000 \times \frac{10}{12} \% = $1,250 \]

Since the closing is through the fifteenth, the seller should owe for the first through the fifteenth, or fifteen days. As this is half the statutory month, half the interest should be owed:
\[ 0.5 \times $1,250 = $625 \text{ accrued interest through the 15th} \]

EXAMPLE TWO

Consider unpaid real estate taxes, which are an accrued item. When taxes are levied for the calendar year and are made payable during that year, or in the following year, the accrued portion is for the period from January 1 to the date of closing. If the tax bill has not yet been issued, the parties will need to agree to an amount based on last year’s taxes and will also agree to settle accordingly if the estimate is above or below the actual bill. The illustration below will show a typical situation.

A sale is to be closed on August 15th and this year’s tax bill has not yet been received. Last year’s tax bill was $3,450. Thus, the buyers and sellers agree to prorate the taxes based on last year’s bill and will settle any differences upon receipt of this year’s bill.

\[ \frac{3,450}{12} = $287.50 \]
\[ $287.50 / 30 = $9.58.333 \text{ per day} \]

August is the 8th month of the year
The sellers owe 7 months and 15 days worth of taxes
Therefore, 7 months x $287.50 = $2012.50
15 days x $9.58333 = $143.75
$2012.50 + $143.75 = $2156.25

The seller in this case will give a $2156.25 credit to the buyer on the settlement statement and the buyer will pay the $2156.25 plus the remaining taxes due (four months and 15 days) at the end of the year. If the final tax bill is higher, then the seller will owe the buyer the prorated share of the difference. Conversely, if the tax bill is lower, the buyer will owe the difference to the seller.

Insurance is a prepaid item and must be prorated if assumed by the buyer. Individual insurance companies determine if the policy is assumable or not. Suppose a 1-year homeowner’s policy expires on September 17. Say the policy was paid in full the previous September 17 and cost $475. The closing is set for May 29, almost four months prior to the expiration of the policy. Thus, the calculation of the prorated amount will be as follows,

Step 1: Figure the number of days of insurance coverage the buyer will assume.

This example will use calendar days to compute the amount the buyer will owe the seller for the remaining days left on the policy.

May 29 – May 31 = 2 Days
June has 30 Days
July has 31 Days
August has 31 Days
+ 17 Days in September
2+30+31+31+17 = 111 (days remaining)

Step 2: Figure the daily rate for the policy and multiply by the number of days remaining.

475 / 365 = $1.3013 (daily rate)
$1.3013 X 111 = $144.45

In order to assume it, the buyer will credit the seller $144.45 for the remaining 111 days left on the policy.

**SUMMARY**

This lesson covered aspects of financial math as they relate to certain real estate issues. These include the topics of interest, amortization, rate and proration. Interest is the cost incurred for the use of money over a certain period of time. It can be calculated in the form of simple interest or compound interest. (Compound interest will always produce a higher number.) Amortization is the repayment of a financial debt over a period of time in a series of payments. Each payment is divided into principal and interest payments, with the principal payment increasing proportionately over time as the interest is paid off, until the
Prorations involve the debits and credits charged to buyers and sellers based on their proportionate ownership of the property at the time of closing on real estate transactions. Prorations are divided into either accrued items or prepaid items. Accrued items are charges owed by the seller that are not yet due, such as property taxes. Prepaid items involve charges that have been paid in advance by the seller, such as insurance policies. There are two types of calendars that are used to determine debits and credits at closing: The banker’s or statutory year is based on twelve months with thirty days in each, for a total of 360 days, as opposed to the standard calendar with varying days in each month, totaling 365 days, or 366 in a leap year. The final consideration is whether the contract specifies prorating to or through the day of closing. Remember, the seller is through; the buyer is to.

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LESSON FOUR
VALUATION MATH

This lesson focuses on the following topics:

- Loan Discount
- Appreciation and Depreciation
- Value for Income-producing Properties
- Percentage Leases
- Profit and Loss

INTRODUCTION

This lesson focuses on the mathematics involved in valuing assets. Covered are loan discounts, which are fees lender's charge to lower the lending rate; appreciation and depreciation, which are increases and decreases in value over time, respectively; the values of income-producing properties, which deal with the rate at which an income-producing properties convert (capitalize) value into income and include percentage leases; and profit, which is sale price minus cost.

LOAN DISCOUNT

The loan discount is a one-time fee that a lender charges (at closing) to a borrower for granting the loan. The vast majority of the time loan discount points are also related to lowering the interest rate on the loan and thus lowering the monthly or annual interest payments. Loan discounts are purchased in points, and one point is equal to one percent of the loan amount (1 point = 1% of the loan amount). For example, if a lender charges a borrower a two-point loan discount, the borrower is paying a fee equal to 2% of the loan amount. Generally, the amount that the interest rate will be lowered to will depend on the length of the loan and the number of points purchased.

For the purposes of this lesson, we will arbitrarily select interest rates to show how loan discounts can benefit either the lender or the loan recipient, depending on the amount of the loan, the length of the loan, the number of points purchased and a host of other factors. The following example is very simplistic in that it only takes into account a few factors that could possibly affect the results of a loan discount. The sole purpose of this example is to give the student a basic understanding of how loan discounts work.

