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CHAPTER 1 LICENSE LAW

KEY TERMS
- Administrative Discipline
- Apartment information vendor
- Apartment sharing agent
- Article 12-a
- Article 78 proceeding
- Associate real estate broker
- Blind ad
- Commingling
- Continuing Education
- Escrow
- Exemption
- Irrevocable Consent
- Kickback
- Mortgage Banker
- Mortgage Broker
- Net Listing
- New Record of Association
- Pocket Card
- Real estate salesperson
- Reciprocity
- Real estate Broker
- Revocation, Suspension
- Sponsor
- Termination and Notice
- Violation

INTRODUCTION
Just as you are entering the real estate profession, so have thousands of men and women before you. Their plans, like yours include activities such as buying, selling, and leasing. They are interested in careers in residential, industrial, commercial and agricultural real estate. They might be curious about other areas of specialization including appraising, exchanging, counseling, financing and law.

The opportunities for success are limitless. Real estate is said to be a fairly simple business, but not an easy one. Without a doubt, there is much to learn. Within this course, you will be taught about real estate laws, financing, fair housing, construction, environmental issues, property management and a great deal more. However, your education must continue after you obtain your license in order to fulfill the potential for the opportunities that will present themselves. You will need to understand your own market as well as how to make a listing or selling presentation. You will need to learn a great deal about what motivates people to make a major decision such as buying or selling real estate. You will have to become aware of the fact that you will never get a second opportunity to make good “first impression”.

Real estate is a people business and your education will continue long after you have successfully completed this course.

Remember, the definition of “luck” is the point at which opportunity and preparation meet. It is amazing how lucky successful people become when they are prepared for the opportunities that present themselves.

We enter into this business knowing that our state, like all other states has licensing laws which must be followed. These laws set the foundation for the operation of our industry. These laws are enforced by the Dept. of State, which has headquarters in Albany and offices throughout the New York. In this chapter, we will cover all of the laws regarding the licensing of real estate practitioners.

OVERVIEW
When you begin your career assisting others in buying and selling real estate, you will be involved in selling not only houses and buildings, but also the land beneath it. This will include everything to the core of the earth. We will also be selling the air rights above the building up to infinity. We are only permitted to use this property in accordance with the zoning laws. Just because we might own it,
doesn’t mean that we can build as high as we please. Zoning laws will restrict what can be done with the land that we own. The seller transfers all the rights he had in a property when he sells it. These rights include any mineral deposits beneath the surface of the earth unless they have been sold or leased to someone else. A sale is said to include the "bundle of legal rights" of the seller. This includes the rights of owning, leasing, selling, using as collateral for a loan, willing to whomever they want, etc.

As you can see, there is a great deal to learn. As we go through each of the chapters, we will supply you with your new vocabulary under the title of KEY TERMS. These are extremely important to know and understand. After all, in order to qualify for your license you are going to have to take two tests and the material will come directly from the subjects you will be learning here. These terms, for the most part, are used in the text and are defined in a glossary at the end of the book. With that in mind, remember, if you understand the terms you will be able to answer any question on that topic. So, let us begin.

**OBTAINING A REAL ESTATE LICENSE**

Effective July 1, 2008 a 75-hour course of study is required in order to obtain your license. When you complete the required education, you will take a test at an approved school location. The questions will all be multiple choices and a grade of 70 is necessary in order to pass. You will also be required to pass an exam administered by the Dept. of State at one of their locations. This too is multiple choices and a grade of 70 is also passing. The results of this exam will be posted online and there will be no specific grade noted simply pass or fail. The results are not available over the telephone.

It is necessary to make an appointment in order to take your test and there is a $15.00 fee each time you do. In fact you have unlimited opportunities to pass the state exam, however, there will be a fee of $15.00 for each try. The appointment can only be made online.

You can apply for your test through our website, www.realtyinstitute.net, click the link to State Licensing Commissions and then choose New York. You will be on a page labeled “eAccessNY” which contains a great deal of information regarding New York State licensing and other frequently asked questions.

You will need to create a user name and pass code in order to make an appointment at a location that is most convenient for you. A no show will cause forfeiture of your $15.00 fee and the next time you want to make an appointment, you will have to pay another $15.00. However, you are permitted to reschedule your exam by going to your page and clicking “reschedule”. This must be done several days before your appointment. Since the time for allowable rescheduling may change, check the site for rescheduling requirements so you are familiar with them.

No one will be admitted once tests begin. Arrive 45 to 60 minutes before your starting time to allow for security checks.

To enter the testing location you will be required to show photo identification. The name on your identification must be the exact name in which you want your license issued. The only acceptable forms of identification are:

- Drivers license
- Non driver ID
- Military ID
- US Passport, or INS issued ID
- Certificate of Citizenship

If you do not have current photo identification, a non-driver identification issued by the Dept. of Motor Vehicles will serve two purposes. It will provide the needed photo identification and the photo will be used for your pocket card identification which will be explained in depth at another point in this chapter. A thumbprint will be taken at the exam site. You will need a calculator for state and school tests as well as 2 #2 sharpened pencils with erasers. Calculators cannot have any electronic memory.
No PDA’s are allowed. Cellular phones and other electronic devices must be turned off and kept out of sight. Dictionaries, books and other reference materials, large bags and briefcases are not allowed at the test center, as there is no place to store them.

All tests will have questions from each of the subjects covered. The number of questions per subject will be based on the amount of time allocated to teaching it. This is referred to as a “weighted test”. Therefore, you will have many more questions on Law of Agency and Commercial real estate than you would on Math or Predatory Lending. Please keep that in mind when studying.

State requirements limit the number of times the student may take the school test to two tries. In the unlikely event a passing grade is not achieved at the second test, the student must repeat the entire course. **YOU MUST MAKE AN APPOINTMENT BY TELEPHONE FOR YOUR CLASSROOM EXAM, A “NO SHOW” ON EXAM DAY WILL RESULT IN AN ADDITIONAL CHARGE OF $50.00 THERE WILL BE NO EXCEPTIONS.** Your Proctor Exam Form will be required in order to take the school test. In the event you need to contact D.O.S., the phone number is (518) 474-4429.

Please remember the certificate of completion from our school is valid for eight years. The results of the state examination are valid for two years.

**APPLYING FOR YOUR LICENSE**

If you are applying for your license for the first time based on completion of the 75-hour course and having passed both the school and state exams, you can easily apply online. This applies to just about everyone reading this screen. You may pay by check or money order made payable to the Department of State or charge any fee to MasterCard or Visa, using the credit card authorization form available for download on their webpage. Do not send cash. Application and examination fees are nonrefundable. A $20 fee will be charged for any check returned by your bank. Once you have passed your test you will then go on to follow the simple directions to apply for your license and it will be issued quite easily. Remember, your principal broker must authorize your license application.

Upon successful review of your application, your license will be mailed to your business address. Once this process is complete, you need do nothing else unless the Dept. of State contacts you for any additional information they may require. Keep the certificate of completion you receive from the school with your own important personal papers. Do not mail it to DOS unless they specifically ask for it. In addition, you do not need to fill out a paper application. The Dept. of State verifies your completion of the course with our school.

Please keep in mind that until you receive your license, you are not permitted to begin working as a real estate salesperson.

**POCKET CARD**

The Dept. of State will issue a “pocket card” which you need to carry with you at all times. This is your identification as a licensee in the state of New York. The pocket card will have an identifying photo, which will be generated by the Dept. of Motor Vehicles. It must be “shown on demand”. If you are unhappy with the photo on your driver’s license, this might be a good time to have a new one taken. In the event the pocket card is lost or damaged and a new one is needed, there will be a fee of $10.00 to replace it.

**REQUIREMENTS FOR LICENSING**

Real estate salesperson license applicants must be 18 years of age or older and be a legal resident of the United States. A fair knowledge of the English language is also required.

To obtain a license the applicant must be sponsored by a licensed broker. Sponsorship is not required to take either the course or the state test. However, in order to begin to work in the real estate profession, you must have a license and that does require a sponsoring broker. We will discuss the duties of the sponsoring broker later in this chapter.
WHO NEEDS TO BE LICENSED
Anyone, who, for another and for a fee, commission or other valuable consideration, engages in any of the following activities:
- Negotiates any form of a real estate transaction including a mere portion of interest rather than full ownership
- Sell at auction or by other means, an interest in real estate
- List or tries to list real estate (telemarketing included)
- Negotiate mortgages other than residential loans (negotiating residential mortgage loans on one to four family homes requires a person to be licensed through the New York Banking Dept. as a mortgage broker). This is covered in depth in another chapter.
- Collection of rents. A license is required if, as an example, a property owner hires a management company to take care of their apartment building. Their obligations would include collecting rent. A real estate license is required. However, if an owner or the relative or friend of the owner is collecting the rent and it is only being done for this one landlord, no license is required. This will be explained in depth in other chapters.
- Making of leases, leasing, renting or offering to rent
- Relocation of tenants or owners in commercial or residential real estate
- Sell or negotiate a lot or parcel of land pursuant to article 9A
- Sell or lease subdivided land pursuant to article 9A
- Exchange of real property of any sort
- Negotiating the sale of a business where the real estate is an essential part of the sale. The sale of a business that does not include real estate as an essential part of the transaction does not require a license as a broker.

It is important to understand that a licensed broker may not employ an unlicensed person to assist in the negotiation of a real estate transaction. If the broker does, the broker forfeits rights to a commission on the transaction, is guilty of a misdemeanor and may have his/her license revoked. Simply put, everyone involved in the transaction, from start to finish must have a current real estate license.

SUMMARY OF ARTICLE 12-A OF THE REAL PROPERTY LAW
Our licenses and permissible activities are all covered under the license law referred to as “Article 12A of the Real Property Law.

Purpose and effect: This statute was enacted, primarily, for the protection of the public against the dishonest practices of the unscrupulous and the costly blunderings of incompetent real estate agents.

It is quite permissible for anyone to buy, sell, rent or lease real estate for themselves, companies in which they have an interest or to assist friends and families. If no fees are being charged or accepted for any of these services, then a license is not required.

A licensed broker, however, may not employ an unlicensed person to assist in the negotiation of a real estate transaction. If the broker does, the broker forfeits rights to a commission on the transaction, is guilty of a misdemeanor and may have his/her license revoked. Further, in the event of cooperation between brokers, all participants from each of the offices must be properly licensed or again, commission could be forfeited.

TYPES OF LICENSES
Broker/Associate Broker/Salesperson

Definition of a real estate broker: any person, firm, limited liability company, corporation, or other legal entity who, for another and for a fee, commission or other valuable consideration,
- Lists for sale
- Sells or attempts to sell real estate at auction or otherwise
- Sells or attempts to sell real estate in an exchange
• Buys or rents an interest in real estate
• Purchases or rents an estate or interest in real estate
• Collects or offers or attempts to collect rent for the use of real estate
• Negotiates or offers or attempts to negotiate, a loan secured or to be secured by a mortgage, other than a residential mortgage loan
• Engages in the business of a tenant relocator
• Engages in the sale of condominiums
• Engages in the sale of cooperatives
• Engages in the sale of vacant land under the provisions of article 9-A
• Is employed by or on behalf of the owner or owners of lots or other parcels of real estate, at a stated salary, a commission, or a salary and commission, or otherwise, to sell vacant land
• Who sells or exchanges, or offers or attempts or agrees to negotiate the sale or exchange, of any such lot or parcel of real estate.
• Sells a business where the value of the real estate transferred is part of the value of the business

The broker is the party responsible for all of the actions resulting from his salespeople dealing with the public. In the simplest explanation, the broker:
• Can own and operate a real estate office
• Hire and pay his salespeople
• Collect and disburse commissions
• Represent the public in a real estate transaction

An important consideration in understanding the need for a license is to realize that anyone can take any action to buy, lease, or exchange real estate for his own account. The license provision begins when the action is for someone other than himself and that action will cause someone to earn compensation.

“Associate real estate broker,” means a licensed real estate broker who chooses to work under the name and supervision of another licensed broker. The associate broker has completed all of the requirements to act on his own. He does not to do so and affiliates with another company. As an associate broker, he is subject to the same supervision and provisions as a salesperson. He can obtain a broker license by applying for it and paying the fee.

“Real estate salesperson” means a person associated with a licensed real estate broker to perform any of the duties required in a real estate transaction.

“Tenant relocator” refers to brokers who do not handle “traditional real estate”. They specialize in relocation of commercial or residential tenants when buildings are going to be demolished, rehabilitated, remodeled, or in some way structurally altered.

“Office manager” means a licensed associate real estate broker who works for another broker in the capacity of managing his or her real estate office. A salesperson may not act as an office manager. The associate broker/office manager is under supervision and guidance of the sponsoring broker in the same manner as a salesperson.

REQUIREMENTS FOR BROKER/ASSOCIATE BROKER LICENSING
In order to obtain a broker/associate broker license the following are required:
✓ Must be over the age of 20
✓ Complete 120 hours of required education
✓ Pass school and state tests
✓ Be a citizen of the United States or a legal permanent alien
✓ Never have been convicted of a felony or misdemeanor in any state. If the applicant was subsequently pardoned, or issued a certificate of good conduct or a relief from disabilities, an application for a license will be given consideration. Never been convicted as a sex offender in
this state or elsewhere of a felony, or a sex offense, or any offense committed outside of this state which would constitute a sex offense, or a sexually violent offense

✓ Licensed as a salesperson for a minimum of two years or has equivalent experience in the general real estate business of no less than three years
✓ Acquire the necessary experience evidenced by the following point system. 1750 points for each year as required by statute. A salesperson must have two years experience, therefore he needs a total of 3500 points. When using equivalent experience, three years of working in real estate related industries and 5250 points must be proven.
✓ An applicant must be able to establish to the satisfaction of the licensing authority that he personally performed all of the work associated with each transaction claimed for experience credit. Point allocation is available on the DOS website.

When the broker application is submitted, the applicant has to have the approval of the Dept. of State for the trade name that will be used. The DOS wants to be certain that the name is not similar to one used by any other broker which could cause confusion.

**REQUIREMENTS FOR SALESPERSON LICENSE**

✓ Be over the age of 18
✓ Be a legal resident of the United States
✓ Have satisfactorily completed a 75 hour salesperson licensing course
✓ Pass both school and state tests
✓ Never have been convicted of a felony or misdemeanor in this or any other state. If the applicant was subsequently pardoned, or issued a certificate of good conduct or a relief from disabilities, an application for a license will be given consideration.
✓ Never been convicted as a sex offender in this state or elsewhere of a felony, or a sex offense, or any offense committed outside of this state which would constitute a sex offense, or a sexually violent offense.
✓ Have a sponsoring broker

The application for a salesperson contains personal questions about many different areas of the applicants past. These would include:

Information about any criminal background

✓ A child support statement. This includes questions about obligations to pay child support as well as whether or not applicant is or is not more than four months in arrears. Any person who is four months or more in arrears in child support may be subject to having his or her business, professional and driver’s licenses suspended. It is a class E felony to offer a false instrument for filing with a state or local government with the intent to defraud.
✓ Does applicant receive public assistance or supplemental social security income
✓ No person shall be entitled to a license as a real estate broker or real estate salesperson under this article who has been convicted, and who has not subsequent to such conviction, received an executive pardon therefore or a certificate of good conduct from the parole board, to remove the disability under this section because of such conviction.

**DUTIES OF A SALESPERSON**

✓ He can only operate under the supervision of a licensed real estate broker
✓ He cannot operate independently.
✓ Facilitates the purchase and sale of property on behalf of customers or clients
✓ Obtains listings of property for sale with employing broker;
✓ Assists buyers of real estate to locate and purchase property listed with employing brokers or another broker
✓ He lists and negotiates the sale, lease, or rental of real property for others for compensation, under the direction and guidance of a responsible broker.
APPLYING FOR A LICENSE
Any person acting as a Real Estate Salesperson as described above is required by law to have a Real Estate Salesperson license. A person is ineligible to file this application if s/he is a member of the partnership, or is an officer or owns voting stock in the corporation that is the sponsoring broker. He may never own any portion of a real estate company to which he is licensed. If someone has completed the 45-hour salesperson qualifying course prior to July 1, 2008, they will be required to complete the 30 hour remedial course in order to qualify for licensure.

TERMINATION OF SALESPERSON’S ASSOCIATION WITH BROKER
Now that we have been hired, let’s take a moment to understand our relationship with our sponsoring broker and what needs to be done if we leave.

When we go “out into the field”, everything we do is in the name of the broker. At the beginning of this chapter, we wrote, “it is the broker who represents the public”. We, in turn, represent the broker. Therefore, all of our actions relating to the public are in the name and under the supervision of our sponsoring broker.

When we obtain listings, (permission from an owner to market his home) these are in the name of our broker and when we leave his office, they must be returned. Any material or information we obtain during our relationship belongs to the broker and, it too, must be returned.

In accordance with the licensing statute, brokers are required to terminate all salespersons who are no longer working for them. All terminations must be completed by the broker through the online real estate system. The principal broker for the salesperson must log in to their personal online real estate account to perform the transaction.

All change of associations must be also be completed through the online system. If someone has previously worked for another company, the first step is to ensure that the previous broker has already performed a termination. Once the termination is complete, the new representative broker should log in to their own account and complete the process. There is no need to return the license to the Dept. of State. There is a charge of $10.00 for each action.

SUPERVISION OF SALESPERSON BY BROKER
Section 441 of the Real Property Law requires that there be “regular, frequent and consistent personal guidance, instruction, oversight and superintendence by the real estate broker with respect to all business conducted by that broker”. Written records of all listings, sales or other transaction involving the salesperson with a clear identification of the salesperson and dates associated with the transactions should be kept for at least three years. These records will need to be submitted to the Dept. of State if the salesperson applies for a broker license.

LICENSE FEES
All license fees are for two years. If a broker has more than one office location; she needs a branch office license for each one.

Salesperson – $50.00
Associate Broker - $150.00
Broker - $150.00 per office

DISPLAY OF LICENSES
Only the broker’s license is to be displayed in a conspicuous location in the office. Salesperson's licenses can be kept in a secure location. They must be returned to the salesperson upon request.

RENEWAL OF LICENSE
Again, a simple process. The license is issued for a period of two years. Unless it is renewed prior to its’ expiration the agent cannot continue working. There is a period of two years after the date of
expiration within which the license can be renewed without penalty. Again, no real estate activity can take place during this time since there is no active license.

In order to renew the license during either the licensing period or the two years afterward, 22.5 hours of approved real estate education is required. This must include 3 hours of Fair Housing and Discrimination. Real estate continuing education is available both in the classroom and online. All course content and delivery of material must also be approved by the Dept. of State.

If a person was a licensed real estate broker working in the real estate business full time for at least 15 years by July 1, 2008, they are exempt from the requirement for 22.5 hours every two years. No other person will be exempt.

**COMMITTING MONEY OF PRINCIPAL**

A real estate broker is not permitted to commingle the money or property of his principal with his own. Funds in his possession for safekeeping for another shall at all times remain in a separate, special bank account to be used exclusively for their. These funds are to be deposited in a federally insured bank account promptly. If the account earns interest, it cannot be retained by the broker for his personal benefit. Under no circumstances does the broker have the right to use the funds for even a short time with the best intentions of returning it promptly. Additionally, within a reasonable time, the broker shall make a full accounting to his client of all funds collected. He will then remit any money due the client.

**Example:** A buyer makes an offer on a property, which is accepted by the seller. The initial deposit check is made payable to the broker and is deposited in an escrow account for safekeeping until it will be turned over to the seller or his attorney. During this period, some closings the broker counted on are put off and the broker does not have the money to pay his rent and telephone bill. He knows that the closings will occur within the next two weeks and so he “borrows” the money from his escrow account with the full intention of repaying it as soon as possible. He does just that. Nevertheless, by “borrowing” money that is not his, he is guilty of committing funds, which is a felony. He has no right to use the money for any personal reason no matter what his intention to return it might be.

**MANAGING PROPERTY FOR CLIENT**

When acting as an agent in the management of property a real estate broker shall not accept any commission, rebate or profit on expenditures made for his client without his client’s full knowledge and consent.

**Example:** A property manager is seeking bids for new fencing around the perimeter of the property of the office building. There are many companies that can do the job efficiently and their prices do not vary by much. One of the companies offers the manager a $2000 “bonus” if their company is used. Unless the manager advises the property owner of this arrangement, it is illegal.

**BROKER’S PURCHASE OF PROPERTY LISTED WITH HIM**

One of the great opportunities available to licensees is learning about houses as they come on the market. You will no doubt find owners who are anxious to sell for any number of reasons. Perhaps a job transfer is in the works. Or, unfortunately, a job termination has occurred and they can no longer keep the house. Someone has died and the estate has to be settled. The reasons go on and on. This is referred to as “self-dealing”. A licensee can always buy properties for themselves as long as some hard fast rules are followed.

These rules are strict: you cannot buy for yourself or any company in which you have an interest unless you have made your position clear to the seller or their representatives. “A real estate licensee shall not directly or indirectly buy for himself property listed with him, nor shall he acquire any interest therein without first making his true position clearly known to the listing owner.” The same holds true if you are buying property for a client and you have an interest in the company buying the property.

When selling the property there must be full disclosure to the buyer that the seller is a licensee.
Full disclosure gives the public the knowledge that we are professionals and, most likely, are not buying this for our own personal use. It is probably an investment. When selling, we are advising the buyer that we bought this as an investment. The public has the right to know that the property was purchased for the purpose of making a profit.

**COMPENSATION**
Contrary to what you may have heard, all commissions are negotiable. There are no fixed, set, area wide, state approved or “acceptable” commission rates. All commissions are negotiated between the client and the broker. There are many ways that commission can be calculated. It might be a percentage of the sales price, a flat fee, an escalating or de-escalating amount. The fee is negotiated and agreed upon between the parties at the start of the agreement to work together. A real estate broker must make it clear for which party he is acting and he cannot receive compensation from more than one party (both buyer and seller, as an example) except with the full knowledge and consent of all parties.

**OTHER REGULATIONS**
Negotiating with a party to an exclusive listing contract: No real estate broker can negotiate the sale, exchange or lease of any property directly with an owner or lessor if he knows that the owner, or lessor, has an existing written contract granting exclusive authority with another broker. We must have respect for an exclusive listing by another broker. We must take steps not to interfere with another brokers’ exclusive listing.

Inducing breach of contract of sale or lease: We cannot be a party to any action that would try to induce a buyer, seller, landlord or tenant to break an existing contract. This illegal action is usually attempted when the licensee has someone they would like to substitute as the principal.

Broker's offering property for sale must be authorized: A real estate broker shall never offer a property for sale or lease without the authorization of the owner.

Sign on property: No sign shall ever be placed on any property by a real estate broker or his licensees without the consent of the owner.

Delivering duplicate original of instrument: We have the responsibility to deliver all documents that have been executed (signed) by buyers, sellers, landlords or tenants to the respective parties. This is required only when the licensee prepared the document or it was prepared under the supervision of the broker. If the document was prepared by the attorney we do not have any legal responsibility to deliver the documents. Some examples would include:

- Offers
- Binders
- Listing agreements
- Contracts

Accepting services of another broker's salesperson or employee: A real estate broker is not permitted to allow a salesperson licensed to another broker to perform any services or accept any fees without the knowledge and consent of their sponsoring broker.

**EXCLUSIVE LISTINGS—RESIDENTIAL PROPERTY**
When we obtain exclusive listings, they must have a termination date. It is not permitted to have an automatic extension clause in the listing.

For example:
Salesperson Joan writes an exclusive listing for the sale of the Warren home. She does not include a termination or expiration date. This could mean that the listing will continue indefinitely, or, until it is
sold. This is not permitted. It must have an expiration or termination date. This date appears on the listing agreement.

Salesperson Joan writes the exclusive listing knowing that it must contain an expiration date. However, she wants to be able to have it continue indefinitely so she includes a clause that states, “This listing shall automatically renew for the same period of time as the original”. Neither of these examples is permitted. In the event the seller wants to extend the listing period they are free to do so by signing an extension to the original listing or, if they prefer, a new agreement.

When a broker obtains an exclusive listing on one, two or three family homes, the listing must have an explanation of the differences between an exclusive right to sell and an exclusive agency. The explanation is attached to the listing in type size of not less than 6 points and must be signed by the homeowner or the homeowners’ agent. The agent must be fully aware of the differences and explain them to the owner.

Explanation Required:
An “exclusive right to sell” listing means that if you, the owner of the property, find a buyer for your house, or if another broker finds a buyer, you must pay the agreed commission to the present broker.

An “exclusive agency” listing means that if you, the owner of the property find a buyer, you will not have to pay a commission to the broker. However, if another broker finds a buyer, you will owe a commission to both the selling broker and your present broker.”

ENFORCEMENT OF THE LAW
The Dept. of State may revoke or suspend the license of a real estate broker or salesperson for whatever period they choose.
  1. They may impose of fine of not more than $1,000
  2. They may simply reprimand the licensee

REVOCATION, SUSPENSION, REPRIMANDS, FINES
The Department has the power to suspend or revoke a license pending a hearing and to subpoena any person and take testimony. If the license of the broker is suspended or revoked, all salespeople associated with the broker must immediately stop working. However, if they were not involved in the problem, they will be able to move their license to another broker. Until they take that step, once again, they cannot be involved in any real estate transaction.

VIOLATIONS BY SALESPERSONS: In the event the violation is a result of an action by the salesperson or employee of the broker, the broker will not have his license suspended or revoked unless it can be proven that he had actual knowledge of the action causing the violation. Or, he retained benefits or profit from the wrongful transaction. Additionally, the broker will be guilty of a misdemeanor if there is a salesperson associated with his firm who has not secured the required license.

JUDICIAL REVIEW
If there is an action to refuse to grant a license or suspend or revoke one already in existence, or recommend a fine, the aggrieved party will have the right to bring an article 78 proceeding. An Article 78 proceeding is used to appeal the decision of a New York state or local agency to the New York courts. All brokers’ and salesperson’s licenses and pocket cards must be returned to the Department of State within five days after the receipt of notice of a revocation or suspension. The display of a real estate broker’s license after the revocation or suspension is prohibited. If a license is revoked, the licensee will not be eligible for re-licensure until after a period of one year from the date of revocation.

PENALTIES
In case the offender received any sum of money as commission, compensation or profit as a result of his violation of any provision of this article, he will also be liable to a penalty of not less than the amount of money received by him and not more than four times that sum, as may be determined by
the court. The aggrieved party may sue in any court of competent jurisdiction in order to recover this sum. Upon recovery, it will be for the aggrieved party’s own use.

ENFORCEMENT
Any person has the right to make a complaint against a licensee to the Dept. of State. Upon receiving this complaint, the Department can investigate the business, business practices and business methods of any firm or corporation applying for or already holding a license.

Fines: the Dept. of State may impose a fine not exceeding $150 for the first violation, not exceeding $500 for a second violation, and not exceeding $1,000 for a third and each subsequent violation.

COMMON VIOLATIONS OF LICENSE LAW
- Making a material misstatement on a license application such as not completing continuing education as required or failing to state accurate child support information
- Engaging in fraud or fraudulent practices: suggesting to a buyer that a basement apartment would be an excellent way to own a house that otherwise, is out of their price range
- The use of dishonest or misleading advertising: Including words like “desperate seller” or “bring offers” without the seller’s approval. Stating that a house is “in the vicinity of” without actually stating the true geographic location
- Commingling of funds
- Interfering with another brokers’ exclusive listing
- Offering a property for sale or placing a for sale sign without the approval of the owner
- Not making their position clear in all real estate transactions (self-dealing). This would include:
  - Who is the client or the customer
  - Whom do they represent
  - Are they personally involved in the transaction in any way other than as a licensee (are they the buyer or seller or acting in any ownership capacity)
- Salesperson retaining listing information after terminating his relationship with the broker
- Entering into a net listing: net listings state the net price to the seller, but not the amount due the broker. The broker receives the difference between the agreed upon net price and the selling price. This type of listing is illegal in New York State.

Only a licensed real estate broker is entitled to sue for an unpaid commission. An unlicensed person or corporation cannot sue since they are not entitled to compensation for a real estate transaction.

There is always ample time granted for the licensee to prepare a defense. If the license is suspended or revoked it must be returned to the Dept. of State within five days.

DRAWING OF LEGAL DOCUMENTS
The license as a real estate broker gives the right to negotiate real estate transactions, it does not give the right to draw legal documents or give legal advice. The preparation of a legal document may result, in addition to other penalties and damages, the loss of commissions and the revocation of the license.

The Duncan/Hill decision was a landmark decision handed down in 1978 by the New York Appellate Division. In essence, this decision said that no licensee may include detailed legal terms and conditions beyond filling in a purchase offer contract approved by the Dept. of State. The terms typically prohibited might include a seller holding a purchase money mortgage and the broker inserting the terms of such financing. To do so would constitute practicing law without a license.

STATE REAL ESTATE BOARD
The Dept. of State is permitted to establish a State Real Estate Board consisting of 15 members. They will include the Secretary of State, an executive director of the Consumer Protection Board and 13 additional members. The board holds meetings at least three times each year. In addition, there are public meetings held in Albany, Buffalo and New York City, once each year in order to get input from the real estate community. The State Real Estate Board has the power to implement rules and
regulations affecting real estate brokers and salespeople. This includes approval of schools, studying laws and regulations and enforcing programs and activities.

REALTOR®
The word is not synonymous with a real estate licensee. A REALTOR® is a member of a trade organization. The term REALTOR® is trade name copyright protected by the National Association of Realtors (NAR). Not all licensees are REALTORS®. NAR members are licensees in all states of the United States and are involved in all phases of real estate. There are state and local boards throughout the U.S. and members are pledged to uphold a Code of Ethics as well as Standards and Practices in order to protect the public and fellow members. Multiple Listing Services are usually owned by the local Board of REALTORS®. A Multiple Listing Service provides members with information about houses for sale as well as other important property facts such as selling prices, taxes, etc.

NON-SOLICITATION
The Secretary of State may adopt a rule, to be known as a non-solicitation order, directing all real estate brokers, salespersons and other persons regularly engaged in the trade or business of buying and selling real estate to refrain from soliciting residential real estate listings or otherwise soliciting the sale of residential real estate within a clearly defined subject area. A non-solicitation order may prohibit any or all types of solicitation directed towards particular homeowners, including but not limited to letters, postcards, telephone calls, door-to-door calls and handbills.

CEASE AND DESIST
If the Secretary of State determines that some owners of residential real property within a defined geographic area are subject to intense and repeated solicitation by real estate brokers and salespersons to place their property for sale or to sell their property, a “cease and desist” zone may be adopted.

Once each year on or before Dec. 31, the Secretary of State will print a list for each zone. These lists are available to the public and real estate licensees at a very nominal fee. In recent years, it has only charged $10.00 per zone. This information is also available online.

A licensee cannot solicit the sale or lease of residential property after the owner has notified them they are not interested in selling, leasing or listing or their name appears on the cease and desist list.

The prohibited contact includes both oral or in writing using any of the following:

- Telephone
- Mail
- Delivery service
- Personal contact
- Delivery or presentation to anyone at the homeowners address
- Left for the owner or anyone else
- Placed on a vehicle, structure or object at the premises
- Contact includes:
  - Letters
  - Postcards
  - Handbills or leaflets or fliers
  - Direct advertising delivered by mail or other service
  - Telephone calls
  - Door-to-door calls
  - Postings in public places

The following is not prohibited by a nonsolicitation order:
Advertisements that are published in newspapers of general circulation if such newspaper has a general readership throughout the metropolitan New York City area or throughout a substantial portion of the metropolitan New York City area IF such newspaper is:
A. published not less than once per week
B. sold by subscription or by individual copy and is not distributed free of charge

Remember, the owner put his name on the list voluntarily. Therefore, they know that they should not be hearing from you!

RECORDS OF TRANSACTIONS TO BE MAINTAINED
Section 175.23: The broker is required to keep and maintain for three years, records of all transactions in his office of mortgages or sales of all one to four family homes. Perhaps the simplest way to comply with this section, 175.23, would be to keep a copy of the:

- Contract of sale,
- Commission agreement
- Closing statement
- Statement showing disposition of proceeds of mortgage loan
- Complete record keeping is an important part of the duties of the broker.

ADVERTISING
Unfortunately, advertisements by real estate professionals are often filled with misrepresentations. This is not so much because the broker is deliberately looking to mislead the public. It occurs frequently simply because the broker is not aware of what can and cannot be included in ads and how they should be worded. Let us go over some of the essentials points to remember in order to be able to recognize and prevent misrepresentation.

- Only the broker is permitted to place advertising for the sale or lease of real estate including the shares of stock in a cooperative corporation.
- A salesperson or associate broker cannot place an ad in his/her name only.
- All ads must contain the name of the real estate broker allowing the public to recognize that the ad is placed by a licensee.
- The name of the broker or the brokerage company name must be 25% larger than that of the salesperson or associate broker named in the ad.
- Classified ads must include the name of the broker/brokerage and the name of the salesperson or broker associate if they are listed as contact persons. The name of the company does not have to be 25% larger than the associate in the case of classified advertising.
- When a salesperson or broker associate’s name appears in any advertising it must be the true name as listed on their license. Nicknames cannot be used without the licensees’ official name.
- All ads must list the type of license held by anyone named in the advertisement.
- The telephone number of the brokerage office must be in all ads. If the salesperson/associate broker wishes to include their own telephone number, that is permitted as well. These numbers must be clarified as being “office, home phone, or cell phone” etc.

Titles and designations are permitted in advertising as long as they are not the most prominently listed. The prominent required designation is that of a licensed real estate broker, licensed real estate salesperson or licensed associate broker and are the only permissible titles. Using titles such as “sales associate, sales agent or broker” are prohibited. Designations such as relocation specialist or office manager as well as designations as a result of affiliations with associations or board or organization membership are permitted.

When logos are included they can only be the ones associated with the licensed real estate broker. Real estate teams or individual licensees cannot use a logo created separately from that of the brokerage company. All logos must be 25% larger than the name of the licensee.

Business cards are a form of advertisement and, therefore, must comply with rules and regulations. All business cards must have the name and address of the brokerage or broker with whom the agent is associated. The name of the company must be 25% larger than that of the agent. They must contain
the office phone number. If other phone numbers are used they must be classified as “home, or cell, etc.”

The full name and type of license must be included. Again, the person’s name as it appears on their license and the type of license issued.

All ads must have an honest and accurate description of the location of the property. If the ads states “in the vicinity of” the actual name of the subdivision or geographical area must be included in the body of the ad.

All statements in advertising must be honest and accurate. Advertising free appraisals when what is being offered is a market value analysis would not be honest or accurate.

**POSTING OF BUSINESS SIGNS**
Real estate brokers must post a sign containing the name under which they are licensed and indicating their business (which must be stated as "licensed real estate broker") on the outside of the place of business. If the business is located in an office, apartment or hotel building, his/her name and the words "licensed real estate broker" must be posted in the space provided for that purpose in the lobby of the building, other than a mailbox. Otherwise, it must be posted on the door to the apartment or wall next to the door.

In case a sign is posted on the outside of the building, it must be readable from the sidewalk. A similar sign must be posted on each branch office maintained by the licensee. A real estate broker cannot open an office in his home or in a location that does not permit signs.

**RECIPROCITY**
Nonresident licensees:
A nonresident of this State may become a real estate broker or a real estate salesperson by conforming to all of the provisions of this article. If they maintain a definite place of business in another state, which offers the same privileges as New York, they are not required to maintain a place of business within this State. If a state restricts or prohibits the rights of residents of this State to a non-resident license, then issuance to a resident of that state is also restricted.

Example: XYZ state does not permit New York residents to have a non-resident license in XYZ state; therefore, New York would not allow XYZ residents to have a license here. ABC State does permit New Yorkers to have a non-resident license, and so, their residents would be granted a New York non-resident license.

The non-resident broker or salesperson must file a duly executed "irrevocable consent" in which they agree to be under the jurisdiction of courts in this state. Simply put, a non-resident must agree to return to New York State in the event there are any charges or complaints against them.

We are currently reciprocal with the following states:
- Arkansas
- Colorado
- Connecticut
- Georgia
- Massachusetts
- Mississippi
- Oklahoma
- Pennsylvania
- W. Virginia

**PERSONS EXEMPT FROM APPLICATION OF LAW – SECTION 442, SAVINGS CLAUSE**
The following do not need a license:
Public officers while performing their official duties: Example: a sheriff involved in the eviction or sale of property, state agencies in condemnation proceedings, etc.

Persons acting in any capacity under the judgment or order of a court: Example, an executor or executrix in an estate, a trustee in a bankruptcy proceeding, guardians, administrators, etc.

Attorneys at law duly admitted to practice in the courts of New York. When an attorney employs a salesperson or salespersons, the attorney must obtain a license as a real estate broker. He is not required to take a course or pass a test. He must only submit the appropriate application and fee.

Building superintendents and others who work for the building owner may collect rents and perform other duties.

Property managers working for one owner may also perform real estate related duties.

Tenants associations and other nonprofit organizations, which have the necessary approvals, are also exempt from licensure.

Territorial application of law: The statute is statewide in its application (section-440a). Whatever is legal and applicable is legal and applicable in all parts of the state.

Contrary to some beliefs, everyone licensed in New York State is governed by the same set of rules.

**UNLICENSED ASSISTANT GUIDELINES**

Some successful licensees need help with administrative work such as making appointments, checking on contracts and mortgages, keeping track of new listings and reports of closings, etc. These administrative activities are allowable without a license. The agent must be certain not to permit any activities that are covered under Article 12A which governs who must be licensed and the specific activities requiring a license. Many new agents do not realize just how much record keeping and analysis of homeowner’s views and buyers requirements need to be noted. It is very important to recognize the need for excellent record keeping.

**MULTIPLE LICENSES**

A salesperson may hold more than one license at a time. However, all sponsoring brokers need to give their permission. A qualified licensee may hold both a broker and an associate broker license.

The process for exchanging a broker license for an associate broker license is relatively simple. It merely involves a new application and payment of the $150.00 fee. No additional education is required.

**USING AN ASSUMED NAME**

If a broker wants to operate under an assumed name, (business name) that name must be approved by the Dept. of State. If a business is to be opened as a corporation, that corporation must also be approved before the name can be used.

Each company operating under an assumed name needs to have a licensed real estate broker responsible for all real estate related activities. In the event more than one licensed real estate broker is assuming responsibility for the company, they must each have a corporate license. All corporate licenses will expire on the same date.

Real estate brokers and salespersons licenses are issued and mailed directly to the business name and business address shown on their application.

**CHANGE/TERMINATION OF ASSOCIATION**

When there is a change of association by a salesperson, termination of association as a salesperson, or change of address by a broker, the following procedures must be followed and can usually be completely online:

1. Change of association - $10.00 fee, and a change of associate form
2. Termination of Association - $10.00 fee, and a termination form
3. Broker Change of Address - the broker must notify the Dept. of State when moving a principal or branch office to a different address.

The following steps must be completed within five days after the new premises are occupied:
The broker will complete form entitled Broker Change of Address online and submit it to the Dept. of State
1. Pay a required fee of $10
2. Each salesperson or associate broker sponsored by that broker must also submit a change of address form and pay the appropriate fee of $10.

**COMPENSATION OF SALESPERSON**
A real estate salesperson may not demand or receive compensation from any person other than a duly licensed real estate broker regularly employing the salesperson. Brokers typically charge a percentage of the sales price of a property as their commission and this is split in an agreed upon amount with the salesperson. Salespeople and brokers often further divide the commission between the "listing" and "selling" companies.

Splitting commissions: A real estate broker is not permitted to pay any part of a fee or commission or compensation of any type to any person for help or service in the negotiation of a real estate transaction unless the person is a properly licensed salesperson employed by the broker or a real estate broker licensed in this state or another. Payment of an improper fee is commonly referred to as a "kickback".

**DEATH OF BROKER**
Upon the death of the broker responsible for the operation of the real estate business, the license issued can be used for a period of 120 days. The sole purpose of this provision is to complete any unfinished transactions. In the event all transactions are not completed within 120 days, the executor or administrator of the estate may ask for an additional period of time not exceeding another 120 days. If the license expires within this period, it will be automatically renewed for the balance of the extension.

**REAL ESTATE AGENCY DISCLOSURE FORM**
When we deal with buyers, sellers, landlords and tenants, we must establish our legal working relationship with each party before we begin the process of showing or listing real estate. This is referred to as our “agency relationship”. In order to do this, under New York State licensing law, a mandatory agency relationship form must be presented to all members of the buying, selling or leasing public at the first substantive meeting during which a discussion regarding real estate occurs. This is required on all one to four family homes, not including cooperative or condominium units. These laws and the required forms will be discussed at length in the “Law of Agency” chapter.

**PROPERTY DISCLOSURE**
Although there are many aspects of real estate that must be disclosed to buyers, tenants and/or sellers, there are times when information cannot be disclosed. When this occurs, the properties are referred to as “stigmatized properties”. The following are included:

(a) an owner or occupant of the property is, or is suspected to be, infected with h.i.v. or diagnosed with aids or
(b) the property is, or is suspected to have been, the site of a homicide, suicide or other death by accidental or natural causes, or any crime punishable as a felony.

In the event the buyer/tenant feels that the information is important to them, they may submit a written inquiry for it. The buyer/tenant agent will give the request to the seller or their agent. The seller may then choose whether or not to supply the requested information. The public cannot bring a
complaint against the licensee for nondisclosure even if they feel the information is extremely important.

**OTHER STATUTES AND LAWS**

**CONVEYANCES & MORTGAGES**

Disclosure prior to the sale of real property
In the event property to be sold has no utility electric service, the buyer must be informed prior to an offer being accepted. In the event a buyer or prospective buyer suffers a loss, they are entitled to recover any actual damages from the person offering to sell the property. If there are any gas or electric utility surcharge payments due, these payments must be disclosed prior to the sale.

**ARTICLE 9: RECORDING INSTRUMENTS AFFECTING REAL PROPERTY LANDS IN AGRICULTURAL DISTRICTS**

If we are dealing with property located partially or completely within an established agricultural district a formal disclosure is required.
CHAPTER 2 LAW OF AGENCY

KEY TERMS
Accountability
Agency disclosure form
Agent
Broker's agent
Buyer agent
Client
Confidentiality
Cooperating agent
Customer
Designated sales agent
Disclosure
Dual agency
Estoppel
Exclusive agency
Exclusive right to sell
Expressed agency
Fiduciary
Fiduciary duties
First substantive contact
General agent
Group boycott

Implied agency
Informed consent
Landlord's agent
Loyalty
Market allocation
Misrepresentation
Obedience
Open listing
Price fixing
Principal
Reasonable care
Self dealing
Seller's agent
Special agent
Subagent
Tenant's agent
Tie-in arrangement
Undivided loyalty
Undisclosed dual agency
Vicarious liability

This chapter is devoted to Law of Agency. Interesting term isn’t it? But what exactly does it refer to? We have all heard the terms “customer and client”. To many students these words might seem interchangeable. After all, if I am buying a house or renting an apartment doesn’t that mean that I am a client of the salesperson I am working with? The answer is a resounding NO. The words “customer” and “client” are quite different. They mean different responsibilities for the salesperson and broker. They mean different rights or expectations for buyers, sellers, landlords or tenants. They define the information we are permitted to reveal, how offers are presented and are a consideration in almost every aspect of a real estate transaction.

Before we begin to learn about “agency”, let us first explore the key terms that we will use.

MYTH vs FACTS
Unfortunately, over the years, many myths have existed about what is permissible and non-permissible in our profession. In order to begin to understand all that Law of Agency involves, let us explore some of them and compare them to the facts.

Myth 1: The seller always pays the commission and therefore is always represented in the real estate transaction.
Fact: Either party or both parties can be represented. Either party or both parties can participate in paying the commission.

Myth 2: If a house is listed with a broker, he cannot share his commission with anyone other than a sub-agent.
Fact: The listing broker can share his commission with any licensed real estate broker he chooses to.

Myth 3: Both buyer and seller can never be represented by the same broker.
Fact: With the creation of a dual agency agreement, it is perfectly permissible for the same broker to represent both buyer and seller.
Myth 4: If the listing broker is going to sell a home listed with his office, he must create a dual agency agreement.
Fact: The only time a dual agency agreement must be signed is when both buyer and seller have hired the broker to represent them in a real estate transaction. In many cases, the buyer is a customer and not a client, therefore, no dual agency agreement is required.

Myth 5: Buyers and sellers must each have a representative from a different real estate office.
Fact: Buyer and seller clients can be represented by one broker. A dual agency agreement is required and they can have a designated agent appointed to assist them during the transaction.

Myth 6: A property listed through a Multiple Listing Service requires that all members must represent the seller.
Fact: Members of Multiple Listing Services can be sub agents, buyer brokers or broker agents. They can certainly represent a buyer.

Myth 7: Brokers are not advocates of the public.
Fact: When a buyer or seller hires a broker to act as their agent, they are hiring that broker to become their advocate in the transaction. They have every right to expect their agent to work for their benefit.

That is certainly a lot of information to digest so early in this chapter. So, let us get a little more specific.

**AGENCY DEFINED**

It is a legal relationship guaranteeing that when someone, the Principal, hires another, an Agent, to act in their behalf, there will be a fiduciary or trust relationship established. The Agent is hired by anyone who does not want to or cannot accomplish something. Agency is usually created when actions involve money or property.

The Agent would be expected to be an expert and the Principal could expect to rely on him. More and more, both buyers and sellers have come to expect the real estate licensee to be both expert and professional in their dealings. Remember, the actions of the Agent will always be to the benefit of his Principal.

**EXAMPLE:** A homeowner wants to sell his home. He decides to hire a real estate broker to assist in its marketing. The real estate broker would have a fiduciary or trust relationship with the seller. All of the actions the broker takes in the marketing of the home will be to the benefit of the homeowner who hired him. In so doing, however, he cannot in any way misrepresent the property to the customer, in this case, the buyer.

Homeowner = Principal
Real Estate Broker = Agent

The law of principal and agent, or agency governs the relationship of real estate brokers, salespeople and their clients and customers. By definition, The Client has a principal/agent, and therefore fiduciary relationship with the broker. The customer does not. The Client has hired the broker/agent to look out for his best interest, the Customer has not.

Misunderstandings can occur because of the frequency of two brokers cooperating in the sale of real property. One broker may have the exclusive listing and another broker has the buyer. The buyer, not being properly informed, believes that the broker who is showing him property will look out for his benefit. In fact, in the majority of situations, the broker showing the property is actually a sub agent of the seller and, therefore, represents the seller’s best interests, not the buyers.

Sounds a bit confusing doesn’t it. We are quite sure that by the time you have completed this chapter you will have a full understanding of all the rights and responsibilities of the licensee and the public.
**TYPES OF AGENCIES**
To complicate the issue of agency just a little more, let us understand that there are three different types of agencies. Each of these would be created for a totally different purpose.

**UNIVERSAL AGENCY**: Must always be in writing. The agent has the right to make all legal and financial decisions which would be binding on the principal.
*EXAMPLE*: An elderly person has created a trust and all of his legal and financial decisions will be made by the person appointed as his trustee. This trustee can make decisions regarding issues such as the purchase or sale of possessions in the trust. These might include real estate or stocks or savings accounts as some examples. These decisions must be honored by the person who created the trust even if he would have preferred something else to have been done. Unfortunately, over the years there have been some horrifying examples of the misuse of a universal agency.
*EXAMPLE*: An elderly couple creates a trust naming their children as trustees. As time goes by perhaps one of the children is having financial troubles and decides to sell major assets of his parents. Eventually the parents are left penniless and have to rely on public assistance in order to survive. This isn’t a pretty story, but one that has been repeated quite often especially in light of downturns in the economy.
*EXAMPLE*: The trustee decides to sell a home listed in the trust in order to invest the proceeds in municipal bonds to guarantee an income for the life of the principal. The principal would prefer to keep the house and not invest the money. The trustee is making a legally binding decision and the principal must abide by his decision. The principal has to move out of his home because it was sold. Once again, a universal agency is a written agreement that allows one person, the agent, to make binding decisions for another, the principal.

**GENERAL AGENCY**: It must be created in writing, and is binding upon the principal. Whereas in a universal agency, the principal is bound by all decisions regarding many different legal or financial situations, the General Agency is usually created for only one legal or financial matter or range of matters. It is specific in the actions allowed.
*EXAMPLE*: A landlord hires a property manager to look after his apartment building. This agreement is in writing and the property manager is given the legal right to make some decisions about the building that would be binding on the landlord. These would be spelled out in the property management agreement.
Perhaps the elevator develops a problem on a Sunday. The manager calls the maintenance company and they agree to make a service call, however, since it is Sunday, they will charge an additional $500.00. The manager authorizes the additional charge. If the landlord decides on Monday it could have waited for one more day, the landlord would still be bound to pay the $500.00. When a principal/agent relationship is established, as in a property management agreement and the agent acts in what he believes to be the best interest of the principal, the principal is bound by the agents actions.
*EXAMPLE*: A young couple from California buys a house in New York. After the contract is signed they return to California to close on the house they are selling. Before they return to California, they appoint “Uncle Charlie” as their agent to oversee the closing of the property in New York. “Uncle Charlie” is their general agent and his decisions cannot go beyond ones leading up to the closing of the house in New York. The document that the attorney would draw up determines what responsibilities “Uncle Charlie” would have. It is called a “power of attorney”.
Both a universal and general agency is created through the document known as a power of attorney.

**SPECIAL AGENCY**: These are quite different from the universal and general agency agreements. The real estate profession is generally operating under this type of agency. The agent cannot make decisions that will be binding on the principal. Our job is to bring the buyer and seller to an agreement on the terms of the sale or lease. We do not make decisions and must always realize that we are representing the decision maker.
*EXAMPLE*: A homeowner employs a real estate broker to market his home. The owner chooses to give the broker an open listing and does not put it in writing. The broker has established a principal/agent
relationship with the homeowner and is acting in a fiduciary or trust capacity in the marketing of the home. Even though the listing is a verbal one, every action that the broker, his salespeople or cooperating brokers and their salespeople take, must be in the best interest of the homeowner, their principal.

This holds true unless the cooperating office is representing the buyer in which case that office’s fiduciary or trust relationship is on behalf of the buyer. The broker who accepts the special agency agreement with the seller generally does not have the legal right to make any binding decisions for the seller. Of course, if something was specifically provided for in the listing agreement the agent would be bound by the agreement. The agent is really a “conduit” through which information flows. We get information and we reveal it to our client. We are responsible to let our client know “everything that materially effects the transaction”.

EXAMPLE: A buyer customer, wishes to make an offer on the house. It is priced at $550,000. The buyer offers $500,000. The salesperson tells the buyer that the offer is too low and that he will not present it because the owner might be offended by such a low offer. This is not permitted. The salesperson must present all offers and allow the seller to determine whether or not it is attractive to him.

EXAMPLE: This similar scenario occurs: the house is listed at $550,000 and the buyer tells the agent that he is willing to go up to $535,000 for the house buts wants to start negotiating at only $500,000. The agent, who represents the seller, agrees to make the offer of $500,000 without revealing the willingness of the buyer to go higher. This is not permitted. The agent represents the seller and is obligated to inform the seller that the buyer will pay $535,000.

EXAMPLE: A buyer is represented by an agent and makes an offer of $500,000 on a house listed at $550,000. He informs the agent that he will go as high as $535,000 if necessary. The agent makes the offer of $500,000 without any mention of the willingness of the buyer to go higher. In this example, the action is perfectly legal. The buyer is the client of the agent and the agent has an obligation to get the best terms for his client......the buyer.

EXAMPLE: A buyer insists that the appliances remain with the house even though the listing does not indicate that they will. The agent, who is representing the seller, assures the buyer that he can convince the seller to leave them. The agent cannot make any binding decisions or agreements on behalf of the seller. Therefore, the only remark that would be permitted would be an indication that he will bring the offer to the seller and will explain the buyer’s request. To make an assurance would be to violate his fiduciary responsibility to his client.

**AUTHORIZATION/EMPLOYMENT**

The foundation of an agency is an authorization or contract of employment, the terms of which may be either expressed or implied. Simply put, unless there is an agreement between the public and the broker, we don’t have the right to represent them. To further confuse you at this point, let us also briefly understand that if, perhaps a buyer, doesn’t want to sign an agency disclosure agreement, she doesn’t have to and we can still show her houses. However, in this situation, we would not represent her and would not be looking out for her best interests. We would still have to deal honestly and fairly with her throughout our working relationship. We are going to spend a good deal of time in this chapter going over this type of situation.

An expressed agreement is one in which the terms have been discussed and agreed to by the parties, either verbally or in writing. The party understands what our job description is and willingly accepts it. An implied agency is one which arises from the act of the parties. Too often the agent doesn’t discuss his agency relationship and the buyer believes the agent to be “his” agent.

EXAMPLE: The agent of the seller gives advice to the buyer giving the impression that he is acting on the buyers behalf. This would prevent the seller from getting the protection to which he is entitled in the principal/agent relationship.

**WHAT DO WE NEED IN ORDER TO ESTABLISH THIS EMPLOYMENT?**

Broker with a valid license
Principal established through the use of an agency disclosure form
Commission determined through negotiation. The agreement includes the amount to be paid, when it will be paid and to whom it will be paid.

The agency disclosure form spells out the terms of agency, not the terms of HOW the principal will be represented. In order to determine HOW we will help them, we need a separate agreement, a listing contract, with our principal which will include such specifics as:

1. Is this an exclusive right to sell or an exclusive agency, or even, perhaps, an open listing?
2. When does the agreement begin and end?
3. What are the specifics of the house?
4. When will the sellers be ready to give occupancy or the buyer be ready to close on a purchase?
5. Any other terms and conditions of the purchase or sale should be included in the written agreement.

Again, the agency disclosure form creates the PRINCIPAL/AGENT relationship and the listing agreement creates the terms under which we will carry out our agency responsibilities.

**PRINCIPAL**

(SELLER or BUYER)

↓

**AGENT**

(BROKER)

↓

**SUB-AGENTS**

(Represents principal, MLS, etc )

**COOPERATING BROKERS**

(Non Sub-Agents, Buyer Brokers, etc)

**EXPLANATION OF DIAGRAM**

The Principal, who is either the buyer or seller, hires a broker to act as his Agent. The Agent then allows other licensees to participate in the sale or search for property.

Sub-Agents would include other real estate offices who are either members of the same Multiple Listing Service as the Agent or non affiliated offices that might assist the Listing Broker. These offices would all represent the Seller/Client. Licensees within the broker’s own office would also be sub-agents of the principal. Since Agency is always created between the broker and the member of the public, the salespeople in the listing office are always sub-agents of the owner, unless a dual agency agreement is necessary. We will discuss dual agency a bit later.

Cooperating Brokers might be Buyers Agents who have rejected the offer of sub agency. In this instance, the cooperating broker is representing his own Client. He does have a responsibility to deal fairly and honestly with the seller. However, his fiduciary responsibility is to his own Client, the buyer.

We need to keep in mind that each of the parties in a real estate transaction could conceivably have completely different expectations from the licensee. The seller wants the house sold in the time frame that suits him and he also wants the highest possible price and the best terms possible. The buyer, on the other hand, wants to buy in a time frame that suits his needs and at the price most favorable to him. The broker for the seller assists the seller and the broker for the buyer assists the buyer. However, in the event the buyer is not represented, then the broker for the seller is showing houses to
a non represented buyer. He must, of course, deal honestly and fairly with his buyer/customer. In both situations there are salespeople involved who have their own expectations. These would certainly include receiving referrals after the sale is made. Therefore, we need to go out of our way to ensure that all parties understand their role and ours as well. All parties want the transaction to close with as little dispute as possible. All parties, as well, will try to achieve a “win/win” scenario. Nevertheless, with so many individuals involved and so much money and property at stake, there is no doubt that there will be times when conflicts are unavoidable. Therefore, a complete explanation of everyone’s legal obligations and responsibilities should be discussed before marketing plans or specific homes are brought up.

MANDATORY AGENCY DISCLOSURE FORM
In order to make the creation of agency as simple and understandable as possible, the State of New York introduced a mandatory agency disclosure form in January of 1992. It has been updated and simplified several times. This form needs to be signed by all buyers, sellers, landlords and tenants at the first substantive meeting between buyer and agent or seller and agent. This is required on all 1-4 family houses. Condominiums, co-ops and vacant land are exempt.

When the agency disclosure form is not required, we still must know whether the party we are working with is our client or customer. Discussion should take place in order to determine the relationship being created. It is also necessary to understand our responsibilities and avoid an unintentional dual agency at all costs.

This first substantive meeting, sometimes referred to as the “warm body” approach, is defined as the first meeting between the licensee and the public where there is a discussion of information regarding real estate. New York State requires that the disclosure form be completely explained to prospective buyers, sellers, landlords and tenants. An informed decision will then be made by the public as to whether or not they want to hire a licensee to represent them in a real estate transaction. In the event the public refuses to sign this disclosure form, the licensee must document the refusal. This formal affidavit of refusal contains all the information surrounding the refusal, including but not limited to name, and address of the consumer and the reasons for the refusal. The document should be notarized and kept on file for three years.

It would be more common for buyers rather than sellers to refuse to sign the agency agreement. The seller will probably sign a listing agreement and will see the disclosure form as something of an "accompaniment" to a listing form. The buyer, however, is usually unaccustomed to signing anything when being shown property, so careful explanations will be needed.

Some misunderstandings have occurred with regard to whether or not the Agency Disclosure form has to be signed when a buyer visits an Open House. The answer is, ABSOLUTELY. Remember, the disclosure must be signed at the first “substantive meeting”. The Open House would certainly qualify under the definition of that term. It is also important to know whether or not the visitor is already represented by a broker, found out about the Open House and decided to visit it on their own. We cannot interfere with another broker’s client.

Agency can be created either through express agreement or through implication, the actions of the agent. We will explore this further as we continue on with this chapter. However, it is most important that the agent always keep in mind “who is my client” and act accordingly.

FIDUCIARY RESPONSIBILITIES
Once the agency agreement has been established, we are bound by specific fiduciary or trust responsibilities. Among those responsibilities are:

REASONABLE SKILL AND CARE- The broker is expected to have a great deal of skill when representing a client. There is a need to know the community as well as the physical characteristics of the specific property. The licensee’s skill and competence must include knowledge of financing and existing zoning regulations as well as local tax laws. Licensees are not permitted to nor expected to give tax advice.
However, if a buyer is entitled to some form of tax relief, say a veterans tax exemption we could be helpful by putting them in the right direction to apply for their benefits.

There are agents who don’t take the time to learn the basics of mortgage financing. Instead, they turn the buyer over to a mortgage person immediately. When you do this, you lose control of the relationship with the buyer. There is no doubt that a mortgage professional must step into the picture in every case where financing will be needed to complete the sale. However, simple initial qualifying should fall on the agent’s shoulders.

The agent would be expected to know about zoning changes that have been approved or construction that might impact the property. Extreme care needs to be taken not to give speculative information that could hurt the seller’s ability to sell.

The licensee should be more careful with the property of the public than if it were his own. They must always act in such a way as to avoid any negligence that might result in a loss to the principal. In the event the licensee’s actions create a loss to principal, the licensee would be liable for the loss and would not be entitled to any compensation for the transaction.

The licensee is expected to have the necessary skill and training required to carry out his duties. Further, the broker would be responsible for the proper training of his sales staff in order to avoid inappropriate actions by the salesperson. He must also supervise his agents.

**UNDIVIDED LOYALTY** – It is the job of the agent to get the best terms and conditions for his principal. As such, he must be certain that his actions do not create an unintentional or undisclosed dual agency. The Agent Can Never Lose Sight Of Who His Client Is and He Can Never Betray the Loyalty Required. **EXAMPLE**: The agent recently obtained a listing on a property. He does not really like the seller. He shows the house to a buyer who is his relative and with whom he has been working for quite some time. Because his relative has chosen not to hire him as a buyer’s agent, the licensee needs to exercise extreme caution in being certain that his loyalty to his principal never comes into question. A situation such as this can be nearly impossible to deal with and certainly difficult at best. The ideal way to deal with friends, relatives and those who have been referred to you would be to strongly recommend they hire you so that you can do the job they expect you to do: Get the best terms for them. By always being aware of “who is my client?” The licensee will not be caught up in an unintentional or undisclosed dual agency.

**CONFIDENTIALITY**-When an agent comes upon information with regard to his principal, this information cannot be disclosed without the express permission of the principal. This would be similar to the attorney/client privilege.  
**EXAMPLE**: The seller confides to his agent that he has lost his job and is fearful that he might also lose his house. He explains does not want the agent to reveal this information because a buyer might use it as an advantage in negotiating. Once again, the buyer is the friend of the agent, and asks the question you will hear so often, “why is he selling the house?” Because the seller has expressly forbidden us from revealing his motivation for selling, we cannot share this confidential information with our friend the buyer.

**FULL DISCLOSURE**-The principal has the right to know anything that could materially affect the property in question. Such information as: The buyer’s financial position: Seller has the right to know that the buyer will be in the financial position to actually close on the house.

The buyers making an offer lower than what he might actually be willing to pay: Buyer wants agent to offer $25,000 less than he is willing to pay in order to buy the house at the lowest possible price. If the buyer is our client then we obey his instructions. If the buyer is our customer, then we must make full disclosure to our seller client.
The licensees desire to purchase the property for himself, or for a company in which he has an interest. This is referred to as “self-dealing.” This is permissible as long as the public is informed that a licensee is involved in the transaction. This holds true if he is selling the property as well.

The fair market value of the property in the current marketplace: We cannot deceive the seller by inflating the recommended selling price in order to get the listing with the full intention of recommending a price reduction shortly thereafter.

The existence of other offers to buy the property: The seller is entitled to know about all offers whether during the time of negotiations prior to an acceptance or, if the owner wishes, even those subsequent to his acceptance.

**Obedience** - The agent is expected to obey all legal and reasonable instructions which have been agreed to. This would include items such as showing appointments, negotiations, advertising, open houses, signs, co-operating brokers, etc. If it is the buyer who is being represented, then anything he might want to be kept private would have to be. This would include his willingness to pay more than his original offer.

**Duty to Account** - The licensee must keep accurate records of all funds being held for others. This includes notifying the public the name of the bank in which an escrow account has been established. The purpose of this account is to hold money belonging to the public. The licensee cannot use the funds in this account for any personal needs. To do so would be considered commingling.

**Some Statements That Should Always Be Avoided**
“There is no need to have a home inspection; the appraiser will let you know what is wrong with the house.”
“I know the seller will accept this offer.”
“I can’t present this offer, it is just too low.”
“I won’t tell the seller you have to sell your own house order to buy this one.”
“I will present this offer just to see what price the seller really wants. Even if he accepts it and you change your mind, I guarantee I can get this deposit returned to you.”
“You will have no problem converting this basement into a rental apartment. Many other owners have done it and they haven’t had any legal problems.”
“If you don’t buy a house now you won’t be able to afford one soon because I know that prices and interest rates will go up very soon.”
“Don’t worry about those different textures in the wallboard. I am sure it is nothing.”

**Who Is My Client/Customer?**
There are several different types of agency relationships. The broker needs to analyze his goals and objectives and determine which form of agency best suits his business plan. Agency is only established by agreement between the parties. This is referred to as “mutual consent”.

**Single Agency** – The broker represents either the buyer or the seller, but never both. The single agent may reject sub-agency. If the Buyer Client wants to purchase a Seller Client property, the broker would most likely release one of the clients or refer them to another agency.

**Seller Agency** - represents the seller only and usually works with cooperating brokers either in a sub-agency agreement or with buyer agents. This agency looks out for the best interests of the seller. If the cooperating broker is a sub-agent, they too are looking out for the best interest of the seller. Salespeople working in this type of agency would represent the seller even if they are showing houses to buyers.

Since all agency agreements are created between the Broker and the Principal, the salesperson would be a subagent. A salesperson is never permitted to represent the principal directly.
When the broker obtains a listing, whether through his own efforts or that of a salesperson in his office, it is the broker who is responsible to the seller. The salesperson might have day to day contact, but he is only an extension of the broker.

**Buyer Agency** - becoming more popular as time goes on. Therefore, including a buyer agent commission on a listing is an excellent way of attracting more potential buyers. Buyer Agents represent the buyer only and usually work with cooperating brokers. This agency looks out for the best interest of the buyer. Potential buyers are realizing the advantages of having a licensee represent only their interests. Such important information as their willingness to pay more than their first offer could not be revealed to a seller if a buyer has opted for representation. Further, a Buyer Agent would be able to create a market analysis in order to assist the buyer in determining how much to pay for the house. Since his job is to get the best terms for the buyer, offering this information would be extremely valuable to his buyer/client. If the buyer were not represented, then the market analysis would be viewed as a tool to be used against the seller. This, of course, would not be permitted.

There are other considerations as to **WHO MUST or WHO SHOULD be represented in a real estate transaction.**

**The Following Must Be Buyer Clients**
Any buyer who wants to remain anonymous. If a buyer is a professional in an industry known for producing high income, such as a doctor or lawyer, they may want their personal information kept private. This would require a Buyer Agency.

A licensee purchasing real estate for himself or any company in which he has any interest. The licensee must make his position known to the seller and his actions would, of course be to his own benefit.

**The Following Should Be Buyer Clients**
A Former Client would most probably need to be represented once again. If a seller had been our client and is now looking to purchase a home from us, then Buyer Agency should certainly be created. If we had been working with a buyer in the past as our client and they came back into the buying market, they should become our client once again.

First Time Buyers have no experience with the home buying process. As a result, they can get much more guidance and information by becoming a **CLIENT** rather than a **CUSTOMER**. The agent would be in a position of assisting the new buyer with evaluating the choices available.

Friends, Relatives or Others who have been specifically referred to the licensee. This is so because when a person is referred to a professional, they expect the professional to do everything that will help them get the best possible terms. If the buyer were a friend or relative, the agent would know a lot about their personal situation. If the buyer were a Customer and not a Client, then any knowledge of facts that could affect the transaction would have to be made known to the seller. Obviously if they were the Client then the information would be confidential.

If we were dealing with a Seller Agency, then our fiduciary or trust responsibilities would be to get the seller the highest price. If we represent the buyer, then we must get the best terms for the buyer. Therefore, careful thought and consideration must be taken in order to guide our buyers and sellers in the right direction.

**HOW DOES THE BUYER AGENT GET PAID?**
Typically, the broker and buyer have an agreement signed up front to determine what their commission would be should a sale take place. This could be either a flat fee or a percentage of the selling price, a sliding scale, or any other legal arrangement they make.

If the listing agreement protects the Buyer Agent commission, and the amount is as agreed to between the buyer and the agent, then no further negotiation would be required. If the amount on the listing is
less than what was agreed to then the Buyer Agent could either accept that amount or require that the buyer pay the difference.

Many brokers simply accept the listed buyer broker commission. By doing this, it ensures the buyer that they are not paying any more for the house by hiring a Buyer Agent than they would have if they did not have their own representative.

**ADVANTAGES OF BUYER BROKERAGE**

Another advantage to the public of hiring a Buyer Agent would be that they may be able to be shown houses not listed through a broker. Since a Buyer Agent is paid by his own client, homeowners who have been reluctant to list their homes might agree to allow them to be shown. There really is no “down side” to the seller. Buyer Agency has been used extensively in commercial real estate. The buyer hires an agent to locate property for him and pays him accordingly. The seller hires an agent to sell his property, and pays him accordingly. Each party to the transaction has an advocate representing only them.

**BENEFITS TO THE BUYER BROKER**

When Buyer Agency is created, the broker usually finds that he has greater client loyalty. Typically a non represented buyer wanders from broker to broker, from open house to open house, from newspaper ad to newspaper ad. A buyer client relies on his Agent to locate property that would be of interest to him. Thus, he does not find it necessary to search out property on his own. The buyer has confidence that only information that will be to his benefit will be shared with the seller, so he is more likely to be completely honest about his buying situation. Many buyers, realizing that the agent represents the seller in a typical transaction are reluctant to reveal their true financial picture or other information that might be used in negotiating terms and conditions. This often puts the agent at a great disadvantage in the negotiating process.

When we know all of the facts, we can weigh them and determine what is most beneficial to our client. Another benefit to the Buyer Broker is that they are not liable for acts of the listing broker or their sub agents. They also generally check the facts about the construction or legal occupancy restrictions, or zoning, or material defects and other important issues regarding the property since the buyer is relying on their expertise. This puts the Buyer Broker in a better position should a legal problem arise in the future.

Some agents have expressed concern because seller agents have at times refused to allow a buyer agent to show their exclusive listing. Dept. of State rulings on this matter are perfectly clear. Anyone is entitled to have a broker represent them and they must be allowed to view any property that is of interest to them. The listing agent may not, under any circumstances, stand in the way of the buyer viewing the property. Allowing a buyer agent to show the property does not guarantee payment of commission. The listing broker will only support payment to a buyer broker if the seller is willing.

**BROKER’S AGENT**

They are hired by the listing broker or buyer broker to represent him, not the home owner. The seller or buyer have no direct contact with the broker’s agent and have no vicarious liability for their actions. The listing or buyer broker has the vicarious liability and fiduciary responsibility to the principal.

**DUAL AGENCY**

These are created when one broker tries to represent both the buyer and the seller. If this is the case, the agency must be in writing signed by all parties agreeing to the dual agency. When a dual agency occurs, each of the parties gives up their rights to undivided loyalty. This is so because it is obviously impossible to be loyal to both parties in a transaction.

Typically a dual agency is created when a broker represents a seller in marketing his home and then is hired by a buyer to represent him. In this case, the seller would have to give his permission in writing on the required disclosure form allowing for his home to be shown to this buyer. It is imperative to
have all parties understand that they are giving up their right to full representation. The dual agency agreement must be signed by both parties.

A dual agency is created between A Specific Buyer and A Specific Seller. In any case where a dual agency is going to occur, a new disclosure form will be signed by each buyer and seller.

Dual agency is created on an “as needed” basis. There can never be an agreement between the seller and the agent permitting all dual agencies in order to avoid having to sign a new form each time.

Agency is a serious, legal arrangement that is to be handled with the utmost respect.

**UNINTENTIONAL DUAL AGENCY**

Every licensee must be very careful not to create an unintentional dual agency. This could occur if the seller’s broker reveals any information to the buyer that might undermine the seller’s position in the marketing of his home.

**EXAMPLES:**

- Advising the buyer that the seller has lost his job, could possibly result in the buyer making an offer lower than would have been made had he not been given this information.
- Telling a buyer that the market is depressed and the seller will have to take less than the listed price if he wants to sell his home.
- Assuring the buyer that you will negotiate on their behalf and will remind the seller of everything that is wrong with the house in order to have them accept a low offer.
- Telling the seller that the buyer is also making an offer on another house when in fact they are not, might give the seller a reason to accept a lower price.
- Another example of an unintentional dual agency could occur when a seller has hired a broker to assist in the sale of his home and then wants to buy a house from that same office. The seller/buyer would believe that they are being represented in the purchase as they were in the sale of their home. In this case the salesperson would have to inform the seller turned buyer that a disclosure form should be signed and the type of agency representation requested and agreed to would be covered in this disclosure form.
- Failing to disclose that the broker is a dual agent violates not only Agency Law, but License Law as well. The broker is potentially liable for any damages that might be the result of his actions.
- If the properly represented party learns of the unintentional dual agency, they would have the right to rescind their agreement. This would undoubtedly result in the broker becoming ineligible to collect his commission.

