

Environmental issues	• duties of detecting, disclosing, remediating for owner and agent vary; typically include: lead-based paint, mold, asbestos, air quality, water quality, carbon monoxide, septic system, drug manufacturing, radon, formaldehyde, underground tanks • agents need to be familiar with requirements of EPA, CERCLA/Superfund Act, Clean Air and Water Acts, Lead-based Paint Act, among others • licensees must be aware of issues, know where to find professional help, disclose
Warranties	• agents should inform clients of limitations of home warranties; not a substitute for inspection
Inspections	• inspections can reveal structural, electrical, plumbing, roof, foundation, pest, environmental issues; agent must disclose inspection results if known
Homeowners' Associations	• agent must make sure existence, requirements, mandates, costs of homeowners' association are disclosed
OTHER PROFESSIONAL PRACTICES	• codes of ethics provide self-regulating standards of conduct covering all facets of the profession; serve clients, customers, and the public; avoid sanctions and liability; cover practices such as job performance, duties to clients and customers, disclosures, non-discrimination, professional relationships
Job performance	• maintain knowledge of market, laws, practices; recognize limits of agent's role
Duties to clients	• fiduciary duties; truthful representation of facts; respect client relationships; submit offers; avoid illegal practices; document transaction
Duties to customers	• truthful representation of facts; truthful advertising
Disclosure	• compensating parties; property defects; agent's interest in property; use of client funds; agent's identity in advertising
Wholesaling	• acting as an intermediary in a transaction by contracting to purchase, assigning the contract to another buying, and taking the difference as a fee; licensing may or may not be required
Love letters	• personal notes from buyers to sellers to enhance attractiveness of an offer
Non-discrimination	• compliance with fair housing laws
Professional relationships	• no disparagement of competitors; no unfair advantage; respect for others; arbitration of disputes
Residential property condition disclosure	• where required, re-seller of residential property must complete and deliver to buyer on or before offering; failure gives buyer right to rescind prior to closing or occupancy; agents must disclose material facts; buyers must acknowledge receipt

21 Closings

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The setting

The closing event is the culmination of the real estate transaction. During this event, the buyer pays the purchase price and receives title to the purchased real estate. At the same time, the buyer completes financing arrangements, and buyer and seller pay all required taxes, fees, and charges.

Customary Practices. Procedures and customary practices for conducting real estate closings vary from state to state. For example, it is common in some states for sellers to pay title insurance, while in other states the buyer and seller might share this expense. Students should refer to supplemental state materials to ascertain prevailing practices in their state.

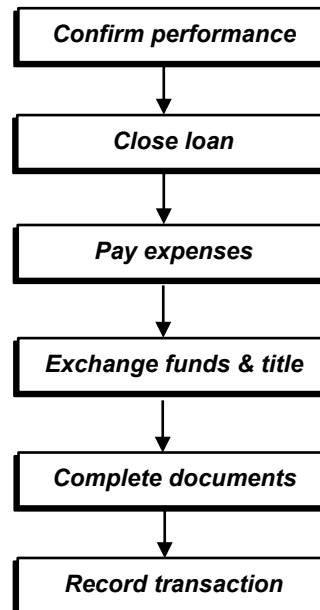
Time. The sale contract sets the date of the closing, usually within sixty days of signing. The time period between signing and closing is expected to be sufficient for the removal of any contingencies, such as the buyer's obtaining of financing, the performance of inspections, and the correction of identified physical defects. Failure of either buyer or seller to perform pre-closing actions specified in the contract can delay or terminate the transaction. If the contract includes a statement that "time is of the essence," all parties agree to meet the time limitations exactly as stated. If both parties consent, however, they can re-schedule the closing date.

Location. Closings occur at various locations, such as the office of the title company, the lender, the escrow agent, one of the attorneys, the broker, or the county recorder. The sale contract specifies the location.

Parties at closing. The primary parties at the closing are normally buyer, seller, and a closing agent or escrow officer. Other parties who might be present include the title officer, attorneys, brokers or agents, and the lender's representative. It is not actually necessary for any of these parties to attend the meeting. The closing agent can complete the transaction, provided all documents have been duly executed in advance.

The closing process The closing process consists of buyer and seller verifying that each has fulfilled the terms of the sale contract. If they have, then the mortgage loan, if any, is closed, all expenses are apportioned and paid, the consideration is exchanged for the title, final documents are signed, and arrangements are made to record the transaction according to local laws.

Exhibit 21.1 The Closing Process



Transfer of title The seller must produce evidence of marketable title, such as a commitment for title insurance by a title insurer. Before making a title commitment, a title company performs a title search to discover any liens, encumbrances, restrictions, conditions, or easements attaching to the title.

If there are any encumbrances or liens that damage the title, the seller is expected to remove these prior to the date specified in the contract. The most common title cloud is an unpaid lien.

The seller may also be asked to execute an affidavit of title stating that, since the date of the original title search, the seller has incurred no new liens, judgments, unpaid bills for repairs or improvements, no unrecorded deeds or contracts, no bankruptcies or divorces that would affect title, or any other defects the seller is aware of.

The purchaser, purchaser's lender, or title company may require a survey to verify the location and size of the property. The survey also identifies any easements, encroachments, or flood plain hazard.

The buyer should inspect the property to make certain that the property is in the condition in which the seller states that it is, and that any repairs or other required actions have been performed. A final inspection, called a **buyer's walk-through**, should be conducted as close to the closing date as possible.

If the seller's mortgage lien(s) are to be satisfied at closing, the lender will provide a **payoff statement**, also called an **offset statement**, specifying the amount of unpaid principal and any interest due as of the closing date, plus fees that will be due the lender and any credits or penalties that may apply. The holder of a note secured by a trust deed will provide a similar statement, called a **beneficiary statement**, to show any unpaid balance. Even if the buyer is assuming the seller's mortgage loan, the buyer will want to know the exact amount of the unpaid balance as of the closing date.

Finally, the seller produces and/or deposits with the escrow agent the deed that conveys the property to the buyer.

Transfer of purchase funds

The buyer usually produces and/or deposits with the escrow agent the following:

- ▶ earnest money
- ▶ loan funds and documents
- ▶ any other cash needed to complete the purchase

Escrow procedures

If the closing occurs "in escrow" rather than face-to-face, the principal parties deposit funds and documents with the appointed escrow agent, and the escrow agent disburses funds and releases documents to the appropriate parties when all the conditions of the escrow have been met. If for any reason the transaction cannot be completed, for instance if the buyer refuses the title as it is offered, or the buyer fails to produce the necessary cash, the escrow instructions usually provide a mechanism for reconveying title to the seller and funds to the buyer. In such a case, both parties return to their original status as if no sale had occurred.

Lender closing requirements

A lender is concerned about the quality of the collateral a borrower is providing in return for the mortgage loan. The collateral would be endangered by defects in the title, by liens that would take precedence over the mortgage lien, such as a tax lien, and by physical damage to the property which is not repaired. Consequently, the lender typically requires a survey; a property inspection; hazard insurance; a title insurance policy; a reserve account for taxes and insurance; and possibly, private mortgage insurance. In some cases the lender may also require a *certificate of occupancy* verifying that any new construction performed complies with local building codes.

Broker's role

A broker usually continues to provide service between the signing of the sale contract and the closing by helping to make arrangements for pre-closing activities such as inspections, surveys, appraisals and repairs and generally taking steps to ensure that the closing can proceed as scheduled.

A broker may conduct proceedings at the closing meeting, or may have no further role in the transaction after the sale contract is signed, depending on local practices and the transaction in question. In many states, the broker is charged with the responsibility for accuracy and timely delivery of the closing documents to the principal parties. A broker may also have the responsibility for reporting the transaction to the Internal Revenue Service.

Finally, if the seller of the property is a non-resident alien, U.S. law may require the broker to withhold and transmit to the Internal Revenue Service a portion of the sale proceeds to cover the alien seller's income tax liability. There are also special reporting requirements when the transaction involves a non-resident alien.

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)

TRID

Information booklet

Loan Estimate

Mortgage servicing disclosure

Closing Disclosure

Disclosures after settlement

Limits on escrow accounts

Referral fees and kickbacks

The **Real Estate Settlement Procedures Act (RESPA)** is a consumer protection statute enacted in 1974. Its purpose is to clarify settlement costs and to eliminate kickbacks and fees that increase settlement costs. RESPA specifies certain closing procedures when a purchase:

- ▶ involves a residential property, including one- to four-family residences, cooperatives and condominiums;
- ▶ involves a first or second mortgage lien; and
- ▶ is being financed by a "federally-related" mortgage loan, which includes loans made by a federally-insured lender; loans insured or guaranteed by the VA or FHA, loans administered by HUD, and loans intended to be sold to FNMA, FHLMC, or GNMA.

RESPA regulations do not apply to transactions being otherwise financed except in the case of an assumption in which the terms of the assumed loan are modified or the lender's charges for the assumption are greater than \$50.

RESPA is directed at lenders and settlement companies, but licensees should be familiar with requirements and changes implemented as of January, 2014. The Dodd-Frank Act of 2010 granted rule-making authority under RESPA to the Consumer Financial Protection Bureau (CFPB) and generally granted the CFPB authority to supervise and enforce compliance with RESPA and its implementing

regulations. In 2013, the CFPB made substantive and technical changes to the existing regulations. Substantive changes included modifying the servicing transfer notice requirements and implementing new procedures and notice requirements related to borrowers' error resolution requests and information requests. The amendments also included new provisions related to escrow payments, force-placed insurance, general servicing policies, procedures, and requirements, early intervention, continuity of contact, loss mitigation and the relation of RESPA's servicing provisions to State law. These RESPA amendments went into effect on January 10, 2014.

TRID

Effective October 3, 2015, a TILA/RESPA Integrated Disclosure Rule (TRID) integrates the disclosure requirements of RESPA and Truth-in-Lending, replacing the old Good Faith Estimate form and HUD-1 Uniform Settlement Statement a new Loan Estimate form and Closing Disclosure form, respectively.

Information booklet

A lender subject to RESPA must give loan applicants the CFPB booklet, "Your Home Loan Toolkit," within three days of receiving a loan application. This booklet describes loans, closing costs, and the Closing Disclosure form.

Loan Estimate

A lender must give the applicant, at the time of application or within three business days of application, a Loan Estimate (H-24) of likely settlement costs. This estimate is usually based on comparable transactions completed in the area. The terms stated in the Closing Disclosure must agree with those of the Loan Estimate within certain limits.

Mortgage servicing disclosure

The lender must disclose to the buyer whether the lender intends to service the loan or convey it to another lender for servicing. This disclosure must also be accompanied by information as to how the buyer can resolve complaints.

Closing Disclosure

Under CFPB rules, a lender must use the Closing Disclosure (H-25) to disclose settlement costs to the buyer. This form covers all costs that the buyer will have to pay at closing, whether to the lender or to other parties. Use of this form enforces RESPA's prohibitions against a lender's requiring a buyer to deposit an excessive amount in the tax and insurance escrow account or to use a particular title company for title insurance. The consumer must receive the completed form not later than three business days before closing and has the right to inspect a revised form one business day before closing. A description and example of this form are provided later in this chapter.

Disclosures after settlement

Loan servicers must provide borrowers with an annual escrow statement which summarizes all inflows and outflows in the prior 12-month period. The statement must also disclose shortfalls or overages in the account, and how the discrepancies will be resolved.

Limits on escrow accounts

Section 10 of RESPA limits the amounts lenders can require borrowers to place in escrow for purposes of paying taxes, hazard insurance, and other property-related expenses. The limitation applies to the initial deposits as well as deposits made over the course of the loan's term.

Referral fees and kickbacks

RESPA prohibits the payment of fees as part of a real estate settlement when no services are actually rendered. This prohibition includes referral fees for such

services as title searches, title insurance, mortgage loans, appraisals, credit reports, inspections, surveys, and legal services.

Business relationships and affiliations among real estate firms, mortgage brokers, title insurance firms and other such companies that are involved in a transaction are permitted, provided the relationships are disclosed in writing to the consumer, the consumer is free to go elsewhere for the relevant service, and the companies do not exchange fees for referrals.

FINANCIAL SETTLEMENT OF THE TRANSACTION

Settlement process

Selling terms and closing costs

Debits and credits

Non-prorated items

Prorated items

Settlement process The process of settlement consists of five basic steps:

1. Identify selling terms and closing costs.
2. Determine non-prorated debits and credits.
3. Determine prorated debits and credits.
4. Complete the closing statement.
5. Disburse funds.

Selling terms and closing costs

Selling terms are the price of the property, the buyer's deposit and downpayment, and the terms and amounts of the buyer's financing arrangements. Closing costs are final expenses that buyer or seller must pay at closing to complete the transaction. The sale contract identifies all selling terms and who pays which costs. The apportionment of expenses is subject to negotiation, and in the absence of a specific agreement, is determined by custom. Closing costs include such items as brokerage fees, mortgage-related fees, title-related expenses, and real estate taxes.

Debits and credits

The closing statement accounts for the debits and credits of the buyer and seller to settle and complete the transaction. A debit is an amount that one party must pay at closing or has already paid prior to closing. A credit is an amount that a party must receive at closing or that has already been received prior to closing.

Exhibit 21.2 Debit and Credit



The excess of the buyer's debits over the buyer's credits is the amount the buyer must bring to the closing. The excess of the seller's credits over the seller's debits is the amount the seller will receive at closing.

An individual expense item that one party owes to a party unrelated to the transaction, such as an attorney or the state, is treated as *a debit to that party only*. An income or expense item that affects both parties is apportioned, or **prorated**, to each party to reflect the proper amount that each owes or should receive. A prorated item is treated as *a debit to one party and a credit to the other party for the same amount*.

Buyer's debits and credits. To determine how much money the buyer owes at closing, the buyer's debits are totaled and compared with the total of the buyer's credits. The excess of debits over credits is the amount the buyer must bring to the closing, usually in the form of a cashier's check or certified check. The items typically debited and credited to the buyer are illustrated in the following exhibit.

Exhibit 21.3 Buyer's Credits and Debits

Buyer's Credits
earnest money
loan amount (borrowed or assumed)
seller's share of prorated items the buyer will pay

Buyer's Debits
purchase price
expenses (per agreement or custom)
buyer's share of prorated items prepaid by seller

Seller's credits and debits. To determine how much the seller will receive at closing, the same procedure is followed for the seller's debits and credits. The excess of credits over debits is what the seller will receive. The items typically debited and credited to the seller are illustrated in the following exhibit.

Exhibit 21.4 Seller's Debits and Credits

Seller's Debits expenses (per agreement or custom) seller's share of prorated items the buyer will pay loan balance or other lien to be paid off
Seller's Credits purchase price buyer's share of prorated items prepaid by seller

Non-prorated items Non-prorated items are costs *incurred by one party only*. Items not prorated include those listed in the next exhibit.

Exhibit 21.5 Non-Prorated Items

Buyer usually pays	Seller usually pays
Mortgage recording fees Documentary stamp tax Intangible tax on mortgage Mortgage-related fees: appraisal, credit, survey, loan Impound reserves: insurance, taxes Attorney fees	Stamp tax on deed Title insurance Brokerage fee Inspection fees Title-related expenses Attorney fees

Prorated items Many of the items to be settled at the closing are partly the responsibility of the buyer and partly of the seller. Some are expense items that the seller has *paid in advance*, where the buyer owes the seller part of the expense. Some are income items that the seller received in advance, and the seller owes the buyer a part of the income. Others are items the buyer will have to pay *in arrears*, and the seller owes the buyer part of the expense. The method of dividing financial responsibility for such items is **proration**. With a prorated item, there is always a debit to one party and a corresponding credit for the same amount to the other party.

Items paid in advance. At the time of closing, the seller has paid some items in advance that cover a period of time that goes beyond the closing date. In effect, the seller has prepaid some of the buyer's expenses, and the buyer must reimburse the seller. Heating oil and natural gas are typical items. By the same

token, the seller of a rental property may have received rent or rental deposits in advance, and must reimburse the buyer for the part that belongs to the buyer. For an expense the seller paid in advance, *the buyer receives a debit and the seller receives a credit*.

For income the seller received in advance, *the buyer receives a credit and the seller receives a debit*.

Items paid in arrears. At the time of closing, the seller has incurred certain expenses that have not been billed or paid at the time of closing and that the buyer will have to pay later. A typical item is real estate taxes.

For an item the buyer will pay in arrears, *the buyer receives a credit and the seller receives a debit*.

Exhibit 21.6 Items Paid in Arrears and Advance

	arrears	advance
real estate taxes	x	
mortgage interest	x	
rents received by seller		x
utilities	x	

Charging shares. If the seller has paid the buyer's share of an item, *charge the buyer for the buyer's share of the period*. If the buyer will pay the seller's share of an item, *charge the seller for the seller's share of the period*. If the seller has received the buyer's share of an income item, *charge the seller for the buyer's share of the period*.

Exhibit 21.7 Who Gets Charged

Seller paid for the year: charge buyer for buyer's share

Annual expense – closing August 7											
Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
							7	8			
Seller's share								Buyer's share			

Buyer will pay for the month: charge seller for seller's share

Monthly expense – closing August 7											
August											
1	2	3	4	5	6	7	8-31				
Seller's share							Buyer's share				

COMPUTING PRORATIONS

12-month/30-day method 365-day method

The primary methods of calculating prorations are the 360/30-day method, which computes prorations on the basis of a 360-day year and 30-day month, and the 365-day method, which computes prorations on the basis of a 365-day year. The 360/30-day method is commonly used for prorating mortgage interest. Either method may be used for real estate taxes, depending on local practice.

It is customary in most states that the seller owns the property up to and including the day of closing unless stated otherwise in the contract. Thus the closing day is apportioned to the seller in computing prorations. The method of prorating, if not specified in the contract, will follow local custom.

12-month / 30 day method

The 12-month/30-day method determines an average daily rate of payment for an item to be prorated *based on a 30-day month and a 360-day year*. The method consists of the following steps for annual and monthly items.

Annual items

1. Identify the total amount to be prorated.
2. Divide this amount by 12 to obtain an average monthly rate.
3. Divide the monthly rate by 30 to obtain an average daily rate.
4. Multiply the monthly amount times the seller's number of months of ownership in the year of the sale up to the month of closing. For the month of closing, multiply the seller's number of days of ownership times the daily amount and add the result to the previous result. The final result is the seller's pro rata share of this item.
5. The buyer's pro rata share of an item is the total amount less the seller's pro rata share.

Monthly items

1. Identify the total amount to be prorated.
2. Divide this amount by 30 to obtain the average daily amount.
3. Multiply the daily amount times the seller's number of days of ownership. The result is the seller's pro rata share of this item.
4. The buyer's pro rata share of an item is the total amount less the seller's pro rata share.

Exhibit 21.8 Prorating Annual Item: Real Estate Tax 12-month/30-day Method

A sale transaction on a single-family house closes on March 2. County taxes for the previous year, to be paid in arrears, amount to \$1,730. The seller owns the house through the day of closing. What are the seller's and buyer's prorated shares of this item?

Total amount due:		=	\$ 1,730.00
Monthly amount:	$1,730 \div 12$	=	\$ 144.17
Daily amount:	$144.17 \div 30$	=	\$ 4.81
Seller's share:	$144.17 \times 2 \text{ mo.}$	=	\$ 288.34
	$4.81 \times 2 \text{ days}$	=	\$ 9.62
	$288.34 + 9.62$	=	\$ 297.96
Buyer's share	$1,730 - 297.96$	=	\$ 1,432.04

Closing statement entries. The seller will be charged for the seller's share of the proration; an amount of \$297.96 will be entered as a debit to the seller and a credit to the buyer because the buyer will have to pay the seller's share when the tax bill is received.

Exhibit 21.9 Prorating Monthly Item: Rent Received 12-month/30-day Method

The house in the previous example has been rented during the listing and selling period at a rate of \$1800 per month. Rent for the month of March was paid to the seller on March 1. What is the buyer's prorated share of this rent? The day of closing, March 2, belongs to the seller.

Total received:		=	\$ 1,800.00
Daily amount:	$1800 \div 30$	=	\$ 60.00
Seller's share:	$60.00 \times 2 \text{ days}$	=	\$ 120.00
Buyer's share	$1800.00 - 120.00$	=	\$ 1,680.00

Closing statement entries. The seller will be charged for the buyer's share of the proration; an amount of \$1,680.00 will be debited to the seller's account and credited to the buyer's account because the seller has received rent that belongs to the new owner after closing.

365-day method

The 365-day method uses the actual number of days in the calendar. The steps in the calculation are the same for annual and monthly prorations. The steps are:

1. Identify the total annual or monthly amount to be prorated.
2. For an annual proration, divide the total amount by 365 to obtain a daily amount (366 in a Leap Year). For a monthly proration, divide the total amount by the actual number of days in the month to obtain the daily amount.
3. Multiply the daily amount times the seller's number of days of ownership. The result is the seller's pro rata share of the item.
4. The buyer's pro rata share of an item is the total amount less the seller's pro rata share.

Exhibit 21.10 Prorating an Annual Tax Bill, 365-day Method

The seller in the previous example has a \$1,730 tax bill, paid annually in arrears on December 31. Closing is on March 2, and the seller owns the day of closing. What is the seller's prorated share of this item?

Total amount due:		=	\$	1,730.00
Daily amount:	$1730 \div 365$	=	\$	4.74
Seller's share:	$61 \text{ days} \times 4.75$	=	\$	289.14
Buyer's share:	$1730 - 289.14$	=	\$	1,440.86

Closing statement entries. The seller will be charged for the seller's share of the proration; an amount of \$289.14 will be debited to the seller's account and credited to the buyer's account because the buyer will have paid the seller's share of the tax bill in arrears.

TAXES DUE AT CLOSING

State taxes on the deed State taxes on the mortgage

Certain transfer taxes that are due in connection with the closing appear and are accounted for on the closing statement. These include state taxes relating to the deed and to the buyer's mortgage. In addition to state-imposed taxes, counties and municipalities may also impose a tax on the real estate transfer.

**State taxes
on the deed**

Most states impose a **transfer tax** when real estate is conveyed. The tax is usually paid when the deed is recorded, often in the form of **documentary stamps** purchased from the recorder where the deed is recorded. The stamps must be attached to deeds and conveyances before they are recorded.