Example:
Suppose that a lender agrees to a loan of $100,000 at 10% simple interest with annual payments for a period of 10 years ($100,000 at 10% to be paid over 10 years). If the lender decides to charge a 2% loan discount (2 points), what is the reduced interest rate he can charge and still net the
same amount? Assume that the loan recipient is going to pay 10% of the original loan principal a year with interest.

Without the loan discount, the lender would make $55,000 from interest payments based on the following:

\[ \$100,000 \times (10\% \text{ interest rate}) + \$90,000 \times (10\%) + \$80,000 \times (10\%) + \ldots + \$10,000 \times (10\%) \]

That’s a lot to add, but we can make it simpler. If we factor out the interest rate and the annual payment of $10,000, we come up with the following formula:

\[ \$10,000 \times 10\% \times (10 + 9 + 8 + \ldots + 1) = \$55,000 \]

Now, we consider the same loan after a 2-point loan discount. If the loan discount rate is 2 points (or 2%), the amount of the discount is:

\[ \$100,000 \times 2\% = \$2,000 \]

It is important to remember that after the loan discount, the principal balance still remains $100,000, even if the loan recipient only nets $98,000 after paying the fee. The $2,000 discount will count toward the lender’s net profits.

Because the principal ($100,000) and the annual amount of the principal to be paid will remain the same (10% of $100,000 annually), we can use a slightly modified formula from the one used earlier to calculate the net profit of the lender:

\[ \$2,000 \text{ discount fee} + \left[ \$10,000 \times \text{new reduced rate} \times (10 + 9 + 8 + \ldots + 1) \right] = \text{Total net profits} \]

We want to determine the interest rate that the lender needs to charge in order to net $55,000, so we allow total net profits to equal $55,000.

Then using simple algebra, we solve the formula for the reduced interest rate:

New reduced interest rate = \((\$55,000 - \$2,000) / \left[ \$10,000 \times (10 + 9 + 8 + \ldots + 1) \right] \]

\[ \text{OR} \]

\[ \text{New reduced interest rate} = 53,000/550,000 = .0964 = 9.64\% \]
Thus, with the loan discount, the lender has lowered the interest rate to 9.64% and has still made the same net profit. If he had lowered the interest rate slightly less with the same discount, his profit would have increased. Similarly, a larger decrease in the rate would have provided a greater profit to the loan recipient.

This is merely an introduction to loan discounts. In a real-life situation with mortgage loans there are many more factors to take into account when considering the pros and cons of loan discounts.

**APPRECIATION AND DEPRECIATION**

Appreciation and depreciation are important factors in the long-term valuation of real estate. Appreciation is the increase in value of an object over time, while depreciation is the decrease in value. The amount by which a property appreciates or depreciates is dependent on many factors, including supply and demand, the state of the neighborhood in which a property is located, any modifications made to the property and the amount of upkeep (or lack thereof). Appreciation and depreciation rates, therefore, are never constant, and speculation on how much a property will appreciate or depreciate over a certain time period is difficult to predict.

Those wishing to *invest* in real estate, however, will find that monitoring appreciation and depreciation rates for a particular neighborhood, or for a particular type of property, will provide valuable insight into market trends. For instance, an investor may want to purchase property in a neighborhood that has shown high rates of appreciation in the recent past because if this trend continues, the investor has a higher likelihood of making a profit on that property in the future. Granted, it is important to remember that average rates over previous years are not necessarily indicative of future trends.

Below are some simple methods for calculating average appreciation and depreciation rates. Included are approaches useful for determining appreciated or depreciated values of a property given average interest rates.

**T- METHOD TO SOLVE FOR APPRECIATION**

To solve these types of problems the T-Method presented in the preceding lesson is used.

\[
\text{Current Value} \times \text{Average Annual Appreciation Rate} = \text{Average Annual Appreciation}
\]
Current value x Average annual appreciation rate = Average annual appreciation
Average annual appreciation / Average annual appreciation rate = Current value
Average annual appreciation / Current value = Average annual appreciation rate
Average annual appreciation rate x Number of years = Total appreciation rate

100% + Total appreciation rate = Percentage change in value

\[
\begin{array}{c|c|c}
\text{Starting Value} & \times & \text{Percentage Change in Value} \\
\text{Always > 1} & & \\
\end{array}
\]

Starting value x Percentage change in value = Current value

Current value / Percentage change in value = Original cost

Current value / Starting value = Percentage change in value

**Example:**

Ten years ago a parcel of real estate was purchased at market value for $98,500. What is the total value of the land today, given an average appreciation of 6% per year?

6% appreciation per year x 10 years = 60% total appreciation rate

Original value (100%) + 60% appreciation = 160% percentage change in value

\[
\begin{array}{c|c|c}
\text{Original Value} & \times & \text{Percentage Change in Value} \\
\text{160% or 1.60} & & \\
\end{array}
\]

160% of \$98,500 is \$157,600
Therefore, the total value of the land after 10 years is $157,600. The land has appreciated $59,100.