**UNDISCLOSED DUAL AGENCY**

This might occur when a salesperson gives the buyer some recommendations about a price to offer on a house. If the suggested offering price is lower than the listed price it could undermine the seller’s potential for getting full listed price.

**SELF DEALING**

A broker or salesperson wants to buy a property listed with them. Care must be taken so that an Undisclosed Dual Agency is not created. In order to protect himself and the seller, it would be wise to recommend having the home appraised. Once this is done, there would be proof that the seller was made aware of the market price and if he accepted a lower one from the broker, no harm was done. If the licensee were selling her own property, there would have to be full disclosure to the buyer as well.

**VICARIOUS LIABILITY**

One person becoming responsible for the actions of another even if he never gave permission or instructions to carry out the action.

**EXAMPLE:** The broker is responsible for the actions of his salespeople and would be vicariously liable if he was aware his salespeople did something improper and did nothing about it. If he did not know that the action was occurring, but earned money and kept it even after learning that something improper had occurred liability would, no doubt, ensue.
CREATING AND TERMINATING WRITTEN AGREEMENTS AND DISCLOSURE FORMS

NEW YORK STATE MANDATORY AGENCY DISCLOSURE FORM
This form is used to create an Agency agreement between the parties. It does not spell out the specific responsibilities or authority the Agent incurs. It also does not spell out compensation. These items and many more would be included in an additional agreement such as a listing contract.

The following is the most current Agency Disclosure Form required in New York State.

NEW YORK STATE DISCLOSURE FORM FOR BUYER AND SELLER
THIS IS NOT A CONTRACT
New York state law requires real estate licensees who are acting as agents of buyers or sellers of property to advise the potential buyers or sellers with whom they work of the nature of their agency relationship and the rights and obligations it creates. This disclosure will help you to make informed choices about your relationship with the real estate broker and its sales associates. Throughout the transaction you may receive more than one disclosure form. The law requires each agent assisting in the transaction to present you with this disclosure form. A real estate agent is a person qualified to advise about real estate. If you need legal, tax or other advice, consult with a professional in that field.

DISCLOSURE REGARDING REAL ESTATE AGENCY RELATIONSHIPS
SELLER'S AGENT: A seller's agent is an agent who is engaged by a seller to represent the seller's interests. The seller's agent does this by securing a buyer for the seller's home at a price and on terms acceptable to the seller. A seller's agent has, without limitation, the following fiduciary duties to the seller: reasonable care, undivided loyalty, confidentiality, full disclosure, obedience and duty to account. A seller's agent does not represent the interests of the buyer. The obligations of a seller's agent are also subject to any specific provisions set forth in an agreement between the agent and the seller. In dealings with the buyer, a seller's agent should (a) exercise reasonable skill and care in performance of the agent's duties; (b) deal honestly, fairly and in good faith; and (c) disclose all facts known to the agent materially affecting the value or desirability of property, except as otherwise provided by law.

BUYER'S AGENT: A buyer's agent is an agent who is engaged by a buyer to represent the buyer's interests. The buyer's agent does this by negotiating the purchase of a home at a price and on terms acceptable to the buyer. A buyer's agent has, without limitation, the following fiduciary duties to the buyer: reasonable care, undivided loyalty, confidentiality, full disclosure, obedience and duty to account. A buyer's agent does not represent the interests of the seller. The obligations of a buyer's agent are also subject to any specific provisions set forth in an agreement between the agent and the buyer. In dealings with the seller, a buyer's agent should (a) exercise reasonable skill and care in performance of the agent's duties; (b) deal honestly, fairly and in good faith; and (c) disclose all facts known to the agent materially affecting the buyer's ability and/or willingness to perform a contract to acquire seller's property that are not inconsistent with the agent's fiduciary duties to the buyer.

BROKER'S AGENTS: As part of your negotiations with a real estate agent, you may authorize your agent to engage other agents whether you are a buyer or seller. As a general rule, those agents owe fiduciary duties to your agent and to you. You are not vicariously liable for their conduct.

DUAL AGENT: A real estate broker may represent both the buyr and the seller if both the buyer and seller give their informed consent in writing. In such a dual agency situation, the agent will not be able to provide the full range of fiduciary duties to the buyer and seller. The obligations of an agent are also subject to any specific provisions set forth in an agreement between the agent, and the buyer and seller. An agent acting as a dual agent must explain carefully to both the buyer and seller that the agent is acting for the other party as well. The agent should also explain the possible effects of dual representation, including that by consenting to the dual agency relationship the buyer and seller are giving up their right to undivided loyalty. A buyer or seller should carefully consider the possible consequences of a dual agency relationship before agreeing to such representation.

DUAL AGENCY WITH DESIGNATED SALES AGENT: If the buyer and the seller provide their informed consent in writing, the principals or the real estate broker who represents both parties as a dual agent may designate a sales agent to represent the buyer and another sales associate to represent the seller.
to negotiate the purchase and sale of real estate. A sales agent works under the supervision of the real estate broker. With the informed consent of the buyer and the seller in writing, the designated sales agent for the buyer will function as the buyer’s agent representing the interests of the buyer and the designated sales agent for the seller will function as the seller’s agent representing the interests of the seller in the negotiations between the buyer and seller. A designated sales agent cannot provide the full range of fiduciary duties to the buyer or seller. The designated sales agent must explain that like the dual agent under whose supervision they function, they cannot provide undivided loyalty. A buyer or seller should carefully consider the possible consequences of a dual agency relationship with designated sales agent before agreeing to such representation.

This form was provided to me by the company named below:
Licensee or Associate of Licensee: __________________________ (signature) of Company: ___________________________________________

The above-named company, which is licensed as a real estate broker, is (check one)
[ ] the seller's agent    [ ] a dual agent
[ ] the buyer's agent    [ ] a dual agent with designated sale agent
[ ] the broker's agent

If dual agent with designated sale agent is checked:

is appointed to represent the buyer; and
is appointed to represent the seller in this transaction.

(I)(We) acknowledge receipt of a copy of this disclosure form:
Signature of [ ] Buyer(s) and/or [ ] Seller(s):

____________________________  ______________________________
Date: __________________      Date: __________________

There is a similar form to be used when leasing property.

REVIEWING THE AGENCY DISCLOSURE FORM
In reviewing this mandatory agency disclosure form, extreme care needs to be taken to understand its’ proper usage and the meaning of all terms. It is not permissible to merely hand the form to the buyer or seller. It has to be completely explained before it can be signed. Even though the agency disclosure form is not required in many situations, there is never a time when agency does not have to be discussed and agreed upon.

Remember, this form is only required in 1 to 4 family houses. Co-ops and condos are excluded unless they are in a house with a total of no more than 4 units. There is a requirement in New York State that this must be signed at the “first substantive contact” between the public and the licensee. Simply put, this would be the very first time real estate is discussed.

Remember, we cannot know what we can and cannot disclose until we know whether the person with whom we are speaking is our customer or client.

PURCHASE OFFER AGREEMENT
It always makes sense to have a written purchase offer agreement in order to negotiate terms and conditions with the seller. These agreements become the foundation for a more formal contract in many areas of the state. In other areas, they become the actual contract subject to an attorney review.

Whichever way your area conducts business, putting it in writing saves everyone from major problems as the transaction progresses.

PROPERTY CONDITION DISCLOSURE
A property condition disclosure form is currently available for the seller to complete upon listing his home for sale. A buyer is entitled to receive the document before presenting terms and conditions to
the seller. This document was created in order to allow a buyer to have as much knowledge as possible about a house he intends to purchase.

The seller is expected to answer all questions yes, no, unknown or not available. This should be done at the time the property is being listed for sale. It is important to note that the Property Condition Disclosure form is not a substitute for a professional home inspection. Buyers should always be encouraged to get professional advice about the condition of the home, property and environment.

If the seller chooses, instead of filling out the disclosure form he is permitted to give the buyer a $500.00 credit at closing. If he does fill out the form, he is expected to be honest and will be held accountable and responsible if he is not truthful in his statement.

This form is only required on 1-4 family homes. It is broken down into several components:

1. General Information
2. Environmental
3. Material Defects

The form in its entirety can be downloaded from the Dept. of State website.

**CREATING AND TERMINATING THE LISTING AGREEMENT**

It is often said in real estate that if a salesperson "doesn't list, he won't last". The listing is the most important part of the business of real estate because, without good property, a sale, obviously, is impossible. Many brokers and agents prefer to represent the buyer, however, again, without good listings, no sale is possible. The term "listing" in its’ most simplistic definition is the right to market a property given to a broker by the owner.

The law of New York does not require that an agreement be in writing, unless, it will not be completed within one year. The hiring of an agent can be verbal or by implication. An owner can give the broker the verbal right to show his house. By allowing him to enter with a customer, there is an implication of agency which has been ratified by the action of the owner. This sounds quite simple. We are going to learn that it really isn't.

Not only do we have to get the seller’s permission to market his home, we also have to have an agreement as to which type of listing we will have. There are essentially three types of listings and each one has very specific rights and obligations both to the licensee and the homeowner. It is extremely important that the licensee understands each one and can accurately explain them to the homeowner.

**TYPES OF LISTINGS**

**OPEN LISTING**

The open listing might be verbal and it can be given to as many or as few different brokers as the owner chooses. In using the open listing format, the owner can give each of those brokers’ different terms and conditions for the property. Different selling prices, different personal property to be left, even different commission structures are not uncommon. Brokers are competing with each other to sell the house as well as the homeowner.

Only the broker who brings about a meeting of the minds is entitled to the commission. If the owner sells the property himself, no commission would be due to any broker. A multiple listing service will not accept an open listing. Therefore, the owner must personally contact each office he wishes to allow to market his home. In most areas the open listing is not a signed listing and can be an oral one. Some real estate companies, however, are insisting that all listings, including open listings be signed by the seller in order to be sure that the terms of marketing the house are agreed upon.

**EXCLUSIVE AGENCY**

In granting the Exclusive Agency, the owner names the broker as sole agent to the exclusion of all other brokers. In the event the owner succeeds in selling the property without the help of any broker,
there is no liability for commission to the broker holding the exclusive agency. This type of listing can be co-brokered to other offices. The listing broker is only paid if he brings about a sale or if an office that has accepted co-brokerage brings about a sale. Again, if the seller sells it herself, no commission is due.

**EXCLUSIVE RIGHT TO SELL**
Where an owner has granted an Exclusive Right to Sell to a broker, the owner becomes obligated for a commission even though the owner succeeds in selling the property himself. The owner, in granting the exclusive right to sell, in effect has given all marketing rights to the broker. By doing this, he has assured the broker of a commission no matter who sells the house. Again, co-brokerage can be used with this type of listing.

**EXPLANATION OF TYPES OF LISTING**
The listing agreement MUST contain an explanation of both the Exclusive Right to Sell and the Exclusive Agency. The following is required on all exclusive listing agreements:

An exclusive right to sell listing means that if you the owner of the property, find a buyer for your house, or if another broker finds one, you must pay the agreed commission to the listing broker.

An exclusive agency listing means that if you, the owner of the property, find a buyer you will not have to pay commission to the broker. However, if a broker finds a buyer, you will owe commission.

The listing agreement will provide that the homeowner shall have the option of having all negotiated offers to purchase the listed residential property submitted either through the listing broker or submitted through the selling broker.

**MULTIPLE LISTING SERVICE**
A Multiple Listing Service is an organization of affiliated brokers who share real estate information. Contrary to what many people believe, a Multiple Listing Service does not actually sell houses. It is a forum for co-operating brokers to learn of each other’s listings and other real estate related information.

Each local Multiple Listing Service has rules and regulations governing their listing forms and how specific situations are handled and you must comply with those rules. Most Multiple Listing Services are owned by REALTOR® organizations and the National Association of REALTORS® Code of Ethics is the basis for the way in which members interact with each other and the public.

**SUB-AGENCY**
This occurs when, typically, the listing broker allows other brokers to show his listing to buyers. These licensees, however, represent the seller even though they are showing the property to buyers. Whether the listing broker is a member of a Multiple Listing Service or merely allows local brokers to participate in the selling of his listing, the sub-agency that has been created is a Seller Agency. This means that the broker representing the seller has agreed to allow other brokers to participate in trying to sell the home. All cooperating brokers have a fiduciary relationship toward the seller. The listing broker may allow co-operating Buyer Brokers to show the home in which case the listing broker represents the seller and the showing broker represents the buyer.

The listing signed by the owner will stipulate the full commission to be paid when the property is sold as well as the amount that will be received by the cooperating broker. Only the amount the cooperating broker will receive will be published on the information provided to offices. By doing this, offices are prevented from engaging in anti-trust law violations regarding price fixing. By publishing only the amount paid to the office that brings the buyer to the transaction, it would not be possible for other brokers to determine the full amount of commission earned on a sale. Remember, the commission on the listing agreement will always show an amount paid to a Selling Broker, it can also include payment to a Buyer Broker.
**PRESENTING AN OFFER**

Once a buyer has decided on the house she wishes to purchase, typically, an offer in writing is presented to the seller for his approval. There are many possibilities surrounding how the offer will be presented, depending upon the circumstances. Let us explore some of them.

Problem: An offer is presented to the listing office but, the homeowner is not available for an appointment to submit it. By the time they return home, two other offers are also submitted to the listing office.

Solution: Since the broker has a fiduciary responsibility to keep his principal aware of all possible choices, the principal must be given the opportunity to review all the offers, not just the first one.

Problem: A cooperating broker insists that he and his buyer be informed of any other offers on the property until one is accepted.

Solution: Typically both the listing and cooperating brokers are agents of the seller. As such, they have an obligation to their principal and to serve his best interests. Therefore, they have no obligation to the buyer/customer other than giving honest and accurate information as needed. Since agents must treat everyone fairly and honestly, and since it is usually a good marketing practice to advise a buyer that there is competition for the property, it would, no doubt be in the best interest of the seller/client to let it be known that there is more than one offer.

Problem: An offer has been submitted to the seller which he is considering. Before making a decision, two additional offers are presented to the listing broker.

Solution: Since the seller has not yet accepted the terms of the first offer, she must be advised of all subsequent offers. Again, remember, the seller has the right to know about anything that concerns the marketing of their home.

Problem: An oral offer is presented to the seller which he accepts. A second offer is then brought to the listing broker.

Solution: Again, the second offer must be presented to the seller.

**TERMINATION OF AN AGENCY AGREEMENT**

Once the owner has agreed to hire a broker to represent him, the period of time for representation can be definite or indefinite. A definite time would be included in an exclusive agency or an exclusive right to sell. It has both a starting and ending date. An indefinite time is most common in an open listing. Open listings typically have a beginning date, but not an ending one. This listing would continue until it is sold, taken off the market or exclusively listed.

If a principal cancels the exclusive listing agreement before its expiration, the principal could be liable for damages. If there is no written agreement or no definite end to the agreement, (open listing) either party acting in good faith may terminate the broker's employment at will. The notice of termination may be in writing, oral or implied from circumstances.

A seller has the right to cancel an agency agreement at any time before there has been a meeting of the minds. If the seller decides he no longer wants to sell his home, he has every right to remove it from the marketplace. He cannot inform the broker that he plans to take it off the market when, in fact, he has a buyer and is using a ploy to prevent the broker from collecting a commission on the sale. The seller has to act in good faith when asking to have the listing terminated. In some cases when an owner cancels an exclusive agreement which is for a specified period of time, they might be liable to pay damages. The damages would usually be the amount of money the broker spent to market the home.

It is quite difficult to collect a commission when a house has not sold unless the seller has engaged in some form of fraud.
If there is no specified time, (an open listing) then no damages could be claimed. Whether the broker's authority is for a specified or unspecified time, it can terminate if any of the following occur:

**SOME REASONS FOR TERMINATION**

- The purpose of the agency has not been completed within a reasonable time. A seller has a reasonable expectation that his house will be sold in a timely manner. This is subjective and relative to the area and motivation of the seller and general market conditions.
- Death or insanity of the broker or principal. The death or incompetence of the broker would prevent the marketing of the home. The listing was taken in the name of the broker and when the broker can no longer perform required licensing functions, the seller would no longer be bound by the terms of the listing. Should the seller die, depending on the right of succession on the property, the listing could terminate because the owner has no longer authorized the sale. This is a situation that would, no doubt, have to be settled through attorneys.
- Bankruptcy of either party. A bankruptcy court would determine the future of the listing and sale of the property.
- Destruction of the subject matter. In the event a property burns to the ground, there obviously would no longer be a home to sell and the listing would terminate.
- Brokers fraudulent conduct for her benefit. If a broker has used fraudulent tactics to convince a seller to put his home up for sale, then it could be released from the listing with no penalty. An example might be a broker using blockbusting tactics to convince a seller that “undesirable people” are moving into the neighborhood and unless he sells immediately he will find it nearly impossible to sell in the future.
- Another concern could be a legal action against the broker by the seller for the loss that resulted in his selling the home for less than it was actually worth. Example: The broker deliberately underprices the house and buys it himself.
- Sale by another broker or owner if the authority is for an unspecified time. This would more than likely occur in an open listing arrangement. Since it is an open listing, it would not have a termination date. Therefore, if it were sold by either the owner or another broker it would terminate and no commission would be due anyone other than the broker who was the procuring cause. If on the other hand, the listing has a termination date which would be the case in an exclusive listing, it automatically terminates at that time. The broker would have to obtain permission from the owner to continue marketing the property and the new terms of the listing would have to be negotiated and agreed to.

**TYPES OF RELEASES AND TERMINATIONS**

A. **Unconditional Release**: the listing simple ends at a time agreed to between the principal and agent and the principal does not have any obligation for payment of any damages. The value in this type of release is that it can create good will because the owner, for whatever reason, simply doesn’t want to work with the broker any longer. As long as the broker is reasonably assured that the release is not the result of the owner trying to sell the property himself in order to avoid paying a commission, it can be good public relations in the community to simply allow the termination. However, remember, he is free to relist the house with any broker of his choice after receiving an unconditional release.

B. **Conditional release**: the broker and homeowner agree that some condition exists and must be completed in order to allow the release to become effective. A common condition would be the agreement to re-list the house with the same broker if the seller puts it back on the market. The release would spell out the terms of the re-listing such as: within what span of time, how long would the new listing remain in effect, and the type of new listing.

C. **Release for Consideration**: the seller has a relative who wants to buy the house and the seller and broker work out an agreement for consideration to allow this to happen. Some brokers will write an exclusive right to sell with a clause allowing the homeowner to sell on their own at a reduced commission rate.

Forms used for listing of real estate or the release of those properties are usually provided by the local Multiple Listing Service.
Let us keep in mind that the law states that an agreement made in New York will be governed by the Laws of New York, even if the property is outside of the state. Therefore, listings and terminations must be in accordance with real property and contract law.

**LANDLORD/TENANT AGREEMENTS**
Every office that handles leases should be certain that they abide by all disclosure rules and have a lease agreement that would be signed by all parties if it is for a period of one year or more. These agreements must be as carefully drafted as buyer/seller agreements.

**CREATING AND TERMINATING DISCLOSURE FORMS AND AGREEMENTS**
Purchase offer agreements also referred to as binders are common in the downstate area and are the foundation for the more formal contract drawn up by any attorney. In upstate areas, brokers fill in a contract which is subject to an attorney’s review. Commission should be spelled out in exact terms in the purchase offer agreement and contract for sale.

Sellers are expected to fill out the Property Disclosure Form when the property is listed for sale. Buyers are entitled to receive a Property Condition Disclosure form before they make an offer on the property. It does not take the place of a professional Home Inspection. If the seller chooses not to make the form available, they will owe the buyer a credit of $500.00 payable at the closing.

**LEAD PAINT, STIGMATIZED PROPERTY, LATENT DEFECTS**

**DEFINITION AND EFFECTS OF LEAD**
Lead paint effects and laws regarding disclosure are covered in depth in the environmental issues chapter. We are including this overview because the problem exists in so many homes because of the age of the housing stock in most urban areas. Lead is a metallic element that is found in rocks and soil. The toxic affect of lead has been known for hundreds of years. Lead can be found in many different applications in the home.

**LEAD DISCLOSURE GUIDELINES**
In 1996 HUD and the Environmental Protection Agency, known as EPA, set guidelines for lead based paint disclosure. This disclosure obligation was put into print September, 1996. It was put in place to protect the public and covers homes that were built prior to 1978. Federal law requires that individuals must receive this information prior to renting or buying or when renovations are being done.

Landlords are required to disclose known lead based paint conditions to their prospective tenants. A federal form must be included and attached to the lease. Also, the EPA pamphlet Protect Your Family From Lead In Your Home must be distributed. This form is discussed in depth in Environmental Issues chapter.

Sellers would have to disclose known lead based paint to a prospective buyer and the completed disclosure form would be attached to the sales contract. The buyer is entitled to receive a 10 point risk assessment as to whether or not the home has lead. The EPA pamphlet Protect Your Family From Lead In Your Home will be distributed.

Renovators who disturb more than 2 square feet must present the pamphlet as well before starting any renovations. It is always recommended that when a contractor is renovating your home a lead test be done to determine if lead is present. Young children and pregnant adults should be removed from the home during the renovation process.

**STIGMATIZED PROPERTY**
The term is used to describe a property that has a reputation as being the site of something horrible or unusual. These homes are usually difficult to sell because whatever makes them stigmatized
properties plays with people’s emotions. An important thing to remember about residential property buyers is that they generally “buy emotionally and justify logically”. There is a great deal of emotion that goes into making the decision to buy a particular home and when there was some horrendous occurrence, many buyers will just say no. Others really don’t care.

Some well known homes that are stigmatized include the one in which Charles Manson followers murdered Sharon Tate the wife of movie director Roman Polanski. The heiress to the Folger coffee fortune was also murdered during that awful killing spree. The home was rented at the time of the murders and just a few weeks after the location was no longer an active crime scene, the owner moved back into the house. He lived there for many years and eventually sold it. At that point it was demolished and a new home constructed.

The home where O.J. Simpson was accused of murdering Nicole Brown-Simpson was on the market for over 2 years before it was ultimately sold.

Perhaps the most famous stigmatized property however, is the “Amityville Horror” mass murder location. This house became famous after a film was made about Ronald DeFeo and the murder of his family. The family who bought the house claimed that there were evil spirits present and they feared for their lives and left. Many curiosity seekers sought out the house and it became a tourist attraction. Eventually it was repainted and the house number changed so that it was difficult to determine which house was actually the site of the “Amityville Horror”

In learning how to deal with these properties, certain considerations must be taken: How accurate is the information you have that could classify it as stigmatized? Are you sure the murder took place there or the owner really did commit suicide? Was it really the home of drug dealers who mixed their “potions” there?

Learn your responsibilities for disclosure. An owner or occupant of the premises who has been diagnosed with or suspected of having human immunodeficiency virus or acquired immune deficiency (H.I.V. or Aids) or any other disease which has been determined by medical evidence to be highly unlikely to be transmitted through occupancy of dwelling cannot have his privacy invaded. The only instance where an illness might be disclosed would be if it were considered to be passed from one to another through the air or environment of the building.

Learn whether or not the stigma will be important to the buyer. As we stated, sometimes even the most horrific crime will not bother a buyer, in other instances a home owned by a white collar criminal might not be acceptable.

A discussion should be held with the seller explaining that it might be beneficial for the seller to be upfront with a buyer who shows a real interest in the property. It is usually better to have it come from the seller than for the buyer to learn about a stigma from the neighbors.

Remember, this section clarifies that it is NOT a material defect if a residential property offered for sale or lease regardless of the number of units contained, is or is suspected to have been the site of a homicide, suicide or other death by accidental or natural causes or any crime punishable as a felony. The issue here is the fact that an emotion about someone else’s action does not have an actual physical impact on a home.

**LATENT DEFECTS**
We use the term to describe a situation where a problem with the real estate might not have been discovered through a home inspection. We live and work in a state where the legal rule of the sale of property is caveat emptor, (let the buyer beware). However, we also have a property disclosure form that is required in most one to four family houses unless the seller pays a $500 credit to the buyer at closing. In which case, they do not disclose anything in writing they know about the property.
Nevertheless, a buyer is always entitled to a home inspection prior to closing. The contract will spell out the terms of this contingency. The problem with the home inspection, however, is that it might not be sufficient to discover latent defects. If there is a problem with the brick around the fireplace, it might be nearly impossible to detect without removing some of the brick. This would most likely not be permitted by the seller who wouldn't want the brick removed.

If the wood beams were deteriorating, but it was not visible, again, this would be nearly impossible to detect. So, what is a buyer to do? If the buyer is well represented by an attorney, there might be a clause in the contract covering possible latent defects. This clause would not automatically make a seller liable if a defect is found after closing unless it could be proven that the seller knew about it and didn’t reveal it. Generally the seller has to prove that he did not know about the defect rather than the buyer having to prove that he did. This clause is extremely important to the buyer because under caveat emptor, it is the responsibility of the buyer to learn about the house and once title passes, without some protection, the buyer is out of luck.

Needless to say, we are not inspectors or engineers or contractors, but we are real estate professionals and, as such we have an obligation to be observant and question anything about the property that could be considered a defect. We then pass this information on to the buyer. Obvious defects such as bug infestation or leaky plumbing or faulty wiring are just some of the things that we need to look out for.

**OTHER EXAMPLES OF MISREPRESENTATION**

**STATEMENTS MADE DURING A PRESENTATION:** There have been cases where an overzealous agent has gossiped about or “bad-mouthed” another agent who is trying to get the same listing. If the statement is true, obviously, it is not a problem, if it is false, of course, a problem exists.

“Puffing” is an opinion or judgment or exaggeration that is not a representation of fact. It is purely the opinion, usually of a salesperson, and does not constitute a legally binding contract. If a salesperson were to say “this is the most beautiful house in the neighborhood”, it would be puffing. If, however, he said, “if you buy this house now you will be able to sell it at a great profit in a year or two”, that could be fraudulent misrepresentation. He made the statement that the public felt they could rely upon in deciding whether or not to buy the house.

**Fraud** is a deliberate dishonest statement or action taken in order to obtain an advantage.

Discrimination, even when unintentional is a major problem. Fair housing and discrimination are studied in depth in a later chapter. However, it is important to recognize that discrimination, such as steering a buyer into a neighborhood where many of his fellow countrymen live, even when done with the best of intentions, is illegal.

**PRICE**
Strange as it might seem, price can become an issue of misrepresentation. Example: A home is listed for $475,000. The agent knows the buyer could very well be interested in this particular house. The buyer has made it very clear that he is looking for a bargain and will make offers on any house he is interested in.

The agent shows the house for $500,000, telling the buyer that the seller is anxious to sell. He then recommends the buyer offer $475,000 which is what the house is actually listed for. The buyer makes the offer of $475,000 and, of course, buys the house. The buyer thinks he got a bargain when in reality he paid the listed price. This would certainly be unacceptable behavior on the part of the agent.

**GEOGRAPHY**
Example: A house is located in Millertown which does not have a highly rated school district. The next school district, Warrentown is rated far better. When the broker advertises the house it reads in
“Warrentown vicinity”. The only way this would be permitted would be if in the body of the ad he wrote the actual district in which the house is located, Millertown.

**MARKET CONDITIONS**

Example: Unfortunately some agents have been known to grossly exaggerate the real estate market in order to convince buyers to buy or sellers to sell. They might try to convince a buyer to “buy now because interest rates will definitely go up within the next six months”. Or, “if you don’t buy now you won’t be able to afford a house like this in the future”. While the market may seem to indicate that interest rates might rise, no one knows for sure. If you simply state that what you are saying is your opinion, you are giving the buyer or seller the opportunity to agree or disagree with your statements. This is perfectly acceptable. Remember, the buyer and seller, whether customer or client, is entitled to fair and honest information.

**MEGAN’S LAW**

Without a doubt most states have tried to protect their citizens from sexual predators. Many local civic associations or homeowner organizations would pass out flyers in their community or even go so far as putting pictures of sexual offenders on trees or billboards. These groups were trying to do a good thing by warning parents that there might be sex offenders living in the area. Unfortunately, there were times that someone was named as a sex offender when all that had happened was an accusation but he was never found guilty. This kind of stigma could easily ruin the life of a person who has done no wrong.

Megan’s Law was named for a seven year old child named Megan Kanka who was the victim of a vicious kidnapping, rape and murder. The perpetrator, Jesse Timmendequas, a repeat violent offender, had moved into a home immediately across from where the Kanka family lived. He lived with two other convicted sex offenders, one of whom had lived in the house for six years. Although many of the Kanka neighbors knew of the history of the residents, the Kanka family claimed that they did not. If they had the information, they stated, they would have warned their daughter not to go anywhere near the occupants or the house.

Jesse Timmendequas was found guilty and resided on death row in New Jersey. In 2007 the death penalty was ended in New Jersey and he now must serve a life sentence without any chance of parole. Richard and Maureen Kanka started the Megan Nicole Kanka Foundation in order to allow “every parent the right to know if a dangerous sexual predator moves into their neighborhood”. The Kanka’s efforts paid off. They gathered over 400,000 signatures on petitions and the law was passed in their home state of New Jersey in 1994.

The following year, Federal legislation entitled Violent Crime Control and Law Enforcement Act of 1994, included provisions requiring community notification. This Act requires every state to implement a plan for the notification to the public if a perpetrator of certain crimes moves into a neighborhood. There have been many amendments to the bill and there are different requirements and procedures in different states.

Megan’s Law has a great impact on the way in which we carry out our day to day business. A common question would be “as an agent, do I have to disclose the fact that a convicted sex offender lives in the neighborhood?”. The answer to this has not really been clearly defined in our state of New York. The best recommendation would be to consider whether you are a seller agent or a buyer agent. As a seller agent in a caveat emptor state, it would be reasonable to assume that any information a buyer requires is available through public records. We are not required to disclose facts which an ordinary person under ordinary circumstances could discover for themselves.

As an example, the buyer would have an interest in learning which school district the house is in. Through a simple phone call to the local school districts this would be discovered. Additionally they would need to know about clear title and any liens recorded against the property. These also are available through public record.
If the information they require is about registered sex offenders, that is available from many sources including the local police department, school districts, civic associations etc., depending on the location of the house. We can certainly provide the buyer with information about where they can look to get whatever they are interested in.

No matter, there are stronger obligations when we practice buyer brokerage then when we are engaged in seller representation. Possibly the best advice is to clearly have the buyer brokerage agreement spell out what the obligations of the licensee are to the buyer, not unlike a seller listing agreement which spells out the obligations to the seller.

The broker needs to consult an attorney when crafting these agreements and carefully determine the obligations he is willing to undertake and those he is not. That way, all parties are completely clear on what they can expect from each other during the transaction. Needless to say, if the courts revise thinking on the matter, the broker will have to comply with the law as it exists at the time.

**COMMISSION**
Contrary to what many believe, commission rates are not set by any local real estate board or groups of brokers. All commissions are negotiable between the public and the broker. The terms of commission are usually agreed to when the seller/buyer and licensee agree work together. Commissions are typically a percentage of the selling price of the property. They can, however, be a flat amount. Commissions might also be on a sliding or escalating scale. The sooner the house is sold the higher the rate of commission. The seller might also reduce the commission if the sale does not take place within a specified time. Another option sellers or buyers could use would be to grant a bonus if the transaction occurs within a specific time.

Some brokers are offering a sliding scale of commission depending on what marketing tools the seller might want. This is commonly referred to as the “unbundling of services”. The broker creates a marketing plan indicating many possible choices and the seller decides which ones to use. As an example, open houses, signs, printed flyers, brochures, advertising, mailings, frequency of updating information, submitting to the multiple listing service, etc. are possible choices. Once the seller determines which services he wants to take advantage of, the broker calculates the commission rate for those activities. An advantage to this type of marketing plan would be that if the seller were unhappy with the exposure his house was getting, he would be able to request additional services at an additional cost.

The broker has many options in charging commission and a professional broker will work out details with his staff so that everyone understands any and all programs available.

In accordance with New York license law, a real estate broker cannot pay any part of a fee, commission or other form of compensation to any person for any service, help or aid given as part of a transaction involving buying, selling, exchanging, leasing, renting or negotiating a loan on any form of real estate, condominiums and cooperatives included, unless that person is a licensed real estate salesperson or associate broker licensed and associated with that broker or a broker engaged in real estate outside the State of New York.

New York Real Property law does not permit offering incentives to unlicensed parties for providing services that require a license. Promotional offerings such as free airline tickets, free use of vacation rental property; free termite and mechanical inspection; discounts from local businesses; free home security system; moving expenses; free insurance on major appliances; gift certificates; and cash have been found to be acceptable by the Department of State.

**COMPENSATION OF THE SALESPERSON**
Let us spend some time explaining something you have all wanted to know: How will I be compensated by my broker? The simple answer to this is “any way the broker chooses to divide the
commission with his licensees”. At the beginning of your career you might receive as little as 35 or 40 percent of the amount the office receives on the transaction. There may even be additional fees charged to you such as advertising or office fees.

As you progress you might be entitled to 60 or 70 or maybe even 95 percent of the amount the office receives. Many top producers willingly pay a “desk fee” in order to earn the highest end of the commission spectrum. Desk fees are monthly charges paid to the broker whether or not you earn anything. They are essentially desk rental fees for the privilege of associating with a particular brokerage and the opportunity to earn the bulk of the commission. By working with this type of arrangement, the agent is associated with a well known office, but totally controls his income and expenses. Many agents use this type of setup to build a team and earn an override on commissions earned by licensees on the team.

Remember, when trying to figure out how much you are going to earn on a transaction, there are typically two sides to each sale or rental: The listing agents’ fee and the selling agents’ fee.

Co-Broker Splits: The total commission is split based on the terms the listing broker and seller agree to offer to cooperating brokers in order to sell the house. This split can be any division the listing broker feels will encourage others to participate in selling the home.

Buyer’s Brokers: The fee to the buyer broker can be paid by either the buyer or the seller

**PROCURING CAUSE**
As defined by the National Association of Realtors, procuring cause is “the uninterrupted series of causal events that leads to a successful transaction.” Simply put, it is the basis for determining who is entitled to the commission for bringing about the sale. Procuring Cause is a standard the National Association of Realtors® uses to protect agents from having their commissions stolen. It functions like this: A licensee is introduced to a buyer and begins to establish a working relationship with them. Over a span of time the agent shows them houses, transacts a sale, even helps them find financing for the purchase. After all this effort either the buyer or seller tries to deprive them of the commission they are entitled to collect. This can happen even if the parties were quite satisfied with the work the agent did.

They have a friend or relative working in the business who tells them to go out and find the house of their dreams and the friend/relative will get it for them for less money than the agent who introduced them to the property. The friend/relative puts the transaction together and claims the commission. Does that mean that the “honest guy” is out of luck? Well, that depends on a couple of things. If the friend/relative had an exclusive buyer agreement with the buyer, then yes, the honest agent will probably be out of luck.

If the honest agent had the buyer broker agreement then they would be entitled to the commission. We need to protect ourselves and the easiest way to do that is to thoroughly understand the business and take the necessary steps to protect our commission. Remember, the number one cause of commission disputes boils down to what is "procuring cause." The state REALTOR® association establishes guidelines to determine procuring cause and has the mechanism to hear cases involving broker disputes.

A broker is not entitled to a commission until the buyer and seller agree, not only as to the price, but also to the terms of the transaction and all other important points.

A broker may not be entitled to commission where, although the broker introduced the purchaser to the seller, the broker did not bring them to an agreement and the transaction was subsequently negotiated by another broker. In order to be considered the procuring cause, the broker must prove responsibility for creating a desire for the property in the buyer.
The broker has usually done his/her job when he produces a buyer ready, willing and able to meet with all the terms fixed by the owner or by any terms agreed to between the parties. The words "ready" and "willing" are synonymously used to mean that the broker’s customer is prepared to enter into a contract with the broker's principal on his/her terms. The word "able" refers to the customer's ability to enter into a contract with the broker's principal on his/her terms. It means he has the financial ability to buy the property. If the customer can show at the time of the agreement of contract terms that he can pay for the purchase, he is considered to be "able".

The broker is entitled to a commission if the broker brings the client and the customer together and, after mutual bargaining, they come to an agreement, even at a price and on terms materially different from those specified in the listing. When a written contract has been signed, both parties are considered to be mutually satisfied of each other's ability to perform.

Some of the terms essential to creating a meeting of the minds are:

- **Price:** Needless to say, the first area of interest of most sellers is “how much are they willing to pay?”
- **Amount of Cash:** Sellers, however, should know how much cash the buyer is going to be working with. This is important because, obviously, the higher the cash down payment, the easier it would be for the buyer to obtain financing. Additionally, the seller would need to know if the buyer has sufficient closing costs. In many sales, some or all of the closing costs are included in the selling price of the home. This could cause the appraisal to come in too low for the buyer to obtain the necessary financing.
- **Duration of Mortgage:** Is the length of time for the financing available in the present mortgage market? If the maximum duration of a loan in the current market is 30 years and the buyer needs 40 years in order to be able to afford the monthly payments, this loan may not be readily available.
- **Rate of interest:** Can the buyer get financing at typical “prevailing rate of interest” or do they need a rate not easily obtained in the present market. If this is the case then, obviously, there could be a problem obtaining financing.

If financing is a contingency in the agreement and the buyer does not obtain same in accordance with the agreement, then the broker would not be entitled to compensation.

**WHEN IS COMMISSION PAYABLE**

Unless there is a different agreement, a broker's commission is due and payable when it has been earned. Remember, we earn it when we are the procuring cause. However, traditionally an agreement is entered into whereby the commission will be paid at the passing of title. There are usually contingencies in contracts that have to be fulfilled before title can pass. Our commissions aren’t payable in most cases until this occurs.

**PROTECT OUR PROCURING CAUSE STATUS**

There are some important steps an agent should take in order to protect themselves in the event of a procuring cause lawsuit.

Find out if the buyer is working with another agent. If they are, determine whether they have an exclusive agreement with that company. If they do not have an exclusive agreement with another office, GET ONE SIGNED IMMEDIATELY after having them sign an Agency Disclosure Agreement. Explain that they should not ask another agent to show them property. That your job is to find houses for them and negotiate on their behalf.

Advise them not to call listing agents directly. If they see a house that is of interest to them they need to call you and you will arrange an appointment to see the property. Also, you can get them any information they might be interested in regarding the house. Be sure they understand that if they go to an Open House without you, they need to hand the agent your business card and explain that they are already represented.
DISCLOSURE OF CUSTOMER
A broker may not be entitled to commissions where the broker did not inform the client of the name of the prospective customer and, after negotiations failed, the purchaser found the owner and bought the house directly.

Some agents don’t bother to inform the seller of the name of the buyer introduced to the house when the owner wasn’t at home. If the buyer approached the owner personally and didn’t let them know that you had shown the property earlier, how could the seller possibly know that you might have been the procuring cause? We need to take responsibility for our own actions and to protect ourselves in the transaction.

EXCEPTIONS TO THE RULE
There are instances when the transaction doesn’t close and yet, commission might still be earned. Some examples are:

A. The seller fires the salesperson in order to avoid commission and sells or leases the property himself.
B. A seller refuses to sign a contract after agreeing to the terms.
C. The seller puts a property for sale which has unmarketable title.
D. The owner of the property is guilty of fraud:

THE COMMISSION ESCROW ACT
Try as we might to satisfy our clients, every once in a while that seems to be impossible. We believe we have done everything properly and that we are entitled to the commission agreed upon. However, our client doesn’t seem to agree. In years past, there was almost nothing that could be done if the seller walked away from the closing table without paying our commission. Since we are not a party to the contract for the sale of the property, we cannot interfere with the closing.

After the fact we could bring a lawsuit against the seller and that might work out alright if they remain in this state. The real problem occurs when they close on the house and then immediately move across state lines. Fortunately in August, 2008 Governor David Paterson signed a commission escrow bill that went into effect in January, 2009. The act includes a provision requiring the seller to deposit any unpaid commission with the county clerk until there has been a decision of whether or not the broker is entitled to it. No lien will be placed against the property and there are many requirements before the seller must deposit the unpaid commission.

The Commission Escrow Act is located in Section 294-b of the Real Property Law. The act only applies to the sale of residential real property, a condominium or an interest in a cooperative apartment. Vacant, commercial or leased property is not included in the Act and creating the lien does not interfere with the passing of title. Finally, the seller is required to place the amount of the commission into an escrow account only if title, stock certificates or the proprietary lease actually passed. It is important to recognize that the only party permitted to sign the “affidavit of entitlement” in order to get the process started is the “duly licensed broker” who is the party licensed to do business as an individual, partnership, corporation, limited liability company, limited liability partnership or trade name by the Dept. of State, Division of Licensing Services. No other licensee can sign the affidavit, but anyone authorized by the broker can actually file the paperwork on behalf of the broker.

In order to be able to file the affidavit of entitlement for commission there are very specific provisions that must be adhered to. If they are not exactly as specified, no affidavit will be permitted.

The listing agreement initially signed by the seller must contain the following statement in bold face type: “At the time of closing, you may be required to deposit the broker’s commission with the county clerk in the event that you do not pay the broker his or her commission as set forth herein. Your obligation to deposit the broker’s commission with the county clerk may be waived by the broker.” The
seller is only bound by the Act if the agreement contains the exact language stated. Obviously, if the commission is paid as agreed upon, there would be no further action taken by the broker.

Once the broker presents the agreement and the seller signs it, the broker can file the affidavit of entitlement with the county clerk. There are specific items that must be included. The language of the Act is as follows:

- The name and license number of the broker claiming the commission
- The name of the seller or person responsible for commission
- The name of the person authorizing the sale on behalf of the seller, if any, and the date of such authorization
- A copy of the written agreement, if any
- A description of real property involved
- The amount of commission claimed
- A description of the brokerage services performed and the dates thereof

Please note that the Act states “a copy of the written agreement, if any,” however, without the written agreement, the escrow provision cannot be enforced.

Even though it is not required, the broker may benefit by including some additional disclosure information such as:

- The seller will be required to deposit unpaid commission,
- If the seller fails to take the proper actions he could be responsible for paying the broker’s legal expenses including attorney’s fees if it is found that the broker was entitled to compensation and did not receive it according to the terms of the agreement signed by the seller.

If the above language is included in the agreement, the seller will be aware that if he doesn’t pay the commission as agreed or doesn’t deposit the money with the county clerk, he could be responsible to pay brokers legal and other costs.

A breach of contract suit has a limitation of six years for the suit to begin. However, the Commission Escrow Act reduces the broker’s statute of limitations to six months. Only brokers who file the affidavit are subject to the shortened statute of limitations. Brokers who did not file the affidavit are still entitled to the full six years.

Once the commission is deposited in accordance with the Act, the broker can initiate a proceeding to have his rights decided in the court system. The broker would file an action just as was the case prior to the act taking effect. If the seller and broker come to an agreement, the court can accept a “stipulation” signed by both parties and the funds will be released based on the agreement.

Even though the affidavit of entitlement was filed in the county clerk’s office, if the broker does not begin legal action, they could lose the ability to claim their commission.

Brokers need to be aware that just because they filed the affidavit there is no presumption that they are actually entitled to the commission. That has to be proven. Also, if the seller deposited the disputed commission and the broker is found to be entitled to the funds, each party will be paying their own legal fees.

If the affidavit is filed for a commission that is not earned or the broker acts in a dishonest or untrustworthy manner, the Dept. of State can take action against the broker. This could result in fines and/or suspension or revocation of their license.

Finally, if an affidavit is filed and the broker fails to start the legal action within six months, they may be subject to disciplinary action by the Dept of State.
REFERRING EXPERTS
No doubt, as you pursue your career, buyers and sellers will ask you to find experts who will help them with the transaction. Attorneys, accountants, home inspectors, mortgage companies are just a few of the categories you will be asked about. In order to protect yourself and not be involved in any “tie-in arrangements” as we discussed under License Law here are some practical recommendations:

Make a list of all categories of experts that buyers or sellers might need. Narrow each category down to between three and five names based on your own experience or the recommendation of others you trust. Be sure to disclose anyone on the list who is associated with your company or you personally.

Once the list is complete, give it to every buyer and seller you work with who asks for a referral. By taking this action, you are certain that everyone gets the same information. Under no circumstances ask for or accept a referral fee or any form of compensation from anyone on this list.

DEPOSIT MONEY
The broker often holds money belonging to other people. When an offer to purchase is accepted, the money should be turned over to the seller if it is not to be deposited in the brokers escrow account. In the event the offer is not accepted, it is to be returned to the buyer. An escrow account is a separate bank account to hold other people’s money. It is non interest bearing and cannot be "commingled" with business funds.

The real estate broker must, at all time, remember that he/she occupies the status of agent acting on behalf of others. The broker should always be aware of his/her obligation as an agent and must have complete awareness that in dealing with the property of others, he is held to a very high degree of accountability.

Usually, real estate brokers have authority limited to finding a buyer ready, willing and able to meet the seller’s conditions. Therefore, by virtue of the broker's employment by the owner, he becomes a mere negotiator or intermediary between the owner and prospective purchaser.

The deposit, which is in the broker's possession, remains the property of the purchaser until the moment the seller accepts the offer. When that occurs, the deposit becomes the property of the seller and the broker is no longer responsible to the purchaser to refund the deposit.

In the event that the offer made by the purchaser is rejected by the seller, the deposit received by the broker still remains the property of the purchaser and, therefore, must be refunded to the purchaser. If the offer has been rejected by the seller, the deposit, in the possession of the broker is still held by the broker as agent of the purchaser and the broker is, therefore, accountable to the purchaser for such deposit. If the buyer changes his mind about purchasing before the seller accepts his offer, then the deposit must be returned to the buyer.

Most transactions require mortgage financing. Because the broker knows that the buyer does not have the full amount of the price of the sale available, both the binder and contract will have a contingency. This means that in the event the financing is not obtained, the buyer will have an escape clause, which will allow him to have his deposit money returned in full.

The situation changes if the buyer arbitrarily refuses to accept the terms of the loan, or refuses to buy the property. In that case, it would most likely be given to the seller as liquidated damages. Where the buyer is not at fault a broker refusing to return the deposit is considered to have demonstrated untrustworthiness and can have disciplinary actions brought against him/her.

In the event there is doubt about how to handle deposit money; the broker should seek legal advice.
NATIONAL ASSOCIATION OF REALTORS®
Many of the students taking this course will eventually become members of the National Association of REALTORS®. Becoming a REALTOR® means joining the largest trade organizations in the United States. There are more than one million members nationwide. NAR, as it is commonly referred to, includes many educational opportunities, councils and societies which are geared toward both residential and commercial real estate. The organization was founded in 1916 in Chicago, Illinois.

Members are brokers, salespeople, property managers, appraisers and many others engaged in the various forms of business surrounding “immovable property”. Throughout the United States there are approximately 1600 local boards or associations. All members are pledged to a Code of Ethics and Standards of Practice which define their duties and responsibilities to the public and each other.

Members of NAR become members of their local boards and associations. The Code of Ethics is enforced at the local level through a Professional Standards Council or Committee. In the event of a complaint against a member, a trained panel of members holds a hearing in order to listen to testimony and evaluate any evidence presented to them. These complaints can originate either from members or the public. If a member is found to be in violation they could be subject to substantial fines, suspension or expulsion from NAR, required to take specific educational courses, reprimand as is deemed proper by the panel. All members of the Professional Standards Committee go through extensive training.

You will note that when using the word REALTOR® it is in capital letters and there is the ® after the word designating that it is a registered trademark.

Another facet of NAR is Multiple Listing Services. These are local organizations of brokers who share real estate information. In the today’s world, the internet plays a huge part in marketing property and there are opportunities for member brokers to interact with each other and the public. The majority of Multiple Listing Services nationwide are governed by NAR, however, there are many that are independent.

An important aspect to the National Association of REALTORS® is their impact on politics. They are the third largest donor to Political Action Committees and have contributed in excess of thirty million dollars to campaigns revolving around regulations of real estate related industries.

ANTI-TRUST LAWS
Anti-trust laws were enacted to protect the public so that there would be fair and open competition and no restraint of trade. Unlike most business people, real estate brokers and agents are put in the unique position of having to be both competitive and cooperative. This environment leads to another area that must be observed and practiced - antitrust.

The United States Congress passed the Sherman Antitrust Act July 2, 1890. Part of this legislation was aimed at stopping businesses from creating monopolies for themselves and conspiracies against others. This would prevent fair and open competition. People found guilty of this restraint of trade could be guilty of committing a felony. The Clayton Act passed on October 15, 1914 established the right to sue and collect treble damages from guilty parties involved in these conspiracies.

The Clayton Anti-trust was similar to Sherman, except that Clayton covers interstate commerce. Clayton also allows class action lawsuits as well as individual lawsuits. So antitrust is serious business, especially in the real estate industry.

The law is essentially this - it is illegal for real estate companies, brokers, and agents to be involved in an agreement, a conspiracy, or an understanding that unreasonably restraints competition.

The penalties are stiff for antitrust violations. First, there is liability for three times the plaintiff's actual damages. Then, the guilty party could be required to pay the plaintiff's reasonable attorney's fees.
Third, the court may elect to supervise the defendant’s business practices for up to ten years. And finally, there could be actual prison time for the guilty party. This would include any action that would restrict or impair any individual from enjoying free trade within the law.

**Federal Trade Commission:** The FTC was formed by Congress in 1914 as a way to investigate and enforce the Sherman and Clayton anti-trust laws.

Many individual states have enacted anti-trust laws, New York being one of them. In this state our law makes it illegal to create a monopoly, create unfair trade practices, engage in any form of restraint of trade and in general prevent the public from having a non-competitive marketplace.

**PRICE FIXING**
The most common violation of anti-trust laws, price fixing, would occur if competing offices set a commission rate which all brokers agree to charge.

This would be anti-competitive because buyers or sellers would have no choice but to pay the one commission rate that has been set. The public would be unable to negotiate a fee based on service or any other criteria. This would most likely encourage higher than usual commission rates due to lack of competition.

Price fixing is defined as a conspiracy among brokers and agents to establish standard rates and fees for services. We can be guilty of price fixing by our actions as well as our words. This seems to occur most often as we compete for listings. Since many sellers interview more than one agency, the subject of commission rates inevitably becomes a topic for discussion.

Also, if we are using a REALTOR® board or association form, the fact that commissions are negotiable often enters the discussion. Like most consumers, sellers of properties are looking for good service but at an attractive price.

This is where the problem arises. In defense of our own commission structure, we sometimes imply that there is a "standard" or "normal" commission rate in the industry. If we communicate that thought, then it must be assumed that we licensees have all conspired to fix those rates. This is illegal.

Therefore, we must avoid saying the following:
"Our rates are pretty standard."
"We charge what most all the other companies charge."
"A few companies charge less, but the good brokers maintain the standard going rate."
"Agents will not show your listing if you pay less than the regular commission rates".

Interestingly, antitrust goes beyond price and commission rates charged. The following statements can also get us in trouble:
"All agents get at least 120 days for the listing period."
"An exclusive right to sell is the standard type of listing."
"All companies split their commission 50/50 with the cooperating broker."

When confronted with these types of issues by the consumer, your proper response is a description of what you and your company charge, with no reference to the competition. Each company has the right and privilege to establish policy, including commission rates, for their services.

Here are some proper responses when asked by the seller about your rates:
"My broker has established our rate based on the services we provide."
"We feel that our reputation is worth ___%."
"We feel that our marketing efforts are worth ___%."
"Based on the marketing plan I have customized for you, I charge ___ dollars."
"Our firm determines its commission based on the services we provide to insure that you reach your real estate goals."

In other words, you are worth what you charge without any reference to any other agent or brokerage company.

Another warning - never, never, ever discuss your company's commission rates with an agent of another company. That conversation is in itself a conspiracy and an antitrust violation. The only time it is permissible to discuss commission is when there are negotiations on a property. The total commission on this one sale can be included in the negotiations.

One final thought about commission rates - it does not matter if most firms charge similar rates as long those firms have not all agreed to do so.

**BOYCOTT**

Another area of antitrust has to do with group boycotting. If two or more agents and/or brokers with different firms discuss the business practices of a third firm in the spirit of harming that firm's reputation or restraining that firm's business, then there is a violation of the antitrust laws. When two or more brokers conspire to limit or harm another company's ability to conduct business, the conspiring brokers face very serious charges.

Avoid statements like

"With their reputation, all other agents avoid doing business with them."

"Most of us don't like them anyhow and don't think they should be in the MLS."

"Agents do not want to show that company's listings."

By the way, the boycotting of non-real estate companies can also be an antitrust violation. For example, if a group of brokers got together to pull out of advertising in a periodical because the brokers all agreed that the ad rates were too high, then, the brokers have committed a violation.

Finally, if you are ever become involved in a discussion of commission fees charged or company reputations with agents or brokers from other firms, whether it be one-on-one over a cup of coffee or in a group association meeting, take the following steps:

- Ask that the discussion cease immediately.
- Leave the meeting if the others do not heed your request.
- Ask that the records indicate that you objected to the discussion and that you left the meeting if the forum is an official gathering.

Every company should have a written antitrust policy that is shared with its agents and staff periodically.

Every company has the right and privilege to establish its own policies and fees, but those must be established independently. All agents and staff must know that the company's fees are not set in agreement with any other real estate company. Anti-trust suits can be brought against individual brokers and, real estate boards.

**MARKET ALLOCATION**

As an example, four real estate offices in one town decide that they will separate the town into four separate markets. Broker A handles only the north side of town, broker B the south side of town, broker C the west side of town and broker D the east side of town. If any buyer or seller wanted to engage a broker in any of the markets, they are limited to only the office given the opportunity to do business there. This office would determine commission rates for the entire portion of the town and the terms of all listings since he is the only one allowed to operate in that section of the town. Again, fair competition would be effectively eliminated.
TIE-IN ARRANGEMENTS
These are created when the broker insists the public use affiliated companies or services as a condition of working with them. When a buyer buys a house, she must use the attorney of the broker, or mortgage company of the broker, or inspection company of the broker, these could be considered tie-in arrangements and if they are, they would be illegal. A broker could certainly make recommendations to buyers or sellers. The broker would not, however, be able to make a REQUIREMENT of the purchase or sale, the hiring of companies he suggests.

There is nothing wrong with an agent having a list of several attorney’s or home inspectors or moving companies. These are common areas where a buyer new to the community might want names of companies you have successfully worked with. As long as you give several, say 3 or 4 names in any category, no problem!

The problem arises when you give one name and state that whenever anyone does business with your company they are expected to use a particular party. That is tying in the party referred to the real estate transaction and would be a violating anti-trust regulations. Keep in mind also that referral fees paid by these businesses is not permitted.

REFERRAL FEES AND KICKBACKS
Referral fees are often agreed to by brokers when the buyer or seller is seeking to do business in an area in which the originating broker does not usually do business. In this case the party being referred must be made aware of the fact that a referral fee will be paid in the event a transaction has been completed.

These are perfectly fine as long as the referral fee is being paid by a licensed real estate broker to a licensed real estate broker.

Example: An agent working in Broker John’s office has a customer for a home quite a distance from his effective service area. John knows that broker Mario handles that geography quite well and works out a referral. When the transaction is complete Mario pays John the agreed upon fee and John pays his salesperson the share that was agreed upon. Perfectly fine!

However, if the agent in John’s office referred the buyer directly to Mario and Mario paid the agent directly, that would be a license law violation. A broker may never pay an agent licensed to someone else directly. It must be paid broker to broker.

In all cases, when a referral is being made and there will be a fee paid as a result of the completion of the task for which it was made, the party referred must be made aware that a fee is being paid.

MORTGAGE BROKER REFERRAL FEES
If a mortgage broker is paying a referral fee, a disclosure to dual agency must be signed. Mortgage lending laws are very clear regarding the documentation required. In order for a real estate broker to be entitled to fees from a mortgage broker, there are very specific actions that the broker must perform. He is not entitled to be paid simply for giving the mortgage broker information that a buyer is in need of financing.

KICKBACKS
Typically a kickback is the result of an agreement between the parties that if, as an example, broker Yvonne sends buyers or sellers to attorney Sherman, she will receive a percentage of the legal fees charged. This is illegal. Problems can arise when the recommended party actually represents the licensee and not the public. When the licensee is paid for the referral without the knowledge of all parties to the transaction an illegal act has occurred.
A typical example of this anti-trust violation would be an attorney who is recommended by the broker to the buyer. The attorney will pay the broker a referral fee for every client the broker sends to him. After a while, the attorney is solely concerned with getting the transaction closed no matter what the terms might be. He doesn’t look out for the best interests of his client. He knows that if the broker’s transactions don’t close the broker will stop sending referrals. The reality of this would be that he is representing the broker and not the buyer or seller.

This same problem would arise if the mortgage company picked appraisers solely because they would come in with the appraisal the lender wanted. Often this causes major financial problems for buyers when they want to refinance or sell in the future. If the house was over appraised, the buyer would get a higher mortgage loan. If they chose to refinance, the new bank could turn them down because they do not have enough equity since the original loan was too high.

**ANTI TRUST LAWSUIT**

A most interesting suit was brought against the Long Island Board of Realtors in 1972. The outcome of this suit was, in part, to prevent this Board, and others, from taking action such as fixing commission rates, suggesting commission rates, publishing commission rates. Preventing licensees from negotiating commissions with the public, or recommending or demanding the split between the listing and selling brokers, encouraging a specific rate or split, adopting rules and regulations regarding prohibition of brokers working with whomever they choose. These are but some of the areas covered in this suit.

In another suit, multiple listing services came under scrutiny and in 1982 the U.S. vs. Realty Multilist, Inc. was determined. The outcome of this suit included, no multiple listing service can refuse membership to a licensee who complies with reasonable and non-discriminatory regulations. MLS charges must be equal to the cost of setting up the participant in the MLS. The cost of operation must reflect the pro rata share of operating expenses. Reasonable and non-discriminatory per listing fees must be established. Part-time brokers must be admitted. MLS cannot regulate office hours of members. Membership in other services cannot be restricted. No restrictions regarding the types of advertising or property, and finally, a Multiple Listing Service cannot prohibit members from cooperating with non-members.

It is important for the licensee to understand the impact of these cases on the way in which we must conduct ourselves.

It is perfectly acceptable for a broker to set commissions and splits within his own operation. It is not acceptable and, in fact illegal, for competitors to jointly set commissions, or splits of commission.

Multiple Listing Services and Boards of Realtors must be cautious to avoid setting any rules or regulations that would recommend, suggest, or establish commissions and splits.
CHAPTER 3 INDEPENDENT CONTRACTOR

KEY TERMS
Independent Contract
Salesperson

 Surprise, we are not employees, not independent contractors either. So, what are we? Well, the proper description from the Internal Revenue is Statutory Non Employee. We know you probably never heard the term before and wonder what it means. Actually, it is really quite similar to Independent Contractor with one notable difference. Since the law requires that we be licensed to a broker who must supervise our activities, we do not live up to the letter of the law being described as Independent Contractors, so a new title had to be created for professionals like us. We file our taxes and abide by the same rules as I.C.’s, but we are supervised and act on behalf of our broker therefore, the term “statutory non employee”

At year-end, we receive a 1099 form, which totals earnings for that year and on which taxes will be due. This compensation is directly related to sales or other output. Any person who is not an employee and earns $600.00 or more during the year must be provided with a a1099 form no later than January 31 of the year following the collection of the income. The IRS is provided with a copy by February 28 or March 31 depending upon how the firm files their taxes.

The independent contractor needs to sign a contract with his broker, which spells the following:

• Compensation is directly related to sales or other output
• The broker cannot offer a weekly stipend to get the agent started
• He cannot offer a “draw against commission” even if the transaction is solid and will close within a short time
• Commission is paid without any deductions for taxes
• No remuneration based on number of hours worked
• Salespersons are permitted to work any hours they choose
• Salespersons can work from home or the broker’s office
• Brokers can provide office facilities and supplies but salespeople are responsible for their own expenses
• Broker supervises but does not direct and control
• Either party may terminate at any time
• Both Federal and State laws require a written contract

These precautions must be taken in order to avoid being classified as an employee, in which case the agent will be responsible for payment of taxes such as Federal and State withholding taxes, unemployment, worker’s compensation and disability insurance as examples. These taxes would be due on the gross income determined to be earned by an employee instead of an independent contractor. As an I.C. we are permitted to deduct many business expenses which will lower our taxable income.

An Independent Contractor agreement should be signed immediately after obtaining your license and has to be resigned every 12 to 15 months. Without it, in the event of an IRS audit, the licensee will automatically be classified as an employee.

Rule 175.21 requires supervision of the salesperson by his broker. Problems arise in determining whether an agent is an I.C. or an employee based on the differences between “supervision” and “control”.

Substance over form: The broker’s duty to supervise takes precedent over all other written agreements.
Section 441 states the supervision shall consist of "regular, frequent, and consistent personal guidance, instruction, oversight and superintendence by the real estate broker with respect to the general real estate brokerage business conducted by the broker and all matters relating thereto”. This does not give the broker the ability to demand an agent work a specified number of hours each week or perform a certain amount of activity. It also does not all allow the agent to be required to attend meetings.

Many offices have “floor time” or “up time” or “in time” policies. These terms apply to the agent being present in the office to share in buyers and sellers contacting it. The agent who sees the value in getting new customers and clients without having to do personal marketing might want to participate. Agents who do their own marketing and get referral business would probably not see any value. The broker cannot mandate the salesperson’s agreement to participate. At the beginning of your career, floor time is extremely valuable. It will give you the opportunity to begin working with public and developing an understanding of the real estate profession.

It is equally valuable to spend a great deal of time becoming familiar with properties for sale in your area as well as learning about zoning and demographics. You also need to know the price ranges at which properties have sold. The prices of homes currently on the market need to be learned as well.

Remember, an Independent Contactor can be told what to do, but not when and where to do it.

Regulation 175.23 “requires the broker to keep written records of all real estate listings obtained by the salesperson and of all sales and other transactions affected by, and with the aid and assistance of the salesperson, during the period of his association. These records shall be sufficient to clearly identify the transactions and shall indicate the dates thereof. These records must be kept for a period of three years. Such records must be submitted by the salesperson to the Dept. of State with his application for a broker's license.”

It is also in the best interest of both the broker and the agent to have an employment agreement so that the working relationship between the two is clearly defined. Some issues that should be resolved in the employment contract could include:

- Amount and time of payment of commission
- Distribution of office leads
- Training
- Membership in real estate organizations
- Hours of office operation
- Out of pocket expenses required
- Market area and focus

Factors that will affect termination including:

- Handling of listings and contracts
- Payment to other agents to conclude transactions
- Restrictions upon termination – example: the broker insists the agent not be allowed to work in any real estate office within 3 miles of this office for 3 years. It is highly unlikely that this provision will be upheld in a court of law. However if the restriction were for perhaps a half mile for a year, that would be more reasonable.

When determining the status of an agent consideration is given to the following:

- Behavioral Control
- If the business has the right to control and direct the person, they would be an employee

The behavioral control factors fall into the categories of:

- Type of instructions given
- Degree of instruction
- Evaluation systems
- Training
Types of Instructions Given
An employee is generally subject to the business’s instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do the work.

- When and where to do the work
- What equipment to use
- What workers to hire or to assist with the work
- Where to purchase supplies and services
- What work must be performed by a specified individual
- What order or sequence to follow when performing the work

Degree of Instruction
The more detailed the instructions, the more control the business exercises over the worker. Instructions that are more detailed indicate that the worker is an employee. Less detailed instructions reflect less control, indicating that the worker is more likely an independent contractor. The key consideration is whether the business has retained the right to control the details of a worker’s performance or instead has given up that right.

Evaluation System
If there are evaluations of all aspects and details of the performance of the worker, likely, he is an employee. If only the results are measured, then either an employee or an I.C. is possible.

Training
If there is mandatory training that requires the tasks only be performed in a specific manner, this would indicate employee. The I.C. can use his own judgment. However, in real estate, training is usually available so that the agent learns the basics of the business.

Financial Control
The financial control factors fall into the categories of:

- Significant investment: need to purchase own equipment or supplies
- Unreimbursed expenses: automobile, postage, advertising, telephone, etc.
- Opportunity for profit or loss
- Services available to the market
- Method of payment

Method of payment
An independent contractor is paid a fee for the specific job. There is no compensation based on the number of hours we work. Nor can we be paid an hourly wage or given advances against uncollected commission.

Allowable deductions
One of the benefits of working as an Independent Contractor is the fact that we are permitted to deduct certain expenses incurred in the course of pursuing our career. These expenses are listed on the Schedule C included with your tax return. These deductions are covered in depth in the income chapter of this course.
CHAPTER 4 VALUATION PROCESS

KEY TERMS

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New agents learn early in their careers how critically important it is to price the property correctly. There are two reasons for this:

1. In order to give the house the maximum exposure
2. Attract as many buyers as possible.
By doing this, the seller will have the opportunity to recognize where their house price is in relation to other houses currently on the market.

Since the majority of real estate transactions require financing most of us will be faced with a house selling for more than the appraisal and financing is not forthcoming. Unless both parties are willing to renegotiate, this transaction will probably not close. We need to understand an appraisal as compared to a market analysis prepared by a salesperson.

First, let us examine the criteria required to become an appraiser.

Who may call themselves a real estate appraiser? Appraisers are licensed by the state or states in which they work. This mandate came down from the federal government 1989. It was a result of a crisis that occurred when non-qualified appraisers overpriced houses. In subsequent years if the owner of one of these homes tried to refinance it, they learned that the house was actually worth less than their mortgage balance. This caused a major problem in the real estate industry and it became apparent that appraisers were not well educated and the standards to become one were insufficient.

Before mandatory licensing was the law, anyone could call himself an appraiser. Traditionally real estate appraisers associated with other experienced appraisers to gain knowledge and experience in order to learn real estate appraisal. Many licensed real estate brokers or salespeople held themselves out to be appraisers. Since no licensing was required, this was common practice.

In order to obtain clients and become independent one would join trade organizations. These organizations would offer appraisal education and a minimum standard for performing appraisals. Many have been in existence for many years and are still a viable part of the profession. Although each one has individual requirements, they all require some education and an appraisal to be submitted for review.

APPRAISAL CATEGORIES: RESIDENTIAL AND COMMERCIAL

Residential Appraisals include 1 to 4 family homes, and/or vacant land that could be developed with a single home. There are far more residential appraisals than commercial ones. Typically, a residential appraiser can produce one or more per day. The educational and experience requirements are easier to meet, and an appraiser can become independent in much less time. As in real estate sales, the appraiser tends to work in an area close to home. They prefer a short travel distance and by working close to home, they become familiar with their effective service area.
Commercial Appraisals include everything that is not a 1 to 4 family home or vacant land that would be developed with a single home. Becoming a commercial appraiser takes a lot more time and effort than becoming a residential appraiser.

**COMMERCIAL PROPERTY INCLUDES:**
- Industrial Buildings
- Apartment Buildings
- Office Buildings
- Shopping Centers
- Mixed Use Buildings
- Land Zoned for Commercial Use
- Warehouses

**TYPES OF APPRAISAL FORMAT REPORTS**
- **Narrative** - This report contains the greatest amount of information. It is extremely detailed and the typical “man on the street” should be able to understand the report, follow the logic, and accept the conclusions. Most commercial appraisals are presented in this format. Writing a narrative appraisal is similar to writing a term paper in college.
- **Form** - This is the type of report typically used for residential appraisals, the form is standardized and utilized throughout the industry.
- **Letter** - This is not typical and is used only in special circumstances, followed by one of the other report formats in the near future. A lender might use this letter just to schedule a closing date.
- **Oral** - Similar to a letter, a lender or user just wants the value to schedule a closing or to facilitate paper work until the actual written report becomes available.

**APPRASIALS ARE REQUIRED BY**
- **Lending Institutions** - The largest source of appraisal work is for mortgage purposes.
- **Insurance Companies** - These companies also invest in real estate and hold mortgages to hedge against losses.
- **Mortgage Brokers** - In busy times, the mortgage brokers facilitate loans and often utilize independent appraisal companies to produce the appraisals.
- **Lawyers** - Appraisals settle disputes in divorce settlements, estate settlements, etc.
- **Accountants** - Used in accounting and for IRS purposes.
- **Corporations** - Make buy or lease decisions based on appraisals.
- **Developers/Builders** - Appraisals often help the developer determine which projects are worth pursuing.
- **Government Agencies** - For condemnation, land preservation, or buying or selling government owned properties.
- **Private Clients** - Appraisals are often utilized for transfer or to make personal or business decisions.

**REQUIREMENTS TO BECOME AN APPRAISER**
Due to the savings and loan crisis in the late 1980’s which forced the federal government to bail out failing lending institutions, it was obvious that drastic action had to be taken. To deal with this the government formulated rules and regulations not only on how to conduct these bailouts but how to prevent the problem from reoccurring in the future.

These regulations are referred to as FIRREA, the Financial Institutions Reform, Recovery and Enforcement Act of 1989. It created the Office of Thrift Supervision under the Treasury Department and the Resolution Trust Corporation (RTC) to dispose of assets of failed banks. The FDIC, (Federal Deposit Insurance Corporation) underwent many changes as well. Legislation provided for formulating rules and regulations governing appraisals performed for federally related transactions. This would include any banks regulated by the FDIC, and those who insure mortgages, or guarantee mortgages. According to this act, not only do appraisers need to be licensed, they are also governed as to the way in which they perform these appraisals.
One of the main provisions was for appraisers to conduct appraisals in conformance with the Uniform Standards of Professional Appraisal Practice or USPAP.

**USPAP**
The Appraisal Standards Board of the Appraisal Foundation sets forth a guide to performing appraisals titled the “Uniform Standards of Professional Appraisal Practice”. It dictates not only standards but also the code of ethics that goes along with those standards. These standards are so important that USPAP is one of the first required classes and must be repeated every two years.

Federal Requirements for appraisers - All appraisers are required to be licensed in the state in which the properties they are appraising are located for federally regulated transactions. NY State Requirements for appraisers - This criterion is established by the Appraisal Subcommittee of the Federal Financial Institutions Examination Council or by the appraiser qualification board of the appraisal foundation as referred to in Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Based on an authorization by Congress, the Appraisal Foundation is the source of appraisal standards and qualifications. States have a limited amount of latitude in their educational requirements and the student must check with their own state to ascertain the individual requirements.

**APPRAISAL THEORY AND PURPOSE**
A major part of success for a real estate professional starts with the understanding that “price affects exposure”. In other words, if it is priced right, it will be exposed to the greatest number of potential buyers. If it isn’t, then few buyers if any, will want to see the property.

An appraisal is an estimate of value for a particular property as of a particular point in time. It is usually presented in a written form report and contains information about the property appraised, the method(s) used to arrive at a value, and the analysis.

As salespeople, we are faced with the question of “how much is it worth” day after day, week after week, month after month. All too often we take a deep breath, some number comes off the top of our heads, and that is what we will tell the seller his home is worth. How many times has this proven to be wrong? Probably more than we would like to know. However, if we use approaches similar to the ones used by professional appraisers, we will get a better outcome. With that in mind, we are going to learn appraisal basics so we can use them in our own career.