Tax rates are specific to each state. Methods of stating the transfer tax due include quoting the tax as a percentage of the taxable consideration and as a dollar rate per \$100.00 of total selling price. If the number of 100's is not a whole number, it must be rounded up to the next 100. For instance, if a property sells for \$350,120 and the tax rate is \$.55 per \$100.00 "or any fraction thereof," the tax stamps will cost:

350,120 ÷ 100.00	=	3,501.20
3,501.20 <i>rounded up</i>	=	3,502
3,502 x \$.55	=	\$1,926.10

**State taxes
on the mortgage**

Some states also impose a tax on instruments that contain promises to pay money, such as mortgages, notes, and contracts. Such taxes may be paid by the purchase of documentary stamps from the agency which will record the instrument. In addition, some states impose a further tax on the mortgage as an item of intangible personal property.

Taxes on the mortgage are typically paid by the buyer/borrower.

**CLOSING COST ITEMIZATION:
CASE ILLUSTRATION**

**Selling terms and closing costs
Prorations and charges**

The Closing Disclosure summarizes the financial settlement of a transaction. At closing, the closing agent also generally provides a statement to the buyer and/or seller detailing receipts and disbursements from relevant escrow accounts to which the buyer and seller have contributed funds as part of the transaction. The following illustration shows how some of these cost components are calculated and allocated in a sample transaction.

**Selling terms and
closing costs**

Lawrence and Sandy Binder have accepted an offer on their house located at 928 Elm Street, Littleburg. The buyers, Bill and Dillis Waite, offered \$450,000, with earnest money of \$70,000 and the remaining \$380,000 of the purchase price to come from a new conventional loan from Scepter Mortgage Company. The loan is for 30 years at 5.5% interest, with a monthly principal plus interest payment of \$2,158. The lender is charging 1.5 points and a 1% origination fee. Closing is set to occur at Alta Title Company at 4 p.m. on May 10 of the current (non-leap) year.

The Binders have an agreement to pay a broker's commission of 6% to Littleburg Realty. Their unpaid mortgage loan balance as of May 1 will be \$184,000. Their monthly interest payments are \$613.00. The annual interest rate is 4%. The previous year's county taxes, amounting to \$2,572, have been paid by the seller in arrears. The current year's taxes, not yet billed or paid, are assumed to be the same as the previous year's. The parties agree to prorate using the 365-day method, and that the day of closing belongs to the seller. The relevant facts and costs, and who pays them according to the terms of the sale contract, are summarized below.

Selling terms

Sale price:	\$450,000
Deposit/downpayment	\$70,000
Loan amount	\$380,000

Seller-paid Costs

Commissions:	6% of sale price (.06)
Real estate taxes:	\$2,572, to be prorated
Title insurance:	\$900 owner's coverage
Seller's attorney:	\$1,500
Record Release Deed:	\$25
Survey:	\$550
Transfer stamps	
state:	\$162
county:	\$162
Seller's loan payoff:	\$184,000 + 10 days' prorated May interest @ \$613/month

Buyer- paid Costs

Sale price:	\$450,000 (\$70,000 earnest money already deposited by buyer)
Appraisal fee:	\$400 already paid by buyer
Credit report:	\$50 already paid by buyer
Closing fee:	\$350
Recording fees:	\$55
Title insurance:	\$250 for lender's coverage
Buyer's attorney:	\$1200
Pest inspection:	\$100
Buyer's loan:	\$380,000; 30-year fixed @ 5.5% (.055) points: 1.5% of loan amount (.015) origination fee: 1.0% of loan amount (.01)
Hazard insurance:	\$2,400/year
Real estate taxes:	\$2,572.00, to be prorated
Tax and insurance escrow:	8 months' taxes, 4 months' insurance
Prepaid interest:	from day after closing to end of month

Prorations and charges

According to the summarized sale contract, the only cost to be prorated and shared between seller and buyer is the real estate tax. Other costs to be computed are the broker's commission, the seller's unpaid mortgage interest, the buyer's loan fees and points, the buyer's tax and insurance escrows, and the buyer's prepaid mortgage interest.

Commission. The commission paid by the seller is:

$$\$450,000 \times 6\% = \$27,000.00$$

At closing this amount will be charged, or debited, to the seller.

Real estate taxes. Using the 365-day method, the daily amount is $\$2,572 \div 365$, or \$7.05 (rounded). The total number of days is the number of days in January, February, March and April, plus 10 days in May, or $(31+28+31+30+10)$, or 130 days. At closing, the seller's share of \$916.50 is charged to the seller and the buyer is credited with the same amount.

Total amount due:		=	\$	2,572.00
Daily amount:	$2,572 \div 365$	=	\$	7.05
Seller's share	7.051×130	=	\$	916.50
Buyer's share:	$2,572 - 916.50$	=	\$	1,655.50

Seller's unpaid mortgage interest. Since mortgage interest is paid in arrears, the seller owes the lender for interest not yet charged for the ten days of the month of closing. This amount is therefore debited to the seller.

Daily amount:	$613 \div 31 \text{ days}$	=	\$	19.77
Seller's charge:	$19.77 \times 10 \text{ days}$	=	\$	197.70

Buyer's loan origination and points. The buyer's debits for loan fees and points are:

Fee:	$380,000 \times 1\%$	=	\$	3,800
Points:	$380,000 \times 1.5\%$	=	\$	5,700

Buyer's escrow. The lender requires the buyer to establish an escrow account to cover eight months of real estate taxes and four months of hazard insurance. The debits charged to the buyer are therefore:

Taxes:

Annual amount:		=	\$	2,572.00
Monthly amount:	$2,572 \div 12$	=	\$	214.33
Amount due:	$214.33 \times 8 \text{ mo.}$	=	\$	1,714.64

Insurance:

Annual amount:		=	\$	2400.00
Monthly amount:	$2400 \div 12$	=	\$	200.00
Amount due:	$200 \times 4 \text{ mo.}$	=	\$	800.00

Prepaid interest. The lender requires the buyer (borrower) to pay, in advance, the interest on the loan amount disbursed at closing to cover the 21 days of the closing month that would be due in arrears later. Note that the lender is not charging the borrower for interest for the day of closing. The buyer's first mortgage payment, which will cover the month of June, will not be due until July 1. Charged to buyer:

Monthly amount:	$380K \times 5.5\% \div 12$	=	\$	1741.67
Daily amount:	$1,741.67 \div 31$	=	\$	56.18
Total prepaid interest	$56.18 \times 21 \text{ days}$	=	\$	1179.78

TILA/RESPA INTEGRATED DISCLOSURE RULE

Forms and procedures

Good faith

Types of charges

Applicable transactions

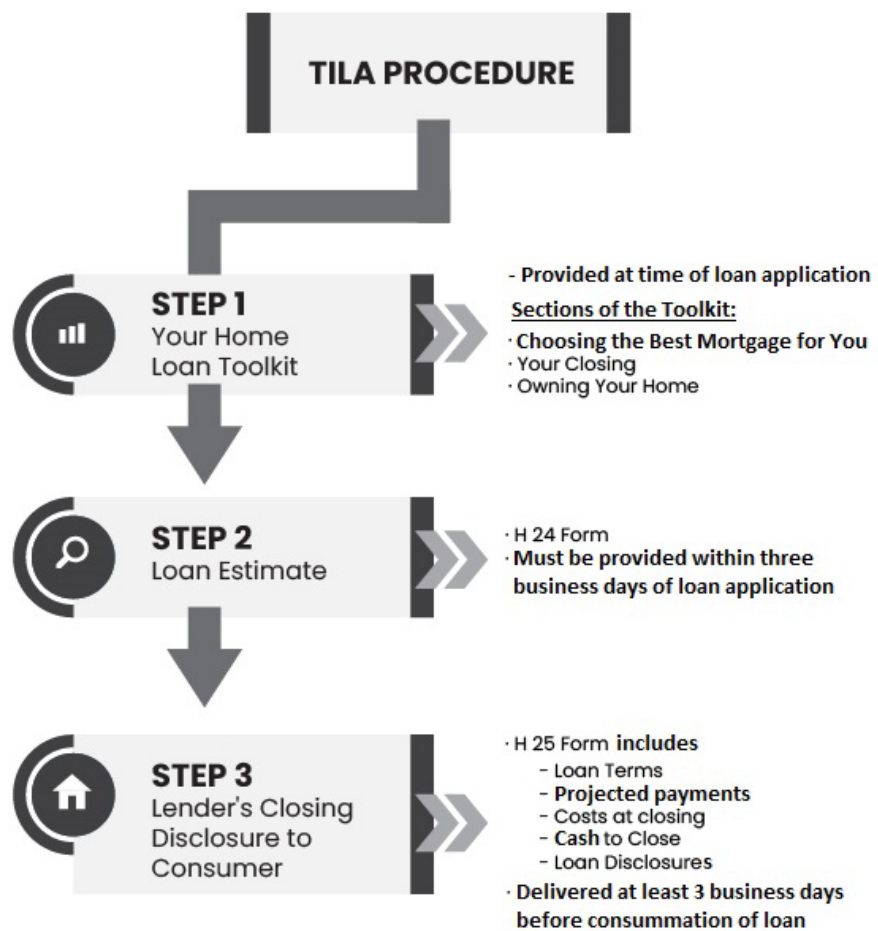
The H-25 Closing Disclosure form

Forms and procedures

As mentioned earlier, the TILA/RESPA Integrated Disclosures (TRID) rule is in effect as of October 3, 2015. These changes introduce new mandatory forms and procedures to replace the old ones, as follows.

- ▶ Lenders must give the consumer a copy of the **booklet**, "Your Home Loan Toolkit" **at the time** of loan application.
- ▶ Lenders must deliver or mail the **Loan Estimate** (Form H-24) to the consumer **no later than the third business day** after receiving a loan application. (A "business day" in this context is any day on which the lender's offices are open for business. An "application" exists when the consumer has given the lender or mortgage broker six pieces of information: name; income; Social Security number; property address; estimated value of property; loan amount sought).
- ▶ Lenders must provide the **Closing Disclosure** (Form H-25) to the consumer **at least three business days** before consummation of the loan. (A "business day" in this context is any calendar day except a Sunday or the day on which a legal public holiday is observed. "Consummation" refers to the day on which the borrower becomes indebted to the creditor; this may or may not correspond to the day of closing the transaction.)

Exhibit 21. 11 TILA/RESPA Disclosures



Good faith

Creditors are responsible for ensuring that the figures stated in the Loan Estimate are made in good faith and consistent with the best information reasonably available to the creditor at the time they are disclosed.

Good faith is measured by calculating the difference between the estimated charges originally provided in the Loan Estimate and the actual charges paid by or imposed on the consumer in the Closing Disclosure.

Generally, if the charge paid by or imposed on the consumer exceeds the amount originally disclosed on the Loan Estimate it is not in good faith, regardless of whether the creditor later discovers a technical error, miscalculation, or underestimation of a charge, although there are exceptions.

Types of charges

For certain costs or terms, creditors are permitted to charge consumers more than the amount disclosed on the Loan Estimate without any tolerance limitation.

These charges are:

- ▶ prepaid interest; property insurance premiums; amounts placed into an escrow, impound, reserve or similar account
- ▶ charges for services required by the creditor if the creditor permits the consumer to shop and the consumer selects a third-party service provider not on the creditor's written list of service providers
- ▶ charges paid to third-party service providers for services not required by the creditor (may be paid to affiliates of the creditor)

However, creditors may only charge consumers more than the amount disclosed when the original estimated charge, or lack of an estimated charge for a particular service, was based on the best information reasonably available to the creditor at the time the disclosure was provided.

Charges for third-party services and recording fees paid by or imposed on the consumer are grouped together and subject to a 10% cumulative tolerance ("10% tolerance" charges). This means the creditor may charge the consumer more than the amount disclosed on the Loan Estimate for any of these charges so long as the total sum of the charges added together does not exceed the sum of all such charges disclosed on the Loan Estimate by more than 10%.

For all other charges ("zero tolerance" charges), creditors are not permitted to charge consumers more than the amount disclosed on the Loan Estimate under any circumstances other than changed circumstances that permit a revised Loan Estimate.

If the amounts paid by the consumer at closing exceed the amounts disclosed on the Loan Estimate beyond the applicable tolerance threshold, the creditor must refund the excess to the consumer no later than 60 calendar days after consummation.

Applicable transactions

The Integrated Disclosures rule applies to most closed-end consumer mortgages. It does not apply to:

- ▶ home equity lines of credit (HELOCs)
- ▶ reverse mortgages
- ▶ mortgages secured by a mobile home or by a dwelling that is not attached to real property (i.e., land)
- ▶ loans made by persons who are not considered "creditors" by virtue of the fact they make five or fewer mortgages in a year.

However, certain types of loans that used to be subject to TILA but not RESPA are now subject to the TILA-RESPA rule's integrated disclosure requirements, including:

- ▶ construction-only loans
- ▶ loans secured by vacant land or by 25 or more acres
- ▶ credit extended to certain trusts for tax or estate planning

Guides and detailed information about the current TILA-RESPA rule can be found on the Consumer Financial Protection Bureau (CFPB) website at

<https://www.consumerfinance.gov/policy-compliance/guidance/tila-respa-disclosure-rule/>

The H-25 Closing Disclosure form

The H-25 Closing Disclosure form consists of five pages. Pages 1, 4, and 5 vary, depending on the loan type. To illustrate the form, we use a sample disclosure for a *30-year fixed rate* loan that is presented on the CFPB website.

Page 1 has four sections: general information, Loan Terms, Projected Payments, and Costs at Closing.

General information. This section has three columns:

- ▶ Closing information –issue date, closing date, disbursement date, settlement agent, file number, property address, and sale price
- ▶ Transaction information – names and addresses for borrower, seller and lender
- ▶ Loan information – loan term, loan purpose, product type, loan type and loan ID number

Loan Terms. This section states the loan amount, interest rate, and monthly principal and interest payment, and indicates whether any of those amounts can increase after closing. It also gives specifics of any prepayment penalty or balloon payment.

Projected Payment. This section displays the borrower's payment for principal and interest and mortgage insurance, an estimated escrow payment, and the total estimated monthly mortgage payment for years 1-7 and 8-30 of the loan term. It also provides an estimate of monthly tax, insurance, and assessment payments and indicates whether the payments will be held in escrow.

Costs at Closing. The last section of page 1 shows the borrowers' total closing costs (brought forward from page 2) and the total amount of cash the buyer needs to close (brought forward from page 3).

Page 2 details the closing costs. There are two sections divided into four columns:

- ▶ Description of the costs—loan costs and other costs
- ▶ Costs paid by the borrower – "at closing" or "before closing"
- ▶ Costs paid by the seller – "at closing" or "before closing"
- ▶ Costs paid by others (in the example, someone other than buyer or seller pays for the appraisal)

Loan Costs. The first section deals with the loan costs:

- A. Origination charges, such as points, application fee, and underwriting fee
- B. Charges for services the borrower did not shop for - items the lender requires, such as appraisals and credit reports

- C. Services the borrower did shop for - items the borrower orders on his own, such as pest inspections, survey fees, and title insurance
- D. The total of A, B, and C above

Other Costs. The second section deals with additional transaction-related costs:

- E. Taxes and other government fees, such as recording fees and transfer taxes
- F. Prepaid items, such as homeowner's insurance, mortgage insurance, prepaid interest, and property taxes to be paid before the first scheduled loan payment
- G. Initial escrow payment at closing – an amount the borrower will pay the lender each month to be held in escrow until due, typically for insurance premiums and tax instalments
- H. Other costs not covered elsewhere on the disclosure, such as items as association fees, home warranty fees, home inspection fees, real estate commission, and prorated items
- I. The total of the costs of E, F, G, and H above
- J. The total borrower-paid closing costs from D + I above. This total is carried to the bottom of page 1 as "Costs at Closing – Closing Costs."

Page 3 has two sections, one for calculating cash to close, the other for summarizing the transactions of borrower and seller.

Calculating Cash to Close. The first section compares the final costs of the loan with the lender's original Loan Estimate. This calculation considers costs paid before closing, down payment, deposits, seller credits, adjustments, and other credits. The last line of the calculation is "Cash to close," the amount the borrower needs to produce at closing.

When an amount has changed, the creditor must indicate where the consumer can find the amounts that have changed on the Loan Estimate. For example, if the Seller Credit amount changed, the creditor can indicate that the consumer should "See Seller Credits in Section L." When the increase in Total Closing Costs exceeds the legal limits, the creditor must disclose this fact and the dollar amount of the excess in the "Did this change?" column. A statement directing the consumer to the Lender Credit on page 2 must also be included if the creditor owes a credit to the consumer at closing for the excess amount.

Summaries of Transactions. The second section of page 3 is divided into two columns (or subsections), one to summarize the borrower's transaction and the other for the seller's transaction. The borrower's column includes:

- K. amounts due from the borrower at closing, including the sale price and adjustments for items paid by the seller in advance.
- L. amounts already paid by or on behalf of the borrower at closing, such as deposit, loan amount, loan assumptions, seller credits, other credits, and adjustments for items unpaid by the seller, such as taxes and assessments.

The calculation at the bottom of the left column subtracts the totals already paid by the borrower (line L) from the total due from the borrower (line K) to derive the Cash to Close due from the borrower at closing. This figure is the same as that at the bottom of page 1 under "Costs at Closing – Cash to Close."

The seller's column of the Summaries section includes:

- M. amounts due to the seller at closing, including the sale price of the property and adjustments for items paid by the seller in advance.
- N. amounts due from the seller at closing, such as closing costs the seller will pay, payoff of first or second mortgages, seller credit, and adjustments for items unpaid by the seller, such as taxes and assessments.

The calculation at the bottom of the right column subtracts the total due from the seller (line N) from the total due to the seller (line M) to derive the Cash to Seller, which is the amount the seller will receive at closing.

Page 4 provides additional Loan Disclosures:

- ▶ Assumption –whether the lender will allow a loan assumption on a future transfer
- ▶ Demand feature –whether the lender can require early repayment
- ▶ Late payment – the fee the lender will charge for a late payment
- ▶ Negative amortization –whether the loan is negatively amortized, which increases loan amount and diminishes the borrower's equity over the term
- ▶ Partial payments –whether the lender accepts partial payments and applies them to the loan
- ▶ Security interest –identifies the property securing the loan
- ▶ Escrow account – itemizes what is included in the escrow account and states the monthly escrow payment

Page 5 provides additional calculations, disclosures, and contact information:

- ▶ Loan Calculations –the total amount of all payments on the loan, the dollar amount of the finance charges over the life of the loan, the amount financed, the annual percentage rate (APR), and the total interest percentage (TIP)
- ▶ Other Disclosures –other important information for the borrower, including the right to a copy of the appraisal report and an indication of whether the borrower is protected against liability for the unpaid balance in the event of a foreclosure
- ▶ Contact Information –names, addresses, license numbers, contact names, email addresses, and phone numbers for persons involved in the transaction.
- ▶ Confirm Receipt –the borrowers' signatures confirming receipt of the Closing Disclosure document. **Signing the document does not indicate acceptance of the loan.**

Exhibit 21.12 Sample H-25 Closing Disclosure, Page 1

Closing Disclosure

This form is a statement of final loan terms and closing costs. Compare this document with your Loan Estimate.

Closing Information		Transaction Information		Loan Information	
Date Issued	4/15/2013	Borrower	Michael Jones and Mary Stone	Loan Term	30 years
Closing Date	4/15/2013		123 Anywhere Street	Purpose	Purchase
Disbursement Date	4/15/2013		Anytown, ST 12345	Product	Fixed Rate
Settlement Agent	Epsilon Title Co.	Seller	Steve Cole and Amy Doe	Loan Type	☒ Conventional ☐ FHA
File #	12-3456		321 Somewhere Drive		☐ VA ☐ _____
Property	456 Somewhere Ave		Anytown, ST 12345		
	Anytown, ST 12345	Lender	Ficus Bank	Loan ID #	123456789
Sale Price	\$180,000			MIC #	000654321

Loan Terms		Can this amount increase after closing?
Loan Amount	\$162,000	NO
Interest Rate	3.875%	NO
Monthly Principal & Interest <i>See Projected Payments below for your Estimated Total Monthly Payment</i>	\$761.78	NO
Does the loan have these features?		
Prepayment Penalty	YES	• As high as \$3,240 if you pay off the loan during the first 2 years
Balloon Payment		NO

Projected Payments		
Payment Calculation	Years 1-7	Years 8-30
Principal & Interest	\$761.78	\$761.78
Mortgage Insurance	+ 82.35	+ —
Estimated Escrow <i>Amount can increase over time</i>	+ 206.13	+ 206.13
Estimated Total Monthly Payment	\$1,050.26	\$967.91
Estimated Taxes, Insurance & Assessments <i>Amount can increase over time See page 4 for details</i>	\$356.13 a month	This estimate includes ☒ Property Taxes ☒ Homeowner's Insurance ☒ Other: Homeowner's Association Dues <i>See Escrow Account on page 4 for details. You must pay for other property costs separately.</i>
		In escrow? YES YES NO

Costs at Closing	
Closing Costs	\$9,712.10 Includes \$4,694.05 in Loan Costs + \$5,018.05 in Other Costs – \$0 in Lender Credits. See page 2 for details.
Cash to Close	\$14,147.26 Includes Closing Costs. See Calculating Cash to Close on page 3 for details.