THE T-METHOD TO SOLVE FOR DEPRECIATION

\[
\text{Current value} \times \text{Average annual depreciation rate} = \text{Average annual depreciation}
\]

\[
\frac{\text{Average annual depreciation}}{\text{Annual depreciation rate}} = \text{Current value}
\]

\[
\frac{\text{Average annual depreciation}}{\text{Current value}} = \text{Average annual depreciation rate}
\]

\[
\text{Average annual depreciation rate} \times \text{Number of years} = \text{Total depreciation rate}
\]

\[
100\% - \text{Total depreciation rate} = \text{Percentage change in value}
\]

Example:
The value of a house at the end of 7 years is $147,000. What was the original value of the house if the average yearly rate of depreciation was 3.7%?

\[
3.7\% \text{ depreciation per year} \times 7 \text{ years} = 25.9\% \text{ total depreciation rate}
\]
100% - 25.9% depreciation = 74.1% percentage change in value

\[
\begin{align*}
\text{Current Value} & = \frac{\text{Original Value}}{\text{Percentage Change}} \\
$147,000 & = \frac{\$198,380}{74.1\%} \\
\end{align*}
\]

$147,000 ÷ 74.1\% = $198,380.57

**DEPRECIATION FROM A TAX PERSPECTIVE**

A different type of depreciation is figured when determining the amount of taxes a property owner must pay on income received from a property. It does not represent the actual market value of a property. This depreciation, as opposed to the depreciation discussed above, is purely an accounting device which is structured so that a property will depreciate at a constant rate over a certain amount of time; rates and timeframes are pre-determined by the IRS.

Depreciation, in this case, only measures the value of an asset that has a limited lifetime. For example, land is not depreciable, because it is not considered to have a limited lifespan, although the property built on that land is depreciable. Only property used in business or held for investment is depreciable in this case.

When it comes time to calculate the taxes owed on an investment, the value of that investment must be determined. However, the value of an investment is not simply the value of the investment at tax time. An investment often has costs such as fees, commissions and even losses. Therefore, the *basis* of the investment must be determined. The *basis* is the dollar amount of the investment at a particular point in time, and it is that basis that is used to determine the taxable value of the investment. The *basis* when an investor acquires a property is usually the price he or she paid for the property. This basis is adjusted for depreciation over the life of the asset.

The IRS publishes the depreciation rates for the various types of investments. Many assets can be depreciated using several methods of the taxpayer’s choice, but investment property, both residential and commercial, must be depreciated using the straight-line method. This means that the rate of depreciation does not increase or decrease over the useful life of the property. Nonresidential property, for example, is considered to have a useful life of 39 years and depreciates at a constant rate of 2.564% annually.
Suppose an investor purchases an office building for $80,000 in April 2004. What is her basis in March 2014 after factoring in straight-line depreciation? To determine the investor’s basis we must use the rates provided by the IRS in the table below:

### Depreciation Rates for Nonresidential Property

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2 – 39</th>
<th>Year 40</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>2.461%</td>
<td>2.564%</td>
<td>0.107%</td>
</tr>
<tr>
<td>February</td>
<td>2.247%</td>
<td>2.564%</td>
<td>0.321%</td>
</tr>
<tr>
<td>March</td>
<td>2.033%</td>
<td>2.564%</td>
<td>0.535%</td>
</tr>
<tr>
<td>April</td>
<td>1.819%</td>
<td>2.564%</td>
<td>0.749%</td>
</tr>
<tr>
<td>May</td>
<td>1.605%</td>
<td>2.564%</td>
<td>0.963%</td>
</tr>
<tr>
<td>June</td>
<td>1.391%</td>
<td>2.564%</td>
<td>1.177%</td>
</tr>
<tr>
<td>July</td>
<td>1.177%</td>
<td>2.564%</td>
<td>1.391%</td>
</tr>
<tr>
<td>August</td>
<td>0.963%</td>
<td>2.564%</td>
<td>1.605%</td>
</tr>
<tr>
<td>September</td>
<td>0.749%</td>
<td>2.564%</td>
<td>1.819%</td>
</tr>
<tr>
<td>October</td>
<td>0.535%</td>
<td>2.564%</td>
<td>2.033%</td>
</tr>
<tr>
<td>November</td>
<td>0.321%</td>
<td>2.564%</td>
<td>2.247%</td>
</tr>
<tr>
<td>December</td>
<td>0.107%</td>
<td>2.564%</td>
<td>2.461%</td>
</tr>
</tbody>
</table>

Prorated depreciation for the first year is $1,455.20 (1.819% x $80,000) because the property was acquired in April. Depreciation for 2005 through 2013 is based on the original value, not on the depreciated value of the previous year, so the rates may be multiplied: 2.564% annual rate x 9 years = 23.076%. Thus, depreciation over that time period is equal to $18,460.80 (23.076% x $80,000). Importantly, because the investor no longer possesses it when taxes are due, the property cannot be depreciated in the year of sale.

$1,455.20 (Year 1 depreciation) + $18,460.80 (Years 2 – 9) = $19,916.00 (Total depreciation)

However, if the investor sells the property in March, her total investment at that point will be as follows:

$80,000 (Original Investment) – $19,916 (Total depreciation) = $60,084

Therefore, if she sells the building for $90,000, she has realized $90,000 – $60,084, or $29,916 in taxable capital gains.