**DEFINING AN APPRAISAL**
An appraisal is actually an opinion of value. The appraiser makes an unbiased estimate of the nature, quality, value or utility of an interest of specific real estate including personal property. It is as of a specific date and is prepared by a professional appraiser who does not have an undisclosed interest in the property. This is quite a bit more in depth than what a salesperson would do when preparing a Competitive Market Analysis (CMA).

**Example:** Julia and Frank are newlyweds. They each have good steady jobs and know where they want to settle to start their lives together. They go to a bank and talk to the lender about how much of a mortgage they qualify for and how much they can afford to spend on a house. With this knowledge and a coveted pre-approval, they shop for a home. They find the perfect starter home, small enough for two with room to expand when they have children. Lucky for them, the price of the home is exactly what they have to spend. So they sign the contract and go for the mortgage. Three weeks later, the lender informs them that they can’t get the loan because the property “didn’t appraise.” The appraiser doesn’t think the property is worth what the purchaser’s are paying. Not to be deterred from their quest, Julia and Frank go to their second choice lender and lo and behold, the appraisal supports the loan request and they close on their new home.
There have been many instances when one appraiser’s opinion of value would differ from another’s on the same property. However if each one did their due diligence in valuing the property, then the opinions would not differ more than say, 10%.

This is the same situation we see in our day-to-day operation as a salesperson in pricing a property. We give our opinion and another broker gives a different one. Who is right? Sometimes, within reason, both are. Remember, an appraisal is an opinion.

**AN APPRAISAL MUST BE APPROPRIATELY SUPPORTED**

**Example:** Thomas and Linda are getting a semi-amicable divorce. The lawyer for each advises they get their own appraisal of the property they own together. Linda will remain in the house and buy out Tom’s half.

Tom’s appraiser estimates the value to be $250,000 while Linda’s appraiser estimates the value to be $200,000. They go to court and the judge compares the two appraisals. Tom’s appraisal gives the address, a brief description of the property, and three listings of properties for sale in the neighborhood. Based upon this information the agent states his opinion of value. Linda’s appraisal gives the address, a brief description of the property, describes the details of four sales that took place recently in the neighborhood, compares those sales to the property appraised, sets forth a logical comparison and analysis, and arrives at an opinion of value. Whose opinion do you think the judge will favor? The one with the best support for the value conclusion. Of course, this would be Linda’s.

**AN APPRAISAL IS AS OF A SPECIFIC DATE**

**Example:** Smith and Jones Appraisal Professionals receive a request to prepare a property appraisal. They are given the address; the appraiser inspects the property one week, and completes the appraisal a week later.

The lender receives the appraisal, and closes on the loan. The borrower never makes a payment. Within the first week of ownership, the levy breaks, the whole town floods, the structure is carried downstream, and the land is now underwater. The lender goes back to the appraiser and tells him the appraisal is no good, that the property is worthless and wants the appraiser to repay the loan. The appraiser reminds the lender that the appraisal is as of a week before the levy broke and the value is based upon the condition of the property as of that date and the state of the market as of that date. Now the lender is the one “up the creek”. Thank Goodness,

**THE VALUE ESTIMATE MUST BE DEFINED**

**Example:** Two unrelated appraisers (Bruce and Daniel) are assigned to appraise an industrial building. Both are knowledgeable and experienced. Each one inspects the building and submits an appraisal that is well supported, fairly analyzed and clearly presented. Daniel’s opinion of value is $100,000 less than Bruce’s appraisal. Yet both appraisals are valid. How could this be? Daniel’s definition of value identified the property rights to be a leased fee estate. In other words, a tenant in the building had a lease giving him the right to occupy the building for a certain period. Bruce’s definition of value identified the property rights to be a fee simple estate. It supposed there was no lease and that no occupancy rights were relinquished.

**THE PROPERTY MUST BE ADEQUATELY AND ACCURATELY DESCRIBED**

**Example:** Marie and William are retiring and moving south to live with their children. They want to put their home in trust for their 25 grandchildren and need to have it appraised. William hires an appraiser who does a quick walk through inspection, and is soon “off to do the field work.” In his appraisal, he describes the condition of the improvements as average. He does not mention the water stain on the ceiling caused by the hole in the roof, the sagging gutters, the worn torn flooring or the fact that the lights flickered as he walked from room to room.
Nowhere does it mention the shopping center under construction on the lot behind. His appraisal also presents and analyzes comparables he describes as average in condition and similar in location to the property being appraised. How reliable do you think this opinion of value will be? Not very. This appraisal obviously misses some of the most important aspects of the home.

**THE APPRAISER MUST BE QUALIFIED**

**Example:** Picture a large family sitting around waiting for old Uncle Sam’s last will and testament to be read. We all loved Uncle Sam and thought he loved all of us too. 90 years is a long time to collect things and Uncle Sam, well he collected things as easily as he collected relatives.

Finally, the list of recipients gets down to his two great, great grandchildren. The list has been reduced, but Low and behold, he leaves them his house, each one to get an equal share. Suzanne, who lives in another state, jumps out of the chair and hollers, “I'm rich, I'm rich.” Jonah, who has been living with and taking care of Uncle Sam, knows the rundown condition of the home, how the neighborhood has deteriorated over the years, and that there is an incinerator under construction on the lot next door. He lets out a disappointed “sigh.” Its home to him though and he wants to stay and buy Suzanne out. They begin to argue over what it is worth. What do the older, wiser, relatives tell them? “Get it Appraised!” Why?

- They know the appraiser will be unbiased, will not take one side or the other.
- They know the appraiser will be able to assess the condition of the home and how it affects value.
- They know the appraiser will be knowledgeable about the market in which the home is located.
- They know the appraiser’s opinion of value should accurately reflect what the home is truly worth.

**THE APPRAISER MUST BE UNBIASED**

**Example:** Jonah has a casual acquaintance, Janine, who happens to be a real estate appraiser. He hires Janine to appraise the property. She is also an investor and offers to put up the money for Jonah to buy out Suzanne. She knows she must be unbiased in her opinion of value. She feels she can do this. She prepares a well-written, well-supported, thoroughly analyzed appraisal. Any qualified, experienced appraiser familiar with this market would agree with the value conclusion. Unfortunately, this appraisal cannot be relied upon because the appraiser has a personal interest in the property.

**THE APPRAISER MUST HAVE NO UNDISCLOSED INTEREST IN THE PROPERTY**

If all the parties who need to rely on this appraisal know in advance that Janine has an interest in the property, and agree to let her perform the appraisal, and she discloses in the appraisal that she has an interest in the property, it would be acceptable.

**THE PURPOSE OF THE APPRAISAL: TO DETERMINE SOME KIND OF VALUE:**

**ASSESSED VALUE** - A value placed on properties by the assessor for tax roll purposes. This assessed value is then multiplied by an equalizer of tax rate to establish the actual tax bill.

**Example:** Scooter Sr. and Scooter Jr. have agreed that Scooter Jr. will buy their family home when Scooter Sr. retires. Together they try to decide what a fair price for the property would be. Scooter Jr. gets the tax bill and finds the assessed value to be $200,000. He thinks to himself, okay, that sure is affordable and what a bargain. He suggests using the assessed value for the exchange of ownership. Scooter Sr. says- that is ridiculous- the house next door sold for $600,000 last month. Certainly, the assessed value is not a fair barometer. They call the assessor and find out that the assessed value is some kind of percentage of fair market value, and the date of that market value is three years prior. Assessed value does not usually represent market value.

**VALUE IN USE** - This is too is not necessarily market value. The owner user has a specific purpose for the property based upon its income, utility or amenity. There may not be an open market for the improvements to the site.
Example: In a small town, far from any metropolitan area the townspeople convince a young doctor to move there so they can get medical care without having to travel hundreds of miles. He works with an architect to design a small medical building that can double as an emergency room. Because of the equipment he needs to service his patients the building has to be equipped with electrical capacity far beyond the typical office building. In addition, the building has to have its own back-up generator, and computer floors.

When he goes to the bank to apply for a loan, they hire an appraiser to appraise the market value of the building. The appraiser informs him that he cannot appraise the market value because there is no data on any sales or rentals of buildings like his within a reasonable distance. He then suggests the appraisal be for its “value in use”. There is no market for medical buildings in this area; however, there is a specific need for one building to service the needs of the local community.

**INVESTMENT VALUE** - Meeting personal investment objectives, not those of the general market place

**Example:** Harry Jenkins wants to purchase an apartment building where he and his family will live. He expects to save money because he won’t have to pay rent. In addition, since his parents live next door he will save on babysitting expenses. He knows the building is overpriced but is willing to buy it anyway. He advises the investor that although the going rate of return is 10% he is willing to accept 8%. The appraiser uses the 8% return in his analysis to value the building. The lender rejects the appraisal because it is based on Jenkins desired return, the “investment value” rather than a typical market return.

**INSURABLE VALUE** - Replacement or reproduction cost of physical items subject to loss from hazards.

**Example:** Al and Peg purchased a new home and got copies of the appraisal done for the lender and the one done for the homeowner’s insurance. They were shocked to see that the values were nowhere near each other. They called the real estate appraiser who explained that he had appraised the market value of their home while the insurance appraiser had appraised the replacement costs for the building if there were to be a loss. The insurable value did not include depreciation nor take into account the land value.

**LIQUIDATION VALUE** - A quick sale with less than reasonable market exposure

**Example:** A company wants to relocate its corporate operation to a place with less expensive labor. To entice its key employees to make the move with them they offer to buy their current homes at market value. The next thing they know they are in possession of ten homes and need to dispose of them quickly. They list with a broker and give that broker instructions to sell all the homes in the next month no matter what they have to do. The corporation paid market value for the homes and the directors want to know what they are worth. The broker explains that with the directive to sell them quickly, the corporation is not likely to get all its money back. The estimate he gives them is the “liquidation value.”

**MARKET VALUE** - It is the most probable price a property should bring in a competitive and open market with all the conditions of an unbiased sale. Both the buyer and seller are acting in their own best interest. This is assuming the price is not affected by undue pressure. This is the accepted definition in use in metropolitan New York.

- Buyer and seller typically motivated.
- Both parties are well informed or well advised, and acting in what they consider their best interests
- A reasonable time was allowed for exposure in the open market
- Payment is made in terms of cash in United States dollars or in terms of financial arrangements
- The price represents the normal consideration for the property sold unaffected by special or creative financing, or sales concessions, granted by anyone associated with the sale.

As salespeople helping a seller price his home, we have to use the same considerations as the appraiser would in determining the value of a home. Always keep in mind that **PRICE EFFECTS EXPOSURE**.
The higher the price, fewer buyers would be interested in seeing the home. The lower the price, more buyers would be interested in seeing the home.

**DIFFERENCES BETWEEN COST, PRICE AND VALUE**

**Cost:** Past - Dollar expenditures for labor, materials, legal services, architectural design, financing, taxes during construction, interest, contractors overhead and profit, entrepreneurial overhead and profit, etc.

**Price:** Present - An amount agreed to by the parties to consummate a sale. Each party should be acting independently and without undue pressure.

**Value:** Future - The future benefit of present worth based on an individual’s perception of those benefits.

**UNDERSTANDING VALUE**
Some value comes from the social aspect of real estate. The social aspect deals with the fact that the supply of land is fixed and the earth itself is a resource shared by all. How would we get from place to place without roadways? How would our society survive without government buildings or parks, beaches and preserves?

We also need land for private use such as housing, industry, retail, and education to name just a few. This makes it a marketable commodity.

Because of the different desires of groups of people, sometimes the social aspect creates conflict. We hear about land preservation opposing the need for affordable housing. Both social aspects of real estate are important. The question often becomes “which is the most important”?

**WHAT IS REAL ESTATE?**
A parcel of land and all the physical improvements to that parcel is referred to as real estate. This is defined as “from the core of the earth up to infinity”. The use of the real estate is determined by zoning or other local building codes.

**IMMOBILITY AND TANGIBILITY**
They are what set real estate apart from other goods and services. Real Estate cannot be moved from place to place yet it is a physical item, which can be touched. Ownership of real estate conveys certain rights and interests for the use or enjoyment of that land and all its improvements.

**THE DIFFERENCES BETWEEN REAL ESTATE AND REAL PROPERTY**
Real Estate refers to the land and improvements (structures). Real Property is all the interests, benefits and rights inherent in the ownership of physical real estate.

**Personal property:** the movable items not permanently attached to any part of the real estate. Personal property refers to any property that could easily be removed without causing damage to the real estate itself. Bedroom furniture, scatter rugs, pictures etc. would be examples of personal property. Dishes, towels, pots and pans, clothing are additional examples and the list goes on and on. When pricing a property, the value of the personal property is usually not included.

**Fixtures** have yet another meaning: These items had originally been personal property but are now permanently attached to real estate. Wall to wall carpeting and built in wall ovens would be considered fixtures. It is important to recognize the differences between personal property and fixtures since typical personal property does not remain for the buyer and fixtures probably would. There are many items that give real estate its’ value. Included would be the anticipated use of the land which would depend on the following:

**GEOGRAPHIC OR PHYSICAL ELEMENTS**
Location - We all know that location is a major factor in value. Many people will insist that the three most important words in real estate are location, location, location. However, it is more likely price,
price, price because no matter what the location if it isn’t priced fairly it probably won’t sell. On the other hand, if it is priced well it might sell no matter what the location. The most important considerations in the geographic or physical elements are:

- Size
- Shape
- Topography
- Soil
- Climate
- Water

The basic concept of land ownership includes the surface as well as above and below it. Use is limited based on legal and local restrictions. We know that land is a major source of wealth. But where is the value in land? Value is in the physical ownership. With that ownership, we have certain rights known as the bundle of rights.

**LEGAL RIGHTS IN REAL ESTATE**

When we own real estate we own a “bundle of legal rights” These rights include:

- The right to occupy and use the land: We can put the land to whatever use we see fit (provided it is a legally permitted use).
- To sell it in whole or in part: We can sell off the whole parcel or subdivide it and sell off the pieces.
- To bequeath: We can leave it to our heirs.
- To lease: We can give someone else the right to use it for a specific period.
- To transfer occupancy and use rights: We can sell off part of our rights, such as selling the development rights for land preservation.
- To do nothing: We can just hold onto it as long as we choose to. Many people buy real estate with the intention of simply holding on to it. It could be increasing in value so in fact, although you appear to be doing nothing, you are investing in a future expectation.

These rights become the basic value in owning real estate.

**USES FOR MARKET VALUE**

A. A Transfer of ownership - To establish how much money or like property should be exchanged to transfer a property from one party to another.

B. Financing and Credit - To protect the lender in case the borrower defaults on the mortgage loan.

C. Condemnation - The government takes a property or a part for the “common good”.

D. Taxation - Usually the assessed value is based upon some percentage of current market value.

E. Rental/Leases - Landlords or tenants could use this to determine how much they should charge or pay.

F. Feasibility Study - When trying to decide what would be a good use for a property.

**THE ECONOMIC FORCES THAT DRIVE REAL ESTATE**

**Supply and Demand** - We need to know some basic information about the item we wish to value. What can it be used for? This is its utility. Of course what land can be used for has all sorts of implications. It has to be a legally permissible use (in compliance with zoning and building codes). How much do we want it? This is its desirability. What is the demand for this type of property at this point?

How hard is it to get? **This is scarcity.** If there is a greater demand than supply, the price would be higher.

How can it be paid for? This is known as **Effective Purchasing Power.** The housing market would be nowhere without financing.
In real estate, demand is the amount of a type of real estate desired for purchase or rent at various prices in a given market for a given period. The price of real property varies directly, but not necessarily proportionately, with demand, and inversely, but not necessarily proportionately, with supply. The more we want it and the harder it is to get, the more we’ll pay for it provided we have the means to pay. The easier it is to get, the less we’ll pay for it. The more we have of any one item the less special each individual item becomes.

In understanding value, we need to pay particular attention to the differences between real property and consumer goods.

**Anticipation** - Much of the value in real estate is in the anticipation of occupancy, possible income and or the sale of the property afterwards. Consumer goods are often “used up” during the time we own them. A can of beans would be “used up” after our dinner. Our refrigerator would be “used up” after many years of use. The tires on our car would be “used up” after many thousands of miles of driving. These are all consumer goods. Real estate, on the other hand will always be there in one form or another.

Remember, value is the present worth of the rights to all prospective future benefits, tangible and intangible, accruing to the ownership of real estate.

**Contribution** - What is the positive or negative effect of a component of real estate on its’ value.

**Example:** If you were buying a house and the owner has put on a new deck that cost him $5,000 - would you be willing to pay $5,000 more for that house than the identical house next door that doesn’t have the deck?

This is the concept of contribution. Does a single component add to or take away from the value of the whole. Another example would be dealing with the number of bathrooms. How much more would a typical purchaser pay for a house with two bathrooms than a house with just one bathroom-all other aspects being equal?

**Increasing and Decreasing Returns** - Adding one component will increase the value, however, adding two may not double that amount. Simply put, there comes a point when putting additional money for improvements into a house will not bring a return on the owner’s investment.

**Example:** Let’s say you want to sell your four bedroom one bath house. The agent thinks your house will sell for $200,000. They also think the house would sell for $225,000 if it had another bathroom. The cost of adding a bathroom is $10,000. Your return on adding that bath is $15,000. This would be an increasing return. Wow - you think, that is great so you hire a contractor who tells you they could easily put in two more bathrooms. You go ahead without consulting the agent but when you sell the home instead of $250,000 or $50,000 more for adding two bathrooms, you can only get $230,000. The return on the third bathroom diminished or there was a decreasing return.

**HIGHEST AND BEST USE**
The most basic theory when dealing with appraising is the concept of highest and best use. It answers the question, what is the best thing we can do with this property? In formal terms, Highest and Best Use is defined as: “The use from among reasonable probable and legal alternative uses, found to be physically possible, appropriately supported, and financially feasible which results in the highest land value.”

If the land is or were to be vacant, what use should be made of it?

When applied to the property as improved: Should the existing improvements be maintained, renovated, expanded or perhaps demolished?

The four tests of highest and best use are:

**Legally Permitted:** What could we build given the zoning, building codes, environmental regulations, historical districts, and any other restrictions that can be placed on the property? A long-term lease
could affect this too. A possible change in zoning might need to be addressed. Deed restrictions could also have an effect.

**Physically Possible**: What we can build will be limited by the physical aspects of the site as well as capacity and availability of public utilities.

**Economically feasible**: There must be a demand for that property type. To determine financial feasibility of potential income producing uses the appraiser estimates the future gross income. Vacancy and collection loss are then subtracted to obtain net operating income. From this, a rate of return is established.

**Most profitable**: (Highest value) (highest return) If the expected profits are greater than the cost, then the project is considered to be financially feasible. Taking into account all the economically feasible uses, which one would create the maximum return on the investment?

The highest and best use would conform to the neighborhood and market in which it is located.

**THREE APPROACHES TO VALUE**

Once we have a good idea of what the highest and best use will be we are ready to apply the three approaches to value. These approaches actually answer three theoretical questions.

How much would it cost to buy the land, and build a house similar to the subject, given the fact that we need to depreciate the improvements for wear and tear and anything else that would make a difference between a new home and the one that actually exists? This is the basic theory behind the cost approach.

How much would the typical buyer be willing to pay, and the typical seller is willing to sell for, a home similar to the subject? This is the basic theory behind the sales approach.

How much would a buyer be willing to pay and the seller is willing to sell for, to get a certain income and return? This is the basic theory behind the income approach.

The three approaches to value property include the **cost approach**, the sales comparison approach and the **income approach**. When pricing the home we must always take these three approaches into consideration.

**THE PRACTICAL SIDE TO APPRAISING**

Working as an appraiser is not unlike working as a real estate sales person. They work independently or for an appraisal company and are trained to use certain software and approaches that the company requires. At the beginning of their career they are usually assigned to an experienced appraiser who will take the assistant out into the field to get hands on experience. Eventually the assistant will be experienced enough to work independently and with great flexibility.

The company and the appraiser choose assignments and set fees by asking some of the following questions:

- What am I appraising?
- Where is it located?
- Why do they want the appraisal?
- Is it going to be market value?
- Is it owner occupied?
- As of when?
- Anything special I should know about?
- How much time and effort will go into this appraisal?
- What should I charge for this appraisal?

The appraiser needs to obtain all the legal elements ownership including the description, owner and anything else that might be pertinent. She then inspects the property. Appraisers will then look for sales of properties similar to the subject and in the subject neighborhood. These are **comparables**. This information is available from many sources such as the Multiple Listing Service.
SELECTING COMPARABLES

Recent Sales - They want property that sold within a reasonable period from the date of the appraisal. In densely populated areas with good sales activity, this usually means within six months. It is common to scan back a full year to see where the market was and look at current listings to see where the market is headed.

Close Proximity - In urban or suburban areas, the sales should be within a one-mile radius of the subject. At the same time, they should be within the neighborhood boundaries. In more rural areas or when dealing with waterfront properties, it may be necessary to spread out the sale search to find similar locations.

Similar in size and number of rooms - Sales should be as similar as possible in size and room count to the subject. Obviously, people are willing to pay more for a bigger home and or a home with more bedrooms or bathrooms.

It is important to make sure that our sales make sense. If they are much higher or much lower than others in the area there is probably a reason. Before we decide to use them, we must find out the reason.

Land sales - In areas where it is applicable, look for sales of comparable building lots. They would be lots that have similar utility services in place on the street, and that are similar in size and zoning.

Rentals - If the subject property has rental income, then, of course, we would look at other similar rental income producing property.

CHECKING THE HOUSE AND IMPROVEMENTS

An appraisal inspection is extremely in-depth. As an agent, you will certainly need to have the same information in order to assist the owner with pricing his home or other real estate. Our market analysis is not as in-depth as an appraisal, however, good information will lead to a good pricing procedure.

INSIDE THE CAR

✓ Drive down the street of the subject, look at it briefly and circle the surrounding blocks making note of how it compares to other property in the area.

FROM OUTSIDE THE CAR

✓ Photos are an important part of the appraisal process. As agents, they are of less importance. However, a few good pictures of the house can be used for flyers or other marketing material.

FROM INSIDE THE HOME

✓ Again, appraisers need many pictures to document their findings. Agents should have some for marketing. Be sure not to include occupants of the home or pictures displayed. Be prepared to take many notes.

At this point in the process it would not be uncommon for the owner to try to engage the appraiser or agent in conversation concerning the house. Agents need to establish rapport with the owner since they would like to represent them.

CONTINUING THE APPRAISAL PROCESS

Once the necessary tour, photographs and notes on the subject property have been completed, the appraiser begins to do their fieldwork. This is the work done outside the subject property and generally relates to the comparables, referred to as “comps”. These are the similar properties that are used in order to assist in determining the conclusions on the subject property. Each comp is visited and photographed. They have to be viewed personally so that their locations are observed in the same manner as the subject property. Most agents are familiar with the neighborhood and probably know most of the comps.

When viewing “comps”, see if you can engage the owner in conversation explaining why you are interested in their home. Often that owner is thinking of selling their home and you would be the first one they speak to.
OTHER APPRAISAL APPROACHES

Income Property
There is a need to gather rent comparables. If the subject is an income property or if the neighborhood is supportive of income properties this information is necessary. Appraisers visit neighborhood brokers, describe the subject property and get a few comps. They are reviewed with the same scrutiny as the sale comps.

Dealing with the land sales
✓ Drive by and take photos
✓ Take notes regarding the state of development of the land.
✓ Is the property cleared or wooded?
✓ Is there a foundation poured?
✓ Has a home been constructed on the site?
✓ How does this location compare to the subject property?

THE ANALYSIS
Now that the fieldwork has ended, the actual analysis of all the information we have gathered will begin. The first action that we must take is to decide which approach to value is applicable to the subject.
- Cost
- Income
- Comparable Sales

The comparable sales approach is the one most often relied upon for residential sales. This is the most direct approach. Buyers and Sellers can relate to this as “comparison shopping.” It is the reason the asking price and or contract price on a property may be different from the appraised value.
In real estate sales, the asking price is arrived at by a combination of events looking to the future.
- What are the current asking prices?
- How long is it taking these properties to sell once they are listed?
- Why is the seller putting his home on the market?
- What is the seller’s time frame for closing on the property?
- How much room is there to negotiate with the buyers?
- What actual sales have taken place?

Appraisals on the other hand rely on events that have already taken place. Our comparables are of properties that already sold. This assumes that the property was on the market prior to the date of the appraisal. Therefore, the appraised value is a function of the past while the asking price is a function of the future. Looking at asking prices helps the appraiser see where the market is headed.

COST APPROACH
This is another method of placing value on the property. Think of it as building this subject property from the ground up.
- If there were no home on the site, how much would it cost to buy it?
- What is the value of the land without any buildings?
- How much would it cost today to build everything that is now on the site?
- Based upon wear and tear, how much have the improvements depreciated. (How much less are they worth than similar improvements that are brand new?)

While most people only think in terms of real estate “appreciating”, in reality, when pricing it, we must look at what has “depreciated”.

The land is stable. We can’t really take it anywhere, it is where it is. It lasts forever and ever. Structures or improvements however have a limited although sometime long-term useful life. Typical residences are expected to have an economic life (or useful life) of 60 years. This isn’t usually the case but suppose someone moved in and made no improvements or repairs for say 30 years. The house
would have “used up” half of its expected life. This would be the depreciation to the structure, say 50%. It is quite possible, even probable that the property as a whole has appreciated over this time. In that long span of 30 years, it might overtake the amount of depreciation to the building, over and over again.

If you had established a land value, taken the cost to build the structures and subtracted the depreciation, you would have an indication of value via the cost approach. The cost approach is really useful when we are appraising a property with a new structure, relatively new structure, or proposed construction.

**INCOME APPROACH**

Sometimes properties are purchased as rental or income properties. When people buy these types of property, they expect a return on their investment. The sole purpose in owning these properties is to have enough income to cover all the expenses as well as earning a profit. The investor also hopes to make a profit when he eventually sells it. While this may sound complicated, in fact it isn’t. The rental income needs to be compared to the sales price.

**Example:** How much rent would I have to get for this property in order to pay the price? We must, once again, as we did in the sales comparison approach, find similar properties and gather relative information. This includes: Find a rental property that recently sold and the selling price. Perhaps it sold for $300,000.

Next, we learn what the rent was or what market rent would be. Let’s say $1,000 per month. The price divided by the income equals 300. Therefore, the “going price” could be viewed as 300 times the monthly rent. This is also known as the gross monthly rent multiplier. Needless to say, we would have to use several comparables in order to be certain that our conclusion was correct. Let’s say they all led you in the general direction of 300 times the monthly rent.

The next step would be to determine how much rent should be applied to the subject. Perhaps $800 per month is what we believe would be a fair amount.

Logic tells us that the garage added $10,000 in value to the house with the garage. These are known as paired sales. Adjustments are not made based on just one pair. Many pairs are used and eventually the market perception of each feature is known. These features and the values added or subtracted for them change with the market and the times. Determining the amount of adjustments is a constant ongoing process. Some of the most important features for making adjustments:
Sales or Financing Concessions: A seller allowance toward closing costs. The theory behind this is that if the buyer doesn’t have to pay any closing costs, he might be willing to pay more for the house. Appraisers prefer not to use comparables with financing concessions because they do not show a true picture of the selling price of the house. Sometimes they are the best that are available and they have to be used with adjustments.

Date of Sale/Time: In markets where there is rapid appreciation or depreciation an adjustment is made to the sale based upon the amount of time that has passed. Lenders prefer recent sales since those are the best indicator of the current market. If the market activity slows down to where sales within the past few months are not available then this adjustment may have to be applied.

Location: The location adjustment can be quite tricky. Therefore, appraisers prefer not to have to make location adjustments. To avoid this they stay within the same school district and generally within a one-mile radius. Even though the neighborhood and school district may be the same, there could be more or less preferable locations. Next to or close to a shopping center, a school, a highway, or high-tension wires might affect value. In addition, an interior lot verses an exterior lot might affect value.

Leasehold/Fee Simple: These cannot be “mixed and matched.” The fee simple estate is one where there are no leases in place. The leased fee estate has signed contracts that can enhance the value if the tenants are paying more than the “going rate,” or detract from value if they have a right to stay for less than the “going rate.”

Site: Rarely do appraisers manage to get sales of homes on lots that are exactly the same size. If the difference is large enough that someone would pay more or less for the home as a result, then an adjustment is made. This is based upon market perceptions as well. How much more or how much less would most people pay? For ease of measurement we often make this adjustment on a per square foot basis.

Example: There are two lots, developed with similar houses, the same gross living area and currently in the same condition. One lot contains 8,000 square feet and the other 5,000 square feet. The one on the larger lot sold for $107,500 while the one on the smaller lot sold for $100,000. The difference in the sale price is $7,500. The difference in the lot size is 3,000 square feet. To determine the dollar amount per square foot difference we would divide $7,500 by 3,000 sq. ft. to get $2.50 per square foot.

We would make this comparison many times to settle on a per square foot adjustment that would be representative of the market.

Since we always adjust the comparable to be more like the subject, sales with larger lots would be adjusted downward and sales with smaller lots would be adjusted upward. Now, perhaps, the subject has a 6,000 sq. ft. lot. Sale 1 has an 8,000 square foot lot. How much would the adjustment be and in what direction? 8,000 – 6,000 = 2,000 x $2.50 = $5,000.
The sale would be adjusted downward for being larger or superior to the subject.

View: It is important to look not only at our homes but also from our homes. The more spectacular the view, the more we are willing to pay. View is often noted in selling points when marketing property with better than average views.

Some typical examples might be:
“IT has a panoramic view of the skyline.”
“IT has a view of the lake across the street.”
“It is ocean view.”

Design (Style): Although it is best to keep the design of the sales similar to the design of the subject it is not always possible. Where would the market see value differences? The difference between having to climb stairs or not in two houses the same size such as Ranch versus Colonial.
Quality of Construction: Sometimes quality differences are hard to detect but to make an extreme example, let’s think of the three little pigs, a house made of straw, a house made of twigs and a house made of bricks. The bricks cost more but most would agree that the extra strength and protection and longer life of the structure is well worth it!

Actual Age: The actual age has a bearing when homes are relatively new. In established neighborhoods though it might be preferred to look at the effective ages to make or not make adjustments. The effective age is the age that a property seems to be even though it may be older or younger. More often, the effective age is younger than the actual age because most homes get periodic updates, repairs and renovations. “The home is over 100 years old but it was completely renovated last year so it’s effective age is like new.” This often ties in with the condition of the house.

Condition: This adjustment is used rather often. Certainly, someone would pay more for a house that is in excellent condition than one that needs renovation before moving in.

Above Grade Room Count: Only rooms above grade (not partially below ground level) are considered and count towards gross living area. Keep in mind that gross living areas are finished, heated and have above five feet in ceiling height. The total number of rooms does not include the bathrooms. The number of bedrooms compared to the total number of rooms gives us a mental picture of the interior of the houses. Generally, for a room to be counted as a bedroom there should be a closet. The number of bathrooms is important in the way it corresponds to the number of bedrooms and the size of the house. We really value our bathrooms in this market. All the appraisers make adjustments for the number of bathrooms. How many bathrooms are enough and how many are too much? In more affluent areas with higher home values, it is generally seen that most purchasers expect at least one per bedroom and a half bath for guests. In low income areas with lower home values often one bath in a two to three bedroom house is considered sufficient. So how much value is added by having an extra bath or being short a bath? This depends on the neighborhood.

Gross Living Area: Appraisers try to find sales as close in size to the subject as possible. Still that rarely happens so there is a need to apply a value judgment here. This is done similarly to the size adjustment for site. An important question to ask and have answered is “how much more or less are buyers willing to pay and sellers willing to take, for bigger or smaller homes than the subject? Again, this figure depends on the market in which the subject is located.

Basement & Finished Rooms below Grade: Certainly having a full basement whether it is used for utilities, storage or extra rooms adds value to a home. How much or how little depends on:

- Is the basement finished?
- What is the quality of that finish?
- How it is partitioned?
- Does it have natural light and how much?
- Is it accessible from the interior and exterior?
- Is it a source of legal income?

From both lenders and appraisers standpoint, the space has to be legally finished. It must be in an area where it is legal to occupy it for whatever reason. This is where good research becomes imperative. The appraisal must contain an adequate and accurate description of the property. If there is an illegal apartment and it is reported as such, the lender will most likely not be willing to make the loan. Every lender and every appraisal company has its own guidelines regarding this situation.

**IMPROVEMENTS**

Functional Utility: Is it providing the use for which it was intended? There may be deficiencies such as a poor layout, or not enough bathrooms for the size of the house. If a house has many bedrooms but no recreational or dining areas this would prove to be a negative. The question would then be, does the market reflect a difference in value for these things?
Heating/Cooling: Sometimes the type of heat or the fuel will make a difference in values. Generally, people will pay more for a house with central air conditioning.

Energy Efficient Items: In today’s world, energy efficiency can be a major factor in pricing a home. Buyers will pay more for a home when they know that it is highly energy efficient. Insulated windows and solar energy would certainly increase the value.

Garage/Carport: They will usually add value to a home. However, a one-car garage in an area with mostly 2 car garages would be worth less. Just as a carport in a community where most houses have garages would have a decrease in value.

Porch/Patio/Deck: In many markets, the lack of a porch or patio or deck would definitely decrease its desirability and, therefore, its value. In other areas, it might not matter. The appraiser has to determine whether there is a premium placed on these amenities.

NET ADJUSTMENTS
Appraisers use computer programs to automatically adjust all the items noted. If there are a great many adjustments, most likely the comps used weren’t very good. A lender will not look kindly at this type of appraiser. Similarly, if we use “comps” that are quite different from the subject property, the seller will not be impressed by our conclusions. The appraiser looks at all the comparables, the unadjusted prices, the adjusted prices, the adjustments and decides on a value based upon all the information in front of them. We need to do the same.

SUMMARY OF SALES COMPARISON APPROACH
The sales comparison approach of the appraiser is similar to the approach the agent will take when preparing the market analysis. Unfortunately, many agents simply look at the house and give the owner a “guesstimate”. The professional agent will use the appraisal scenario we just went through in order to structure a market analysis that is worthwhile and can be counted on when the seller is determining a selling price. Remember, once again, if the appraisal doesn’t support the sale and financing is required, it may never close.

COST APPROACH
The cost approach is like building blocks. It starts from the ground up. One object of the cost approach is what would it cost us to purchase the subject if it was a vacant building lot. The best method to find this out would be to get sales of vacant parcels and do a sales approach similar to the one we just performed. In some areas such as the New York-Long Island market, this is easier said than done. There are few if any sales of vacant lots in areas that are fully developed. Therefore one of two methods are used, extraction or allocation.

Extraction - First, an estimate of the cost to build a new building like the subject. Then, an estimate on the depreciation of the subject building is determined. Subtract this from the cost of a new building. Once we have an idea of the total value of the property, we subtract the depreciated cost from the new to arrive at a land value.

Example: The cost of the new building is $75,000 and the structure has an effective age of 15 years. Then the depreciation would be equal to the effective age divided by the economic life of 60 years. 15 ÷ 60 = 25%. Depreciation would equal 25% x $75,000 or $18,750.
Depreciated cost of the new building would be the $75,000 less the depreciation of $18,750 or $56,250.
If the total value is $100,000, then subtracting $56,250 is equivalent to the land value or $43,750.

Allocation - Experienced appraisers see a correlation between total value and land value. They find that there is a typical land value as a percentage of total value in each neighborhood. Before using the extraction method, they would estimate the cost of the new building using acceptable resources. There are subscription services offering this information. The appraiser then makes a choice between using the reproduction or replacement cost method.
**Reproduction cost:** This might be compared to making a photo copy of the original. You want to build an identical structure, including all the original building materials. This would certainly be the method used if the property had historical status.

**Replacement cost:** This method is more often utilized. It calls for building a structure that has the same function as the subject but with modern materials and to current standards.

**Actual Costs**
- **Dwelling:** This is the estimate of the cost of all the sections considered gross living area including the basement.
- **Amenities:** Decks, porches, fences, in ground pool, garage or carport, etc. These would all be added up for a total estimate of cost of a new building.

**TYPES OF DEPRECIATION**

**Physical** - The wear and tear on the building derived by dividing the effective age by the economic life. This can be diminished value due to a lack of something considered standard in this market or even diminished value for items considered unnecessary in the market. Examples might include an office building with no central air conditioning or a 6-story apartment house with no elevator. In today’s world many homes do not have sufficient electricity to support the most common items we use simultaneously. Perhaps we cannot use our hair dryer and air conditioning unit at the same time. Or, the microwave oven and computer. Unnecessary items might be a coal storage area in a home now heated with gas or oil.

**Functional** - This is diminished value caused by something outside the subject site. Things like a sump next door, a shopping center next door, or high-tension wires would tend to diminish value.

**External** - This is diminished value caused by something outside the subject site. Things like a sump next door, a shopping center next door, or high-tension wires would tend to diminish value.

**“As Is” Value of the site improvements** - Site improvements would include items such as bringing utilities to the structure, sewer lines or cesspools, septic systems, landscaping and paving. All the extras required to make this site an integral part of the structure.

These are all analyzed to arrive at a value indicated by the cost approach.

**THE INCOME APPROACH**
This approach is used for commercial property and is a very long and involved process. However, when used for residential property it is usually quite simple.

We need to answer questions from a buyer and seller perspective.

1. How many times the monthly rent am I willing to pay for this property?
2. How many times the month rent am I willing to sell this property for?

The answer to these questions becomes the gross monthly rent multiplier,

**Estimated monthly rent** - It is necessary to do research and determine how much the typical rent would be for this type of property. The sources used would include the Multiple Listing Service, local brokers and perhaps checking out for rent signs in the neighborhood.

**Determining Gross Rental Multiplier** - Find properties that sold and were rented. Divide the sale price by the monthly rent.

**Example:** A property sold for $300,000 and the monthly rent was $1,500. Therefore, we divide $300,000 by $1,500 = 200. ($300,000 ÷ $1,500). Conclusion: The gross rent multiplier on this property was 200.

Another property sold for $350,000 and the monthly rent was $1,750. Therefore, $350,000 ÷ $1,750 = 200. Once again, the same gross rent multiplier.
If this is done with enough property, a pattern begins to emerge. In neighborhoods where properties buy and sell based on the gross monthly multipliers, brokers are usually familiar with this number and can come up with it literally, “off the top of their heads”.

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Perhaps the gross rent multiplier in your area is 200 and the subjects market rent is $1,600. We would then multiply the $1,600 x 200 = $320,000. $320,000 would be the market value of this property.

**PLOTTAGE**
It is also referred to as “assemblage”. This is the theory that assembling two or more properties would result in a higher price than if they were sold individually.
Example: A shopping center is planned and the developer needs to accumulate parcels of land in order to build. The parcels within the boundaries of his development are more valuable to him than others that are nearby. He will pay more in order to assemble the necessary land than another buyer would pay not having to accumulate lots.

**CONCLUSION**
The appraiser writes his report with detail and the agent should do the same. Once again, the market analysis should be in writing with sufficient support material to show that you have done a professional job.
If a salesperson uses many of the same methods and practices the appraiser uses, there is no doubt that his market analysis will be a competent and professional one. It will give the seller a true picture of the current real estate market and allow him to recognize where his house fits under the present conditions.
CHAPTER 5 PRICING PROPERTIES

KEY TERMS

- Assessed value
- Comparative market analysis
- Cost
- Cost approach
- Depreciation
- Direct cost
- Evaluation
- Income approach
- Indirect cost
- Insured value
- Investment value
- Market price
- Market value
- Mortgage value
- Obsolescence/functional/external
- Plottage
- Price
- Sales comparison approach
- Valuation
- Value
- Value-in-use

Perhaps one of the most difficult aspects of our job is to get good quality listings. We all know that we can have the best, strongest, most motivated buyer, but if we don’t have good property to show, a sale will not take place. There is an old saying in real estate “If you don’t list, you won’t last”. This was true years ago, is true today, and will be true as long as there are buyers who want to buy houses.

The key to our success is knowing how to obtain and market good saleable homes at a fair price. If we control the inventory, that is the homes for sale in our effective service area, we will control the sales. On the other hand, if we don’t have those elusive exclusives, then we will always be dependent on other salespeople in our own office and other real estate offices kind enough to want to share their precious exclusives with us.

Granted we must learn how to make a good listing presentation so that we can assure the seller that we will do the very best job possible. However, we must also do a professional job of pricing the home.

All too often salespeople look at a house and then just take a guess as to how much it should be listed for. They give this number to the seller without any support documentation and the seller either accepts the number or rejects it. If the seller rejects it, he usually wants more than our recommendation.

We listen to him; try to change his mind and then accept the listing at his price, knowing that it will never sell at that price. Nevertheless, so what, we have a few months to convince the seller to lower the price so let’s just get started immediately and next week come back and try to convince him the price is too high.

WE TOOK THE LISTING AT AN UNREALISTIC PRICE. WE ARE THE PROFESSIONALS AND WE ARE RESPONSIBLE FOR THIS LISTING.

The main objectives of this section will be to get the salesperson to apply the principals of appraising to determine the value of homes.

AN OVERVIEW

In order assist the seller in pricing his home correctly we have to identify the information or data that will be used. We must also identify the sources of that information. The first step necessary to do a professional job goes without saying and that is, personally visiting the property.

No matter how well you think you know the area and the house, until you have been inside, you cannot do a proper Competitive Market Analysis. You will note that we are not using the more common phrases, Comparative Market Analysis or CMA. First, we don’t want to engage in a conversation about the comparative value of the subject home and the houses that will be used to illustrate our pricing conclusions. We want the seller to understand that he will be COMPETING with
these houses and he must envision a buyer in the market place looking at several different houses, his included, and what their reaction to price might be.

Regarding the term **CMA**, many homeowners are unaware of what these letters stand for. If we are going to use the term CMA, we must explain exactly what it means before taking for granted that the seller knows what we are talking about.

A Competitive Market Analysis analyzes three aspects of the real estate market:

1. Homes that have sold within the last 3 to 9 months in the subject market
2. Homes that are currently on the market with which the subject property will compete.
3. Homes that have been on the market but did not sell.

The market analysis is both a process and a tool. It is the process by which a salesperson determines the value of a home. As a tool, it can be a document that impresses the seller with your thoroughness and professionalism, and can help you convince the seller of a home's true value.

**THERE ARE A VARIETY OF REASONS TO CONDUCT A MARKET ANALYSIS**

**Gathering and displaying pertinent property information.** All homeowners like to see pictures and information about their home whether they just moved in or have lived there for 30 years. The time you spend researching the physical, financial, and legal aspects of your potential listing will pay dividends as you present a thorough analysis of the property and the current market to the homeowner.

**Research and explain market conditions;** Very few sellers despite their education or occupation know much about the real estate market. It is up to you to educate them on the correct way to price and finance their home in today's market.

**A partial description of our fiduciary responsibilities to our client** is the demonstration of skill, care and diligence. Certainly, these terms will be demonstrated to our client as we prepare and discuss our information.

The best way to prepare a seller for the realities of the market is not when an offer comes in but rather, from the very beginning. If the seller understands conditions, you can help him act quickly and decisively when an offer is presented.

Establish a range of prices. Experienced salespeople and appraisers know there is no such thing as one price for a home. Each might reasonably sell for a number of prices within a small range depending upon the financing available, the motivations of the buyer and seller and so forth. The purpose of a market analysis is to show the range of prices you think will produce a buyer

**Recommend financing alternatives in your market analysis;** it will be necessary to describe the nature and availability of current financing and recommend alternatives for your client. This is critical in selling most homes today.

For the new salesperson, getting an appointment to visit the seller can seem like an impossible task. Offering a market analysis is a great way to meet with sellers.

Homeowners may be contacted by many salespeople and don't want their time wasted. If you state that you want to conduct an in-depth market analysis on their home, you have a reason to meet with the sellers.

Show professionalism. Although sellers tend to gravitate towards people who reinforce their beliefs in their home’s high value, few sellers will list with the salesperson who simply states the price with no research or proof. This is not professional behavior. Sellers will think hard before declining to list a home with someone who has obviously done a lot of work and research on their property.

Create trust and confidence. As the analysis assignment progresses the owners of the home will start to develop a level of trust and confidence in a particular salesperson. The market analysis will serve as
a script for the listing presentation as well as serving to assist the seller when evaluating offers. It will be a guide to lead you and the sellers through the data and to your conclusions of value. Perhaps the most important point to learn is: **Why Is the House Being Sold?** We must understand the seller’s motivation to sell. We will all deal with sellers who tell us “if I get my price I will sell my house: Or, I know how much I want and no one is going to “steal it” Do we really want to spend our time marketing a home that will probably never sell because the price is unrealistic and the seller doesn’t care if he sells or not? Is it fair to the seller to cause him to believe that his inflated price will result in a sale? There is no guarantee that a well-priced house will sell or a motivated seller will remain one. However, unless we know the reason the house is being sold and the seller’s time frame, we are putting ourselves and the seller at a great disadvantage.

Our task at this point is: how can we price this property to make it competitive with similar properties, get the most exposure, and to sell in a time frame that will satisfy the seller? Unfortunately, it can be quite difficult to get the homeowner to accept the realities of the market. **EXAMPLE:** A suburban couple was approaching retirement and decided to move down south. They had already purchased property and were in the process of building their retirement home.

The husband was quite handy and over the years, they had improved and customized the home with top quality materials and workmanship. It was in tiptop condition and they were sure not only could they get top dollar, but it would sell right away. When they were sure home values were no longer appreciating, they listed the home. Unhappy with the first few agents who suggested prices lower than they thought it was worth (“the kitchen alone cost me $50,000 to renovate,”) they found an agent out of the area who agreed to their terms.

In the sellers minds this was certainly the best house on the market in their neighborhood. Still, day after day, week after week, month after month, no one came to see it. No agents came to preview, no buyers came to look. Even the listing agent brought very few prospects. Two, three, four, five months went by. The sellers complained to their friends, they complained to their neighbors, why didn’t anybody want to look at their beautiful home?

Eventually they sought out an appraiser and learned that there were more than 30 homes presently on the market. These homes were between $10,000 and $50,000 less than the subject property.

The question the appraiser posed to the seller was a simple one: why would anyone want to see your house when there were so many on the market at considerably lower prices? The seller took the advice of the appraiser and significantly lowered their price and still, few prospects came. By overpricing the house initially and allowing it to languish on the market for a long period, even when the price was reduced, it was a “stale” listing.

Buyers often ask two significant questions regarding houses:

1. How long has it been on the market?
2. Why are they selling?

If the buyer learns that the house has been on the market for a long time they begin to wonder if something is wrong with the property. If there is no good reason for the house being sold, the buyer might categorize the seller as one who is just out to “make a killing”. In either case, very negative scenarios are being played out.

One of the unfortunate circumstances that led to the problem in our example was that the salesperson was from “out of the area”. If we really want to control our destiny and be truly the professional we aspire to, we need to think in terms of not being a jack-of-all-trades, but rather a master of one. Agents need to learn everything about their own effective service area. That is, the geography in which they want to specialize.
If a homeowner wants to sell their home, they will likely choose someone with whom they may have become familiar through for sale signs on either lawns or local advertising or marketing programs initiated by the agent. This is referred to as “name brand recognition”.

**PREPARING THE MARKET ANALYSIS**

**Gathering the data**

In order to do a proper market analysis, we need to gather a great deal of data and information before we can conclude the seller in the form of a recommended price range. The information gathering process should resemble the process taken by an appraiser.

**INFORMATION NEEDED REGARDING THE HOME:**

- Property location
- Property size
- School district
- Style of the home, (Colonial, ranch, cape cod, etc.)
- Total number of rooms
- Number of Bedrooms
- Number of bathrooms
- Overall condition of the home
- Was house updated, upgraded or renovated?
- Basement, finished or not
- If finished, condition of the basement

Any external factors that might add to or subtract from the property; such as, overhead power lines, air traffic, high traffic street, schools or stores that might bring unwanted foot traffic, etc. could subtract from the value. Close to shopping or public transportation could add to the value for some buyers.

**ASSESSING THE CURRENT MARKET**

We look into the past, at the present and try to predict the future. We certainly do not pretend to have a crystal ball into which we can gaze and determine what the market will be like in a year or two. Wouldn’t it be wonderful if we could do that! What we actually do is look at the houses that sold within the last 3 to 9 months depending on the current market. We use the data typically available to us, such as the Multiple Listing Service or any professional information gathering organizations we might subscribe to.

We look at all property in the area, not just those similar to the subject in order to recognize a trend in sales prices. Are they going up or down in the general market place? Once this is determined, we separate the property that we will need. This would only include property similar to the subject.

Next we want to ascertain the typical time it takes to sell a property in the current market. We would look at houses that sold within the last 3 months and determine the time factor for those and then do the same exercise for property that sold 6 to 9 months ago. We could then see a pattern emerge.

This is an important factor in determining the price at which to market the home. If a seller is in need of a quick sale, and we knew that at best it was taking 60 to 90 days for a well priced home to sell, we might have to convince the seller that he must price his home considerably under what homes have sold for in the past.

If the market is strong and sales are taking place within, perhaps 30 days, then if his home were priced similarly to closed sales, he would probably be in a good position to satisfy his needs. Because of this research, we have a good idea of market conditions and trends. We can determine whether they have gone up or down or remained stable. Remember, we are simply looking for trends.

We are going to assemble documentation regarding similar properties that are presently on the market, houses that have sold and houses that were for sale but have been taken off the market. This
most certainly occurs when a house is overpriced and becomes “stale” As we discussed earlier, the comparables or “comps” as they are usually referred to come from a wide variety of sources. Multiple Listing Services, office files, and various other providers of this type of information are among the main sources used. When deciding which properties to use for our analysis some criteria must be determined: This would include similar

- Location
- Style and amenities
- Number of bedrooms and baths
- School district
- Condition
- Any other pertinent characteristics

We analyze approximately 4 to 6 houses presently on the market, sold within the last 3 to 6 months and no longer for sale. The agent would choose the most similar comps. We eliminate those that were highest and lowest if they seem out of place.

Before we can come to any conclusions, we need to have an understanding of the process of pricing. Residential evaluation and pricing are two different subjects. One is logical and done by a salesperson, and the other is emotional and done by the sellers. The seller determines value based on his own life and experiences. The salesperson on the other hand has to determine price in order to attract potential buyers.

Two assumptions can be usually be made: one, most sellers have an opinion of value of their home, and two, their opinion is generally higher than market. Our goal is to bring the sellers opinion of value closer to the market price. Although we diligently seek out houses that have a similarity to the subject property, sometimes, they are nowhere to be found. Inevitably, you will be faced with a situation where the comparables you do find don't make sense. Don't become discouraged. This happens every day to experienced professional appraisers as well. What we need to do is look at the typical problems and seek ways to solve them.

**PROBLEMS WITH THE MARKET**
Sometimes there is simply not enough information available. There are no laws that limit our search for comparables. It might be necessary to expand your geographical search and go farther back in time. Sometimes by calling other salespeople, you might locate homes that you did not see in your MLS book or in your files.

Also, ask yourself if you are really looking for a true comparable or are you trying to prove the owners opinion of value? A lower price range might contain the comps you are looking for. If we try to justify the seller’s price, we may not be able to provide the professional service to which the seller is entitled. Preparing a market analysis must be independent of the seller’s desire for a particular price. Lack of similar property can be a problem with higher priced homes since they are often unique. If this is the case, don't worry about location, style, and age as much as concentrate on square footage, amenities and the impressiveness of the home. Buyers of higher priced homes may not be as tied to a specific area because of job needs as other people.

Remember listing sheets don't tell the whole story and a picture might not show anything about surrounding properties. You need to drive by some of your comparables. Interior features and amenities, such as extreme quality, exceptionally good or bad decorating, odors, views, etc. are impossible to display in an MLS book. In addition, subtle differences in location and neighborhood preferences might not be ascertained by the inexperienced salesperson.

**MARKET DATA APPROACH AND THE ADJUSTMENT PROCESS**
Another problem is that the comparables are dissimilar. Sometimes it is difficult to sort the major differences between the subject property and other properties you assemble. The salesperson should employ a technique called the adjustment process.
Here is a simple example:
A home similar to your subject sells for $375,000. The only difference between the sale and your subject home is that the sold property had a fireplace; your subject home does not. Ideally, the only way the sold property could be comparable would be if it did not contain the fireplace. How do you remove a fireplace? You remove it on paper by subtracting its estimated value from the sales price of the comparable. Let’s say a fireplace is worth $10,000. You would subtract the $10,000 from the $375,000. Therefore, a house without a fireplace is worth $10,000 less. Your subject home is worth $365,000.

Let’s continue with this example. You find another comparable that does not have a fireplace, so it is similar to your subject home, but it has a two-car garage. Your subject home has only a one car garage. Although you might be inclined to think that a two-car garage is a plus, and it is, in our analysis we must subtract the value beyond a one-car garage to bring it down to what your subject home with just a one-car garage will sell for. Perhaps a final item is carpeting. The above comparable with no fireplace but a two-car garage also happens to have old worn-out carpeting. The carpeting in the subject property you are analyzing is new. Let us use $10,000 as the difference between a one car and a two-car garage and $7,000 as the value of all the new carpeting compared to the worn-out carpeting. Our analysis would go something like this:

<table>
<thead>
<tr>
<th>SUBJECT PROPERTY</th>
<th>COMPARABLE</th>
<th>ADJUSTMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>No fireplace</td>
<td>No fireplace</td>
<td>zero</td>
</tr>
<tr>
<td>One car garage</td>
<td>Two car garage</td>
<td>-$10,000</td>
</tr>
<tr>
<td>New carpeting</td>
<td>Carpeting worn out</td>
<td>+$ 7,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>-$ 3,000</td>
</tr>
</tbody>
</table>

Conclusion: The subject house is worth $3,000 less than this particular comp.

WHY SELLERS OVERPRICE THEIR HOMES
They believe that the improvements they made will be worth the amount they spent to put them in. In reality, buyers are not willing to pay for all the improvements the seller made. Sellers don’t always realize that what they put in as an “improvement” such as an in ground swimming pool might be a hazard to the buyer and therefore, to them, it subtracts from the value of the home. A finished basement might not be attractive to all. To determine the value of improvements, the question to ask is if the home were purchased today without these improvements, what a buyer would pay to have them put in exactly as they are now.

Need: they add up all the money they will spend when they sell this house, buy a new one, and use that as the basis for the price they want.

Greed: if the motive for money is greater than the motive to sell, then you do not have a salable listing.

Ego: the money itself is not as important as being able to say, “I got the most”. It is also a defense against the fear of “being taken” by selling too cheap

Bargaining room: unfortunately sellers believe that they need to leave “bargaining room”. If a home is properly priced homes you do not need a lot of bargaining room

Paid too much: with the rise and fall of the real estate market it is possible that in relation to today's market, sellers paid too much for the house.

Unmotivated: they want to “test the market” to see if they can get their price.

THE PRESENTATION
We do not set the price. Our job is to educate the seller and make some suggestions and recommendations. Ultimately, the seller decides the listing price. We review the benefits and importance of good pricing:

Faster sale: well priced homes sell much more quickly than overpriced ones that tend to age or become stale.

Less inconvenience: overpriced listings are used as a comparison for more realistically priced homes. Unfortunately for the seller, this results in any number of unqualified buyers walking through their home, sometimes for months on end. Exposure to more prospects; when salespeople are looking for
homes to show, they enter computer parameters right at the upper limit of the buyer’s price range. By pricing the home properly, it will be seen by more buyers who can afford it.

Price Effects Exposure
The higher the price in the specific market fewer possible buyers will be interested in looking at it. Lower the price, and more buyers will be interested in it. The seller needs to learn that by overpricing their home they are limiting the number of buyers who might be interested in looking at it.

**A well priced home creates salesperson enthusiasm:** we feel excited when a well priced listing becomes available and try to get our buyers out as soon as possible.

**We know we will get better ad and sign response:** if the price is attractive, buyers will make an appointment to see it.

**It will attract higher offers:** when a house is well priced, a buyer takes a great risk of losing the house by making a low offer.

**CHOICE OF SALESPERSON**
A common problem we face in trying to obtain an exclusive listing at a realistic price is that often, the sellers will make their decision based upon “who can get them the most money”? In reality, they should consider the services and marketing plan of the agents, not simply who promises to get them the highest price. If we prepare a good presentation including a fully documented market analysis we are well on our way to overcoming this objection.

It is important to explain the actual selling price of a house is determined by the market. The price is not determined by salespeople, not by owners and not by friends, unless they going to buy. There is no exact price for real estate, but rather a range most likely to produce a prospective purchaser.

The seller needs to recognize that the choice of agent best suited to market their home should be based on a solid marketing plan and not simply by a promised, but possibly unobtainable listing price. To reinforce the fact that the market actually sets the price, an interesting conversation might be one regarding how they determined how much they were willing to pay for the house when they bought it. More than likely, they looked at several houses, comparison-shopped, and then determined how much they would be willing to pay for the house that they were going to buy. This is the same process that a buyer will use in determining whether they want to own the subject property.

A good presentation of the facts of marketing his home accompanied by a well-prepared market analysis would certainly be in keeping with our responsibilities to our client. Check your office policy to see what minimum time guidelines there are. Many offices will only accept exclusive listings based on specific criteria.

Unfortunately, the number one reason sellers are unhappy is that the agent doesn’t keep in contact with them. Sometimes we are embarrassed by lack of activity and don’t stay in contact. Keep good showing records. Update the market analysis monthly and call sellers weekly to keep them happy. Make these promises part of your listing presentation. We have to have a strong presentation, putting everything in writing and giving us a reasonable period in which to bring buyers.

On the one hand, sellers are uncomfortable committing for a long time. On the other, we need to be able to run the open houses, put up the sign, place ads, enter it in our online inventory, etc. Again, explain, explain, and explain some more.

**THE OFFER**
By addressing the possibility of offers during our initial presentation, we are getting the seller to realize that his price may or may not be in keeping with what buyers are willing to pay. Unfortunately, some sellers believe that if they put their homes in the high end of the pricing range, they will attract buyers willing to make an offer. In fact, they lose the real buyers for their home. Most buyers are reluctant to look out of their price range hoping to find a seller who will accept a low offer. In addition, buyers, who
are actually in the higher price range, are expecting much more than what this overpriced home represents.

So, by overpricing the house, the seller is in a **LOSE/LOSE SITUATION**. This is exactly what we want to avoid.
CHAPTER 6 LEASES

KEY TERMS
Assignment
Constructive eviction
Covenant
Eviction/actual and constructive
Graduated lease
Gross lease
Ground lease
Holdover tenant
Implied lease
Index lease
Landlease
Lease/net lease/triple net lease
Leasehold estate
Lessee/lessor
Option to renew
Percentage lease
Periodic lease
Proprietary lease
Quiet enjoyment
Security deposit
Sublease

Remember, a lease is a contract. Therefore, the Law of Contracts prevails. Two parties, the landlord and the tenant come to an agreement of the terms upon which the premises will be occupied. This includes the fees charged, known as rent, and any other terms or condition required. This contract can be verbal if it is for a period of less than a year. However, it must be in writing if it is for a longer period in order to be enforceable. In the event the contract is will be recorded, it will have to be notarized. Typically, residential leases are not recorded but long term commercial leases might very well be.

Typically, a residential lease is straightforward in that it lists all of the responsibilities of both parties including the rent and when it is to be paid. There would also be clauses for nonpayment or non-compliance with the terms. Commercial leases are much more complex since there will be clauses regarding issues that are not relevant in residential leases. Tenants should always carefully read the lease so that there are no surprises when the rent bill comes in the mail.

TYPES OF LEASES
Net Lease: The tenant pays the rent as well as all the expenses of occupancy such as utilities, taxes, water, insurance and any other agreed upon payments. This is most common in commercial rentals but can also apply when renting a single family home, or condominium. Depending on what the tenant is responsible to pay, you might hear this referred to as a triple net lease.

Gross Lease: The tenant pays the rent as stated and the landlord pays all other occupancy expense. There may be an exception for the payment of electricity. A residential apartment lease is typically a gross lease.

Percentage Lease: The tenant pays a stated amount for the rent and occupancy expenses. In addition, they pay a percentage of their gross income. This is most common in a shopping center lease. The landlord may allow a new tenant a fair market rent or slightly below to get their retail business up and running. The percentage of sales the tenant pays would then allow the landlord to participate in the growth of his tenants.

Ground Lease: The building is built on land that is not owned, but rather leased for perhaps 50 or 75 or 99 years. Tax laws would be the main reason this type of transaction was popular. As tax laws changed, ground leases became more or less attractive to the landlord or tenant. In many cases, there is a guarantee of purchase at the end of the lease.

Land Lease: These can also be referred to as a ground lease. However, when the use of the land is specified, it can only be termed a “land lease”. Examples might include a farmer leasing land to farm or an oil company leasing land on which to drill for oil, or a precious gem dealer mining for those gems.

LEASEHOLD ESTATES AND INTERESTS
Estate for years: There is a stated beginning and end. This type of lease is most common in residential real estate and must be in writing. The lease provides occupancy/possession, but not ownership.
Ownership, of course, is retained by the landlord. The landlord retains a **reversionary right**. The property automatically reverts to the landlord upon the termination of the lease. This type of estate automatically ends on the last date of the lease.

**Periodic estate**: Generally referred to as a “**month to month**” tenancy: The landlord and tenant agree to a beginning date, the date the tenant will gain possession, but no ending date. Unless there is notice of one to the other, the estate automatically renews each month. If either party wants to terminate the agreement, written notice must be served based on the statutes in place in the community. Generally, 30 to 60 days notice is required.

**Estate at will**: A very casual arrangement. It is usually among family members whereby someone occupies the premises with very loose terms. There is no ending date and no specification for notice to terminate.

**Tenancy at sufferance**: The tenant had been in possession legally, but that has ended. Instead of moving from the premises, he remains. At this point, he is referred to as a “**holdover**”. If the landlord does not give him permission to remain, he is trespassing and is a **tenant at sufferance**. If the landlord does give him permission to remain in possession of the premises, a periodic estate is created and the tenant is no longer a “holdover” The landlord would have the right to begin eviction proceedings against the “holdover” as long as he does not accept payment of rent. Once payment of rent is accepted, a periodic estate has begun.

**Constructive eviction**: The tenant no longer has “quiet enjoyment of the entire leased premises”. Perhaps there was a leak from an upstairs apartment and the ceiling collapsed in the apartment in question. Until the ceiling is repaired, the tenant does not have the use of the entire premises on which he is paying rent. In order to claim constructive eviction the tenant must vacate the premises.

**Actual eviction**: The landlord has obtained the right to remove the tenant through court proceedings. The judge would determine the terms of the eviction and a sheriff or marshal will carry out the physical process of removing the tenant. The landlord is not permitted to evict the tenant himself.

**Right of first refusal**: The tenant or another prospect reserves the right to learn the terms of the sale or rental in an offer made by a third party. The terms are presented and the party in control of the right of first refusal can match the terms of the third party offer and could not be denied the property. If he chooses not to match the terms, he forfeits the right. In that case, the owner would be legally free to deal with the third party.

**Option to buy**: An agreement between two parties, often the landlord and tenant, whereby, the tenant has the right to purchase the property at agreed upon terms. In an option to buy, the tenant can exercise his right to buy even if the landlord decides not to sell. The landlord is bound by the terms of the option but the tenant does not have to exercise his right if he doesn’t want to.

**Proprietary Lease**: Used in cooperative apartments to allow the shareholder the use of the apartment annexed to the shares they have purchased. In a cooperative apartment purchase, the buyer is actually buying shares in a corporation that usually owns the land and the building. In order to be able to occupy the apartment she purchases, she will be given a proprietary lease that will remain in force as long as she owns the shares. Upon the sale of her shares, she relinquishes her right to the proprietary lease.

**ESSENTIALS OF A VALID LEASE**: What should a lease contain and who can sign it?

**Competent parties** (sane adults, having the mental and legal capacity to enter into binding agreements).

**Names of all parties to the lease**. These would include the landlord, tenant and if applicable, the landlord’s managing agent. The tenant has the right to know the **address of the landlord or his**
management company. In the event the address changes the tenant must be informed within 30 days of the new address becoming applicable.

A definite demising clause, whereby the lessor (landlord) leases and lessee (tenant) takes the property leased.

A description of the location of the unit including any specific apartment number as well as any appliances included in the unit. A residential lease will usually contain the street address and if applicable, the apartment number. A commercial lease will most often contain the legal description such as section, lot and block number in order to allow the contract (lease) to be recorded.

A clear statement of the term of the letting. The lease will contain the starting and ending dates. There is no minimum or maximum amount of time allowed. The length of the lease is negotiated between the parties. It is common to have renewal options in commercial leases.

The amount of rent and the date it is due, including any grace period, late charges or return check fee charges.

How rent is to be delivered to the landlord and whether by check, money order or cash.

Methods to terminate the agreement prior to the expiration date and what, if any, charges will be imposed.

The amount of the security deposit and the account where it is held.

Utilities furnished by the landlord and, if the landlord charges for such utilities, how the charge will be determined.

Amenities and facilities on the premises, which the tenant is entitled to use such as swimming pool, laundry or security systems.

Rules and regulations such as pet rules, noise rules and whether or not breaking such rules can be grounds for eviction.

Identification of parking available, including designated parking spaces, if provided.

Pest control, if provided, and how often.

How tenant repair requests are handled and procedures for emergency requests.

Use provisions. Typically, the residential lease will state that the use is only for the tenants named in the lease. Some leases do not use the word only and that would give the tenant the right to have roommates occupy the premises without violating the terms of the lease.

Commercial leases frequently state the exact purpose for which the tenant intends to use the premises. This is sometimes followed by “for no other purpose” stipulation. Having this in the lease strictly limits the business activities permitted in the demised premises. Other leases might be more general and state for “any lawful purpose”. Again, the terms are negotiated between landlord and tenant.

Any renewal options and the specific terms of the renewal. More common in commercial than residential leases.

The tenant should read the lease completely and understand all of the terms. Remember, a lease is a contract and the terms are binding on all parties.

Examples of what might be overlooked in a typical residential lease could include:

✓ The date on which the rent is payable
✓ Any surcharge for late payment
✓ The landlord’s right to enter the apartment
✓ Any notice necessary to the tenant and the purposes allowable under this clause should be spelled out in full so that all parties have a full understanding of when the landlord can enter
✓ The right to remove or not remove any improvements to the premises

Example: The tenant installs new carpeting and at the end of the lease expects to have the right to remove it and use it in their new home. In fact, many leases do not permit this to occur. Improvements to the property often revert to the landlord as a “betterment”: Anything added to the property that increases its’ value. If the carpeting is in reasonably good condition, the landlord could insist on it remaining for the next tenant. Conversely, if it is not attractive or dirty and would be a
negative to a new tenant, the landlord could demand its’ removal. For these reasons, it is very important to know how improvements made by a tenant will be handled at the conclusion of the lease and this should be clearly stated in the lease agreement.

**Repairs:** In most residential leases, the tenant is responsible for all repairs unless the lease states something to the contrary. This sometimes comes as a major surprise to tenants who believe that the landlord is always responsible for residential repairs.

**Assignment and subleasing:** Assignment of a lease generally requires the permission of the landlord and an approval of the new tenant. When the lease is assigned, the original tenant no longer has any obligations under the terms of the original lease. The assignee is responsible. Subletting is quite different. Again, this is done with the permission of the landlord. When an apartment is subleased, the original tenant is still obligated under the terms of the lease if the sub-tenant goes into default. **Example:** The sub-tenant is paying the rent directly to the landlord and the original tenant is not keeping up with what is occurring. He suddenly gets a bill from the landlord for 3 months unpaid rent. The sub-tenant has stopped paying and the landlord is looking to the original tenant for the rent. The original tenant would be obligated to make the payments. It is often a better idea to have the sub-tenant pay the original tenant who in turn will pay the landlord. In that way, the original tenant is aware of any possible default.

**WARRANTY OF HABITABILITY**
Every tenant has the right to expect the premises to provide the necessities of life such as heat, water and electricity. It also means that the unit will be free from improper or illegal wiring, crumbling plaster and lead paint. The tenant also has the right to expect the apartment to be free of pest infestation.

**WRITTEN LEASE VS. VERBAL LEASE**

**Written Lease**
- All terms are specified
- Little or no room for misinterpretation
- Binding agreement for a specified period

**Verbal Lease**
- Terms can be changed at will by landlord
- Can terminate with short notice

**SECURITY DEPOSITS**
The purpose of the security deposit is to protect the landlord from damage caused by the tenant. There are regulations regarding security deposits. Security deposits are kept in an escrow account which may or may not bear interest. The security is returned to the tenant generally no longer than 30 days after the tenant vacates the premises. The landlord has the right to use the security deposit to clean the apartment or do any repairs caused by the actions of the tenant. The provisions for the use of the security deposit should be contained in the lease. If the landlord uses a portion or all the security deposit, the tenant is entitled to a comprehensive list of what the money was used for. Security deposits are never intended to be used as payment for the rent at the end of the lease.

**EVICITION**
Landlords must generally go to court in order to get legal permission to have a tenant evicted. In most eviction proceedings, the tenant will have the right and opportunity to correct the problem and remain in the property. Remember, the landlord does not have the right to physically evict the tenant. A sheriff, a marshal or other court appointed party are the only people who can do the actual eviction.

**PRIVACY**
Whether the lease is in writing or verbal, the tenant has the right to expect privacy in their own home. There are laws regarding the landlord’s right to make repairs or to make inspections if the tenant is
away for a specified period of time. A written lease should have specific wording to cover the landlords rights and the tenants protection against loss of privacy. In every case, however, the landlord cannot demand entrance into an apartment without a valid reason or a provision in the lease.

**APARTMENT SHARING**

It is not uncommon for the landlord to require the names of all occupants whether or not they are responsible on the lease. Many leases limit occupancy only to those named in the lease. In all cases, the landlord is allowed to restrict the number of occupants based on health and zoning codes.

**ABANDONMENT AND WITHHOLDING RENT**

If the tenant simply abandons the property, that is, moves out without notice to the landlord, the tenant would still be responsible for the rent or other agreed upon expenses until the landlord finds a new tenant. The landlord must use his best efforts to find a replacement tenant.

Rent strikes can sometimes occur when the landlord does not provide the necessities of life: heat, hot water, electricity, or the building becomes infested with vermin. In such cases, the rent should be deposited into an escrow account until the dispute is settled. A court may find that the landlord is required to pay compensatory or punitive damages for withholding services required. Again, keep in mind that a lease is a contract and the terms are binding on all parties.

**THE LEASE SURVIVES THE SALE**

In the event of the death of either the landlord or the tenant, the lease remains in force and effect. A landlord would have the right to hold the heirs of the tenant to the terms of the lease if he chose to do so. This is probably a rare occurrence; however, it is certainly possible. If the landlord dies, his heirs must continue with the terms of all existing leases. The same is true if the building is sold. When a landlord sells his building the new owner is bound by the terms of the existing leases.

**RENT CONTROL/RENT STABILIZED LAWS**

Rent control laws went into effect in New York State in 1943 due to the lack of decent affordable housing. They gave way to Rent Stabilization Laws in 1969. These laws were intended to protect people living in privately owned buildings from unconscionable rent increases and to allow landlords the opportunity to earn a fair profit on their investments.

Rent Control applies to buildings constructed before 1947 and Rent Stabilization to buildings constructed between 1947 and 1974. Rent Stabilization laws also apply to apartments that are removed from Rent Control.