CLOSING DISCLOSURE

PAGE 1 OF 5 • LOAN ID # 123456789

Exhibit 21.13 Sample H-25 Closing Disclosure, Page 2

Closing Cost Details

Loan Costs		Borrower-Paid		Seller-Paid		Paid by Others
		At Closing	Before Closing	At Closing	Before Closing	
A. Origination Charges		\$1,802.00				
01	0.25 % of Loan Amount (Points)	\$405.00				
02	Application Fee	\$300.00				
03	Underwriting Fee	\$1,097.00				
04						
05						
06						
07						
08						
B. Services Borrower Did Not Shop For		\$236.55				
01	Appraisal Fee to John Smith Appraisers Inc.					\$405.00
02	Credit Report Fee to Info Co.		\$29.80			
03	Flood Determination Fee to Info Co.	\$20.00				
04	Flood Monitoring Fee to Info Co.	\$31.75				
05	Tax Monitoring Fee to Info Co.	\$75.00				
06	Tax Status Research Fee to Info Co.	\$80.00				
07						
08						
09						
10						
C. Services Borrower Did Shop For		\$2,655.50				
01	Pest Inspection Fee to Pests Co.	\$120.50				
02	Survey Fee to Surveys Co.	\$85.00				
03	Title - Insurance Binder to Epsilon Title Co.	\$650.00				
04	Title - Lender's Title Insurance to Epsilon Title Co.	\$500.00				
05	Title - Settlement Agent Fee to Epsilon Title Co.	\$500.00				
06	Title - Title Search to Epsilon Title Co.	\$800.00				
07						
08						
D. TOTAL LOAN COSTS (Borrower-Paid)		\$4,694.05				
Loan Costs Subtotals (A + B + C)		\$4,664.25	\$29.80			
Other Costs						
E. Taxes and Other Government Fees		\$85.00				
01	Recording Fees Deed: \$40.00 Mortgage: \$45.00	\$85.00				
02	Transfer Tax to Any State			\$950.00		
F. Prepays		\$2,120.80				
01	Homeowner's Insurance Premium (12 mo.) to Insurance Co.	\$1,209.96				
02	Mortgage Insurance Premium (mo.)					
03	Prepaid Interest (\$17.44 per day from 4/15/13 to 5/1/13)	\$279.04				
04	Property Taxes (6 mo.) to Any County USA	\$631.80				
05						
G. Initial Escrow Payment at Closing		\$412.25				
01	Homeowner's Insurance \$100.83 per month for 2 mo.	\$201.66				
02	Mortgage Insurance per month for mo.					
03	Property Taxes \$105.30 per month for 2 mo.	\$210.60				
04						
05						
06						
07						
08	Aggregate Adjustment	- 0.01				
H. Other		\$2,400.00				
01	HOA Capital Contribution to HOA Acre Inc.	\$500.00				
02	HOA Processing Fee to HOA Acre Inc.	\$150.00				
03	Home Inspection Fee to Engineers Inc.	\$750.00			\$750.00	
04	Home Warranty Fee to XYZ Warranty Inc.			\$450.00		
05	Real Estate Commission to Alpha Real Estate Broker			\$5,700.00		
06	Real Estate Commission to Omega Real Estate Broker			\$5,700.00		
07	Title - Owner's Title Insurance (optional) to Epsilon Title Co.	\$1,000.00				
08						
I. TOTAL OTHER COSTS (Borrower-Paid)		\$5,018.05				
Other Costs Subtotals (E + F + G + H)		\$5,018.05				
J. TOTAL CLOSING COSTS (Borrower-Paid)		\$9,712.10				
Closing Costs Subtotals (D + I)		\$9,682.30	\$29.80	\$12,800.00	\$750.00	\$405.00
Lender Credits						

CLOSING DISCLOSURE

PAGE 2 OF 5 • LOAN ID # 123456789

Exhibit 21.14 Sample H-25 Closing Disclosure, Page 3

Calculating Cash to Close		Use this table to see what has changed from your Loan Estimate.	
	Loan Estimate	Final	Did this change?
Total Closing Costs (J)	\$8,054.00	\$9,712.10	YES • See Total Loan Costs (D) and Total Other Costs (I)
Closing Costs Paid Before Closing	\$0	– \$29.80	YES • You paid these Closing Costs before closing
Closing Costs Financed (Paid from your Loan Amount)	\$0	\$0	NO
Down Payment/Funds from Borrower	\$18,000.00	\$18,000.00	NO
Deposit	– \$10,000.00	– \$10,000.00	NO
Funds for Borrower	\$0	\$0	NO
Seller Credits	\$0	– \$2,500.00	YES • See Seller Credits in Section L
Adjustments and Other Credits	\$0	– \$1,035.04	YES • See details in Sections K and L
Cash to Close	\$16,054.00	\$14,147.26	

Summaries of Transactions		Use this table to see a summary of your transaction.	
BORROWER'S TRANSACTION		SELLER'S TRANSACTION	
K. Due from Borrower at Closing \$189,762.30		M. Due to Seller at Closing \$180,080.00	
01 Sale Price of Property	\$180,000.00	01 Sale Price of Property	\$180,000.00
02 Sale Price of Any Personal Property Included in Sale		02 Sale Price of Any Personal Property Included in Sale	
03 Closing Costs Paid at Closing (J)	\$9,682.30	03	
04		04	
Adjustments		05	
05		06	
06		07	
07		08	
Adjustments for Items Paid by Seller in Advance		Adjustments for Items Paid by Seller in Advance	
08 City/Town Taxes to		09 City/Town Taxes to	
09 County Taxes to		10 County Taxes to	
10 Assessments to		11 Assessments to	
11 HOA Dues 4/15/13 to 4/30/13	\$80.00	12 HOA Dues 4/15/13 to 4/30/13	\$80.00
12		13	
13		14	
14		15	
15		16	
L. Paid Already by or on Behalf of Borrower at Closing \$175,615.04		N. Due from Seller at Closing \$115,665.04	
01 Deposit	\$10,000.00	01 Excess Deposit	
02 Loan Amount	\$162,000.00	02 Closing Costs Paid at Closing (J)	\$12,800.00
03 Existing Loan(s) Assumed or Taken Subject to		03 Existing Loan(s) Assumed or Taken Subject to	
04		04 Payoff of First Mortgage Loan	\$100,000.00
05 Seller Credit	\$2,500.00	05 Payoff of Second Mortgage Loan	
Other Credits		06	
06 Rebate from Epsilon Title Co.	\$750.00	07	
07		08 Seller Credit	\$2,500.00
Adjustments		09	
08		10	
09		11	
10		12	
11		13	
Adjustments for Items Unpaid by Seller		Adjustments for Items Unpaid by Seller	
12 City/Town Taxes 1/1/13 to 4/14/13	\$365.04	14 City/Town Taxes 1/1/13 to 4/14/13	\$365.04
13 County Taxes to		15 County Taxes to	
14 Assessments to		16 Assessments to	
15		17	
16		18	
17		19	
CALCULATION		CALCULATION	
Total Due from Borrower at Closing (K)	\$189,762.30	Total Due to Seller at Closing (M)	\$180,080.00
Total Paid Already by or on Behalf of Borrower at Closing (L)	– \$175,615.04	Total Due from Seller at Closing (N)	– \$115,665.04
Cash to Close ☒ From ☐ To Borrower	\$14,147.26	Cash ☐ From ☒ To Seller	\$64,414.96

CLOSING DISCLOSURE

PAGE 3 OF 5 • LOAN ID # 123456789

Exhibit 21.15 Sample H-25 Closing Disclosure, Page 4

Additional Information About This Loan

Loan Disclosures

Assumption

If you sell or transfer this property to another person, your lender

- ☐ will allow, under certain conditions, this person to assume this loan on the original terms.
☒ will not allow assumption of this loan on the original terms.

Demand Feature

Your loan

- ☐ has a demand feature, which permits your lender to require early repayment of the loan. You should review your note for details.
☒ does not have a demand feature.

Late Payment

If your payment is more than 15 days late, your lender will charge a late fee of 5% of the monthly principal and interest payment.

Negative Amortization (Increase in Loan Amount)

Under your loan terms, you

- ☐ are scheduled to make monthly payments that do not pay all of the interest due that month. As a result, your loan amount will increase (negatively amortize), and your loan amount will likely become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☐ may have monthly payments that do not pay all of the interest due that month. If you do, your loan amount will increase (negatively amortize), and, as a result, your loan amount may become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☒ do not have a negative amortization feature.

Partial Payments

Your lender

- ☒ may accept payments that are less than the full amount due (partial payments) and apply them to your loan.
☐ may hold them in a separate account until you pay the rest of the payment, and then apply the full payment to your loan.
☐ does not accept any partial payments.

If this loan is sold, your new lender may have a different policy.

Security Interest

You are granting a security interest in

456 Somewhere Ave., Anytown, ST 12345

You may lose this property if you do not make your payments or satisfy other obligations for this loan.

Escrow Account

For now, your loan

- ☒ will have an escrow account (also called an "impound" or "trust" account) to pay the property costs listed below. Without an escrow account, you would pay them directly, possibly in one or two large payments a year. Your lender may be liable for penalties and interest for failing to make a payment.

Escrow		
Escrowed Property Costs over Year 1	\$2,473.56	Estimated total amount over year 1 for your escrowed property costs: Homeowner's Insurance Property Taxes
Non-Escrowed Property Costs over Year 1	\$1,800.00	Estimated total amount over year 1 for your non-escrowed property costs: Homeowner's Association Dues You may have other property costs.
Initial Escrow Payment	\$412.25	A cushion for the escrow account you pay at closing. See Section G on page 2.
Monthly Escrow Payment	\$206.13	The amount included in your total monthly payment.

- ☐ will not have an escrow account because ☐ you declined it ☐ your lender does not offer one. You must directly pay your property costs, such as taxes and homeowner's insurance. Contact your lender to ask if your loan can have an escrow account.

No Escrow		
Estimated Property Costs over Year 1		Estimated total amount over year 1. You must pay these costs directly, possibly in one or two large payments a year.
Escrow Waiver Fee		

In the future,

Your property costs may change and, as a result, your escrow payment may change. You may be able to cancel your escrow account, but if you do, you must pay your property costs directly. If you fail to pay your property taxes, your state or local government may (1) impose fines and penalties or (2) place a tax lien on this property. If you fail to pay any of your property costs, your lender may (1) add the amounts to your loan balance, (2) add an escrow account to your loan, or (3) require you to pay for property insurance that the lender buys on your behalf, which likely would cost more and provide fewer benefits than what you could buy on your own.

Exhibit 21.16 Sample H-25 Closing Disclosure, Page 5

Loan Calculations

Total of Payments. Total you will have paid after you make all payments of principal, interest, mortgage insurance, and loan costs, as scheduled.	\$285,803.36
Finance Charge. The dollar amount the loan will cost you.	\$118,830.27
Amount Financed. The loan amount available after paying your upfront finance charge.	\$162,000.00
Annual Percentage Rate (APR). Your costs over the loan term expressed as a rate. This is not your interest rate.	4.174%
Total Interest Percentage (TIP). The total amount of interest that you will pay over the loan term as a percentage of your loan amount.	69.46%



Questions? If you have questions about the loan terms or costs on this form, use the contact information below. To get more information or make a complaint, contact the Consumer Financial Protection Bureau at www.consumerfinance.gov/mortgage-closing

Other Disclosures

Appraisal

If the property was appraised for your loan, your lender is required to give you a copy at no additional cost at least 3 days before closing. If you have not yet received it, please contact your lender at the information listed below.

Contract Details

See your note and security instrument for information about

- what happens if you fail to make your payments,
- what is a default on the loan,
- situations in which your lender can require early repayment of the loan, and
- the rules for making payments before they are due.

Liability after Foreclosure

If your lender forecloses on this property and the foreclosure does not cover the amount of unpaid balance on this loan,

- ☒ state law may protect you from liability for the unpaid balance. If you refinance or take on any additional debt on this property, you may lose this protection and have to pay any debt remaining even after foreclosure. You may want to consult a lawyer for more information.
- ☐ state law does not protect you from liability for the unpaid balance.

Refinance

Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

Tax Deductions

If you borrow more than this property is worth, the interest on the loan amount above this property's fair market value is not deductible from your federal income taxes. You should consult a tax advisor for more information.

Contact Information

	Lender	Mortgage Broker	Real Estate Broker (B)	Real Estate Broker (S)	Settlement Agent
Name	Ficus Bank		Omega Real Estate Broker Inc.	Alpha Real Estate Broker Co.	Epsilon Title Co.
Address	4321 Random Blvd. Somecity, ST 12340		789 Local Lane Sometown, ST 12345	987 Suburb Ct. Someplace, ST 12340	123 Commerce Pl. Somecity, ST 12344
NMLS ID					
ST License ID			Z765416	Z61456	Z61616
Contact	Joe Smith		Samuel Green	Joseph Cain	Sarah Arnold
Contact NMLS ID	12345				
Contact ST License ID			P16415	P51461	PT1234
Email	joesmith@ficusbank.com		sam@omegare.biz	joe@alphare.biz	sarah@epsilontitle.com
Phone	123-456-7890		123-555-1717	321-555-7171	987-555-4321

Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature

Date

Co-Applicant Signature

Date

CLOSING DISCLOSURE

PAGE 5 OF 5 • LOAN ID # 123456789

REPORTING REQUIREMENTS

Who must report What must be filed

Who must report

The Tax Reform Act of 1986 requires that persons designated by the act as "real estate brokers" must report a closed real estate transaction to the Internal Revenue Service and provide the information contained in the report to each party to the transaction. The act defines "real estate broker" as any of the following:

- ▶ the seller's broker
- ▶ the buyer's broker
- ▶ the settlement agent, escrow agent, attorney, title company or other party responsible for closing the transaction
- ▶ the mortgage lender
- ▶ anyone so designated by the Internal Revenue Service

What must be filed

The person reporting files a Form 1099-S information return with the Internal Revenue Service. This form includes the names and addresses of the parties to the transaction and information about the sale proceeds.

The reporting person also provides each party to the transaction with a written statement showing the name and address of the reporting party as well as the information reported in the 1099.

If the transaction involves a non-resident alien, the reporting person may also have tax reporting and withholding responsibilities under the Foreign Investment and Real Property Tax Act of 1980 (FIRPTA), the Deficit Reduction Act of 1984 (DEFRA), and/or the Branch Profits Tax and Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

21 Closings Snapshot Review

THE CLOSING EVENT

- The setting**
 - sale contract sets date, location, and who participates
- The closing process**
 - verify contract fulfillment; exchange consideration and title; pay expenses; sign final documents; arrange for recording the transaction
- Transfer of title**
 - seller gives evidence of marketability-- title abstract or title insurance commitment; may also need affidavit stating no new encumbrances incurred; seller must remove encumbrances or liens prior to the specified date; if seller is paying off mortgage lien, lender provides a payoff statement
- Transfer of purchase funds**
 - buyer produces funds and documents needed to complete the transaction
- Escrow procedures**
 - if closing "in escrow," escrow agent holds and disburses funds and releases documents when escrow conditions have been met
- Lender closing requirements**
 - common: survey, inspections, hazard insurance, title insurance, certificate of occupancy, reserves for taxes and insurance, private mortgage insurance
- Broker's role**
 - broker's role ranges from nil to conducting the proceedings to reporting the transaction

REAL ESTATE SETTLEMENT PROCEDURES ACT

- Information booklet**
 - lender must provide borrower with CFPB booklet, "Your Home Loan Toolkit"
- Loan Estimate**
 - lender must provide CFPB's H-24 Loan Estimate of settlement costs
- Mortgage servicing disclosure**
 - lender must disclose who will be servicing loan
- Closing Disclosure**
 - lender must use CFPB's H-25 Closing disclosure
- Disclosures after settlement**
 - loan servicers must provide annual escrow statements to borrowers
- Limits on escrow accounts**
 - places ceiling on amounts lenders may compel borrowers to place in escrow
- Referral fees and kickbacks**
 - RESPA prohibits payment of referral fees and kickbacks; business relationships between firms involved in the transaction must be disclosed

FINANCIAL SETTLEMENT OF THE TRANSACTION

- Settlement process**
 - identify closing costs; determine who pays what; do prorations; assign debits and credits; complete closing statement; disburse funds
- Selling terms and closing costs**
 - price, deposits, downpayment, financing, final expenses to be paid at closing; apportionment of expenses determined by sale contract or custom
- Debits and credits**
 - excess of buyer's debits over credits is amount buyer must produce at closing; excess of seller's credits over debits is amount seller must receive

Non-prorated items	incurred by one party only; not shared
Prorated items	incurred by buyer or seller in advance or arrears; shared by buyer and seller; typical: real estate taxes, insurance premiums, mortgage interest, rents
COMPUTING PRORATIONS	
12-month/30-day method	sale contract or local custom establishes methods of proration to be used for particular items
365-day method	determines average daily amount based on 12-month year and 30-day month
TAXES DUE AT CLOSING	
State taxes on deed	state, counties and municipalities may impose taxes on transfer
State taxes on mortgage	state may impose taxes on mortgages, notes and contracts
TILA/RESPA INTEGRATED DISCLOSURES RULE	
Forms and procedures	- effective October 3, 2015 - mandatory: Your Home Loan Toolkit booklet at loan application; Loan Estimate form 3 business days after loan application; Closing disclosure 3 business days before consummation
Good faith	- Loan Estimate costs based on best information available - Closing Disclosure costs equal estimate costs within certain tolerances
Types of charges	- no limitation on increase over estimate 10% tolerance charges 0 tolerance charges
Applicable transactions	- most closed-end consumer mortgages, including: construction loans, loans secured by vacant land, loans to trusts - not covered: home equity loans, reverse mortgages, loans on mobile homes, loans by small lenders (no more than 5 loans per year)
The H-25 form	5 pages, variable by loan type
REPORTING REQUIREMENTS	
Who must report	"real estate broker" defined by the Tax Reform Act of 1986; buyer's or seller's broker, settlement agent, mortgage lender, other IRS-designated party
What must be filed	- Form 1099-S Information Return - statements to each party - tax reporting and withholding if FIRPTA applies (non-resident alien)

22

Risk Management

Risk Management Strategies

Risk Management Procedures

Primary Areas of Risk

Risk is the chance of losing something. Its two dimensions are the probability of occurrence and the extent of exposure to monetary or non-monetary consequences. Since most risks are related to judgments and decisions, the real estate licensee, who makes numerous complex decisions every day, faces a high degree of *risk potential*.

Risk management is a structured approach to dealing with the uncertainties and consequences of risk. In real estate practice, the aim is to reduce risk to an acceptable level through anticipation and planning.

RISK MANAGEMENT STRATEGIES

Avoidance Reduction Transference Retention

Four well-established strategies for managing risk are:

- ▶ Avoidance (elimination)
- ▶ Reduction (mitigation, sharing)
- ▶ Transference (outsourcing, insuring)
- ▶ Retention (acceptance and budgeting)

Not all of these strategies are always possible or available, but a real estate firm or licensee who fails to make a conscious effort to employ one or more of them increases the likelihood of loss from the many potential risks that are always present in the real estate business.

Avoidance

Avoidance includes refraining from an activity that carries risk. One can avoid the risks of being in an automobile accident by not riding in automobiles. Avoiding risks also means missing the opportunity to benefit from the avoided activity. By avoiding automobile travel, one is confined to modes of transportation, such as buses and walking, that do not offer the same high degree of personal freedom and efficiency. Complete avoidance of risk in real estate practice is almost impossible. A broker, for instance, may believe that hiring only experienced affiliates eliminates the risk that affiliates will commit license law violations. However, even experienced practitioners may not know the law, and, sometimes, people break the law deliberately. The risk may be reduced, but it remains.

Reduction

Reduction involves taking steps to reduce the probability or the severity of a potential loss. However, this strategy may result in reducing risk in one area only to increase it in another. A familiar example is a sprinkler system that dispenses water to reduce the risk of fire but at the same time increases the risk of water damage.

In real estate practice, one risk reduction tactic is to share responsibility for making a decision. The agent provides the consumer with expertise, and perhaps some advice, but lets the consumer decide how much to offer. In this way, the agent gets some relief from the risks inherent in the buyer's decision to purchase.

Transference

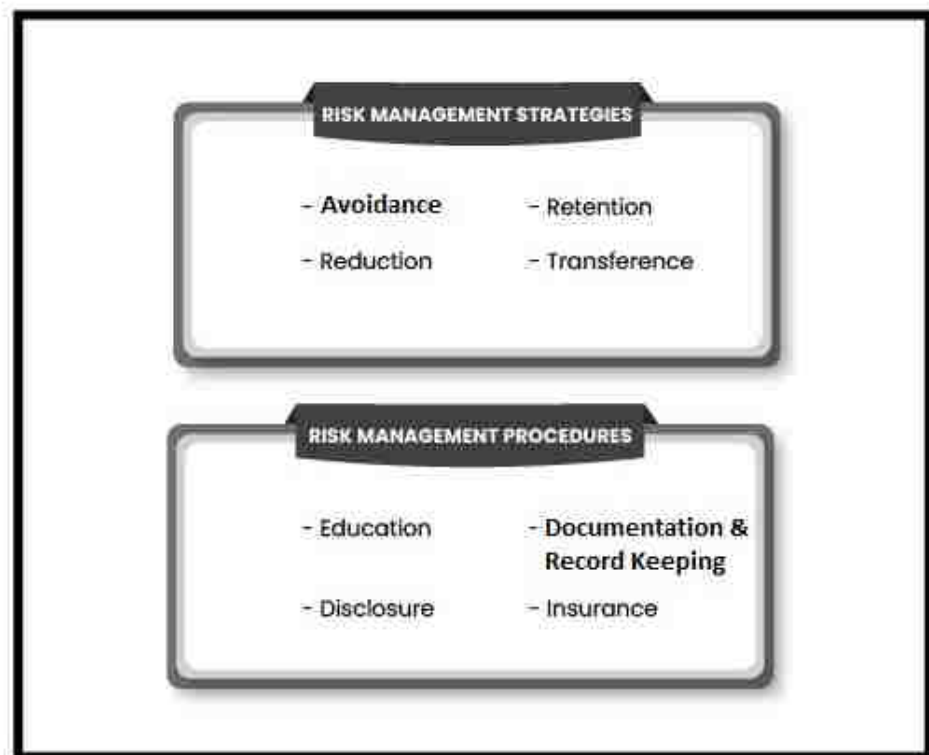
Transference means passing the risk to another party, by contract or other means. An insurance policy is the common example, but sometimes the wording of a sales or personal services contract can transfer risk without resorting to insurance.

In the real estate business, transference is typically and most successfully accomplished by means of an errors and omissions (E&O) insurance policy, either on the individuals in a firm or on the firm itself. State law may require such insurance.

Retention

Retention of risk means entering into an activity in spite of known risks and taking full responsibility for the consequences. This is, in effect, self-insurance, the only strategy left when risk cannot be reduced or transferred and one has decided not to avoid it because of the desirability of the potential benefits.

Exhibit 22.1 Risk Management Strategies and Procedures



RISK MANAGEMENT PROCEDURES

Education

Disclosure

Documentation and record keeping

Insurance

Experience shows that the most practical strategies for risk management in real estate practice are reduction and transference, with procedures focusing on:

- ▶ Education
- ▶ Disclosure
- ▶ Documentation
- ▶ Insurance

Education

Education is the first line of defense against risk. When agents are familiar with the forms provided by the office, how and when to complete them and where to send them, the likelihood of errors is reduced. Likewise, agents need to be able to identify and understand common contract elements, complete contract forms developed by attorneys, and evaluate offers received from co-op agents on their listings without committing a license violation or breach of law.