### VALUE FOR INCOME-PRODUCING PROPERTIES

The value of an income-producing property is determined by calculating the annual net operating income (NOI) and the current market rate of return, otherwise known as the capitalization rate. To capitalize something is to turn it
form an expense into an asset. This is normally accomplished by paying down the balance owed (such as on a mortgage balance) until the item is paid off and is then worth X dollar amount, making it an asset.

**NET OPERATING INCOME**

Annual scheduled gross income (the income expected from the property) is adjusted for credit losses and vacancies to arrive at annual effective gross income (the actual income brought in), which is adjusted for the annual expenses of operation, to arrive at the annual net operating income (NOI).

\[
\text{Annual Scheduled Gross Income} - \text{Vacancies and Credit Loses} = \text{Annual Effective Gross Income}
\]

\[
\text{Annual Effective Gross Income} - \text{Annual Operating Expenses} = \text{Annual NOI}
\]

**FORMULA FOR DETERMINING VALUE**

\[
\frac{\text{Annual NOI}}{\text{Annual rate of return}} = \text{Value}
\]

\[
\text{Value} \times \text{Annual rate of return} = \text{Annual NOI}
\]

\[
\frac{\text{Annual NOI}}{\text{Value}} = \text{Annual rate of return}
\]
Example:
An office building produces $154,200 annual gross income. If the annual expenses are $36,600, and the appraiser estimates the value of the building using a 7.5% rate of return, what is the estimated value?

\[
\text{$154,200 \text{ annual gross income} - $36,600 \text{ annual expenses} = $117,600 \text{ annual NOI}}
\]

\[
\begin{align*}
\text{\$117,600 Annual NOI} & \quad = \text{\$1,568,000} \\
& \quad \times 7.5\% \text{ or .075}
\end{align*}
\]

\[
\frac{\$117,600}{7.5\%} = \$1.568 \text{ million}
\]

Return on Investment

The above formulas also can be used to calculate the return on an investment. In this instance, the total becomes investment or original cost instead of value.

Example:
If you invest $473,000 in a property that should produce an 8% rate of return, what monthly NOI will you receive?

\[
\begin{align*}
\text{\$37,840 Annual NOI} & \quad = \text{\$473,000} \\
& \quad \times 8\% \text{ or 0.08}
\end{align*}
\]

A $473,000 investment at an 8% annual rate of return yields $37,840 annually. Monthly NOI is therefore $3,153.33 ($37,840 / 12).

PERCENTAGE LEASES

When arriving at a rent rate to be charged in a lease for retail space, the lease can be a percentage lease instead of a flat, monthly dollars-per-square-foot
lease. Percentage leases typically charge a minimum monthly (base rent), plus some percentage of the income generated from the tenant’s business at the property.

**FORMULA TO SOLVE FOR PERCENTAGE LEASES**

If a lease stipulates a percentage of gross sales in excess of some minimum amount to be paid, the gross sales that are subject to the percentage is given by the formula:

\[
\text{Gross sales} - \text{Minimum amount} = \text{Gross sales subject to the percentage}
\]

In the following diagram, the term *annual percentage rent* refers to the additional rent paid as a percentage of the gross sales subject to the percentage:

\[
\text{Annual percentage rent} = \text{Gross sales subject to the percentage} \times \text{Percentage stipulated in the lease}
\]

\[
\text{Annual percentage rent} / \text{Percentage stipulated in the lease} = \text{Gross sales subject to the percentage}
\]

\[
\text{Annual percentage rent} / \text{Gross sales subject to the percentage} = \text{Percentage stipulated in the lease}
\]

\[
\text{Annual percentage rent} + \text{Base or minimum rent} = \text{Total rent}
\]

**Example:**
A lease calls for monthly minimum rent of $1,200 plus 4% of the annual gross sales in excess of $320,000. What was the annual rent in a year when the annual gross sales were $473,450?

\[
\$1,200 \times 12 = \$14,400 \text{ Annual minimum rent}
\]

\[
\$473,450 - $320,000 = \$153,450 \text{ Annual gross sales subject to 4%}
\]
$14,400 Annual minimum rent + $6,138 Annual percentage rent = $20,538
Total annual rent

**PROFIT AND LOSS**

A profit results when something is sold for more money than was originally paid for it. A loss results when we sell something for less money than was paid for (and sometimes the expense of keeping) it. The formula for profit is sale price minus cost \( (P = S - C) \). Alternatively, if the “\( P \)” in the equation \( P = S - C \) is a negative number, that’s a loss.

If we wish to determine the percentage profit from the sale of a piece of real estate, we may calculate it in the following manner:

\[
\text{Profit} = \text{Cost} \times \text{Percentage profit}
\]

\[
\frac{\text{Profit}}{\text{Percentage profit}} = \text{Cost}
\]

\[
\frac{\text{Profit}}{\text{Cost}} = \text{Percentage profit}
\]

\[
\text{Profit} + \text{Cost} = \text{Sale price}
\]

In the following diagram, *percentage of cost sold* refers to the price that the property was sold for in relation to the price that the property was originally bought for.
(Percentage profit + Cost = Percentage of cost sold)

Percent of cost sold x Cost = Sale price

Sale price / Percent of cost sold = Cost

Sale price / Cost = Percent of cost sold

**Example:**
A property sells for $230,000, which amounts to a 12% profit over the original cost. What was the original cost?