Outside of NYC the Emergency Tenant Protection Act (ETPA) follows Rent Stabilization laws in Nassau, Westchester and Rockland counties. The Rent Guidelines Board sets maximum Rent Stabilized increases each year for new leases starting Oct. 1. Leases are for a period of either one or two years. Rents can also be increased based on the following:

1. With the written consent of the tenant in occupancy, if the owner increases services or equipment, or makes improvements to an apartment;
2. With DHCR approval, if the owner installs a building-wide major capital improvement;
3. Or in cases of hardship with DHCR approval.

**Division of Housing and Community Renewal (DHCR)** handles complaints which must be submitted on specific forms.

Rents may be reduced if the owner fails to provide required services, or fails to make necessary repairs for an individual apartment or on a building-wide basis.

Rent control tenants cannot be evicted as long as they comply with the terms of their agreement. Rent control operates under the Maximum Base Rent (MBR) system. A maximum base rent is established for each apartment and adjusted every two years to reflect changes in operating costs. Owners, who
certify that they are providing essential services and have removed violations, are entitled to raise rents up to 7.5 percent each year until they reach the MBR. Tenants may challenge the proposed increase on the grounds that the building has violations or that the owner's expenses do not warrant an increase.

For New York City rent controlled apartments, rents can also be increased because of increases in fuel costs (pass alongs) and in some cases, to cover higher labor costs. Outside New York City, the New York State Division of Housing and Community Renewal (DHCR) determines maximum allowable rates of rent increases under rent control. Owners may apply for these increases periodically. Rent Stabilized units can become destabilized in either of the following ways: The rent is over $2,000.00 per month and the tenant has an annual income of $175,000.00 or more for two consecutive years. If the apartment becomes vacant and the rent is over $2,000.00 per month it will no longer be considered stabilized.

**THE COMMERCIAL LEASE: WHAT YOU SHOULD KNOW**
Commercial leases are as different from residential leases as day is to night. The commercial tenant is as different from the residential tenant as winter is to summer. Residential tenants deal with emotion: will I like living here? Commercial tenants deal with logic: will I be able to run my business and make money here? They are covered in depth in the Commercial chapter.

**THE TERMS OF THE LEASE**
Once the decision is made to lease a specific location, the next step is negotiating the terms of the lease. More than likely the landlord will present a lease prepared by his attorney. Keep the following two rules in mind:

**Rule 1**: The landlord *always* has the lease written in his favor.

**Rule 2**: Every lease has negotiable points.

**Who is the Tenant?** Just because you are showing Mr. Smith property does not mean that Mr. Smith will be the tenant. In fact, in most cases he will not. Who then is the tenant? Smith Printers, Inc. This is a huge difference. The landlord might not want to rent to Smith Printers because they have just started in business. He might not accept the corporation without a personal guarantee from Mr. Smith. Even in situations where the landlord insists on the guarantee, there may be an agreement that it remains in effect for a specified time and not for the entire term of the lease.

**The Term of the Lease**: Of particular importance is the term of the lease......how long will the tenant be obligated to the space and is there an option to renew the space if things are going well? One obvious possibility would be a short term, perhaps two or three years with one or more five year options.

**Calculating the Rent**: There are several ways that rent is calculated:

**NET LEASE**
The tenant pays the rent as well as all the expenses of occupancy such as utilities, taxes, water, insurance and any other agreed upon payments. Commercial leases are usually written with the tenant being obligated to paying some or all of the expenses of the premises.

**GROSS LEASE**
The tenant pays the rent and the landlord pays all other occupancy expenses. There may be an exception for the payment of electricity. The tenant is most secure in a gross lease since, obviously, he knows exactly how much he will have to pay each month for the life of the lease. That is exactly why commercial leases are seldom written this way. Remember rule #1......the lease always favors the landlord.
PERCENTAGE LEASE
The tenant pays a stated amount for the rent and occupancy expenses. In addition, they pay a percentage of their gross income. This is most common in a shopping center lease.

What happens if I want to move or my business fails? Not pleasant to think about, but certainly a consideration when signing any long term contract. The easiest way to sleep well at night would be to have a sublease or assignment clause in the lease. Remember the differences are:

Assignment of a lease generally requires the permission of the landlord and an approval of the new tenant. When the lease is assigned, the original tenant no longer has any leasehold obligations. The assignee is responsible.

Subletting is quite different. Again, this is done with the permission of the landlord. When a location is subleased, the original tenant is still obligated under the terms of the lease if the sub tenant goes into default.

THE TRUE COST OF THE RENT
In commercial real estate, the rent is usually stated as dollars per square foot. If the space is 1000 square feet and the rent is $24.00 per square foot then the annual rent would be $24,000 and the monthly rent $2,000. $24,000 annual rent divided by twelve months equals $2,000 per month. Sounds simple, however, there are many different ways to calculate the square footage.

- **Rentable**
- **Useable**
- **Carpetable**

Rentable refers to the total amount of square footage that the tenant will actually use plus a percentage of the building that is considered “common space”. Common space includes hallways, elevators, lobbies, parking areas and staircases and any other portion of the building that is used or could be used by all tenants. This can add considerably to the cost of the space and must be closely scrutinized.

Useable refers to the total space the tenant has access to when he enters his premises. This includes hallways, closets, bathrooms, etc.

Carpetable refers to the space that will be used for his business purposes. Not really important in calculating the rent, but certainly a consideration to the tenant.

Different landlords measure space differently. Is the measurement taken from inside wall to inside wall or, more commonly, from the outside or exterior wall to outside or exterior wall? This can substantially increase the rent. Let’s say for example the landlord determines he is renting us 1000 square feet as we earlier determined at $24.00 per square foot. We now want to know the real cost of the space. We measure the useable space and find it is only 900 square feet, the balance being our portion of common area. Now a different set of calculations occur. The $24,000 has to be divided by 900 to determine the real cost of the space. It is actually a bit more than $26.00 per useable square foot. We are only able to use 900 square feet, but are paying for 1000 square feet. This is important because it is a truer way of comparing the real cost of space. By understanding and using this method, the tenant might realize that a space costing $25.00 per square foot can be less expensive than one at $24.00 because of the amount of common space included in the calculation.

Electricity and Air Conditioning: In the high tech world of today, electricity and air conditioning are important considerations.

Insurance requirements: How much and what type of insurance does the landlord require?
AVOID ZONING TROUBLE
If a restaurant is the purpose for leasing the space, will it be permitted? When in doubt be sure the lease contains a “contingency” clause. This will protect in the event the zoning does not allow a restaurant. It would be catastrophic to sign the lease and then learn that zoning does not permit the tenant to operate her chosen business. Continuing with the restaurant; perhaps a restaurant is permitted, and this area is a good market for outdoor dining. Does the zoning permit this or just an indoor restaurant? Check it out. Other considerations would be signage. If you wanted an interior lit sign is it legal?

Although many zoning violations aren’t brought to the attention of the governmental agency that oversees it, a disgruntled neighbor or competitor might be the biggest problem. Don’t take the chance. Check out the law and abide by it. Never use the previous tenants experience as a guarantee that the same will apply to a new occupant.

PARKING, SIGNS, LANDLORD’S ENTRY, AND SECURITY
Likely the tenant will find several clauses in the lease that concern practical understanding’s she has with her landlord. These could be about such things as parking and business signs. Knowing she wants the space may make her want to accept as much of the lease as she can without asking for changes. But this can be a huge mistake. Remember every line in that lease will define what can and cannot be done and what the tenant will and will not pay for. Read it carefully and negotiate it well.

There are a great many variables in residential and commercial leases and there may be a need for an attorney to review its contents before the tenant signs it. This would certainly hold true in a commercial lease.

This chapter should serve as a basis for the agent planning to enter the business as a rental specialist, commercial salesperson or for your own personal needs as your career progresses.
CHAPTER 7 CONTRACTS

KEY TERMS
"As is" Offer and acceptance
Assignment Option
Caveat Power of attorney
Caveat emptor Reformation
Consideration Rescission
Contingency Rider
Counteroffer Right of first refusal
Earnest money deposit Specific performance
Express/implied contracts Statute of frauds
Executed contract/executory contract Statute of limitations
Forbearance "time is of the essence"
Liquidated damages Uniform commercial code
Novation Void/voidable

The definition of a “contract” is a simple one. It is the agreement between two competent parties to either do something or not do something for consideration. “Something” is spelled out specifically in the written agreement called a contract. We are going to go through all stages of real estate contracts.

HOW IT ALL BEGINS
An owner of real property decides to sell it. Prospective purchasers are shown the property and either between themselves or with the assistance of the broker, a price is offered by the Purchasers, agreed to by the Sellers and then a contract must be entered into by both parties in order to start the transactional ball rolling. This really sounds great, how easy it will be to make a great deal of money!

In most cases, however, it is not quite this simple. More often, there is an offer, the seller will then make a counter-offer. The buyer might accept that or make another counter-offer themselves. On and on and on, until the parties agree to the terms and conditions.

How fortunate we are. We have an agreement to terms and conditions either in the form of a binder prepared by the broker and ready for the attorney to put into contract form or, a purchase offer contract which will allow the respective attorney’s to review the contents. If the contract has to be prepared we just need to wait and see that everyone signs on the dotted line. It still sounds nice and easy! Or is it?

In fact, at this point in the transaction your work is really just beginning. If you are in area where contracts are prepared by the broker, (upstate) then you are involved “hands on”. If it is more common in your marketplace for the attorney to draw up the contract (downstate) then you have to be sure that she/he has received all the pertinent information so that the contract contains the terms the parties agreed to.

In most states, there is a legal requirement that an attorney represent each party at the closing. Once the price of the property and significant terms are agreed upon, each party will contact or retain legal representation for the transaction.

It is customary for the contract of sale to be drawn up by the Seller’s attorney and forwarded to the Purchaser’s attorney for review. As stated earlier, in some areas it may be customary for the real estate broker to draw up a purchase offer agreement, which is usually subject to an attorney’s review within a few days. Each municipality has its’ own laws and customs and practices.

Once the Purchaser’s attorney receives the contract, he will meet with his clients, and review all of the significant terms. If they are in agreement with the contents of the contract, they will sign it and
provide their attorney with a check representing the down payment to be forwarded to the Seller’s attorney with several copies of the contract. This down payment is known as **consideration**. Consideration is defined as something of value. *Without consideration, there is no valid contract even if the documents are signed.*

If there is a disagreement as to the contents of the contract, or if significant changes need to be made, either additions or deletions, then the contract is returned to the Seller’s attorney with the initialed changes for further review and discussion. Once a final draft is sent to the Purchaser’s attorney, and there are no more amendments to be made, the final signed documents are returned to the Seller’s attorney where his clients will sign and as of that date, there is either a fully **executed** or an **executory** contract. An executed contract refers to one in which all of the terms have been fulfilled. This is rarely the case in a real estate contract. More typically, they are “executory” in that there are contingencies, which have to be met in order for the closing to take place.

Several original copies are retained at the Seller’s attorney’s office and several original copies are forwarded to the Purchaser’s attorney for distribution to his clients. The Purchasers will require a signed, original, contract in order to proceed with obtaining a loan to purchase the property, if one is required.

Among the items agreed upon in the contract is the form of ownership the seller will convey to the purchaser. This form of ownership will determine how property will be transferred upon the death of the owner or if ownership will transfer in the future. Property can be owned **in two ways:**

**In severalty** – single ownership with a confusing name. The term is properly defined as “being severed from all others. Therefore, one individual owns it.**

**Co-ownership** – two or more owners with varying forms of rights:

**Tenants by the entirety:** Owners are married to each other and there is a right of survivorship. Upon the death of one, the other will automatically inherit the deceased share. This will occur even if there is a will, which leaves the property to someone other than the spouse. In order to terminate this estate, both parties must agree.

**Joint Tenancy:** Two or more owners who are usually unmarried to each other. Each party has the right to possession of the whole. At death, interest of decedent passes to surviving tenants automatically (right of survivorship)

Joint Tenancy must be created on purpose:

- There can only be One deed
- Equal interests for each of the parties
- Survivorship must be specified

There must be **“four unities”**

1. **Time** - The ownership for all was given at the same time
2. **Title** - All owners share one title
3. **Interest** – Each owner has an equal interest
4. **Possession** – They each have an equal right to possess and enjoy the property

They are each equally responsible for expenses and equally entitled to rents and profits. Joint tenancy will be terminated by the sale of one or more co-tenants. If one of the joint tenants sells his undivided share, the new owner will become a “**tenant in common**”.

**Tenancy in Common**

- Tenancy in common may occur accidentally through:
  - Inheritance by more than one heir
  - Purchase in which shares may or may not be equal
Through failure to specify joint tenancy with right of survivorship

Tenancy in common does not allow for the right of survivorship. Sale by one co-tenant does not terminate the tenancy. The new buyer gains a specified interest.

Since, obviously, there are great differences among the forms of ownership, the buyer must consult with her attorney in order to be certain that the proper form of ownership will be stated in the deed.

**ESSENTIALS OF A VALID CONTACT**

**Once again, the definition of a contract is:** An agreement between competent parties to do or not to do certain things. There must be some form of consideration and it is legally enforceable.

A contract for leasing for a longer period than one year, or for the sale of any real property or an interest in the property is void, unless the contract, or some note or memorandum of the lease or sale is in writing, signed by the parties, or by their lawful agent. Consideration must be expressed.

**The Statute of Frauds,** which is in effect throughout the United States, was enacted in order to prevent the misunderstandings that could occur if contracts for the sale of real estate were oral. Therefore, real property contracts and leases for a term of more than one year must be in writing.

**Competent parties** (sane adults): in New York State the age of majority that is, the age at which a person can enter into a legally binding contract is 18. If a party to the contract is not of legal age or is considered mentally incompetent, then any contract they enter into would be **voidable.** A voidable contract may or may not be **enforceable.** If the party who has created this situation chooses to end the contract, they would legally be entitled to end it and would suffer no consequences. If they choose to continue under the terms of the contract they may.

This is quite different from a contract that is considered “**void**”. In order to be declared void, the contract no longer has any “force or effect”. The term often used is “null and void”. A contract would be considered void if the purpose of it were to carry out some illegal action such as discrimination. Also, if it is impossible to carry out the terms of the contract, perhaps because the house burned to the ground. Obviously, there is no possibility of completing the terms as they have been agreed upon.

**An expression of their agreement to sell and buy:** The parties must agree to the terms of the contract and have acted voluntarily.

**Lawful objective:** The purpose of the contract must be legal. If two parties enter into a contract to commit a crime, obviously it would not have a lawful objective. If a listing agent agreed to discriminate in locating a tenant for a landlord, that listing agreement would not have a lawful objective. Nor would a contract, which prevents fair and open competition, have a lawful objective.

**Expressed Contract:** The terms are agreed upon and the parties are fully informed of those terms.

Examples:

- Contract for the sale of real estate
- Listing agreements
- Leases
- Mortgages

**Implied Contract:** The terms are not in writing and action creates an agreement

Examples:

- Buying gasoline
- An owner allowing a salesperson to show his house without having any of the terms and conditions of the listing agreed upon
- Ordering a meal in restaurant
We have obligated ourselves by our actions rather than a discussion of the terms and conditions of our agreement.

**Offer and Acceptance:** An offer has been made and accepted. In real estate we refer to this as the “meeting of the minds”

A survey is usually required in order to clearly define the property being purchased. It is written documentation of the description of the property and buildings. The property will usually have three descriptions:

1. **House number and street name**
2. **Metes and bounds:** measurement system using distance from one identifiable landmark or monument to another in combination with surveyed marks and measurements. A point of beginning is necessary so that the directions from point to point are easily identifiable.
3. **Section, block and lot:** Located on a plat map the property is easily identifiable.

**Consideration:** Anything of value exchanged as part of a contract, usually the amount of cash and terms of financing.

**Place and date of closing:** There are two common ways in which these are described:

- **On or about** – a date, usually with approximately a 30 day window either before or after which, title is expected to pass.

- **Time is of the essence:** If the date specified as being “time of the essence” passes, the contract is considered to have been breached. Example: “Time is of the essence on January 10, 2010” is in the contract. If the closing does not take place by January 10, 2010, the terms will be breached.

**Unenforceable:** Some contracts may seem legal but cannot be carried out

- ✓ The contract speaks for itself.
- ✓ When preparing contracts attorneys or licensees must take extreme care to be certain that all terms are included in the contract. In the event the buyer and seller agree to something verbally which is not included in the written contract, It is quite probable that, in the event of a dispute, the verbal agreement will not be upheld. This is an example of parole evidence.

**Contracts are classified as:**

A. **Unilateral:** one party makes a promise to do something or not to do something without receiving a reciprocal promise from the other person.

B. **Bilateral:** two parties promising or doing something or promising not to do something. A real estate contract is a bilateral contract. The buyer promises to pay for the property and the seller promises to deliver title.

**ADDITIONAL CONTRACT TERMS AND CONDITIONS**

**Indemnification:** An agreement by one person to compensate another in the event there is a specified loss. This is also referred to as a “hold harmless agreement”. Example: an agreement that only the broker named in the contract is entitled to commission.

**Personal Property:** A list of any personal property that is included in the sale of the house.

**Consideration and terms of payment:** This would include the deposit that was given at the acceptance of the offer, the additional amount payable upon signing the contract and the balance and how it will be paid at the closing. The terms of any financing would be included.

**Loan contingency clause:** If the buyer must obtain financing in order to close on the house, the contract would provide for the return of any funds given to seller in the event such financing is not forthcoming.

**Deposits:** Who will hold the deposit and where it will be kept, as well as the dispersal of any interest that might accrue.

**Condition of property:** In areas where a property condition disclosure is required, the contract would make note of that fact. The seller is required to advise the buyer of any defects in the property. In
many areas property is considered to be delivered in an “as is” condition. The buyer is responsible for investigating the condition of the property since New York is a “Caveat emptor”, let the buyer beware, state. Again, however, this does not prevent the seller from incurring liability for misrepresentation.

**Appraisal:** Buyers who obtain a loan will be required to obtain an appraisal. If it comes in below the contract price there could be a problem getting financing.

**Home Inspection:** Buyers have the right to hire a home inspector and conduct a complete inspection of the premises. If the buyers report requires repairs, the seller should receive a copy and the request for repairs.

**Lead-based Paint:** Federal laws give all buyers 10 days to inspect for lead based paint. Many homes built before 1978 contain lead-based paint.

**Wood Destroying Pest Inspection:** The contract should specify who will pay for the pest inspection and whether outbuildings or garages are covered in the inspection.

**Roof Inspection:** Many home inspectors will not walk on a roof due to possibility of damage and / or liability. Some buyers hire a roofing company to conduct this inspection.

**Sewer Inspection:** Sewers can be clogged from tree roots or deteriorate over time. Plumbing companies can insert a camera into the sewer line to check for damage.

**Radon, Mold or Asbestos Inspections:** Depending on a visual inspection, some situations will call for additional inspections by licensed entities to check for special situations involving possible carcinogens.

**Early Occupancy Agreements:** Contracts can be contingent upon the buyer and seller entering into a written agreement that allows the buyer to rent the property prior to closing. This is known as “early buyer possession” or “purchaser in possession”.

**Possession clause:** The time at which control of the property passes from seller to buyer or landlord to tenant.

**Private Well Inspections:** If the home is not connected to city water but instead has a private well, buyers may want assurance that the water is potable (drinkable) and meets acceptable health standards.

**Preliminary Title Report:** Title investigations will disclose easements, CC&Rs, and monetary liens of record, including the ability of the seller to transfer clear title the buyer.

**Homeowner Association Documents:** Buyers should obtain, a copy of all homeowner association documents, including meeting minutes, if applicable.

**Contingency for the sale of buyers home:** Sometimes the buyer cannot or will not sign the contract if his own house is still not sold. In these situations, a contingency for that sale and the time allowed would be stipulated.

**Broker clause:** The contract will state the name of the broker/brokers and the amount of commission due. It will usually also state when the commission is payable and by whom.

**“Subject to” provision:** The buyer buys the house subject to an existing mortgage lien. This is not common in the current real estate market.

**Apportionments:** The pro ration of expenses between the buyer and the seller including but not limited to:
- 1. Property taxes
- 2. Prepaid insurance
- 3. Association or maintenance fees and dues
- 4. Oil in the tank
- 5. Any other items that the seller may have prepaid that will benefit the buyer

**THE FORM THE DEED WILL TAKE**

**Type of deed to be delivered:** The contract will stipulate the type of deed the purchaser will accept at closing. Deeds are covered in-depth in another chapter.

**Warranty deed with full covenants** gives the greatest protection to the purchaser. The following are the covenants in this type of deed:

**Bargain and Sale without covenant against grantor:** This is the simplest form of deed. It is most often used when the purpose is to convey all right, title and interest of the owner of record in the real property described in the document and the grantor is not under contract to deliver specified covenants.
**Bargain and sale deed with covenant against the grantor:** This form of deed contains the following covenants by the grantor. “And the party of the first part covenants that he has not done anything, to encumber the property whatever, except what might be stated in the deed” This form of deed is acceptable to most lenders whereas the **Bargain and sale deed without covenants** is usually not acceptable.

**Quitclaim deed:** The usual purpose is to remove a cloud from the title to real property. A cloud on title refers to a possibility that someone may have a claim against the property. Some possibilities include paid tax liens or mortgage liens, claims by a spouse after a divorce or mechanics liens. It contains no warranties and is just a **deed of release**.

**Judicial deed:** Used to convey title after a court action. This could include guardian’s deeds or sheriff or referee’s deeds, tax, administrator, executor or administrator deeds. These carry no warranties.

**TERMINATION OF THE CONTRACT**

This is usually referred to as “Discharge of Contract”. Just as a contract can be created, it can, of course, be terminated. However, there are very specific methods in order to cancel an enforceable contract.

- **Agreement of the parties** - If all of the parties agree to terminate the contract upon whatever terms are favorable and agreeable to each then it becomes a very simple matter.

- **Novation** – The terms are changed or substituted with agreement of both parties. The agreement remains valid. This could include an agreement to change the buyer from A to B.

- **Full performance** - All parties have performed all the terms of the contract. This is an example of an executed contract.

An **executory contract** is one in which all terms have not yet been completed.

- **Impossibility of performance** - One party is unable to perform according to the terms of the contract. The party is still liable. When entering into a contract that might contain an agreement to accomplish something that possibly cannot be done, it is wise to include a provision for relief in such an event. **Example:** A provision for mortgage financing. In the event the buyer does not get his financing the contract would have to provide for his ability to have his deposit returned and for the contract to terminate.

- **Breach/ default** - Occurs when a party to the contract does not perform according to its terms.

- **Specific Performance** - A suit to have the terms of the contract performed exactly as agreed to. This remedy is used when money damages are not sufficient to cure the problem. **Example:** A contract for the sale of real property calls for a possession date of April 1. This date has long since passed. The buyer could go to court in an action for specific performance in order to gain possession of the house.

**DAMAGES**

- **Compensatory** - The amount of money actually lost as a result of a breach or default of the contract

- **Liquidated** - An agreed upon amount in the contract. Typically, it is the amount of the down payment kept by the seller in the event of a default by the buyer.

**STATUTE OF LIMITATIONS**

Limits the time allowed to start a lawsuit. In real estate, a defect can be discovered after the **Statute of limitations** has expired. For this reason, some statutes contain the clause “five years from the date of the sale or three years after the discovery of the defect, whichever is earlier.” Once the Statute of Limitations has expired, legal action is no longer possible.
COOPERATIVE AND CONDOMINIUM CONTRACTS

In many areas, both co-ops and condo’s are readily available. While they may seem similar to the public, they are actually quite different and it is important to understand the differences. These are covered in depth in another chapter. However, let us have a brief review in order to understand what these buyers need to know that a residential homebuyer does not.

COOPERATIVES

The contract for a cooperative apartment will show the name of the seller as well as the corporation that owns the property. It will also contain the number of shares being transferred, the unit number and the address of the property to which the shares are attached. Agents need to explain this that they are not “buying” the apartment they are buying shares in the corporation with the right to occupy a particular unit. Learn the terms of the proprietary lease and explain them as well. A copy of the house rules should also be available as soon as possible to be certain that any restrictions imposed by the cooperative will be understood prior to signing a contract. The contract should contain a clause that will call for the return of the down payment if the buyer does not get board approval. This too, needs to be explained in order to prepare the buyer for the inevitable screening committee meeting.

CONDOMINIUMS

The condominium contract is very similar to one signed in a home purchase. The condo is usually purchased “fee simple” and ownership is passed with a deed. Condo’s have house rules which contain the day to day rules. The buyer is expected to uphold these rules and, therefore, should know what they are before signing a contract.

Another point in both cooperative and condominium ownership are “pet rules”. Can you have one? If you can, is there a size limitation? Where can the pet be walked? Again, a need for an explanation in order to avoid unpleasantness down the road exists.

The contract will include a definition of the estate that is being transferred.

ESTATES AND ENCUMBRANCES

The legally recognizable right a person has in real estate is referred to as his “estate”. Now we know why we are going into the “real estate business”. There are different types of estates available in landlord/tenant agreements as well as buyer/seller agreements. The agent needs to understand the differences in order to explain the rights that will be transferred. Estates and Interests are covered in depth in another chapter.

A. LEASEHOLD ESTATE - TENANT
B. Periodic estates are defined by their term i.e. weekly, monthly, annually, etc. They automatically renew unless specifically terminated by either party.
C. Estate for years has a definite beginning and ending. This is your typical lease. It begins on Jan. 1, 2010 and ends of Dec. 31, 2012.

Some other important issues that might need to be addressed in the lease include:
Lease with option to buy: In this situation the tenant is granted the option to buy the house/apartment at terms that are stated in the lease. In the event the tenant chooses not to buy, he has no liability. However, if the tenant wants to buy and the landlord has changed his mind, the landlord is still bound by the terms of the lease and must sell.
Right of first refusal: This is quite different in that the tenant is only granted the right to know when the house/apartment is put up for sale and will have the first opportunity to purchase. There is no guarantee or promise that the property will ever be sold.

FREEHOLD ESTATE - OWNERSHIP

Fee Simple is the most comprehensive ownership interest possible in real estate. It is freely transferable, inheritable and potentially indefinite in its duration.
Qualified Fee: automatically reverts if the use is contrary to deed specifications. It will contain the phrase for so long as. Example: An office building is given to a charitable organization with the condition that it can be used by the charity for as long as the building is used solely for XYZ charitable purposes. After a time, the charity needs a larger facility for its own use and decides to use the subject property for income. Since it is no longer used for ‘XYZ charitable purposes, the building will revert back to the grantor or her heirs or others named in the deed.

Fee on Condition: As is the case with a Qualified Fee, the Fee on Condition is defeatable. It must contain the clause “but if”. Example: The owner grants the rights to the property to his daughter. He does not drink any liquor and the deed contains the clause that she can use it as she chooses, but if she permits the selling or consumption of alcoholic beverages, the property will revert back to the grantor, his heirs or others named in the deed.

Reversionary interest: The terms of the “Fee” are not met. The property will “revert back to the grantor”.

Remainder interest: Again, the terms of the “fee” are not met. The grantor has died or the deed specifies that the property will go to someone other than the grantor. In that case, the party who receives the “remainder interest” is referred to as the “remainderman”.

Life estate: Granted for the life of a specified person only. It can be for the life of the party occupying the premises, the life tenant, or for the life of another (pur autre vie) whose life serves as the limitation of the estate. Upon the death of the grantee, the estate will revert back to the grantor or pass to the remainderman.

ENCUMBRANCES
The contract would have clauses that specify how encumbrances will be handled. An encumbrance is any claim attaching to a property that could diminish its value or hinder its transfer. These include liens, easements and encroachments.

LIENS
A monetary claim that a person has against the property of another. These are broken down to two categories:
Voluntary – mortgage
Involuntary - taxes, judgments, mechanics liens, etc.

EASEMENTS
Generally defined as “one person’s right to use another’s land”

ENCROACHMENT
A portion of someone’s property built on land owned by another is an encroachment. A most typical example would be a fence built based on an incorrect survey. It could also be a tree on one property now leaning over on to the next property. Trees, unfortunately, have caused many disagreements between neighbors especially in the autumn when the leaves begin to fall off the tree and the neighbor has to dispose of the ones on his property.

RECORDING
In order for the document to be recordable, it must be a conveyance of real property within that state, duly acknowledged, or otherwise proved as authorized. Deeds, mortgages, leases for more than three years, trust agreements, releases, extensions, assignments and discharges of mortgages, are conveyances of real property eligible for recording and some examples of recordable documents.

An executory contract can also be recorded. These are contracts where all the terms are yet to be performed, usually referred to as contingencies. Perhaps there is no mortgage commitment, no title
report, no home inspection, etc. After the contingencies are satisfied, the contract is referred to as “executed”.

Recording serves two purposes. It preserves the records of the instrument in a public office for convenient reference and it gives general notice of the rights created or conveyed under it. This notice is referred to as “constructive notice”.

**OTHER REAL ESTATE CONTRACTS**

**EMPLOYMENT CONTRACT**
Brokers often insist that their agents sign an employment contract, which is protection for both the broker and the agent. These agreements spell out the general working conditions of the office. As examples, they could include:
- Hours the office is open
- Agents expenses
- Board membership
- Business card information
- Advertising policy
- Commission schedule and time of payment
- Floor time policy
- Insurance requirements
- Termination policy
- Payment of taxes
- Agents authority to negotiate terms with buyers and sellers
- Examples of contracts and memorandums used

The employment contract includes the so-called ground rules so that the agent knows what he should and should not expect. Employment contracts could include a no-compete clause. The agent might be prohibited from working for a competitor for a specified period within a specified geography. Also covered would be the handling of unsold exclusive listings, as well as property under contract. Often brokers assign them to another agent who will be paid by the former agent. The employment contract is in addition to the independent contractor agreement that must be signed by every agent who is not an employee.

**LISTING AND SALES CONTRACTS**
Brokers who are members of a Board of Realtors or Multiple Listing Service usually take advantage of their available contract forms. These include not only the sale and listing agreements but also terminations, changes to the contract, and notifications to affiliated brokers of any pertinent information. Leases are also available. Using Board prepared forms is a good idea because people who are familiar with the law have created them.

In communities where purchase offer agreements are used before the contract, brokers are pretty much on their own to decide the form they might want to use. An attorney should always be consulted when creating forms that buyers/sellers/landlords and tenants are going to sign.

**INSTALLMENT SALES CONTRACTS**
Also known as land sales contracts, they provide a formal agreement between the parties which includes the fact that title will not be passed until some future date at agreed upon terms. These terms will provide for the buyer (vendee) to pay the seller (vendor) an amount of money, usually monthly, in return for occupying the premises. Upon payment of the full purchase price, the buyer will get title to the property.

The advantage to the buyer is quite plain, he may not presently qualify for financing, he won’t have to come up with a down payment and he doesn’t have to pay a huge sum of money toward lender closing
costs. The advantages to the seller include the ability to depreciate the property since he is still the owner and not have to pay capital gains taxes since he hasn’t sold the property.

These types of sales contracts are also common when developers are selling land for future development. The buyer will enter into a land contract and get title when he has paid a percentage of the purchase price as his down payment and obtains financing for the balance.

Remember, if it isn’t included in writing in the contract, it cannot be enforced.
CHAPTER 8 CONTRACT PREPARATION

KEY TERMS

Attorney review clause
Down payment
Lawyer’s fund for client protection
Mortgage contingency clause

A contract is generally defined as an agreement between competent parties to do or not to do certain things. It is legally enforceable, and each party acquires a right. In the event of a breach, there are lawful remedies.

Let us briefly review the essentials of a valid contract: A contract for leasing for more than one year, or for the sale of any real property must be in writing in accordance with the Statute of Frauds under the General Obligations Law. It is signed by the parties or by their lawful agent. It does not have to be in a formal legal document. It can be as simple as a memorandum of agreed upon terms.

**COMPETENT PARTIES** – (sane adults)
**Mutual Agreement** – both parties want to enter into a contract.
**Offer and Acceptance** - an expression of their agreement to sell and buy. The terms of the agreement were met without any undue stress on either party. There were no mutual errors, or misrepresentation or fraud.
**Lawful objective** - The purpose of the contract must be a lawful one and could be enforced in a court of law.
**Consideration** - It is necessary to give something of value in order for a contract to be deemed valid.

COMPONENTS OF THE CONTRACT

**Upstate New York Contract:** It is common for the sales agent to prepare the contract of sale. The sales agent will fill in the specific information such as name, purchase price, down payment amount. There will be an attorney review clause within a specified period of time, usually three days.

**Downstate of New York Contract:** The five boroughs, Nassau, Suffolk, Westchester, Rockland and Orange counties are considered “downstate”. The seller’s attorney, not the listing agent, prepares downstate contracts. As such, there is no need for an attorney review period.

DATA REQUIRED FOR CONTRACT PREPARATION

A copy of the prior title insurance policy – this aids the preparer in determining whether the previous obligations - such as an old mortgage of the previous seller are satisfied and the property has title insurance.

A copy of the prior deed is needed to confirm ownership and ensure that the seller’s name is correct on the new deed.

Survey – a survey is the picture depiction of the property lines setting forth accurate property lines.

Certificate of Occupancy – usually issued by the Building Dept. or similarly named municipal agency that determines what is legally permitted on a property.

Personal Data – name, address, telephone number and social security number of parties is some of the information required.

Tax Bill – real estate property tax bill

Verifying Property Description: The legal address must be verified and it is usually accomplished by checking the section, block and lot number as well as the corresponding street address.

Metes and Bound Description - describes the property based on how it relates to the streets around the property.

Street Address is the description that is most common to the non real estate professional. The street address is how people describe where they live. However, the weakness with a street address is that there are multiple “Main Streets” in any given town or city.

Who Prepares the Contract of Sale? Seller’s Attorney/ Seller’s Broker, depending on the area of the state, it could be either.
Purchase Offer Contract: This is the preliminary agreement usually filled out by the agent for the buyer and becomes the foundation for the more formal contract drawn up by the attorney. It is often referred to as a “binder”.

The Down Payment is the buyer’s commitment to buy. It accompanies the contract the buyer has signed which is turned over to the seller’s attorney. The amount is negotiable. Who holds the down payment?

Listing Agent: In areas where the broker prepares the contract and in the event no attorneys are used, the listing agent will place the money into the broker’s escrow account until the end of the transaction. Once the closing is completed and the property is conveyed to the purchaser – the broker will give the money held to the seller or the party legally entitled to it, and, if agreed, will pay himself the commission due.

Seller’s Attorney: Generally the seller’s attorney holds the down payment. The money is kept in their IOLA account. IOLA means “Interest on Lawyers Account”. If any interest accrues it is placed into a statewide fund for injured clients called the Lawyers Fund for Client Protection. This money is used to make the public “whole” if they have a loss due to the actions of an attorney. The party holding the down payment is referred to as the escrow agent.

FINANCING/MORTGAGE CONTINGENCY
Because property is usually purchased with borrowed money, most contracts will contain a mortgage contingency clause. This gives the purchaser a prescribed amount of time normally thirty to forty five days to get a commitment. If the purchaser is unable to get a commitment, they can cancel the transaction and the contract deposit will be returned to him. The purchaser’s attorney can request additional time to get a loan commitment via an extension if necessary.

TYPES OF FINANCING
The contract will stipulate the type of financing the buyer is applying for.

Traditional or Conventional Financing: This typically meant that the purchaser would have at least twenty percent (20%) of the purchase price as the deposit to purchase the property and finance the remaining eighty percent (80%). There are other types of conventional financing available from time to time.

FHA Loans: Federal mortgage loans insured by the Federal Housing Administration (FHA). The loans may be issued by federally qualified lenders.

VA Loans: Loans guaranteed by the U.S. Department of Veterans Affairs. The loan may be issued only by qualified lenders.

Purchase Money Mortgage: Simply put, financing that the purchaser receives from the seller.

Assumable Mortgage: Assumable mortgages are loans that were made to the sellers and the purchaser now finds it to his advantage to take over the existing mortgage. The purchaser will have the same lender, interest rate, amortization and payment date each month as the seller had. Today, assumable mortgages are not commonly available because banks would prefer to qualify their buyers and, use current financing criteria.

CONTRACT PROCEDURES
Review of contract: The buyer’s attorney reviews the contract and if there are any edits and or revisions the attorneys will “workout” an agreeable contract. The buyer’s attorney will then arrange for the buyer to sign the contract

Who signs first? The purchaser signs the contract first because the agreement is still an offer to purchase. The offer is not accepted until the seller signs the contract and receives the down payment. The seller is not obligated to the transaction until he signs the contract. If the seller decides not to go through with the sale, he may be in a position to terminate the contract. However, there will probably be an obligation to pay the broker.

Riders to the contract: The riders contain relevant information and/or give specific details regarding provisions in the boiler plate section of the contract – such as a post occupancy clause, seller concession clause, or a repair credit clause. In addition, a rider will set forth any special conditions of the sale such as the requirement of the lender’s approval in a short sale transaction or the limited warranty that is traditionally provided in a new construction real estate transaction.
**Additional Relevant Clauses:** Along with a rider to a contract, other relevant clauses are required in a real estate transaction.

**Lead Based Paint Clause:** In New York, all contracts will include a clause to address lead based paint. This provision states that if the property was built prior to 1978, it may contain lead based paint that has been known to cause disabilities in children younger than two years of age. The purchaser is provided with an EPA booklet that explains in detail the effects of lead based paint and the methods to test it. The booklet is provided by the United States Environmental Protection Agency (EPA). The buyer’s attorney will likely provide her client with a copy of the booklet.

**CUSTOMS & PRACTICES REGARDING SIGNING CONTRACTS**

Although there are many practices involving the way the attorneys receive the contracts and the way the attorneys arrange for the parties to sign the contracts – there are some dominant practices used in the industry.

**Delivery of Contracts:** Once the contract is prepared the attorney will either fax, mail or email it to the purchaser’s attorney. Upon receipt, the purchaser’s attorney will make three additional copies including the riders. At this point the attorney reviews the contract and if there are any edits and or revisions they will “workout” an agreeable contract.

**Sit Down Contract Signing:** Some attorneys request an appointment with the client to discuss the terms and to formally meet the new client. At this time, the attorney will provide legal advice to his client regarding the obligations to the other party – such as closing date, mortgage contingency etc.

**Delivery of Down Payment:** A down payment check accompanies the signed contract. Unless otherwise requested, the down payment can be a personal check made payable to the sellers attorney who then deposits it into his escrow account.

**Attorney Review Clauses:** Because brokers prepare the contracts in many upstate areas, attorneys are given three to five days to review the contract of sale and possibly change terms if necessary.

Remember, no matter how much you learned in this chapter, the licensee is not permitted to give legal advice or in any way downplay the need for an attorney to represent each of the parties to the transaction.
CHAPTER 9 ESTATES AND INTERESTS

KEY TERMS
Act of waste Illiquidity Reversionary interest
Air rights Joint tenancy Right of survivorship
Beneficiary Joint venture Riparian rights
Bundle of rights Life estate Severalty
Chattel Littoral rights Special purpose real estate
Curtesy/dower Parcel Tenancy in common
Escheat Partition Trustee/trustor
Estate for years Personal property Undivided interest
Fee simple estate Real estate/real property Unities of interest,
FIXTURE/TRADE FIXTURE Remainder possession, time and title
Homestead interests/remainderman

LAND VS. REAL ESTATE VS. REAL PROPERTY
Some new agents believe that their job is only about selling land or real estate. Now, you might think that using both “land” and “real estate” might seem like overkill. However, there are differences between the two. Land is the physical property and any natural objects on it—like trees and bodies of water. A piece of land is often called a “parcel”. Real estate, on the other hand, is land with permanent manmade improvements.

An agent facilitates the sale of not only the land and its improvements, but also the rights, powers, and privileges that are legally connected to that land. To keep things brief, we will refer to these rights, powers, and privileges simply as “rights” in this section.

Think of a piece of real property not simply as a lot and some buildings, but more as a bundle of rights that a buyer is purchasing. To further illustrate this, let’s think of these rights as a bundle of sticks—with each stick representing a right associated with the property. A property owner can take a stick from that rights bundle and sell it without necessarily affecting the other rights. For example, as we will see later in the Liens and Easements chapter, a property owner can allow another party access to his or her land without jeopardizing his or her ownership claim on the land.

The sticks in this bundle of rights can be separated into two basic categories:

Tangible rights are based on the physical aspects of a property, such as claims to:
- Land
- Buildings or other improvements
- Fixtures (which we will talk more about a little later)
- Anything produced by the land (e.g. crops)

Intangible rights, on the other hand, are claims associated with areas above and below the land surface, and access issues on the property, such as:
- Air rights
- Water rights
- Subsurface rights (mineral rights)
- Easements
- Licenses
- Profits
- Leases
- Mortgages

Collectively, the land, its improvements, and its accompanying tangible and intangible rights are known as “real property”
LAND RIGHTS INCLUDE
A. Air rights
B. Subsurface rights
C. Water rights

AIR RIGHTS
The Federal Aviation Administration (FAA) controls the airspace above the United States. The FAA requires a minimum altitude of 500 feet above any people and structures—with the exception of takeoff and landing. However, a landowner has the authority to use the airspace directly above his or her property, if it reasonably contributes to his or her enjoyment of it. For example, let’s say that a property owner decides to erect a wind farm. Even though this would interfere with aircraft flying over the property, the owner can legally do it. An urban property owner can also sell (or “transfer”) his or her air rights (or “development rights”) to another property owner. The price for these will vary by area just as the price of real estate varies.

SUBSURFACE RIGHTS
Subsurface rights represent the owners claim to any natural resources found beneath the ground. These rights are more generally known as mineral rights. Depending on the situation, subsurface rights can be almost as valuable in rural areas as air rights are in urban areas.

The main difference between air and subsurface rights is that the owner can sell the rights to individual resources. For example, let’s say a landowner finds herself sitting on a rural parcel that is rich in oil, natural gas, and coal. Theoretically, she could transfer the rights to the oil and natural gas to one company, and the rights to the coal to another entity. Or, she could sell or lease each of the mineral rights to a different company—one for oil, one for natural gas, and one for coal.

If a company has bought the subsurface or air rights to a property, that company’s ownership of those rights will not be challenged by a sale of the property.

WATER RIGHTS
In New York, you will typically encounter two types of water rights:
A. Riparian rights
B. Littoral rights

Both riparian and littoral rights pertain to properties that have a body of water as a property boundary. The term “riparian rights” refers to land that borders a river or stream. There are two considerations; is the water navigable or non-navigable. A river or stream is considered navigable if it can be used for transportation or shipping goods.

Under riparian rights, a property owner with land that borders on a navigable body of water can claim the land to the high water mark. This mark would be (roughly) where the water hits when the medium tide rolls in. However, beyond that mark, the land and water is considered public property. The landowner can enjoy the river and use the water, as long as that enjoyment or usage is not detrimental to other owners with riparian rights to the same body of water.

If the river or stream is considered non-navigable—meaning that it isn’t used for transportation or commerce—then the rules of ownership change a little. In such a situation, the property owner’s boundary extends out to the middle of the body of water. The property owner is also allowed to claim any new land that is created by sand, silt and other natural material washing up on shore. This right is called accession, while the process by which all of the material washes ashore and creates a new land mass (alluvion) is called accretion.

However, the river can also diminish an owner’s land through erosion—when water washes away land over a long period of time.
**Littoral rights** are so closely associated with riparian rights that you will often hear people use the two terms interchangeably. This happens because littoral and riparian rights for navigable bodies of water are nearly identical. Littoral rights refer to larger bodies of water, such as lakes, bays, and oceans.

Just like a property owner with riparian rights to a navigable river or stream, an owner with littoral rights can only claim the land down to the high water mark. They can use the shore and the water as they please. However, the government owns all of the land beyond the high water mark. Unlike air or subsurface rights, water rights cannot be leased, sold, or kept when the property changes hands.

**PERSONAL PROPERTY**
If something can be moved relatively easily, then it is designated “personal property. Items such as jewelry, vehicles, and furniture come to mind. However, mobile homes or the year’s harvest are also personal property. Crops still growing are attached to the land and therefore are part of the real property, once they are harvested, they become personal property.

Tangible personal property is sometimes called “*chattel*”. This term is a modernized version of the Middle English word “*chatel*”. You will hear the term “chattel mortgage” used when a loan is secured on items such as a car, truck, or boat.

**FIXTURES**
Personal property that becomes permanently linked (or “fixed”) to a parcel of land, a house, or building is then called (appropriately enough) a “*fixture*”.

Personal property becomes a fixture through:  
**Permanent Attachment**: The permanent attachment rule applies to anything that is affixed to the property in an enduring way. One big test for interior fixtures is this: if you would have to significantly damage the house to uninstall the item, then it is a fixture. Outside of the house or building, things like storage sheds (with or without a foundation), and landscaping would be considered fixtures.

Trees, shrubs, and other landscaping are attached to the land by roots and are part of a property’s charm (and market value). If a seller digs up the landscaping or tears out a cement walkway before the buyer moves in, the property’s attractiveness and value will be diminished. Because their removal can completely change the character of the property, landscaping elements (both natural and manmade) are considered fixtures.

**Custom Adaptation**: If an item can be removed fairly easily, it could be designated a fixture because it is precisely designed for the space. Custom window treatments are an example.  
**Installer’s Intention**: If a homeowner builds or installs an item in a property in a way that suggests that it is meant to be permanent or custom, then the item will usually be considered a fixture.

**Party Interest**: In general, if a homeowner installs something, the intent is to enhance the property and increase its value. However, when a tenant installs something, it may or may not be considered personal property.

The only time a tenant’s rights regarding personal property are not in question is with *trade fixtures*. These fixtures are business-specific items that a tenant will install in a rented space, such as product shelving, display cases, or even agricultural supplies on a farm property. Since such items are necessary for the tenant to conduct business, they will be considered the tenant’s personal property. This means that the tenant can legally and reasonably remove them from the property when he or she moves out unless the lease specifically prohibits removal.

**Written Agreement**: The best way to distinguish between fixtures and personal property is through a written agreement. Writing everything down ensures that all parties involved are on the same page.
THE FIVE MOST COMMON CATEGORIES OF REAL PROPERTY ARE:
Residential property—including single-family homes, co-ops and condominiums, apartment buildings.
Commercial property—including retail spaces, business offices, hotels, restaurants, gas stations, and other service businesses.
Industrial property—including manufacturing facilities of all types, distribution centers, and warehouse spaces. In New York City, this type of property might also be called “manufacturing property”.
Agricultural property—including crop fields, grazing lands, orchards and other similar lands.
Vacant land—land that does not contain buildings or other improvements. This could also be called “unimproved land”.

There is another category referred to as special purpose properties which include:
Parks and recreational areas: these lands are preserved for recreational, ecological, and educational purposes by either the local government or by the Department of Environmental Conservation (DEC) and the Office of Parks, Recreation, and Historic Preservation (OPRHP). In some cases, all three agencies will supervise a park and recreation area.
Institutional properties: including universities, public schools, hospitals, prisons, libraries, and other buildings for public entities.

CHARACTERISTICS OF REAL PROPERTY
Real property characteristics fall into two basic categories:
1. Economic characteristics
2. Physical characteristics

ECONOMIC CHARACTERISTICS
When assessing a property’s market value, the best indicators are its four economic characteristics:

Scarcity: If the properties are scarce in a given area, then prices in that specific area could trend a little higher. If the properties are not so scarce, then prices in that area might trend a bit lower.

Of course, this is the basic rule of supply and demand. When supply goes up, demand goes down (and so do prices). On the flip side, when the supply is scarce, the demand goes up (along with the prices). Always remember that “the real estate market is local in nature”. One area might go up or down more than another.

Improvements: A unique characteristic of real property is that you can enhance a parcel of land’s value by constructing a home or other building on it. Additionally, nearby real estate will also be affected.

Permanence of investment: Land is a safe and desirable long-term investment because it is a permanent commodity. It is an indestructible, immobile commodity that buyers will always be in the market for.

Location: How many times have you heard someone say, “The three most important things about property are location, location, location”? Location affects the value of a piece of real property more than any of its other characteristics.

PHYSICAL CHARACTERISTICS
Besides the economic characteristics, real property has physical characteristics that make it different from other forms of property, including:

Immobility: You cannot move a parcel of land from one area to another. Land stays in one place and the fact that it does, contributes to a property’s market value.

Indestructibility: Buildings can burn down, be blown away, or demolished, but the land beneath those buildings is indestructible. Because land cannot be destroyed, you will always have something of valu
**Uniqueness:** Pieces of real property are like snowflakes—no two are exactly alike. Even in subdivisions, you will find subtle differences among the various plots. Each property has its own unique qualities that make it stand out from other real properties. Even properties with roughly the same market value could have very different qualities.

**FREEHOLD ESTATES AND LEASEHOLD ESTATES**

**ESTATES IN REAL PROPERTY**
When a person holds an estate interest in a property, he or she has the right to possess that property. However, being an estate holder does not necessarily translate to ownership. There are two types of estates in real property, freehold and leasehold.

**FREEHOLD ESTATES**
A freehold estate offers the holder ownership rights to a property for an unspecified length of time. There are two basic forms of freehold estate:
1. **Fee simple estates**
2. **Life estates**
The main difference between the two forms of freehold estate is: the holder of a fee simple estate can pass on his or her property to an heir, while the holder of a life estate cannot.

**FEE SIMPLE ESTATES**
Sometimes called fee or fee simple absolute, it is the most comprehensive type of property ownership. It includes the bundle of rights we have previously discussed.

With fee simple estates, though, our particular interest lies in how these rights allow the owner to use, license, and convey the property, including rights to:

- Quiet, legal enjoyment of the property
- Gift the property to another party
- Sell the property (right of disposition)
- Pass on the property in a will (right to devise)
- Forbid others from entering or occupying the property (right of exclusion)
- Control the use of the property within lawful limits

Of the rights listed above, there are two that will be of particular interest to us—the rights of disposition and devise. They show the property owner’s ability to pass on, or convey, a property (or certain rights to it) in any way he or she sees fit. In order to devise (or pass on) the property to an intended heir, the owner must make a will. When a property owner dies *intestate*, it means that he or she did not leave a will behind. In such a situation, the state will have guidelines about the chain of inheritance among immediate family members.

The surviving spouse would be the first in line to inherit the deceased person’s assets, then his or her children or grandchildren. If none of those people are still living or ever existed, then the deceased’s assets would go to his or her parents or siblings. However, if the property owner dies intestate and there are no heirs, then the state could *escheat* the property.

*Escheatment* is an action that the government takes to ensure that the property is never left ownerless. In some states, the property automatically reverts to the government. In others, like New York, escheatment is more of a custodial law that translates into a long legal process. Additionally, during the escheatment process, a potential heir could turn up and file a petition to claim the property. The state of New York actually allows up to forty years for this to happen.

Even though a property owner who holds a fee simple estate has a lot of control over how his or her property is conveyed, that control could be lost if that owner does not take the proper precautions.
Nevertheless, if someone owns a property in fee simple, he or she can:

- Use the property to secure a debt
- Grant an easement to another party for use of or access to the property
- Grant a license to another party for a particular activity on the property
- Convey a life estate (in reversion or in remainder) to another party
- Convey a leasehold estate to another party

These rights illustrate the owner’s true control over a property in a fee simple estate. The fact that the owner can make decisions about how to convey or pass on the property (or grant easements and licenses for it), shows how complete fee simple ownership really is. However, there are other forms of estates in the “fee” family that are not so comprehensive. Let’s take a look at those right now.

**FEE DEFEASIBLE**

A deed conveying a property might have some conditions or restrictions built into it. Many times, these conditions dictate how the property will be used. If the person (or organization) receiving the property does not abide by these conditions, then that party’s ownership of the property will be in jeopardy of being destroyed.

This type of ownership is called “fee defeasible” for that very reason—because it can be destroyed. As long as the property is used according to the conditions or restrictions listed in the deed, the receiving party owns it in fee simple—including all of the rights that go along with that ownership. As long as the new owner abides by the conditions or restrictions outlined in the deed, he or she will have fee simple ownership of the property. That person can sell or lease the property, secure a debt using the property, or pass the property on to an heir.

Fee defeasible estates are quite rare. There are two types:

1. Fee simple on condition
2. Qualified fee simple

**FEE SIMPLE ON CONDITION**

A person’s ownership under a fee simple on condition estate hinges on a restriction listed in the deed. The language in the deed that outlines this restriction usually contains the words “but if”.

For example, let’s say a landowner named Larry Whitaker (the grantor) deeds his apple orchard to his son Chet. In the deed, Larry conveys the property to Chet with one restriction: he cannot plow down the orchard and build over it. The language in the deed will probably read like this:

“I grant this property to Chet Whitaker, but if he builds a structure on the part of the land containing the orchard, Chet Whitaker’s ownership terminates.”

Such a clause in a deed creates a fee simple on condition estate. Additionally, as long as Chet abides by the condition that Larry has outlined, he (and any future owners) will enjoy fee simple ownership on the property. However, if Chet (or any future owner) destroys the orchard and builds over it, Larry (or his heirs) will be able to repossess the property by filing a lawsuit.

**QUALIFIED FEE SIMPLE**

While a qualified fee simple estate is much the same concept as a fee simple on condition estate, there are some differences in deed language and repossession rights.

Let’s use Larry and Chet from our example above. If Larry conveys the title to his orchard property to Chet via a deed for a qualified fee simple estate, the clause outlining its conditions will read like this:

“Grantor transfers the property to Chet Whitaker as long as the property is used as an orchard.”
You will notice the difference between this clause and the language used in a deed for a fee simple on condition estate. The key words here are “as long as”. These three words indicate that this is a qualified fee simple estate.

Now, you might be saying, “Well, these estates are essentially the same.” And you would be mostly right. However, there is one major difference in the grantor’s repossession rights. If the person receiving the property (the grantee) does not abide by the condition laid out in the deed for a qualified fee simple estate, the person conveying the property (the grantor) can immediately reclaim that property.

So, for example, let’s say Larry (the grantor) conveys the orchard property to Chet (the grantee) with a deed that contains a qualified fee simple estate clause. If Chet does not abide by the clause and flattens the orchard to build a bed and breakfast, then Larry could immediately repossess the property. Chet’s fee simple ownership of the property would be terminated.

This clause will follow the title. So, if Chet sells the property to another buyer—which he has the right to do—the property will still have to remain an orchard. If the new buyer does not use the property as an orchard, ownership will immediately revert to Larry (or his heirs).

**LIFE ESTATES**

This is a form of ownership in which an original property owner transfers a property to another person (called a *life tenant*) for the duration of that person’s (or another person’s) lifetime. This type of estate can be created by a deed (or a will), or through a court ruling. There are two types of life estates:

1. Ordinary life estate (or estate for life)
2. Estate pur autre vie (for another life)

When a property’s original owner grants an ordinary life estate to a life tenant, it means that the life tenant enjoys the rights to use and enjoy that property for the rest of his or her life. Then, when the life tenant dies, the estate will either:

1. Be in remainder; or
2. Be in reversion

If the estate is in remainder, the original owner has appointed a third party (a remainderman) to take over ownership of the property after the life tenant’s death. In such a situation, the remainderman’s interest in the property is called (appropriately enough) a “remainder interest”. Once the original owner designates a remainderman, and the title has been conveyed on the life estate, the deal is set in stone. The original owner cannot change his or her mind about the remainderman.

On the other hand, if the estate is in reversion, the property will return to the original owner (or his or her heirs) after the life tenant’s death. In this case, the original owner’s interest in the property is called a reversionary interest.

An estate *pur autre vie* is a slightly different. The rough translation of the phrase “pur autre vie” is “for another life”—which is exactly what this type of life estate depends on. A life estate pur autre vie is a situation in which a tenant owns the property for the duration of someone else’s life. A common situation is that the original owner conveys the property as a life estate to a life tenant, who then leases or transfers his or her interest in the property to a third party tenant. For example, let’s say that Sam decides to convey his property to Dave as an ordinary life estate—making Dave the life tenant on the property.

However, while he has the right to use and enjoy the property, Dave does not have the right to devise the property (or pass the property on) to an heir upon his death. Sam will choose who will receive the property after Dave’s death—whether it reverts back to Sam or goes to a remainderman. To keep things simple, let’s say that Sam keeps a reversionary interest in the property—meaning that when Dave dies, the property will automatically return to Sam (or his heirs). Additionally, Dave does not have the right to convey fee simple ownership of the property to another person. While he can receive
income from a lease on the property, Dave cannot offer another person more than his actual interest in the property.

Nevertheless, Dave does lease his interest in the property to Patty. Now, while the ownership that Sam originally granted to Dave was an ordinary life estate, Dave creates an estate pur autre vie by conveying the property to Patty. The life estate is still attached to Dave’s lifetime. This means that when Dave dies, Patty will have to give the property back to Sam. Theoretically, in the above situation, Patty might be able to pass on her interest in the property to heirs—at least for as long as Dave lives. If Patty dies while Dave is still alive, her interest could be inherited. However, as soon as Dave dies, the property would still revert to Sam, no matter who owns it.

**LIFE TENANT’S RIGHTS AND RESPONSIBILITIES**

The life tenant can occupy and use the property. He or she can lease or otherwise receive income from the property. A life tenant can even use the life estate property to secure a debt—assuming he or she can find a lender who would be willing to do it. However, while the life tenant enjoys many of the rights associated with ownership, he or she also has a responsibility to maintain the property. When a life tenant damages a property in any way, it is called an **act of waste**.

An act of waste can take many forms. Burning down any improvements on the property is probably the first one that comes to mind. However, the physical aspects are not the only ones a life tenant has to consider. There are also financial considerations like paying property taxes on time, and making sure that any debts that the life tenant secures with the property are not delinquent. Additionally, the life tenant must preserve the overall character of the property. This means not changing how the property is used—for example, converting a residential estate to a commercial property. If a life tenant commits an act of waste, the remainderman or the owner with a reversionary interest in the property can take the tenant to court.

**OUTDATED VERSIONS OF LIFE ESTATES**

There are three forms of life estate that are either not recognized in or have been abolished by the state of New York:

- **Dower**
- **Curtesy**
- **Homestead**

The first two, dower and curtesy, are two sides of the same coin. Sometimes, even though a married couple lives together on a property, the title to that property may only be in one of their names. In such a case, if the spouse whose name is on the title passes away, the surviving spouse can have a life estate claim to the property through a dower or curtesy. A dower is a life estate that a surviving wife claims when her title-holding husband passes away. A curtesy is the exact opposite—a surviving husband’s life estate after his title-holding wife passes on. In states where they are recognized, both a dower and curtesy can be applied to all inheritable property.

A homestead life estate is similar to a dower and curtesy, except that it only applies to the family’s primary residence.

None of these life estates are recognized in the state of New York. While the homestead has never been part of New York law, the dower and curtesy once were, but have been abolished.

**LEASEHOLD ESTATES**

If you have ever leased an apartment or a house, then you are familiar with a leasehold estate. This is created when a landlord grants a tenant the right to possess a property, without conveying the title to that tenant. The landlord is still the title holder. A leasehold estate will be documented with a lease contract that will outline the relationship between the landlord and tenant, how much the tenant will pay in rent, and the tenant’s rights and responsibilities while in possession of the property.
The four basic types of leasehold estates are:

- Estate for years
- Periodic estate
- Estate at will
- Estate at sufferance

If the lease is for more than one year, it must be represented with a written agreement that is signed by both the landlord and the tenant to stand up in court. However, if the lease is for less than one year, a written agreement is not necessary to make the deal legally enforceable.

**ESTATE FOR YEARS**
An estate for years is valid for a specified time which could be for one year, one month, or even one day. The time limit is the essential element. If there is no agreed-upon time limit, then the leasehold is not an estate for years. Once the time limit expires, the estate (or rental agreement) will automatically expire. No notice from either the landlord or the tenant is required, and the tenant must vacate the premises immediately. However, a termination of an estate for years before the time limit has expired requires an agreement between both parties, unless one party can prove the other is guilty of breaching the contract.

**PERIODIC ESTATE**
This lease can be for any amount of time. Typically, though, the time will be shorter—week-to-week, month-to-month, or even year-to-year. Unlike an estate for years, a periodic estate does not have an expiration date that locks both parties into a deal for an extended period of time. Instead, the lease is automatically renewed at the end of every agreed-upon time period. If the periodic estate goes month-to-month, then every time the lease is renewed, it will be for another month. This will go on indefinitely until one of the parties decides to opt out of the deal. To be valid, certain provisions must be met. The lease contract should contain a clause outlining the periodic nature of the deal, the length of each time period, the automatic renewal, and the methods for terminating the agreement.

A periodic estate can also be created by circumstances. In New York, if an area does not have rent regulations, a tenant who stays past the expiration date of a lease will be treated as though they have a month-to-month periodic estate. Such tenants are known as “holdover tenants”. However, this periodic estate is only valid as long as the landlord accepts a tenant’s rent checks. If the landlord stops accepting the rent checks, then the tenant could find him- or herself in legal trouble. We will talk more about holdover tenants in the Estate At Sufferance section.

In general, when terminating a periodic estate, the party ending the agreement should give notice to the other party in a reasonable amount of time. While the exact timeframe for furnishing such a termination notice will be different depending on where the property is located, the typical guidelines are:

- Week-to-week lease = one week’s notice
- Month-to-month lease = one month’s notice
- Year-to-year lease = three to six months’ notice

The rules for terminating a month-to-month periodic estate in New York are the same for both the landlord and the tenant. Whoever decides to end the agreement must provide the other party with written notice at least 30 days before expiration of the lease period. The state of New York and New York City are pretty close on this time limit—the state requires one month, while the city requires 30 days. Additionally, the termination notice should be filed with the other party at least one day before a rent check is due for the following month.

For example, landlord John wants to terminate a month-to-month lease with a tenant Charles. Like most lease agreements, the rent for this one is due on the first day of every month.

John decides that he wants Charles to be out of the property by September 1st. In order to give proper notice to Charles, John would have to notify his tenant about the termination on July 31st—one day before the August rent is due.
ESTATE AT WILL
Of all of the leasehold estates, an estate at will arrangement is the most informal. Such an estate has no expiration date because it is for an indefinite amount of time, with no real written agreement between the parties. Typically, an estate at will is created because of a special relationship between the landlord and the tenant or when a property is in transition. A grandparent renting to an adult grandchild is a situation that might spawn an estate at will.

ESTATE AT SUFFERANCE
This is the most contentious form of leasehold estate. When a tenant refuses to leave a property after his or her lease has expired, an estate at sufferance is created. A tenant who stays in a property after the lease expiration date is called a “holdover tenant”. This person might also be known (for obvious reasons) as a “tenant at sufferance”. The main difference between a holdover tenant and a squatter or trespasser is that the holdover tenant once had a lawful lease claim to the property.

A landlord can either begin eviction proceedings or keep accepting rent checks from the holdover tenant. As we stated in the previous section, as long as the landlord continues to take rent from the holdover tenant, their lease agreement becomes a month-to-month periodic estate. Under New York law, the landlord is allowed to charge a holdover tenant up to double the usual rental rate. So, not vacating a property once the original lease has expired could prove pretty costly for a stubborn holdover tenant.

FORMS OF REAL PROPERTY OWNERSHIP
Real property ownership comes in many forms. As long as it can afford to pay for it, any entity can own real property. Corporations, limited liability companies, and other similar entities may purchase real property to physically expand their operations or to diversify their portfolios.

There are three fundamental forms of ownership:
- Estate (ownership) in severalty
- Co-ownership
- Trust

ESTATE (OWNERSHIP) IN SEVERALTY
When one person (or entity) is the sole titleholder on a property, it is called an “estate (ownership) in severalty”. While the word “severalty” might look like it means there are several owners, in fact, it means that ownership of the property is “severed” (or separated) from any other claim on the property.

CO-OWNERSHIP
There are three types of co-ownership:
- Tenancy in common
- Joint tenancy
- Tenancy by the entirety

Regardless of which type of co-ownership tenancy exists, the parties involved have some specific rights and responsibilities that pertain to how they deal with each other, and how they care for the property.

The rights these owners share are as follows:
- Unrestricted access
- Each property co-owner must have unrestricted access to that property. If one co-owner unjustly blocks another co-owner from using the property, the wronged co-owner can take the issue to court.
- Profit report
Every co-owner has a right to receive a report detailing any profits that a property creates. Any income generated by the property (e.g. rent) will be split pro-rata among the co-owners. “Pro-rata” is legal term that means each co-owner will receive a proportionate share of the income.

Contribution to property expenses
Even though this is typically listed as a right, it is more like a responsibility. While co-owners are not necessarily required to help pay for repairs or improvements on a property, they will be responsible for expenses like property taxes or mortgages on the whole property. An owner has a “right” to contribute money to repay any debts or bills associated with the entire property.

If one co-owner makes an improvement on the property that increases its value, without consulting his or her partners, that co-owner cannot demand that those partners help pay for the improvement. It does not matter what kind of improvement the co-owner adds—building, road access, or utilities. It does not even matter if the other co-owners make a profit because of the improvement. They still are not obligated to contribute to its cost at the time of completion.

One fundamental difference between a tenancy in common, a joint tenancy, and a tenancy by the entirety lies in the right of survivorship.

When an ownership agreement between parties has a right of survivorship, it means that if one owner dies, the other owner (or owners) will automatically receive the deceased’s share in the property. It cannot be left to heirs. Additionally, if all but one of the co-owners dies, the last remaining partner will own the whole property in severalty.

**TENANCY IN COMMON**
Two or more co-owners (or tenants in common) hold title on a property simultaneously, then it is considered a tenancy in common. The only real requirement is unrestricted use and enjoyment of the entire property. This requirement is called the unity of possession.

A tenancy in common can be created any number of ways. Frequently, though, there are four scenarios that result in a tenancy in common:
- Two or more people inherit a single piece of property.
- Two or more people purchase a piece of property without designating a specific co-ownership structure.
- Two or more people purchase a property and decide to take title as a tenancy in common.
- Another co-ownership structure between two or more people is destroyed or deemed invalid.

Each tenant in common holds an undivided interest in the whole property. No one tenant owns a specific piece of the land, and all tenants are entitled to the entire property. Additionally, the tenants’ fractional shares do not have to be equal. For example, if Stephanie and Neil own a property as tenants in common, they do not have to necessarily split the property 50/50. Stephanie might own 75% of the property to Neil’s 25%, because she put up more money in the purchase. However, an uneven split between co-tenants must be explicitly stated in the agreement documents. If the size of each tenant’s share is not specifically outlined, it is assumed that they own equal shares of the property.

Another really important feature of a tenancy in common is that an individual tenant can convey or transfer his or her interest in the property to another party without consulting the other tenants. Selling or giving away his or her share does not affect the tenancy in common agreement, and the other co-owners cannot do anything to stop the property share from changing hands.

Additionally, a tenant can pass his or her share on to an heir—either through a will or by law. A tenancy in common stands out among the types of co-ownership as the one that does **not** have a right of survivorship. **So, when a tenant dies, the other tenants do not automatically split his or her share.**
Instead, the deceased tenant’s share will be devised (or passed on) to an heir, even if that tenant did not leave behind a will. If there is no will, the state will (via the probate process) devise the deceased tenant’s share in the property to his or her “natural heirs”—spouse, parents, siblings, children, or other family members.

**TERMINATING A TENANCY IN COMMON BY PARTITION**

A tenancy in common is terminated (or “destroyed”) when one of the co-owners brings a legal action to partition the property. Partitioning the property means splitting the physical property into separate lots that reflect the co-owners’ shares. For example, let’s say that Hal, Jack, and Randy are co-owners of a property under a tenancy in common arrangement. Hal owns 50% of the property, while Jack and Randy each hold a 25% stake. Hal decides that he wants to dissolve their arrangement, so he files a suit in court to partition the property. If the court rules in Hal’s favor, the property will be split into separate lots—with Hal receiving half of the original property and Jack and Randy each receiving a quarter of the parcel. Thus, the tenancy in common is terminated. If the property that Hal, Jack, and Randy own cannot be physically split into three lots the court will order a partition sale. Then, when the property finally sells, Hal will receive 50% of the proceeds, while Jack and Randy will each get 25%.

**JOINT TENANCY**

Like a tenancy in common, a joint tenancy can be created when two or more tenants co-own a property—with each holding an undivided interest in that property. However, that is where the similarities end. One of the most striking differences between a joint tenancy and a tenancy in common is that a **joint tenancy contains the right of survivorship**. This means that if a joint tenant dies, his or her share in the property will automatically be split equally among the other co-owning tenants. Even if a joint tenant tries to devise a property through a will, the right of survivorship takes precedence—meaning that the part of the will dealing with the property is void.

Another important feature of a joint tenancy is that (unlike a tenancy in common) all of the tenants own equal shares of the property—regardless of who puts up more money to purchase it.

The final feature that truly sets a joint tenancy apart from a tenancy in common is the concept of the **four unities**. These are the four unifying elements that make a joint tenancy valid. They are:

1. **The Unity of Possession**: This is the most basic requirement for any co-ownership. The unity of possession entitles all of the tenants to enjoy, use, and occupy the entire property. If any of the tenants does not have the same possession rights as the others, then there is no co-ownership.

2. **The Unity of Time**: The title for a property must be conveyed to the joint tenants at the same time, through the same event. If this is not the case, then the joint tenancy is invalid.

3. **The Unity of Title**: This requirement goes hand-in-hand with the unity of time. After all, if the joint tenants do not receive the title at the same time, they will not be granted the title through the same documents, either.

4. **The Unity of Interest**: When all of the joint tenants on a property have the same type of interest that is valid for the same amount of time, it is called a unity of interest.

The safest way to represent a joint tenancy in a deed is to use a passage that says that the property is granted to the co-owners “as joint tenants, with the right of survivorship, and not as tenants in common.” Remember that nothing is presumed in a joint tenancy. The nature of the ownership structure should be expressed as clearly as possible in the deed. Otherwise, the agreement will be considered a tenancy in common.

**TERMINATING A JOINT TENANCY**

Terminating (or “breaking”) a joint tenancy happens when one tenant sells, conveys or transfers his or her share of the property to another person. When a tenant does this, he or she violates a couple of
the unities necessary for a valid joint tenancy. The best way to look at these violations is through an example.

Let’s say that Greg, Myra, and Jody own a property as joint tenants—each with a one-third share. Myra decides to sell her share to Darryl. Once Myra’s share is conveyed to Darryl, the overall ownership ceases to be a joint tenancy. Darryl’s relationship with Greg and Jody will be as tenants in common. This means that Darryl can do pretty much anything he wants with his share of the property. Most importantly, Darryl has the right to devise his share to an heir. However, while Darryl is considered a tenant in common, Greg and Jody are still joint tenants with one another. They are still bound by the rules and enjoy the rights of a joint tenancy.

The reason Greg and Jody are still considered joint tenants is because they have not violated the unities of time and title, while Darryl has violated these unities by taking title to his share of the property at a later date.

To go further with the example, let’s say that Jody dies in an accident. Since she and Greg were still joint tenants in the property, Greg will automatically receive her one-third share. At this point, the ownership structure will become a true tenancy in common, because Greg was the last original joint tenant involved with the property. Now, Greg and Darryl own the property as tenants in common. They can each devise their shares to their respective heirs.