In most states, brokers have a legal obligation to provide training to affiliated licensees. Licensees also have the obligation to seek out appropriate education and training outside the brokerage to ensure that they know how to comply with the law. In addition, licensees must satisfy legal requirements for continuing education, while those who care about personal excellence will seek further education and training to enhance their professional skills.

Disclosure

By ensuring that all parties have the information they are entitled to, proper disclosure reduces the risk that clients and customers will accuse a licensee of misleading or inducing them to make a decision with incomplete information. Further, laws in every state require disclosures of one kind or another.

Disclosure may be made in writing or verbally and may or may not require written acknowledgment from the receiving party.

Required disclosures usually include:

- ▶ agency relationships
- ▶ property condition
- ▶ duties and obligations
- ▶ personal interest in the transaction
- ▶ personal interest in referrals

Documentation and Record keeping

Documentation provides evidence of compliance with laws and regulations. It proves what clients and customers and licensees said and did in a transaction. Some documentation is required by law.

The components of a thoroughly documented paper trail include:

- ▶ Policy and procedure manuals
- ▶ Standard forms
- ▶ Communication records
- ▶ Transaction records
- ▶ Contracts
- ▶ Accounting
- ▶ Other important documents

Policy manual. A written and uniformly enforced company policy lets everyone in the firm know what to expect before problems arise. The policy manual should cover the company's rules in such areas as floor duty privileges, assignment of relocation properties to agents, referrals between agents within the company, and requirements for continuing education, sales meeting participation, and property tours.

Procedures manual. A company procedures manual should spell out how to handle every aspect of the company's business that agents and brokers need to know—from handling consumers' funds and documents, conducting consumer transactions, dealing with MLS-related matters, and placing signage, to all procedures prescribed by state or federal law, especially license, banking and fair housing laws. Adherence to a procedures manual reduces the risk that an individual will inadvertently commit an unlawful act. Whenever changes are made to the policy or procedures manual, each agent should sign the revised manual as evidence that the agent has examined it.

Standard forms. Standard forms save time and protect against the unauthorized practice of law. Since they are most often prepared by lawyers familiar with the market area, they can address contingencies that are common in the area in a manner that reflects the real estate laws of the state. On the other hand, a licensee often needs to adapt a standardized form for a client by assisting with filling in blanks, modifying terms, and attaching addenda. The licensee must always remain aware of the limitations the state has placed on such activities.

Here are a few of the standard forms a brokerage should provide for its agents and affiliates:

- ▶ buyer and seller representation agreements
- ▶ agreement to show property
- ▶ purchase and sale agreement
- ▶ agency disclosure form
- ▶ property condition disclosure, disclaimer, and exemption form
- ▶ lease agreement
- ▶ personal interest disclosure form
- ▶ referral for service disclosure form
- ▶ lead-based paint disclosure form
- ▶ special disclosure forms (mold, radon, subsurface sewage system, impact fees/adequate facilities taxes, etc.)
- ▶ referral agreement
- ▶ independent contractor agreement
- ▶ closing checklist

Communication records. Some communications with transaction parties are good and necessary for business. Others are required by law, such as certain disclosures. A transaction checklist is a good tool for managing risk associated with the failure to make required communications to all principals and for keeping track of required communications from co-op agents.

Retaining evidence that information has been communicated is a necessary procedure. Electronic communications should be archived on suitable electronic media. Copies of mailed or faxed communications should be maintained in the transaction folder.

It is always difficult to document telephone or face-to-face conversations, especially with the constant use of cell phones from a variety of locations. It is a good practice to make brief notes at the time and then write them up later for mailing or faxing to the other party. Be sure, however, that you can produce these notes on demand, lest you be accused later of withholding documentation that has been promised.

Maintaining a good record of communications is useful for resolving disagreements where parties dispute what has been said because it allows the agent to produce a dated document that resolves the issue definitively.

Transaction records. State laws require licensees to document transactions. Firms are required to keep written records of all real estate transactions for a number of years (usually three to five) after closing or termination. Required records typically include:

- ▶ listing agreements
- ▶ offers
- ▶ contracts
- ▶ closing statements
- ▶ agency agreements
- ▶ disclosure documents
- ▶ correspondence and other communication records
- ▶ notes and any other relevant information

Accounting. In addition to other accounting records, there is the requirement to maintain written accounting of escrow funds. For each transaction, property, and principal, escrow records will include:

- ▶ depositor
- ▶ date of deposit
- ▶ date of withdrawal
- ▶ payee
- ▶ other information deemed pertinent by the real estate commission

Other documents. Additional documents may be required by law or regulation, or should be kept simply as protection in case of disputes and lawsuits. These would include copies of advertising materials, materials used in training agents, records of compliance with continuing education requirements, safety manuals,

and anything else that shows how the firm conducts its business and safeguards its staff as well as the rights of consumers.

Insurance

Many forms of insurance are available for property owners and managers. Some of these types are also used to manage certain risks of brokers and licensees.

General Liability. General liability insurance provides coverage for risks incurred by a property owner when the public or a licensee enters the owned property (**public liability**). The insurer pays the covered claim and legal fees, costs, and expenses, including medical expenses, resulting from owner negligence or other causes. This type of insurance does not cover **professional liability**, for which an Errors & Omissions policy is necessary.

Errors and Omissions. Professional liability is of two general types:

1. Unprofessional conduct – a claim that one has failed to carry out fiduciary duties and provide an acceptable standard of care
2. Breach of contract – a claim that one has failed to perform services under the terms of a contract in a timely manner

The primary method for transferring the professional liability risks of brokers, managers, and licensees is Errors & Omissions (E&O) insurance. A standard E&O policy provides coverage for “damages resulting from any negligent act, error or omission arising out of Professional Services.” A standard policy does NOT cover:

- ▶ violations of law
- ▶ fraudulent, dishonest, criminal or malicious acts
- ▶ mishandling of escrow moneys, earnest money deposits, or security deposits
- ▶ antitrust violations
- ▶ sexual harassment
- ▶ Fair Housing violations
- ▶ agent-owned properties
- ▶ environmental violations
- ▶ failure to detect or disclose environmental conditions, including mold
- ▶ acts committed prior to licensure or after termination of active status
- ▶ activities as an appraiser if licensing other than a real estate license is required

E&O insurance, in short, covers “mistakes” but not crimes.

Fire and hazard. The risks of property damage caused by fire, wind, hail, smoke, civil disturbance, and other such causes are covered by fire and hazard insurance.

Flood. The risks of property damage caused by floods, heavy rains, snow, drainage failures, and failed public infrastructures such as dams and levies are covered by a specialized flood policy. Regular hazard policies do not include flood coverage.

Other insurance. Other common types of insurance coverage for income and commercial properties include:

- ▶ **casualty**—coverage for specific risks, such as theft, vandalism, burglary, illness and accident, machinery damage
- ▶ **workers' compensation**—hospital and medical coverage for employees injured in the course of employment, mandated by state laws
- ▶ **contents and personal property**—coverage for building contents and personal property when they are not actually on the building premises
- ▶ **consequential loss, use, and occupancy**—coverage for the business losses resulting from a disaster, such as loss of rent and other revenue, when the property cannot be used for business
- ▶ **surety bond**—coverage against losses resulting from criminal or negligent acts of an employee

PRIMARY AREAS OF RISK

Agency
Property disclosures
Listing and selling process
Contracting process
Fair Housing
Antitrust
Rules and regulations
Misrepresentation
Recommending providers
Financing and closing
Trust fund handling
Safety And security

Risks for licensees are present every day in business transactions. Many of these risks carry legal implications as well as possible financial and professional consequences.

Exhibit 22.2 Real Estate Management Risks

Agency	Finance	Compliance
Disclosures	Trust Funds	Referrals
Contracting	Listing / Selling	Closing
Misrepresentation	Fair Housing / Antitrust	

Agency

The risks of agency will occur in one of two areas:

- ▶ the requirement to inform and disclose
- ▶ the requirement to carry out an agency duty.

Most states require agency relationships to be in writing and to be disclosed to all parties to a transaction. State law may spell out agency duties, or the duties may be a part of general agency law. In states that do not use agency, there is still the obligation to explain and disclose the nature of the relationship.

Disclosure requirements. A licensee may be acting in a transaction as facilitator, agent, subagent, designated agent, single agent, dual agent, non-agent or in some capacity. Regardless of status, the licensee must follow state disclosure requirements. These are, typically, to:

- ▶ disclose status **verbally** to other licensees on initial contact
- ▶ disclose status **verbally** to buyer and seller before providing real estate services
- ▶ confirm the disclosure **in writing** before signing a listing agreement or presenting a purchase offer (to an unrepresented seller) or before preparing a purchase offer (to an unrepresented buyer)
- ▶ get a **signed receipt** indicating the written disclosure has been made

Carrying out the duties of agency also require disclosures of :

- ▶ personal interest the agent has in a transaction (such as owner or buyer)
- ▶ personal benefit the agent will derive from a service referral
- ▶ required property and market information
- ▶ information about customers a client is entitled to have

Duties. A licensee who acts for a principal in a real estate transaction is required by law to assume certain responsibilities toward the parties to the transaction. Whether a state applies the fiduciary duties of agency law or specifies its own duties toward clients and consumers, the basic duties remain:

To all parties

- ▶ honesty
- ▶ fairness
- ▶ reasonable care and skill
- ▶ disclosures

To clients

- ▶ skill
- ▶ care
- ▶ diligence
- ▶ loyalty
- ▶ obedience
- ▶ confidentiality
- ▶ accounting
- ▶ full disclosure

The duty to exercise **skill, care and diligence** means that licensees may not be casual or negligent in their actions. Licensee negligence is actionable when principals are harmed by the licensee's failure.

The duty of **loyalty** requires the agent to *put the client's interests above those of everyone else*, including his or her own.

The duty of **obedience** requires the agent to act on the principal's wishes regarding the transaction as long as they do not result in any illegal action. The duty of obedience never overrides the legal obligation of agents to deal fairly and honestly with all parties.

The duty of **confidentiality** requires the agent to hold in confidence any information that would harm the client's interests or bargaining position or anything else the client wishes to keep secret, unless the law requires disclosure. The duty of confidentiality survives the termination of the listing contract.

The duty of **accounting** applies to all funds involved in a real estate transaction. Accounts must be maintained as required by law, and escrow funds are to be handled strictly in accordance with the law.

The duty of **disclosure** applies to both parties to a transaction, although usually with some differences. Proper disclosure to customers primarily concerns agency, property condition, and environmental hazards. To the client, it generally concerns all known facts regarding the property and the transaction, including information about the other transaction party. State laws prescribe what may, must, and must not be disclosed. Licensees must be vigilant to avoid oversights and conflicts of interest that can lead to a disclosure to the wrong party or disclosure of information that is confidential.

Conflicts of interest. Conflicts of interest arise when an agent forgets to put the best interests of a client ahead of those of everyone else. This can happen in situations involving undisclosed dual agencies, broker-owned listings, licensees buying for their own account, vendor referrals, and property management subcontracting of services, among many others. Even ordinary, everyday transactions carry a built-in risk of conflict of interest. Consider the fact that a licensee usually receives no compensation for a failed transaction. Therefore, it is in the licensee's interest to see the transaction completed, even if it may not be in the client's best interest. A negative result from a home inspection or other test has the potential to cause a buyer to back out of a contract. A licensee who has forgotten whose best interest should be primary might be tempted to recommend inspectors who will overlook problems in exchange for receiving referrals. Licensees must always disclose any self-interest they have in a transaction, and always remember their duties to clients and consumers.

Confidentiality. Licensees have a responsibility to maintain the confidentiality of certain kinds of information they obtain concerning clients and customers. The duty to maintain confidentiality generally survives the termination of a listing agreement into perpetuity. If it seems that revealing confidential information might benefit the client, the licensee should obtain the client's written permission to proceed.

Confidential information generally includes information about a client's motivations in a transaction, financial and personal details, and information specifically designated as confidential by the client. Public information, such as that contained in public records, information that becomes known without the licensee's participation, or that the client reveals to another, is not considered confidential.

State laws often require businesses to provide security for the personal information they obtain about consumers. Security procedures should protect personal information from unauthorized access, destruction, use, modification, or disclosure. Confidential information, when it is not to be retained, must be disposed of in a secure manner.

Penalties. Possible penalties for breach of agency relationships include:

- ▶ rescission of transaction
- ▶ loss of compensation
- ▶ fees and costs
- ▶ punitive damages
- ▶ ethics discipline
- ▶ license discipline

Property disclosures

Property condition. Most states require the seller of a residential property to deliver to the buyer a written disclosure or disclaimer about the property's condition, including any material defects the owner knows about. The disclosure is usually required before any purchase contract is accepted.. A second disclosure may be required at closing. The licensee should always obtain the parties' signatures acknowledging receipt of these disclosures.

Depending on the state, the licensee may have no further duty to disclose property condition after properly informing parties of their rights and obligations. However, the licensee may still be subject to legal action for

- ▶ deliberately distorting the facts (intentional misrepresentation)
- ▶ cheating any party (fraud)
- ▶ concealing or failing to disclose adverse facts which the licensee knew about or should have known about (intentional or unintentional misrepresentation)

Lead-based paint and other disclosures. Federal law requires sellers of houses built before 1978 to make a lead-based paint disclosure before accepting an offer to purchase. The licensee must tell the seller about this requirement, give the seller the proper disclosure form, and make sure that the buyer receives it.

The licensee must also make sure the seller discloses any other circumstances the situation and the law require, which may include:

- ▶ wood infestation inspection report
- ▶ soil test report
- ▶ subsurface sewage disposal system permit disclosure
- ▶ impact fees or adequate facilities taxes disclosure

Listing and selling process

- ▶ mold and radon reports or treatments

Nature and accuracy of the listing agreement. In most states, a listing agreement is enforceable only if it is in writing. Most states forbid net listings, because they violate the requirement that a valid listing agreement must specify a selling price and the agent's compensation. The licensee, in accordance with the duty of due diligence, must verify the accuracy of the statements in the listing regarding the property, the owner, and the owner's representations. Especially important facts for a broker or agent to verify are:

- ▶ the property condition
- ▶ ownership status
- ▶ the client's authority to act

An agent who does not act with a reasonable degree of due diligence in these matters may be exposed to liability if it turns out that the property is not as represented or the client cannot perform the contract as promised.

Comparative Market Analysis (CMA). In preparing a Comparative Market Analysis, licensees should guard against using the terms "appraisal" and "value," which are reserved for the use of certified appraisers. Misuse of these terms could lead to a charge of misrepresenting oneself as an appraiser. In discussing listed properties with clients or customers, real estate licensees should be careful to use guarded terms such as "recommended listing price," "recommended purchase price," and "recommended listing price range."

Agents should make every effort to help the sellers find a reasonable listing price based on the current market. If the CMA leads the seller to list at a price that is too high, the seller may blame the agent when the transaction fails because of an appraisal that comes in below the selling price. To minimize this risk, it is best to be conservative in the CMA and retain documentation that the seller went above the recommended price in spite of the agent's advice.

Estimate of Closing Costs. In preparing an estimate of closing costs for a seller or buyer, there is the risk of forgetting something, leading to an unpleasant surprise when the consumer suddenly faces unexpected costs or conditions. Licensees should use their broker's form, if there is one, and make it clear to the consumer that it is only an estimate of likely costs, not a statement of actual costs. In some states, brokers and agents do not prepare closing cost estimates, leaving that task to the lender.

Advertising. State and federal laws regulate advertising, including the federal Fair Housing laws as they pertain to discriminatory advertising and providing of services. Advertising includes electronic communication, social media/networking, and internet marketing. Usage must be consistent with company image and legal requirements. The license laws of most states list illegal advertising actions subject to discipline such as:

- ▶ making any substantial and intentional misrepresentation
- ▶ making any promise that might cause a person to enter into a contract or agreement when the promise is one the licensee cannot or will not abide by
- ▶ making continued and blatant misrepresentations or false promises through affiliate brokers, other persons, or any advertising medium
- ▶ making misleading or untruthful statements in any advertising, including using the term “Realtor” when not authorized to do so and using any other trade name, insignia or membership in a real estate organization when the licensee is not a member.

Committing such acts may result in license suspension or revocation.

Authorizations and Permissions. Licensees should stay within the bounds of the authority granted by the agency agreement or must not do anything requiring permission without first getting that permission in writing. For instance, permission should be obtained before doing any of the following unless the listing agreement specifically grants the authority:

- ▶ post a sign on the property
- ▶ remove other signs
- ▶ show the property
- ▶ hand out the property condition disclosure
- ▶ distribute marketing materials
- ▶ advertise in various media
- ▶ use a multiple listing service
- ▶ cooperate with other licensees
- ▶ divide the commission or negotiate a commission split
- ▶ share final sales data with the MLS
- ▶ place a lock box on the property
- ▶ appoint subagents
- ▶ appoint a designated agent
- ▶ change agency status

Scope of expertise. Real estate licensees are not, by nature, financial consultants, accountants, appraisers, soil scientists, well diggers, lawyers, decorators, contractors, builders, plumbers, carpenters, inspectors, prognosticators, and a number of other kinds of expert. However, in today’s competitive environment, consumers often demand much more from a licensee than the traditional basic services. An agent who fails to live up to prevailing standards may be held liable for negligence, fraud, or violation of state real estate license laws and regulations. At the same time, agents must be particularly careful about the temptation to misrepresent themselves as experts and offer inappropriate expert advice. Disclaimer and referral are always the best risk control procedures to forestall an accusation of misrepresentation from a consumer who claims to have been harmed by reliance on the licensee’s non-existent expertise. The exact nature of the services to be provided should be stated as clearly as possible in the listing agreement.

Contracting process According to the Statute of Frauds, all contracts for real estate must be in writing to be enforceable. Contracts that contain incorrect information or are inadequately prepared can pose a serious liability for a licensee. To avoid such a situation, it is imperative for the contract to reflect the terms that the parties have agreed upon in the most accurate and honest manner. The agent must also be careful to comply with the letter of the real estate law. Violations can jeopardize the enforceability of a listing or sales contract, in addition to resulting in criminal prosecution.

Common risks and errors in the contracting process include:

- ▶ using an illegal form

A licensee may be punished for using any real estate listing agreement form, sales contract form, or offer to purchase form that lacks a *definite termination date*.

- ▶ failing to state inclusions and exclusions

The parties should identify as included in or excluded from the transfer any ambiguous items. Unwritten agreements between the parties are a source of later dispute and trouble.

- ▶ failing to track the progress of contingency satisfaction

The time period for completing contingencies such as inspections is specific and limited. Failure to meet or waive a condition may terminate the contract. A “time is of the essence” clause in the standard agreement makes the time period for contingencies critical.

- ▶ mistakes in entering data in a form

All data should be checked and verified: dates, times, amounts, warranties, descriptions, names, representations, promises, procedures, authority, etc. One way to reduce risk in the contracting process is to use a checklist that covers all the contract items.

Unauthorized practice of law. The unintentional practice of law without a license is a great risk in the contracting process, as well as in the representation process. It is illegal for real estate professionals who are not attorneys to draw up contracts for transactions they are not involved in or to charge a separate fee for preparing a contract.

Such licensees may fill in blanks or make deletions on a preprinted contract form prepared by a lawyer. While a licensee may make deletions, additions to a form should be drafted by an attorney. The principals themselves can make changes as long as each change is signed or initialed by all signers. Preprinted riders can often be attached as addenda to a contract without an attorney.

It is also illegal for real estate licensees who are not lawyers to give legal advice or interpret contract language. Licensees, however, may express opinions. For

instance, if a licensee believes that a party has grasped the meaning of a contract, it is permissible to say something like, "Though I am not an attorney, in my opinion your understanding of this contract is correct." It would be questionable to make a definitive statement like, "That's correct."

Fair Housing

The risk of violating fair housing laws can be minimized through ongoing education that addresses both the content and the intent of the laws. It is especially necessary for paperwork and documentation to be accurate and concise in a situation where a fair housing issue could arise.

Advertising. The Fair Housing Act forbids real estate advertising that mentions race, color, religion, national origin, sex, handicap, or familial status in any way that suggests preference or discrimination. State laws may add other protected categories, such as creed and age.

Risk can be reduced by the use of street names or other non-biased geographical references when stating where the property is located, and by describing the property rather than the type of persons who might live in or around it. Even if a home appears "ideal for a young family," it is best not to advertise it as such. Such advertising would exclude other groups such as singles, the elderly, and older families.

In advertising the sale or rental of housing covered by the Fair Housing Act, HUD recommends using the Fair Housing Logo or phrase "Equal Housing Opportunity."

Answering questions. When faced with questions that might lead to a *steering* charge or other violation of fair housing laws, it is best for the licensee to limit the response to features of the home and to the process of selling, buying, and listing properties, and refer the questioner to someone else to answer questions about such matters as the demographic make-up of the neighborhood. It is illegal for the licensee to voice an opinion based on race, religion, color, creed, national origin, sex, handicap, elderliness, or familial status. The agent should explain this fact to the buyer and be wary of any situation where the agent's behavior might be construed as discriminatory.

Listing agreements. Before entering into a listing agreement, a licensee should explain that it is necessary to comply with fair housing laws and obtain the potential client's acknowledgment and agreement. The agent should make it clear that the agent will

- ▶ reject the use of terms indicating race, religion, creed, color, national origin, sex, handicap, age or familial status to describe prospective buyers.
- ▶ terminate the listing if the seller uses race, religion, creed, color, national origin, sex, handicap, age, or familial status in the consideration of an offer.
- ▶ inform the broker if the seller makes any attempt to discriminate illegally.

Offers. A seller cannot refuse to sell a property to an individual based on the individual's belonging to a protected class, and if this is attempted, the real estate professional must not be involved. If the seller asks about the color, religion, creed, national origin, ethnicity, age, or familial status of a buyer, the agent must explain that it is illegal to give out such information. The best risk reduction procedure is to treat all buyers and sellers equally, showing no preference for one over another.

Antitrust

Antitrust laws forbid brokers to band together to set a price on their services in listing and selling property. Even being overheard discussing commission rates or being present at such a conversation can lead to charges of *price fixing*.

The law recognizes that some cooperative arrangements between firms – such as joint development projects – may help consumers by allowing these firms to compete more effectively against each other. Even so the government does not prosecute all agreements between companies, but only those that will raise prices for the public or deny the public new and better products.