12% Profit + 100% Original cost = 112% Sale price

Original cost = Sale price / Percent of cost sold
= $230,000 / 1.12
= $205,357.14
SUMMARY

A loan discount is a fee which lenders charge for granting a loan and is usually used to also lower the lending rate. A loan discount is expressed in percentage points, where one point is usually equal to 1% of the loan amount.

Appreciation and depreciation are increases and decreases in value over time, respectively. The projected appreciation or depreciation of a property (based on previously recorded, average rates) influences investors’ strategies in the marketplace.

Remember that a different type of depreciation is used when determining a property owner’s taxable basis for a property. This type of depreciation only applies to property used in business or held for investment and assumes that the value of property depreciates at a constant annual rate. This is also called straight-line depreciation. The IRS determines the rates of depreciation for different types of property.

The value of an income-producing property is a function of its net operating income (NOI) and its annual capitalization rate (rate of return). The NOI is the income remaining after the expenses of a property have been subtracted. The annual capitalization rate is the rate at which an income-producing property converts (capitalizes) its value into income.

Oftentimes landlords will rent property to income-producers using a percentage lease. These leases typically consist of a base-rent plus a percentage of the tenant’s sales in excess of some agreed upon amount.

Profit is sale price minus cost. A lender’s profit is a combination of the discount points he charges plus monthly interest payments on the loan. The profit of an income-producing property is the property’s NOI—i.e., the amount remaining after expenses have been paid out of the income.

Return to your online course player to take the Lesson Quiz.
LESSON FIVE
REAL ESTATE PRACTICE

This lesson focuses on the following topics:

• Insight into Practical Applications of Real Estate Math
• Case Studies

INTRODUCTION

This module has covered many specifics over a relatively short period of time. To ensure a comprehensive understanding, we will integrate the information provided in this module through a series of comprehension questions and case studies. The first half of this lesson presents comprehensive questions and dilemmas. Please write your response and then read the brief explanation that follows. The second half presents brief case studies that illustrate principles and ideas presented within the module.

INSIGHT INTO PRACTICAL APPLICATIONS OF REAL ESTATE MATH

Q1: An empty backyard of a newly completed home is in need of grass sod. The standard amount of sod per pallet is 100 square feet and currently sells for $95 per pallet. How many pallets will it take to sod the backyard and what will the cost be if the area measures 65 feet wide and 117 feet long?

Q2: What is the difference between cubic units and square units, and how would you decide which one applies in a particular situation?

Q3: How is the amount of the annual property tax for a property assessed?
A1: First we must determine the area of the lot needing sod. Remember that area = length x width. So 117’ x 65’ equals 7,605 square feet. Next, divide the area of the lot by the area of coverage provided by each pallet to determine the number of pallets required: 7,605 square feet / 100 square feet = 76.05 pallets. Finally, multiply the number of pallets by the cost per pallet to find the total cost: 76.05 x $95 = $7,224.75.

A2: Cubic measurements are three-dimensional and are used to express the volume of an object. Square units of measurement are two-dimensional and express the surface area of an object. Cubic measurements apply when the situation asks for volume. Remember the question: How much dirt would it take to fill a hole in the ground? A hole is three-dimensional (i.e., it has length, width and depth). Therefore, this is a volume situation and the answer would be expressed in terms of cubic yards. However, if a situation refers to surface area, it is two-dimensional and involves square measures. For example, solving a problem might mean answering how many square yards of carpet it would take to cover a floor.

A3: The annual amount of property tax owed is based on a tax rate (determined by the taxing authority) multiplied by a unit that is, almost universally, equal to $100 dollars of appraised value of the property. On a house appraised at $95,000, there are 950 units. This amount is calculated by dividing the appraised value of the property, $95,000, by $100 in order to get 950. So, if the tax rate were $2.45 per $100 dollars of appraised value, then a property appraised for $95,000 would have an annual property tax of $2327.50.

\[ 950 \times 2.45 = 2327.50 \]

CASE STUDIES

The following pages present 10 case studies highlighting some of the math principles covered in this module. The content contained in these studies is hypothetical, although some information may resemble situations that have occurred in fact. Any similarity to actual persons or events is purely coincidental. Try your best to work a solution for each study.

The case studies will cover the following topics in the order listed below:

- Area
- Volume
- Simple Interest
CASE STUDY ONE

Area

A right triangle with legs four feet and three feet has endpoints that lie along the edges of a circle. The third leg (the hypotenuse) passes through the circle’s origin (its center) as shown in the following diagram:

What is the approximate area of this circle? (Hint: Hypotenuse$^2 = Leg \ 1^2 + Leg \ 2^2$)
Case Study One Response:

The hypotenuse of a right triangle is equal to the square root of the sum of the squares of its legs. Four squared is 16; three squared is 9; and the sum of 16 and 9 is 25. So the hypotenuse = \( \sqrt{25} = 5 \) feet.