**TENANCY BY THE ENTIRETY**
A tenancy by the entirety is a form of co-ownership that is reserved for couples who are married when they take title to a property. A tenancy by the entirety is very similar to a joint tenancy.

Just like joint tenants, tenants by the entirety have the right of survivorship. So, when one spouse dies, the other automatically receives the deceased person’s share in the property. Additionally, just like a joint tenancy, a tenancy by the entirety is only valid as long as the agreement satisfies the four unities of possession, time, title, and interest. However, the fifth unity, marriage, is a requirement.

There is one major difference in a tenancy by the entirety; one spouse cannot convey or transfer the property to a third party without the consent of the other spouse. Both husband and wife must sign the deed for it to be valid. The only time both signatures are not needed is if one spouse is conveying his or her interest in the property to the other spouse. In that situation, only the conveying spouse needs to sign the deed.

Additionally, tenants by the entirety cannot sue to partition the property, while they are still married and still hold title on the property. The only way that a tenancy by the entirety can be broken is through a divorce. In that case, the tenancy is automatically terminated and the ex-spouses become tenants in common on the property.

**TRUSTS**
The three parties involved in a trust are:

1. Trustor—sometimes called a grantor or settlor, this is the person who creates the trust.
2. Trustee—the person who (or entity that) owns, manages, and controls the assets in the trust.
3. Beneficiary—the person who receives the assets or the income they generate.

A trust is created when a trustor conveys property to a trustee, who then holds, manages, and controls that property for the benefit of a third party (the beneficiary). In effect, a trust is an act of faith put down on paper. The trustor shows his or her faith in the trustee by conveying property to that person. Before the property is completely passed to the beneficiary, the trustee legally owns the property. So, not only is the position of trustee as huge responsibility, it also shows the trustor’s faith in that person or corporate entity.
While a trust is pretty simple in theory, in practice, it can be a complex legal process that comes in a few variations. Trusts are set up for inheritance purposes, financial security, and tax planning purposes.

There are two basic types of trusts:
1. Living trust (inter vivos)
2. Testamentary trust

A living trust (or inter vivos) is created by a trust instrument. This instrument is a written document that outlines the trustor’s intentions and the trustee’s responsibilities in managing the assets in the best interests of the beneficiary. The trust document will also be signed by the trustor and the trustee (or trustees). The trustor could, potentially, also be the trustee and the beneficiary—at least, for the duration of his or her life.

A trustor will name him- or herself the trustee in order to maintain control of the assets contained in the trust. However, in such a situation, the trustor will also designate backup trustees, in case he or she becomes mentally incapacitated or dies unexpectedly.

Additionally, a trustor might designate him- or herself as the beneficiary on a trust so that he or she can still reap the financial benefits of the trust assets. Of course, this will only last until the trustor/beneficiary’s death. The trust document will name a secondary beneficiary (or beneficiaries) who will receive the property (or the income generated by it) after the trustor dies.

A testamentary trust is one that is created by a will. The differences between this and a living trust are pretty apparent. While the trust works the same way, there is no period where the trustor also takes on the role of trustee and beneficiary. A testamentary trust is strictly an inheritance tool.

Regardless of which type of trust is created, the beneficiary will probably have to satisfy certain conditions to receive the money or assets contained in the trust. The most common condition is that the beneficiary must reach a certain age to take possession of the trust fund or assets.

However, until the beneficiary reaches that age, the trustee will be responsible for the trust fund or assets. This could mean anything from simply maintaining an asset to actively investing or otherwise using the asset to generate income for the beneficiary.

**OWNERSHIP OF REAL ESTATE BY BUSINESS ORGANIZATIONS**

When a business entity owns real estate, it can open the door for individuals to invest in large projects that they could never fund by themselves. This opportunity could, in turn, allow those individuals to reap solid financial returns without investing more money than they can afford.

In this section, we are going to take a look at the various forms of business organizations that can own real estate, including:
- Partnerships
- Corporations
- Cooperatives
- Condominiums

**PARTNERSHIPS**: two or more people co-own a for-profit business, and share in its profits and losses.

There are two types of partnerships:
1. General
2. Limited

In a **general partnership** all of the partners are involved, in some way, in operating and managing the business. This can be a very hands-on form of ownership, where the success of the business rests in the hands those who invest in it.
The partners’ involvement in the business also extends to any losses or other financial obligations. Members of a general partnership are held personally responsible for such shortfalls. Additionally, if a member of a general partnership dies, withdraws, or goes into bankruptcy, the partnership will either be terminated or reorganized.

A **limited partnership** does not have this problem. The agreement creating it will outline what will happen when a general or limited partner can no longer be part of the organization.

While a limited partnership also has at least one general partner, the presence of limited partners truly defines it. If you have ever heard the term “silent partner”, then you have a basic idea of what a limited partner is.

**CORPORATIONS**

Most of us do not think of a corporation as a person. However, legally, they are considered virtually the same as a person. They are intangible, artificial, taxable entities that only exist because of the rule of law. They can be for profit or non-profit.

A corporation is created through a charter or certificate of corporation, which is filed with the state. This charter will outline the corporation’s purpose and its powers, including its right to receive and convey real property. Additionally, because it is viewed as a virtual person, a corporation can own property in severality.

The bylaws will also establish the ground rules for operating and managing the corporation—including the company’s management structure and the rights of shareholders, directors, and officers. The shareholders will elect a board of directors, who will be responsible for making policies and hiring officers to run the company’s day-to-day operations. Shareholders can also weigh in on important issues and policy decisions through a vote.

There are two types of corporations:

1. C corporation (or “C corp”)
2. Subchapter S-corporation (or “S corp”)

The vast majority of companies are classified as C corporations (or C corps). As long as they go through the proper channels in establishing the company, C corps have no restrictions on the number, nationality, or identity of their shareholders. A Chinese company can be a shareholder in an American C corp. However, C corps (literally) pay for this freedom of choice in investors through “double taxation”. In this tax structure, profits are taxed at the corporate level, and then the dividends are taxed at the shareholder level.

While a subchapter S corporation (or S corp) operates like a corporation, it is taxed like a partnership. So, this type of corporation does not pay taxes. Rather, shareholders must report profits and losses on their individual tax returns. This sort of taxing structure is called “single taxation”, because any taxes taken from the profits made by the corporation are only taxed one time. That is a pretty good deal for a corporation.

**LIMITED LIABILITY COMPANIES AND PARTNERSHIPS**

A limited liability company (or LLC) can be created by one or more people that are known as “members”. LLCs are attractive to investors because they combine the best qualities of a corporation with those of a partnership. Just like a corporation, LLC members bear no personal liability for the losses of other financial obligations of the company. However, just like a partnership, the members are taxed individually—meaning that there is no double taxation.

A limited liability partnership (or LLP) is a little bit different. In New York, an LLP can only be created by groups of professionals, such as accountant, architects, or lawyers. While an LLP is taxed like a partnership, its management structure is much less rigid. There are no general partners in an LLP, and
the partners who are involved can fully participate in the management of the company. The requirements and process for creating LLCs and LLPs are typically different from state to state.

**SYNDICATES AND JOINT VENTURES**

A syndicate is a group of two or more people or organizations who join together for at least one business project. While it can be for just one project, typically, a syndicate will be a more consistent relationship that accomplishes more than a single project. Such a group may consist of individuals, partnerships of various types, and corporations. Some of these members will actually be on the ground, managing and completing projects, while others will simply be investors.

While a joint venture is similar to a syndicate, it is usually formed by two or more individuals or entities for a single project or investment. Typically, once the intended project has run its course, the joint venture will be dissolved. For example, if the project is a real estate development, the joint venture may only last until the property is finished and sold. Finally, the joint venture members can own real property in the same way as a syndicate.

**COOPERATIVE AND CONDOMINIUMS**

Cooperatives and condominiums are unique forms of property that combine elements of home ownership with those of apartment living. Oftentimes, buyers have a hard time distinguishing between these two forms of property ownership. After all, both types of communities usually mean apartment-style living (especially in urban areas).

However, while they appear very similar at first glance, the differences between cooperatives and condominiums are in the details.

**COOPERATIVES**

When you delve deeper into cooperative (or co-op) ownership, you will notice that it very much resembles corporate ownership because...well...the co-op community is owned by a corporation.

The residents of a co-op community do not own their apartments (or any real estate, for that matter). As stockholders in the corporation, the residents will elect a board of directors that will address issues affecting the community, including:

- Hire the manager (or management company) to take care of the day-to-day operation of the building
- Interview (and approve or deny) applicants for vacant units
- Work up an annual budget
- Make decisions about major renovation projects in the building
- Approve or deny construction projects by individual residents
- Mediate resident disputes
- Make amendments to house rules

However, the most important thing to consider about a co-op is this: All of the residents are dependent on the corporation remaining solvent. This is the primary reason why the co-op board has so much control over the community—for the good of the corporation.

**CONDOMINIUMS**

A condominium (or condo) has some of the same features as a co-op. Both communities have residents who live in units. Both have house rules that residents must abide by to live in the community. Both have an elected board overseeing the community. They both have shared or common elements, and monthly maintenance fees.

However, the differences between these two types of ownership lie in how each community handles these seemingly similar elements. In a condo community, each resident owns his or her unit in fee
simple—just like a single-family home—instead of controlling shares in a corporation. As such, the condo unit is treated as real property.

The owner can devise the property to an heir or convey fee simple ownership to another party. Even though many condo boards might claim that they have a tight control over who buys a unit in their community, they do not have as much sway as a co-op board. A condo unit owner is typically free to sell just like any other homeowner. The owner of a condo can get a conventional mortgage loan to pay for the unit. He or she will also be able to get home equity loans or lines of credit, while many co-op shareholders might not have that option.

This fee simple ownership also means that the owner will pay property taxes on his or her own unit, rather than paying them as part of their monthly maintenance charge.

In addition to owning the unit, a condo resident also owns a share of (and has an undivided interest in) the common elements in the community. These elements include the basement, roof, lobby, gym, and any other area used by all of the residents. This is very different from a co-op, where the corporation owns all of the common elements.

However, just like a co-op shareholder, a condo resident will also have to pay maintenance fees on top of his or her mortgage.

Co-op maintenance fees can be a little more expensive because the shareholders must also pay for the community’s property taxes and insurance. In addition, if there is an underlying mortgage on the property, the shareholders portion of payment for debt service will be included as well. Sometimes, a co-op will even include utilities in its maintenance fees.

Condo owners do not have to pay for all of these extras in maintenance fees, but they will have to pay for those things on their individual properties. Plus, they will still have to pay a maintenance fee to the condo association.

We will talk in much more detail about co-ops and condos in the Cooperatives and Condominiums course.
CHAPTER 10 LIENS AND EASEMENTS

KEY TERMS

Appurtenances | Easement for light and air | Mortgage
Dominant tenement | Easement in gross | Party wall
Easement | Encroachment | Possessory/non-possessory
Easement appurtenant | General lien/specific lien | Right of way
Easement by condemnation | Involuntary/voluntary lien | Servient tenement
Easement by grant | License | Subordination agreement
Easement by implication | Lis pendens | Tax lien
Easement by necessity | Easement for light and air | Easement in gross
Easement by prescription | Encroachment | General lien/specific lien

Liens and easements can be the little hidden time bombs in a property’s title. Claims of any kind against a property are never usually positive, but liens and easements on a property can turn a wonderful new dream home into a powerful nightmare. At first, they might not seem to go together. While liens can lead to a possessory interest in a property, easements never do. While liens are based on seizing a property to recover unpaid debts, easements are based on seizing rights to another person’s property.

The one thing that liens and easements do have in common, though, is that they can both detract significantly from a homeowner’s enjoyment of the property. While you may not necessarily deal with liens and easements on a daily basis, as an agent, you should be familiar with the basics of each. Such knowledge will help you to better protect your customers from buying properties that have questionable claims of one form or another attached to them.

VOLUNTARY AND INVOLUNTARY LIENS

A lien is a monetary claim on a property that is used as security for a debt. If the owner/debtor fails to meet the obligation, then the lien holder (lender, creditor, etc.) can foreclose on the property to satisfy the debt.

there are two forms of liens—voluntary and involuntary. A voluntary lien stems from an action by the property owner, while an involuntary lien comes about through an action by a court.

A mortgage loan to buy a property would be committing yourself to a voluntary lien. However, if you fail to pay property taxes for a few years, then you could look forward to a tax lien, and that is an involuntary lien.

GENERAL LIEN

A general lien is a claim against all of a person’s assets—both personal and real property. Such a lien usually comes from a legal judgment or an unpaid income tax or estate tax debt. Examples:

- Judgments (Lis Pendens)
- Estate and inheritance taxes
- Deceased person’s debt
- Corporation franchise tax
- IRS Tax

JUDGMENT LIENS

The phrase “judgment lien” means exactly what you think it means—a court order that results in a financial claim against an owner’s property. A lawsuit goes through the court system and produces a judgment debtor and a judgment creditor. The debtor owes the creditor a specified amount of money based on the court’s decision. This ruling is outlined for each party in the dispute on a document called a notice of judgment. The debtor will have a certain amount of time to pay up. In New York, the timeframe is 30 days. If the debt is not paid on time the creditor can seize the assets of the debtor.
When a creditor collects a judgment by seizing a debtor’s personal property, he or she will have to go through an enforcement officer, such as a sheriff or marshal. The creditor is responsible for giving the enforcement officer the necessary information to track down the debtor’s assets that will be seized to satisfy the judgment. This can come from the information subpoena or from the creditor’s own knowledge, but the enforcement officer will not investigate such things.

The officer must get an “execution of judgment” from the court in order to collect the debt. This ruling gives the enforcement officer the authority to seize the debtor’s personal property—like bank account funds, a percentage of his or her wages, or any other money that is held by or owed to the debtor.

To take a debtor’s real property, a creditor will have to file a transcript of judgment with the county clerk’s office. Once the clerk has recorded this transcript, the judgment turns into a lien, making the debtor’s real property in that county fair game for seizure.

The time of recording is especially important in cases where there are multiple creditors. The timestamp on a lien determines its place in line at the payment window. So, if you have two creditors who went through the process to put a lien on the same debtor’s real property, it is a first come, first serve situation. The creditor who gets to the county clerk’s office first will be paid off first.

A judgment lien against personal property usually has an initial time limit of ten years. However, a creditor can get a 10-year extension if he or she files for one before the first term runs out. So, if a creditor still holds a lien against a debtor’s personal property after eight years, he or she could file for an extension any time within the next two years. Liens against real property have a limit of ten years with no possibility of extension.

To seize real property that a debtor has in other counties, the creditor must file in that county. Once the judgment lien has been placed on a debtor’s real property, the enforcing officer can seize it and sell it at an auction. The money from the sale goes toward settling the judgment. It can be placed on all property owned by the debtor.

**BANKRUPTCY PROTECTION**

In New York, if a debtor files for bankruptcy, his or her home could be protected from a judgment lien by the homestead exemption. This exemption limit is $50,000 for a single person and $100,000 for married debtors. This has nothing to do with taxes, and everything to do with equity. If a single debtor owns a primary residence with less than $50,000 in equity built up, then that home is exempt from being taken because of a judgment lien. As we stated above, the number jumps up to $100,000 for married debtors. This applies only if the debtor files for bankruptcy.

**LIS PENDENS**

When a creditor (or other claimant) attaches a lien to a debtor’s real property, a lis pendens comes with it. Translated from Latin as “suit pending” or “pending litigation”, a lis pendens is a document that tells possible purchasers (and anyone else who is interested) that there is a lawsuit involving the property. While a title can be transferred with a lis pendens attached to it, most buyers and lenders will steer clear of such a clouded title.

**ESTATE AND INHERITANCE TAX LIENS**

An estate tax lien is attached to a decedent’s estate by the federal government. Usually, this tax will be paid from the funds left by the decedent (bank accounts, insurance policies, stocks, etc.) or by selling some of the decedent’s assets. More often than not, the executor will make sure this tax is paid. An executor is a court-appointed person who is responsible for taking care of a decedent’s affairs. We will talk more about executors in the Deeds section.
DECEASED PERSON’S DEBT LIENS
Whenever someone dies, one of the first questions raised is whether the estate can cover the debt that person leaves behind. Based on whether it can cover the decedent’s debts, an estate will either be known as solvent or insolvent.

A solvent estate is one with enough (or more than enough) assets to pay off the decedent’s debts. In this situation, the estate representative (executor or administrator) will pay the debts before the remaining assets are transferred to the designated heirs.

An insolvent estate is one without enough assets to pay off the decedent’s debts. In this situation, the estate representative will have to consult state and federal laws to find out which bills should be paid first. Some debts, like mortgages, might take precedence over others, like credit card bills. Of course, since there are not assets to cover all of the debts, some creditors are either going to end up with significantly less than the total payoff amount or with nothing at all. This also means that the decedent’s beneficiaries will, most likely, not see anything from the estate.

CORPORATION FRANCHISE TAX LIENS
In most states, when a corporation sets up shop, the basic income taxes are not the only ones the organization faces. There is also something called a corporation franchise tax. This tax is charged to the corporation for the privilege of doing business in the state. If the corporation franchise tax goes unpaid, it will evolve into a lien against the company’s assets. These assets could then be subjected to foreclosure proceedings to pay for the debt. If the tax lien is not satisfied, the corporation could be dissolved and barred from doing business in the state.

IRS/INCOME TAX LIENS
These liens can be attached to a debtor’s property for evading a range of income-based taxes, including:
- Individual income tax
- Unemployment taxes
- FICA
- Self-employment taxes
- Sales and use taxes

But the lien is not just for the amount of the overdue tax bill. If the government puts a lien on your property, you will have to pay enough to cover the unpaid amount, plus other expenses, including (but not limited to) interest, penalties, and other costs that either relate to the tax bill or accrue until the debt is paid off.

A tax debtor will be given written notice of the overdue bill and be given 10 days to pay up. If that person does not satisfy the IRS request within the allotted time, then the debt automatically becomes a lien against his or her personal and real property.

Additionally, this lien reaches back in time to when the tax was originally assessed—meaning the date on which it was recorded in the official Department of Treasury books. Any real or personal property that the debtor acquires after the assessment date is also fair game under the lien. After ten years, the lien will probably be unenforceable. If the debtor is not going to pay after a decade, he or she probably never will. However, the lien can be re-filed and extended, if the IRS so chooses.

CERTIFICATES FOR EVERY SITUATION
When a federal tax lien changes or is affected in some way, the IRS will file a certificate to note the shifting circumstances. These certificates include:

Certificate of Subordination
Sometimes, the federal government will file a certificate of subordination and willingly let another creditor’s lien take priority over the IRS lien. This usually happens when a debtor decides to refinance his or her property, so that he or she can use the proceeds to repay the overdue tax debt.
Certificate of Discharge
When the debtor sells property that is covered by the lien, and then uses part of the proceeds from the sale to pay toward the tax debt, the IRS will issue a certificate of discharge. This certificate detaches the lien from the sold property and removes it from the list of items that can be sold to recover the tax debt.

Certificate of Withdrawal
While a certificate of withdrawal does not remove a lien, it does signify that the debtor and the IRS have come to a payment agreement. Usually, this agreement involves the debtor paying off the tax debt on an installment plan.

Certificate of Release
The ultimate goal for any debtor is to receive the certificate of release for a federal tax lien. This document issued by the IRS after the overdue taxes have been paid or when the lien can no longer be enforced because it has expired. This IRS should issue this certificate no more than 30 days after the lien has been satisfied or eliminated.

The IRS will only issue the above certificates after the debtor convinces the government that it is the best course of action—which typically means that the IRS will be repaid more quickly than if the action is not taken.

SPECIFIC LIENS
A specific lien is a claim that is attached to a particular property in a debtor’s possession. The three most common liens that fall under this category are:

- Real property tax liens
- Mortgage liens
- Mechanic’s or materialmen’s liens

REAL PROPERTY TAX LIENS
A real property tax lien is a state or local government’s claim against a specific piece of real property for unpaid property taxes. Just like the IRS tax lien we discussed earlier, the bill due to satisfy the real property tax lien does not simply amount to overdue taxes. It also includes interest, penalties, and other fees that are associated with the property and the process. The only way that these extra charges could be waived is if the collecting municipality votes to suspend them.

In New York, the real property tax lien takes precedence over all other liens. This means that if the property is sold to pay off a number of debts, the local government’s tax office will be the first creditor on the list to receive payment.

DECLARATION AND DEFENSE
Once the petition for foreclosure is filed, anyone who has an interest in the property can come forward to declare the interest in the property covered by the petition.

These interested parties might include:

- Lenders
- Tenants
- Lien holders
- Other tax districts

Usually, an interested party comes forward because they want to receive notices about the progression of the lien and foreclosure proceedings. As we will see a little later, the people listed on the delinquent tax list will receive a personal notice about the proceedings. However, there might be some other parties who have a legitimate interest in the property, but were not listed on the tax rolls.

 Whoever the interested party might be, that person or entity must file a declaration of interest form with the enforcing officer. The declaration of interest is valid for ten years, but can be renewed for another decade.
PERSONAL NOTICE OF FORECLOSURE
In addition to notifying the public of the foreclosure proceeding, the enforcing officer must send out personal notices to the principal parties. Every other interested party will receive a personal notice via first class mail. Other interested parties include:

- Any other person listed on the delinquent taxes list with an interest in the property
- Another tax district claiming a lien on the property
- Any party who has submitted a declaration of interest

It will describe the property and state that it is subject to a delinquent tax lien. Additionally, the notice states that any removal or destruction of buildings or other valuable assets connected to the property beyond the date of the notice will result in a recovery proceeding. This recovery proceeding will be against the person (or persons) responsible for removing or destroying the assets. When the foreclosure proceeding is completed and the tax district takes control of the property, the person responsible for despoiling the property will be required to repay the district for the full value of the assets he or she (or they) removed or destroyed. At that point, the tax district can actually require the despoiler to pay for damages to and removal of assets from the time the delinquent taxes list was filed all the way to the end of the foreclosure proceeding. By then, the date that the notice forbidding despoiling was filed does not really matter.

NOTICE OF FORECLOSURE
The enforcing officer must also issue a notice of foreclosure. New York law affords the enforcing officer two options for issuing the notice of foreclosure. The text of the notice can be published in full in newspapers within the tax district. First, the notice must be published in at least two newspapers within the tax district where the property is located. New York and Bronx counties are the only exceptions to this rule. In those counties, the notice must appear in a daily law journal and a newspaper, both chosen by the appellate justices in the first judicial department.

REDEMPTION PERIOD
A debtor has what is called a redemption period in which he or she can pay the property tax lien in full and keep the property. Municipalities have the power to lengthen the standard redemption period to three or four years without having a public referendum vote. When a property has multiple local tax liens against it, the liens do not need to be redeemed all at once. However, when a debtor does redeem the liens, he or she must start with most recent lien and work backwards.

For example, let’s say that a debtor named Rick has neglected to pay his property taxes for two consecutive years—2007 and 2008. So, realistically, both of these liens will be in their redemption periods in 2009. Now, Rick could pay off both of these liens in 2009 and be done with the whole situation.

But what if he only has the money to repay one of them? If Rick can only pay off one of the liens, by law, he must repay the 2008 lien first. This would release Rick’s property from the 2008 lien, but the 2007 lien proceedings would go on as scheduled. That means that if the redemption period runs out on the earlier lien, Rick would lose the property. While this chronology might seem a little weird at first, the law actually makes a lot of sense. Realistically, if this law was not in place, a debtor could keep paying off earlier liens and skate on the later ones until the last minute. So, the debtor would always be one, maybe even two years behind on property taxes, but never lose the property.

When all of the liens are repaid on a property, the debtor will receive a certificate of redemption from the enforcing officer.

REDEMPTION ON THE INSTALLMENT PLAN
A tax district can amend its law to allow some debtors the option to pay delinquent taxes on the installment plan. If you will notice, that first sentence included the phrase “some debtors”. That is because not every debtor is eligible to pay delinquent taxes in installments.
A debtor is not eligible for the installment program if:

- There is another delinquent tax bill on the same property or a different property that would not be eligible for the installment plan
- The debtor owns another property with a delinquent tax lien in the same tax district—unless that property is also included in the installment agreement
- The debtor owned another property that was foreclosed within the last three years because of a delinquent tax lien
- The debtor defaulted on another installment agreement to pay delinquent taxes within the last three years

**BANKRUPTCIES**

A foreclosure action to recover a delinquent tax lien will stop if the relevant property becomes involved in a bankruptcy proceeding. In a bankruptcy situation, the rule about not accepting partial payments for overdue taxes will be waived. However, the partial payment must be accompanied by proof of the bankruptcy proceeding—such as copies of orders related to the action. When a bankruptcy proceeding makes a lien completely and permanently unenforceable, the tax district will cancel it, and the municipal corporation who is entitled to the tax will be out of luck.

**MORTGAGE LIENS**

A mortgage lien is the most common lien on real property—and the one truly voluntary lien. A mortgage is an instrument that specifies a particular property as the security for a loan. In essence, the mortgage document represents a lender’s right to foreclose on a property if the borrower does not faithfully pay off the loan. Just like documents for other liens, the mortgage will be filed with the clerk’s office in the county where the property is located.

While the lender’s interest in the property is secured through the mortgage lien, the borrower is the true titleholder for the property. The only restriction is that before transferring the title to another person, the borrower/seller must pay off the mortgage lien, unless there is an assumption agreement in place with the buyer. Once the mortgage lien has been paid, then the lender will file a release with the county clerk, freeing the borrower from the debt. This release filing should be followed a few weeks later by a letter to the borrower stating that the release has been finalized. Of course, if the borrower fails to pay back the loan, the mortgage lien turns into a foreclosure proceeding, much the same as we saw in the Real Property Tax Lien section above.

Some borrowers will have two or more mortgage liens on a property at any given time. In that situation, the primary lien position will be held by the “first mortgage”, while the secondary lien position will be held by the “second mortgage”, and so on. While these mortgage liens are prioritized by filing date (just like other liens), there are circumstances in which one lender might voluntarily relinquish its lien priority spot to another lender.

**MECHANIC’S LIENS**

When a homeowner hires a contractor to do work on his or her house, the relationship seems straightforward—the contractor does the work (or hires others to do it) and he or she is paid for the materials and the labor. Sometimes, a homeowner will refuse to pay for one reason or another. Maybe the owner feels some of the work was done wrong. Or, maybe he or she just might not want to part with the money once the work is completed.

Whatever the reason, when a homeowner neglects or refuses to pay a contractor once a job has begun, that contractor can file a mechanic’s lien against the property to recover the money he or she is owed. New York does not allow a contractor to file a mechanic’s lien before construction begins. A contractor can file this lien, as long as the homeowner agreed to the improvements—whether they were for initial construction or renovations.
However, the law does make a distinction about husbands who make decisions about improvements without their wives’ consent and vice versa. When one spouse hires contractor without the other spouse’s knowledge, the hiring spouse is presumed to be speaking for the other spouse, as well.

If this is not the case, the other spouse can notify the contractor within 10 days after the agreement for the job is made that he or she does not consent to having the improvements done. If that is the case, then the job contract could be in jeopardy. Many contractors will require both spouses to sign the contract in such a situation just to be sure there is no trouble down the road.

Additionally, the mechanic’s lien probably will not apply to jobs a contractor is hired to do by a tenant of a property. If the owner is not in on the contract, then the mechanic’s lien will, most likely, not be a viable option for the contractor to receive a remedy from the owner.

Some owners might try to avoid the lien by demanding that the contractor waive it in their agreement. Any agreements with a provision like that are void under New York law, though.

The contractor is allowed to waive the ability to file a lien whenever the owner pays in full or thereafter. But that is only for completed labor and materials that have been paid for. The contractor could still file a lien for any work or materials that are, as yet, uncompensated. So, for example, let’s say the contractor and his or her crew have finished half of the job and the owner pays for the work done and the materials used thus far. The contractor could waive the right to file a lien against the property for the first half of the job without waiving his or her right to file a lien if the owner does not pay for the second half in a timely manner.

**SUBCONTRACTORS**

The term “contractor” tends to be a catch-all term when we talk about mechanic’s liens. This term is used because the contractor is the person making the deal with the homeowner. In reality, though, quite a few laborers or suppliers can effectively file such a lien, including:

- Subcontractors
- Materialmen (material supplier)
- landscapers
- Nursery owner
- Architects
- Engineers

Essentially, anyone who makes permanent improvements to the property or provides the materials or planning necessary for those improvements is eligible to file a mechanic’s lien. In fact, a material supplier can file a mechanic’s lien if he or she is not paid for materials that were manufactured and earmarked for the project. The materialman does not have to actually deliver the materials to the job site to be eligible to file a mechanic’s lien.

The big requirement is that the person supplying materials or doing work is contributing to permanent improvements that add value to the property. An improvement is considered “permanent” when it does not have to be redone somewhat frequently. So, for example, painting would be considered more temporary than, say, an extra room added onto the home or a huge landscaping job. Since this is the case, painters would not be eligible to file mechanic’s liens.

The subcontractor does not have to make a direct contract with the owner to be eligible to file a mechanic’s lien. In reality, since the contractor usually hires the subcontractors, the law allows that the contractor’s deal with the owner is grounds enough to allow a subcontractor to file a mechanic’s lien when necessary.

However, while the contractor’s deal with the owner does give subcontractors the right to file liens on private property, the payment situation between the contractor and the owner dictates whether the subcontractor can actually file the lien.
The contractor must put the money he or she receives from a homeowner into a trust for the workers and subcontractors on a job. So, before filing a mechanic’s lien, a subcontractor will have to find out how much money is in that trust—i.e. how much money the owner had already paid to the contractor.

The law states specifically that the amount of a mechanic’s lien cannot exceed the originally agreed upon price for the job. This means that the subcontractor must be careful not to file a lien that will, ultimately, be thrown out or, worse, be viewed as an exaggeration. As we will see when we talk about the consequences for exaggerating a lien a little bit later, such an accusation could deal a horrendous blow to a subcontractor’s business. The subcontractor must also consider whether the contractor has filed his or her own mechanic’s lien. In that case, the subcontractor’s payment should be rolled into that lien.

Of course, there is always the possibility that the subcontractor does not need to file a mechanic’s lien at all. Sometimes, the owner has paid the contractor in full, but that contractor is holding onto the money for whatever reason. If the subcontractor files a lien in such a situation, the fact that the owner has already paid in full for the job would be a complete defense of the lien. Then, the subcontractor would, most likely, have to consider suing the contractor for a breach of trust.

**FILING THE LIEN**

Just like other liens, a mechanic’s lien requires the contractor (or lienor) to file a formal notice to begin the process—a notice of lien. There are time restrictions required for filing and they are amended from time to time. The notice of lien must be filed with the clerk in the same county where the property is located. If the property sits in multiple counties, the lienor will need to file a notice with the clerk’s office in all of the counties.

As with any lien, the county clerk will record the date and time of filing. This is important to establish the mechanic’s lien in the priority line of creditors. Of course, everything filed before it takes precedence and everything filed after the mechanic’s lien is subordinate to it. In fact, a mechanic’s lien will stay attached to a property even if the debtor tries to assign it for the benefit of creditors—which is a method for paying past due debts, while avoiding bankruptcy.

**STATUTE OF LIMITATIONS**

For the most part, mechanic’s liens have a time limit of one year. The lienor can file for a one-year extension, as long as he or she does it before the initial year expires. No extensions are allowed beyond that, unless by a court order. For a single-family home, the mechanic’s lien will only be valid for one year, with no possibility of extension.

Additionally, if a lienor decides to bring an action to foreclose on the property, he or she must do that within the timeframe that the lien is valid—either during the first year or the extension period. He or she will lose out on the opportunity to sue under the mechanic’s lien, unless it is filed in a timely manner, the lienor still has a six-year window to sue for breach of contract.

**EXAGGERATING A LIEN**

Exaggerating a lien means that a lienor intentionally demanded more money through the lien than he or she was legally allowed. Committing such an action can lead to a laundry list of penalties and fees. The first, and most obvious, penalty is that the lien in question will be deemed invalid by the court. This means that the lienor will lose any legitimate amount that was included in the lien. Additionally, the lienor will not be allowed to file another lien for that particular claim.

Finally, the most devastating consequence of exaggerating a lien lies in the fees. If the court finds that the lienor has exaggerated a mechanic’s lien, the lienor will be on the hook for a myriad of financial damages, including:

1. Bond costs
2. Attorney fees
The difference between the amount claimed on the lien and the actual amount the lienor was legally due. So, if a lienor is caught exaggerating a lien, in the long run, he or she could end up paying to do a job. That is a poor business model, no matter what industry you are in.

**EFFECT OF LIENS ON TITLE**
Except for a current mortgage lien, a lien on a property’s title has a definite negative effect on the marketability of that property. Most buyers and lenders will not generally enter into a purchase agreement knowing that there is a lien on the title. At the very least, such a cloud on the title will lower the value of the property in the buyer’s eyes, if not turn them off completely.

For lenders, a lien is even less palatable, because it means they are (at best) second in line for repayment—if they are repaid at all. Consequently, getting a lender to sign off on a property with a lien will probably be very tricky.

**PRIORITY OF LIENS**
In New York, the real property tax lien is king. It is the lien against a property that will be repaid before any other lien will see a dime, even if one of the other lienholders is the federal government. Beyond the real property tax lien, other liens are generally prioritized by the date and time they are recorded with the county clerk’s office. When a creditor goes into the county clerk’s office to file a lien, the bad news is that he or she effectively becomes the last in line behind every other lienholder who has already filed a claim. However, there are a couple of actions that could switch up the lien priority lineup a little. First, there is the subordination agreement. When a lienholder in a primary repayment position signs this document, it means that lienholder is voluntarily stepping aside to let a secondary lien holder take its place.

A common example of the use of a subordination agreement is a property with two mortgages and a refinance. When the borrower refinances the first mortgage, it creates a new mortgage. This means that the second mortgage now moves into the primary priority status. Of course, since the new lender is refinancing a loan with a primary lien status, that new lender will want to take that first slot in the priority line. Many times, a lender will not even agree to refinance a mortgage unless it can have the same lien priority consideration as the old mortgage. This means that the second mortgage lender will need to sign a subordination agreement to give up its new primary priority slot to the new mortgage lien. Many lenders will sign this agreement because releasing its lien and re-filing means paying out more money and possible priority problems. Also, if the second mortgage lender feels that there is enough property value to pay off both liens, it makes subordinating its lien that much easier.

The second action that could rearrange the priority of liens is a foreclosure action. During a foreclosure proceeding, the court has the option of looking at the various liens on a property and reordering them, if it sees fit to do so.

**EASEMENTS**
Essentially, an easement gives someone who does not own your land the right to use it in some way. For this reason, easements are often called non-possessory interests in a property. While it grants the right for usage, an easement does not grant any ownership interest in a property. Consequently, an easement is commonly referred to as a right-of-way, because it is granted for action and not for possession. Easements fall into two basic categories:

1. Easements appurtenant
2. Easements in gross

The fundamental difference between these two categories is that easements appurtenant are attached to two specific, adjoining properties, while easements in gross are attached to individuals or entities.

**EASEMENTS APPURTEINANT**
An easement appurtenant is an agreement for usage between two property owners. One of the owners provides access to or usage of his or her land to another owner of an adjacent property. In such
an agreement, the land that is accessed or used is called the **servient tenement**, while the land that benefits from the access or usage is called the **dominant tenement**.

An easement appurtenant will “run with the land”. The right granted by the easement will transfer with the title to a property. This applies to both the dominant and the servient properties. In fact, these agreements are called easements appurtenant because they offer appurtenances—which are rights and features that come with property ownership. Appurtenances can include physical features like a dock on a lake or intangible features like an easement to use a neighbor’s well. Or, a subdivision developer might grant an easement in the deed offering the buyer use of a neighborhood recreation area. As long as the feature or right is connected with the property and transfers with the title, it is an appurtenance.

**EASEMENTS IN GROSS**

An easement in gross is a right to use or access a property that is given to a person or an entity. Unlike an easement appurtenant, an easement in gross does **not** require the person or entity accessing or using the servient tenement (or property) to have an adjoining dominant tenement.

When an owner grants an easement in gross to an individual, it is valid for the remainder of that person’s life. Furthermore, it is irrevocable, meaning that the property owner can never take it away, as long as the easement holder lives. However, a personal easement in gross is not transferrable. The person cannot assign it to a friend or family member or pass it on to an heir. Once the easement holder dies, the easement dissolves.

For entities, the rules are a little bit different. In fact, when such an easement is granted to an entity, it is called a commercial easement in gross. The most common recipient of a commercial easement in gross is a utility company. The service that such an entity provides comes with an implied easement to access your property to check for service, read the meter, repair damaged power lines, and other duties. An entity holding a commercial easement in gross can assign, lease, or sell its easement to another entity. For example, your local phone company might lease (or sell the use of) its commercial easement in gross on your property to a cable television company. Under that arrangement, the cable company could run its lines onto your property right alongside the phone lines.

Another frequent recipient of an easement in gross is good old Uncle Sam. A government agency can employ its right of eminent domain to create an **easement by condemnation**. Here, condemnation means the government is exercising its **eminent domain** power and transferring the title for part (or possibly all) of a citizen’s property to itself.

By law, the government agency creating an easement by condemnation must pay fair market value for the piece of property it is taking title to. Additionally, the reason for the easement must be for the public good. Typically, such easements are created for expanding roads, pouring sidewalks, or on behalf of public utilities. However, an easement can be put in place now for land in anticipation of some future activity.

**CREATING AN EASEMENT**

Easements are created through circumstance. A situation calls for a compromise or an understanding between two parties and an easement is granted as a solution.

**EASEMENTS BY NECESSITY**

A shared driveway or a driveway across a servient tenement to access a dominant tenement is the most common easement by necessity. In New York, you might see this referred to as an easement by necessity. This type of easement can be a recorded agreement between the two initial property owners. Usually, though, it will come about by court order.
EASEMENTS BY PRESCRIPTION
An easement by prescription is created through open, hostile, and exclusive usage of a property for a continuous 10-year period. Here, the term “open” means that the dominant tenement uses the servient tenement in a way that anyone looking at the properties can see. In addition, the term “hostile” means that the dominant tenement is using or accessing the servient tenement without the servient owner’s permission. The word does not refer to violence or weaponry of any kind. Additionally, the term “exclusive” means that the dominant tenement must be the only beneficiary of the servient tenement usage. If the owner of the servient tenement is also using the land in question while the dominant tenement owner is accessing it, that is not exclusive.

For an easement by prescription to be created, though, open, hostile, and exclusive usage or access must take place for ten consecutive years. Otherwise, the easement claim is invalid.

EASEMENTS BY GRANT
This can be created in a deed when a title transfer takes place, or by a written agreement between two property owners. It can focus solely on the location and purpose for the easement being granted. For example, if two adjoining properties use the same well for water, the owners of those properties could create an easement by grant. This easement would give the dominant tenement owner the right to use the well and have access for maintenance or other well-related purposes. The agreement might also outline how the two property owners will share the cost of maintaining the well.

LICENSE
Sometimes, people confuse an easement by grant with a license. However, the rules for a license are a bit different. First, a license does not give the bearer any possessory or non-possessory interest in the property. It simply allows the person to come onto the property for a specific purpose—usually hunting or fishing. Additionally, a license can be a written or issued document or it can be verbal. A property owner could give someone permission to park on his land for the day. That would be a form of license.

In addition, unless there is an agreed upon expiration date or the license has been paid for, the property owner can revoke the license at any time. If the license has an expiration date or has been paid for, it can still be revoked if the person bearing it performs an action outside of the rights the license grants. For example, if a person with a license for fishing is caught hunting on the same grounds, then his license could be revoked. Finally, a license represents a temporary right to perform a specific action. The holder cannot assign, lease, or sell it to someone else. Also, the license does not transfer with the title of the land. Think of your real estate license and your driver’s license. They each have an expiration date and rules that must be adhered to.

EASEMENT BY IMPLICATION
An easement by implication usually applies to an entity that buys or leases a right from the property owner—for example, mineral rights. If a property owner sells his or her mineral rights to a company, that company then has (at least) an easement by implication that allows it to come onto the land to mine for the minerals. However, for this mining company to have an easement by implication, it first has to have something called a “profit”.

In this context, the word “profit” does not mean money—at least not directly. It actually refers to the right to take something that is produced on someone else’s property. In our example above, the landowner sold the profit for his minerals to a mining company. That means that the company has a legal claim on whatever minerals that land produces. A profit is created in much the same way as an easement—by necessity, by grant, or by prescription. Unlike an easement, though, a profit can be assigned, leased, or sold. The basic restriction on an easement by implication is that use by the holder must be reasonable and for the specific purpose outlined by the profit.
EASEMENT BY CONDEMNATION
The only recipient of an easement by condemnation is the government. This easement is based on the government’s right of **eminent domain**. It is typically exercised by a government agency for some sort of public project—like expanding a road. Sometimes, the government can create an easement by condemnation on behalf of a privately owned public utility. The property (or piece of the property) must be purchased at fair market value.

PARTY WALL
A party wall is (typically) a structural one that is shared by two adjoining properties. It seems like a simple concept, but it can get complex. While each person owns his or her own side of the wall, the fact that it provides support to both structures means that an easement should be created. Also known as a cross-easement, this is an agreement that states that each owner has the right to use the wall to hold up their respective buildings. An agreement for a cross-easement can be implied, but writing it down initially in an agreement would be a good idea for protection against any unforeseen problems. After the initial agreement, the cross-easement will run with the land on both sides.

NEGATIVE EASEMENTS
Conservation easements are considered negative, not because they are inherently bad, but because they restrict developers from building on certain wildlife areas. Negative easements are not limited to public lands, though. These agreements can also allow an adjacent property owner, a developer, or some other entity to restrict what a property owner can do on his or her own property. An easement for light and air restricts a property owner from building anything on his or her property that would obstruct the view of a neighbor.

TERMINATING AN EASEMENT
Terminating an easement is not an easy task to accomplish. More often than not, it will take a legal action of some sort to remove an easement because it is a legally-recognized right that is granted from one owner to another. Additionally, the easement agreement may have provisions in it for how the relationship can be dissolved. Nevertheless, an easement can be removed in quite a few ways—most of which depend on how the agreement was created in the first place.

An easement could be terminated because the need for it is gone. Example: After years of sharing a driveway, the government comes through and builds a new road that will make way for a new driveway for a homeowner. If this happens, the easement between the owners should be terminated because Sue no longer needs to use Jean’s driveway to access her own property. In a situation like this, Jean and Sue would probably just execute a release agreement that would dissolve the easement. And that is another way easements are terminated—through a release agreement.

Sometimes, adjoining properties are bought by new owners and the dominant property owner decides that he or she does not need the easement, for whatever reason. In that case, the dominant owner could give a signed and notarized release agreement effectively killing the easement.

Another way to terminate an easement is by merging the dominant and servient properties. This happens when either the dominant or servient owner buys the other property. Regardless of which owner buys which property, merging the two will dissolve the easement because a property owner does not need to grant a right to access to himself for his own land.

For some easements, though, there is a finite amount of time attached to whatever rights they grant. If an easement agreement has an expiration date written into it, then the easement will terminate on or after that date. An example of this would be the construction crew that needs to cross one property to get to another for a job. An easement in that situation would, most likely, expire when the construction job is finished.
Finally, the servient owner might be able to go to initiate a lawsuit called a quiet title action. Usually, this sort of action is taken to clear the title of defects and establish the plaintiff as the sole owner of the property. However, it can also be used to remove easements—especially prescriptive ones.

This action will reestablish the land boundaries with a new survey and examine the various easements that affect the property to see if they are still valid. A quiet title action is particularly useful for older properties with easements that could be outdated or properties that were conveyed with a quitclaim deed.

ENCROACHMENT
An encroachment is a (typically unintentional) breach of a property boundary by an improvement or a landscaping feature. John wants to have a patio installed in his yard and the contractor mistakenly installs part of it on his neighbor’s property. This would be an encroachment. Another common example is the good old tree. One party plants a small tree and over the years it turns into a big tree with apples falling on both sides of the fence. The tree and its’ fruit is encroaching on the neighbors property.
CHAPTER 11 DEEDS

KEY TERMS

Accession
Accretion
Acknowledgement
Adverse possession
Alluvion
Avulsion
Bargain and sale deed
Consideration
Conveyance
Dedication/dedication by deed
Delivery and acceptance
Description
Executor
Full covenant and warranty deed
Grantee/grantor
Habendum clause
Involuntary/voluntary alienation
Land patent
Lot and block
Metes and bounds
Public grant
Quit claim deed
Referees deed
Reference to a plat
Survey

Purchasing a property means buying the right to occupy a piece of land. As such, having a paper trail to prove ownership is vital to protecting your interest in a property. A deed provides that paper trail in a legal and recordable fashion. As an agent, you will leave the preparation of real property deeds to real estate attorneys. However, you should understand the basics. Having such insight will better attune you to the purchase process and make you a better advisor to your customers and clients.

DEFINITION AND PURPOSE OF A DEED

Sometimes known as an instrument of conveyance, a deed provides a written document of the transfer of title ownership from one party (the grantor) to another (the grantee). This transfer is also called “alienation”, because as it gives title ownership to the grantee, it also removes ownership from the grantor. There are two types of alienation—voluntary and involuntary.

Voluntary alienation is the most typical situation. A grantor willingly sells a property to a grantee and a deed is written up and recorded to document the transfer and guarantee the grantee ownership and use of the property (possibly with some conditions). Or, maybe a grantor has willed his or her property to a grantee, and after the grantor passes on, the title transfer takes place.

As you might guess, an involuntary alienation stems from a financial hardship (like a foreclosure or bankruptcy), or from a grantor who dies without a will in place that covers the property.

To better understand the concepts of voluntary and involuntary alienation, take a minute to review this chart. It is okay if some of the terms are unfamiliar to you. We will cover them later. Just use this as a backdrop for the information presented in the rest of the course.

SUMMARY OF TITLE TRANSFERS

<table>
<thead>
<tr>
<th>Type of Title Transfer</th>
<th>Type of Alienation</th>
<th>In Life or After Death</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale</td>
<td>Voluntary</td>
<td>In Life</td>
</tr>
<tr>
<td>Dedication</td>
<td>Voluntary</td>
<td>In Life</td>
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<tr>
<td>Gift or Grant</td>
<td>Voluntary</td>
<td>In Life</td>
</tr>
<tr>
<td>Through a Will or By Descent</td>
<td>Voluntary</td>
<td>After Death</td>
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<tr>
<td>Foreclosure or Bankruptcy</td>
<td>Involuntary</td>
<td>In Life</td>
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<tr>
<td>Adverse Possession</td>
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<tr>
<td>Escheat</td>
<td>Involuntary</td>
<td>After Death</td>
</tr>
</tbody>
</table>

Just remember that regardless of whether the alienation of a title is voluntary or involuntary, a deed will be involved.

**ESSENTIAL ELEMENTS OF A DEED**
While the concept of a deed is pretty simple, the actual document is only legal if specific essential elements are in place and certain actions are taken.

First and foremost, a deed must be in writing. In times past a handshake and a promise was all that was necessary for a transfer of title. Unfortunately, those days are gone. Not only is it not safe to make an oral agreement to transfer a title, but New York law does not even recognize a deed or transfer unless it is written and signed (at least by the grantor).

In the following subsections, we will take a look at the other requirements that a deed must satisfy in order to be considered valid by the state of New York.

**GRANTOR**
The grantor is the person who is offering (or conveying) the title. In the actual deed document, the grantor might be called the “party of the first part”.

For a deed to be valid, the state of New York requires that the grantor be at least 18 years old and mentally capable of entering into a contract. If a deed is signed by a minor or someone who is not competent, it probably will not be legally binding. Remember “voidable” from the contract chapter? Such a deed would, most likely, be found unenforceable in a lawsuit should the matter go to court. However, if the parties do not challenge the validity of the contract, it will stand.

A married, mentally capable minor can be a grantor on a deed and would be treated as though he or she was already 18 years old. Therefore, the deed is valid and cannot be challenged. A court appoints a guardian for the minor or mentally incapable person who would represent that person as grantor on a guardian’s deed.

In addition to age and mental capacity requirements, a grantor must also provide positive identification, including a legal name and address. If there are two or more grantors, each must be included on the deed for it to be valid.

Because the majority of real estate transactions involve a “title in fee simple” transfer—meaning the new owner has total control of the property—all present owners must be on board as grantors. Not having them (and their signatures) on the deed will significantly hamper the future owner’s hold on the title. Theoretically, a grantee could receive individual deeds from each owner/grantor for a single property, but this is not the norm.

**GRANTEE**
The grantee is, of course, the person who is receiving the title from the grantor. In the deed, the grantee might be called the “party of the second part”. Just like a grantor, a grantee must provide a legal name and address for inclusion on the deed. Other than that, the grantee just needs a pulse. You heard that right. Besides positive identification, a grantee just needs to be alive when the deed is
delivered. How’s that for easy? Even though a minor or a person of limited mental capacity cannot transfer a title, such a person can legally receive the title and own property.

**CONSIDERATION**
To document the change in title ownership completely, the deed at least must acknowledge that something valuable was exchanged for the property. That “something valuable” is called consideration, and there are a couple of things about it that might surprise you. The first thing you might not know is that consideration does not necessarily have to be money. There are deeds that record a title transfer in exchange for a consideration of “love and affection”. Seriously!

This language is used in the deed because the grantor is gifting the property to the grantee—such as a parent giving his or her home to a child. While there was no financial consideration given for the property, the transfer happens because of a special relationship between the grantor and the grantee. While you might not see this very often as a real estate agent, you should be aware that this sort of phrasing could appear on a deed.

Even though information like legal names and addresses and the property description (as we’ll see) must be exact, the purchase price only needs to be expressed as nominal consideration for the deed to be valid. Nominal consideration is usually denoted with a phrase like “one dollar and other good and valuable consideration”. Such phrasing acknowledges that the property title is being exchanged for money, while also keeping the purchase price secret. In New York, the only time an actual dollar amount will be written into the deed is when the document is signed by an executor, trustee or an attorney who represents a grantor.

**GRANTING CLAUSE**
The granting clause is the most important passage in the deed, because it spells out the grantor’s desire to transfer (or convey) the title to the grantee, as well as what rights the grantee receives by owning the title. If there are two or more grantees, this clause will specify that nature of each grantee’s rights to the property.

This is especially important when dealing with grantees who are receiving the title in a joint tenancy or tenants by the entirety because of the issue of survivorship. In both cases, if one title owner dies, his or her share in the property automatically transfers to the surviving owner without requiring a will or court order of any kind.

So, when the grantees on a deed are going to be joint tenants or tenants by the entirety, the text must specifically reflect that relationship. For example, if Brenda Johnson and John Thompkins are going to be joint tenants in a property, the deed will state that property is being transferred “to Brenda Johnson and John Thompkins, jointly, with full rights of survivorship”. Two grantees that are going to hold the title as tenants by the entirety would have similar language outlining their ownership relationship.

It is also important to find out what phrasing is used for each ownership relationship, because while joint tenancy and tenants by the entirety share the concept of survivorship, there are a few crucial differences between them.

First, the tenancy by the entirety status is only available to married couples. So, if two lifelong, unmarried partners (like Brenda and John above) want to ensure that the surviving titleholder inherits the property, they will have to go with a joint tenancy designation.

Another difference between the two statuses is that both spouses who own a property as tenants by the entirety must be involved in subsequent property sales and title transfers, while joint tenants do not.

For example, let’s say that Luke and Jenny Gorshin own a property as tenants by the entirety. Because of that ownership designation, Jenny could not go out and sell her share in the property while Luke is
still alive and they are still married. The reason for this restriction is that both Luke and Jenny own 100% of the property, so they must both be party to and sign off on any permanent title transfers on their primary residence.

Now, let’s think back to our joint tenants—Brenda and John. Unlike Luke and Jenny, Brenda and John each own just 50% of their property. This difference in ownership structure means that John could, legally, transfer the title to his share of the property without Brenda’s knowledge or consent.

The language of the granting clause will also vary depending on the type of deed. For example, a warranty deed will express the grantor’s intention to transfer with a phrase like “grant, sell and convey with general warranty of title”, while a quitclaim deed might use the phrase “quits any and all claims to”.

Additionally, a title in fee simple transfer will have language in the granting clause that states that the property is being transferred to the grantee “and to heirs and assigns forever.” This frees the grantee to pass on the property to whomever he or she sees fit upon his or her death.

**LEGAL DESCRIPTION**

A valid deed must have a property description that will satisfy a court of law, because the boundaries of a property become very important if there is a dispute about how you use the land once you own it. As such, when looking at a deed, you will see that this section could read more like an Old English description of the property’s footprint than a virtual tour of the house. In fact, the house (and any other improvements) will not be mentioned at all. This is the case because the description is based on more permanent things—like boundaries and monuments—than the improvements to a physical piece of land.

Theoretically, you could buy the property, tear down the house, and build a new one. Nevertheless, the description of the property on your deed would still be accurate and probably even serve as a reference for the deed that is written up years from now when you decide to sell.

There are three accepted methods for describing a property on a deed:
1. Metes and bounds
2. Monuments
3. Lot and block (plat of subdivision)

Most deed descriptions will use more than one of these methods. So, even though we are going to talk about them individually, you should understand that the majority of deeds you will come across will employ at least two, if not all three, of these methods to create an accurate property description.

**METES AND BOUNDS**

Often used in New York, a metes and bounds description usually stems from a survey done by a licensed professional, and represents an exact virtual walk around the boundary lines of the property.

This type of description starts with a point of beginning (POB). This point must be readily identifiable and easily located—like the corner of a property that coincides with an intersection. The POB is where the survey begins and ends, so anyone who goes out to walk the boundaries of a property should be able to find it without much effort. If the point is hard to find, it could call the entire survey and description into question.

From the POB, the surveyor will take a clockwise stroll around the perimeter of the property, noting the distances between the various turning points (metes) and the direction from one point to the next (bounds).

Metes are usually expressed in feet, while bounds are written as compass directions, possibly with longitude and latitude citations. Since most properties are not usually exactly square or rectangular,
there will be multiple points along the property boundary where the direction changes. These points might be marked by man-made monuments or they could be known corners of the property delineated by sidewalks, fences, etc. Whatever the case, the deed description should reference these features. If the boundary lines are curvy or irregular, the description might contain an explanation of the shape of the line.

**Example** of a metes and bounds description for an irregular shaped property situated on the corner of Maple Street and Cobb Avenue:

Beginning at a point on the Northeast corner of the intersection of Maple Street and Cobb Avenue, distant 30 feet northeasterly from the intersection of Maple Street and Cobb Avenue running thence northerly, parallel with the easterly side of Maple Street 150 feet 11 inches to the center line of the block, thence easterly, 105 feet 9 inches to a stake, thence southerly, 45 feet 2 inches to a stake, thence easterly, 45 feet 2 inches to a stake next to the fence post for the adjoining lot, thence southerly, 105 feet 9 inches to the common corner of Lots number 22 and 23, thence westerly, parallel with the northerly side of Cobb Avenue 150 feet 11 inches to the BEGINNING.

Can you draw a reasonably accurate sketch of the property described above?

**MONUMENTS**

Now, this method of description might seem a little confusing at first. After all, we did talk about monuments in the above section on metes and bounds. But the differences in the two ways of describing a property are based more on the types of monuments referenced and the exactness of the distances. The monuments method is typically used for larger, more rural properties where traditional boundaries have been set by natural monuments—like boulders or unique trees—rather than more permanent, man-made ones.

Such a description might say something like:
Beginning at the west side of the road going from Ashton to Louisville, at the northeast corner of David Jones’ farm, thence southerly along David Jones’ land to three large oak trees near Jim Johnson’s property fence, thence westerly along Johnson’s place to a set of boulders near Chester Bloom’s grain silo, thence northerly along Bloom’s place to Miller Creek, thence easterly to the beginning.

As you can see, unlike the metes and bounds method, the distances between these monuments are not measured and the subtle changes in the direction of the boundary lines are not recorded. The divides are more of a vague outline of the property than an actual footprint. Because natural formations change over time—trees fall and are hauled away, boulders are moved—using this method for describing land in a deed could cause confusion further down the line.

The monuments method depends heavily on the local residents’ knowledge of the land, which is beyond the scope of the description that ends up on the deed. If this knowledge is not passed on, future deeds could require a more accurate survey to establish hard and fast boundaries.

**LOT AND BLOCK (PLAT OF SUBDIVISION)**

Lot and block is the newest of the three methods of property description. It came to be used more frequently in the 19th century, when farms were being increasingly overtaken by cities. Then, of course, the lot and block method experienced another boom in the 1940s and 1950s when suburban development really took off. The idea behind a lot and block is that a developer buys a huge piece of land. This tract of land is then surveyed—most likely using the metes and bounds method of survey and description.

Once the developer has this survey, he or she then breaks the land down into a subdivision of lots that will be sold to buyers. Each of these lots is then individually surveyed (once again, probably using the metes and bounds method). After the lot surveys are completed, a plat map is created that outlines the individual lot boundaries within the larger tract of land, and differentiates those lots with numbers.
or letters. Then the appropriate government office records this map, and everything becomes official. Take a look at the following sample plat map.

Once the plat map is recorded, the developer can simply reference it when describing a particular lot in a deed or other official document. A lot and block deed description should include the:

- Number or letter for the individual lot
- Number or letter for the block in which the lot is located (if applicable)
- Name of the subdivision or phase
- Information for finding the map, such as the book and page numbers; and
- Physical location of the map, such as the County Clerk’s Office

So, a typical lot and block description might look like this: Lot 22 of Block 15 of the Bullock Homes Subdivision plat as recorded in Map Book 53, Page 47 at the County Clerk’s office. Armed with this description, you could easily go down to the County Clerk’s office and look up the lot.

**ACCESSION RIGHTS**

If you, as a landowner, buy a property that has a border on a body of water, you have accession rights. This means that when sand, silt and other sediment washes ashore and builds up, your property boundary expands and you own that new land no matter how much or how little the expansion. This process is referred to as **accretion**, and the land created by it is **alluvion**.

Likewise, if the water level recedes, exposing more land, your property boundary expands and you own the newly uncovered shore. This process is called **reliction**.

Sometimes, things can go the other way and **erosion** occurs. While erosion has given us some great wonders, like the Grand Canyon, for a landowner it can be mildly frustrating. If water from a stream or river adjoining your property erodes the shore and washes away your land, your property boundary shrinks and you lose that land. This process is called **avulsion**.
While accession rights might not mean all that much in Manhattan, they will help in rural areas where people might meander out to fish a stream without knowing whose land they are treading on.

**HABENDUM CLAUSE**
This is the safety net in a title in a fee simple transfer. It must agree with the granting clause, confirming the grantor’s intention to turn over absolute ownership to the grantee. The clause usually goes something like this: "To have and to hold the property herein granted to the party of the second part, (his or her) heirs, successors and assigns, forever." In New York, not having this clause in the deed means the title will be unmarketable, because the legality of any transfer is uncertain.

For example, a grantor could transfer a title to a grantee as a life estate, which means that the grantee has unlimited rights to the property while he or she is alive. However, when the grantee dies, he or she would not be able to pass the property on to heirs. Ownership would revert back to the grantor. Such a limit on the grantee’s rights would be included in the habendum clause.

**LIMITATIONS, EXEMPTIONS, AND RESERVATIONS (“SUBJECT TO” CLAUSE)**
Restrictions (usually called restrictive covenants) are most commonly used in subdivisions, where the developer can dictate everything from the size of your home to how you trim the trees. These types of restrictions keep the subdivision as uniform and marketable as possible, while also, hopefully, providing a nice living environment for the residents. Restrictions on deeds for subdivision lots could also include rules about:

- How many homes can be built on the property
- What material you can use to build a fence (if they are allowed, at all)
- How far off the road a home must be built (usually called “set backs”)
- How you must store a broken down vehicle
- Whether you can have a home-based business

But restrictions are not just confined to subdivisions. Be sure to look at the previous deeds for the land you are buying, because any previous restriction cannot be removed once it is on a deed for that property. The only ones that can be removed are illegal ones. A restriction that violates fair housing laws would be an example of a restriction that would be removed.

Another thing to look for in a deed is if the grantor has kept or is granting any easements on the property. These could be for mineral rights, power line access, or just general usage. For example, a farmer might sell his house and property, but keep an easement for growing crops.

Or, a subdivision developer might offer an easement in the lot deed giving the grantee the right to use a park or recreation area in the neighborhood. Such an easement is called a dedication. When the developer transfers property to a municipality, in writing, it is called a dedication by deed.

Make sure you know what easements a grantor is reserving on the property you are marketing before you get too far into the purchase process. It could make for some uncomfortable situations down the road.

**SIGNATURE OF GRANTOR**
A valid deed must be signed by the grantor before delivery to the grantee. Typically, the grantee does not have to sign the document. The only time a grantee’s signature would be required is if that person is assuming the grantor’s mortgage on the property. If there are multiple grantors, they all must sign the deed to make the transfer legal. In New York, it is also legal to have an attorney-in-fact (a person who has been given power of attorney) sign for the grantor. This is only legal as long as the grantor is still alive, though, because the designation of power of attorney ends with the grantor’s death. So, to ensure that the grantor is still living and breathing, a confirmation phone call might be placed during the closing session. In addition, the attorney-in-fact’s power to represent the grantor will probably have to be filed in the same county as the location of the property.
ACKNOWLEDGEMENT AND RECORDING
When a grantor (or his or her attorney-in-fact) signs a deed, he or she must state that the act is voluntarily in front of a notary public, judge, justice of the peace, or other such legal officer. Additionally, that officer must verify the grantor’s identity. Together, this declaration and verification of identity are called an acknowledgement.

Keep in mind that just because a deed is notarized does not mean that it is necessarily legal. A notary’s signature and stamp means that the official has witnessed the grantor signing the deed and/or that the grantor has testified to the honesty of the contents of the document.

While an acknowledgement might sound like a standard procedure, it is not actually necessary to make the deed valid. A deed can be perfectly legal without an acknowledgement, but, in New York, a fully executed deed without an acknowledgement cannot be recorded in the public records. And, if the deed is not recorded, the grantee’s title to the property is not fully protected. If a grantee has an unrecorded deed, then, theoretically, a grantor could sell that property again to another grantee. Then, if that second grantee gets an acknowledgment on his or her deed and records it with the appropriate government office, he or she could claim the property right out from under the first grantee.

As a general rule, recording is essential in a mortgage transaction. For example, an unrecorded mortgage lien could result in a loan balance going unpaid. To illustrate this, we should take a look at the case of Leonard and Josephine and their son Eddie. Eddie decided to buy a house when he relocated after college, even though he had a substantial amount of student loan debt. His parents, Leonard and Josephine, agreed that buying a house was a good investment for Eddie.

However, Leonard and Josephine were worried about him going further into debt so early in life—especially given that he had to live so far away from them. So, they loaned him the money to buy the house from their own funds. Since this was a loan between family members, Leonard and Josephine elected not to have Eddie record the mortgage lien or sign any sort of agreement, after all, he was their son. Eddie was a good borrower for quite a few years, and his relationship with Leonard and Josephine was as strong and happy as ever. But then he met and married Lorraine—someone that neither Leonard nor Josephine was very fond of. After that, Eddie’s relationship with his parents became strained to the point that they stopped speaking. Then, the mortgage payments stopped coming. Finally, a year or so later, Eddie and Lorraine sold the house and moved to another city without telling Leonard and Josephine.

Since they had never required Eddie to record the mortgage lien they rightfully had on the house property, Leonard and Josephine will probably never see Eddie pay off that loan. If the lien had been recorded, then Eddie would have been compelled to settle up with Leonard and Josephine when he sold the property. Always be sure that the deed is recorded—even if you are dealing with a family member.

Once the deed is recorded, the actual document is really not terribly important. Most people keep it in a safe place. However, if it is lost it can be replaced as long as it is recorded in the public records.

DELIVERY AND ACCEPTANCE OF THE DEED
The delivery of the deed and the grantee’s acceptance is where the magic happens in the process. Once this is done, the title has been completely transferred and the property officially changes hands.

In olden times, the property literally “changed hands”. The grantor and grantee would go out to the property, and inspect the boundaries together. Then the grantor would grab a handful of earth and give it to the grantee to signify the delivery and acceptance of the property.

However, these days, a grantor delivers a deed document instead of a fistful of dirt. The grantor can deliver the deed directly to the grantee or to someone representing the grantee, such as a real estate agent, attorney, or title company. This keeps the conference tables shiny and the three-piece suits
clean. In metropolitan New York, the deed will usually be mailed along with the closing documents several weeks after the closing session. Usually, a grantee’s acceptance of the deed is a foregone conclusion. After all, if the grantee has gone all the way through the process, he or she probably will readily accept the title upon delivery. Nevertheless, the grantee’s acceptance of the deed is confirmed when the deed is recorded.

**FORMS OF DEEDS**

As a real estate agent, you could come into contact with every form of deed known to mankind. But the chances of that happening are pretty slim. In New York, the most commonly used types of deeds are:

- Full covenant and warranty deed
- Bargain and sale deed (with or without covenants)
- Quitclaim deed
- Executor’s deed
- Judicial deed

These deeds vary based on two elements: protection and context. The type of deed used for a transaction will depend on how much title protection the grantor is offering the grantee and the circumstances of the transfer.

While all of the deed types listed above are designed to transfer a property title, they all do it with varying degrees of title protection (the first three) or under circumstances other than a regular sale and transfer (the last two).

**FULL COVENANT AND WARRANTY DEED**

The terms “covenant” and “warranty” are important for grantees because they guarantee the soundness of the title that the grantor is handing over. The fewer covenants and warranties you have in a deed, the less protected the title will be from possible claims in the future. A full covenant and warranty deed (or general warranty deed) is the “gold standard” of deeds, because it offers the grantee every possible assurance that the grantor is transferring a title that is free and clear of encumbrances.

While deed covenants are important, a buyer should never depend on them in place of a title search and title insurance. The buyer’s attorney should always order a title search and make sure he or she is protected by title insurance. A typical full covenant and warranty deed includes six basic covenants—three that are called “present covenants” and three known as “future covenants”.

**PRESENT COVENANTS**

In a full covenant and warranty deed, the present covenants provide the grantee with guarantees from the grantor about the current state of the title. The three present covenants in a full covenant and warranty deed are:

**Covenant of seisin**

The word “seisin” comes from an Old French term meaning “possession”. Easy enough, right? So, as you might guess, the covenant of seisin is a guarantee from the grantor that he or she legally possesses the title to the property covered by the deed. The clause for this covenant will, most likely, say something to the effect that the grantor promises that he or she is “seised of said premises in fee” if they hold the title in fee simple.

**Covenant of right to convey**

Some sources will combine the covenant of the right to convey with that of seisin because they are typically mentioned in the same sentence on the deed. So, if we are looking at a sentence containing these two covenants, then it might read something like this: “Grantor covenants that he (or she) is seised of the property in fee and has the right to convey the same in fee simple.” The covenant of right
to convey simply promises that the grantor not only owns the property (seisin), but also has the legal
right to convey (or transfer) it to the grantee.

**Covenant against encumbrances**
This covenant assures the grantee that there are no problems with or claims on the title. The deed will
most likely state that the property is “free from encumbrances” to satisfy this covenant. Sometimes,
the grantor and grantee will agree to some encumbrances on the title, like the grantee taking over the
grantor’s mortgage. Easements and restrictions also fall into the category of encumbrances that are
acceptable in spite of this covenant. If there are any exceptions, a phrase like “except for the above
stated” or something similar will appear in the deed to cover them.

**Future covenants**
Some people say that the future covenants are a little more important in the scheme of things than
their present counterparts, because they are like a “trail of legal breadcrumbs”. Future covenants
represent an ongoing commitment from the grantor to both the current and future grantees that their
title ownership will never come under fire because of a mistake or malicious act by the grantor.

In a typical full covenant and warranty deed, the three future covenants are:

**Covenant of quiet enjoyment**
This covenant has absolutely **nothing** to do with how loud you play the stereo, and **everything** to do
with protecting your ownership of the title. This covenant is a guarantee from the grantor that the
grantee will not be bothered by a third party claiming ownership of the property because of a defect in
the title that is passed on by the grantor. In the deed document, it will usually state that the grantee
“and his (or her) heirs and assigns will quietly and peacefully have, hold, and possess the property”—or
something similar.

**Covenant for further assurances**
This covenant requires the grantor to do everything in his or her power to correct any problems with
the title or the deed. Of course, these corrections must be reasonable. They cannot be things that are
beyond the grantor’s control. Also, if the grantor does violate this covenant, the grantee can usually
only sue to make the grantor perform the specific action to clear up the title problem. The deed will
acknowledge this covenant by stating that the grantor will “execute such reasonable and necessary
assurances to perfect the title.” If not in those exact words, it will be something close.

**Covenant of warranty**
Among all of the present and future covenants, this one is the most important. The covenant of
warranty is usually stated in the deed as a guarantee that the grantor will “warrant and defend the title
for the grantee against the lawful claims of all persons”. This warranty is the best protection a grantee
can hope for because it means that the grantor will be responsible for and help out with any third party
claims to the ownership of the title—no matter who that third party might be.

**Lien covenant**
Based on Section 13 of the New York Lien Law, the lien covenant is an assurance from the grantor that
there will be no outstanding liens on the title when the grantee actually receives it. The grantor is
promising to pay off his or her mortgage balance with the money from the grantee (the consideration)
to ensure a clear title is transferred to the grantee. Also, should any lien arise on the title, the grantor
would be responsible for taking care of it for the grantee.

**BARGAIN AND SALE DEED (WITH AND WITHOUT COVENANTS)**
Depending on where you do business, you might see a bargain and sale deed quite often. While this
type of deed contains the conveyance and consideration clauses we have talked about, it may or may
not contain covenants. A bargain and sale deed implies that the grantor’s title to the property is good
and that he or she has the legal right to convey that property to the grantee.
When a bargain and sale deed does contain a covenant, it is usually one that guarantees that the grantor has not done anything to “encumber the property”, besides anything already listed in the deed. However, this covenant does not cover any past encumbrances or protect the grantee against any future claims. Nevertheless, a bargain and sale deed with covenants is often used in New York because it satisfies a lender’s requirements for funding the loan—especially when you factor in title insurance. Without this covenant, a bargain and sale deed does not provide much protection to the grantee’s title ownership, and many lenders will not fund the loan for such a purchase. If a problem with the title did arise, the grantee would have no real legal recourse. The deed would not support it.

QUITCLAIM DEED
Simply a release form—or a deed of release. By signing this deed, the grantor waives any right to or claim of ownership that he or she might have for the property. And…that’s it.

The quitclaim deed is usually used in instances where the grantee just needs to clear up any blemishes on or potential problems with the title. This is referred to as “clearing a cloud on title”. Relatives will use it to transfer a title within the family. A quitclaim deed might be used to wipe away claims on a title stemming from a divorce or a lien issue. As we said earlier, a quitclaim deed might also be used for a dedication by deed, in which a developer transfers land to a municipality in writing.

In an adverse possession matter, a quitclaim deed from either side would end the dispute, because it would be an acknowledgement from one party that the other party owns the section of property in question. So, for example, if the original owner decides to let go of some land that is not really useful to him or her, that owner could use a quitclaim deed to relinquish that property to the adverse possessor neighbor who has found more use for it. This would not only keep the neighbors friendly, but it would also avoid a costly court action down the line.