Sherman Antitrust Act. The *Sherman Antitrust Act* makes illegal all contracts, agreements, and conspiracies among competitors that would unfairly restrict interstate trade by fixing prices, rigging bids, or other means. An unlawful monopoly is created when one company becomes the only supplier of a product or service by getting rid of competition via secret agreements with other companies. **Clayton Act.** The *Clayton Act* prohibits mergers or acquisitions that are likely to lessen competition and increase prices to consumers. The Act also prohibits certain other business practices that under certain circumstances may harm competition. Private parties injured by an antitrust violation may sue in federal court for three times their actual damages, plus court costs and attorneys' fees.

Federal Trade Commission Act. The *Federal Trade Commission Act* forbids unfair competition in interstate commerce but establishes no criminal penalties.

Enforcement. Federal antitrust laws are enforced in three main ways:

- ▶ the Antitrust Division of the Department of Justice (DOJ) brings criminal and civil enforcement actions
- ▶ the FTC brings civil enforcement actions
- ▶ private parties bring lawsuits claiming damages

To collect evidence, Department of Justice lawyers often work with the Federal Bureau of Investigation (FBI) on court-authorized searches of a business, monitoring phone calls and employing informants equipped with secret listening devices.

State attorneys general may sue under the Clayton Act on behalf of injured consumers in their states, and groups of consumers often bring lawsuits on their own.

Rules and regulations

Anyone associated with an organization found guilty of an antitrust violation and determined to have had knowledge of that violation may also suffer legal consequences.

Penalties. Penalties for Violation of Antitrust Laws include:

- ▶ fines for individuals and corporations, as well as possible imprisonment.
- ▶ Under the Clayton Antitrust Act, parties can sue antitrust violators and recover three times the damages they incurred plus court costs and attorneys' fees.

State real estate laws and commissioners' rules and regulations attempt to cover every possible risky situation. Non-compliance poses a direct threat to the legal and financial status of licensee and license in the following general ways:

- ▶ license expiration
- ▶ license revocation or suspension
- ▶ licensee discipline
- ▶ suit for damages

License expiration. Licenses expire because licensees neglect to:

- ▶ maintain E & O insurance when required
- ▶ meet education requirements
- ▶ observe correct renewal procedures

License revocation or suspension. Licenses are typically revoked or suspended when a licensee is found guilty of:

- ▶ obtaining a license under false pretenses
- ▶ committing a "prohibited act"
- ▶ neglecting to present every written offer as required
- ▶ neglecting to deliver signed copies of accepted offers to transaction parties as required
- ▶ failing to make sure that all required terms and conditions are present in a contract to purchase
- ▶ handling earnest money and other escrow funds improperly

Licensee discipline. A state real estate commission may assess a civil penalty for violations of a statute, rule, or order. Licensees are disciplined for:

- ▶ acting without a license when a license is required
- ▶ demanding a referral fee without reasonable cause
- ▶ entering into a net listing
- ▶ trying to induce another licensee's client to end or change an existing agency contract
- ▶ paying a commission to an unlicensed individual or company
- ▶ receiving an illegal referral fee, rebate or kickback
- ▶ practicing with an expired license

Licensee lawsuits. A licensee may be sued by the Department of Justice, Federal Trade Commission, a state real estate commission, a human rights commission, another licensee or firm, or an individual consumer. Licensees are mainly sued for:

- ▶ fair housing violations
- ▶ antitrust violations
- ▶ license law and other state law violations
- ▶ breach of contract
- ▶ agency duty violations
- ▶ illegal practice of law
- ▶ failures to disclose
- ▶ customer or client dissatisfaction
- ▶ fraud
- ▶ theft

Misrepresentation Misrepresentation may be unintentional or intentional.

Unintentional misrepresentation. This type of misrepresentation occurs when a licensee *unknowingly* conveys inaccurate information to a consumer concerning a property, financing or agency service. False or inaccurate information that the licensee, as a professional, should have known to be false or inaccurate may be included in the definition. Those found guilty generally have to pay fines and may be disciplined by state real estate regulators and professional organizations.

Risky areas for unintentional misrepresentation include:

- ▶ making and reporting measurements
- ▶ describing property
- ▶ offering opinions about future growth and development of a neighborhood or neighboring property
- ▶ making declarative statements about the presence or absence of hazardous materials

The risks of unintentional misrepresentation are reduced if an agent

- ▶ learns to measure and calculate areas accurately
- ▶ relies on measurements reported by others only with extreme caution and specific disclaimers
- ▶ refrains from exaggeration
- ▶ avoids stating opinions a consumer might take for expertise

Intentional misrepresentation. Also known as fraud, this kind of misrepresentation occurs when a licensee *knowingly* conveys false information about a property, financing or service. Fraud is a criminal act that may result in fines and incarceration, in addition to discipline from state regulators and professional organizations.

Recommending providers

There are several risks attending the recommendation of vendors and service providers to a consumer. First, the consumer may not be satisfied with the performance of the recommended party and blame the licensee. Second, in cases where a recommended provider performs illegal acts, there may be legal

Financing and closing

consequences for the licensee. Third, if a licensee has a business relationship with a recommended vendor or provider and neglects to disclose the fact, there are license violation consequences.

The major risk management technique is to shift the responsibility for choosing a vendor to the consumer. This can be done by refusing to recommend vendors at all; by presenting a broad range of choices and allowing the consumer to select; or by presenting a short list of thoroughly vetted vendors and allowing the consumer to make the decision, always with the disclaimer that *to the best of the licensee's knowledge*, the vendors on the list are competent and honest, but that the consumer is responsible for investigating and making his or her own judgment before hiring or buying.

In the financing and closing phases of a transaction, a consumer may feel that a licensee has been incompetent or misleading. Licensees have an obligation to inform and educate their clients throughout the transaction process. Surprises and accusations of incompetence or misrepresentation are among possible results of failing to keep the party informed.

Discrimination. Of course, it is important to comply with relevant laws. Licensees must be mindful of the requirements of ECOA and refrain from participating in any manner of discriminatory lending. It is illegal to:

- ▶ threaten, coerce, intimidate or interfere with a person who is exercising a fair housing right or assisting another other to exercise that right.
- ▶ indicate a limitation or preference based on race, color, national origin, religion, sex, familial status, or handicap in any advertisement or communication. Single-family and owner-occupied housing that is otherwise exempt from the Fair Housing Act is subject to this prohibition against discriminatory advertising.

Progress reporting. All inspections and tests must comply with local and state laws and with the purchase contract. Progress reports should be accurate, timely, in writing, and free of speculation. If a consumer has a question about the meaning of something in an inspection report, the licensee should refer the consumer to the person who wrote the report rather than trying to explain it. This method transfers some of the risk inherent in interpreting the report.

Qualifying buyers. Many transactions fail because a buyer has been improperly qualified before the offer is presented. Using a lender to qualify the buyer saves time and protects the agent against leading a seller to believe a purchaser is fully qualified when this may not be the case. Also, lenders and loan agents are better able to look into the buyer's qualifications than a real estate licensee is. If it becomes necessary to show a property to a potential buyer who has not been qualified by a lender, the licensee can gain some protection by performing an informal qualification and documenting the fact that it was based on the information provided by the buyer. The buyer's signature on this documentation

indicates the buyer's acceptance of at least partial responsibility for the qualification.

Lending fees disclosure. The licensee should explain loan fees, charges,

amounts, timing, and responsibilities. Agents can assist in the loan decision by explaining how to compare loans with differing charges and interest rates. The fact that a high origination fee and points may make a loan with a low interest rate unattractive to a borrower is important information for the agent to provide, and providing it may protect the agent against a later complaint that the buyer suffered a loss because of the agent's failure to inform.

Appraisal problems. Delays and appraised value are the typical problem areas. Failure to inform parties about delays can compromise the transaction. An under-appraisal will require the buyer to make a larger down payment or the seller to lower the price. If the property appraises for more than the purchase price, the seller may blame the agent for suggesting the lower price. In such a case, the seller's agent's defense is that the seller agreed to the listing price and that the price was a factor in attracting the buyer to the property.

RESPA Violations. The **Real Estate Settlement Procedures Act (RESPA)** stipulates that the parties to certain purchase transactions must be given accurate information reflecting their closing costs. It also prohibits certain business practices that are not considered to be in the consumer's best interest.

The licensee's risks regarding RESPA primarily relate to

- ▶ failing to ensure that the consumer is informed about his or her rights under the law
- ▶ giving or receiving an illegal kickback.

RESPA currently requires lenders to:

- ▶ give a copy of a Consumer Financial Protection Bureau loan information booklet to the applicant. The booklet explains RESPA provisions, general settlement costs, and the required **Closing Disclosure** form. The lender must provide the estimate of closing costs within three business days following the borrower's application.
- ▶ give the applicant a Loan Estimate (Form H-24) of expected closing costs within three business days of receiving the application. Actual closing costs may not vary from the estimate beyond certain limits.
- ▶ give the buyer the Closing Disclosure (Form H-25) specifying costs to be paid by buyer and seller at closing three business days before consummation.
- ▶ give the **buyer** the opportunity to review the final settlement statement *one business day prior to closing*.

RESPA specifically *prohibits* any fee or kickback paid to a party for a service when the party has not actually rendered the service. For example, it is prohibited for an insurance company to pay a real estate agent or a lender for referring a client.

Fees for referring clients to the following services are strictly forbidden:

- ▶ title services (search, insurance)
- ▶ appraisals
- ▶ inspections
- ▶ surveys
- ▶ loan issue
- ▶ credit report
- ▶ attorney services

The sharing of commissions and the payment of referral fees among cooperating brokers and multiple-listing services are not RESPA violations.

Trust fund handling

State laws prescribe how licensees must handle any escrow or earnest money deposits they receive. Those laws usually state that a broker must hold money received in connection with the purchase or lease of real property in a trust fund account. The type of account and financial depository are specified. The broker must record receipt of the money and place that money in the trust account within a specified time period. Usually, the law allows the broker to hold an earnest money check uncashed until the offer is accepted, provided the buyer gives written permission and the seller is informed.

Typical trust fund handling requirements include:

- ▶ the broker named as trustee of the account
- ▶ a federally-insured bank or recognized depository located in the state
- ▶ an account that is not interest-bearing if the financial institution ever requires prior written notice for withdrawals
- ▶ maintenance of records in a particular accounting format
- ▶ separate records kept for each beneficiary, property, or transaction
- ▶ records of funds received and paid out regularly reconciled with bank statements
- ▶ withdrawals only by the broker-trustee or other specifically authorized person

Commingling and conversion. Mixing of personal or company funds with client funds is grounds for the revocation or suspension of a real estate license. Depositing client funds in a personal or business account, or using them for any purpose other than the client's business, is also grounds for suspension or revocation of a license. It is important for the broker to remove commissions, fees or other income earned by the broker from a trust account within the period specified by law to avoid committing an act of commingling.

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Risk Management Snapshot Review

RISK MANAGEMENT STRATEGIES

- two dimensions of risk: size, probability; risk management: structured approach to uncertainty
- Avoidance**
 - refrain from risky activity
- Reduction**
 - reduce probability; share responsibility
- Transference**
 - pass risk by contract; insurance
- Retention**
 - accept risk; self-insurance

RISK MANAGEMENT PROCEDURES

- Education**
 - train in laws, forms and procedures, job performance
- Disclosure**
 - provide information to reduce misunderstanding & lawsuits; agency, property condition, duties, personal interest
- Documentation and record keeping**
 - maintain evidence of compliance; manuals, forms, records, contracts, accounting, other documents
- Insurance**
 - general liability, E & O, fire and hazard, flood, casualty, workers, personal property, consequential loss, surety bond

PRIMARY AREAS OF RISK

- Agency**
 - main failures: to inform and disclose, to fulfill duties
 - disclosures: verbal, written, signed receipt; agency relationship and duties; personal interest in transaction; required information
 - duties: to all– honesty, fairness, care, skill, required disclosures; additional to clients– diligence, loyalty, obedience, confidentiality, accounting, full disclosure
 - conflicts of interest arise from failing to put client’s interest first
 - confidentiality duty lasts forever; laws define what is confidential, how to treat and dispose of information
 - penalties include loss of transaction, compensation, fees and costs, damages, license
- Property disclosures**
 - property condition, lead-based paint, other conditions; disclosure may discharge liability; failure to disclose may be construed as misrepresentation
- Listing and selling process**
 - areas of risk include listing agreement accuracy, Comparative Market Analysis results, closing cost estimates, advertising, authorizations and permissions, exceeding expertise
- Contracting process**
 - contracts for real estate must be in writing; inaccuracy endangers contract; other risks: illegal form, omitted elements, lapsed contingencies, wrong data
 - unauthorized practice of law: non-lawyers may fill in blanks and delete words on standard contract forms; no legal advice to public allowed
- Fair Housing**
 - advertising may not state preference, limitation or discrimination based on race, color, religion, national origin, sex, handicap, familial status
 - agent must not be involved with discriminatory actions of a client or customer

Antitrust	● government prosecutes cooperative arrangements that raise prices or reduce consumer choices; Sherman Antitrust Act outlaws restraint of trade; Clayton Act outlaws practices that harm competition; Federal Trade Commission Act outlaws unfair methods of competition ● violations punishable by government criminal and civil actions as well as by private lawsuits; fines, damages, and imprisonment possible
Rules and regulations	● violators of state rules and regulations risk license expiration, revocation, suspension, and other discipline ● prime causes of discipline include commission of prohibited acts, practicing with an expired license, disclosure failures, earnest money mishandling
Misrepresentation	● unintentional: inaccurate information conveyed unknowingly; subject to fines and license discipline; occurs most often in measurements, property descriptions ● intentional: fraud, knowingly conveying false information; criminal act subject to fines, license discipline, and incarceration
Recommending providers	● risks include consumer dissatisfaction, possible vicarious liability for illegal acts committed by a recommended provider, undisclosed business relationship (RESPA violation as well as license violation) ● best practice: do not recommend any vendors, or provide a list of trusted vendors with no recommendation and a disclaimer
Financing and closing	● risk areas include fair housing and ECOA violations; failed transactions because of agent failure to monitor contingency period; failure to ensure proper disclosure of closing costs; RESPA violations
Trust fund handling	● risk areas include mishandling of earnest money deposits; commingling and conversion of trust funds; errors in use of trust accounts

23 Property Management

Management Functions
The Management Agreement
Leasing Considerations
The Management Business

MANAGEMENT FUNCTIONS

Reporting
Budgeting
Renting
Property maintenance
Construction
Risk management

Property management is a specialty within the real estate profession. Many states require persons who manage real estate on behalf of other persons or entities to be licensed as real estate brokers. Other states license such persons specifically as property managers. Real estate firms that handle the sale of commercial and investment properties are in a natural position to manage those properties for their owners. Some property managers work for firms that manage multiple properties under blanket management contracts. Others are independent agents. Some are employees of the owner. They generally fall into one of the following categories:

- ▶ **individual property manager**-- usually a real estate broker who manages properties for one or more owners; may belong to a small property management firm devoted to full-time property management, be self-employed, or be one of several managers in a large real estate firm.
- ▶ **individual building manager**-- usually manages a single large property; may be employed by a property manager or directly by an owner; may or may not have a real estate license.
- ▶ **resident manager** (residential properties only)-- lives on the property and may be employed by a real estate broker, a managing agent or an owner to manage a property on a part-time or full-time basis; may be required by state law for properties of certain types and sizes.

A manager has a fiduciary relationship with the principal and, in general, is charged with producing the greatest possible net return on the owner's investment while safeguarding the value of the investment for the owner/investor. At the same time, the manager has some responsibilities to tenants, who want the best value

and the best space for their money. Professional managers are therefore much more than rent collectors. They need technical expertise in marketing, accounting, finance, and construction. Property managers often specialize in one type of property - apartment, office, retail, industrial, farm, single-family-and acquire specialized knowledge of that property type. Whatever the property type and management arrangement, the manager's work involves leasing, managing, marketing, and maintaining the property. The services a manager provides thus can be seen to fall into three areas: financial, physical, and administrative. Specific functions, duties, and responsibilities are determined by the management agreement, although most agreements will include at least the following functions.

Reporting

Financial reporting to the principal is a fundamental responsibility of the property manager. Reports may be required monthly, quarterly, and annually. Required reports typically include an annual operating budget (see below); monthly cash flow reports indicating income, expenses, net operating income, and net cash flow; profit and loss statements based on the cash flow reports and showing net profit; and budget comparison statements showing how actual results match the original budget.

Budgeting

An operating budget based on expected expenses and revenues is a necessity for management. The budget will determine rental rates, amounts available for capital expenditures, required reserve funds, salaries and wages of employees, amounts to be paid for property taxes and insurance premiums and mortgage or debt service. It will indicate the expected return, based on the previous year's performance. A typical budget will contain a projection, also based on past performance and on current market information, of income from all sources, such as rents and other services, and of expenses for all purposes, such as operating expenses, maintenance services, utilities, taxes, and capital expenditures. Operating statements itemizing income and expenses are then presented to the owner on a regular basis so that the owner can evaluate the manager's performance against the budget.

Income. The total of scheduled rents plus revenues from such sources as vending services, storage charges, late fees, utilities, and contracts is the *potential gross income*. Subtracting losses caused by uncollected rents, vacancies and evictions gives *effective gross income*. Operating expenses are subtracted from this total to show *net operating income*. When debt service and reserves (which are not counted as operating expenses) are subtracted, the result is *cash flow*.

Expenses. Expenses may be fixed or variable. Fixed expenses are those that remain constant and may include operating expenses, regular maintenance costs, and administration. Variable expenses are those that may change from month to month or occur sporadically, such as specific repairs or capital expenditures.

Capital expenditures. Expected expenditures for major items such as renovation or expansion should be included as a budgeting item. Large-scale projects are typically budgeted over a period of years.

Cash reserve. A cash reserve is a fund set aside from operating revenues for variable expenses, such as supplies, redecorating, and repairs. The amount of the reserve is based on experience with variable expenses in previous years.

Renting

The property manager, whose full responsibilities include maintaining and managing the property in accordance with the owner's financial goals, include seeing that the property is properly rented and tenanted. The manager may use the services of a leasing agent, whose concern is solely to rent the space. In such a situation, some of the manager's tasks may be performed by the leasing agent. Renting the property includes the following tasks, regardless of which party is actually performing them.

Controlling vacancies. There are many possible reasons for vacancies in a building:

- ▶ rent too high or too low
- ▶ ineffective marketing
- ▶ management quality
- ▶ poor tenant-retention program
- ▶ image and appearance problems
- ▶ high market vacancy rate

Successful managers look for these factors and take steps to limit or counteract their effects.

Marketing. Finding and attracting the right kind of tenants for a property is the aim of a marketing program. A marketing plan based on the property's features and the relationship between supply and demand in the market area, and consonant with the money available, will determine the best mix of advertising and promotional activities. Marketing methods include:

- ▶ billboard advertising
- ▶ brochures and fliers
- ▶ meetings and presentations
- ▶ networking
- ▶ newspaper ads
- ▶ radio and television advertising
- ▶ signs
- ▶ tenant referrals
- ▶ websites and online services

The efficiency of marketing activities can be judged in terms of how many prospects per completed lease they generate. The lower the cost per prospect per lease, the more effective and efficient the program.

Setting rents. Rental income must be sufficient to cover fixed expenses, operating expenses, and desired return on investment. But rental rates must also be realistic, taking into account what is happening in the market. The manager must consider prevailing rents in comparable properties as well as vacancy rates in the market and in the property. The manager makes a detailed survey of competitive space

and makes adjustments for differences between the subject property and competing properties before setting the rental rates for the property. Residential apartment rates are stated in monthly amounts per unit, while commercial rates are usually stated as an annual or monthly amount per square foot. If vacancy rates in the managed property are too high, the manager may have to lower rates or identify problems in the property or its management that are contributing to vacancy level. On the other hand, if the property's vacancy rate is significantly lower than market rates, the manager may conclude that higher rental rates are called for.

Selecting tenants. To ensure that the property produces the desired level of income from rent, it is essential to find the most suitable tenants. For commercial space, the manager must determine that:

- ▶ the space meets the tenant's needs for size, configuration, location, and quality.
- ▶ the tenant will be able to pay for the space.
- ▶ the tenant's business is compatible with that of other tenants.
- ▶ there is room for expansion if the tenant's need for space is likely to grow.

For residential space, in addition to ascertaining the tenant's creditworthiness, the manager must be careful to comply with all federal and local fair housing laws. A manager should collect the same type of information on all prospective tenants. However, even though the law prohibits discrimination on the basis of race, sex, age and other protected classes, a manager may discriminate in certain other ways. For example, a manager has the right to refuse to rent to a person who has a history paying rent late, damaging property, fighting with other tenants, or spotty employment.

Collecting rents. The lease agreement should clearly specify the terms of rental payment. The manager must establish a system of notices and records as well as a method of collecting rents on schedule. Compliance with all state laws and regulations concerning collecting and accounting for rents is a necessity to avoid unwanted legal complications. As for monies received, the manager must follow trust fund handling procedures established by law and laid out in the rental and management agreements. If authorized by the management agreement, the manager may also collect security deposits and handle them as required by law.

Maintaining tenant relations. Happy tenants remain in a rented space longer than unhappy tenants. High tenant turnover adds to increased advertising and redecorating expenses. For these reasons, it is incumbent on the manager to

- ▶ communicate regularly with tenants
- ▶ respond promptly and satisfactorily to maintenance and service requests
- ▶ enforce rules and lease terms consistently and fairly
- ▶ comply with all relevant laws, such as fair housing and ADA (Americans with Disabilities Act) regulations

Property maintenance

Legal issues (Fair Housing, ADA, and ECOA). Fair housing laws govern landlords and tenants just as they do sellers and buyers. They ensure that persons receive fair treatment regardless of race, color, religion, national origin, sex, handicap, or familial status. Families with children must receive equal treatment with those who do not have children. Landlords cannot charge higher rents or security deposits because of the presence of children. Managers must make sure that their marketing and leasing practices are in accordance with fair housing laws.

The Americans with Disabilities Act similarly requires landlords in certain circumstances to make housing and facilities available to disabled persons without hindrance. Familiarity with this law and with the latest state, federal, and local fair housing laws is essential.

The Equal Credit Opportunity Act, which prohibits discrimination in lending, applies to how property managers evaluate potential tenants. The manager must be consistent in evaluating the creditworthiness of applicants. The same application forms and the same credit requirements should be used with all applicants.