Because the hypotenuse runs through the origin and has both its endpoints on the circle, it represents the diameter of the circle. To determine the area of the circle, we need to know the length of the radius, which is half the diameter, or 2.5 feet. The area of a circle is \( \pi \) or \( 3.142 \times \text{radius squared} = 3.142 \times 2.5^2 = 3.142 \times 6.25 \) square feet = 19.6375, or approximately 20 square feet.

CASE STUDY TWO

Volume

A homeowner wants to build a circular walkway, four feet wide and 6 inches thick, around his house. If the edge closest to the center of the circle is 200 feet from the center, how many cubic feet of concrete will it take to build the walkway? (Assume \( \pi = 3.142 \).)
Case Study Two Response:

Since the question asks for an answer in cubic feet, we know this is a volume problem. The amount of concrete needed to build the walkway is equal to the volume of the walkway. To determine its volume, we'll need its dimensions. We are given its depth, but we also need to find its surface area.

We can imagine the area of the walkway being the area of the circle created by the far edge minus the area of the circle created by the near one. If the closest edge to the center is 200 feet away, then the far edge must be 204 feet away from the center, because the walkway is four feet wide.

The distance from the center of a circle to its outer edge is the radius of the circle. Because the area of a circle is \( \pi \times \text{radius}^2 \), the area of the larger circle is \( 3.142 \times 204' \times 204' = 130,757.472 \) square feet, and the area of the smaller circle is \( 3.142 \times 200' \times 200' = 125,680 \) square feet. So, the surface area of the walkway is the difference between the two areas, or: \( 130,757.472 - 125,680 \), which equals \( 5,077.472 \) square feet.

To find the volume of the walkway, we simply multiply surface area by depth. The depth is 6 inches, but first we need to convert this into feet because the problem asks for units of cubic feet: 6 inches is \( 6/12 \) feet = 0.5 feet.

This gives us: volume = \( 5,077.472 \times 0.5 = 2,538.736 \) or approximately 2,540 cubic feet.

CASE STUDY THREE

Simple Interest

An investor deposits $12,300 into an account that earns a variable, simple interest rate quarterly. If over the next two years the interest rates are 2.5%, 3%, 2.25%, 2%, 2%, 2.5%, 3% and 3% respectively for each quarter, how much money will the investor have?
Case Study Three Response:

The T-method may be used to find a solution. Given $12,300 (the whole), the rate(s) and asked to find the part, there are two ways to go about finding the amount of interest the investor earns on an investment.

First, we could calculate the interest earned each quarter by multiplying each quarterly rate by the principal and taking the sum. Because we are dealing with simple interest we can do this, and then each quarter’s interest is not compounded with the principal to determine the next quarter’s principal. But this method requires nine separate calculations, which is more than we ideally might want to do.

A better method of finding the interest in a simple interest-rate problem is to add all the simple interest rates and multiply that sum by the principal. The sum of the rates is 20.25% (2.5 + 3 + 2.25 + 2 + 2 + 2.5 + 3 + 3). Next take the interest earned on the principal over two years: whole x rate = $12,300 x 0.2025 = $2,490.75. But we’re not finished: the question asks how much money the investor has, not how much he has made. Therefore, we must calculate the sum of the principal and the interest earned = $12,300 + $2,490.75 = $14,790.75.

CASE STUDY FOUR

Compound Interest

A husband and wife want to give $2,000 as a present to their daughter for her graduation in three years. How much money would they need to put into an account bearing 5% compound interest annually to reach their goal?
Case Study Four Response:

This question asks that we find principal. We know that principal = $2,000 – interest, but to solve this problem we’ll have to figure interest in terms of principal. So, let the value of the principal = x. Then, at the end one year the interest would equal the rate times the principal, or 0.05x.

After two years, the interest would equal the rate times the new principal (after the previous year’s interest had been compounded):

\[
0.05 (x + 0.05x) = 0.05x + 0.0025x = 0.0525x
\]

And after three years the interest will be equal to:

\[
0.05 (x + 0.05x + 0.0525x) = 0.05x + 0.0025x + 0.002625x = 0.055125x
\]

The total interest earned on the loan will be the sum of the annual interest payments, or 0.05x + 0.0525x + 0.055125x = 0.157625x. Because we know that the total interest is the difference between the principal and $2,000, we can set up an equation and solve for x:

\[
0.157625x = $2,000 - x
\]

\[
1.157625x = $2,000
\]

\[
x = $2,000 / 1.157625
\]

\[
x = $1,727.68
\]

$1,727.68 is the amount of money the parents must invest to have accumulated $2,000 when their daughter graduates.

CASE STUDY FIVE

Loan Discount

A lender makes two 3-year loans of $3,000 each. In both cases, the borrower will pay one-third of the original principal, plus interest annually. The first loan returns 4% annual interest. If the second loan has a 2-point discount, what annual interest rate should the lender charge on the second loan to net the same amount on both loans?
Case Study Five Response:

Here we are asked to find the rate of the second loan. First, we must determine the amount that the lender will net on the first loan. This is the amount of total interest received.