JUDICIAL DEEDS
In some situations, transferring property using a deed is necessary to satisfy a court ruling. Such documents are collectively known, for obvious reasons, as “judicial deeds”. Individually, though, the deeds are named for their respective grantors or (in one case) the purpose of the document. Judicial deeds include:

- Guardian’s Deed
- Sheriff’s Deed
- Referee’s Deed
- Executor’s (or Executrix’s) Deed
- Administrator’s (or Administratrix’s) Deed
- Tax Deed

While some locales might have a special document for one or all of these purposes, usually a basic quitclaim deed or bargain and sale deed without covenants will be used.

GUARDIAN’S DEED
Sometimes called a conservator’s deed, this document is used by a court-appointed guardian of a minor or an incompetent person to transfer the title to that person’s real property. In this situation, the guardian would sign the deed in place of the minor or mentally incapable person. If you recall, a minor or mentally incapable person cannot serve as grantor in a title transfer. The only exception to this is if the minor is married and mentally competent.

Minors and mentally incapable persons can be grantees in title transfers. So, it is perfectly legal for an eligible adult grantor to transfer a real property title to such a grantee. In that case, no guardian’s deed would be necessary.

SHERIFF’S DEED
In some places, a sheriff’s deed is necessary to transfer the title to a property that sold through a sheriff’s sale or auction or because of a court decision against the owner of the property. The sheriff’s
deed can be used in sales based on foreclosure or tax debt—which would make it much the same as a referee’s deed or tax deed, in those cases.

In New York, there is no right to redemption (a time after the foreclosure when the owner can pay the outstanding balance and reclaim his house). Once the foreclosure sale is done, it is done. However, New York City has one of the longest pre-foreclosure sale grace periods in the nation—445 days. This means that the original owner has 445 days before the property goes to auction to pay off the debt that is causing the forced sale. The rest of New York State has a pre-foreclosure grace period of 335 days.

**REFEREE’S DEED**

When a property is sold as a foreclosure, a court-appointed person called a referee oversees the sale. Much like an executor, the referee will sign the deed as the grantor, transferring the title to the grantee buyer. This is the referee’s deed. Unlike the deed in a conventional title transfer, the referee’s deed must list the full dollar amount of the consideration paid for the property so it can be a matter of public record.

**EXECUTOR’S AND ADMINISTRATOR’S DEEDS**

Both executor’s and administrator’s deeds are for conveying the title for a deceased person’s (or decedent’s) property to the designated heirs. Of course, this means that the executor or administrator will sign the deed as grantor in the decedent’s place. The main difference between an executor and an administrator is that:

- The executor handles the estate affairs of a decedent who left behind a will; and
- The administrator distributes the property for a decedent who did not leave a will.

Like the referee’s deed, the executor’s and administrator’s deeds must include the full dollar value of the property. We will discuss an executor’s deed in more detail a little later in the “Conveyance After Death” section.

**TAX DEED**

When a homeowner does not pay real estate taxes, a government agency may take the title on the property to cover those back taxes. When the property goes to auction, the eventual buyer will receive a tax deed conveying the title to him or her. Such an auction would start out at a bid that would cover the delinquent tax bill (plus interest), as well as any costs associated with selling the property. Usually, bids would then escalate in $10 to $100 increments until the property is sold.

Let’s say you buy a house at a tax auction and receive the title through a tax deed. Later, when you want to sell the property and, of course, transfer the title again, you would only be safe using a quitclaim deed to do so. This restriction is not by law, but by common sense. The tax deed that you receive on the property will, more than likely, be a quitclaim deed—meaning that there will be no covenants or warranties attached. Furthermore, this could make it tough for you to get title insurance on your new purchase. Offering the next buyer any sort of warranty or covenant about the condition of the title would leave you open to huge legal and financial problems if there is a cloud on the title you do not know about.

**PUBLIC GRANT**

When the state or federal government gives real property to an individual or a private company, it is called a public grant. The document recording this grant is called a land patent. Public grants were common in our country’s early days, when much of the land had yet to be settled.

**CONVEYANCE AFTER DEATH**

Conveying a property’s title after the death of its owner is an unfortunate duty for any family. Nevertheless, it must be done so that the property goes through the proper channels to end up with a new owner or to be distributed to the deceased person’s designated heirs. When a property owner dies, his or her estate may be in one of two basic title transfer situations:
1. **Intestate**—an estate without a valid will
2. **Testate**—an estate with a will

In either case, a deed will be necessary to transfer the title legally. Let’s take a look at these situations a little more closely.

**INTESTATE**

If a property owner dies without leaving behind a last will and testament for guidance, he or she dies **intestate**. When an heir receives land from a family member who dies intestate, it is called receiving **title by descent**.

If a deceased person’s (or decedent’s) assets are valued at more than $30,000, a court will appoint an administrator who will be responsible for paying off his or her debts and the appropriate taxes. Then the administrator will distribute the decedent’s remaining assets to any eligible heirs in a process called intestate succession. The law even differentiates between the genders—with a female being designated as administratrix. In this section, we’re going to use the term “administrator” to stand for both genders.

If all of the eligible heirs give their consent to the court, the administrator could be someone outside of the family. Usually, though, the administrator in an intestacy situation comes from within the decedent’s family, and it is typically the person who is set to receive the largest share of the decedent’s assets. If the heirs decide to keep the administrator position in the family, the right of succession looks like this:

- Living spouse
- Children
- Grandchildren
- Decedent’s parents
- Decedent’s siblings

So, if there is no surviving spouse, then the child (or one of the children) will be eligible, as long as they satisfy the requirements. If not, it goes on down the list. Obviously, this is not an exhaustive list. Beyond the decedent’s siblings are increasingly more distant family members. Once the eligible family member is chosen, he or she must file an administration petition with the surrogate court in the same county where the decedent lived. Then, if the court finds that everything is in order, it will issue letters of administration.

These documents will give the family member the title of administrator and the authority to handle the estate’s affairs. One of the administrator’s responsibilities will be to take care of any issues regarding the title to the decedent’s property if the situation calls for it.

As we discussed earlier, if the decedent and his or her spouse were listed as tenants in the entirety, then the ownership of the house will automatically go to the surviving spouse. On the other hand, if the house was only in the decedent’s name, then the administrator will have to ensure that the correct percentages of the property are distributed amongst the rightful heirs under New York law.

Yes, we used the word “percentages” in that last sentence. The laws in New York about intestacy are widely considered to be some of the most complicated in the nation. As such, intestate succession will be a pretty tough job for an administrator. Under New York law, the structure for distributing the decedent’s remaining assets depends on the situation. Here is a list of possible scenarios and how the heirs would receive title by descent:

- If there is a surviving spouse and a surviving child or children, the spouse gets $50,000 plus half of the remaining assets, while the child (or children) will receive (or split) the other half.
- If there is a surviving spouse and no children, then everything goes to the spouse.
- If there is a surviving child or children, but no spouse, then everything goes to the child or is divided among the children (see the executor’s deed section above for an example).
If there is no spouse and there are no children, then everything goes to the decedent's parents.
If the decedent has no spouse, children or parents, everything will go to a sibling or will be divided among the decedent’s siblings.

While the majority of this list looks pretty standard, the first entry could cause some problems—especially with a property title. Of course, if the decedent and his or her spouse hold the title to the property as tenants by the entirety, then the property will go to the spouse. However, if the title was only in the decedent’s name, and there is a surviving spouse, as well as a child (or children) to consider, then the intestate succession process could become a little more complex. For example, let’s say a man named Jim passes away intestate. He is survived by his wife Joan and his two grown children—Jeff and Judy.

Jim leaves behind some assets, including a house that he bought before he and Joan were married. The title to the property is solely in Jim’s name, meaning Joan does not receive the automatic ownership allowed by a “tenants by the entirety” designation. So, Joan petitions and becomes the administrator, since she will receive the largest share of Jim’s remaining assets. After she pays off the last of Jim’s debts and the funeral expenses, there are assets totaling $200,000. In addition to this, Jim’s house—where Joan still lives—is also worth $200,000.

Under New York law, Joan would get $50,000, plus half of the remaining assets beyond that, while Jeff and Judy would split the other half.

That means that the three of them could, possibly, each receive deeds for a share of the property—deeds that Joan, as administrator would sign off on as grantor. Like the executor’s deed we discussed previously, these will be basic bargain and sale deeds with covenants. In this particular case, Joan would have a 50% share in the property, while Jeff and Judy would each have a 25% share. They would all own the house as tenants-in-common.

Now, as long as they have a good relationship, Joan will probably go on living in the house. However, if their relationship is not so good, there could be problems around the bend. Jeff or Judy could force a sale of the property if they wanted to go through the legal wrangling necessary to do it.

Examples like these show the importance of creating a life estate. You will find an in-depth explanation of life estates in the “Estates and Interests” chapter.

**ESCHEATMENT**

Now, you might be asking, “What happens if a decedent dies and intestate and there are no heirs to claim his or her assets?” If you will recall, in such an unfortunate situation, who takes control of (or escheats) the property depends on the state where it is located. Of course, we are not just talking about real property here. The state can escheat personal property, as well. Abandoned bank accounts, insurance policies, payroll checks, and the like could all be fair game—depending on the state.

For example, in New York, the escheat law for real property is more of a custodial law. This means that, if the state is still in the process of trying to escheat the property, a potential heir could turn up and file a petition of his or her own to release the land from the state’s grasp. The state law actually allows up to forty years for this to happen. Being the long lost heir in this situation is not easy, though. The heir’s petition must be approved by the office of general services before it can be filed to release the escheated land. Even if the petition is filed, the land may or may not be released, depending on the state’s case in its action.

Frankly, most people who are not around when the decedent passes are probably not going to have the desire to go head-to-head with the state over the escheated property. If the state escheats the land, then the case is closed forever. In New York, a successful escheating action is a judgment “for the people” and against any defendants—both known and unknown.
TESTATE
When a person dies testate, it means that he or she has left behind a valid will. In fact, when a man makes a will, the law designates him as a **testator**, while a woman making a will is known as a **testatrix**. Of course, in this section, when we refer to the testator, we will be talking about both genders.

Most people would say that since the testator left a will behind, everything should be pretty open-and-shut. And, for the most part, it usually is. Nevertheless, the executor and the heirs must still go through the probate process. For the most part, the probate process looks like the one for administrating an intestate estate. The will’s executor (or executrix) serves the same function as the administrator. The assets are gathered and appraised. Debts and taxes are paid, and then the remaining assets are divided among the designated heirs.

However, for a testate estate, there is one more key step—proving the will is valid. This is done via the probate process, which, in New York, means filing the will and any other accompanying documents with the Surrogate’s Court. The court will hear the case, and look over the will to see that everything is in order.

Under New York law, a will is considered valid if the following conditions are met:
The testator is at least 18 years of age and competent (“of sound mind”).
The will is in writing using formal procedures.
The only exceptions to this rule are nuncupative and holographic wills—both of which are only allowed for armed service members serving in a conflict, anyone who accompanies them, and, as the law puts it, “mariners while at sea”. A nuncupative will is an unwritten testament that is valid as long as the testator has two witnesses. A holographic will is a testament written in the testator’s own handwriting, also with two witnesses, but without all of the pomp and circumstance of the formal procedures.

The will is signed at the end by the testator (or his or her representative).

**There must be (at least) two competent, available witnesses to the testator’s (or representative’s) signature.** The act of a witnessing a testator sign the will is called **attestation**. For witnesses to a will, the attestation can take place at the same exact session or within a 30-day period. In fact, the witnesses do not necessarily have to see the testator sign the will. The testator just has to verbally declare that the document represents his or her will and acknowledge that the signature indeed belongs to the testator (or the testator’s representative). As far as the character of a witness goes, he or she should be competent and available in case the court needs testimony as to the validity of the will. The two witnesses must be people who are **not** also listed in the will as beneficiaries. While a beneficiary can do double duty as a witness, the validity of the will must not hinge on his or her testimony, alone. If that turns out to be the situation, the beneficiary could lose whatever the testator willed to him or her.

Any changes in the will must be done through amendments called **codicils**, which are supplemental clauses that might add a new request or change one that is already in the will. These codicils must go through the same procedures outlined above to be added to the will.

The probate process can take a month or it can take three months, depending on whether there are family members who do not like what they do (or do not) receive in the will. There could be challenges that will stall the process even longer. Once the will is validated by the court, though, the executor can begin handling the testator’s affairs, like paying debts, taxes, etc.

EXECUTOR’S DEED
In many testate situations, the decedent will leave real property for a relative or other heir. In this instance, the real property is called a **devise**, and the recipient who inherits the property is called the **devisee**.
The devisee can choose whether he or she wants to sell the property or to move in and take the title. Whatever the case, the executor will use an executor’s deed, which is a bargain and sale deed with covenants that is used to convey the property of a deceased person. If the devisee decides to keep the property, the executor will draft a deed. He or she will then represent the deceased person by signing the deed as grantor, with the devisee listed as grantee. Once this done, the title will officially transfer to the devisee.

CROSSING OVER
A testator’s final wishes regarding real property can become a little more complicated when he or she either does not keep the will in sync with business affairs or leaves behind unfinished business. Luckily, the New York law provides for some of these situations, and the best way to tell you about them is through some examples.

Example 1:
Sixteen years ago, when Maurice made out his will, he decided to leave his house to his nephew Alan. But three months ago, Maurice decided that the house was too much for him and put it on the market. One month ago, Maurice found a buyer and was in the process of conveying the title when he died unexpectedly. Since Maurice didn’t change his will to reflect his pending sale, where does that leave Alan? Is the clause willing him the house revoked?

Because Maurice willed the property to Alan before he entered into this agreement with the buyer to convey the title, Alan can still claim his inheritance (sort of). No, Alan will not get the house, but he will inherit the rights under the agreement to convey the title that Maurice had before his untimely death.

Example 2:
Janine owned a large house in a neighborhood full of friends. Eight years ago, she created a will which stated that she would leave the house to her son Gary upon her death. Then, three years ago, Janine decided to partner with a young couple in a bed and breakfast venture. Since the house was a little more than she wanted to take care of, she saw the business venture as an opportunity to bring in some money in her retirement.

Janine moved into an apartment and let the young couple move into her house to run the business. She let them buy a 50% ownership stake in the house. Although she kept saying she wanted to alter her will to reflect this change, Janine never got around to it. So, since Gary was supposed to get the house, what happens now?

Under New York law, Gary is entitled to Janine’s 50% ownership share in the home, but not the rest. If Janine had just sold the house to the young couple, the clause in her will leaving the property to Gary would have been revoked entirely.

Example 3:
Seven years ago, when creating his will, Wyatt wrote a clause in the document bequeathing his farmhouse to his grandson Chet. Around the same time, Wyatt appointed his sister Bertha as a possible guardian or conservator in case he would become unable to handle his own affairs.

Unfortunately, a few years later, Wyatt was diagnosed with Alzheimer’s disease. As he slipped further and further away, Bertha felt it would be better to sell his farmhouse and move Wyatt into an assisted living community. In juggling her own life and her brother’s care, Bertha forgot to alter Wyatt’s will to reflect the farmhouse sale. All of the proceeds from the sale went into a bank account to cover Wyatt’s assisted living care. After one year, Wyatt died. Do all of these unfortunate circumstances void the clause in Wyatt’s will about Chet inheriting the farmhouse?

Under New York law, Chet cannot inherit the property, itself. However, he will receive the remaining money from the bank account that held the proceeds from the sale—minus the money that has already been spent on Wyatt’s end-of-life care.
ADVERSE POSSESSION
Most of us know the concept of adverse possession by its more common name—“squatter’s rights”. The basic scenario goes like this: If someone (called an adverse possessor) uses your property as if it was their own, consistently, for everyone in the neighborhood to see (including you), for a period of 10 years, then they would be entitled to whatever part of your property they have been using as their own. Now, admittedly, this is an oversimplified version of the New York code. But at its core, this is what the law amounts to.

In order to have a valid title claim under adverse possession, a potential possessor must:

**Occupy or use the property under a claim of right.**
The adverse possessor must have a belief that he or she has a right to the title on the property. This might be based on a faulty deed or on traditional property lines and usage. The only instance where a claim of right is not necessary is if the true owner of the property cannot be proven through the county clerk’s records for the period of time the adverse possessor occupies the land.

**Occupy or use the property in an open, but hostile way.**
Another key element to an adverse possession claim is that the possessor must use the land in a way that everyone can see—including the true owner of the property.

Sneaking on to a neighbor’s land and logging timber in the dead of night is not an action of adverse possession. It’s stealing. But building a hot tub that stretches a few feet over the property line could lead to an adverse possession claim. The idea behind this requirement is that the possessor must give the true owner a chance to either say, “Hey, you’re encroaching on my land. Back it up,” or to give the adverse possessor permission to use the property. If you, as an owner, notice that a neighbor has encroached on your property with a structure of some sort, you do not necessarily have to sue that person or make them remove the structure. Let’s face it, sometimes removing the structure is more trouble than it is worth. What you would do in that situation is acknowledge to the neighbor that you know of the encroachment and have him or her sign a document saying that you gave permission for the structure to stray over the property line. This document would, most likely, negate the hostile occupation requirement necessary for a successful adverse possession claim.

**Occupy or use the property in an actual way.**
When an adverse possessor occupies or uses the property in an actual way, it means that he or she somehow encloses it. Previous versions of the New York law allowed adverse possessors to do this by erecting a fence or planting shrubbery on an owner’s land. At one time, a potential adverse possessor could even maintain a part of the lawn that actually belonged to the owner and use that as grounds to make an adverse possession claim.

Now, the law explicitly excludes “fences, hedges, shrubbery, plantings, sheds and non-structural walls” as methods for an adverse possessor to occupy a property in an actual way. To satisfy the actual occupation requirement, the New York law says that the property must be in a “substantial enclosure.” This could possibly mean a home addition or other significant add-on to the adverse possessor’s house, such as a deck, pool, or hot tub.

**Occupy or use the property continuously.**
In order to make an adverse possession claim of any kind, the possessor must use or occupy the property (according to the requirements) continuously for at least 10 years.

Let’s say an adverse possessor builds an above ground pool complete with a deck enclosure that veers over the property line into the neighbor’s yard. The possessor has the structure for five years, but does not really take care of it. The pool springs multiple leaks and the deck falls apart. So, the possessor decides to take the whole thing down and think about putting up something else later. The owner’s land is free of encroachments for two years. If the possessor puts up another pool/deck structure that
crosses the property line again, the clock on the 10-year requirement for adverse possession starts all over again.

The only way an adverse possessor can make a successful claim on a title without putting in 10 years is through a method called “tacking”. Let’s go back to that pool example. Let’s say that the adverse possessor who installed the structure is named Rick. The owner whose land Rick is encroaching upon is named Tom. After Rick builds that second pool and deck structure, it stays up, partly on Tom’s land, for seven years. Then Rick sells his property to Helen, who loves the pool and deck and keeps it meticulous.

If Tom has not said anything about the situation the whole time, Helen could possibly accomplish adversely possessing the encroached part of Tom’s property after only three years in the house. Why? Because she can tack Rick’s seven years of adverse possession onto her three years to get to the magic ten.

**Occupy or use the property exclusively.**
The adverse possessor must be the only one to use or occupy the property. No other owners or the original owner can use or occupy that land while the possessor is on it.

In the example above, let’s say that Tom (the owner) had taken it upon himself to repair and maintain the side of Rick’s (the possessor’s) pool/deck structure that encroached on his property. The dilapidated condition just bothered him. The very fact that Tom did something regularly to repair and maintain Rick’s pool could be viewed as Tom using the property, which voids the exclusivity requirement.

If the adverse possessor satisfies all of the above requirements, the claim would still not be automatically granted. He or she would have to obtain a court action to quiet title. So, maybe possession is nine-tenths of the law, as long as you are willing to pay the possibly tens of thousands of dollars in legal fees it would take to prove an adverse possession claim.

“What is the purpose of such a law?” The theory behind the law is that it protects the current titleholder from previous titleholders coming back to lay claim to a property. For example, let’s say that you have lived in a house for five years. Then, one day, a titleholder from fifteen years ago shows up, deed-in-hand, saying that she is the rightful owner of the property.

Theoretically, you could use the adverse possession law to stave off her claim. After all, if you are an adverse possessor, then so is everyone else who has lived in the house for the last fifteen years. This means that you could tack those other previous possessors’ time in the home onto your own to create a 15-year adverse possession timeline. Additionally, you have satisfied all of the other requirements of the adverse possession law. You believed that you had a right to claim the property, as did the previous owners. You have occupied and used the property exclusively, continuously, and actually in an open fashion that was well-known to your neighbors. So, legally, you could claim an adverse possession to squash this long lost titleholder’s complaint. Some title insurance companies will not ensure a title with an encroachment on it that could result in an adverse possession. Buyers need to be sure to watch the surveys to see if any of their new neighbors might be creeping over the property boundary. It could save you a lot of money and headaches in the long run.
CHAPTER 12 CO OPERATIVES AND CONDOMINIUMS

KEY TERMS

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When talking about condominiums and cooperatives, potential buyers often ask, “What’s the difference?” It’s a great question that you, as an agent, should be ready to answer in detail, because, as we’ll see, buying into these types of communities can confuse and intimidate even the most seasoned buyer. On the surface, both condos and co-ops represent apartment-style living with ownership benefits. However, each form of property also comes with the potential for hidden heartaches for buyers who aren’t educated about how the responsibilities of communal living magnify with ownership.

CONDOMINIUMS

When we think of condominiums (or condos), we usually think of living space, however, “condominium” can also refer to a collection of offices, retail spaces, etc. A condo is a building or collection of buildings that consist of multiple units, which are owned by the occupants, as well as common areas, for which occupants share ownership. Condominiums are usually newly constructed.

COMMON ELEMENTS AND COMMON INTEREST

Even though the form of ownership of a home or a condominium is the same, fee simple, there are major differences. In your home, you could landscape, paint the garage doors, or even put a pig statue in the front yard, if you so choose. Sure, your neighbors might not like it, but it’s your decision.

Quite different with a condo. Any space outside your individual unit is considered a common element. In an apartment building-style condo community, the lobby, elevator, roof, workout room, and other such areas are examples of common elements. If your condo is situated in a community of freestanding homes, the common areas could include your yard and driveway, as well as any clubhouse or other such building.

While your condo unit is your own, the common elements are shared by everyone in the community and are subject to the by-laws. You cannot make any alterations that are not approved. The percentage that you are responsible for is called “common interest”, and it’s usually figured one of two ways:

1. The square footage of your individual unit is divided by the total square footage of the condo building; or
2. The price of your individual unit is divided by the total price of all the units combined.

Your common interest will determine how much you pay in maintenance and operating fees and real estate taxes. In most condo communities your unit entitles you to one vote as compared to a co-op where you vote the number of shares attached to your unit.

CREATING A CONDO COMMUNITY

The Condominium Act (or Article 9B) of the New York real property law outlines all of the provisions for creating and administering a condo community. Under this article, a community is legally created when an owner or developer writes and signs a declaration, which includes the following information:

A statement designating the property as a condominium, meaning that it will comply with the provisions of the law;

✓ A description of the land
A physical description of the building (or buildings), including information such as:
- Location
- How many units and stories (including basements and cellars) the structure will have
- What materials were or will be used to build it
- Identification information for each unit, including:
  - Where the unit is located;
  - Its approximate size;
  - The number of rooms in each unit;
  - Which common areas are immediately accessible from the unit; and
  - Any other necessary identification information.
- A description of the common areas of the condo community, and each unit owner’s common interest.
- A statement about how the building and each unit will be used;
- A statement allowing the secretary of state to act as an agent of the corporation or board of managers who owns the condo. This allows the secretary of state to receive documentation about any legal proceedings against the Condo Corporation or board and send copies of the documents to an address specified by that corporation or board.
- Any other relevant details or information; and
- How the declaration can legally be changed.

THE ROLE OF THE SPONSOR
The owner or developer of a condo community is called a sponsor. The sponsor must:
- Do CPS1 market research;
- File bylaws for the condominium;
- Choose board members for the condominium corporation;
- Choose a management company or agent to oversee the day-to-day operations of the community;
- Impose a limit on sponsor control over the board.

CPS1 Phase
Most sponsors want to do market research to see if there is any actual demand for their proposed community. In order to do so, a sponsor must go through the CPS1 process. CPS1 stands for “Cooperative Policy Statement #1”, a set of guidelines written by the attorney general’s office for sponsors to use in researching market demand for their cooperative, condominium, or homeowners association ventures. To start the CPS1 process, the sponsor must submit an Application to Test the Market to the attorney general for approval.

The sponsor submits all of the advertising materials that will be used to test market the property. The attorney general guidelines for advertising state that the sponsor must include a “legend” in every advertisement from the attorney general’s office. This disclaimer reads: "This advertisement is not an offering. No offering can be made until an offering plan is filed with the Department of Law of the State of New York. This advertisement is made pursuant to Cooperative Policy Statement No. 1 issued by the New York State Attorney General. If pricing is mentioned in ads it must use the word “estimated”. Every claim the sponsor makes in the advertisements must be “provably true”, according to the attorney general’s office. Test marketing must begin within 120 days after application is approved. A 60 day extension is possible if required.

If a sponsor decides to go through the CPS1 phase, he or she cannot submit an offering plan until the test marketing process is complete. Until the offering plan is in place, the sponsor cannot take any deposits or even reservations (binding or nonbinding) from buyers. Therefore, the CPS1 phase is a time when no money or promises change hands. It’s just a campaign to gauge interest from the public.

BYLAWS
Sometimes called Covenants, Conditions, and Restrictions (or CC&Rs), the bylaws of a condo community are written and filed by the sponsor. These bylaws will govern things like:
✓ The board of managers’ powers and functions
✓ Dates for annual unit owner meetings
✓ Whether individual owners have the right to schedule additional meetings
✓ The minimum number of people needed in a meeting to conduct business
✓ Dates for elections for the condo board
✓ How many seats a sponsor can hold on the board
✓ How long the sponsor can hold those seats
✓ How to amend the declaration, if necessary
✓ How to add or amend bylaws
✓ How units and common elements will be used
✓ Pledge to maintain the community
✓ Responsibility to pay maintenance fees or other liens against the property
✓ Day-to-day community rules
✓ Any restrictions on pets, subleasing, etc.
✓ The bylaws will also spell out any fines that might be incurred from violations of the community rules.

APPOINTING BOARD MEMBERS
The sponsor chooses members for the condo’s board of manager. They make and enforce policies, keep up with property maintenance, do the financial books, and ensure (to the best of their abilities) that the individual owners’ investment is protected. If the condo community you buy into contains both commercial and residential space, there could be as many as three boards—one for the commercial tenants, one for the residents, and one for issues pertaining to both. This is done to prevent one type of tenant from getting control of a board and making decisions that affect the other negatively.

A solid board of managers will either have property management experience represented in its ranks or will be dedicated enough to submit to training in that field. This knowledge will help the board to make decisions that are more informed when it comes to budgeting, maintenance, and the myriad of other issues that confront a condo community. This is a monumental task and experienced people should be chosen.

LIMITATIONS ON SPONSOR CONTROL OF THE BOARD
While the first board of managers for a condo community might resemble the sponsor’s Christmas card list, over time the board should be dominated by a majority of actual residents. This member make-up will ensure that any issues confronting the community will be dealt with swiftly and in the best interest of the inhabitants. In New York, the rule for condo conversions—buildings converted from one use to a condo community—is that the sponsor must give up control of the board when either:
✓ 50% of the units are sold; or
✓ Five years after creating the community.
Whichever of these events comes first is the deadline.

For new developments, the sponsor will be allowed to dictate how many units must be sold before he or she must give up control of the board. But the five-year time limit still stands. So, even on new developments, after five years, the board should consist of a resident majority. Usually, these promises for relinquishing control will be included in the offering plan (which we’ll talk about a little later).

APPOINTING A MANAGING AGENT OR COMPANY
The board of directors is responsible for appointing a managing agent or company to oversee the community’s daily operation, which means:
✓ Taking care of maintenance
✓ Fielding questions and complaints from residents
✓ Dealing with emergencies
✓ Collecting fees
Day-to-day accounting
✓ Budget issues
✓ Security
✓ Acting as a liaison between the board and the unit owners.
Because the manager is in tune with the needs of the property, he or she can offer advice to the board about what will be necessary to improve or maintain the property most effectively.

NEW DEVELOPMENT
The condominium market consists primarily of newly built developments and, on rare occasions, older, previously-owned homes. Whether the building is brand new or has just been converted to a condo, it can still be called a “new development”. In both cases, the paperwork will be identical, as will the process for setting up the board, the sponsor control issues, etc.

READING AN OFFERING PLAN
The Martin Act (Article 23 of the General Business Law) requires that both co-ops and condos submit an initial offering plan to the Attorney General before anything can be sold to the public. This first draft is often called the “red herring” because of the red lettering on the front branding it as a preliminary report. Once the attorney general accepts this offering plan, the red lettering goes away and the plan is called the “black book”, and the sponsor can begin selling units. It is the black book that all potential purchasers will be able to read before buying a unit.

An important thing to remember about the offering plan is that the attorney general doesn’t necessarily “approve” it. While an assistant attorney general will investigate the disclosures in the plan to make sure they are honest and accurate, the attorney general’s office has no real power to make the sponsor change anything about the property before selling units. The attorney general’s office does not determine what is fair in the offering plan or what is in the best interests of the buying public. They are only concerned that what is in the plan is true.

The offering plan is detailed, extensive and usually an exhaustive 200-400 page document that details information such as:
✓ Building material for the condo structure
✓ Real estate taxes
✓ Floor plans of all buildings
✓ Size and location of all units on each floor
✓ Occupancy and possession dates
✓ Recreational facilities
✓ Types of windows
✓ Types of appliances
✓ Landscaping
✓ Extensive blue prints
✓ Topography maps

SPECIAL RISKS
If something is not specified in the offering plan, then the sponsor does not have to provide it. “Special risks” are things that the sponsor might promise, but aren’t in the offering plan. If you see pictures of units with hardwood flooring and stainless steel appliances unless the offering plan specifies these items they don’t have to be provided.

REAL ESTATE TAX VALIDATION
This is a fairly simple process for existing buildings. However, new construction verification can be tricky. Numbers included in the offering plan are only a “guesstimate”. Agents need to make buyers aware of this as well as the fact that in resale units the seller might be entitled to tax exemptions that the new buyer will not be.

FLOOR PLANS
It is not uncommon for units on different floors to be different from each other in layout or square footage. Therefore, the agent needs to know the floor plan before making any statements...
**PRICE INCREASES**
Since the offering plan is a pliable document, it should come as no surprise that even the purchase price is only a quote and could change. An agent needs to be aware of any increases before making a quote to a buyer.

**HIDDEN FEES**
Hidden fees come about in part because the buyer expects certain amenities that are not included. Those hardwood floors or stainless appliances might add to the base price. The offering plan must make an honest statement about what is included in the selling price.

**CLOSING DATE**
The offering plan should also let you know when the buyer could expect to close. Just like a lot of the numbers in the offering plan, this is a projection and could change depending on construction delays.

**LETTER OF INTENT**
Many developers will require a buyer to sign a letter of intent. This document spells out the terms of the offer and acceptance, but is usually nonbinding, meaning that there is not a firm commitment to sell from the sponsor or to buy from the purchaser. It is simply a document from the buyer letting the sponsor know that he or she is interested.

The letter of intent is used by purchasers regardless of their individual situation. For example, if you lived in a building that was being converted to a condo community, and decide that you want to buy the unit when it is finished, you would still have to submit a letter of intent. When you move into the actual purchasing stage, the letter usually serves as a template for the purchasing agreement.

A typical letter of intent will include:
- **Price**—the sponsor reserves the right to raise the price if the market so dictates.
- **Deposits**—this money, which is held in escrow, reserves the unit.
- **Completion and closing dates**—remember these dates may be delayed if the construction hits some snags. The letter of intent should offer some guidance as to the sponsor’s and the buyer’s respective rights should the project be delayed.
- **Use of the unit**—this clause will declare whether the unit can be used for commercial or residential purposes.
- **Non-exclusive status**—since there is no signed sales contract, the sponsor can still try to sell the condo unit to someone else.

An attorney should be consulted before this is signed. This letter may not be enforceable in a court of law since it is not a contract of sale. It is a pledge by both parties to keep up a negotiating relationship. While the majority of letters of intent are non-binding, there may be some that in fact contain all the elements of a contract. In those cases, they are binding on both parties.

**PRICE CHANGES**
A sponsor can change the price of individual units, or whole classes of units, depending on the market and other factors. If the sponsor is converting an apartment building into a condo community, he or she must give the current tenants 90 days to decide whether they want to buy their apartments. When negotiating with the tenants, the sponsor cannot charge different prices for similar units—a discount for one tenant means a discount for all tenants. Any discount that is negotiated between the sponsor and the tenants in this 90-day timeframe has to be submitted for the attorney general to review because the change will be made on the offering plan. When the attorney general accepts the price, then the offering plan will be amended and the discount will be officially offered to the tenants. After the 90-day exclusive buying period is over for tenants, the sponsor is free to negotiate different prices for individual units.

Those are the rules for a conversion. The rule for a new development is a bit different. For a new development, a sponsor can negotiate varying prices for individual units right off the bat. There is no 90-day time limit and no amendment to the offering plan is necessary. The only way an amendment to
the offering plan would be required is if the sponsor decides to change the price of all the units in a
community or particular group of units. But, if the price is the only change made to the offering plan—
if there aren’t any other facts that need altering—then the change is not reviewed by the attorney
general. It’s simply accepted and filed.

**CERTIFICATE OF OCCUPANCY**
Before construction or renovation, the developer must get a building permit. When the building or
renovations are finished, the developer needs a certificate of occupancy (CO) before any of the unit
sales can close.
The C of O is required for:
1. New buildings;
2. Buildings that have been re-purposed (for example, a warehouse space that becomes a condo
   community); or
3. Buildings change occupants or owners.

**DEVELOPER’S POLICY ON FLIPPING**
Flipping means purchasing a property for one price, and then selling it as quickly as possible at an
inflated price to make a profit. Some investors even schedule simultaneous closings—meaning that a
buyer is already on deck, ready to close on a second loan to buy the condo, as soon as the investor
closes on his or her own loan. Developers are wary of flipping because it can falsely inflate prices and
destabilize the market. With this in mind, some developers have policies that control straight
investment in a condo community. Many communities require **owner occupancy**. Therefore, an
investor cannot buy because he is not occupying the unit he is purchasing.

**TITLE ISSUES IN PURCHASE OF CONDOMINIUMS**
The issues associated with a condo title are, for the most part, identical to those of any fee simple
transaction—such as a single-family home. A title search and title insurance are necessary parts of the
process, but there are a couple of differences for condos. First, the title search covers individual unit
title, as well as those of the entire condo community. Also, condo title insurance usually requires
endorsements in addition to the regular provisions to ease lender worries. While they do cost the
buyer a little extra money, the added coverage is well worth it.

**RIGHT OF FIRST REFUSAL**
This clause gives the association first chance on any unit that goes up for sale in the building. There are
quite a few reasons for this clause. For example, if the association decides to upgrade its management
agent’s living quarters, it might use the right of first refusal to buy a unit as soon as it goes on sale to
relocate the agent. Perhaps a buyer is known to be troublesome. The association can buy the unit at
the price the buyer was willing to pay and then resell it. They cannot do this if discrimination is
involved. They might also use the right if a unit is being sold below market in order to keep the selling
price of units to the public higher. The right of first refusal does not apply to homes that are sold or
willed to family members.

**CLOSING COSTS—BUYER**
The closing costs on a condo/ co op unit are much the same as those for a single-family dwelling, with a
few exceptions. A condo buyer can expect to pay:
- Financing costs
- Credit report
- Lead paint disclosure fee
- Attorney
- Title search and report fees
- Title insurance
- Tax escrow
- UCC-1 (co-op only)
- Appraisal
- Condo/co-op attorney
- Personal attorney
- Move-in fee/damage deposit
- Mortgage recording tax and fee
- Common charges (1-2 months of maintenance and service fees)
- Transfer taxes (if buying directly from a sponsor)
- Real estate broker
- Mansion tax on purchases over $1,000,000 (see later section
COMMON CHARGES
These are the fees for maintenance and services for the common areas of the community—like landscaping, repairs, snow shoveling, etc. A good management company and an involved board will try to contain costs as much as possible. In a new development, the common charges could inflate by as much as 20% in the first year, if management underestimates the budget or if the owners ask for more involved repairs or services. At closing, the buyer might be required to pay a pro-rated amount for common charges for the first month in the unit, or even one or two month’s worth as a buffer. This depends on the condo association policy.

CLOSING COSTS—SELLER
A private seller of a condo unit will, for the most part, pay similar costs to those of a seller of a single-family home, including:
- Attorney
- Move-out fee (protection against damage)
- Transfer tax (if applicable)
- Real estate broker
- Taxes and fees
- Title fees

CLOSING COSTS—SPONSOR
If a buyer purchases a unit directly from a sponsor, then that buyer has to pay the sponsor’s closing costs, as well. These include:
- Sponsor’s attorney fee
- City transfer tax
- State transfer tax

RECORDING TAX AND OTHER CHARGES
The buyer is always responsible for the taxes and fees associated with recording a mortgage with public offices. Again, this tax will vary depending on where you buy a condo unit.

MANSION TAX
While the name might sound like something right off a Monopoly card, the mansion tax is a very real and very costly assessment that a buyer must pay when purchasing a property. The tax amounts to 1% of the purchase price of a property, if that price is more than $1,000,000. Enacted in 1989, the mansion tax came along at a time when a million dollars went quite a bit further in New York than it does now. Remember, tax laws change and we need to keep up with them.

DEDUCTING REAL ESTATE TAXES
As with a single-family house, a condo unit owner is responsible for real estate taxes. And, just like mortgage interest, these taxes are deductible on federal returns. The transfer, recording, and mansion taxes we’ve talked about in the previous sections, though, are not deductible. Once they are paid, they are gone—sort of. The big exception here is the mansion tax. You see, even though it is not deductible, the mansion tax is added to the overall basis (or original cost) of your property. This addition helps offset capital gains and, in turn, lowers your tax liability when you resell the property down the road.

THE BIG QUESTION IS: CAN THE BUYER AFFORD IT?
Buyer’s financial viability in a condo transaction will be based on information about income and assets, just as the buyer of a traditional home.

DEFINING “CO OPERATIVE”
The main distinction between a co-op and a condo (or other forms of homeownership) is that in a housing co-op you don’t directly own real estate. Instead, you buy shares in the not-for-profit corporation, which owns all of the land, buildings, and rights to the property. As such, the corporation is named as the owner on the title and deed for the property. Also, while condo communities are usually new developments, co-ops are only rarely built brand new these days.
During the 1960s and 70s, the federal government subsidized a boom in affordable co-op housing construction. There are some types of co-ops that support low and moderate income families, which are financed by local governments or through a federal property disposition program.

Many of the early cooperatives were sponsored by trade unions, such as the Amalgamated Clothing Workers of America. One of the largest projects was Cooperative Village in Lower East Side of Manhattan. Also, the United Housing Foundation, which was founded in 1951, built the Co-op City in Bronx. Over the years, co-op communities have also been created for people with similar needs or lifestyles—such as senior citizens, artists, students, or members of certain professions. This structure for a co-op makes sense given that (as we will see in later sections) many of the communities day-to-day rules center on lifestyle issues such as noise and the use of the common areas.

**CO-OP CONVERSIONS**

Today, the most common method of developing cooperatives is conversion. This involves changing an existing building of renting tenants to a co-op building owned by shareholder/tenants. Most of the co-ops you will see in the Greater New York area were converted in the 1970’s and 80’s. This trend began when landlords and corporations who owned apartment buildings saw their profitability fading because of rent stabilization laws. Moreover, this unprofitability made the rental market in general less attractive both to those already in it and those looking to invest in housing.

Conversion was viewed as a way for landlords and investors to get out from under complicated rent control/stabilization laws and make these huge buildings profitable once again. After going through the conversion process, the sponsor was no longer required to rent apartments at set prices once they became vacant. He or she could rent the apartment at market prices, which were significantly more than rent control rates.

An approach to spurring ownership was the “insider price.” The sponsor would offer an apartment in a building going through conversion to the current tenant for a discounted price. However, while this insider price did constitute a good deal for the tenants, it presented a problem: profiteering. It was common for tenants to buy the unit at the insider price, and then resell it at a profit.

To combat this, many buildings instituted a flip tax—a fee charged to a seller and/or a buyer in a share purchase transaction. The money collected from this tax is usually rolled into the reserve fund to protect the co-op against excessive maintenance fee increases.

Co-op conversions can happen according to, either:

1. An eviction plan; or
2. A non-eviction plan

**EVICITION PLAN**

With an eviction plan, tenants who decide not to purchase an apartment will be evicted when their leases are up, as long as 51% or more of the units have been sold. Once the sponsor hits that 51% mark, the eviction plan is considered “effective”. The only exceptions to this rule are the elderly and the disabled. A senior citizen is eligible for protection from an eviction plan if he or she is at least 62 years old or has a spouse who is at least 62 years old on the day the sponsor files the plan with the attorney general. Qualified senior citizens can refuse to buy their apartments and be offered renewed leases. Tenants who are rent-controlled senior citizens are also exempt from the provisions of the eviction plan. A disabled person is eligible for protection from the eviction plan, as long as the person is in that condition on the day a sponsor files an offering plan with the attorney general. The disability must be a permanent physical, mental or anatomical condition that can be proven through mainstream medical testing. The disability must also keep the person from being employed full-time.

A sponsor can dispute eligibility claims from elderly or disabled tenants by taking it up with the attorney general no more than 30 days after receiving an exemption form from the tenant. This sort of dispute will then be settled by a decision from the attorney general’s office.
**NON-EVICTION PLAN**

With this plan, tenants who either decide not to purchase or are rent-regulated cannot be evicted. Units not purchased by tenants can be sold at the end of the present lease, as long as the unit isn’t subject to rent regulation. The sponsor must still provide all of the services required by law to the remaining non-purchasing tenant. A non-eviction plan requires the landlord to renew rent-regulated tenants’ leases. Under this plan, the sponsor only has to sell **15% of the apartments** for the plan to be considered effective.

As soon as the offering plan is accepted by the attorney general, the sponsor can begin selling eligible units. But actual closings on those units cannot happen until the chosen plan (eviction or non-eviction) has been declared effective. This has to happen no more than 15 months after the black book becomes available to the public. If that timeframe is not met, the plan will be null and void.

**BUYING IN**

The price you pay for shares in a co-op represents what the unit would be worth in the open real estate market. So, just like a condo, the value of the property depends on the location of the property, the location of the unit within the building, and amenities and services the co-op offers. However, unlike a condo, the purchase price is also influenced by the financial position of the corporation. The total selling price is often stated as a “price per share”. So, if a unit had 1000 shares and sold for $200 per share, the selling price would be $200,000.

**SHARE LOANS AND UCC STATEMENTS**

To finance a co-op purchase, the buyer obtains a share loan. The collateral for these are the shares attached to the unit rather than in a typical home loan, the home itself. The terms are similar; based on the current market. Instead of recording a mortgage with the municipality, a Uniform Commercial Code (UCC) financing statement is filed with the county clerk. For co-ops, this document is called a UCC-1. It will remain in effect for 50 years after you file it, unless you sell your shares in the co-op.

**CO-OP LIEN SEARCH**

Either the buyers’ attorney or lender will do a co-op (or UCC) lien search on the shares. Just like the title search on a fee simple transaction, this search is done to make sure the shares have no claims against them—or, if they do, that those liens can be paid before the purchase transaction is complete. This search will also extend to the current shareholder and the entire co-op building, just to be thorough.

**LENDER/CO-OP RECOGNITION AGREEMENT**

The lender/co-op recognition agreement is like a friendly, but cautious, handshake between the two entities. Essentially, this document spells out the responsibilities a co-op corporation has in dealing with a lender who finances a shareholder’s unit ownership.

**MAINTENANCE FEES**

The amount of this fee is established each year according to the budget requirements and is approved by the board of directors. When you pay this monthly maintenance charge, you’re covering your share of the:

- Actual operating costs;
- Principal and interest on the co-op’s overall debt;
- Property taxes;
- Insurance; and
- Reserve fund.

The “overall debt” refers to an underlying mortgage that the co-op might still have for the property. This will be covered in more detail a little later on. The “reserve fund” refers to the cash the co-op puts away for large scale repairs and emergencies.
**EQUITY (OR THE LACK OF IT)**

Even though it’s not considered real property, you can still build equity in your co-op unit. There are three types of equity structures in the co-op market:

- Market rate
- Limited-equity
- Zero-equity

In market rate co-ops, you, as the owner, gain equity in much the same way as you would with real property—as your share loan balance decreases and the value of your co-op shares increases.

In a limited equity co-op (LEC), you are restricted on how much money you can walk away with when selling your shares. Because an LEC is typically created through government loans or grants, tax breaks or other programs, the share prices are lower than market-based co-ops. This makes the housing more affordable for people who can’t afford to purchase a home by any other means. When a resident decides to sell, the corporation will buy back the shares at the original price. Then, when they resell the shares at the market price (which should be higher), the profit will be rolled into reserve accounts to help the community. So, you walk off with what you originally paid, but little or no profit.

A zero-equity co-op (sometimes called a leasing co-op) is a situation in which a nonprofit organization purchases a building, and then leases it to the co-op corporation. While the co-op has the option to buy the building should it go on the market later, until then, the co-op builds…well…zero equity in the property.

For the purposes of this section of the course, we will be talking mostly about market-rate co-ops because they are the most common. But you should at least be aware of these other types.

**BUYER DUE DILIGENCE**

If you were buying shares in any other corporation, you would want to know everything you could about its financial health. You’d check its pulse to make sure the business is still vibrant. You’d find out if there are any nagging long-term issues that never seem to be solved. In short, you would do your due diligence to find out if the corporation is a sound investment.

The more questions you ask and the more documentation you see on a co-op, the better. To get started, take a look at this list of some big questions the buyer should ask of the co-op before deciding to buy.

- How much are the shares?
- Where can you find share loan financing?
- What can you expect to pay in monthly maintenance fees?
- How much and how often have the maintenance charges increased?
- What percentage of the maintenance fee can you deduct from income taxes?
- What are the details of the underlying mortgage?
- What is the balance of the reserve fund and how is it used?
- Have there been any special assessments?
- Are there any major capital improvements coming up? And, how will they be paid?
- What are the requirements of the alteration agreement?
- Does the sponsor still own apartments in the building?
- What is the situation with the board of directors?
- What are the house rules?
- What is the co-op’s policy about subletting?
- Who is managing the community?
- What type of security does the co-op have for residents?

**UNDERSTANDING THE FINANCIAL STATEMENT**

Lenders will want to see the co-op’s financial statements before making a share loan and buyers should inspect no less than two years’ worth of financial data. A co-op’s financial statement includes:
1. A balance sheet (with assets and liabilities)
2. A statement of operations (with income and expenses)
3. A cash flow statement

**THE BALANCE SHEET**
The balance sheet is a freeze-frame of a co-op’s books at any given time, which lays out all of the co-op’s assets, liabilities, and member equity. This report is created monthly, quarterly, or annually, depending on when the organization does its books. Assets are broken down into two categories: current and fixed. Put simply, current assets are cash and things that will turn into cash within one year. Fixed assets, on the other hand, are the things that a co-op needs to operate from day-to-day (i.e. buildings, equipment, etc.).

Liabilities are also separated into two categories: current and long-term. Current liabilities are bills, accounts, or short-term loans that have to be paid within one year. Even the amount paid on a long-term debt over the period covered by the balance sheet can be considered a current liability. For example, if a co-op creates a monthly balance sheet, then that month’s payment on the underlying mortgage could be considered a current liability.

Long-term liabilities are bills, accounts or other debts that will come due after one year—like the underlying mortgage. You will also see an equity section. This covers the stock the members have bought in the co-op, as well as money they have paid into reserve funds. The assets should be equal (or balance) with the liabilities and equity. Visually, the equation looks like this:

\[ \text{Assets} = \text{Liabilities} + \text{Equity} \]

Obviously, if the co-op’s balance sheet doesn’t work out this way, then you’ve got a problem.

**THE INCOME STATEMENT**
This outlines the money that flows in and out of a co-op during a specific period. Like the balance sheet, the income statement can be prepared monthly, quarterly, or annually. For a housing co-op, while most of the income is from the shareholders, there are opportunities for commercial income—like parking garage rental or leasing roof space. In addition, there could also be some revenue from investments made with co-op reserve funds. Of course, expenses are operating costs, repairs, insurance, or any other responsibility that costs the corporation money.

When the income and expenses are compared on the income statement, you will see whether the co-op operates with a net profit or a net loss. And it doesn’t take a rocket scientist to know which state of affairs is more desirable.

**THE CASH FLOW STATEMENT**
The cash flow statement is simple to understand: It displays how money moves in and out of the co-op corporation. In the actual document, you will see three distinct sections:

1. Operations
2. Financing
3. Investment

In a healthy cash flow situation, the first two sections are all about making money right now and the third is all about spending it for future development.

**The operations section** refers to the money a co-op makes from providing services. This would be shareholder maintenance fees and leasing of space to commercial interests.

**The financing section** represents the money that the co-op raises through stocks and bonds. This number will change when a unit is sold or bought back by the co-op. Believe it or not, in most corporations; a negative number in this section is a good thing. It means that the company is buying...
back stock and keeping the share prices high. Remember, though, that not all co-ops are willing to buy back shares.

The investment section is where a co-op actually spends money. It could be for capital improvements, additions to reserve funds, or anything else that pertains to the long-term viability of the property or corporation. Ideally, the co-op should be able to pay for the investment amount from the money made in the operations section. If not, the co-op has a negative cash flow, which is not good.

MEMBERSHIP PRIVILEGES AND RESPONSIBILITIES
The basic entitlement you have as a co-op shareholder is to live in a safe, peaceful environment with great neighbors. You are given the exclusive right to live in a specific unit through an occupancy agreement or proprietary lease for as long as you choose to stay. Unlike the terms for a condo community, this lease does not entitle you to any ownership interest in the common areas. You are allowed to use them, for sure, but the corporation owns them in fee simple—just as it owns the rest of the building. Of course, this lease is only good as long as you obey the co-op’s rules and regulations. These can be found in the documents like the proprietary lease, the articles of incorporation, and the bylaws.

In addition to these documents, the board will also establish “house rules”, which cover the day-to-day issues such as:

- Pet ownership
- Parking rights
- Recreation area regulations
- Noise limits
- Garbage disposal

These rules will not necessarily be part of the formal bylaws, but you can always request a copy from the co-op administration.

As a shareholder (and part owner) of the co-op, you are also entitled to be notified about the co-op’s financial health at least once a year. The organization will do this by giving you a financial statement—just as any corporation notifies its shareholders. Your status as a shareholder also gives you a voice in community decision-making by voting on issues and in board elections. Shareholders vote in board elections, on issues facing the organization, and on changing rules and policies.

The weight of your vote depends on how many shares you own. So those who own more shares (and, thus, live in larger apartments) will have more impact. Of course, they are also paying more in maintenance.

TAXES AND INTEREST
Being a co-op shareholder also has tax benefits. Even though the shares you are buying entitle you to a lease, they are considered personal property (like other shares of stock or securities), instead of real property. You pay your share of the overall real estate taxes for the co-op building as part of your monthly maintenance bill. Just like other homeowners, you can deduct your share of the co-op property taxes on your federal income taxes. Also, you can deduct your portion of the interest paid on the co-op’s mortgage loan, and the interest paid on your individual share loan.

CAPITAL GAINS TAX
Just like single-family homeowners, a co-op shareholder or a condo owner who sells his or her shares/unit enjoys some shelter from capital gains tax. If you are single shareholder selling a co-op that has been your primary residence for at least two of the past five years, then the first $250,000 of capital gains will be excluded from federal income tax. If you’re married, the number jumps up to $500,000. For a complete list of tax benefits, consult your tax preparer.

HOMEOWNERS INSURANCE
A shareholder/unit owner is often required to have a specific policy called HO-6. This covers your personal property inside your unit. The corporation insures the building, property and common areas.
BOARD OF DIRECTORS
Just like a condo community, a co-op has a board of directors that is responsible for maintenance, financial issues, and other policy and legal matters involving the organization. The law typically requires a co-op board to have at least five members that are elected from among the residents in the community.

Legally, the board of directors must:

- Adhere to the co-op rules and regulations, including those listed in the bylaws, proprietary lease, certificate of incorporation, and the house rules; and
- Exercise good judgment in making business decisions.

By far, the biggest responsibility a co-op board will undertake is representing its shareholder residents. While there are times when the whole community will come together and raise hands to vote on an issue, the vast majority of the heavy lifting on community issues is done by the board. And, the fact that the board members are elected from among the residents helps enormously, because it means the co-op is being governed from the shareholders’ point of view. The board must be certain that the community is financially viable, and maintains a safe and serene living environment.

DOCUMENTS NECESSARY FOR AGENT IN A CO-OP TRANSACTION
As an agent, you’re going to need to be familiar with the:

- Proprietary lease
- Stock certificate(s)
- Offering plan
- Co-op’s house rules
- Alteration agreement
- Board package

PROPRIETARY LEASE
The proprietary lease is what a co-op unit buyer receives at closing, instead of a title or deed. This document entitles the shareholder to occupy a unit within the building. It is a long term lease with an expiration date. It is a simple process to extend the life of the lease through a vote by the shareholders.

Among the rights and responsibilities of the shareholder, you’ll see everything from nuts-and-bolts issues (like due dates for maintenance fees and alteration rules) to atmospheric issues (like noise regulations and pets) to future planning (like subletting and the conditions for surrendering your apartment).

STOCK CERTIFICATE(S)
While the proprietary lease allows you to occupy the unit, the stock certificate proves that you’re part owner of the co-op. You could receive a stock certificate for each share you buy or you might have one blanket certificate that states how many shares you own in the co-op. Unlike mortgages, co-op stock certificates are not recorded by a municipality. So, while a home or condo owner can lose his or her title or deed without too much fuss, misplacing a stock certificate could be catastrophic and very expensive. If you’re financing with a share loan, you might have to give the stock certificates to the lender. Losing a stock certificate means whoever misplaces it has to:

- Submit an affidavit saying that the certificate has been lost; and
- Indemnify, or financially cover the co-op against the possibility of loss or damage if someone else stakes a claim on the shares at some point.

THE OFFERING PLAN
We’ve talked previously about offering plans for condos. Just like those offering plans, the documentation for a co-op goes through an investigation and acceptance process with the attorney general’s office. The initial proposed plan is called a “red herring” and the final plan is termed the “black book”. Co-op offering plans also contain much of the same type of information as their condo
counterparts—building descriptions, bylaws, etc. But the co-op version will also contain some unique documents, such as:

- Proprietary leases;
- Subscription agreements; and
- Articles of incorporation.

We’ve already discussed proprietary leases, but we haven’t yet touched on subscription agreements and articles of incorporation. A subscription agreement is a sales contract for the stock shares you’ll purchase to join a co-op. It will spell out how many shares you’re buying in the co-op, their value, and any the monthly charges associated with them. The articles of incorporation offer profile information about the co-op, how much and what kind of stock it will be selling, and how its powers will be distributed. Overall, the offering plan will be a vital package of information you’ll want to be very familiar with, because it paints the clearest, ground-up picture of the co-op and the organization that runs it.

WHY AGENTS SHOULD KNOW A CO-OP’S HOUSE RULES
As an agent, you should definitely know the rules for the particular co-op involved in your transaction. It is easier to explain to a prospective buyer that they cannot screen in their terrace than it will be when they are already in contract. But you should also be aware of some standard rules among all co-ops.

Typical house rules govern issues such as:
- Obstructing common areas
- Disposing of garbage and recycling
- Decorating windows and doors
- Service entrances
- Pets;
- Noise, noise, noise

One of your jobs as an agent is to make sure your potential buyer’s lifestyle matches up with the house rules he or she will be living with. The house rules are designed to make the community safe, while also maintaining the value of the property.

ALTERATION AGREEMENT
An alteration agreement outlines the corporation’s rights and the shareholder’s responsibilities when that shareholder wants to do any sort of major renovation work on his or her unit.

THE SCREENING PROCESS
A major source of strength for you, as an agent, will be to understand all sides of a deal—to know what the opposing parties expect and know how to satisfy those expectations. When you buy into a co-op, you’re purchasing shares in a corporation. The co op board wants to be sure you are financially capable to be a partner in their venture, because that’s what keeps the boat afloat. The buyer needs to know what the co-op is looking for financially. Not finding out wastes everyone’s time and resources. But the board will not approve or reject based solely on finances. They will also gauge whether they want to live with the buyer. Never lose sight of the fact that the co-op board is made up of residents. So, when they’re looking over a package and interviewing, they’re not just scrutinizing a buyer, they’re meeting a potential neighbor.

Finally, as unfair as it sounds, the co-op board doesn’t have to give a reason for a rejection. While they do have to abide by fair housing, equal opportunity, and civil rights laws, they can deny an applicant from moving in for just about any reason.

THE BOARD PACKAGE
The difficulty of putting the package together will typically depend on the price of the unit. The more expensive the place is, the more checking, verification, and rechecking the co-op will require. The board package will contain documents covering both financial and personal information, including:

Purchase Application Form—This form closely resembles an apartment application. It collects basic information about the applicant (and co-applicant), such as:
• Names and contact information
• References
• Housing history
• Employment
• Income
• Education
• Children
• Pets
• Disabilities

Of course, this list isn’t complete. A co-op has the right to ask whatever it wants in the purchase application form, but the above info is pretty standard.

1. Fully Executed Contract of Sale
2. Financial Statements and Verifications

This verification information could include statements about:

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<td>Trust fund</td>
<td>Stocks</td>
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<tr>
<td>Other real estate holdings</td>
<td>Bonds</td>
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Expect them to require at least three months of each type of statement. While that rule is not hard and fast, it’s a good place to start.

The co-op’s managing agent will be the first person to see the package. He or she will make sure you’ve included all of the necessary documents. If you didn’t, then the managing agent will send it back to you. Once the manager approves your package, it goes on to the board.

Who reads the package at this point depends on the co-op. In some organizations, all of the board members must read the package, while others have an approval committee of a few of the members who will review it. Then the board or the committee will vote on the package. And, if you get the magic number of approval votes covered in the co-op’s bylaws, you’re in good shape.

THE INTERVIEW
Depending on the co-op, you either could meet with the entire board or with a screening committee made up of board members. It could be an informal get-together or a more formal grilling. Whichever kind of meeting is held there should be an understanding that the questions would be invasive. As an agent, you should prepare your buyer in much the same way a lawyer preps a witness—just as you would like to be prepared if you were the buyer. Go through the board package (especially the financial portions) in painstaking detail and have canned answers ready for possible board questions.

PRIMARY RESIDENCY VS. SUBLETTING
The majority of the units in any co-op building are primary residences. In fact, the whole idea behind a co-op is that you get apartment-style living without all of the transient and unpredictable elements of rental units. But, sometimes, a shareholder needs to sublet his or her unit. They may have to move for work or go away to be with a sick relative. Or, they may just be trying (unsuccessfully) to sell the unit because they can’t afford to live there anymore. Whatever the case, a co-op corporation can make it extremely difficult to sublet a unit, if they don’t just prohibit it outright.

The corporation can attack the issue of subletting from a number of angles, including: Establishing a minimum residency timeframe for owners. For example, an owner might be required to live in the unit for at least two or three years until they can sublet it.
Establishing a limit to the percentage of units in the building that can be sublet at any one time. For example, if a co-op caps the sublet percentage at 10%, once that quota is met, any sublet requests would be automatically denied.

   1. Establishing limits for the amount of time an owner can sublet a unit. For example, the corporation might prohibit the shareholder from subletting the unit for more than two years.
   2. Charging the shareholder a fee for subletting a unit. For example, the corporation might charge the shareholder $6 per share, per year to sublet his or her unit.
   3. Prohibiting the subletting of any of its units.

Regardless of what actions they take, co-op corporations have good reasons for limiting or outlawing subletting. First, the number of sublets in a building can affect the corporation’s ability to get financing or to refinance the underlying mortgage. Lenders will shy away from co-ops with a large number of sublets because it makes the corporation look like an unstable investment. And, if lenders do let such co-ops borrow money or refinance an underlying mortgage, it’s usually at a much higher interest rate for that very reason—because the risk on the co-op appears to be greater.

Another reason co-ops limit or prohibit subletting is because an overabundance of sublets could negatively affect individual buyers’ share loan financing. Lenders won’t approve loans for the buyer because the future of the co-op is uncertain when so many units are sublet. Or, if a buyer does get a share loan, it might be at steeper interest rate than normal. In fact, lenders like Fannie Mae, Freddie Mac, and the FHA all demand a high percentage of primary residences in a co-op building before they will agree to finance loans connected with it. The more shareholders you have populating a co-op, the better that co-op will be.

Financial information, credit history, criminal background, and everything else covered in a board package may be scrutinized before the subtenant is allowed to move into the unit. And, much the same as a denial for a regular buyer, the board does not have to tell the subtenant why he or she was rejected, unless the issue goes to court.

**SPONSOR SHARES**

The sponsor enjoys some privileges that other shareholders do not—like unregulated subletting. Since a sponsor writes an offering plan, there is usually a clause exempting him or her from the subletting restrictions that regular shareholders will adhere to. This means that the sponsor can sublet any apartments he or she owns shares in without having to pay fees or follow the time limits guidelines that the other shareholders in the co-op would. And, even if subletting were prohibited in the bylaws, the sponsor would still be allowed to sublet his or her unit (or units) without restriction.

**HOLDER OF UNSOLD SHARES**

In order to understand the designation of “holder of unsold shares” we must first define the term “unsold shares”. In a co-op, unsold shares are shares that are attached to a unit that has never been sold as a primary residence, but only for investment purposes. This usually happens because of the sponsor. When a co-op conversion is complete, there could be a number of units that are still vacant. The shares that are attached to those vacant units are kept by the sponsor, and become known as unsold shares. The sponsor can sublet those vacant units without restriction. But, sometimes, an investor comes along who wants to buy one of those units directly from the sponsor and sublet it.

When the sponsor sells the unit to this investor, that investor becomes an owner of unsold shares. According to regulations from the attorney general, the investor/owner of unsold shares can only become a holder of unsold shares if:

   - He or she is designated as a holder by the original sponsor for the co-op;
   - The sponsor promises in writing to cover the holder’s financial responsibilities to the co-op;
   - The holder follows the escrow and trust fund rules in the General Business Law;
   - The holder registers as a broker-dealer with the Department of State; and
   - The holder files offering plan amendments regularly.
The status of holder of unsold shares entitles this investor to the same privileges as the sponsor. The holder does not have to get board approval for a purchaser or a subtenant of a unit, and does not have to pay sublet fees or flip taxes. What the holder does have is the right to vote on issues and in elections related to the co-op. But, if the sponsor (or a sponsor’s relative) or the holder of unsold shares (or a holder’s relative) moves into the unit in question, the spell is broken. The “unsold shares” status no longer applies, which means that the sponsor and the holder lose all of their special rights and privileges related to that unit.

A buyer should know the situation with the co-op they are attempting to buy into, because the longer a sponsor or holder of unsold shares sublets units in your building, the more chance the co-op has of destabilizing and negatively affecting your investment. The resident shareholders want to make the co-op the best possible living environment and increase the value of their investment. But the sponsor and holders of unsold shares are investors, so they want to maximize profit. These two sides are often at odds with each other because the resident shareholders want the freedom to run the co-op in a way that best benefits them, while the sponsor and holders of unsold shares want to keep rents going up and maintenance costs down. Such a situation could prevent the building from getting some much-needed repairs or even making improvements to amenities or security systems.

**SOLD SHARES**

When a unit is purchased as a residence, but then goes into foreclosure, the shares could revert to the sponsor. These shares would be called “sold shares” because they were attached to a unit that had been used as a primary residence and not as an investment. When this happens, the shares can no longer be sold with the holder of unsold shares rights and privileges.

**CONDOPS**

The condop is one of the most misunderstood entities in real estate because there are a couple of different definitions running around out there. For some people, the term “condop” means a community that is financially run like a co-op, but employs less strict condominium-type rules for purchasing, financing and subletting. This usage of the word is more for marketing than anything else.

The other definition for a condop goes like this: A building has two types of spaces—commercial and residential. Usually, the commercial space is at street level, and the residential space is up above. This building may have been constructed this way or it could be converted. The owner files a declaration stating that the building is a condo community with two units—a commercial one and a residential one. In this case, the term “units” doesn’t mean the same thing as “apartments”. Instead, the term “units” refers to the different types of spaces in a single building. The commercial unit might have one retail or office space or multiple spaces, and the residential unit will have multiple apartments.

Once the building has been constructed as or converted to a condominium, the owner transfers the residential unit to a co-op corporation, probably in exchange for shares. As for the commercial unit, the owner can sell it or hold on to it and collect rent from the businesses that move in. So, the commercial space is the “cond” and the residential space is the “op”, which makes up “condop”. Easy, right?
chapter 13 real estate finance

key terms

acceleration clause  lifetime cap/ceiling  rate cap; payment cap
adjustable rate montage  loan to value ration  red-lining
(alarm)  margin
alienation clause  loan to value ration
amortization  mip/mortgage insurance
assignment  premium
balloon mortgage  mortgage, mortgagor,
borrower, mortgagee
blanket mortgage  negative amortization
bridge loan  package mortgage
buy down  pledged account
construction mortgage  mortgage
conventional mortgage  pmi/private mortgage
default  insurance
discount points  point
"due on sale" clause  predatory lending
fha/mortgage  prepayment penalty
grace period  clause
graduated mortgage  primary
home equity loan  market/secondary
inflation  market
interest and tax  promissory note
deductibility

much like the real estate industry, there are many misconceptions in the general public about mortgages, how they work, and what the best way to obtain them is. because a real estate agent is usually a source of information trusted by the buyer, we will often be asked many questions about mortgages and asked to offer advice as to what a buyer should do. the purpose of this course is to familiarize you with the basics of financing, to understand the differences among the various types of loans available, and an explanation of the process involved with obtaining a mortgage.

the study of mortgage loans is ultimately a study of risk. every mortgage written has a level of risk for every party involved. the lender has the risk of losing their money if they make a bad lending decision, and the borrower has the risk of losing their property if they choose a loan that they cannot afford.

a lender faces risk whenever another variable is added to a transaction. investment homes are riskier than primary residences. self employed borrowers with hard to document incomes are riskier than documented wage earners. lenders respond to added risk by either raising their price (the interest rate or fees), or lowering their exposure to the risk (lending less money or requiring a third party to assume some of the risk via insurance). it is important to keep risk in mind as we review this course, as the different products available as well as the various loan programs on the market are all a direct result of the risks borrowers and lenders face. when you understand risk, you understand why certain decisions are made.

mortgage basics
when a decision to purchase a home is made, most people start the process by working with a real estate agent. the real estate agent is usually trusted by the buyer, and therefore viewed as a vital source of information. because of this relationship, the real estate agent will often be asked questions about the types of mortgage financing that may be available, as well as who would be a good source to obtain the financing from. generally, the licensee has had experience with several mortgage brokers, mortgage bankers, and various depository institutions more commonly known as traditional banks.
When we do offer up recommendations as to where to obtain mortgage funding, we need to make sure that we offer the buyer a variety of choices in order to avoid any appearance of tie in arrangements, which are illegal. This would occur when the broker demands, as a condition of the sale, the buyer use a mortgage company he recommends.

For example, it is perfectly appropriate to say “I would recommend that you use A plus Mortgage loans, Superior Banking Company, Honest Bob’s Mortgage Loans, or New York Loan Company, as I have dealt with all three in the past and found them to be reputable”, but it would be considered an illegal tie-in arrangement if you were to state “I have been burned by so many shady brokers that I will only deal with A Plus Mortgage Loans, so you must call them and get a loan if you are going to work with me”. Our job requires that we be well informed about the availability of financing and options for the borrower as well as common terminology.

**MORTGAGE BANKER OR MORTGAGE BROKER?**

All too often the terms mortgage banker and mortgage broker are used interchangeably and in fact, they are quite different, though the end result for the borrower is usually the same, a loan is forthcoming.

A Mortgage banker can issue loan approvals and fund loans. They typically have a line of credit that allows them to fund mortgage loans in their own name. They then immediately sell the loans to larger investors for a premium. In fact, the loan is usually sold to an investor before it ever closes, and is underwritten to the guidelines of the third party investor. This allows the mortgage banker a wide variety of lending options. A mortgage banker will usually have a relationship with several investors, allowing them to offer numerous types of loans.

A Mortgage Broker CANNOT issue loan approvals or fund loans. Mortgage Brokers have relationships with many different lenders that offer a wide variety of loans. A broker will analyze the borrower’s specific needs and credit profile, and then attempt to match them with the most appropriate lender. Though the broker cannot issue an approval in their own name, they can obtain them from the third party lender.

Dual Agency occurs in the event a licensed real estate broker is acting in the same transaction as a mortgage banker, mortgage broker or exempt entity. Example: A licensed real estate broker is also a licensed mortgage broker or mortgage banker. He is going to arrange the financing of a house he just sold. In this case, it must be disclosed that the real estate broker has become a dual agent at the first substantive contact between the licensee and borrower. The appropriate disclosure form and acknowledgement that must be used has to be provided and signed by the buyer/borrower and the seller before services as a mortgage broker or mortgage banker may be rendered. A copy of the disclosure form and signed acknowledgement must be maintained by the mortgage broker for at least 3 years.

**WHAT IS A MORTGAGE?**

Believe it or not, many people don’t really understand the term mortgage. Most people use the term mortgage to describe the loan, when the mortgage is actually the lien against the property that will secure the loan. Don’t let that bother you though, as it is perfectly acceptable to use the term mortgage to describe the mortgage loan.

**MORTGAGOR/MORTGAGEE**

The mortgagor borrows money and gives a mortgage to secure the payment for the amount borrowed.
The mortgagee lends money and takes the mortgage to secure the payment for the debt.

**EXAMPLE:** Mary goes to XYZ Bank and wants to borrow money in order to buy a house. Mary is the one giving a mortgage, NOT the one getting a mortgage from the bank. XYZ Bank is the lender, and therefore, getting the mortgage from Mary. In this case, Mary is the mortgagor and XYZ Bank is the
mortgagee. As a result of the transaction, the mortgage is secured by her house which is used as collateral (security for the debt). A promissory note is then created. This is the contract detailing the terms of a promise by the mortgagor to pay an amount of money during a specified period of time to the mortgagee.

**ESSENTIALS OF A VALID MORTGAGE**
- It must be in writing
- The parties must be competent (sane adults)
- Its purpose must be stated (to secure payment for a specific obligation)
- There must be an appropriate mortgage clause (the mortgagor hereby mortgages to the mortgagee)
- An adequate description of the property
- It must be signed by the mortgagor
- It must be acknowledged (notarized) by the mortgagor
- It must be delivered to the mortgagee

The mortgage contains the following agreements
- That the mortgagor will pay the indebtedness
- That the mortgagor will keep buildings insured for fire and liability
- That no building on the premises will be removed or demolished without the consent of the mortgagee.
- That the entire unpaid sum can become due if the mortgagor falls behind in the mortgage payments, with certain caveats as to the foreclosure laws of the state the loan was issued in.
- That the holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver.
- That the mortgagor will pay all taxes, assessments and water charges. In the event of a default, the mortgagee may pay them.
- That the mortgagee will furnish a statement of amount still due on mortgage if requested in writing.
- That notice and demand or request may be in writing and be served in person or by mail.