Physical maintenance of the property is one of the property manager's primary functions. The costs of services provided must always be balanced with financial objectives and the need to satisfy tenant needs. The manager will also be concerned with staffing and scheduling requirements, in accordance with maintenance objectives.

Maintenance objectives. The foremost maintenance objective is generally to preserve the value of the physical asset for the owner over the long term. Although not every property is best served by vast expenditures on top-level maintenance, it is almost always important to maintain the viability of the property as a rental. Three general types of maintenance are required to keep a property in serviceable condition: routine, preventive, and corrective.

Routine maintenance. Routine maintenance activities are those necessary for the day-to-day functioning of the property. Regular performance of these activities helps to keep tenants satisfied as well as forestall serious problems requiring repair or correction. Routine activities are such things as:

- ▶ regular inspections
- ▶ scheduled upkeep of mechanical systems-heating, air-conditioning, rest rooms, lighting, landscaping
- ▶ regular cleaning of common areas
- ▶ minor repairs
- ▶ supervision of purchasing

Preventive maintenance. Preventive maintenance goes beyond the routine in attempting to deal with situations that can become serious problems if ignored. Seasonal or scheduled replacement of appliances and equipment, regular painting of exterior and interior areas, and planned replacement of a roof are a few examples.

Corrective maintenance. When routine and preventive maintenance fail, repairs and replacements become mandatory to keep the property operational. A boiler may develop a leak, an air-conditioning unit may break down, an elevator may cease to function properly.

Maintenance contracting. Depending on building type and size, tenant needs, and budgetary constraints, a manager may decide to hire an outside firm to handle maintenance services rather than hiring on-site employees. Efficiency, competence, responsiveness, and effective cost will be major deciding factors.

Construction

Commercial and industrial property managers are regularly called upon to make alterations to existing space to accommodate a tenant's needs. They may also have to undertake or oversee construction that alters or expands common areas or the entire building itself. Again, such work may be contracted out or done by in-house employees.

Tenant improvements. Alterations made specifically for certain tenants are called build-outs or tenant improvements. The work may involve merely painting and re-carpeting a rental space, or erecting new walls and installing special electrical or other systems. In new buildings, spaces are often left incomplete so that they can be finished to an individual tenant's specifications. In such cases, it is important to clarify which improvements will be considered tenant property (trade fixtures) and which will belong to the building.

Renovations. When buildings lose functionality (become functionally obsolescent), they generally also lose tenants, drop in class, and suffer declining rental rates. Maintenance becomes more expensive because of the difficulties of servicing out-of-date building components. Renovation may solve some of these problems, but the manager will have to help the owner determine whether the costs of renovation can be recovered by increased revenues resulting from the renovation.

Environmental concerns. A variety of environmental concerns confronts a property manager, ranging from air quality to waste disposal, tenant concerns, and federal, state and local environmental regulations. The managed property may contain asbestos, radon, mold, lead, and other problematic substances. Tenants may produce hazardous waste. The manager must be aware of the issues and see that proper procedures are in place to deal with them, including providing means for proper disposal of hazardous materials, arranging for environmental audits and undertaking possible remediation. For instance, an audit may show that a building is causing tenants to become sick because of off-gassing from construction materials combined with a lack of ventilation. Remediation may consist of nothing more than replacing carpets and improving ventilation, and the manager, if empowered to do so, should take the necessary steps.

Legal concerns (ADA). The Americans with Disabilities Act requires managers to ensure that disabled employees and members of the public have the same level of access to facilities as is provided for those who are not disabled. Employers with at least fifteen employees must follow nondiscriminatory employment and hiring practices. Reasonable accommodations must be made to enable disabled employees to perform essential functions of their jobs. Modifications to the

physical components of the building may be necessary to provide the required access to tenants and their customers, such as widening doorways, changing door hardware, changing how doors open, installing ramps, lowering wall-mounted telephones and keypads, supplying Braille signage, and providing auditory signals. Existing barriers must be removed when the removal is "readily achievable," that is, when cost is not prohibitive. New construction and remodeling must meet a higher standard. Managers must be aware of the laws and determine whether their buildings meet requirements. If not, the manager must determine whether restructuring or retrofitting or some other kind of accommodation is most practical.

Risk management

Many things can go wrong in a rented property, from natural disaster to personal injury to terrorism to malfeasance by employees. Huge monetary losses for the owner, in the form of civil and criminal penalties, legal costs, fines, damages, and costs of remediation can be the result. A manager must consider the possibility of such events and have a plan for dealing with them.

Risk management strategies. Depending on the nature of the risk, the size of the potential losses, the likelihood of its happening, and the costs of doing something about it, a manager and owner will generally choose one or more of the following risk management strategies:

- ▶ avoidance-removing the source of the risk, such as by closing off a dangerous area of the building
- ▶ reduction-taking action to forestall the event before it happens, such as by installing fire alarms, sprinklers, and security systems
- ▶ transference-shifting the risk to someone else by buying an insurance policy
- ▶ retention-taking the chance that the event is not likely enough to occur to justify the expense of one of the other strategies; self-insurance

Security and safety. A court may hold a manager and owner responsible for the physical safety of employees, tenants, and customers in leased premises. In addition to standard life safety and security systems such as sprinklers, fire doors, smoke alarms, fire escapes, and door locks, a manager may have to provide electronic and human monitoring systems (security cameras, security guards) and be prepared to take action against tenants who allow, conduct or contribute to dangerous criminal activities such as assault and drug use.

Insurance. Many types of insurance are available to allow for the shifting of liability away from the owner. An insurance audit by a competent insurance agent will indicate what kind of and how much coverage is advisable. Common types of insurance coverage for income and commercial properties include:

- ▶ casualty-coverage for specific risks, such as theft, vandalism, burglary, illness and accident, machinery damage

- ▶ liability-coverage for risks incurred by the owner when the public enters the building; medical expenses resulting from owner negligence or other causes
- ▶ workers' compensation-hospital and medical coverage for employees injured in the course of employment, mandated by state laws
- ▶ fire and hazard-coverage for damage to the property by fire, wind, hail, smoke, civil disturbance, and other causes
- ▶ flood-coverage for damages caused by heavy rains, snow, drainage failures, and failed public infrastructures such as dams and levies; flood insurance is not included in regular hazard policies
- ▶ contents and personal property-coverage for building contents and personal property when they are not actually on the building premises
- ▶ consequential loss, use, and occupancy-coverage for the business losses resulting from a disaster, such as loss of rent and other revenue, when the property cannot be used for business
- ▶ surety bond-coverage against losses resulting from criminal or negligent acts of an employee

The owner may opt for a multi-peril policy which combines standard types of commercial policies and may allow special coverage for floods, earthquakes, and terrorism.

The amount of coverage provided by certain types of policies may be based on whether the property is insured at depreciated value or current replacement value. Depreciated value is its original value minus the loss in value over time. Current replacement value, which is more expensive, is the amount it would cost to rebuild or replace the property at current rates.

Commercial policies include coinsurance clauses requiring the insured to bear a portion of the loss. Fire and hazard policies usually require the coverage to be in an amount equal to at least 80 percent of the replacement value.

Owner's policies do not cover what is owned by the tenant. Tenants should obtain their own renter's or tenant's insurance to cover personal belongings. Residential and commercial or business variants are available. The question of who owns tenant improvements is not only important when it is time for the tenant to leave the premises. It is also likely to determine whether the tenant's or the landlord's insurance company will be paying if the improvements are damaged or destroyed.

Handling of trust funds. Managers are responsible for proper handling of monies belonging to other parties that come into the manager's hands in the course of doing business. For property managers, such funds include rents collected from tenants, security deposits, and capital contributions from the

property owner. State laws, usually incorporated into real estate commission rules and the state's real estate law, specify how a property manager is to manage trust funds. In general, the agent is to maintain a separate bank account for these funds, with special accounting, in a qualified depository institution. The rules for how long an agent may hold trust funds before depositing them, and how the funds are to be disbursed, are spelled out. The fundamental requirements are that the owners of all funds must be identified, and there must be no commingling or conversion of client funds and agent funds. Mishandling carries heavy penalties.

THE MANAGEMENT AGREEMENT

Components Rights, Duties, and Liabilities

Components

The management agreement establishes an agency agreement between manager and owner as well as specifying such essentials as the manager's scope of authority, responsibilities, objectives, compensation, and the term of the agreement. Property managers are usually considered to be general agents empowered to perform some or all of the ongoing tasks and duties of operating the property, including the authority to enter into contracts. The agency relationship creates the fiduciary duties of obedience, care, loyalty, accounting, and disclosure. The contractual relationship ensures that the manager will strive to realize the highest return for the owner consistent with the owner's objectives and instructions. The agreement should be in writing and include at least the basics of any real estate contract, as follows.

- ▶ **names of the parties**--owner, landlord, manager, tenant or other party to be bound by the contract
- ▶ **property description**--street address, unit number and location, square footage, and other information that specifies the leased premises
- ▶ **term**--time period (**months**, years) covered by the contract; termination conditions and provisions
- ▶ **owner's purpose**--**maximize** net income, maximize asset value, maximize return, minimize expenditure, maintain property quality, etc.; long-term goals for the property
- ▶ **owner's responsibilities**--**management** fees, plus any management expenses such as payroll, advertising and insurance that the manager will not be expected to pay
- ▶ **manager's authority**--the **scope** of powers being conveyed to the manager: hiring and staffing, setting rents, contracting with vendors, ordering repairs, limits on expenditures without seeking owner permission

- ▶ **manager's responsibilities--specification** of duties, such as marketing, leasing, maintenance, budgeting, reporting, collecting and handling rents; the manager should be included as an additional insured on the liability policy for the property
- ▶ **budget--**amounts, or percentages of revenues, allotted for operations, taxes, insurance, capital expenditures, etc.
- ▶ **allocation of costs--**who is to pay certain expenses, that is, which will be treated as expenses of the manager vs. which will be paid directly by the owner
- ▶ **reporting--**how often and what kind of reports are to be made
- ▶ **compensation--**the management fee or other means of compensation to the manager; there may be a flat fee based on square footage, a rental commission based on a percentage of annual rent, a combination of these, or some other arrangement; in compliance with anti-trust laws, management fees are not standardized but must be negotiated by agent and principal
- ▶ **equal opportunity statement--**the HUD statement or equivalent concerning availability to all persons and classes protected by law, incorporated into the agreement in the case of a residential property

Rights, duties, liabilities

Both the manager and the landlord have rights, duties and liabilities under the terms of the management contract. How these are apportioned should be clearly stated in the agreement.

Landlord. The landlord has the right to receive rent according to the agreement, and to receive the premises in the specified condition at the end of the agreement term. The landlord and his or her agents may have the right to enter and inspect the premises, examine the books, hire and fire staff, and choose vendors. The landlord may retain or grant the power to enter into contracts, to set rents, and to select tenants. The landlord will have the right to terminate the management contract according to the terms of the contract. The landlord will have the duty to pay the agreed management fee, and to make other such payments as detailed in the agreement. State law will determine to what extent a principal is liable for the acts of the manager and the manager's employees. As owner, the landlord is liable for failures to comply with certain local, state, and federal laws, particularly the Environmental Protection Act and fair housing laws.

Manager. Depending on the degree of authority granted by the agreement, the manager may have the right to hire and fire, enter into contracts, and perform routine management tasks without interference from the owner. The manager has the duties described earlier: to maintain financial records and make reports; to budget; to find, retain, and collect from tenants; to maintain and secure the property; to meet the owner's objectives. The manager's liabilities include the consequences of mishandling trust funds, violating fiduciary responsibilities, and violating fair housing laws, credit laws, and employment laws.

Exhibit 23.1 Abbreviated Sample Management Agreement

MANAGEMENT AGREEMENT

Agreement made _____ [date], between _____, a corporation organized under the laws of the State of _____, having its principal office at _____ [address], _____ [city], _____ [state], here referred to as owner, and _____, a corporation organized under the laws of the State of _____, having its principal office at _____ [address], _____ [city], _____ [state], here referred to as agent.

RECITALS

1. Owner holds title to the following-described real property: _____ [insert legal or other appropriate description], here referred to as the property.
2. Agent is experienced in the business of operating and managing real estate similar to the above-described property.
3. Owner desires to engage the services of agent to manage and operate the property, and agent desires to provide such services on the following terms and conditions.

In consideration of the mutual covenants contained herein, the parties agree:

EMPLOYMENT OF AGENT. Agent shall act as the exclusive agent of owner to manage, operate, and maintain the property.

BEST EFFORTS OF AGENT. On assuming the management and operation of the property, agent shall thoroughly inspect the property and submit a written report to owner concerning the present efficiency under which the property is being managed and operated, and recommended changes, if necessary.

LEASING OF PROPERTY. Agent shall make reasonable efforts to lease available space of the property, and shall be responsible for all negotiations with prospective tenants. Agent shall also have the right to execute and enter into, on behalf of owner, month-to-month tenancies of units of the property.

ADVERTISING AND PROMOTION. Agent shall advertise vacancies by all reasonable and proper means; provided, agent shall not incur expenses for advertising in excess of _____ Dollars (\$_____) during any calendar quarter without the prior written consent of owner.

MAINTENANCE, REPAIRS, AND OPERATIONS. Agent shall use its best efforts to insure that the property is maintained in an attractive condition and in a good state of repair. Expenditures for repairs, alterations, decorations or furnishings in excess of _____ Dollars (\$_____) shall not be made without prior written consent of owner.

EMPLOYEES. Agent shall employ, discharge, and supervise all on-site employees or contractors required for the efficient operation and maintenance of the property. All on-site personnel, except independent contractors and employees of independent contractors, shall be the employees of agent.

INSURANCE. Agent shall obtain the following insurance at the expense of owner, and such insurance shall be maintained in force during the full term of this agreement:

1. Comprehensive public liability property insurance of _____ Dollars (\$_____) single limit for bodily injury, death, and property damage;
2. Comprehensive automobile insurance of _____ Dollars (\$_____) single limit for bodily injury, death, and property damage;
3. Fire and extended coverage hazard insurance in an amount equal to the full replacement cost of the structure and other improvements situated on the property; and
4. A fidelity bond in the amount of _____ Dollars (\$_____) on each employee who handles cash, and workers' compensation and employer liability insurance to cover the agents and employees of both employer and agent.

Exhibit 23.1 Abbreviated Sample Management Agreement, continued

COLLECTION OF INCOME. Agent shall use its best efforts to collect promptly all rents and other income issuing from the property when such amounts become due. It is understood that agent does not guarantee the collection of rents.

BANK ACCOUNTS. Agent shall deposit (either directly or in a depository bank for transmittal) all revenues from the property into the general property management trust fund of agent, here referred to as the trust account. From the revenues deposited in the trust account, agent shall pay all items with respect to the property for which payment is provided in this agreement, including the compensation of agent and deposits to the reserve accounts as provided for. Agent shall remit any balance of monthly revenues to owner concurrently with the delivery of the monthly report.

RESERVE ACCOUNT. Agent shall establish a reserve account for the following items: taxes, assessments, debt service, insurance premiums, repairs (other than normal maintenance), replacement of personal property, and refundable deposits.

RECORDS AND REPORTS. Agent shall furnish owner, no later than the end of the next succeeding month, a detailed statement of all revenues and expenditures for each preceding month. Within days after the end of each calendar year, agent shall prepare and deliver to owner a detailed statement of revenues received and expenditures incurred and paid during the calendar year that result from operations of the property.

COMPENSATION OF AGENT. Agent shall receive a management fee equal to __ percent (__ %) of the gross receipts collected from the operation of the property. Any management fee due agent hereunder shall be paid to agent within _____days after the end of each month.

TERMINATION AND RENEWAL. This agreement shall be for a term commencing on _____[date], and ending on _____[date].

MODIFICATION. This agreement may not be modified unless such modification is in writing and signed by both parties to this agreement.

IN WITNESS WHEREOF, the parties have executed this agreement at *[designate place of execution]* the day and year first above written.

LEASING CONSIDERATIONS

Lease types
Owned and leased inclusions
Reversionary rights of owners
Landlord rights and responsibilities
Tenant rights and responsibilities
Evictions
Tenant improvements
Termination of a lease
Security deposit procedures
Universal Residential Landlord-Tenant Act

Lease types

Recall from the chapter on leases that a leasehold estate may grant tenancy for years, from period-to-period, at will, and at sufferance.

For years. An estate for years may be for any definite period—years, months, weeks, days. When the estate expires, the lessee must return the premises to the lessor and vacate the premises. Most commercial leases grant this type of estate.

Periodic. An estate from period-to-period does not have any definite period. Such an estate begins as a lease for a definite period but continues after the expiration of the lease, as long as the lessee continues to pay rent at the regular interval, the lessor accepts it, and no one gives notice to terminate the lease. This type of leasehold is common with residential properties.

At will. A tenancy at will is similar to the periodic tenancy, except that it does not begin with a definite period. It continues, with the consent of the lessor, as long as the tenant pays rent at regular intervals. It is terminated by the death of either party. The tenancy at will is rarely, if ever, used in a written lease.

At sufferance. A tenancy or estate at sufferance comes into existence when a tenant stays beyond the expiration of another type of lease without the lessor's permission. This type of tenancy is never intentionally used in a written lease.

Leases, depending on how rent is determined, are also defined as gross, net, percentage leases, and graduated leases.

Gross. In a gross lease, the tenant pays an established, fixed rent, and the landlord pays all property operating expenses, such as taxes, insurance, utilities, and other services. This is the arrangement commonly used in residential leases.

Net. Net leases have the tenant paying rent plus some or all of the operating expenses attributable to the rented space. This arrangement is commonly used in office and industrial leases.

Percentage. A percentage lease may be gross or net, but the rent is not fixed, but depends on the income generated by the tenant in the leased property. A common arrangement is to set a fixed base rent plus a percentage of the tenant's gross income or sales at the site. The percentage calculation may take effect only

when the income reaches a certain level. This arrangement is commonly used in retail leases.

Graduated. Either a gross or a net lease may also be a graduated lease, in which the rental rate increases at specified times over the lease term.

Owned and leased inclusions

The lease should set forth items that are excluded or included in the leased property. For instance, a residential lease may include built-in appliances such as dishwashers but exclude freestanding ones, such as refrigerators. Furniture may be included or excluded. At issue for the landlord is the cost of maintenance. If a refrigerator is not included, it does not have to be maintained by the property manager.

Ownership also relates to insurance policies: one can only insure what one owns, so if a property item is destroyed by fire, the owner's policy will not provide any coverage for an item that is not included in the lease as belonging to the property. This may be of critical importance in a commercial lease where certain improvements might be owned by either the landlord or the tenant, according to the lease.

The lease should also have clear rules about making alterations. If the tenant is not satisfied with an item that is part of the property, the lease may provide for the tenant to make changes only with permission or with the obligation to return the premises to their original condition on termination, or that any alterations made to fixtures become the property of the landlord. Trade fixtures, by definition, belong to the tenant and can be removed when the tenant leaves.

Inclusions may also be of a financial nature-what is included in the rent. Principal and interest on a mortgage loan, homeowner's association dues, common area maintenance charges, liability and hazard insurance, and various operating expenses are items that might be included in the lease as the owner's or the tenant's responsibilities.

Reversionary rights of owners

Like the grantor of a life estate, the grantor of a leasehold estate retains a future interest in the estate. The lease grants a number of rights to the property, including, primarily, the rights to enter, possess, and use the property for the term of the lease. The lessee does not enjoy the full bundle of rights to the property. For instance, the lessee may not encumber or sell the property. When the lease expires (a condition subsequent), all rights revert to the original owner. A common example is the leasing of an apartment for a one-year period. When the lease expires, the lessee has no further rights in the property and full ownership reverts to the lessor. Another condition subsequent that may cause reversion of rights is tenant default.

Landlord rights and responsibilities

State law, often incorporating or modeling the Universal Residential Landlord Tenant Act (see below) prescribes rights and responsibilities for residential landlords and tenants.

Rights. Commonly, the landlord retains a right of entry into the premises in order to perform needed repairs and maintenance on a property. The lease and/or the law may specify that a landlord may enter the tenant's property only under one or more of the following conditions:

- ▶ An emergency requires the landlord to enter.
- ▶ The tenant gives consent to enter.
- ▶ The landlord enters during normal business hours and only after giving notice to either make repairs or to show the property to prospective tenants, purchasers or contractors.
- ▶ The tenant has abandoned or surrendered the property.
- ▶ The landlord has a court order allowing the entry.

Likewise, the landlord has the right to expect prompt payment of rent and adherence to building rules. At the end of the lease term, the landlord has the right to retake possession of the premises. In case of tenant breach or default, the landlord has the right to pursue the remedies provided by law, such as eviction, to take possession.

Responsibilities. The landlord (by way of the property manager), is expected to deliver a property that is habitable. This means that the landlord at the very least must:

- ▶ keep the heating, cooling, electrical, and plumbing systems in good working condition
- ▶ keep floors, stairways and railings safe and in good repair
- ▶ provide pest control as needed
- ▶ repair roof leaks and broken windows promptly.

Tenant rights and responsibilities

Rights. Beyond the right to quiet enjoyment (privacy) of a property received and maintained in a habitable condition, the tenant has other rights, depending on state law. For instance, a tenant may be able to take any of the following actions if a landlord fails to correct a problem that is the landlord's responsibility:

- ▶ move out without liability for back rent or the unexpired portion of the lease
- ▶ refer the problem to mediation, arbitration or small claims court
- ▶ after giving the owner written notification of an emergency situation, call a professional repair person and deduct the cost from the next month's rent.

Responsibilities. Depending on state law, a tenant generally must:

- ▶ Pay rent on time
- ▶ Follow the rules and regulations set out by the landlord
- ▶ Give a 30-day notice when terminating a month-to-month lease
- ▶ Return all door and mailbox keys when leaving the property
- ▶ Leave the unit in as clean a condition as it was at the start of the lease
- ▶ Keep the unit clean and sanitary
- ▶ Dispose of all rubbish, garbage and other waste in a sanitary manner

- ▶ Use and operate all electrical, gas and plumbing fixtures properly
- ▶ Refrain from destroying or damaging the property
- ▶ Prevent others from destroying or damaging the property
- ▶ Use the property and the rooms only for their intended purposes

Evictions

An **actual eviction** follows a procedure prescribed in state law and stated in the lease contract. The landlord must serve notice on the tenant a specified number of days before beginning the eviction suit. A court issues a judgment for possession, which requires the tenant to vacate. A court officer, such as a sheriff, may forcibly remove the tenant and possessions if the tenant refuses to vacate. The landlord can then enter and take possession.