The interest on the first loan is the sum of the annual interest payments. If the loan recipient pays off a third of the original principal every year ($1,000), then we can determine the total interest as follows:

\[
\begin{align*}
3,000 \times 0.04 &= 120 \quad \text{interest (first year)} \\
2,000 \times 0.04 &= 80 \quad \text{interest (second year)} \\
1,000 \times 0.04 &= 40 \quad \text{interest (third year)}
\end{align*}
\]

So total interest = $120 + $80 + $40 = $240 (Total net amount lender receives on Loan 1).

Now, we must determine the rate of interest a lender must charge on Loan 2 to net $240 after charging a 2-point loan discount. With the discount, the lender up front nets $3,000 x 2% = $60. Thus, the amount of total interest payments must equal $180 ($240 - $60). Knowing that the loan recipient will pay $1,000 of the principal every month, we can develop a formula for determining total interest:

\[
(3,000 \times \text{New rate}) + (2,000 \times \text{New rate}) + (1,000 \times \text{New rate}) = 180
\]

We can simplify this formula to:

\[
1,000 \times \text{New rate} \times (1 + 2 + 3) = 180
\]

Then:

\[
6,000 \times \text{New rate} = 180
\]

Finally, solving for the new rate, we have:

\[
180 / 6,000 = \text{New interest rate} = .03
\]

Thus, we realize that after a 2-point discount, the lender must charge a 3% interest rate to net the same amount as Loan 1.
CASE STUDY SIX

Proration

A seller holds a 7-year, $10,000 insurance policy for the building he is selling. April 5th is the day of closing; the policy began on February 15 of a leap year and runs through February 15th of the next year. If the closing contract stipulates that prorations will occur to the day of closing, how much does the buyer owe the seller for the remaining portion of the policy (using a calendar year)?
Case Study Six Response:

This question asks for a part: the amount the buyer owes = the daily rate x the number of days remaining. The daily rate is the amount of the insurance policy divided by the number of days it covers. In seven years, beginning with a leap year, there are \((2 \times 366) + (5 \times 365) = 2,557\) days. So, the daily rate is \(\frac{10,000}{2,557} = 3.91\) per day.

The number of days remaining are \(26\) (April 5th through April 30) + 31 (May) + 30 (June) + 31 (July) + 31 (August) + 30 (September) + 31 (October) + 30 (November) + 31 (December) + 31 (January) + 15 (February 1st through February 15th) = 317 days.

Thus, the buyer owes the seller 317 days x $3.91 per day = $1,239.47.

CASE STUDY SEVEN

Appreciation

A speculator buys four lots at market value: lot A for $15,000; lot B for $12,000; lot C for $25,000; and lot D for $10,000. After five years, the aggregate value of all the lots is $90,000. What is the percentage change in value of lot D if the other lots appreciated at an average rate of 2% annually? Did lot D appreciate or depreciate and at what average annual rate?
Case Study Seven Response:

The percentage change in value of lot D is the current value of lot D divided by its original value. The original value is $10,000 and the current value is $90,000 minus the sum of the current values of lots A, B and C.

The current value of lot A is $15,000 + ($15,000 x 0.02 Appreciation x 5 Years) = $16,500.

The current value of lot B is $12,000 + ($12,000 x 0.02 x 5) = $13,200.

The current value of lot C is $25,000 + ($25,000 x 0.02 x 5) = $27,500.

So, lot D’s current value is $90,000 − ($16,500 + $13,200 + $27,500) = $32,800.

Now we are in a position to find the percentage change in D’s value: $32,800 / $10,000 = 3.2 or 320%. To change in value this much, lot D had to appreciate at (3.2 − 1) / 5 years = .44 or 44% annually. Lot D increased in value at 22 times the rate of the other lots! The other lots only increased in value at a rate of 2% but because lot D increased at a rate of 44% annually, lot D increased in value at a rate of 22 times that of the other lots (44 / 2 = 22). Lot D appreciated at an average annual rate of 44%.

CASE STUDY EIGHT

Percentage Leases

An owner leases two units in a strip mall to two different businesses. She charges a minimum rent of $15,000 per year, plus a certain percentage of net annual operating income in excess of $125,000. The business that rents the first unit has an annual capitalization rate of 19% and is valued at $980,000. If the owner charges the first business 10% in excess of $125,000, what percentage must she charge the second business, if its NOI is $155,800, to make the same amount of money from both businesses?
Case Study Eight Response:

In order to answer this question, we must calculate how much money the owner makes from the first business, and use that figure to find the percent in excess of $125,000 NOI that she must charge the second business.

The first business is worth $980,000, and it converts this worth to wealth at a rate of 19% a year. So, its annual net operating income is $980,000 x 0.19 = $186,200. The owner charges the business 10% of this amount in excess of $125,000: 0.10 x ($186,200 − $125,000) = 0.10 x $61,200 = $6,120. So, the total amount of rent charged annually to the first business is $15,000 minimum rent + $6,120 percentage rent, which equals $21,120.