**SECURED LOANS**
This is a loan in which the borrower pledges some asset, such as an automobile or house, as collateral for the loan. For instance, a loan taken out to purchase a new or used automobile may be secured by the automobile in much the same way as a mortgage loan is secured by housing. Obviously, the duration of the loan period on a car is considerably shorter than on a home. Often it corresponds to the useful life of the object pledged. The most common type of secured loan is a mortgage loan. The lender is given security in a form of a lien on the title to the house until the mortgage is paid in full. If the borrower becomes delinquent and defaults on the loan, the lender would have the legal right to repossess the house and sell it in order to get back the amount borrowed which is still outstanding.

**TYPES OF MORTGAGES**
The main factor that determines the type of mortgage is how the loan amortizes. Amortization is the repayment of a single lump sum over a period of equal payments that include a portion of the principal being repaid, and a portion of the interest being repaid. If the principal balance owed is zero when the last scheduled payment is made, a loan is said to “fully amortize”. This is most popular since the payments remain the same for the life of the loan and there is no balance at the end. These are the safest loans.

**FIXED RATE MORTGAGE**
Loans in which the interest rate and the payment remain the same through the entire term, as opposed to adjustable rate loans where the interest rate will move up or down based upon external market conditions. Typically terms are 15 to 30 years, but shorter and longer terms are sometimes available. Fixed rate mortgages usually have a higher initial payment than adjustable rate mortgages due to the way the lender is repaid. Example: Imagine for a moment you are a lender, and have the
option of making either a fixed rate or adjustable rate mortgage loan. When the time comes to make
the loan, the rates for both an adjustable rate mortgage and a fixed rate mortgage are low. However,
obody can predict the future, you don’t know what is going to happen in later years. If you make a
fixed rate mortgage, and the interest rates go up, you cannot earn that better rate of return because
your money is tied up in the fixed rate mortgage. If you use an ARM mortgage, you will enjoy returns
that match the market. However, you will also get a lower return if rates go down. It is this inability to
profit from future market increases that causes fixed rates to be higher initially than Adjustable Rate
Mortgage Loans.

**ADJUSTABLE RATE MORTGAGE – (ARM)**
The main feature of an ARM is that the interest rate will go up and down with the market at
predetermined intervals. It will rise and fall based on a stated index and margin. These loans typically
have a lower start rate than fixed rate interest. It will change in a specified period of time, known as
the adjustment period. The adjustment period can be as low as 1 month, or as high as 10 years. 6
month and 1 year adjustment periods are the most common. Although there are different varieties of
adjustable rate mortgages available they share the following features.

*Index:* an external market indicator that can easily be followed by the borrower. Some of the most
common indices used in mortgage lending are:
Government Treasury Bonds (1 year and 10 year)
London Interbank Offered Rate (LIBOR)
MTA (12 Month Treasury Average)

*Margin:* represents the percentage over the index that the rate will adjust. When a borrower is
looking at the price of a loan, the index is far less important than the margin. Because it is an often
misunderstood concept. Many borrowers will overlook the margin when comparing competing
adjustable rate loan offers, when it is the most important part of a loan that will determine future cost.

*Caps:* adjustable rate mortgages have rate caps, and sometimes payment caps, which will limit the rate
of interest and or the maximum payment amount allowed under the loan. Most ARM’s have caps that
determine the maximum amount the loan can adjust per adjustment as well as life of loan caps that
determine the maximum the rate can increase over the length of a loan.

“EXOTIC LOANS”
Many of these “exotic loans” were created during the buying craze that lead to the downfall of the
economy. Most are no longer used but bear looking at to get an idea of why the housing market
crashed. Most of them allowed people who could not qualify under conventional lending guidelines to
own a home that they could not afford.

**HYBRID ARM**
A Hybrid Arm shares characteristics of both a fixed rate and an adjustable rate mortgage. It will start
with a fixed rate period, and then switch to an ARM type program. Most hybrid ARM’s have fixed rate
periods between two to five years. They are often referred to by a series of numbers, that will tell how
long the loan is fixed, and how long it is adjustable. For instance, if a thirty year loan has a fixed rate
period of three years, and then adjusts for the remainder, it would be called a 3/27. The monthly
payment will adjust over the balance of the life of the loan and might not be affordable to the buyer
any longer.

**INTEREST ONLY**
The borrower is only obligated to pay the interest owed on the loan, usually for a set period of time.
For example, 5 years. At this point the buyer will have to begin repaying the principal as well and,
often, the loan will no longer be affordable.
NEGATIVE AMORTIZATION
Each year an analysis of the amount of interest the lender might have earned is made. If the loan allows for negative amortization then the earned but not collected interest is added to the principal. It is quite possible that after a number of years the borrower could owe more than the amount borrowed. As the negative amortization increases the principal and the interest rate go up causing the borrower to longer be able to afford their home. This leads to borrower defaults and foreclosure.

BALLOON MORTGAGE
During the life of the loan, installment payments are made that do not pay the entire principal and/or the interest that would normally be due. It is unique in the fact that the payments are calculated as if the loan were fully amortizing, but then, at a specified time, the unpaid balance of principal becomes due and payable. This is referred to as the balloon. In many cases this substantial amount might be refinanced if the borrower cannot make the final payment. These loans are often used in commercial financing and serve a good purpose for the educated borrower.

GRADUATED PAYMENT MORTGAGE
There may be some confusion between an adjustable rate mortgage and a graduated payment mortgage. The graduated payment mortgage changes the monthly payment based on a specific payment schedule and has a fixed rate of interest. The borrower is aware, from the beginning of the loan, exactly what his payments will be for the life of the loan.

LOAN PROGRAMS
CONFORMING LOANS
Loans secured by government sponsored entities such as the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) and the Government National Mortgage Association (Ginnie Mae). FNMA is more commonly known as Fannie Mae and FHLMC is more commonly known as Freddie Mac. Fannie Mae and Freddie Mac are two publicly traded corporations that purchase mortgage loans that comply with the guidelines from different mortgage lending institutions. They also package the mortgages into securities and sell the securities to investors. By doing so, Fannie Mae and Freddie Mac, like Ginnie Mae, provide a continuous flow of affordable funds for home financing that result in the availability of loans for Americans.

NON-CONFORMING LOANS
These are not eligible for purchase under standard Fannie Mae guidelines. A loan could be considered non-conforming for a variety of reasons. The most common are High Loan to Value ratios, unconventional sources of income, unverifiable assets, or some type of credit impairment. Oftentimes, people will make the mistake of thinking that a non-conforming loan is only for a borrower with less than perfect credit. However, this is not the case. Loans for people with damaged credit are called sub-prime. In fact, Fannie Mae will often purchase non-conforming loans through its “expanded approval” program.

GOVERNMENT INSURED LOANS
FHA insured loans are federal assistance mortgage loans insured by the Federal Housing Administration (FHA). The loans may be issued by federally qualified lenders. Historically, FHA loans have allowed lower income Americans to borrow money for the purchase of a home that they possibly would not have been able to afford. The program originated during the Great Depression of the 1930s, when the rates of foreclosures and defaults rose sharply. It was intended to provide lenders with sufficient insurance for them to make a loan that they might not have made without it. The FHA insures lenders against loss on low down payment loans provided that both the borrower and the property comply with FHA underwriting guidelines.

FHA does not make loans or build houses. The loan is made directly with a financial institution. In order to obtain the insurance, the borrower pays an insurance premium of one half of 1 percent on
declining balances for the lender's protection. This premium is paid for the life of the loan. They have several features that benefit borrowers:

- Rates are usually lower than market rate conforming loans.
- The credit score of the borrower is not considered.
- The appraisal report required by the FHA is far more stringent than those required for regular conforming loans, providing the borrower much more information about the property they are purchasing.

Over time, private mortgage insurance (PMI) companies came into existence. Private mortgage insurance is used in conventional high loan to value ratio loans. It protects the lender in the event the borrower defaults much the same way as a lender is insured in an FHA loan. FHA loans now mainly serve people who do not have a conventional down payment or otherwise do not qualify for PMI insurance.

**VA LOANS**
Mortgage loans guaranteed by the U.S. Department of Veterans Affairs. The loan may be issued only by qualified lenders. The purpose of the VA loan is to offer long-term financing to American veterans or their surviving spouses who do not marry again. The VA loan allows veterans 100% financing without private mortgage insurance or a 20% down payment second mortgage. Veterans may borrow up to 100% of the sales price, or the reasonable value of the home, whichever is the lesser of the two. An interesting aspect of the VA loan is that it allows the seller to pay all of the veteran's closing costs as long as they do not exceed 6% of the sales price of the home.

**PRIVATE MORTGAGE INSURANCE**
Loans that are eligible for purchase are said to “conform” to the guidelines, and are called “conforming”. However, those guidelines are rather strict, and no loan above 80% is technically eligible for purchase by Fannie Mae or Freddie Mac. In those instances, Fannie and Freddie will allow the borrower to purchase additional insurance against loss, called **Private Mortgage Insurance (PMI)**. The inclusion of PMI will make the loans eligible for purchase by the GSE’s. Any conforming loan over 80% LTV will include PMI. Once the original loan balance or the amount owed versus the appraised value drops to 78% LTV or less, then the PMI coverage is dropped.

Private Mortgage Insurance can be quite expensive, which leads some borrowers to look for ways to avoid paying it. The most popular is to take an 80% LTV conforming loan, and then couple it with a smaller or “second” mortgage, called a Home Equity Mortgage or “purchase money second”.

**HOME EQUITY LOANS**
These are fixed or adjustable rate loans used for a variety of purposes and they are secured by the equity in the home. They have an advantage over personal loans since interest could be tax deductible. Frequently they are used for home improvements or freeing up equity for investment in other real estate or investment opportunities

While this might be an excellent opportunity for some, it must be carefully scrutinized since a lien will be placed against the home. If the borrower runs into financial problems, he could lose his home in a foreclosure action. In order to obtain a home equity loan, the individual must have a good to excellent credit history.

**JUMBO MORTGAGES**
A residential mortgage offered to borrowers whose loan requirements are in excess of the FNMA / FHLMC ("Fannie Mae" or "Freddie Mac") conventional conforming loan limits for single family homes. Jumbo Mortgages expose the lender to increased risks because of the size of the loan. These are substantially greater than a conforming mortgage and there is no government agency support and no pool of investors that will secure these mortgages.
REVERSE MORTGAGE
A Home Equity Conversion Mortgage is a relatively new mortgage concept that enables borrowers to convert their home equity into cash. There are no monthly mortgage payments to make while still in the home. The loan proceeds can be disburse to borrowers in several different ways, including an option for a monthly payment for life. In order to qualify for a reverse mortgage, the borrower must meet 3 major qualifications.

- All borrowers must be 62 years or older.
- The subject property /home must be the primary residence.
- Property types allowed include single family residency, 2-4 units or condos.

In addition, the home must have enough equity to cover any lien payoffs, loan fees, interest accrual and servicing fees.

Reverse mortgages are different from conventional mortgages in that there are NO income, asset or employment requirements. Also, borrower counseling is required on every reverse mortgage loan. These loans can be an excellent source of income for seniors whose taxes and other housing expenses may have exceeded their fixed monthly income.

COMMERCIAL MORTGAGE
Similar to a residential mortgage loan in that it uses real estate as collateral to secure repayment. The collateral is commercial real estate rather than the traditional residential. The borrower may be a partnership, incorporated business, Limited Liability Company, or Limited Liability Partnership.

Typically the ability for the lender to evaluate the credit worthiness of the borrower is much more complicated in commercial lending than it would be in residential. In residential, the lender would look at the borrower’s credit history and availability of funds and determine whether or not to grant the loan. In commercial lending often the assets of the business, its income and expenses as well as those of the borrower are taken into consideration. An analysis of the tenant and guarantor of the loan may be required. Neighborhood and market trends are considered. The composition of the surrounding areas and activity are analyzed. New construction, traffic congestion or lack thereof and neighborhood vacancies could affect the lenders decision.

SOME OF THE PROVISIONS OF A COMMERCIAL LOAN ARE:
Prepayment terms: Not all loans allow a prepayment. If prepayment is allowed, the lender may dictate when the note may be prepaid and if there will be a prepayment penalty.
Cure periods and notice requirements: The existence and length of cure periods for defaults and whether notice of defaults must be given to the borrower are not automatic. Different provisions for cures and notice are often negotiated based upon whether the default is monetary such as the payment of a principal and interest installment or non-monetary such as repairing damage to the property.
Default provisions: The note should include the events which will cause it to be in default. A reference to make timely payments is generally a provision in all loans.
Acceleration of maturity, hand-in-hand with the default provision is the acceleration of maturity provision without which the ability to foreclose or to exercise the power of sale could be fatal.
Late charges and default rate of interest: These amounts are often negotiated, but in any event must be limited by the maximum rate of interest permitted under applicable law.
Joint and several liability, This provision is always appropriate. Even when there is only one borrower at loan inception. This protects the lender in the event that the loan is modified after closing to add additional borrowers
Usury: Charging interest above the legally permit rate.
Recourse versus non recourse loans: In most jurisdictions, unless otherwise indicated in the loan documents, the note is recourse, which means that the borrower is personally liable for the repayment of the debt. If the loan is non recourse, the lender will want protection against liability in specific situations; such as liability for environmental contamination, failure to pay taxes and insurance premiums and retention of rental income after a default. The general purpose for this is that many
laws significantly prevent the creditor from going after the borrower for any deficiency. They may require a clause which allows the lender to take the property immediately regardless of any bankruptcy proceedings currently taking place.

**BRIDGE LOANS**
Temporary financing for either an individual or business until permanent or the next stage of financing can be achieved. Frequently, Bridge loans are used for commercial real estate purchases to quickly close on a property, retrieve real estate from foreclosure, or take advantage of a short-term opportunity in order to secure long term financing. They are usually repaid when the property is sold, refinanced with a traditional lender/bank, the borrower's creditworthiness improves, the property is improved or completed, or there is a specific improvement or change that allows a permanent or subsequent round of mortgage financing to occur. Typically, the term of a bridge loan up to 3 years and perhaps 2-4 points or more may be charged.

**BLANKET MORTGAGE**
A mortgage lien on more than one parcel of land. These are most often used by developers. Example: A developer has 5 building lots and obtains financing, pledging all 5 lots. The mortgage usually contains a “release clause”. As the houses are built the lot used is “released” from the lien upon payment of an agreed upon amount. This allows the developer to obtain financing, build his houses and repay the loan in an orderly fashion.

**PACKAGE MORTGAGE**
Personal property as well as real estate is pledged as security for the debt. If furniture or major appliances are included in the sale, the financing would be referred to as a “package mortgage”.

**CONSTRUCTION LOANS**
The borrower submits his building plans to the lender along with all specifications for building. The lender then establishes a value based on an appraisal of the impending construction. Once approved, the loan will have specific times when funds will be disbursed. This is usually at stated stages of development. Once all the money is disbursed and the house is complete the lender will usually convert the loan to long term permanent financing.

**HARD MONEY LOANS**
These loans are typically issued at much higher interest rates than conventional commercial or residential property loans and are almost never issued by a commercial bank or other depository financial institution. Hard money is usually needed for a distressed financial situation. Perhaps the borrower is in arrears on other mortgage financing or pending foreclosure or bankruptcy. Many hard money loans are made by private investors in their local areas. They are usually collateralized against the quick-sale value of the property for which the loan is made. This could mean that the true value of the real estate is not used as the basis for the amount of loan available. Instead the basis would be how much the property could bring in a quick or distressed sale. The lender wants to insure his position in the event of a default so the loan to value ratio is lower.

**THE MORTGAGE PROCESS**

**MORTGAGE UNDERWRITING**
Underwriting is the process a lender uses to determine if the risk of lending to a particular borrower under certain parameters is acceptable. Most of the risks and terms that mortgage underwriters consider fall under the four C’s of underwriting:

1. Credit
2. Capacity
3. Collateral
4. Common Sense
To help the underwriter assess the quality of the loan, banks and lenders create guidelines and even computer models that analyze the various aspects of the mortgage. Further, they provide recommendations regarding the risks involved. However, it is always the underwriter’s discretion to make the final decision to approve or decline a loan.

CREDIT
Will the borrower be able to repay the mortgage? There are many different types of credit reports available, and the one used will be determined by the specific needs of an underwriter. Most large lenders will require a residential mortgage credit report (RMCR). These detailed reports contain data from each of the three major credit bureaus; Equifax, Transunion and Experian, and are often referred to as a “tri-merge” credit report. The reports provide information including credit scores, the borrower’s current and past credit card performance, loans, collections, repossessions and foreclosures as well as public record (tax liens, judgments and bankruptcies). Typically, a borrower’s credit history is a likely indicator that the loan will be paid in a timely fashion. But this may not always be so.

Until recently, the reviewing of credit was very subjective. Different underwriters could review the same file, and come up with very different assumptions. A loan file that one underwriter would grade as an “A” loan, could just as easily be rated as a “B” loan by another. This lack of consistency made it difficult for investors to purchase loans and be comfortable in knowing exactly what they had purchased.

To answer this problem, the Fair Isaacs and Company credit bureau developed the FICO score. The other bureaus followed suit. Soon, credit scores were used to help in making a lending decision.

The credit score is a numerical indicator of the likelihood of default. Using a mathematical model, the data regarding each item on the credit report is used to produce a number anywhere between 501 and 990, and rated A through F. The higher the number, the less likely a particular borrower is going to default on their obligations. These ranges changed as of Jan. 2010.

There are many different loans available and they have very different credit criteria. As agents trying to assist a borrower determine what might be best for them, we need to know which loans are available at any given time. We are not the lender and are not making a decision whether or not to lend, or even to give assurance that any loan might be available for that particular buyer. All we should be able to do is discuss different available options and then leave the decision making to the borrower and the lender.

CAPACITY TO REPAY THE MORTGAGE
To determine this, the underwriter will analyze the borrower’s employment, income, his or her current debt and assets. An underwriter is looking for two main things when analyzing income. The first is, can the borrower reasonably afford the loan today, and will they likely have the income to afford the loan in the future?

Self-employed borrowers will often have income that is inconsistent or hard to verify, since they are responsible for the debt and well being of their business in addition to their personal obligations. Because the income can be more difficult to verify, it lowers the overall confidence of the underwriting decision. The lower the confidence in the decision, the higher the perceived risk to the lender. Commission income also carries risks in stability. If for any reason the borrower fails to produce business, his income is reduced. Additionally, it is hard to predict future income for commissioned employees.

In most scenarios, if self-employment or commission income is used to qualify for the mortgage, a two year income history is required. Documentation of the income also varies depending on the type of income. Retirees must show evidence that they currently receive social security and that the social security is likely to continue. This is done by providing a copy of the social security award letter,
However, people that receive income via cash investments must provide statements and determine the continuance of the income from those payments.

In short, the underwriter must determine and document that the income and employment is stable enough in order to pay the mortgage in the years to come. Additionally, underwriters evaluate the capacity to pay the loan using a comparative method known as the debt to income ratio. This is calculated by adding up all of the monthly liabilities and obligations (mortgage payments, monthly credit and loan payments, child support, alimony, etc) and dividing it by the monthly income.

**Example:** A borrower has a $500 car payment, $100 in credit and loan payments, pays $500 in child support and wants a mortgage with payments of $1,000 per month. His total monthly obligations would then be $2100. If he makes $5,000 a month, his debt to income ratio is 42%. ($2100/$5000 =42%) Many lenders want the ratio to be anywhere from 32% for the most conservative loans to 50% for the most aggressive loans. Along with the debt to income ratio, lenders will calculate the “housing ratio”. This number is calculated the same as the debt ratio, except it only considers the total housing payment as a portion of the income. Typically, the housing ratio should be around 27%. The logic behind this number is that we all have additional debts besides our home, and if our home takes up an exorbitant portion of someone’s income, it will be the first thing we default on in the event of financial difficulties.

Assets are also considered when evaluating capacity. Borrowers who have an abundance of liquid assets at the time of closing statistically have lower rates of mortgage defaults

**COLLATERAL**
When granting a mortgage loan, the lender requires collateral. They want security for the debt. If they lend money and the borrower defaults on their payment, the lender would have the right to institute legal proceedings to gain ownership of the pledged property. Property value, the use of the property and anything else related to it might be used as that collateral.

Property type can be classified in the order of possible risk to the lender from lowest to highest.
- Single Family Residence
- Two Unit Residence
- Townhouse
- Low Rise Condominium
- High Rise Condominium
- Three and Four Family Units
- Condotels (Condo Hotels)

Occupancy is also considered as part of collateral. A home can be owner occupied, used as second home or as an investment. Typically, owner occupied homes have the lowest likelihood of default, followed by second homes. Investment properties, however, have higher occurrences of default. Depending on the combination of occupancy and type of collateral, the lender will adjust the amount of risk they are willing to take.

Besides occupancy and property type, value is also considered. It is important to realize cost, price, and value have 3 different meanings. Perhaps the easiest way to distinguish among the three is to consider
- **Cost**=Past
- **Price**=Present
- **Value**=Future

**Cost** is the dollar amount needed to build the home or was paid to acquire it. In addition, any renovation that was made including labor and materials would be included.
**Price** is the dollar amount that a seller agrees to sell a house for and a buyer agrees to pay to own it. This would be in an arm’s length transaction. One in which each of the parties is looking out for his
own benefit. Some transactions that are probably not “arms length” might include, parents selling their home to their children, or a house sold due to a divorce or estate settlement.

Value has several different references and meanings:
Market value would be the most probable price a house would bring in the open market in an arms length transaction.
Mortgage loan value refers to what a bank thinks the home will bring in the event of a foreclosure sale. Mortgage loan value would be quite different from market value.
Investment value would be used to determine how much of a return an investor will receive on his investment.
Value in use is purely subjective. It refers to the future benefit of present worth. Every person has his own value system which will determine how much, if anything, an item is worth to them.
Example: A vacation home might have no value to a young family needing a primary residence. A lovely two bedroom home in a secluded rural area would probably not be a preference for a family with 3 young children. Each person’s lifestyle requirements, personal taste and usefulness of the property, will determine whether or not it has value to them.

Value represents emotion. By determining the emotional value of a property, the buyer may decide whether or not to purchase it. It is often said that in a primary residence, buyers buy emotionally and then justify the purchase logically.

To determine the value for financing, an appraisal is usually obtained. This is covered in depth in another chapter.

Once the lender has analyzed the different factors of a borrower’s credit and collateral profile, they make a determination as to the amount of security they wish to have on that particular loan. The security they require is represented by the loan to value (LTV).

Loan to value is a ratio of the loan amount compared to the value of the property. In addition, the combined loan to value (CLTV) is the sum of all liens against the property divided by the value.
Example: If the home is valued at $200,000 and the first mortgage is $100,000 with second mortgage of $50,000, the LTV is 50% while the CLTV is 75%. $100,000 is 50% of the appraised value of the home. However, after including the second mortgage of $50,000 the combined loans are $150,000 or 75% CLTV. Naturally, the higher LTV and CLTV’s increase the risk of loss to the lender in the event they must reclaim the property via foreclosure. Obviously, borrowers who contribute a significant down payment (lowering the LTV) statistically have lower incidents of foreclosure.

The type of loan also may affect the LTV and is considered when evaluating the collateral. When a lender makes a loan, they are ultimately doing so with the expectation that all payments will be made as agreed. However, lenders also understand the reality that sometimes borrowers can’t, or won’t repay the loan, and the lender will have to foreclose.

COMMON SENSE
When an underwriter is making a decision to approve a loan for a borrower, he or she should definitely use “common sense”. Just because the borrower meets the lender’s criteria, does not necessarily mean that borrower should get the loan approved.

SECONDARY MORTGAGE MARKET
HUD (Housing and Urban Development) created Ginnie Mae in order to guarantee the timely payment of principal and interest from government insured mortgages. These would include FHA, VA, and RHS. The primary focus of Ginnie Mae is to increase liquidity and efficiency of mortgage loan funding. Federal Home Loan Mortgage Corporation (FHLMC) (Freddie Mac) purchases loans from members of the Federal Home Loan Bank or any bank where the deposits are insured by an agency of the Federal Government. Freddie Mac is owned by savings and loan and savings banks.

As with other secondary mortgage market participants, Freddie Mac benefits the borrowing public by creating more liquidity in mortgages. When a mortgage can be sold in the secondary market it makes
the funds available to other borrowers. This is especially necessary when interest rates are low. The loan can be sold and the funds received invested in new mortgages at a higher rate.

**MORTGAGE-BACKED SECURITIES**
Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization. Most MBSs are issued by the Government National Mortgage Association (Ginnie Mae), a U.S. government agency, or the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

One key term to be aware of when attempting to understand the secondary mortgage market is **DISINTERMEDIATION**; long word with an important definition. In times when mortgage interest rates are low and could produce higher yields in other securities, there could be a loss of available funds for making mortgage loans. This is referred to as disintermediation. The secondary mortgage market prevents funds from ‘drying up’ by allowing the sale of existing loans to recycle funds.

**REDUCED DOCUMENTATION LOANS**
Many banks offer reduced documentation loans. These allow a borrower to qualify for a mortgage without verifying certain items such as income or assets. Naturally these are higher risk loans and often come with higher interest rates. Because less documentation is provided by the borrower, there is a high emphasis on the credit and collateral. To lessen the risk of reduced documentation loans, lenders will often reduce the loan to value ratio and limit the loans to smaller amounts, compared to loans that are fully documented.

**APPROVE OR DECLINE**
After reviewing all aspects of the loan, it is up to the underwriter to assess the risk of the loan as a whole. Each borrower and each loan is unique and many borrowers may not fit every guideline. However, certain aspects of the loan may compensate for the lack in other areas. For example, the risk of high LTVs can be offset by the presence of a large amount of assets. Low LTVs can offset the fact that the borrower has a high debt to income ratio and excellent credit can overcome the lack of assets. These are referred to as compensating factors.

**GENERAL LOAN FILE SUBMISSION PROCEDURES AND REQUIREMENTS**
A typical complete loan package includes all required credit, collateral, compliance, and loan setup documents.

**TYPES OF DOCUMENTATION**

**Full Documentation** - This is the most common type of mortgage documentation. With a full “doc” mortgage the borrower will normally be expected to provide the following:
- Complete proof and documentation of all income sources and asset sources
- At a minimum; the last 2 pay stubs
- Last 2 years W-2 forms
- Last 2-3 months bank statements for each bank account (full statements and not just the first page)
- Most recent 6 months of 401K and/or IRA statements
- Many sub prime lenders will allow substitution of the last 12-24 months bank statements in lieu of both pay stubs and W-2s

**Limited Documentation mortgages** generally will use as little as 12 month’s bank statements to prove income.

**Stated Income/Verified Asset** - the borrower simply states their income, it has to be reasonable to the type of work. Similar to a full doc mortgage, assets with documentation would be verified.

**Stated Income/Stated Asset** - both income and assets are stated, they are not verified.
No Ratio-employment information is required, however, the income amount is neither shown nor disclosed. The only information that is verified with the employer and that the borrower is employed there and for how long. Assets will normally be verified with this mortgage type. **No Income No Asset** - neither income nor assets are shown. As with a no ratio mortgage, employment is verified. No Documentation - A no doc mortgage is just that. There is no documentation required to be approved. This mortgage will be strictly based on the borrower’s credit score and depth of his/her credit history.

Is it any wonder that, with some of these loans available, people were getting mortgage loans who would have problems in the future?

**ELIGIBLE BORROWER CRITERIA**
In general, most lenders will approve loans to adults. People who have reached the age of majority usually 18 year of age. At this age the mortgage note can be legally enforced in the jurisdiction in which the property is located.

**LOAN PROPERTY ELIGIBILITY**
Properties must be easily marketable and free of major adverse conditions. When determining property eligibility it is important to remember that certain property conditions might not be acceptable in the secondary mortgage market. The secondary mortgage market is the market for the sale of securities or bonds collateralized by the value of mortgage loans by lenders.

**REAL ESTATE APPRAISAL**
The appraiser’s role is to provide an estimate of value, as well as a complete and accurate description of the property. The most common type of value would be Market Value. This is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arms-length transaction after proper marketing when the parties have each acted knowledgably, prudently, and without compulsion. Simply put, how much a buyer would pay and a seller is willing to accept, each one trying to get the best terms for them.

**FORBEARANCE**
An agreement between a creditor (lender) and a debtor (borrower) on which the lender agrees not to take an action to which he is legally entitled. This would include the right to foreclose in the event the borrower is behind in payments. Two common types of forbearance repayment plans are: Pay a specified amount more than the regular loan payment each month until the full delinquency has been paid. Or, add the delinquent amount to the end of the loan. In either case, the delinquent borrower would not be subject to a foreclosure action as long as he lives up to the terms of the agreement.

**FORECLOSURE**
A legal procedure in which a property pledged to secure mortgage debt or other types of liens against the property is sold to satisfy the debt.

**DEED IN LIEU OF FORECLOSURE**
Often called a friendly foreclosure. The borrower willingly gives the title to the mortgagee in order to avoid a record of foreclosure.

**FORECLOSURE BY JUDICIAL SALE**
This is available in every state and is the required method in many. It involves the sale of the mortgaged property under the supervision of a court, with the proceeds going to satisfy the liens in order of priority. Usually tax liens first and then mortgage liens and then any other liens. Because it is a legal action, all the parties must be notified of the foreclosure, and there will be pleadings and some sort of judicial decision, usually after a short trial.
ACCELERATION CLAUSE
Practically all mortgages today have acceleration clauses. In the event of a pending foreclosure, the lender has the right to accelerate the entire unpaid balance of the loan. If a mortgage does not have one, the mortgage holder has no choice but to either wait to foreclose until all of the payments come due or convince a court to divide up parts of the property - and sell them in order to pay the installment that is due. Alternatively, the court may order the property sold subject to the mortgage, with the proceeds from the sale going to the payments owed the mortgage holder.

BANKRUPTCY

CHAPTER 7 BANKRUPTCY, sometimes called a straight bankruptcy is a liquidation proceeding. The debtor turns over all non-exempt property to the bankruptcy trustee who then converts it to cash for distribution to the creditors. The debtor receives a discharge of all dischargeable debts usually within four months. In the vast majority of cases the debtor has no assets that he would lose so Chapter 7 will give that person a relatively quick "fresh start".

CHAPTER 11 BANKRUPTCY
“Business reorganization” is primarily for corporations/partnerships. However, a Sole Proprietor, a Small Business Debtor, or a Single Asset Real Estate Debtor may also reorganize.

CHAPTER 13 BANKRUPTCY
Used by people who have faced short-term financial setbacks like job loss, illness, or large unexpected expenses. Also those who have been had a crisis and fallen behind on their bills, but who have regular income and are in a position to make regular monthly payments, a Chapter 13 bankruptcy plan may allow the time necessary to get back on track. Many people looking to stop foreclosure or avoid repossession choose Chapter 13 bankruptcy, because it combines the automatic stay with the ability to catch up past due payments over a period of three to five years while keeping current payments up to date.

Repayment Plan
Unlike Chapter 7 bankruptcy, Chapter 13 doesn't liquidate assets and clear the slate in a short period of time. Instead, Chapter 13 bankruptcy is intended to help people facing financial difficulty keep their property while gradually catching up on past due balances.

A typical Chapter 13 bankruptcy repayment plan is 36 to 60 months long. During that time, the bankruptcy petitioner keeps current payments current, but makes monthly payments toward past due balances. Debts are prioritized, and secured creditors get paid first. Remaining disposable income goes to pay unsecured creditors, in a hierarchy established by the Bankruptcy Code. If all payments have been made as scheduled, unsecured debt remaining at the end of the plan may be discharged.

BANKRUPTCY DISCHARGE VS. DISMISSAL
Bankruptcy Discharge - The court order that releases the debtor(s) from the liability/responsibility of their debts.
Bankruptcy Dismissal - Occurs when a bankruptcy case is ended prematurely prior to a final conclusion (discharge).

THE MORTGAGE LOAN and MORTGAGE CALCULATIONS

Loan to Value (LTV) - is a mathematical calculation which expresses the amount of a first mortgage lien as a percentage of the total appraised value of real property.
EXAMPLE: if a borrower wants $130,000 to purchase a house worth $150,000, the LTV ratio is $130,000/$150,000 or 87%.

Loan to value is one of the key risk factors that lenders assess when qualifying borrowers for a mortgage. The risk of default is always at the head of lending decisions. The likelihood of a lender
absorbing a loss in the foreclosure process increases as the amount of equity decreases. Therefore, as the LTV ratio of a loan increases, the qualification guidelines for certain mortgage programs become much stricter. Lenders can require borrowers of high LTV loans to buy private mortgage insurance (PMI) to protect the lender from the buyer default. This increases the costs of the mortgage.

EXAMPLE: A house sells for $250,000 but appraises for $225,000. The bank will use the $225,000 as the basis for loan to value. The house sells for $225,000 but appraises for $250,000. Once again the bank will use the lower of the two or $225,000 as the basis for loan to value.

Low LTV ratios (usually below 80%) hold lower rates for low-risk borrowers. Lenders can consider higher-risk borrowers, such as those with low credit scores, previous late payments in their mortgage history, high debt-to-income ratios, high loan amounts or cash-out requirements, insufficient PITI reserves and/or no income documentation. Generally interest rates are higher for this group than for lower risk borrowers.

Debt to Income ratio (DTI) – is the percentage of a consumer's monthly gross income which goes toward paying debts. There are two key types of DTI ratios which are expressed as a pair using the notation x/y (i.e. 28/36).

The first ratio, known as the front-end or housing ratio, indicates the percentage of income that goes toward housing costs, which for renters is the rent amount and for homeowners is PITI (PITI includes mortgage principal and interest, mortgage insurance premium (if applicable), hazard insurance premium, property taxes, and homeowners association dues (if applicable). In a 28/36 percent ratio, 28% would be the front end.

The second ratio, known as the back-end ratio, indicates the percentage of income that goes toward paying all recurring debt payments, including those covered by the housing ratio, and other debts such as credit card payments, car loan payments, student loan payments, child support payments, alimony payments, and legal judgments.

Again in the 28/36% example, 36% would include all of their front end expenses and recurring debts. The total of all debts, including housing, that is commonly referred to as the “DTI”.

The monthly debt payment is the sum of the following monthly charges:

✓ Monthly housing expense.
✓ Payments on all installment debts with more than ten months of payments remaining: Exception – Payments on automobile leases, regardless of the remaining number of payments, must be included in the calculation of recurring monthly expenses.
✓ Alimony, child support, or maintenance payments with more than ten months remaining.
✓ Monthly payments (or 3% of the outstanding balance if a monthly payment is not provided) on revolving accounts, regardless of the balance
✓ Aggregate negative net rental income from all investment properties owned.
✓ Monthly mortgage payment for second home.
✓ Payments on any loan that is not documented as deferred. If a payment is not indicated on the borrower’s credit report, a copy of the borrower’s payment letter or forbearance agreement is required to determine the payment amount to use in calculating the borrower’s total monthly obligation.

EXAMPLE: In order to qualify for a mortgage for which the lender requires a debt-to-income ratio of 28/36:
Yearly Gross Income = $45,000 / Divided by 12 = $3,750 per month income.
$3,750 Monthly Income x 28% = $1,050 allowed for housing expense. (PITI)
$3,750 Monthly Income x 36% = $1,350 allowed for housing expense plus recurring debt.
36%-28%=8% of monthly income for recurring debt.
Disposable Income
In determining disposable income, lenders typically use the following method to calculate a borrower’s disposable (net) income. For wage and self-employed income, use 75% of the gross income to determine the net income. For Social Security, use the net amount after Medicare deduction. This is the amount of the actual Social Security payment made to the borrower. For Pension and other taxable retirement income, use the net amount after taxes have been withheld. And for child support, use the actual amount of the monthly child support.

EXAMPLE:
Gross income $2000 x 75% $1,500.00
Minus all debts $500.00
(Net) Disposable Income $1,000.00

Amortization payment schedules are readily available and by using their net income as a guide, determine how much principal and interest they can afford which will translate into the amount they can borrow. Add their down payment to the amount they can borrow and you have a general idea of the maximum price house they will be able to buy.

EXAMPLE: A net income of $1,000 per month might hypothetically allow them to pay $360.00 per month for principal, interest, taxes, insurance and recurring debt. ($1,000 x 36% = $360.) Of this, however, only $280.00 will go to P & I ($1,000 x 28%). If the amortization chart shows that the maximum they can borrow paying only $280. per month is $50,000 that would be their maximum mortgage loan.

Perhaps they have $100,000 as a down payment which is coming from the sale of their apartment. They can now afford to buy for no more than $150,000. ($50,000 mortgage financing plus $100,000 down payment)

Full Amortization
This type of mortgage loan is paid through a method in which the amount borrowed is repaid gradually though regular monthly payments of principal and interest. The monthly payment remains fixed throughout the life of the loan. The interest paid each month is calculated on the current outstanding balance of the loan. Therefore, during the first few years, most of each payment is applied toward the interest owed. During the final years of the loan, most of the payment is applied to the remaining principal. By the last scheduled payment there will be no interest or principal owed.

AMORTIZATION SCHEDULE
In order to recognize how much interest or principal will be applied with each payment, we should familiarize ourselves with an amortization schedule. This is merely a table detailing each periodic payment on a loan. Because a portion of every payment is applied towards both the interest and the principal balance of the loan, the exact amount applied to principal each time varies (with the remainder going to interest).

An amortization schedule reveals the exact dollar amount paid toward interest, as well as the principal balance. Initially, a large portion of each payment is devoted to interest. They run in chronological order. The first payment takes place on payment period after the loan originated since interest is calculated on the amount borrowed.

EXAMPLE: Let’s review an amortization schedule based on the following assumptions:
Principal = $100,000
Annual Interest rate = 8%
Number of payments = 360 (30 years x 12 months x 1 payment per month)
Amortized Payment = $733.76
There are a few crucial points worth noting when mortgaging a home with an amortized loan. First, we note that, as we have explained, the amount applied to interest decreases and the amount applied to principal increases each month. In month 1 the amount applied to principal is $67.09 and the amount applied to interest is $666.67. By month 5 the interest payment is reduced to $664.86 and the principal payment has increased to $68.90. Also note that the principal balance has gone down from $99,932.91 to $99,660.04.

Generally the first 20 or so years of a 30 year fixed rate mortgage most of the payment goes to interest. Not until payment 257 or 21 years into the loan does principal and interest distribution become more even and subsequently tip the majority of the monthly payment toward Principal balance pay down.

Note that by the end of the loan the borrower had paid a total of $64,160.50 in interest on $100,000 borrowed. Many borrowers who are interested in reducing the amount of interest paid on their loan will make an extra monthly payment each year. Doing this will not decrease the monthly payment but will reduce the total number of months the loan has to be paid and substantially reduce the amount of interest the lender will earn. Keep in mind that the lender is only entitled to interest on the outstanding balance of the loan. Therefore, by making an extra payment each year the principal reduces more rapidly than the schedule calls for. A rule of thumb is that with one extra payment, applied fully to principal, per year the loan will reduce from 30 years to approximately 21 years. A 15 year loan will reduce to approximately 11 years. These are just approximations and each loan must be calculated individually.

CLOSING THE LOAN
An entire chapter is devoted to closing and closing costs. We are just going to do an introduction to the process at this point.

The closing is, perhaps, the most difficult part of the sale for both the buyer and seller. Important documents are passed around the closing table, signatures are required numbers are crunched and checks are written. For the buyer, this is probably the single largest purchase he has ever made. For the seller, perhaps the single largest item he has ever sold. Emotions are high and part of our job is to understand the process in order to reassure both buyer and seller that what is occurring is quite “normal”.

Both the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) protect the borrower by requiring that he be given all of the terms of borrowing as well as the anticipated closing costs and what they represent. Now that the loan is approved and other contingencies have been successfully dealt with, the wonderful day of “closing” is at hand. All of the details are covered in the Closing Cost chapter.

FRAUD, SCAMS AND RED FLAGS

MORTGAGE FRAUD
Mortgage Fraud is an act of intentional deception involving the securing of real property by taking unjust advantage of someone else. While there may be many ways in which fraud can be accomplished, there are primarily two types of fraud in the mortgage industry, fraud for housing and fraud for profit.
**Fraud for Housing** – The borrower(s) or other involved parties provide misrepresented materials to the bank in order to qualify for a mortgage loan.

**Fraud for Profit** – The individuals involved in the schemes misrepresent material facts about the value or ownership of a property in order to create a financial gain.

Most banks/lenders are required to review loan packages for “red flags,” which may indicate irregularities in the data submitted by a borrower or other parties in the transaction. The presence of one or more red flags is not necessarily absolute proof of a fraudulent loan, however when one looks at the big picture, a trend of fabrication may start to emerge.

**STRAW BORROWER SCHEMES**
A straw borrower would be substituted for the real borrower and serve as a “cover” in a transaction. This would prevent the seller and lender from knowing the true identity of the buyer/borrower. This could allow the true buyer/borrower to receive approval on a loan that he might not have otherwise received. Typically this would occur when the actual borrower may NOT:

- Qualify for the loan
- Plan to occupy the property as a primary residence if required
- Be eligible for a special loan program

**Some Straw Borrower Red flags would include:**
- Minimal or no credit/FICO score by the borrower
- Another individual signing on the borrower’s behalf
- Names added to the purchase contract
- Sales to a relative or related party
- No real estate broker involved
- Indication of default by property seller
- A quit-claim deed is used either right before or soon after closing the loan

**Property Flip Schemes** - Property flip schemes occur when ownership of one property changes several times in a short period of time. Flips are often used to artificially drive up the “value” of a property in order to attain larger loans than what may otherwise be possible. This will result in “stripping” the equity of the property. Example: A house is sold several times. Each sale is higher than the previous one. Ultimately, the house might appraise at considerably more than it is actually worth and a lender would extend mortgage financing far beyond what they should. Flips are also used to hide the identity of the true buyer or seller of the property.

**Potential indicators of property flips include:**
- Ownership changes two or more times in short time span
- Two or more closings occur at nearly the same time, for considerably different prices, typically inflating the property’s value.

**Some Property Flip Red flags that may indicate a property flip transaction are:**
- Property owned by the seller for a short time
- Property seller is not listed on the title
- Parties to the transaction are affiliated
- Property sales that do not involve a real estate broker.
- Double escrow accounts

**EQUITY SKIMMING**
Involves investment property(s) whereby the owner/investor collects the monthly rents and fails to make the mortgage payments. The investor usually obtains the property through either a purchase transaction or an assumption. If obtained through a purchase transaction, the investor generally persuades the property seller to accept a purchase money mortgage in lieu of a cash down payment.
At this point, the investor has no money of his own in the property. He profits by collecting rents for the period of time it takes the lien holder(s) to complete the foreclosure process.

Investors using this method frequently obtain several properties within a short period of time. They will make mortgage payments (while acquiring other properties using the same scheme) before finally defaulting on the mortgage payments.

**FORECLOSURE BAILOUT**
A foreclosure bailout may be either a refinance or purchase money transaction when the real intent of the loan is to prevent the property owner from going into foreclosure. These transactions can be done as either a refinance or a purchase. When structured as a refinance, title is typically transferred (or gifted) to a friend or family member who applies for a loan in their own name. When structured as a purchase, the borrower acts as a “straw buyer” for the true owners of the property. In this case, the sales price and appraisal may be inflated to support an artificially low LTV.

**Some Foreclosure Bailout Red flags**
- Existing loan(s) or lien on title is presently in default
- Borrower cannot verify “equitable interest” (refinance)
- Mortgage loan on title is not in the borrower’s name (refinance)
- Borrower’s mortgage loan is not rated on credit report (refinance of property not in the borrower’s name)
- Gift equity or non-arms length purchase transaction
- Borrower is unable to clearly document the source of funds needed to close
- An “investment company” is somehow involved in the purchase transaction
- “Unreasonable” proposed occupancy (e.g., commuting distance) on the subject property (purchase)
- All documentation (e.g., pay stubs, W-2s, tax returns, bank statements, credit report address, etc.) reflect the borrower living at another address, but the loan was presented as “owner-occupied.” (Refinance)

**Builder Bailout Schemes**
Occur when the builder or developer is motivated to move property quickly in a depressed real estate market.

Potential indicators of builder bailouts include the following:
- The builder is “very eager” to sell the property.
- The borrower is barely qualified or unqualified.
- The sales price and appraised value are significantly higher.
- There is zero down payment made.
- “Silent” or “concealed” second mortgages are involved.
- Sales price has been increased
- Reference to secondary financing on the HUD-1 or purchase contract
- Parties to the transaction are affiliated
- Untraceable source of funds

**Loan Application Red Flags:**
- Significant or unrealistic commuting distance
- New housing not large enough to accommodate all occupants
- Buyer is down-grading from larger to smaller home (except “empty nesters”) for no apparent reason
- Buyer currently resides in property (purchasing from landlord)
- Buyer intends to rent/sell current residence with no documentation
- Down payment other than cash
- Borrower/co-borrower working for same employer (especially if self-employed)
- Same telephone number for home and business
- High income borrower has little or no personal property or minimal liquid assets
✓ New housing expense exceeds 150% of current housing expense with no supporting rationale
✓ Inappropriate salary with respect to amount of loan
✓ Significant or contradictory changes from handwritten to typed loan application

**Verification of Deposit Red Flags:**
✓ Prepared/signed by originator on the same date as completed/signed by depository
✓ Cash in bank not sufficient to close escrow
✓ New bank account (previous one must be verified)
✓ Round dollar amounts (especially on interest-bearing accounts signifies that interest has not accrued on the account)
✓ Borrower has no bank account (does not believe in banks)
✓ Significant changes in balance from prior two months of date of verification
✓ Type or handwriting identical throughout
✓ Credit union for small employer
✓ Document is not folded (never mailed)
✓ High income borrower with little or no cash
✓ Evidence of ink eradicator (“white out”) or other alterations
✓ Addressed to P.O. Box (unless verified using an address cross-check book)
✓ Addressed to a specific individual at the depository

**Tax Returns Red Flags:**
✓ Tax returns not signed/dated by borrower
✓ Address and/or profession does not agree with other information submitted
✓ No estimated tax payments by self-employed borrower
✓ Type or handwriting varies within return
✓ Evidence of ink eradicator (“white out”) or other alterations
✓ Real estate taxes paid but no property owned per URLA (Uniform Residential Landlord and Tenant Act)
✓ No mortgage interest paid when borrower shows ownership of property
✓ (or vice versa)
✓ Additional properties listed on Schedule E but not shown on loan application
✓ Math errors and totals do not add up
✓ No occupation code on Schedule C

**Form W-2 Red Flags:**
✓ Invalid Employer Identification Number
✓ Different type within the form
✓ Handwritten (not acceptable to the IRS)
✓ Round dollar amounts
✓ No address/incorrect address of employee or employer
✓ Incorrect form provided (i.e., borrower should always provide “Copy C,” unless the closing is prior to April 15th)

**Appraisal Red Flags**
✓ Ordered by a party to the transaction other than the loan originator (i.e.
✓ Real Estate Broker or borrower
✓ Comparable sales not verified as recorded (data source MLS, sales office, etc.)
✓ Subject property’s history shows recent sales within the year for a lower price
✓ Appraiser in one locale appraising property in an entirely different locale
✓ (i.e., property in Albany, N.Y completed by an appraiser in Middletown, N.J.)

**Escrow/Closing Instructions Red Flags:**
✓ Reference to another (double) escrow/sale
✓ Right of assignment (Who is the actual borrower?)
✓ Sale “subject to” seller acquiring title
**Phony Employment, Credit or Income** - Phony employment or income occurs when the credit file is developed through fraudulent means. The following scenarios describe common methods of falsifying employment or income.

- A co-worker or superior completes a Verification of Employment (VOE) with false information.
- A co-worker or superior acts as an authorized signer on a VOE.
- The borrower may rent a post office box, or provide another address for their employer.
- The borrower provides false telephone numbers for those lenders that perform telephone verifications.
- The borrower provides false tax returns, W-2s, and pay stubs, all of which may be easily obtained through interested parties to the transaction.
- The borrower may use a fraudulent Social Security Number on the original credit application. When the credit report is generated, it will reflect no credit, thereby effectively hiding the borrower’s poor credit history.
- The borrower may assume the identity of someone else.

**Verification of Employment Red Flags:**
- Prepared/signed by originator on the same date as completed/signed by employer
- Round dollar amounts
- Employer uses mail drop or P.O. Box for business address
- Change in profession from previous to current employer
- Inappropriate verification source (secretary, relative, etc.)
- Overtime equals or exceeds base pay
- Document is not folded (never mailed)
- Evidence of ink eradicator (“white out”) or other alterations
- Answering machine or service at place of business (unless self employed)
- Type or handwriting identical throughout

**Credit Report Red Flags:**
- Employment information/history varies from loan application and/or VOE
- No credit
- Variance in employment or residence data from other sources
- Invalid Social Security Number (or variance)
- Initial or Extended Fraud Alert

**Pay Stub Red Flags:**
- Company name not imprinted
- Employee name not printed
- Handwritten
- Round dollar amounts
- Date of pay period missing
- No tax withholding
- Incorrect Social Security/Medicare deductions

No doubt the possibility for fraud exists in mortgage borrowing. Our job as licensees is to be inquisitive, never forgetting, however, that we are not the lender and we are not processing or underwriting the loan. We must never put ourselves or the borrower in the position of committing fraud or recommending a fraudulent practice. So often fraud is uncovered and the borrower testifies that the salesperson or a representative of the lending company recommended an “easy way” to get the loan. Don’t be a party to it. Remember, honesty, integrity and morality is what we need to be successful.
CHAPTER 14 MORTGAGE BROKER

KEY TERMS
- Mortgage banker
- Mortgage broker
- Mortgage broker dual agency disclosure form
- Mortgage commitment
- Lender rebate
- Nonconforming loan
- Pre application and fee agreement
- Preapproval
- Prequalification
- Rate lock
- Underwriting

Often the terms mortgage banker and mortgage broker are used incorrectly. They have very different meanings. A mortgage banker can be a source of funding. Funding refers to the party who actually lends the money to the prospective borrower. A mortgage broker is quite different. She has no money to lend. She is a go between, the third party between the borrower and the lender. One of the most important responsibilities of the mortgage broker is to inform the borrower of all potential lending institutions available to meet their borrowing needs. A broker can accept and process mortgage application. The underwriting and lending of the money would come directly from the bank. Mortgage brokers are familiar many banks and the available loans that would meet the buyer’s needs. Always remember to check with your local bank and Banking Dept. because laws, rules, and lending criteria change, and it is always best to have the most current information.

BASICS OF MORTGAGE BROKERAGE

MORTGAGE ORIGINATOR - A term that describes either a mortgage broker or mortgage banker who originates the loan.

MORTGAGE COMMITMENT – Is a promise letter from a lending institution to provide funds to a borrower.

LENDER REBATE – A payment made by the lender to the mortgage originator

PREAPPROVAL – Issued after the lender checks on the buyers:
- Credit
- Employment
- Down payment
- Gifts letters
- Debt ratio

Once all the information is gathered, the lender will issue a pre approval based on the information he has gathered on that day. This is not a final approval because things such as interest rates, income or employment can change.

RATE LOCK – The borrower has the ability to lock in the interest rate and points with a lending institution. However, this is a temporary lock and may only be valid for 15-30 days

UNDERWRITING – The next step after a loan has been processed. After all the borrowers information has been collected, the underwriter will evaluate it and based on his banks lending criteria they will approve or deny a loan.

REQUIREMENTS TO BECOME A MORTGAGE BANKER
- Adjusted net worth of not less than $250,000
- An existing line of credit of not less than $1,000,000
- A corporate surety bond or pledged deposit valued at not less than $50,000.
- Business Background: five years verifiable experience in the business of making residential mortgage loans or similar lending credit evaluation experience or that they have engaged or shall engage in their employ one or more persons having such experience. Some formal education may substitute for some lending and credit evaluation at the discretion of the Superintendent.
- Demonstration of honest, fair and efficient character.
- An application on the approved form along with a fee of $1,000.
- A set of fingerprints approved by the N.Y.S. Criminal Justice System.
- A report from a qualified investigatory firm detailing personal and financial background.

**REQUIREMENTS TO BECOME A MORTGAGE BROKER**
Licensed real estate brokers and attorneys are not required to demonstrate their experience to engage in the mortgage brokerage business. A qualified person must demonstrate two years active participation in the residential mortgage brokerage business.

Applicants with a minimum of 2 years of credit analysis or underwriting experience with an exempt organization, mortgage banker, mortgage broker or licensed lender must submit a statement verified under penalty of perjury indicating:
- Specific duties and responsibilities of their employment
- Term of employment, name, address and telephone number of business reference or a current or former supervisor
- Relevant business experience must state specific duties and responsibilities, terms of employment must be fully explained. Application must include name and address of supervisor.
- Relevant educational background, specific courses taken and dates of completion.
- There are investigation, fingerprint and application as well as branch office fees. Check with the banking department for the most current ones.

Licensing applications are processed through Nationwide Mortgage Licensing System (NMLS), which processes but does not approve licenses in many states throughout America. It is a centralized system which will keep track of licensees as they are licensed and then as they proceed from one company to another or even one state to another.

**Credit report**: dated not more than 30 days prior to the filing of the application through the NMLS for each direct and indirect owner, owning 10% or more of the entity, the control person, director and three senior most executive officers.

**Surety bond**: provide an original mortgage banker bond for $10,000 furnished by a surety company authorized to conduct business in New York. Applicants that cannot obtain a surety bond can execute a Deposit Agreement approved by the Superintendent of Banks of the State of New York. The Deposit Agreement requires a pledge of securities or funds of $10,000 valued at the lower of principal amount or market value.

**DUAL AGENCY REQUIREMENTS**
In the event a licensed real estate broker is acting in the same transaction as a mortgage banker, mortgage broker or exempt entity, this must be disclosed at the first substantive contact between the licensee and borrower. The mortgage broker must maintain a copy of the disclosure form and signed acknowledgment for at least 3 years.

**STATE BANKING RULES & REGULATIONS**
Paying or receiving of a fee or anything of value, for the mere referral of a loan or other settlement service is generally prohibited by Section 8 of RESPA (Real Estate Settlement Procedure Act).

Permissible incentive payments may go to:
- Managerial employees provided the payments are not based on the number or value of referrals
- Employees provided they do not perform settlement services in any transaction. Filling out an application would not be considered a settlement service. The employee cannot serve as an ongoing point of contact for coordinating the delivery and provision of settlement services. (If the employee does not receive incentive compensation, these restrictions would not apply)
- Employees for generating business for the employer itself and not an affiliate

**OFFICE SPACE RENTAL** - Real estate offices that lease space to lenders or other settlement service providers must charge the general market value of the office space leased; rent cannot be based on
the number or value of business generated from the location. Real estate firms are prohibited from
charging lenders (or other settlement providers) more than the market rate for office space located in
the real estate firm. This usually means general market rates and related overhead.

PROCESSING FEES – A separate processing fee may not be charged regardless of whether or not an
application fee is imposed. Any fee accepted by a mortgage broker, mortgage banker other entity,
must be called an application fee. A processing fee may not be listed on the Pre-Application
Disclosure, Good Faith Estimate or Settlement/Closing Statements.

APPLICATION FEES – Only one application fee may be charged. A mortgage broker and a lender may
not charge separate application fees on the same loan application. This fee is to be disclosed by the
mortgage broker in the pre-application disclosure as well as on the Good Faith Estimate and
Settlement/Closing Statements.

THIRD PARTY FEES – Refunds must be made of third party fees collected in excess of the cost of the
services provided. Mortgage bankers, mortgage brokers and exempt organization are prohibited from
accepting amounts in excess of the actual cost of a tax reporting service and from collecting attorney
fees at closing in excess of the amount to be remitted to its attorney.

ESCROW ADMINISTRATION FEES – No fee may be charged for establishing or maintaining an escrow
account on any one-to-six family owner-occupied residence or on any property owned by a
cooperative apartment corporation.

PAYMENT OF INTEREST ON ESCROW ACCOUNTS – Interest must be paid by a mortgage investing
institution on funds held in escrow, including insurance loss drafts. Also, in connection with a
mortgage on any one to six family owner occupied residence or any property owned by a cooperative
apartment corporation. The rate of interest paid is not less than two percent per annum credited
quarterly.

PRIVATE MORTGAGE INSURANCE – A mortgagor cannot be required to pay the cost of continuing
mortgage guaranty insurance when the equity amount exceeds twenty five percent of the appraised
value at the time the loan was made.

PRE-APPLICATION DISCLOSURES – Mortgage brokers are required to submit a copy of any separate fee
agreement made with the applicant for a mortgage loan to the lender or a written statement that
there is no separate fee agreement.

CO.-BROKERED MORTGAGE LOANS – Fees divided between more than one mortgage broker and/or
mortgage banker and/or exempt organization acting as a mortgage broker must be disclosed in writing
to the applicant as required. Co-brokering parties must perform actual work in order to justify the
collection of a fee. The services rendered must be necessary to the transaction and cannot duplicate
the services performed by others.

ADVERTISING/SOLICITATION
✓ All advertising for a mortgage broker must include “Registered Mortgage Broker-NYS Banking
Dept”. All mortgage bankers advertising must include “Licensed Mortgage Banker-NYS Banking
Department”.
✓ Any advertisement must indicate the name and address of any one of its offices.
✓ No mortgage loan products may be advertised unless the advertised product is available to a
reasonable number of qualified applicants on the day of the ad or the next day.
✓ No advertisement can contain language, indicating the mortgage broker will fund a mortgage
loan. Any advertisement must contain a statement to the effect that the mortgage broker
arranges mortgage loans with third-party providers.
✓ Ads cannot misrepresent the terms, conditions or charges.
EXAMPLES OF DECEITFUL OR MISLEADING ADVERTISING:

- “Immediate approval” of a loan application or “immediate closing” of a loan.
- “No point” mortgage loans when points are a condition for commitment, or the advertisement of an intentionally incorrect specific number of points.
- “Unqualified access to credit” without disclosing the limitations which may exist; such as the percentage of down payment required, that a higher rate or points may be required, or that restrictions as to the maximum principal amount of the loan offered may apply:
- Advertising a specific time period within which a commitment will be issued unless a commitment will be issued to a qualified applicant within the time period specified, it at all.
- The advertisement of a mortgage loan where a current rate is indicated in the advertisement, unless the advertisement specifically states that the expressed rate may change or not be available at commitment or closing.

Every mortgage broker, mortgage banker and exempt organization must maintain a record of samples of its advertisements, including commercial scripts of all radio and television broadcasts, for examination by the Superintendent for a period of two years from the date of publication.

APPLICATION DISCLOSURES AND PROCEDURES

Article 12D requires and authorizes the Banking Board to institute regulations governing the disclosures and the procedures at the time an application is taken.

MORTGAGE BROKER APPLICATION DISCLOSURES AND PROCEDURES

DISCLOSURES:

- That mortgage broker may not make mortgage loans or commitments
- That mortgage broker cannot guarantee acceptance into any particular loan program, nor can that mortgage broker promise any specific loan terms or conditions.
- Whether the mortgage broker places loans primarily with any three or fewer lenders, and if so, the name(s) of such lender(s)
- A statement to the effect that the rate, points, fees, and other terms quoted at commitment includes consideration to the mortgage broker and the specific amount he will receive.
- The amount of the application fee, and the registrant’s good faith estimate of the credit report fee and/or property appraisal fee and the terms and conditions for obtaining a refund if any.
- The specific services which will be provided or performed for the application fee
- The maximum points, including premium pricing, payable from the lender to the mortgage broker and any fees or points to be paid by the applicant directly to the mortgage broker.
- In those instances, where broker fees and points are paid from the loan proceeds and are not considered to be a cost of the credit, a statement in bold face type at least twelve points in size if printed and in upper case letters and underlined if typewritten, must be included to the effect that such points and fees are costs of obtaining the loan which the borrower may be obligated to repay with interest over the term of the mortgage loan.
- Alternatively, in those instances where broker fees and points are paid directly to the broker in full at or before the closing and are not considered to be a cost of the credit, a statement in bold face type at least twelve point in size if printed and in upper case letters and underlined if typewritten, must be included to the effect that such points and fees are costs of obtaining the loan and that they are in addition to the amount which the borrower will actually receive from the loan.
- Any premiums or bonuses to be paid to the mortgage broker by the lender and/or the basis of its eligibility to receive premiums or bonuses

REQUIRED PROCEDURES FOR MORTGAGE BROKERS

- The application fee may not be based upon a percentage of the principal amount of the loan or the amount financed.
- Every application taken by a mortgage broker shall be signed by the consultant or processor accepting it, and will include the name or title and a toll free telephone number of a person in a
management position with the mortgage broker who may be contacted about problems with the application

✓ No mortgage broker shall accept any fee in connection with a mortgage loan other than an application fee, credit report fee and property appraisal fee prior to the acceptance by an applicant of a commitment from a qualified lender nor shall any mortgage broker accept any fee, prior to closing, other than an application fee, credit report fee and property appraisal fee when the commitment from the lender is subject to any of the following:

a. adequate appraisal value
b. satisfactory credit history and obligations
c. pre-sale requirement clause in a condominium or co-op mortgage commitment
d. A mortgage broker can accept a lock-in fee
e. The credit report fee and property appraisal fee shall be the mortgage broker’s good faith estimate of the actual cost of the service. Any amount collected in excess of the actual cost must be returned at or prior to closing.
f. Some or all of these disclosures may appear in forms used to comply with regulations.
g. All printed disclosures must be made in bold face block letters of black type at least 12 point size. If the disclosures are made in typewritten form, the disclosures concerning refund ability must be all in upper case letters and underlined.
h. All registrants must become familiar with qualifications necessary to fulfill lenders requirements.
i. Each mortgage broker shall provide each applicant with a duplicate of the signed application within 7 business days from the time of receipt of such application by the mortgage broker
j. Each mortgage broker shall submit a copy of any separate fee agreement made with the applicant to the lender or a written statement that there is not separate agreement. If applicable, the disclosure shall be included in the fee agreement.

Every applicant shall sign a duplicate copy of the pre-application disclosures he or she has received which shall be kept by the mortgage broker. In instances of mail applications, the pre-application disclosures must be included in the mail application package with a request that a signed copy of these disclosures be returned to the mortgage broker. The mortgage broker shall keep a copy of this request.

COMMITMENT DISCLOSURES AND PROCEDURES
When the funds are going to be used to finance a home, there are many disclosure requirements. At time of commitment, or prior to the acceptance of a commitment fee or any points, the mortgage banker and exempt organization making a mortgage loan will disclose in writing to each applicant the fees to be paid in connection with the commitment and the terms and conditions under which such fees may be refundable. Each mortgage banker and exempt organization shall also disclose the items listed below:

✓ Terms and conditions of the mortgage loan
✓ Identification of entity making commitment
✓ Identification of borrower(s)
✓ Identification of property securing loan
✓ Principal amount of the loan
✓ Term of the loan
✓ Initial interest rate
✓ Initial monthly payment of principal and interest
✓ A statement that a balloon payment will be required (if applicable)
✓ If the loan is an adjustable rate loan, in addition to the foregoing, the lender shall disclose the frequency of change, the index, the margin and any relevant caps
✓ A statement that private mortgage insurance will be required, if applicable
✓ A statement that flood insurance may be required if the property is in a flood zone
✓ A statement that negative amortization may apply, if applicable
✓ Whether and under what conditions the mortgage is assumable
✓ A statement that funds are to be escrowed, if applicable.
✓ Total points to be accepted directly or indirectly by or on behalf of the mortgage banker or exempt organization at or prior to closing. Upon receipt of a copy of the separate fee agreement between the broker and the applicant, the lender is required to disclose any fees or points to be paid by the applicant directly to the mortgage broker.
✓ Any premiums or bonuses will be identified.
✓ Terms and conditions of the commitment.
✓ Time during which the commitment is irrevocable and may be accepted by the borrower, which shall not be less than 7 calendar days from the date of commitment or date of mailing, whichever is later.
✓ Amount of fees and charges payable at time of commitment including points or other discounts, origination fees or add-ons, however denominated by the mortgage banker or exempt organization.
✓ Expiration date of the commitment, which must be a reasonable time for a consumer to arrange a closing date.

Mandatory Disclaimer: The following notice in block capital letters of at least 12 point size, except if the written disclosures are typewritten, the notice shall be in all upper case letters underlined.

**IF YOU SIGN THIS COMMITMENT, AND YOU DO NOT CLOSE THIS LOAN IN ACCORDANCE WITH THE DESCRIBED TERMS, YOU MAY LOSE SOME OR ALL OF THE FEES OR CHARGES YOU HAVE PAID.**

**COMMITMENT AGREEMENTS:** include notice of all documents required.
✓ Notice of expiration of commitment period: must be mailed to all the applicants not less than 12 business days nor more than 20 business days prior to the expiration of the commitment period.
✓ No commitment may contain any clause, which conditions the commitment upon the mortgage banker obtaining necessary funding or financing.
✓ If an approval is not obtained the mortgage banker will refund any points or commitment fees previously collected from the consumer.
✓ No points can be charged that have not been previously disclosed.
✓ Any additional settlement costs, documents or other items required to close which are found to be necessary after the commitment has been issued must be disclosed to the applicant in a reasonable and timely manner.
✓ All commitment fees must be refundable in full if the appraisal report is not favorable.
✓ A commitment fee and any points accepted by a prior to closing must be refunded in full if an applicant proves not to be creditworthy.

**PROHIBITED CONDUCT**
- Misrepresent or conceal material loan terms, or make false promises to induce an applicant to apply for a mortgage loan. For these purposes, “material term” shall mean any item required to be disclosed, which is likely to influence, persuade or induce an applicant for a mortgage loan to take particular action.
- Conduct business with an entity which it knows or should know is an unregistered mortgage broker or unlicensed mortgage banker.
- Fail to display a license or certificate of registration. License and certificates shall be prominently displayed in every public business office frequented by mortgage loan applicants.
- Fail to provide any disclosures required.
- Fail to make good faith efforts to issue commitments and effect closing in a timely manner.
- Fail to disclose additional settlement costs or terms necessary to close a loan in a reasonable and timely manner.
- Disburse the mortgage loan proceeds in any form other than, as applicable, direct deposit to customer’s account, wire, bank or certified check, or attorney’s check drawn on a trust account, or other form approved.
- Fail to disburse funds in accordance with a commitment to make a mortgage loan, which is accepted by the applicant.
• Accept any fees at closing which were not disclosed in accordance with these regulations.
• Accept attorney’s fees at closing in excess of the fees that have been or will be remitted to its attorneys.
• Refuse to permit the borrower to be represented by the attorney of choice.
• Unreasonably refuse to issue or unreasonably delay the issuance of a satisfaction of mortgage after the mortgage has been fully satisfied.
• Impose a charge on a mortgagor for establishing or maintaining an escrow account or for waiving the establishment or maintenance of an escrow account provided, however, that nothing herein shall prohibit a mortgage banker or exempt organization from imposing a one-time charge to pay the actual cost of an independent tax reporting service, provided such cost is disclosed prior to or at commitment.
• Include any provision in the mortgage brokerage agreement that is intended to limit or prevent a consumer from submitting an application to obtain a mortgage loan through another mortgage broker or mortgage banker or impose a fee on the applicant should he/she do so; or
• Accept a good faith deposit or any other deposit to induce the lender to process the loan, whether or not the deposit is refundable

ADMINISTRATIVE PENALTIES
1. Temporary or permanent deletion from the broker roll
2. Suspension or revocation of a license
3. Fines, $5,000 per violation, $100,000 per proceeding

GROUNDS FOR DISCIPLINARY ACTION
• Fraud or bribery in securing a registration or license
• Making any false statement in an application for registration, licensing or exemption which false statement would have been grounds for rejection of the application.
• Making any false statements on any form or document requested by the Superintendent for examination.
• A pattern of conduct indicating incompetence or untrustworthiness.
• Violation of disclosure requirements.
• Conviction of any crime which would have a bearing on the fitness or ability of a registrant or licensee to conduct its business.
• Failure to perform duties and responsibilities in an honest, fair and reasonable manner.

BRANCH REQUIREMENTS
Such things as a separate telephone number, designation of a responsible party and identification of the address of the primary and branch locations on stationery.

BOOKS AND RECORDS, ANNUAL REPORTS
They contain information about completed and rejected loans as well as any complaints against the broker/banker. An application log and a correspondence file are also required. Must be kept for 3 years.

F.H.A. REQUIREMENTS FOR A MORTGAGE BROKER
In order to participate in FHA programs the following requirements must be satisfied:
• Be a registered mortgage broker in good standing
• Comply with federal requirements to act as an FHA loan correspondent
• Have a minimum net worth of $50,000
• File an audited financial statement
• File a surety bond in the sum of $25,000 or a deposit of $25,000
• Obtain a written agreement with one or more approved sponsors
• Have a satisfactory supervisory and consumer complaint record
CHAPTER 15 PREDATORY LENDING

Buying a home is a very intense experience and can be even more anxiety-ridden if a consumer encounters some unethical and fraudulent practices. Sometimes, labeled as “Predatory Lending,” these practices, though not industry-wide, are common enough that you should use caution and scrutinize every transaction carefully to ensure fairness to everyone involved. Sadly, the term “Predatory Lending” has become part of our everyday vocabulary; so what exactly does it mean? Simply stated it means taking advantage of borrowers who have little or no knowledge about financing.

Unfortunately, because predatory lending takes many forms, there is no singular definition for it. In general, predatory lending involves practices that usually take advantage of the elderly, minorities, and inexperienced, uninformed consumers.

SOME BASIC EXAMPLES OF PREDATORY LENDING ARE:

• Selling properties for much more than they are worth using false appraisals.
• Encouraging borrowers to lie about their income, expenses, or cash available for down payments in order to get a loan.
• Knowingly lending more money than a borrower can afford to repay.
• Charging high interest rates to borrowers based on their race or national origin and not on their credit history.
• Charging fees for unnecessary or nonexistent products and services.
• Pressuring borrowers to accept higher-risk loans such as balloon loans, interest only payments, and steep pre-payment penalties.
• Targeting vulnerable borrowers to cash-out refinance offers when they know borrowers are in need of cash due to medical, unemployment or debt problems.
• "Strip" homeowners' equity from their homes by convincing them to refinance again and again when there is no benefit to the borrower. (Flipping).
• Using high-pressure sales tactics to sell home improvements and then finance them at high interest rates.
• Not giving the borrower the true picture of the costs of borrowing.