A **constructive eviction** occurs when a tenant vacates the leased premises and declares the lease void, claiming that the landlord's actions have made the premises unfit for the purpose described in the lease. The tenant must prove that it was the landlord's actions that were responsible and may be able to recover damages.

Tenant improvements

As discussed earlier, leased spaces are often modified to a tenant's specifications. Such alternations may be made by the landlord on the tenant's behalf or by the tenant. Buildings usually have "standard" improvements, which any tenant improvements must equal or improve on. Many leases have a clause that requires the tenant to return the premises to the condition in which they were received at the end of the lease term. Who pays for improvements and who owns them are major matters for negotiation.

Termination of a lease

Like contracts in general, leases may terminate in a number of ways. Principal among these are the following. See the chapters on leases and contract law for more information.

Expiration. A lease with a term (estate for years) automatically expires at the end of the term.

Performance. Any contract terminates when all parties have performed their obligations.

Agreement. The parties may agree to terminate the lease before the end of the term.

Abandonment. The landlord may retake possession and pursue the tenant for default if the tenant abandons the premises and fails to fulfill lease obligations. The tenant's obligation to pay rent continues.

Default or Breach. A default occurs when either the tenant or landlord violates any of the terms or covenants of the lease. The damaged party may sue for damages, specific performance (of the breached obligation), or cancellation of the lease. When the default arises from the tenant's failure to pay rent or maintain the premises, the landlord may sue for possession and for eviction. Before filing suit, the landlord must give proper notice and allow the tenant to remedy the breach. The most common form of landlord default is failure to maintain the property and provide services. The tenant may vacate the premises and declare the lease

cancelled if the landlord's default has made the premises unoccupiable. This action is called constructive eviction.

Notice. A periodic leasehold or tenancy at will may be terminated by proper notice given by either party.

Destruction. Property destruction is grounds for termination of the lease.

Condemnation. Eminent domain proceedings terminate leases.

Foreclosure. Foreclosure actions terminate lease obligations.

Death. A tenancy at will terminates on the death of either party. The landlord's death terminates any lease if the landlord held the leased property under a life estate, since the landlord cannot convey an interest that extends beyond the landlord's life.

Security deposit Procedures

As previously mentioned in the context of handling trust funds, state laws, real estate commission rules, and the state's real estate law, usually specify how a property manager is to manage security deposits. Such funds are normally held in a special trust account and may not be used for any purpose other than the intended one. Whether the deposit can earn interest, and to whom that interest belongs, are likewise prescribed by law. The law also prescribes when the deposit must be returned to the tenant, and under what circumstances any of it may be withheld. The contract language should clearly state the rules, among other things, governing what happens to the deposit when the lease terminates.

Uniform Residential Landlord-Tenant Act

The Uniform Residential Landlord-Tenant Act is model legislation that has been adopted to a greater or lesser extent in many states. In addition to addressing fair and equitable remedies for breaches by both landlord and tenant, the act aims to clarify imprecise language in residential leases that can lead to confusion or exploitation in such areas as:

- ▶ lease term
- ▶ rental amount
- ▶ security deposit
- ▶ landlord access
- ▶ procedures for default and eviction
- ▶ general obligations of landlord and tenant.

See the chapter on "Real Estate Leases" for more detail.

THE MANAGEMENT BUSINESS

Sources of business

Securing business

Professional development

Sources of business Property management is increasingly a specialization within real estate. There is a growing need for skilled managers because of the increasing number and complexity of properties.

Specialist opportunities. Property managers with specialized training are in demand in a wide variety of property types, including shopping centers, commercial buildings, residential properties, and industrial parks. Within these property specialties are opportunities to specialize even further in such areas as:

- ▶ leasing
- ▶ asset management
- ▶ corporate property management
- ▶ resort management
- ▶ association management
- ▶ housing program management
- ▶ mobile home park management
- ▶ office building management

Owners and investors in these various property types are among the consumers of management services who represent potential clients for a professional property manager. Such owners and investors may be individuals, corporations, developers, landlords, banks, trusts, homeowners' associations, condominium associations, or investment syndicates

Securing business

Reputation, demonstrated competence, professional training, and smart advertising are keys to finding management business. Before entering into a management agreement, the manager should make sure that the owner's management objectives are clear and that they are realistic.

Management plan. Developing a management plan is a necessary step in beginning a management project, and it may also be part of obtaining a management contract. The manager must consider the owner's objectives, including financial goals; the competitive market for the property, both local and regional, depending on the property type; and the features of the particular property. The plan will take into account market indicators such as vacancy rates, occupancy rates, absorption rates, and new supply coming onto the market. It will also include a budgetary component that considers sources of revenue and anticipated expenses. Finally, the plan will indicate what the manager intends to do with the property, given these considerations, to manage the property in a way that will meet the owner's objectives.

Professional development

A number of organizations provide valuable information and training in subjects related to property management. The certifications and designations provided by these organizations are often viewed as valuable signs of competence and can be a significant factor in getting hired as a manager. Important associations include:

- ▶ IREM-The Institute of Real Estate Management, offering the CPM (Certified Property Manager) designation
- ▶ BOMA and BOMI-The Building Owners and Managers Association International and the affiliated Building Managers and Owners Institute International, offering the RPA (Real Property Administrator), SMA (Systems Maintenance Administrator), and FMA (Facilities Management Administrator) designations
- ▶ NAA-The National Apartment Association, offering designations in apartment building management, maintenance, leasing, portfolio supervision and other related areas
- ▶ NARPM-The National Association of Residential Property Managers, offering the RPM (Residential Property Manager), MPM (Master Property Manager) and other related designations
- ▶ ICSC-The International Council of Shopping Centers, offering designations in retail property leadership, management, marketing, leasing, and development
- ▶ NACM-The National Association of Condominium Managers, offering the RCM (Registered Condominium Manager) designation

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Property Management Snapshot Review

MANAGEMENT FUNCTIONS

- main manager types: individual broker or firm managing for multiple owners; building manager, employed by owner or other manager to manage a single property; resident manager, employed by owner, broker, or management firm to live and manage on site.
- manager is a fiduciary of the principal; duty to act in principle's best interests; may specialize in a property type
- needed skills: marketing, accounting, finance, construction; financial, physical, administrative services; specific functions determined by management agreement

Reporting

- monthly, quarterly, or annually; annual operating budget, cash flow reports, profit and loss statements, budget comparison statements

Budgeting

- operating budget based on expected expenses and revenues; determines rental rates, capital expenditures, reserves, salaries and wages; projects income based on past performance and current market
- potential gross income: total of scheduled rents plus revenues from other sources; effective gross income: total gross minus losses from vacancies, evictions, uncollected rents; net operating income: effective gross minus operating expenses; cash flow: net operating income minus debt service and reserves
- expenses are variable and fixed; capital expenditures are outlays for major renovations and construction; cash reserves set aside for variable expenses

Renting

- manager must keep property properly rented and tenanted; vacancies managed by rent setting, marketing, tenant relations, good service
- selecting compatible tenants and collecting scheduled rents are top priorities
- legal issues concern compliance with fair housing laws, Americans with Disabilities Act, and ECOA

Property maintenance

- main consideration: balance between costs of services, owner financial objectives, and tenant needs
- may be routine, preventive, or corrective; staffed in-house or contracted out

Construction

- tenant alterations, renovations, and expansion; also environmental remediation
- legal concerns: Americans with Disabilities Act; applies to employers with fifteen or more employees; manager to determine feasibility of restructuring, retrofitting, new construction, or other alternatives to comply

Risk management

- risk ranges from natural disaster to personal injury, terrorism, and employee malfeasance; handled by avoiding or removing the source, installing protective systems, buying insurance, self-insuring (risk retention)
- life safety systems include sprinklers, fire doors, smoke alarms, fire escapes, monitoring systems
- insurance includes casualty, liability, workers' comp, fire and hazard, flood, contents, consequential loss, surety bonds, multi-peril; tenants need their own insurance
- handling of trust funds is a major risk area; mishandling carries heavy penalties

MANAGEMENT AGREEMENT

Components	names of parties; property description; lease term; owner's purpose; responsibilities; authority; budget; allocation of costs; reporting; compensation; Equal Opportunity statement
Rights, duties and liabilities	- landlord: receive rent; receive premises in specified condition; enter and inspect; examine books; enter into contracts, hire vendors, set rents; pay management; comply with laws - manager: hire and fire; enter into contracts; perform management tasks; maintain records, make reports, budget, collect rent, find tenants, maintain the property, meet owner goals; handle trust funds; comply with laws

LEASING CONSIDERATIONS

Lease types	for years, periodic, at will, at sufferance, gross, net, percentage, graduated
Owned and leased inclusions	- items included or excluded in the lease; owner's insurance covers only what is included; alterations to inclusions only with owner's permission "inclusion" also refers to financial items included as lessee's responsibility, such as operating expenses
Reversionary rights of owners	all rights of ownership revert to owner at end of lease term
Landlord rights and responsibilities	rights: enter premises, receive payment, retake on termination, pursue remedies; responsibilities: provide habitable conditions; maintain heating, cooling, electrical, plumbing; keep clean and in repair
Tenant rights and responsibilities	rights: quiet enjoyment, habitable conditions, right to take action for default; responsibilities: pay rent, obey rules, give proper notice, return property in prescribed condition, use only for intended purpose
Evictions	actual: prescribed legal procedure; notice, suit, judgment, taking of premises; constructive: tenant vacates for landlord failure to maintain premises
Tenant improvements	ownership of and payment for improvements according to agreement
Termination of a lease	causes: expiration, performance, agreement, abandonment, breach, notice, destruction of premises, condemnation, foreclosure, death of either party (tenancy at will), death of landlord (life estate)
Security deposit procedures	determined by state law, commission rules, agreement
Universal Residential Landlord-Tenant Act	model law regulating lease language and lease terms; adopted by many states

MANAGEMENT BUSINESS

Sources of business	leasing, asset management, corporate properties, resorts, association management, housing programs, mobile home parks, office buildings; owners, investors, corporations, developers, landlords, condo and homeowners' associations, banks, trusts, syndicates
Securing business	develop reputation and competence; obtain training; use effective advertising; make management plan in accordance with owner objectives
Professional development	training, designations, certifications to increase and demonstrate competence

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Real Estate Mathematics

Basic Formulas and Functions Real Estate Applications

Answer Key is on page [427](#)

BASIC FORMULAS AND FUNCTIONS

Adding and multiplying fractions
Converting decimals and percentages
Converting fractions and percentages
Multiplying percentages
Calculating area

Adding and multiplying fractions

Adding

1. Formulas:

Same denominator: $\frac{a}{c} + \frac{b}{c} = \frac{a+b}{c}$

Different denominator: $\frac{a}{c} + \frac{b}{d} = \frac{ad+bc}{cd}$

2. Examples:

$$\frac{2}{5} + \frac{6}{5} = \frac{8}{5}$$

$$\frac{3}{4} + \frac{4}{7} = \frac{(3 \times 7) + (4 \times 4)}{(4 \times 7)} = \frac{37}{28}$$

Problem 1: $\frac{3}{19} + \frac{2}{7} = ?$

Multiplying

1. Formula: $\frac{a}{c} \times \frac{b}{d} = \frac{ab}{cd}$

2. Example: $\frac{4}{9} \times \frac{2}{3} = \frac{8}{27}$

Problem 2: $\frac{4}{14} \times \frac{3}{8} = ?$

Converting decimals and percentages

Converting a decimal to a percent

1. Formula: (decimal number) $\times$ 100 = percent number

2. Examples: $.473 \times 100 = 47.3\%$
 $3.456 \times 100 = 345.6\%$
 $.0042 \times 100 = .42\%$

Problem 3: Convert the following decimals to percentages:

$$2.65 = \%$$

$$0.294 = \%$$

$$0.005 = \%$$

Converting a percent to a decimal

1. Formula: $\frac{\text{percent number}}{100} = \text{decimal number}$

2. Examples: $\frac{47.3\%}{100} = .473$

$$\frac{345.6\%}{100} = 3.456$$

Problem 4: Convert the following percentages to decimals:

$$72.1\% =$$

$$90.2\% =$$

$$5.79\% =$$

Converting fractions and percentages

Converting a fraction to a percent

1. Formulas:

$$(1) \quad \frac{a}{b} = a \text{ divided by } b = \text{decimal number}$$

$$(2) \quad \text{decimal number} \times 100 = \text{percent number}$$

2. Examples: $\frac{4}{5} = 4 \text{ divided by } 5 = 0.8 = 80\%$

$$\frac{9}{3} = 9 \text{ divided by } 3 = 3.0 = 300\%$$

Problem 5: Convert the following fractions to percentages:

$$\frac{8}{9} = \%$$

$$\frac{3}{6} = \%$$

$$\frac{14}{42} = \%$$

Converting a percent to a fraction and reducing it

1. Formula: $X\% = \frac{X}{100}$

$$\frac{X \div a}{100 \div a} = \text{reduced fraction}$$

where "a" is the largest number that divides *evenly* into numerator and denominator. If unknown, try 2, 3, 5, or 7.

2. Example $45\% = \frac{45}{100} = \frac{45 \div 5}{100 \div 5} = \frac{9}{20}$

Problem 6: Convert and reduce the following percentages:

$$40\% =$$

$$16\% =$$

Multiplying Percentages

1. Formulas:

- (1) convert percent to decimal by dividing by 100
- (2) whole amount $\times$ decimal = partial amount

2. Example: 33% of 400

- (1) 33% divided by 100 = .33
- (2) 400 $\times$.33 = 132

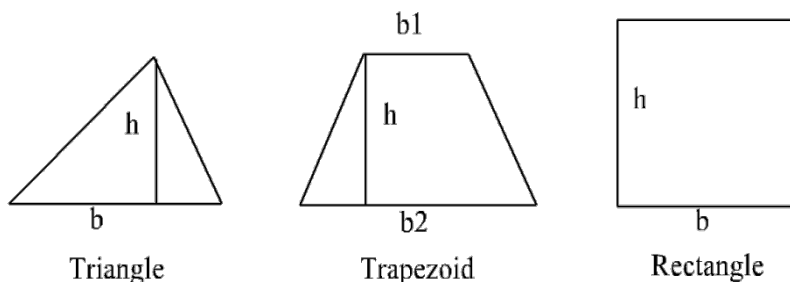
Problem 7: What is 75% of 280?

Calculating area

To find the area of an irregular shape, try dividing it into triangles, rectangles, squares or trapezoids and calculate the areas of those parts; the area of the whole shape is then the sum of the areas of all of its subparts.

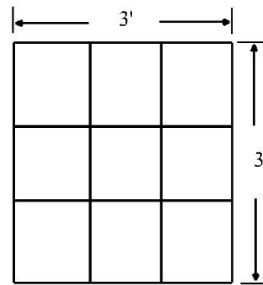
Base and height

- 1. Formulas for area of three- and four-sided shapes use a product of base and height. In the formulas, a represents area, b represents base, h represents height, SF represents square feet.
- 2. The base of a triangle, square, or rectangle may be any side; a trapezoid has two bases, its two parallel sides.
- 3. The height of a triangle is the length of a perpendicular line from the base to the triangle's opposite point. Height in a square, rectangle or trapezoid is the length of a line which is perpendicular to the base line(s).



Area of a square or rectangle

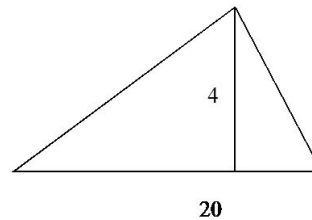
1. Formula: area (a) = base (b) x height (h) $a = b \times h$
2. Example: A square measures 3 feet on each side.



Its area is: $3 \times 3 = 9 \text{ SF}$

Area of a triangle

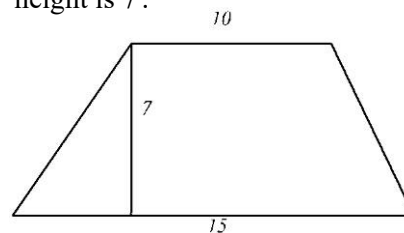
1. Formula: $a = \frac{b \times h}{2}$
2. Example: A triangle has a 20' base and a 4' height.



Its area is: $a = \frac{20 \times 4}{2} = 40 \text{ SF}$

Area of a trapezoid

1. Formula: $a = \frac{a (b1 + b2)}{2}$
2. Example: A trapezoid's two bases are 10' and 15', and its height is 7'.



Its area is: $a = \frac{7 (10 + 15)}{2} = 87.5 \text{ SF}$

Problem 8: Calculate the areas of the following shapes:

a rectangle with height of 4' and base of 36'

a =

a square with a side of 16'

a =

a trapezoid with height of 5' and bases of 6' and 8'

a =

REAL ESTATE APPLICATIONS

Legal descriptions (Chapter 9)

Listing agreements (Chapter 12)

Brokerage business (Chapter 13)

Sales contracts (Chapter 14)

Appraisal (Chapter 16)

Finance (Chapter 17)

Investments (Chapter 18)

Taxation (Chapter 19)

Closings (Chapter 21)

Legal descriptions (Chapter 9)

Linear measures

(cm = centimeter; m = meter; km = kilometer)

1 inch	=	1/12 foot	=	1/36 yard
1 foot	=	12 inches	=	1/3 yard
1 yard	=	36 inches	=	3 feet
1 rod	=	16.5 feet	=	1/320 mile
1 mile	=	5280 feet	=	1760 yards = 320 rods

1 centimeter	=	1/100th m	
1 meter	=	100 cm	= 1/1000th km
1 kilometer	=	1,000 m	

Area measures

1 square inch	=	1/144th square foot
1 square foot	=	1/9th square yard
1 square yard	=	9 square feet

1 acre	=	1/640 sq. mi	=	43,560 SF	=	208.71 ft x 208.71 ft
1 square mile	=	640 acres	=	1 section	=	1/36 township
1 section	=	mile x 1 mile	=	640 acres	=	1/36 township
1 township	=	6 mi x 6 mi	=	36 sq. mi.	=	36 sections

Metric conversions

(cm = centimeter; m = meter; km = kilometer)

1 inch	=	2.54 cm		
1 foot	=	30.48 cm	=	.3048 m
1 yard	=	91.44 cm	=	.9144 m
1 mile	=	1609.3 m	=	1.60 km
1 centimeter	=	.3937 inch		
1 meter	=	39.37 inches	=	3.28 feet = 1.094 yards
1 kilometer	=	3,281.5 feet	=	.621 mile

Fractions of sections, acres, and linear dimensions

Fraction	# Acres	Feet X Feet
1 section	640 acres	5280 X 5280
1/2 section	320 acres	5280 X 2640
1/4 section	160 acres	2640 X 2640
1/8 section	80 acres	2640 X 1320
1/16 section	40 acres	1320 X 1320
1/32 section	20 acres	660 X 1320
1/64 section	10 acres	660 X 660

Calculating area from the legal description

1. Formula:

- (1) First multiply all the denominators of the fractions in the legal description together
- (2) Then divide 640 by the resulting product.

2. Examples:

N 1/2 of the SW 1/4 of Section 6:

$$\frac{640}{(2 \times 4)} = \frac{640}{8} = 80 \text{ acres}$$

W 1/2 of the NW 1/4 of the NE 1/4 of Section 8

$$\frac{640}{(2 \times 4 \times 4)} = \frac{640}{32} = 20 \text{ acres}$$

Problem 9: Calculate the acreage of the following:

SW 1/4 of the N 1/2 of the E 1/2 of Section 14

SE 1/4 of the NW 1/4 of the SE 1/4 of Section 20

Listing agreements (Chapter 12)

Co-brokerage commission

1. Formulas: $\text{sale price} \times \text{commission rate} = \text{total commission}$
 $\text{total commission} \times \text{split rate} = \text{co-brokerage commission}$
2. Example: A house sells for \$600,000. The commission is 6%, and the co-brokerage split is 50-50.
 $\$600,000 \times 6\% = \$36,000$ total commission $\times 50\% =$
\$18,000 co-broker's commission

Agent's commission

1. Formula: $\text{broker's commission} \times \text{agent's split rate} = \text{agent's commission}$
2. Example: Assume an \$18,000 broker's commission and a 60% - 40% agent-broker split rate.
 $\$18,000 \times .6 = \$10,800$ agent's commission (\$7,200 to broker)

Problem 10: A property is co-brokered by listing broker Schroeder and selling broker Hobson for \$425,000. The co-brokerage split is 50-50. Schroeder's agent, Joachim, is on a 65% split schedule. Hobson's selling agent, Wallace, splits 50-50 with her broker. If the total commission rate is 7%, what are the participants' commissions?

Broker Schroeder:	\$
Broker Hobson:	\$
Schroeder's agent, Joachim:	\$
Hobson's agent, Wallace:	\$

Brokerage business (Chapter 13)

Goodwill calculation

1. Formula: $\text{Goodwill} = \text{Price} - \text{Value of assets}$
2. Example: A seller wants \$1 million for a business. Assets in the business, including inventory, furniture, equipment, leasehold improvements, and working capital, have a total value of \$750,000. The goodwill is:

$$\$1,000,000 - 750,000 = \$250,000 \text{ goodwill}$$

Problem 11: A prospective purchaser complained to a seller that the selling price had far too much goodwill: \$200,000. After all, the assets only totaled \$352,000. What was the price?

Sales contracts (Chapter 14)

"Percentage of listing price" calculation

1. Formula: $\text{Percentage of listing price} = \text{offer} \div \text{listing price}$
2. Example: A property listed for \$400,000 receives an offer for \$360,000. The percentage of listing price is:

$$\$360,000 \div 400,000 = 90\%$$

Problem 12: A seller receives an offer of \$674,000 on a property listed at \$749,000. How much is the offer as a percent of the listing price?

Earnest money deposit calculation

1. Formula: $\text{Deposit} = \text{Listing price} \times \text{required percentage}$
2. Example: A seller requires a 2% deposit on a property listed for \$320,000. The required deposit is:

$$\$320,000 \times 2\% = \$6,400$$

Problem 13: A seller requires a 1.5% deposit on all offers. A buyer wants to offer \$312,000 for the property. What must the deposit be?