Let Y be the percentage rent rate charged to the second business. The problem tells us that the net profit the owner makes off the second business, namely the minimum rent plus Y times NOI in excess of $125,000, must equal $21,120. This yields a manageable equation:

\[ \$21,120 = \$15,000 + Y \times (\$155,800 - \$125,000) \]
\[ \$21,120 = \$15,000 + Y \times \$30,800 \]
\[ \$21,120 - \$15,000 = Y \times \$30,800 \]
\[ \$6,120 = Y \times \$30,800 \]
\[ Y = \frac{\$6,120}{\$30,800} \]
\[ Y = 19.87\% \]

The owner must charge the second business a percentage rent of 19.87% if she is to make the same amount of profit on both businesses.

CASE STUDY NINE

Profit

An investor buys a new lot for $25,000; its market value at the time of the sale is $27,000. Over a six-year period, rather than appreciate in value as the investor had hoped, the property depreciates at an average rate of 1.5% annually. The investor thus decides after six years to sell the property, still hoping to make a 10% profit.

What percent of its current market value must the investor sell it for in order to achieve this goal?
Case Study Nine Response:

The profit that the investor makes is the sale price of the lot minus the cost of purchasing the lot. The percent of his profit is the profit he makes divided by the cost of the lot. The problem tells us:

\[
10\% = \frac{\text{Sale price} - $25,000}{25,000}
\]

\[
0.10 \times 25,000 = \text{Sale price} - 25,000
\]

\[
2,500 = \text{Sale price} - 25,000
\]

\[
\text{Sale price} = 27,500
\]

The market value of the lot after six years is its original value less the amount of depreciation accrued over six years:

\[
27,000 - (0.015 \times 27,000 \times 6) = 27,000 - 2,430 = 24,570.
\]

So, the percentage of the market value the investor must sell the property for to make his profit is the sale price divided by the market value.

\[
\frac{27,500}{24,570} = 111.93\%, \text{ nearly } 112\%
\]

CASE STUDY TEN

Amortization

A borrower receives a loan of P at an annual interest rate of R. If monthly payments are M, write an equation that gives the loan balance after three years in terms of P, R and M. Solve the equation for P = $10,000; R = 7%; M = $225.
Case Study Ten Response:

The original principal of the loan is \( P \); the principal after one year will be the initial principal, plus the interest it accrues over the year, minus the yearly payment. The yearly payment is 12 times the monthly payment, or 12M. So, the principal after one year is:

\[
\text{Balance after 1 year} = P + PR - 12M
\]

The principal after the second year will be the principal after the first year, plus the interest it accrues, minus the monthly payment:

\[
\text{Balance after 2 years} = (P + PR - 12M) + R (P + PR - 12M) - 12M
\]
\[
\text{Balance after 2 years} = P + 2PR + PR^2 - 12MR - 24M
\]

The principal after the third year, then, will be the principal after the second year, plus the interest it accrues, minus the monthly payment:

\[
\text{Balance after 3 years} = (P + 2PR + PR^2 - 12MR - 24M) + R (P + 2PR + PR^2 - 12MR - 24M) - 12M
\]
\[
= P + 2PR + PR^2 - 12MR - 24M + PR + 2PR^2 + PR^3 - 12MR^2 - 24MR - 12M
\]
\[
= P + 3PR + 3PR^2 + PR^3 - 12MR^2 - 36MR - 36M
\]

Putting the values given in the problem yields a third year balance of:

\[
$10,000 + 3 ($10,000) (0.07) + 3 ($10,000) (0.07) (0.07) + $10,000 (0.07) (0.07) (0.07) - 12 ($225) (0.07) (0.07) - 36 ($225) (0.07) - 36 ($225)
\]
\[
= $10,000 + $2,100 + $147 + $3.43 - $13.23 - $567 - $8,100
\]
\[
= $3,570.20
\]

The entire amount of the loan should be paid off in less than five years. This case study illustrates the limitations of the mathematical methods we have been using in this course. If a banker was offering a loan at 4% interest for 20 years and he only knew the math we have covered, it would take him or her hours to figure out the monthly payments. However, financial calculators can be used to solve such problems more quickly.

*Return to your online course player to take the Final Exam. You must get 70% of the answers correct in order to pass the Final Exam.*
# Texas Principles of Real Estate

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<tr>
<th>Module Title</th>
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<tr>
<td>Module 1: Texas License Law</td>
<td>5 hrs (300 min)</td>
</tr>
<tr>
<td>Module 2: Real Property Ownership and Land Use</td>
<td>3.5 hrs (210 min)</td>
</tr>
<tr>
<td>Module 3: Code of Ethics</td>
<td>6 hrs (360 min)</td>
</tr>
<tr>
<td>Module 4: Fair Housing</td>
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<tr>
<td>Module 5: Texas Law of Agency</td>
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<tr>
<td>Module 6: Contracts, Purchase and Sales Agreements</td>
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<tr>
<td>Module 7: Environmental Hazards</td>
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<tr>
<td>Module 8: Deeds</td>
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<tr>
<td>Module 9: Titles and Records</td>
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<td>Module 10: Liens, Taxes and Foreclosures</td>
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<tr>
<td>Module 12: Closing and Settlement Costs</td>
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<tr>
<td>Module 13: Real Estate Appraisal</td>
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<tr>
<td>Module 14: Real Estate Finance</td>
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<tr>
<td>Module 15: Real Estate Math</td>
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**TOTAL COURSE TIME**

60 hrs (3600 min)