Rent escalations

1. Formula: New rent = current rent x (100% + escalation rate)
2. Example: An apartment's rent is scheduled to increase by 6%. If the current rent is \$1800, the new rent is:

$$\$1800 \times (100\% + 6\%) = \$1,800 \times 106\% = \$1,908$$

Problem 14: A tenant's rent is currently \$650 per month. This rent is scheduled to increase 5% per year. What will the tenant's rent be at the beginning of the **third** year from now?

FIRPTA withholding

1. Formula: FIRPTA withholding = gross proceeds from sale x 15%
2. Example: Gross proceeds on a FIRPTA-regulated property sale are \$340,000. The required withholding amount is:

$$\$340,000 \times 15\% = \$51,000$$

Appraisal (Chapter 16)

Adjusting comparables

1. Rules:
 - a. NEVER adjust the subject!
 - b. If the comparable is better than the subject, subtract value from the comparable
 - c. If the comparable is **worse** than the subject, **add** value to the comparable
2. Examples:
 - a. A comparable has a pool and the subject does not. The appraiser estimates the value contribution to be \$25,000. Adjust the comparable by entering -25,000 in the CMA.
 - b. A comparable has 3 bedrooms and the subject as 4. The appraiser estimates the value contribution of a bedroom to be \$15,000. Adjust the comparable by entering +15,000 in the CMA.

Problem 15: Identify the proper adjustments for the following:

- (a) The subject has a two-car garage, while the comparable does not. Value of garage is \$33,000.

Adjustment:

- (b) A comparable has a fireplace, and the subject does not. Value of fireplace is \$8,000.

Adjustment:

- (c) The subject has 1,500 square feet. The comparable has 1,600 square feet. The value of extra square feet is \$200/SF.

Adjustment:

Comparative Market Analysis (CMA)

1. Steps:
 - a. Identify comparable sales
 - b. Compare comparables to the subject and make adjustments to comparables.
 - c. Weight values indicated by adjusted comparables for the final value estimate of the subject.

Problem 16: Adjust and weigh comparables to indicate a subject value

- a) Using the data and assumptions provided below, complete the worksheet by filling in value adjustments for each blank entry.
- b) Total the values of each comparable's adjustments to derive a net value change for the comparable.
- c) Reconcile the comparables by weighting their values against each other and estimating a value for the subject.
- d) Explain your reasoning.

Comparables data

Subject:	3 bedrooms, two baths, kitchen, living room, family room; 2,500 square feet of gross living area; 3-car attached garage; condition is good.
Comparable A:	Sold for \$850,000; located in subject's neighborhood with similar locational advantages; house approximately same age as subject; lot size similar to subject; condition similar to subject; two bedrooms, one bath; 2,200 square feet of gross living area.
Comparable B:	Sold for \$950,000; located in subject's neighborhood with similar locational advantages; house ten years newer than subject; lot size considerably larger than the subject's; better condition than subject; four bedrooms, three baths; gross living area is similar.
Comparable C:	Sold for \$1,000,000; located in subject's neighborhood with similar locational advantages; house eight years older than subject; lot size similar to subject; condition similar to subject; three bedrooms, three baths; 2,500 square feet of gross living area.
Comparable D:	Sold for 1,090,000; located in a more desirable neighborhood than subject; house approximately same age and size and condition as subject, with two bedrooms, and two baths; 1,900 square feet of gross living area.

Adjustment Assumptions

Location:	no value differences
Financing & terms:	no value differences
Lot size:	\$10,000 value difference for Comparable B
# Bedrooms and bathrooms:	\$10,000 per room
Effective age and condition:	poor -- \$20,000; good – no change; excellent -- \$20,000
Gross living area:	\$10,000 per 100 feet

CMA Adjustment Worksheet

	Subject	A	B	C	D
Sale price	???	850,000	950,000	1,000,000	1,090,000
Location		\$ _____	\$ _____	\$ _____	\$ _____
Age		\$ _____	\$ _____	\$ _____	\$ _____
Lot size		\$ _____	\$ _____	\$ _____	\$ _____
Condition		\$ _____	\$ _____	\$ _____	\$ _____
Bedrooms	3	\$ _____	\$ _____	\$ _____	\$ _____
Baths	2	\$ _____	\$ _____	\$ _____	\$ _____
Gross living area	2,500 SF	\$ _____	\$ _____	\$ _____	\$ _____
Net adjustments		\$ _____	\$ _____	\$ _____	\$ _____
Indicated value	???	\$ _____	\$ _____	\$ _____	\$ _____

Rationale for comp adjustments:

Comments on weighting of adjustments and estimated value of the subject:

Problem 16 Answers

Completed CMA Adjustment Worksheet

	Subject	A	B	C	D
Sale price		850,000	950,000	1,000,000	1,090,000
Location		equal	equal	equal	-20,000
Age		equal	-20,000	+20,000	equal
Lot size		equal	-10,000	equal	equal
Condition	good	equal	-20,000	equal	equal
Bedrooms	3	+10,000	-10,000	equal	+10,000
Baths	2	+10,000	-10,000	equal	equal
Gross living area	2,500	+30,000	equal	equal	+60,000
Net adjustments		+50,000	-70,000	+20,000	+50,000
Indicated value	1,000,000	900,000	880,000	1,020,000	1,140,000

Discussion of Weighting, Reconciliation and Value Estimate

The completed table indicates four estimated values for the subject, ranging from \$880,000 to 1,140,000.

For comparable A, the estimator has made three adjustments -- for the number of bedrooms and baths, and for gross living area -- totaling \$50,000, or 5.9% of the purchase price.

For comparable B, the estimator has deducted values for age, lot, condition, bedrooms, and baths. The total of five adjustments amounts to \$70,000, or 7.4% of the sale price.

For comparable C, the estimator has adjusted only for the age. The adjustment of \$20,000, 2% of sale price, raises the indicated value of the subject to \$1,020,000.

For comparable D, a deduction has been made for the comparable's superior location. This is offset by additions for the number of bedrooms and gross living area reflecting where the comparable is inferior to the subject. The three adjustments amount to a total of +\$50,000, or 4.6% of the sale price.

Weighting the indicated values of the comparables, the estimator has developed an indicated value of \$1,000,000 for the subject. Underlying this conclusion is the fact that Comparable C is by far the best indicator of value, and therefore receives the heaviest weighting as a value indicator. This property has the fewest adjustments (1) and smallest total adjustment amount (2%). Comparable D might be the second-best indicator, since it has the second-lowest number of adjustments (3), and the net adjustment is also second-best as a percent of the sale price (4.6%). Comparable A might be the third best indicator, since it has the second smallest number of total adjustments (3) but the second highest net adjustment percent (5.9%). Comparable B has the greatest number of adjustments (5) and the highest percent of sale price (7.4%) and is therefore the least reliable indicator.

Income capitalization

Gross rent multiplier (GRM)

1. Formula: gross rent x multiplier = value
2. Example: \$2,000 x 135 GRM = \$270,000

Gross income multiplier (GIM)

1. Formula: gross annual income x GIM = value
2. Example: \$45,000 x 9 GIM = \$405,000

Net income capitalization

1. Formula: annual net operating income (NOI) ÷ capitalization rate = value
2. Example: \$50,000 ÷ .10 = \$500,000

Problem 17: An apartment building grosses \$450,000 annually, nets 350,000, and has a capitalization rate of 9%. Prevailing GIMs are 8.

(a) What is the property value using the GIM?

(b) What is the property value using net income capitalization?

Interest only loans

1. Formulas: interest payment (I) = principal (P) x interest rate (R)
- annual interest payment ÷ 12 = monthly interest payment
- monthly interest payment x 12 = annual interest payment

$$I = P \times R$$

$$R = \frac{I}{P}$$

$$P = \frac{I}{R}$$

2. Examples: A \$300,000 interest-only loan @ 10% has annual payments of \$30,000 and monthly payments of \$2,500.

$$\text{Annual interest} = \$300,000 \times 10\% = \$30,000$$

$$\text{Monthly interest} = \$30,000 \div 12 = \$2,500$$

The loan amount of an interest-only loan that has an annual interest rate of 8% and a monthly interest payment of \$700 is \$105,000.

$$\text{Annual interest} = \$700 \times 12 = \$8,400$$

$$\text{Loan amount} = \$8,400 \div .08 = \$105,000$$

Problem 18:

- (a) A \$250,000 loan carries a 7% rate. What is the monthly interest payment?
- (b) A \$300,000 loan has monthly payments of \$2,000. What is its annual interest rate?
- (c) A 12% loan has annual payments of \$15,000. What is the loan amount?

Loan-to-value (LTV) ratio

1. Formulas: $\text{loan amount} = \text{market value} \times \text{LTV}$
 $\text{LTV} = \text{loan amount} \div \text{market value}$
2. Example: A 75% LTV will allow a lender to make a loan of \$375,000 on a \$500,000 property.
 $\text{loan amount} = \$500,000 \times 75\% = \$375,000$
 $\text{LTV} = \$375,000 \div \$500,000 = 75\%$

Problem 19:

- (a) A lender requires \$90,000 down on a \$400,000 property. Calculate the lender's required LTV.
- (b) A property is valued at \$600,000. The lender will allow a maximum LTV of 75%. How much can the buyer borrow on the property?

Income underwriting ratio calculation

1. Formulas: Conventional:
 $\text{monthly PITI} = (25\text{-}28\%) \times \text{monthly gross income}$
FHA:
 $\text{monthly PITI} = 31\% \times \text{monthly gross income}$
2. Examples: A borrower has monthly gross income of \$2,000. Conventional lenders are using a ratio of 28%. The borrower can afford the following monthly PITI payments:
Conventional:
 $\text{PITI} = 28\% \times \$2,000 = \$560$
FHA:
 $\text{PITI} = 31\% \times \$2,000 = \$620$

Problem 20: A borrower earns \$4,000/month and pays \$600/month in debt repayments. A conventional lender requires a 26% income ratio, and an FHA lender requires 31%. What monthly PITI can this person afford based on the income ratio?

Conventional: \$

FHA: \$

Debt underwriting ratio calculation

1. Formulas: Conventional:

Expense = (36% x gross income) – monthly debt

FHA:

Expense = (43% x gross income) - monthly debt

2. Example: An individual has a monthly gross income of \$6,000, and has monthly debt payments of \$900. The borrower can afford the following monthly housing expense:

Conventional:

Expense = (36% x \$6,000) - 900 = \$1,260

FHA:

Expense = (43% x \$6,000) – 900 = \$1,680

Problem 21: A borrower earns \$4,000/month and makes monthly debt payments of \$600. What monthly payment for housing can this person afford based on the debt ratio?

Conventional: \$

FHA: \$

Points

1. Formula: 1 point = 1% (.01) of loan amount
2. Example: A lender charges 3 points (3%) on a \$350,000 loan. The points charges are:

$$3 \text{ points} = 3\%$$
$$.03 \times \$350,000 = \$10,500$$

Problem 22: A lender is charging 2.75 points on a \$240,000 loan. How much must the borrower pay for points?

Investments (Chapter 18)

Appreciation

1. Formulas: total appreciation = current value – original price

Error! Bookmark not defined.total appreciation rate =
total appreciation / original price

one-year appreciation rate = one-year appreciation /
prior-year value
2. Example: A house bought for \$500,000 appreciates \$50,000 each Year for 3 years.

total appreciation = \$650,000 - 500,000 = \$150,000

total appreciation rate = \$150,000 ÷ \$500,000 = 30%

first- year rate = \$50,000 ÷ \$500,000 = 10%

Problem 23: A property is purchased for \$360,000. A year later it is Sold for \$410,000. What is the amount of appreciation, and what is the appreciation rate?

Equity

1. Formula: $\text{equity} = \text{current value} - \text{current loan amount}$
2. Example: A buyer bought a property for \$600,000 with a loan of \$450,000. The house has appreciated \$60,000 and the buyer has reduced the original loan by \$30,000. The buyer's current equity is:
$$\text{Equity} = (\$600,000 + 60,000) - (\$450,000 - 30,000) = \$240,000$$

Problem 24: A property is purchased for \$450,000 with a \$75,000 downpayment. Five years later the property is worth \$540,000, and the loan balance has dropped \$12,500. What is the owner's new equity?

Pre-tax cash flow

1. Formula and example:

potential rental income	\$50,000
- vacancy and collection loss	3,000
= effective rental income	47,000
+ other income	2,000
= gross operating income (GOI)	49,000
- operating expenses	20,000
- reserves	3,000
= net operating income (NOI)	26,000
- debt service	15,000
= pre-tax cash flow	11,000

Problem 25: An apartment building has a potential income of \$300,000 and vacancy of \$12,000. Its bills total \$128,000, and \$12,000 has been reserved for repairs. Payments on the loan total \$88,000. What is the property's pre-tax cash flow?

Tax liability

1. Formula
and example:

net operating income (NOI)	26,000
+ reserves	3,000
- interest expense	15,000
- cost recovery expense	5,000
= taxable income	9,000
x tax rate (28%)	
= tax liability	2,520

Problem 26: The property from the previous problem has annual cost recovery of \$28,000. Out of the annual debt service, \$8,000 is non-interest principal payback. The property owner's tax rate is 28%. What is the property's annual tax?

Annual depreciation (cost recovery) expense

1. Calculation:
 - a. identify improvements-to-land ratio
 - b. identify value of improvements: ratio x property price
 - c. divide value of improvements by total depreciation term
2. Example: A property was bought for \$400,000. 75% of the value is allocated to the improvement. The property falls in the 39-year depreciation category.
 - (1) improvements-to-land ratio = 3:1, or 75%
 - (2) improvement value = \$400,000 x 75% = \$300,000
 - (3) annual depreciation = \$300,000 ÷ 39 = \$7,692

Problem 27: A property is purchased for \$400,000. Improvements account for 80% of the value. Given a 39-year depreciation term, what is the annual depreciation expense?

Capital gain

1. Formula
and example: (residential property)

Selling price of property	\$300,000
- Selling costs	24,000
= Amount realized (ending basis)	\$276,000
Beginning basis (price) of property	\$250,000
+ Capital improvements	10,000
- Total depreciation expense	0
= Adjusted basis of property	260,000
Amount realized (ending basis)	\$276,000
- Adjusted basis of property	260,000
= Capital gain	\$ 16,000

Problem 28: A principal residence is bought for \$360,000. A new tile roof is added, costing \$15,000. Five years later the home sells for \$440,000, and the closing costs \$35,000. What is the homeowner's capital gain?

Return, rate of return, and investment amount

1. Formulas:

$$\frac{\text{net operating income}}{\text{price}} = \text{return on investment (ROI)}$$

$$\frac{\text{cash flow}}{\text{cash invested}} = \text{cash-on-cash return (C on C)}$$

$$\frac{\text{cash flow}}{\text{equity}} = \text{return on equity (ROE)}$$

2. Example: A property is bought for \$200,000 with a \$50,000 down payment and a \$150,000 interest-only loan. The property has a net income of \$20,000 and a cash flow of \$8,000. In addition, the property has appreciated \$30,000.

$$\begin{aligned}\text{ROI} &= \$20,000 \div \$200,000 = 10\% \\ \text{C on C} &= \$8,000 \div \$50,000 = 16\% \\ \text{ROE} &= \$8,000 \div \$80,000 = 10\%\end{aligned}$$

Problem 29: A multi-unit rental property was bought four years ago for \$1,200,000 with a \$200,000 down payment. The property now rents for \$8,500 per month. Expenses and debt service are \$1,000/month and \$6,500/month respectively. An appraiser estimates the property's current value at \$1,450,000. The investor pays off her principal balance at a rate of \$5,000 per year. Compute the following investment returns for the investor:

ROI =

C on C =

ROE =

Taxation (Chapter 19)

Tax rate calculation

1. Formula: $\text{tax rate (millage rate)} = \frac{\text{tax requirement}}{\text{tax base}}$
2. Example: A municipality has a revenue requirement of \$10,000,000 after accounting for its revenues from sale of utilities. This requirement has to be covered by property tax. The real estate tax base, after homestead exemptions, is \$300,000,000. The tax rate will be:

$$\frac{10,000,000}{300,000,000} = .0333 \quad 33.33 \text{ mills}$$

Problem 30: Barrington has an annual budget of \$25,000,000 to be paid by property taxes. Assessed valuations are \$300,000,000, and exemptions total \$25,000,000. What must the tax rate be to finance the budget?

Homestead exemption calculation

1. Formula and example

assessed value	\$360,000
- <u>homestead exemption</u>	<u>50,000</u>
taxable value	\$310,000

Taxing the property

1. Formulas: taxable value of property x tax rate (mill rate) for each taxing authority in jurisdiction

total tax = sum of all taxes by taxing authority
2. Example: The taxable value of a property after exemptions is 400,000 and tax rates are as shown. The property's tax bill will be:

School tax: \$400,000 x 10 mills = \$4,000

City tax: \$400,000 x 4 mills = 1600

County tax: \$400,000 x 3 mills = 1200

Total tax: \$6,800

Problem 31: A homeowner's assessed valuation is \$225,000. The homestead exemption is \$25,000. Tax rates for the property are 8 mills for schools; 3 mills for the city; 2.5 mills for the county; and .5 mills for the local community college. What is the homeowner's tax bill?

Special assessments calculation

1. Formula:
 - a. Identify total costs to be assessed
 - b. Calculate prorated share for each property impacted
 - c. Multiply cost x prorated share
2. Example: A canal will be dredged at a cost of \$200,000. The improvement affects 30 properties with a total canal frontage of 4,000 feet. One property has 200' of frontage. Its assessment bill will be:
 - (1) $200' \div 4,000' = 5\%$ share
 - (2) $\$200,000 \times 5\% = \$10,000$ assessment

Problem 32: A street beautification project is to cost \$25,000. The project affects 20 properties having a total of 2,000 front feet. One owner's lot has 75 front feet. What will this owner's special assessment be?

Closings (Chapter 21)

Prorations

1. Formulas
and rules:

Accounting for common items paid (or received) in advance vs arrears

	arrears	advance	debit	credit
real estate taxes	x		seller	buyer
rents received by seller		x	seller	buyer
utilities	x		seller	buyer

Whose share is charged to whom?

- if buyer pays taxes in arrears: charge seller, credit buyer for seller's portion
- if seller received rents in advance: charge seller, credit buyer for buyer's portion
- if seller pays utilities in advance: credit seller, charge buyer for seller's portion

Calculating the proration: 360-day method and 365-day method

1. Calculate the daily proration amount

- a. 360-day method: divide the annual amount by 360 or monthly amount by 30
- b. 365-day method: divide the annual proration amount by 365, or monthly amount by # days in that month

2. Calculate # of seller's days

- a. 360-day method: use 30 days for each month; actual number of seller days within the month, counting (or not counting) the day of closing
- b. 365-day method: use actual number of days for each month and partial month

3. Calculate the seller's share

Multiply the daily amount times the number of seller's days – both methods

4. Calculate buyer's share (both methods)

Subtract seller's share (from #3) from total share

2. Example: A rental property closes on January 25 and the closing day is the seller's. The 365-day method will be used for the prorations. Monthly rent already received by seller is \$2,400. Annual real estate taxes to be paid in arrears by buyer are \$4,000. Round to the nearest cent.

1. **Rent proration:** (monthly; 365-day method)

Daily amount: $\$2,400 \text{ monthly rent} \div 31 \text{ days in January} = \$77.42$

Seller's days: 25

Seller's share: $\$77.42 \times 25 = \$1,935.50$

Buyer's share: $\$2,400 - 1,935.50 = \$464.50$

Credit buyer and debit seller for buyer's share of \$464.50

2. **Tax proration:** (annual; 365-day method)

Daily amount: $\$4,000 \div 365 = \$10.96$

Seller's days: 25

Seller's share: $\$10.96 \times 25 = \$274$

Buyer's share: $\$4,000 - 274 = \$3,726$

Credit buyer and debit seller for seller's share of \$274

Problem 33: A rental property closes on March 15th. Proratable income and expenses are: rental income of \$1,800/month, received in advance by seller, March 1; annual taxes of \$4,800/year, to be paid in arrears by buyer, January 1 of the year after sale. The day of closing is the seller's. February has 28 days. Prorate the items using the 365-day method, and assign debits and credits.

rent:	seller's share	\$
	buyer's share	\$
	debit seller/credit buyer	\$
	debit buyer/credit seller	\$
taxes:	seller's share	\$
	buyer's share	\$
	debit seller/credit buyer	\$
	debit buyer/credit seller	\$

REAL ESTATE MATHEMATICS: ANSWER KEY

Problem 1:	$\frac{3}{19} + \frac{2}{7} = \frac{21+38}{133} = \frac{59}{133}$	Problem 23:	\$50,000; 13.89%
Problem 2:	$\frac{4}{14} \times \frac{3}{8} = \frac{12}{112}$	Problem 24:	\$177,500
Problem 3:	2.65 = 265% 0.294 = 29.4% 0.005 = .5%	Problem 25:	\$60,000
Problem 4:	72.1% = .721 90.2% = .902 5.79% = .0579	Problem 26:	\$14,560
Problem 5:	8/9 = 88.8% 3/6 = 50% 14/42 = 33.3%	Problem 27:	\$8,205
Problem 6:	40% = 40/100 = 2/5 16% = 16/100 = 4/25	Problem 28:	\$30,000
Problem 7:	210	Problem 29:	(a) ROI = 7.5% (b) C on C = 6.0% (c) ROE = 2.55%
Problem 8:	144 SF 256 SF 35 SF	Problem 30:	90.9 mills, or 9.09%
Problem 9:	40 acres 10 acres	Problem 31:	\$2,800
Problem 10:	Schroeder: \$5,206.25 Hobson: \$7,437.50 Joachim \$9,668.75 Wallace: \$7,437.50	Problem 32:	\$937.50
Problem 11:	\$552,000	Problem 33:	rent: seller's share \$870.96 buyer's share \$929.04 debit seller/credit buyer \$929.04
Problem 12:	90%		taxes: seller's share \$973.16 buyer's share 3,826.84 debit seller/credit buyer \$973.16
Problem 13:	\$4,680		
Problem 14:	\$716.63 keep or change?		
Problem 15:	(a) +33,000 to comparable - 8,000 to comparable - 20,000 to comparable		
Problem 16:	\$1,000,000		
Problem 17:	(a) \$3,600,000 (b) \$3,888,888		
Problem 18:	(a) \$1,458 8% \$125,000		
Problem 19:	(a) 77.5% (b) \$450,000		
Problem 20:	Conventional: \$1,040/month FHA & VA: \$1,240/month		
Problem 21:	Conventional: \$840 FHA: \$1,120		
Problem 22:	\$6,600		