SOME OF THE SYMPTOMS OF A PREDATORY LENDING SCAM ARE:

• A lender or investor tells you that they are your only chance of getting a loan or owning a home.
• The house you are buying costs a lot more than other homes in the neighborhood, but isn't any bigger or better.
• You are asked to sign a sales contract or loan documents that are blank or that contain information, which is not true.
• You are told that the Federal Housing Administration insurance protects you against property defects or loan fraud - it does not.
• The cost or loan terms at closing are not what you agreed to.
• You are told that refinancing can solve your credit or money problems.
• High fees and interest rates
• Hidden payment terms
• Loss of equity in a home
• Hidden and unnecessary credit insurance packing
• Mortgage service abuses
• Fraudulent inducement for the consumer to sign over the deed on his or her home

Typical schemes and scams that can fall into the category of PREDATORY LENDING include:

PROPERTY FLIPPING
It is perfectly acceptable to purchase a home, make significant improvements on the home and sell it. There are many instances where individuals will purchase foreclosed or run down properties, invest
time and money into those properties and sell the property for a profit. However, flipping is illegal when no significant improvements are made or there is misrepresentation involved. Buyers might be convinced to borrow more than the property is worth and lenders, brokers or even appraisers approve the loan and share in the windfall.

STEERING
This practice is used with consumers who may not have any problems with their credit history, are nevertheless “steered” by the broker or lender to a certain product with higher rates and fees, even though the consumer could qualify for less costly products. Consumers should be shown every product option available to them, regardless of their past or present credit situation.

HIDDEN LOAN TERMS
This practice occurs when a broker or lender promises the consumer a lower monthly payment through refinancing, but does not tell the consumer that they are paying interest only every month. The consumer will have a huge balloon payment of principal at the end of the loan term which he is not aware of. Additionally, there are reports of excessive origination and prepayment fees.

EQUITY STRIPPING
A financially desperate homeowner has equity in his/her house, but not much monthly income. An originator tells the owners that they can get a loan by “padding” their income on the application. The owner knows that he cannot make the payments, but goes ahead with the transaction hoping the house will go up in value and he will be able to sell it at a profit. The owner then cannot make the payments and the lender most likely forecloses and strips the equity in the house from the owner.

LOAN FLIPPING (COSTLY and UNNECESSARY REFINANCING)
These target homeowners who have had their homes for many years and enjoy a low interest rate, affordable monthly payments, and equity in the property. An originator calls with the enticement of some extra cash that would be available through refinancing. Several months after the refinancing, the originator calls offering another inducement (e.g. a vacation for another refinance). All along, the originator charges high points and fees for each refinance, as well as prepayment penalties. In addition, the interest rate could continue to climb with each additional “flip,” or refinance.

Typically, the only result from flipping is an increase in debt that costs more than the cash that the consumer received from the equity that he had in the property.

FRAUDULENT “HOME IMPROVEMENT” LOANS
A home improvement contractor approaches the property owner and tells him that he can remodel his house, install a new roof, etc. for a reasonable price. The homeowner, however, cannot afford the costs and the contractor states that he can assist the owner in getting financing. With this agreement, the contractor then begins work on the project.

The homeowner either signs blank loan papers or is rushed to sign before fully reading or understanding the terms of the agreement because the contractor has threatened to leave the job unfinished if the papers are not signed. Later, the homeowner realizes that the loan is a home equity loan with high fees, interest rates, and points. By this time, the job has become a low priority for the contractor and may not even be done correctly once it is completed. In addition, the broker or lender may have even paid the contractor to set up the transaction.

CREDIT INSURANCE PACKING
The consumer obtains a mortgage that seems affordable. Then, at closing is asked to sign additional papers that include charges for credit insurance and other “benefits.” The consumer did not request these additions and does not want them, and, in hopes that the client will not notice the charges, the broker or lender makes no effort to explain them. If the consumer does inquire about the charges, the lender may tell them that the insurance is included with the loan. This leads the consumer to believe that there are no additional costs involved, that they cannot opt out to save the added charges, and
that they might not get the loan if they do not sign. The bottom line is that the consumer pays for an additional product that they do not want or need.

FAILURE TO REPORT BORROWER CREDIT INFORMATION
This practice limits viable refinancing opportunities available to high rate/point borrowers, because it was a challenge to get an accurate payment history from the current mortgage holder.

REVERSE REDLINING
This practice involves a broker or lender steering minorities, elderly, or low-wealth borrowers to high-cost loans, specifically targeting a susceptible, under educated group of borrowers. The broker knows the borrowers will probably not be able to repay the loans, and the property can be offered to another victim after foreclosure.

LENDING TO PEOPLE WHO CANNOT AFFORD THE LOANS
Some predatory mortgage lenders purposely structure the loans with monthly payments which they know the homeowner cannot afford. The idea is that when the homeowner reaches the point of default, they will return to the lender to refinance which provides the lender additional points and fees.

FALSIFIED LOAN APPLICATIONS, UNVERIFIED INCOME
Lenders knowingly make a loan to a homeowner who does not have sufficient income to repay the loan. The lender wants to resell the loan so their only concern is that the borrower looks as though he can afford it. The loan originator goes along with the scheme because he and everyone else involved will get paid at the closing. The broker has the borrower sign a blank loan application form. The loan originator then inserts false information on the form (e.g. a job the borrower does not have), making the borrower appear to have higher income than he actually has. In other cases, the borrower may have sufficient income to obtain a mortgage loan, but the income was not obtained legally. The loan originator assists the borrower in creating false employment and/or tax documents in order to obtain a mortgage loan.

ADDING CO-SIGNERS
This is done to create the false impression that the borrower is sufficiently creditworthy to be able to pay off the loan, even though the lender is well aware that the co-signer does not intend to contribute to the repayment of the mortgage. The broker gets a commission on a loan that would not have been approved without the false co-signer. Often, the lender requires the homeowner to transfer half ownership of the house to the co-signer. The homeowner has lost half the ownership of the home and is saddled with a loan that is unaffordable.

TAKING ADVANTAGE OF INCAPACITATED BORROWERS
Some predatory lenders make loans to homeowners who are clearly mentally incapacitated. They take advantage of the fact that the homeowner does not understand the nature of the transaction or the papers that he signs. Because of the incapacity, the homeowner does not understand the mortgage loan, does not make the payments, and is subject to foreclosure and subsequent eviction.

FORGERIES
Some predatory lenders forge loan documents, saddling homeowners with loans they know nothing about. In an ABC Prime Time Live news segment, a former employee of a high cost mortgage lender reported that each of the lender's branch offices had a "designated forger" whose job it was to forge documents.

FALSE REPRESENTATIONS ABOUT PREPAYMENT PENALTY
When the borrower applies for a loan he is told the prepayment penalty will end after two (2) years. However, when he wants to refinance, almost five (5) years later, he discovers that the penalty is still in force. By that time, the broker is working for another company, and no one else in the mortgage company claims to know anything about it. This borrower is a victim of “contract knavery”. The term is
commonly used in the mortgage industry. Contract knavery involves sneaking provisions into the loan contract that put the borrower at a disadvantage—provisions that are not standard in the market and for which the lender has provided no balancing incentive. In New York, prepayment penalties can be enforced only in the first year and if the interest exceeds 6%. After the first year, penalties aren’t allowed. Typically, prepayment penalties are more common with commercial property than with residential property.

**PRICE GOUGING**
Most consumers who contact a mortgage broker or originator expect her to arrange a loan with the best terms, at the lowest possible rate. Most mortgage originators do just that, and charge a reasonable fee for their services. However, in the sub-prime market, there are mortgage originators who will attempt to sell the borrower a loan with the most fees and highest rate possible so that the originator will get more compensation. These fees can go well into the tens of thousands of dollars. The interest rates will also be higher than the market.

This method of indirect payment is commonly referred to as a "yield spread premium." Lenders earn a premium similar to brokers, for a lender it is known as a “service release premium.” Borrowers need to understand how their mortgage originator will be compensated.

**BILL CONSOLIDATION EQUITY LOANS**
These encourage consumers to pay off credit card, retail, and auto debt by consolidating them all into one home loan, thus reducing the monthly debt payment. While it is true that in many cases monthly payments are lowered, the problem is that the short term debt was traded for long term. Say a credit card would take 3 years to pay in full; now, it will take hypothetically 15 years. In the end the accumulated interest is much greater.

**HIDDEN BALLOON PAYMENTS**
Another way for a predatory lender to reduce the monthly payment on a home loan is to have the borrower pay off only the accrued interest each month. This method of financing will result in a huge balloon payment at the end of the repayment term, usually after fifteen (15) years. The borrower, believing he is paying down the loan after making all the payments, is unpleasantly surprised when he finds out that he owes almost as much as he originally borrowed fifteen (15) years earlier. The borrower has been misled to believe the loan was a 15-year amortization when in fact it was amortized over 30 years with a balloon payment after 15 years. This type of abuse may be categorized as contract knavery as well as fraud if there is deception and financial gain by the actions of the originator. If the borrower is elderly, it will be very difficult to refinance the loan, and foreclosure may become inevitable.

**WHEN PREDATORY LENDING INVOLVES DISCRIMINATION**
Generally, fraud is perpetrated for financial gain. Lenders or brokers may make false promises of loan application approval to vulnerable, historically underserved groups of people. For example, the broker may take advantage of people who have recently immigrated to the United States because they know these applicants are unfamiliar with our legal system and real estate practices. Under the Fair Housing Act, it is unlawful for any person (or entity) whose business includes residential real estate-related transactions to discriminate against any person in the terms, conditions, or availability of a transaction because of the following:

- Race,
- Color,
- Religion,
- Sex,
- Handicap,
- Familial status, or
- National origin.
Failing or refusing to provide to any person, in connection with a residential real estate-related transaction, information regarding the availability of loans or other financial assistance, Failing or refusing to provide application requirements, procedures or standards for the review and approval of loans or financial assistance, or
Providing information that is inaccurate or different from that provided others.

It would be beneficial to review the chapter on Fair Housing to reacquaint yourself with the law. Again, the Fair Housing Act applies to any aspect of a transaction involving residential real estate – including mortgage loan transactions.

**DISTINGUISHING BETWEEN PREDATORY LENDING AND SUB-PRIME LOANS**

It is important to distinguish between the two because not all sub-prime lenders are predatory lenders. Subprime lenders make loans available to borrowers with low credit scores who are higher credit risks than would be acceptable in a conforming loan. They have been helpful to people who have had credit problems in the past but who are now in a position to buy a house and understand that the lender is taking a greater risk lending them money. They have also made home equity loans available to homeowners who might not qualify otherwise. Therefore, the rate and charges for sub-prime loans are more than for conforming loans. These loans have also been helpful to people who need to consolidate their debt in order to make the payments manageable.

Because their method of operation is to deal with people who cannot obtain conforming financing, some of these lenders have often used illegal and immoral tactics to induce people to borrow money from them. They are the ones classified as predatory lenders. In many cases, because the borrower was uninformed about the real cost of borrowing and the payments in the future, many of these loans have resulted in foreclosure. Some loans have had balloon payments, which could easily result in foreclosure action unless the property has gone up in price.

As you can see Predatory Lending is a very serious threat not only to consumers but to the economy in general. I hope that you now have an understanding of the terrible consequences of predatory lending as well as knowledge of what to look for and avoid.
 Owning real estate almost always includes the obligation to pay real property taxes of one kind or another. Real property taxes are used to fund the operations of the municipality in which a property is located. A municipality’s infrastructure is paid for with the funds collected through property taxes. The term infrastructure refers to the basic features or structure needed for the functioning of a town, city, county or village. Some examples of infrastructure include roads, bridges and buildings.

Property taxes are also used to fund schools; to pay for public services such as police departments, fire departments, libraries, road maintenance, public sewers and many others. They also pay for the salaries of the staff that run the municipality and other general business expenses. They provide the majority of the revenue needed to pay for the public services, which are vital to a community. Without these services, the health and welfare of the residents could not be protected and the quality of life in the community would suffer. This taxation is done by the various local municipalities and not the state.

Property taxes are relied upon by local governments more than other types of taxes for several reasons:

- They are based on a known tax base, which is relatively stable
- They provide a predictable income stream to the local government; and are typically more consistent when there are fluctuations in the economy than other types of taxes
- Real estate is hard to conceal, it is visible to the municipality and ownership is public record

Unlike other types of taxes, property taxes can be applied to all types of real estate, such as residential, commercial and industrial property. Since property taxes are the largest revenue source for most local municipalities and school districts, there is direct accountability to use the funds in a responsible and cost effective manner.

Property taxes become an automatic lien on the property, which protects the municipality. There is a historic relationship between wealth and land productivity. Land ownership is an indicator of wealth and governments rely on this for revenue.

If an agent has a good grasp on how properties are taxed in their market areas; and an understanding of the public services offered, they can help buyers and sellers make informed decisions.

**OVERVIEW**

The calculation of real property taxes can vary according to the assessing unit in which a property is located. An assessing unit is a municipality such as a city, town, county or village with the authority to assess real property.

In NY State, some assessing units are considered approved assessing units. These have been certified by the NY State Office of Real Property Services (ORPS) as having completed a revaluation program implementing a system of real property tax administration, which is eligible for state assistance.
Assessing units either elect or appoint a Tax Assessor, a local government official whose primary function is to estimate the value of all real property within the municipality in which they serve.

There are several basic principles that hold true in the calculation of property taxes. One principle is that real estate is taxed on an \textit{Ad Valorem} basis. Ad Valorem means "according to value". Real property taxes are calculated based on a property's market value or a percentage of market value.

\textbf{MARKET VALUE}

The most probable price that a property should bring in a competitive and open market, under all conditions required for a fair sale and assuming that the price is not affected by undue stimulus.

In simple terms, market value deals with how much a typical buyer would pay for a property if it were on the market for sale under normal terms and conditions. When a homeowner wants to know what their home is "worth", they are typically seeking market value.

Tax assessors use several methods for estimating market value. They are the same that an appraiser would use when appraising a property.

\textbf{SALES COMPARISON APPROACH}

In this method, the property being valued is compared to other similar properties which have sold in the same market area. Their sale prices can be analyzed and adjusted for differences in the properties.

\textbf{COST APPROACH}

The cost approach is very useful for certain property types, such as warehouses, museums, hospitals and municipal buildings because relatively few of these exist, and, therefore, there would not be a great deal of historical sales data.

\textbf{INCOME APPROACH}

The income approach is based on the relationship between income (typically rents) and market value. It can be as simple as taking a property's monthly rent and multiplying it by a factor, which is determined from the market.

\textbf{OTHER METHODS}

Tax assessors do not just rely on the sales comparison, cost and income approaches to value property. They use other methods such as market trends, market indices and statistical modeling to value real property.

One such is method is known as a Mass Appraisal. This is the process of valuing a "universe of properties" as of a given date, (more than one property). They are typically performed using sophisticated computer programs, which can value all the homes in a given market area at one time.

The arms-length transactions in a given market area are verified and input into the mass appraisal model. Adjustments are given for items such as lot size, living area, room counts, baths, garages, etc. are then calculated and input as well. At this point, the model is ready to run. The homes in a selected geographic area are then fed into the model. The model then makes all of the adjustments and ultimately determines the market value for each of the properties.

\textbf{DETERMINE THE TOTAL ASSESSED VALUE OF A PROPERTY}

Once a property's market value has been determined, the next step in the calculation of real property taxes is to determine the assessed value. This is the value of a property according to a public authority such as the Tax Assessor. It is often based on a uniform percentage of market value, known as a level of assessment. A property's assessed value is also known as its "assessment".
A property's assessed value is calculated by multiplying its market value by a uniform percentage of market value (also known as a level of assessment). This is simply a percentage or rate, which is determined by the local assessing unit. The level of assessment can be as low as 1% or as high as 100%.

**For example:** The tax assessor has determined that a property has a market value of $400,000 and the current level of assessment in this municipality is 1%. In this example, the assessed value is $4,000 ($400,000 x .01 = $4,000).

Let’s continue with the example:
If the level of assessment in this municipality was 2%, the assessed value would be $8,000 ($400,000 x .02 = $8,000).

If the level of assessment in this municipality was 50%, the assessed value would be $200,000 ($400,000 x .5 = $200,000).

If the level of assessment in this municipality were 100%, the assessed value would simply be $400,000.

As this shows, determining the assessed value of a property is a very simple process, once the market value and the level of assessment are known.

**Important** - For most assessing units, NY State law requires that all property in the unit must be assessed at the same uniform percentage of value.

**TAX ROLLS AND TAX RATES**
Once the total assessed value for a property has been determined, the tax assessor then adds it to the assessment roll, also known as the tax roll. This is a list of all taxable property in a municipality. It shows the total assessed value of each parcel and all applicable exemptions.

A tax rate is a ratio or percentage at which properties are taxed.

Next, they must determine how much revenue they will receive from all sources other than property taxes. Some of these revenue sources include state aid, sales taxes and fees for services. Once all of the non-property tax revenue has been determined, it is subtracted from the original budget to arrive at the Tax Levy. This is the amount needed to be raised through property taxes. The tax levy, when combined with the other revenue sources, such as state aid, sales taxes, etc., will allow the taxing authority to meet the operating budget.

In order for the tax levy to be implemented, it must first be approved by an authorization process known as appropriation. This is a formal action to allow funds to be set aside for a specific purpose, and specifies the sources of the funds. Once the tax levy has been determined and appropriated, it is divided by the total taxable assessed value of all the real property in the municipality, to arrive at the tax rate.

**For example:**
A county has a tax levy of $10,000,000. The tax roll indicates that the taxable assessed value of all the real property in the county totals $200,000,000. The county simply divides the tax levy by the total taxable assessed value as follows: $10,000,000 ÷ $200,000,000 = .05
In this example, the county tax rate is 5%.

Once a tax rate has been set it is used to calculate the property taxes of each taxable property. This is done by simply multiplying a property’s taxable assessed value by the tax rate.
For example:
Let's calculate the annual village property taxes for a house with an assessed value of $20,000. The current village tax rate is 14%. The taxes would be calculated as follows: $20,000 x .14 = $2,800
In this example, the annual village taxes are $2,800.

**TAX LIENS**

As we have already discussed, real property taxes are the main funding source for most local governments. Since real estate is permanently fixed (immovable), and the ownership of real estate is almost impossible to hide, local governments can rely on real property tax revenue much more than other types of tax revenue. Real property taxes are actually liens against the title to real property.

Remember, a lien is a claim against another's property, typically due to the non-payment of an obligation or debt. It is a non-possessory interest in a property giving the lien-holder the right to foreclose if the owner does not pay the debt owed to the lien-holder.

A Tax Lien is defined as follows: An **In Rem** proceeding, in which the taxing authority places a claim against a property due to the non-payment of taxes. If the taxes are not paid, the taxing authority has the right to take the property. In Rem means that the claim is against a specific property, not a person. Other types of liens such as general liens are against all property owned by an individual.

The local taxing authority only has an interest in the property on which the taxes are delinquent. If the delinquent property taxes are not paid, the taxing authority can foreclose on the property. Delinquent property taxes are commonly referred to as "back taxes". Tax liens take precedence over other previously recorded liens. This is to ensure that the municipality will be paid the money owed them, which is so important to the operation of the local government. If a property is sold or transferred, any tax liens against the property must be paid first.

The taxing authority will hold a tax lien for a specific time period which varies by municipality. The property owner is notified of the delinquent taxes and resulting tax lien. If the owner still fails to pay the delinquent taxes, the taxing authority will then foreclose on the property. In a tax foreclosure, the municipality is the lien-holder who goes to court and subsequently takes title to the property. A deed is executed, delivered and recorded. Once title has been transferred to the municipality, they may keep the property or sell it in a tax sale. Prior to selling the property in a tax sale, the municipality may be required to keep the property for a specified time period, such as two years.

In a tax sale, a notice is published with the date of the tax sale, which is made public and sent to the property owner. The purchaser in a tax sale must pay at a minimum, the amount owed on the taxes and any associated penalties. Prior to a tax sale, the delinquent taxpayer may still redeem the property by paying all delinquent taxes, interest and penalties. This is known as an "equitable right of redemption". NY State Law also allows a delinquent taxpayer to redeem the property for a period of time after a tax sale. This is known as a "statutory right of redemption".

The tax lien, tax foreclosure and tax sale processes can vary with different municipalities. It is a good idea that real estate agents have an understanding of the process that exists in the municipalities in which they work.

**SPECIAL ASSESSMENTS**

Sometimes taxing authorities need to raise money to pay for necessary shared public improvements that will benefit certain properties in their municipality. Some common examples of shared public improvements are curbs, gutters, sidewalks, streetlights, traffic lights, etc. The key factor is that the improvements must benefit or enhance the local properties and community.

When the need for these types of improvements arise, the assessing unit can charge a special assessment. This becomes a lien against the real property of the homeowners who benefit from the improvements. The lien is not satisfied until it is paid in full. If a property owner fails to pay their
portion of the special assessment, the lien can force a sale of the property. Licensees should be aware of any special assessments. Buyers are entitled to know of their existence. The local assessment department is a good place to find this information.

**TAX EXEMPTIONS**

Even though all real property within a municipality is assessed, not all real property is taxed due to tax exemptions that are simply deductions on property taxes. They can be either full or partial. A full exemption means that the owner of the property pays no property taxes at all. A partial exemption means that the owner of the property only pays part of the taxes.

Some examples of properties that typically qualify for full tax exemptions are:
- Property owned by a state government
- Property owned by a local government, such as a county or village
- Property owned by the federal government
- Property owned by various religious organizations
- Schools and other educational facilities
- Hospitals
- Parks

These properties must be used for tax exempt purposes in order to qualify. In addition to properties that qualify for tax exemptions, certain groups of people also qualify for tax exemptions. Some examples of groups of people that qualify for tax exemptions are:
- Senior citizens
- Military veterans
- Persons with disabilities
- Farmers
- Gold Star Parents

These groups typically qualify for partial exemptions from property taxes. Of course, there are requirements that need to be met in order to receive tax exemptions. Two terms that are used often when considering eligibility for tax exemptions are "Homestead" and "Non-Homestead". Homestead refers to a taxpayer's primary residence. Some examples of properties that can fall under the homestead class are:
- One, two and three family homes
- Residential condominiums
- Mixed use parcels which are mostly used for residential purposes
- Manufactured and certain mobile homes when they are owner occupied and are separately assessed
- Certain vacant parcels of 10 acres or less, which are located in zoning areas that allow one, two or three family residential dwellings
- Certain farm dwellings and agricultural land
- Non-Homestead refers to all other real property. Some examples of non-homestead properties are:
- Commercial properties
- Industrial properties
- Utility properties
- Special franchise property
- Vacant land that does not qualify as Homestead Property

Typically only homestead property will qualify for tax exemptions

**Requirements for Tax Exemptions**

There are various exemptions and specifications that are required in order to be entitled to an exemption. These change from time to time and the following are just general examples.

**SENIOR CITIZENS EXEMPTION**
- Applies to residential property only
- Exemptions apply to the owner's primary residence only
The party seeking the exemption must be at least 65 years old
The party seeking the exemption must have lived in the house for at least 12 months (unless the owner received a senior citizens exemption on their prior residence)
The party seeking the exemption must have an income below $26,000 per year
In some localities, an annual income of up to $34,399.99 may qualify for a 5% exemption, known as a "sliding scale option"

Senior citizens exemptions can be issued by counties, cities, towns, villages and public school districts. They can reduce the taxable value of a senior citizen's primary residence by up to 50%, which can result in large savings for the owner. A homeowner who is seeking a senior citizen's exemption must file an initial application and annual renewal applications with the local tax assessor's office prior to the "taxable status date, whatever that might be.

**VETERAN'S EXEMPTION**
These partial tax exemptions are granted to qualified person's who have served in the armed forces of the United States, or purchased their home with "eligible funds". Eligible funds are a veteran's pension, insurance or bonus funds, compensation paid to prisoners of war, etc. There are several types of veteran's exemptions and each has its own requirements.

**Some basic requirements for veteran's exemptions:**
Veteran's exemptions apply to residential property only
Veteran's exemptions apply to the owner's primary residence only

**FARMER'S EXEMPTION**
In certain agricultural areas, property owners can sometimes receive school tax exemptions for all or part of their farm acreage. This is done to encourage continued agricultural use of the property. A party seeking a farmer's exemption should consult the local tax assessor's office, to determine the requirements and exemption amounts they may be eligible for.

**GOLD STAR PARENTS EXEMPTION**
This category allows for a partial exemption on property taxes to parents who have lost a child in military combat. A party seeking a Gold Star Parents exemption should consult the local tax assessor's office, to determine the requirements and exemption amounts they may be eligible for.

**DISABILITY EXEMPTION**
NY State Law permits local governments and public school districts to grant property tax exemptions based on disabilities. In order to qualify for a disability exemption, a person must have documented evidence of a disability. They must also meet certain other requirements, including income limitations.

**S.T.A.R. - School Tax Relief Exemption**
Qualified NY State homeowners can receive this exemption as long as certain eligibility requirements are met. The STAR program is a property tax exemption that applies to school taxes only. There are two categories of the STAR program as follows:

The **Basic STAR** program allows for a partial exemption from school taxes, without any age or income requirements. There are certain other eligibility requirements for the Basic STAR exemption, which will be outlined below.

The **Enhanced STAR** program allows for a larger exemption from school taxes, however, it is subject to age and income requirements. There are additional requirements for the Enhanced STAR exemption.

Requirements for the Basic STAR and Enhanced STAR tax exemptions:

**Basic STAR:**
- Applies to residential property only, including one - three family homes, condos, co-ops, manufactured homes and farm dwellings
Applies to the owner's primary residence only
No limits on the age of the homeowner
No limits on the income of the homeowner
It exempts the first $30,000 of the full value of the property from school taxes

Enhanced STAR:
Applies to residential property only, including one - three family homes, condos, co-ops, manufactured homes and farm dwellings
Applies to the owner’s primary residence only
Applies to persons 65 years old or older
Applies to persons with annual incomes of $60,000 or less, adjusted for annual cost of living increases
Exempts the first $60,100 of the full value of the property from school taxes. In areas with median values that are higher than the statewide average, the exemption increases proportionally
For married or sibling property owners, only one of them must be 65 years or older to qualify for the Enhanced STAR exemption; however their combined income must not exceed $60,000, or the adjusted income limit which reflects cost of living increases

UNEQUAL ASSESSMENT ISSUES
Since properties are taxed on an ad valorem basis (according to value), two homeowners in the same neighborhood whose market values are roughly the same should pay roughly the same in property taxes. Unfortunately, this is not always the case. The NY State Office of Real Property Service (ORPS) requires that real property assessments meet the following criteria:
They are arrived at fairly
They are measured annually
They must be based on an accurate property inventory
The assessment process is simple and understandable for constituents
The assessment process is widely accessible
The assessment process is perceived as fair
The assessment process is open to review

Assessment departments strive to reach these goals, however, there are many situations where assessed values are outdated or simply incorrect. Changes in market conditions are constantly occurring. In areas with growth and new construction existing home values would increase. Where an oversupply or decline of the area exists, assessments should decrease. Updating and renovations can also affect property values, which may not be reflected in a property's assessed value. Conversely, neglect of a property, damage and deferred maintenance can also have an impact on property value.

Undeclared improvements are a big factor when considering unequal assessment issues. Homeowners will often have renovations made to their property without applying for a building permit or certificate of occupancy. In these situations the assessing department would have no way of knowing that the home has been improved and would have no reason to increase the assessment. A problem usually arises when the house is sold and the new buyers demand a certificate of occupancy before closing.

Assessors are not typically permitted to do spot reassessment inspections on individual properties, unless renovations are apparent or have been reported. In the case of undeclared improvements that are not discovered by the assessor, the assessed value of the property will be disproportionally low with respect to the property's actual market value.

Examples of improvements that can cause an increase in assessed value:
• Room additions
• Bathroom additions
• Finishing basements or attics into living area
• Garage Additions or conversions
• Pools, Patios, Fences and Decks
• Fireplaces
Examples of improvements that typically do not cause an increase in assessed value:

- Painting
- Wallpapering
- Flooring or carpeting
- Storm windows
- Landscaping

In order for assessment departments to stay current on assessed values, annual reassessments and field inspections would be the best solution. Unfortunately, this is an expensive process and is not practical in most cases. Field inspections of all properties are required to be done at least once every six years in order for municipalities to qualify for annual state aid. In addition, field inspections are performed in the case of new construction and renovation projects. As permits are filed, the building departments notify the assessment departments, who then send a field inspector to the property.

If a new construction project is not complete or fit for occupancy as of the taxable status date, the percentage of completion is estimated and the assessed value is calculated accordingly. Once the project has been completed, the property will be assessed at its full value starting with the month after completion.

COMMUNITY WIDE RE-ASSESSMENTS

These are performed to maintain fairness within the community. Tax assessors are aware that market conditions are constantly in flux. Conditions of properties are constantly changing. New construction, demolition and renovations are examples of changes that can affect the market value of properties. Over time, these changes result in some taxpayers paying more than their fair share of taxes, and some paying less. Re-assessments are performed to minimize this. In NY State, real property is re-assessed annually. That does not mean that all property in a municipality is inspected annually. In fact, most re-assessments are done without physical inspections. A community wide re-assessment is the process of updating the assessed values of all properties within a municipality. Community wide re-assessments do not always result in property taxes being increased. In areas where property values have declined, the re-assessment should reflect this and the assessed values would be lower.

Even if a community wide re-assessment causes a property's assessed value to increase, it does not necessarily mean that the taxes will go up. The applicable municipal tax rate, such as the town or school tax rate may be lowered, which can offset the increased assessed value. Sometimes municipalities will change their methods of computing taxes during a community wide re-assessment. An example of this is changing from a fractional level of assessment to 100%.

Example: A municipality's level of assessment is 10%. A house with market value of $500,000 will have an assessed value of $50,000 ($500,000 x 10% = $50,000). During the community wide re-assessment, the municipality changes the level of assessment to 100%. Now, this property's assessed value is $500,000. In most instances, the tax rates would be adjusted accordingly to maintain similar tax levels.

In the above example, let's assume that the tax rate was 6% prior to the community wide re-assessment. The taxes would be calculated as follows: $50,000 x .06 = $3,000
After the community wide re-assessment, the tax rate was changed to .6%. The taxes would now be calculated as follows: $500,000 x .006 = $3,000
Even though the assessed value has changed from $50,000 to $500,000, the property taxes have not changed. This is because the municipality changed the tax rate from 6% to .6%.

RE-ASSESSMENT UPON SALE

Some municipalities will re-assess properties when they are sold. While this may sound like a good idea, the tax assessor must be careful and complete in their analysis of the sale in comparison with market values in the area.
Example: A typical single family dwelling in a municipality recently sold for $400,000. Its current assessment is based on a market value of $500,000. Should the assessor lower the assessed value of this property accordingly? The assessor must first analyze this sale to see if it was an arms-length transaction. Consideration is given to the possibility of any undue stimulus or unusual motivation on the part of the buyer or seller. The assessor must also consider whether the financing of this sale was typical for this market area and property type. Also whether or not any unusual sales concessions were included in this transaction. Upon analyzing all of these factors, the assessor may determine that this sale was between related parties and the sale price of $400,000 was not reflective of market value.

This is an involved process and the analysis of the sale must be correct in order to avoid errors. The assessor has additional obligations. In the above example, if the assessor decides to lower the assessed value of this property to reflect a market value of $400,000, the assessor must lower the assessed values of all similar properties in the municipality to reflect the same market value. The same holds true for the reverse. If an assessor raises an assessed value based on a recent sale of a property, the assessor must raise the assessed values of all similar properties in the municipality.

**ILLEGAL ASSESSMENTS**
Sometimes, assessments can be deemed unlawful or illegal. Properties that are fully exempt from taxation but are being taxed can fall into this category. Properties that are on a municipality's tax roll, but are located outside the boundaries of the municipality, can be considered to be unlawfully assessed. A fairly common example occurs when properties are located on the boundary line of two municipalities. This can result in situations where a municipality unlawfully includes part or all of properties on their tax roll, when in fact; the property in question is actually situated in a different municipality. There are many other possibilities.

**THE TAX GRIEVANCE PROCESS**
Taxpayers sometimes feel that their assessments are incorrect. When this occurs, a tax grievance may be filed. A tax grievance is a formal complaint filed by a taxpayer to challenge their property's assessment.

Any of the following are entitled to file a tax grievance:
- The party paying the property taxes
- This includes the owner, purchaser or tenant
- The actual party or their representative
- There are "tax grievance" companies that specialize in helping people file the paperwork. Many of these companies charge a fee based on the amount of a reduction.

**TYPES OF GRIEVANCE PROCEEDINGS**
Two different types of grievance proceedings are available, Administrative and Judicial Reviews.

**ADMINISTRATIVE REVIEW**
This is the first step of the grievance process. In fact, a judicial review cannot be performed without an administrative review first. A complainant must file a tax grievance with the local assessing unit or the Assessment Review Board for the municipality in which the property is located. An Assessment Review Board, which is often referred to as a Grievance Board, is an independent board whose primary function is to hear tax appeals (grievances) from parties who believe that their properties are incorrectly assessed.

Most municipalities have annual filing dates by which taxpayers may file grievances. If it is not filed during the specific period it will not be heard. Filings only apply to the current tentative assessment roll. Once a tentative assessment roll has been made available to the public, taxpayers should review the assessed value of their properties to see if they are reasonable.
TYPES OF DECISIONS
The Assessment Review Board will examine all information regarding the grievance, and then may perform additional research on the property to make a determination. NY State law presumes that the current assessment is correct. The burden of proof is on the complainant to prove that the assessment is incorrect. If the burden of proof is not met, the assessed value will not be changed.

After reviewing the grievance and any additional information, the Assessment Review Board will render one of 3 possible decisions as follows:
- Full denial- just as it sounds, there is no merit to the grievance
- Full re-assessment as per the application- assessed value will be changed to the amount stated in the application
- Partial re-assessment- there is some merit to the application and the assessed value will be reduced based on the determination of the Assessment Review Board, but not as low as the taxpayer requests.

GROUND FOR CHALLENGING ASSESSMENTS:
Under NY State law, complainants may file a tax grievance in order to prove that their assessment is incorrect on four grounds. These grounds are as follows:

EXCESSIVE ASSESSMENT: Also known as a full value disagreement, occurs when a taxpayer believes that their assessed value is greater than the full market value. In other words, the taxpayer feels that their property is "over-assessed". When a taxpayer files a grievance claiming excessive assessment, the issue in question is the market value of the property.

For example: A property owner receives a notice that the current tentative assessed value on her property is $1,000. The level of assessment in this municipality is .25%. This equates to a market value of $400,000 ($1,000 ÷ .0025 = $400,000).

The property owner believes that the market value of this property is less than $400,000. In fact, she believes that the market value of this property is closer to $350,000. This owner decides to challenge the assessed value on this property. She must file her application during the grievance period and provide proof that her property is worth less than $400,000.

Some examples of proof:
Comparables-arms-length sales of similar properties in the same market area, which sold for less than $400,000
- A recent listing of the subject property for less than $400,000
- Recent listings of similar properties in the same market area, which are listed for less than $400,000
- A professional appraisal of the subject property with a market value opinion of less than $400,000

If the owner is able to provide compelling evidence and the Assessment Review Board does not find significant evidence to the contrary, the burden of proof will be met and the assessment will be deemed excessive.

Excessive assessments can also include situations where a taxpayer believes that a portion of an exemption was incorrectly denied.

UNEQUAL ASSESSMENT: Taxpayers sometimes believe that their property is assessed at a higher percentage of market value than other properties in their area. In these cases, the taxpayer is disputing the level of assessment, not the market value of the property. When filing a tax grievance based on unequal assessment, the taxpayer must prove that they are paying a higher level of assessment than other properties on the tax roll.
To prove unequal assessment, the market value of the subject property and other properties on the tax roll must first be established. Much like a grievance based on excessive assessment, the owner can provide various forms of proof.

Once the market value has been established, the level of assessment of the subject property can be compared to the level of assessment for other similar properties on the tax roll. If the taxpayer can prove that these other properties have a lower level of assessment than their property, they can claim unequal assessment.

**UNLAWFUL ASSESSMENT**: Taxpayers can also file tax grievances based on unlawful assessments. An example of an unlawful assessment is when a property is fully exempt from taxation but is being taxed anyway. A property owned by a religious organization for example, might be qualified for a full exemption from taxes, but is being taxed anyway.

**MISCLASSIFIED ASSESSMENT**: Usually pertains to homestead and non-homestead properties.

**JUDICIAL REVIEW**

Once an assessment review board has rendered a decision, there are several different courses of action that taxpayers can take, depending on the decision that was rendered.

Possible decisions of an assessment review board:

- **Full denial**: The assessment review board has determined that there is no merit to the grievance. There is no reduction in assessed value.
- **Full re-assessment as per the application**: A determination that there is full merit to the grievance and a change in the assessed value is warranted. The assessed value will be changed to the amount stated on the application filed by the taxpayer.
- **Partial re-assessment**: A finding that there is some merit to the grievance and a partial change in the assessed value is warranted. The assessed value will be changed to an amount deemed appropriate by the Assessment Review Board, not the amount stated on the application filed by the taxpayer.

A taxpayer who receives one of the above decisions from an assessment review board may simply accept the decision as it stands. In the cases of full denial or partial re-assessment, the taxpayer does not have to accept the decision from the assessment review board. Under NY State law, taxpayers have the right to appeal decisions made by an assessment review board. The appeal process is known as judicial review.

While administrative review covers both residential and commercial property, judicial review is done in two separate hearing processes. The two different processes for residential and commercial property under judicial review are known as:

1. **SCAR (small claims assessment review)**
2. **Certiorari**

**SCAR (small claims assessment review)**

Small claims assessment review is a legal process, which gives taxpayers a second chance to obtain the reduction they are seeking. SCAR cannot be applied for as a first step in the grievance process. Taxpayers must file for an administrative review with the local assessing unit or assessment review board first. Once a decision has been rendered, qualified taxpayers can now file a SCAR petition.

**Who qualifies for SCAR proceedings?**

- Owner occupants of 1, 2 and 3 family dwellings used exclusively for residential purposes
- Owner occupants of certain residential condominium units in Nassau County and NY City that are designated as "Class 1" property; or owner occupants of certain residential condominium units that have been classified as "homestead" by an approved assessing unit
- Owners of residential vacant land that is too small to build a 1, 2 or 3 family dwelling
- What property types do not qualify for SCAR proceedings?
- Commercial property
- Cooperatives
- Condominiums (except those described above)
- Vacant land (except those described above)
- Industrial Property
- Multifamily dwellings over 3 units
- All other non-residential property

**How does SCAR work?**
Taxpayers seeking a SCAR hearing must first file a petition in the county clerk's office of the municipality in which the property is located. A filing fee is required. SCAR filings only apply to the current final assessment roll. They must be filed within 30 days of the filing of the final assessment roll. Taxpayers may not request an assessment lower than that which was requested in the administrative review with the assessment review board.

Just like in the administrative review process, NY State law presumes that the current assessment is correct. The burden of proof is on the petitioner to prove that the assessment is incorrect. If the burden of proof is not met, the assessed value will not be changed. All evidence, supporting statements, records and other information should be submitted at this point. The hearing officer may request additional information or evidence.

The decisions resulting from SCAR hearings are much like those rendered by the assessment review board. Hearing officers are not permitted to reduce an assessment below the amount requested on the petition even if there is evidence that a greater reduction is warranted. A hearing officer may decide that there is no merit to the case and no reduction in the assessed value will be granted. A hearing officer may decide that there is full merit to the case and grant the full reduction of assessed value requested on the petition filed by the taxpayer. A hearing officer may decide that there is some merit to the case and grant a partial reduction of assessed value, but not the amount requested on the petition filed by the taxpayer.

**APPEAL OF A SCAR DECISION**
When a taxpayer files a SCAR petition, they waive their right to a tax certiorari proceeding in state Supreme Court. The only recourse for a taxpayer dissatisfied with a SCAR decision is to commence a proceeding under NY State Civil Practice Law, known as an "Article 78" proceeding. This is a legal proceeding that allows parties to bring action against a government agency or officer, such as a hearing officer. Article 78 proceedings provide a means for the review of a hearing officer's decision in state Supreme Court.

**CERTIORARI PROCEEDINGS**
While SCAR is the judicial review process for residential property taxpayers, Certiorari is the judicial review process for all other property types. Certiorari is a formal, legal review process in NY State Supreme Court, in which taxpayers can challenge a property's assessment. Just like SCAR, a certiorari proceeding cannot be the first step in the grievance process. Taxpayers must file for a grievance with the local assessing unit or assessment review board first. Once a decision has been rendered, taxpayers can now file a certiorari petition. While SCAR has strict restrictions on eligibility, certiorari does not. However, parties who have already gone through the SCAR process have waived the right to a certiorari proceeding.

**Typical property types in Certiorari proceedings**
- Commercial property (most common)
- Condominiums that do not qualify for SCAR
- Vacant land that does not qualify for SCAR
- Industrial Property
- Multifamily dwellings over 3 units
- All other non-residential property
THE PROCESS OF CERTIORARI
Taxpayers seeking a certiorari proceeding must first file a petition in the county clerk's office of the municipality where the property is located. The proceeding must be filed in the state Supreme Court within 30 days after the date that the final assessment roll is filed. Taxpayers seeking a certiorari proceeding must hire an attorney to represent them. Just like in the administrative review process and SCAR proceedings, NY State law presumes that the current assessment is correct. The burden of proof is on the petitioner to prove that the assessment is incorrect. If the burden of proof is not met, the assessed value will not be changed.

RESIDENTIAL ASSESSMENT RATIOS
NY State Law requires the calculation of Residential Assessment Ratios (RARs) each year. These are established by the NY State Office of Real Property Service (ORPS). The purpose of residential assessment ratios is to measure the equity of the assessed values of residential real property in a municipality. It is a way to check that a municipality is assessing its residential real property fairly and accurately. It is a comparison of the average assessed value of residential properties in a municipality with the average sale prices of those residential properties in the municipality that sold within the past year. Once calculated, it will illustrate the equity (or lack of equity) of residential assessed values in a municipality.

HOW ARE RESIDENTIAL ASSESSMENT RATIOS CALCULATED?
They are calculated by first dividing the assessed value of an individual residential property by its sale price as follows: Assessed Value ÷ Sale Price = Ratio

For example:
A property with an assessed value of $20,000 recently sold for $400,000. The residential assessment ratio is calculated as follows:
$20,000 ÷ $400,000 = .05. In this example, the residential assessment ratio is 5%.

EQUALIZATION
Real property taxes are administered locally by the assessing units of various municipalities. Therefore, levels of assessment and the resulting assessed values can vary greatly from municipality to municipality. For example: A municipality uses a level of assessment (uniform percentage of market value) of 50%. Therefore, a property with a market value of $400,000 has an assessed value of $200,000. The neighboring municipality uses a level of assessment of 10%. This means that a property with a market value of $400,000 in this municipality has an assessed value of $40,000.

In this example, two properties with the same market value have vastly different assessed values, simply because they are located in different municipalities. This is a very common situation since there is no fixed level of assessment in NY State. The above situation can create taxation problems, especially when various taxing jurisdictions such as counties or school districts contain more than one assessing unit such as a town or village.

For example: A school district is utilized by six different municipalities, including three towns, one city and two villages. The market values of properties in these municipalities are fairly consistent, with none having significantly higher or lower market values than the others. Each has their own assessing unit; and each assesses properties at different levels. As a result, the assessed values of properties vary greatly among these municipalities, even though the market values are fairly consistent. It would be very difficult for the school district to fairly apportion the school taxes necessary without a process known as "equalization".
Equalization is a program to assure equitable property tax allocation among all of the taxing jurisdictions in NY State. There are over 4,000 different taxing jurisdictions in NY State; and real property taxes are the largest single source of revenue to fund the municipal services and school districts. As a result, a program to ensure equitable property tax allocation is extremely important. The Office of Real Property Services (ORPS) is obligated by NY State Law to administer the state’s equalization program. In order to implement an equalization program they develop an equalization rate for the various assessing units in NY State.

**WHAT IS AN EQUALIZATION RATE?**

A rate calculated by the NY State Board of Equalization and Assessment to measure a municipality's level of assessment. *Note - currently, the NY State Board of Equalization and Assessment is part of ORPS.  It is a comparison of total market value to total assessed value and is calculated as follows:

\[
\text{Total Assessed Value} \div \text{Total Market Value} = \text{Equalization Rate}
\]

**For example:** The total assessed value of all real property in a municipality is $900,000. The total market value of all real property in the municipality is $45,000,000. The equalization rate is calculated as follows:

\[
$900,000 \div \$ 45,000,000 = .02
\]

In the above example, the equalization rate is 2%.

**Relationship of Assessed Value to Market Value:**

An equalization rate of less than 100% means that the total market value of the real property in a municipality is greater than the total assessed value of the real property in the municipality. (As indicated in the example above.)

An equalization rate of more than 100% means that the total market value of the real property in a municipality is less than the total assessed value of the real property in the municipality.

An equalization rate of 100% simply means that the municipality is assessing real property at 100% of market value.

As you can see from these relationships, an equalization process would not be necessary if all municipalities assessed their real property at 100% of market value each year.

**APPORTIONMENT**

The term means “to set funds apart for a special purpose or distribute according to a plan”. Remember, many school districts and special districts exist in more than one municipality. Equalization allows the tax levy to be divided fairly among the municipalities within the district. In these cases, taxes are apportioned so that the properties in different municipalities within the school district or special assessment district to pay their fair share of the tax levy.

In addition to school districts and special districts, apportionment also applies to county taxes. Since counties typically encompass many different assessing units such as cities, towns or villages, the county tax levy needs to be divided fairly. Equalization allows the properties in the different municipalities of a county to pay their fair share of the county tax levy.

**RELATIONSHIP TO LEVEL OF ASSESSMENT:**

When assessing units are able to keep assessments current and reflect changes in the real estate market, the assessed values stated will be very accurate. As such, they will actually be indicating the equalization rate upon which school taxes are allocated. This will result in a consistency between the level of assessment and the equalization rate from year to year.

Summary of Equalization: Levels of assessment often vary greatly from municipality to municipality. Since school districts and various special districts utilize the assessment rolls prepared by the different
municipalities as the basis for school taxes and special assessments, a process of equalization is necessary to fairly apportion real property taxes.

A significant change in property taxes can be the difference in whether or not a perspective buyer can qualify for a mortgage loan. Real estate agents can help avert potential problems arising during a transaction by helping perspective buyers verify the correct property taxes. Sellers also often have issues with property taxes. A potential seller may be over-assessed for example, and the filing of a tax grievance may help make their property more marketable. Another common situation occurs when there are open permits for renovations that have been done to the property. The seller often needs to know how much this will affect their property taxes. A seller may have questions about special assessments or tax liens on their property. They also may need to know if any current exemptions they are receiving can be transferred to a property they are purchasing. While real estate agents are not attorneys and are not in the business of providing legal advice, they can answer many questions with respect to property tax issues.

Agents should be able to direct buyers and sellers to the proper departments of various agencies for information. When we take a listing we should confirm the exact amount of property taxes as well as any exemptions, open building permits, special assessments and pending grievance proceedings.
CHAPTER 17 TITLE CLOSING & COSTS

KEY TERMS
Abstract of title
Assessments
Chain of title
Closing statement
Constructive notice; actual notice
Credits
Debits
Marketable title
Proration
Real estate settlement procedures act (respa)
Reconciliation
Survey
Title
Title closing
Title insurance
Title search

The term Title is commonly used to refer to a formal document that serves as evidence of ownership. Conveyance of the document may be required in order to transfer ownership in the property to another person. Title is distinct from possession, a right that often accompanies ownership but is not necessarily sufficient to prove it. In many cases, both possession and title may be transferred independently of each other. Title might be transferred, however, there may be a valid lease on the property, therefore, the owner does not get possession.

Title Insurance is a guarantee or insurance against loss from defects in title to real property and from the invalidity or unenforceability of mortgage liens. It is meant to protect an owner's or lender's financial interest in real property against loss due to title defects, liens or other matters. In the event of a lawsuit attacking the title, the policy will reimburse the insured for the actual monetary loss incurred, up to the dollar amount of insurance provided by the policy.

Most insurance that we buy is protection against a future action. Car insurance or homeowners insurance or life insurance are examples of buying protection against some event that may or may not occur in the future. Title insurance, on the other hand protects against acts in the past, until the time that title changes hands. It protects the lender and buyer against acts by prior owners or lien holders who might not be known.

In New York, the State is the ultimate regulator of the title insurance industry. In order to participate in this industry, a title insurance company must become licensed and meet qualifications regulated by the State. The State sets the premium amounts to be charged for the actual title insurance creating uniformity across the industry participants and eliminating competitive pricing.

EXAMPLES OF TITLE DEFECTS THAT ARE PROTECTED BY TITLE INSURANCE
- Existing liens in the public records
- Outstanding maintenance fees other than those disclosed
- Loss of use
- Fraud
- Forgery
- Probate issues

Outstanding Mortgages

In New York, title insurance policies may be issued by either
1. Title Underwriters
2. Title Abstract Agencies

These companies provide a specialized type of insurance that protects the policyholder (the insured) against loss from something that has already happened, such as a lien, a judgment or even a forged deed somewhere in the ownership history. They thoroughly examine the chain of owners and lien holders to prove that the title is insurable, also known as clear title. The determining factor which
allows a property to be insured is the lack of noticeable defects in the records which would cause a future claim.

Title Insurance Underwriters are the direct issuers of title insurance policies once it is determined that the property is free and clear of any title defect (judgments, liens, etc.) that may give rise to a future claim against the property. These insurers are members of a group known as the Mutual Indemnification Insurers.

A Title Abstract Company operates as an agent of the Title Insurance Underwriter and performs all the necessary functions necessary in order to issue policies on behalf of the Underwriter(s) for whom they are agents.

They perform searches or hire the necessary entities to perform searches on their behalf. They routinely review the searches and request ‘clearance’ from prior insuring title companies and/or underwriters. They act as an escrow agent for money collected from parties during the closing in order to make necessary payments to assure the Purchaser that all outstanding monetary obligations have been satisfied.

They ensure that all outstanding mortgages have been or will be satisfied prior to or at the closing. They make sure that all documents, which must be recorded, are in fact recorded and provide and coordinate the scheduling of the title closer who will appear on their behalf at the closing.

THE TITLE CLOSER
Title closers may be full-time or part-time in-house employees of an abstract company, or, more routinely, they are independent contractors that act on an ‘on-call’ basis and may be on more than one abstract company’s list of title closers. In New York State, it is not a requirement that title closers are certified or licensed. However, due to the complexity of the transfer of property transactions, and more significantly the potential liability involved, it is necessary for abstract companies to hire title closers that are knowledgeable and preferably experienced as they are acting as agents of the company.

As agents, title closers potentially put the company on whose behalf they are acting at risk for any wrongdoing or oversight at the closing. Therefore, it is in the best interest of both the title company and the title closer to assess whether the title closer possesses both the knowledge and experience before assignment to a closing.

FUNCTIONS OF A TITLE CLOSER
While there are no licensing or educational requirements in order to become a title closer in New York State, there are a number of functions to be performed by the title closer both during and after the closing that require both knowledge and proficiency. Some duties of the closer:

- Understand the outstanding clearance issues to be resolved and clear any outstanding defects to title.
- Validate the identity of the parties to the transaction.
- Verify the amounts of the outstanding mortgages and collect appropriate amounts due at closing.
- Coordinate the collection of and, if necessary, the preparation of recordable documents at the closing.
- Calculate, prepare and distribute the title closing bills at the closing.
- Notarize all documents where a notorial seal is required
- Provide the bank attorney with all required documentation including title insurance policies after verification of accuracy of all information within.
- Provide parties attorney’s with copies of all relevant documents signed at the closing, ie. deed, transfer documents, escrow agreements, etc.
- Provide the title abstract company with a complete file after the closing, including recordable documents, properly executed affidavits, collected fees and marked up title report.
Notaries Public verify signatures on documents, therefore, title closers must become a notary public. They are certified by the New York State Department of State and commissioned in the county where they reside. The public can verify that an individual is certified by the State of New York by contacting the appropriate County Clerk’s office. The New York State Department of State lists the following as the functions of the Notary Public:

- Administer oaths and affirmations
- Take affidavits and depositions
- Receive and certify acknowledgments or proof of written documents such as deeds mortgages and powers of attorney.
- Demand acceptance or payment of foreign and inlands bills of exchange, promissory notes and obligations in writing.

The most common use of notary publics is to certify signatures on documents. If this needs to be done some official form of photo identification is required to be produced at the time of signing.

ON THE WAY TO THE CLOSING
Before we explore the process of closing, let us review all the steps along the way that will lead us to the actual moment when title is passed, and, of course, the time when our commission will be paid.

Time To Order the Title Report:
- There is a valid contract in place
- Consideration in the form of the down payment has changed hands
- It is being held in escrow by the Seller’s attorney until the closing
- A mortgage commitment has been secured

In New York State, it is customarily the right and responsibility of the Purchaser’s attorney to order the title report. This attorney needs to be certain that the title is “marketable”, one that is free of defects and a court would consider acceptable to a buyer. This actually makes sense as there might be a conflict of interest if the Seller’s attorney was to order the title and defects against the current owners (Sellers) or the property were found.

ORDERING THE ABSTRACT
The company will now order searches which include information about the parties to the transaction, both Seller and Purchaser as well as the property to be sold. Within New York, these ‘municipal’ searches against the property include:

Certificate of Occupancy – This search will show the designation assigned to the property as to its lawful use, i.e. one family, two family, three apartments and a store, etc. It is the responsibility of the Purchaser’s attorney to review this search upon to insure that what is being sold to his clients, is in fact what they thought they bought. If the buyer thought they were buying a legal two family and the c.o. is for a one family, obviously, there is a problem. Certificates of Occupancy were not issued for property built prior to 1937.

Franchise Tax – This search is conducted if one of the parties is a corporate entity. The corporation must have all fees and taxes paid current in order to be considered in good standing.

Fire Dept. Search – The abstracter will check with the public records to determine if there are any violations against the property for failure to maintain a safe environment according to Fire Safety regulations and code.

Emergency Repairs – It is quite common to find Emergency Repair violations in multiple dwelling properties where City Inspectors have cited the landlord for failure to correct basic conditions that make the premises unsafe to live in.
Bankruptcy – If the Seller commenced a proceeding in bankruptcy court and it is an open file at the time of the closing, the action stops right there upon discovery. A Seller is not allowed to proceed with the sale of his home, even if the intention is to satisfy unpaid creditors, if the bankruptcy court has not approved the sale.

Street Report – This search provides information regarding the existence of a potential lien against the property for sidewalk repair by the City/Town/County, etc. for the homeowner. It is a little known fact that the responsibility for maintaining safe conditions of existing concrete sidewalks around the property falls to the homeowner. If an inspection by the City reveals extensive cracks and unsafe conditions, then the homeowner will be cited and a violation will be issued against the property. After a reasonable time, this violation will ripen into a lien once the City makes the necessary repairs and invoices the homeowner. The lien will transfer to the new owner if the monetary damages are not collected at the closing and subsequently paid by the title company on the Seller’s behalf.

eto assure that there are not unpaid taxes or water and sewer charges as examples.

In addition to the City Agencies, the abstracter will also conduct searches at the county clerk’s office in the county where the property is situated. Searches will be made for any judgments, mechanics liens, lis pendens, and a host of other recorded claims against the property.

One of the most important searches is for open mortgages against the property. These are the continuing obligation of the Seller as long as he is the owner of the premises. In most closings it must be satisfied by proceeds of the sale unless the Purchasers are taking the property ‘subject to’ the open mortgage; in this case they will continue to make monthly payments on the Seller’s existing mortgage instead of taking out a new loan of their own.

During the search at the county clerk’s office, the abstracter will review the chain of title. This term is used to describe the continuous unbroken sequence of Sellers to Purchasers who eventually become the Sellers to new Purchasers and so forth. It is customary to run a 40 year search of all prior deeds on record against a property. The abstracter is on the lookout for a devolution of title also know as a ‘break in the chain’. This break in the chain of title occurs when you don’t have a continuous deed sequence passing smoothly from deed to deed. This can occur for a number of reasons.

EXAMPLE: Al and Betty sell their property to Charlie and Daisy. Charlie and Daisy are now in title as the new owners. Sometime after, Charlie dies. Daisy sells and deeds the house to Ed and Francis and when her attorney prepares the deed, he just puts down Daisy as the Seller. Where is the break in the chain?

ANSWER: The break in the chain occurs when Charlie’s name is omitted in the deed transferring the property from Daisy to Ed and Francis. Even though Charlie is deceased at the time of the transfer, anyone looking back over time will not know what happened to him. Did Daisy just sell the house without his permission? Did they get divorced and Daisy decided to sell the house? This omission raises questions as to potential claims by Charlie or his heirs if not made clear.

Without a clear chain, these questions may arise many years later to prevent an underwriter from insuring title to a new Purchaser. The correct way to handle the situation in the above example is to put both Charlie and Daisy in the deed as Seller’s but add (now deceased) next to Charlie’s name and have Daisy provide a death certificate as proof at the time of closing. This prevents the ‘break in the chain’ that can be construed as a fatal defect unless corrected.

At the same time, name searches will be requested by the title agency for information about the parties involved in the transaction.

Since September 11, 2001, it has become common practice to run a Patriot Search against the parties to the transaction to determine if they match any names on the known terrorist list. Parking violations,
child support judgments and Environmental Control Board (ECB’s) are just a few of the other name searches run for all of the parties to the transaction.

**READING TITLE**

Once all the pieces have been obtained, the abstracter presents the title abstract to the title company, where it will be assembled into a title report. In the State of New York, legal descriptions are prepared in a format known as metes and bounds. It is imperative that the legal description be flawless since that is what is being insured.

Finally, a certification page is created to cap off the title report. It is a summary page of who the proposed insured is (Purchaser), the purchase price of the property, the loan amount, who is currently in title and from whom they acquired title and the date. Once this is prepared, the title report is completed and assembled and is now ready for distribution to the attorneys for the Purchaser and Seller as well as to the Lender. A copy is retained at the title company in the file for further clearance work and in anticipation of the actual closing sometime in the future.

**CLEARANCE**

Now that the essential component parts of the title report have been obtained and compiled into one full title report, AND distribution of the reports have been made to the attorneys and the Lender, issues which appear within the title report must be addressed prior to closing or the file will not be cleared to close. Some examples of items that must be addressed prior to closing include:

- Open mortgages – current owner and prior owner
- Devolution of title – (break in the chain)
- Open liens or judgments
- Prior owner issues still appearing as open including mechanics liens, etc.
- Federal tax liens
- Estate issues if a party in title now deceased

**SCHEDULING THE CLOSING**

Once the file has been designated as ‘cleared to close’, it is ready for the closing. Scheduling of the closing is usually dependent on two factors; one is the clearance of the title file and the second is the final loan approval by the Lender. When these two events are finalized, then the scheduling of the closing begins.

The time and place for the closing, in New York State, is usually initiated by the representative for the Lender also known as the Bank Attorney. Commonly, the closing will take place in the Bank Attorney’s office where the loan documents have been prepared. The attorneys for the Seller and the Purchaser will be contacted by the Bank Attorney’s office and a date, time and place will be confirmed, convenient for all parties. The attorneys in turn will contact their respective clients and advised them of the scheduling details as well as what will be necessary for them to bring to the closing.

Finally, the title company will be contacted and advised of the date, time and place of the closing.

**AT THE CLOSING**

Closings in New York, unlike other parts of the country, are a sit-down affair. Usually set up in a conference room around a large table, there are designated spots for the parties to situate themselves. The attorney for the Purchaser and his client(s) will sit on one long side of the table across from the attorney for the Seller and his client(s). At the head of the table, it is customary for the bank attorney to set up his paperwork and likewise, at the other end of the table, the title closer will sit either closest to the telephone or the copier.

After everyone has settled in and taken their seats, the title closer will first and foremost ask to see the ID’s of both the Sellers and the Purchasers. Once the identification issue has been dispensed with, assuming all ID’s are in acceptable form, the next most significant task to be performed by the title closer is the preparation of the title bill for the bank attorney.
While the title closer is in the process of preparing the title bill, several activities will be going on simultaneously. Before we get to all those activities, let us understand the differences between debits and credits and pro-rations.

**DEBIT**: A decrease in assets or an increase in liabilities. An entry on a financial statement which reflects payments or disbursements made on behalf of a party for which the party is responsible (opposite of "Credit").

**CREDIT**: The accounting term for a liability or for equity, entered on the right side of the ledger. As a verb, to allot for the benefit of a person (i.e. You must credit the Purchaser on closing for the deposit paid).

**PRORATION**: Division of certain settlement costs between buyer and seller

**Example**: The buyer is obtaining a mortgage in the amount of $200,000. This will appear as a credit on the closing statement because it reduces the amount he will have to spend at the closing.

**Example**: There is $125.00 worth of oil left in the oil tank, this will be a debit to the buyer because he will owe it to the seller.

**Example**: The taxes for the year have been prepaid. They are $1200 annually and the house is closing on Sept. There will be a pro-ration of the taxes since they were paid by the seller but benefit the buyer. The buyer will owe the seller $400 which becomes a debit for him and a credit to the seller.

**MOVING ON**

The **Purchaser’s attorney** will get several sets of loan documents from the Lender. The Purchasers will commence signing these documents while their attorney explains the nature of each document to be signed and/or initialed.

The **Seller’s attorney** reviews the documents for his client’s signature. This will include the Deed and any appropriate county transfer documents that are required to be filed.

The **Bank Attorney**, will be collecting necessary documents and will begin the preparation of the HUD, which is the final closing document to be signed and dispersed at the termination of the transaction.

The **Agent** will just be sitting there watching all the goings on.

**TITLE INSURANCE PREMIUMS (FEES)**

The first two items on the bill represent the title insurance premiums. These are fees regulated and set by the State and are uniform for every title agency and underwriter. A Title Insurance Rate sheet is distributed to each title industry participant and no variance in premiums is allowed. As most title companies create their reports and bills on the computer, the software programs designed specifically for title companies are loaded with the title premiums rates set as the default.

The title insurance premiums represent payment for two distinct policies:

**The Owner’s Policy/Fee Policy** – is issued to the Purchaser and represents insurance coverage for the amount of the full purchase price of the property. In the event of litigation in the future, a settlement will be based on the insured amount and not on the value of the property at the time of litigations.

**The Mortgage Policy/ Loan Policy** – is issued to the Lender and the face amount of this policy is the exact amount of the loan borrowed by the Purchasers.
SURVEY FEES
At almost every closing involving a loan, the Lender may require one of three ways to satisfy its survey exception requirement:

New Survey
If an existing survey cannot be found then the Lender may require that the title company order a new survey for review.

Survey Reading
Once the survey has been discovered or a new survey prepared, a title company member ‘reads’ the survey into the title. Each side of the property, known as a course, is described into the title. The format in New York State for narrating the dimensions and measurements of a survey is known as metes and bounds. Utilizing an existing survey and simply reading it into title will save hundreds of dollars to the Purchaser. This survey reading fee is added to the Purchasers title bill at closing.

Survey Inspection
As with the survey reading, an existing survey is utilized. A surveyor is called to use the existing survey to revisit the property and re-inspect to verify that no new structures are now on the property, either legally or illegally, ie. pool, deck, upper story addition.

RECORDABLE DOCUMENTS
Most buyers and all lenders will want the deed recorded in the public records. This is done “to give legal, public and constructive notice for all the world to see.” Recording Acts give priority to all documents such as deeds and mortgages which have recorded over those that have not. The priority of a loan is established based on the date and time of recording in the public records. In order to be recorded the document must be “acknowledged” by a notary public.

MORTGAGE TAX
When a Purchaser obtains a loan to buy the property, a tax on the amount borrowed is collected from the Purchaser by the title closer on behalf of the State. This mortgage tax is the most significant figure on the title bill by sheer dollar amount. Tax laws change periodically and the closer must be aware of all current taxes.

OPEN REAL ESTATE TAXES & OPEN WATER/SEWER CHARGES
On the day of the closing, the title company will call any one of several of its research companies to order a final search. At the same time, a quick update at the county clerk’s office is done to insure that no new judgments, liens or lis pendens has been filed against any of the parties to the transaction or the property being sold. This includes a search of any new mortgage obligations being recorded against the property.

OTHER CLOSING COSTS WHEN BUYING OR REFINANCING A HOME
Reserves Deposited with Lender
Lenders will often require an escrow account be opened to collect an amount each month that can be used to make payments for insurance, property tax, mortgage insurance when required. The amount required is in addition to the payment for the mortgage debt. The lender’s goal is to always have sufficient funds to pay bills as they come due.

Homeowners Insurance Escrow
The lender will divide the annual premium by twelve to come up with an estimated monthly amount required. Since a lender is allowed to keep two months of reserves the buyer will have to deposit two months into the escrow account to start it up.

Property Tax Escrow
The amount required depends on the time of year the closing takes place in relation to when taxes are payable.
For example, if the closing is in November and property taxes are due in December the deposit would be higher than for someone closing in May.

**Mortgage Insurance Impounds**
When required, most lenders allow this to simply be paid monthly. However, there may be a requirement to put two months worth of mortgage insurance as an initial deposit into the escrow account.

**Pest Inspection**
Also referred to as a Termite Inspection. This inspection tests not only for pest infestations, but also other items such as wood rot and water damage. If repairs are required, the amount to cover those repairs can vary. The seller will usually pay for the most serious repairs, but this is a negotiable item. Usually (not always) the pest inspection fee is paid by the seller of the home and is not normally reflected on the Good Faith Estimate.

Additionally there will be calculations for prorations or apportionments. This term applies to the division of expenses between the buyer and seller at the closing. Typically, the seller is responsible for all expenses and receives all income until the day of the closing. After the closing, expenses and income belong to the buyer. However, there are some items that may have been prepaid and are adjusted at the closing. Some of the most typical adjusted or prorated items are:
- Real Estate Taxes and Assessments
- Insurance
- Fuel
- Water and sewer charges
- Rent
- Security deposits.

The adjustments would be made based on the calendar for taxes, assessments, insurance or other prepaid items. Fuel would be prorated based on the initial cost and the amount of oil left in the tank at closing. Security deposits would be transferred to the buyer in total.

**CLOSING COST DESCRIPTIONS**
The RESPA (Real Estate Settlement Procedures Act) requires a Good Faith Estimate of closing costs three days prior to closing a loan. This law also requires the lender to supply the borrower with a special information booklet outlining details of the financing and settlement. In addition, a Uniform Settlement Statement is required to state all the financial facts of the loan. This is a HUD form. The Good Faith Estimate will give the buyer a way to compare loans and see what closing costs would be.

**Broker Fees**
Sales/Broker’s Commission: If you use a real estate agent or broker to buy a house, the buyer or seller will usually pay a fee to the real estate agent/broker. This commission is usually a percentage of the sales price.

**Lender Fees**
Loan Origination Fee: A fee to cover the lender’s costs for obtaining financing and administrative costs, most often expressed as a percentage of the loan amount (1% = 1 point). Can be a flat fee and/or paid by sellers and third parties.

Loan Discount Fee/Discount Points: Often called "points", is a one-time charge from the lender to lower the interest rate. Generally, the more points you pay, the lower your rate. Each point is 1% of the loan amount. For example, if you have a loan amount of $100,000, one point would cost you $1000. Sometimes you will see offers with negative points.

**Appraisal Fee:** The appraisal fee covers the cost of evaluating the home to estimate the fair market value. The appraised value of the home is used to calculate LTV. (Loan to Value)
Credit Report Fee: This fee covers the cost of obtaining a credit report, which shows how the buyer handled other credit transactions. The lender uses this report in conjunction with information submitted with the application regarding income, outstanding bills, etc. to determine whether the buyer is an acceptable credit risk, how much the lender can loan and at what interest rate.

Lender Inspection Fee: This covers inspections by the lender or outside inspector of the house/property. Most often associated with new construction.

Mortgage Insurance Application Fee: The fee to process an application for Mortgage Insurance (MI) if needed.

Mortgage Broker Fee: Any fees charged by the mortgage broker when they are involved in the loan process.

Underwriting Fee: A cost to cover the final analysis and approval of the mortgage; often the lender’s cost to the investor who will subsequently purchase the loan.

Tax Service Fee: A fee paid to set up a service which identifies the payment due date of local taxes for the servicer of the loan.

Processing Fee: A fee charged by the lender to cover costs associated with the processing and closing of a mortgage loan.

Application Fee: A fee to reimburse the lender for internal costs associated with initiating the application process.

Flood Certification Fee: Since the house is collateral for the loan, the lender wants to be sure the property is not in a flood zone. This fee covers obtaining a report from the Federal Emergency Management Agency (FEMA) that indicates whether or not the property is in a flood zone. If it is located in a flood zone, the buyer will need to get flood insurance. Most homeowner insurance policies do not cover flood damage. This only covers the report and not the insurance if needed.

LENDER PRE-PAID ITEMS

Interest: Lenders require payment of the interest due on the mortgage from the close date to the first day of the following month. The interest due is calculated using the loan’s interest rate, the loan amount and the number of days until the first payment. For example, if you close on the 11th of March, you will pay 21 days interest (3/11-3/31) assuming your first payment is May 1st. Mortgage interest is always collected in arrears therefore you will pay the April interest in the May payment using the example above.

Mortgage Insurance: Premium Lenders usually require Private mortgage insurance (PMI) when the LTV (loan amount divided by property value) is greater than 80%. The insurance protects the lender in case of loan default.

Hazard Insurance: Since the property is collateral for the loan, the buyer is required to insure the house. At closing there must be proof of a paid up insurance policy. Flood damage is usually not covered by a Homeowner’s Insurance Policy. Typically, the lender will require payment of two months of premiums at closing, and then the remaining payments are included in your monthly payments.

City Property Tax: If your property is in a jurisdiction where city taxes apply, you will be required to pay a portion of the taxes at closing.

County Property Tax: The amount of property tax can vary dramatically by county and the date of closing.
**TITLE CHARGES**

**Settlement or Closing Fee**: This fee pays for the services of the escrow holder or settlement service that handles all the financial transfers and payments associated with the closing process. The title company sets these fees.

**Title Fee**: Title fees may include title search, title examination and title insurance.

**Document Abstract Preparation Fee**: Lenders or title companies may charge a fee to cover the costs of preparing the final legal documents required for closing.

**Notary Fee**: This fee covers the cost of a person licensed as a notary public to swear to the fact that the individuals named in the documents are the actual persons that signed them.

**Attorney Fee**: A fee to pay for legal services of a settlement service provider at closing. The lawyer will usually oversee the signing of the documents.

**Title Insurance**: The total cost of borrower and lender title insurance.

**Title Insurance Lender’s Coverage**: Protects the lender against loss due to problems or defects in connection with the title. The face amount of coverage is usually written for the amount of the mortgage loan and covers losses due to defects for problems not identified by title search and examination.

**Owner’s Title Insurance**: This fee covers the part of the title insurance policy that protects the owner against loss due to disputes over ownership of the property. The owner’s policy is not necessary for a refinance transaction as the existing policy remains in full force and effect, if obtained when you purchased your house, for as long as the owner owns the property.

**Carrier Fee**: A fee paid to an overnight delivery service for delivery of mortgage documentation.

**GOVERNMENT FEES**

**Recording Fee**: Fee to record mortgage at the county office.

**City/County Tax/ Stamps**: Based on location of the property.

**State Tax/ Stamps**: A tax on the mortgage based on the state the property resides in.

**SELLER CLOSING COSTS**

**Broker’s commission**

**Cost of the survey**: This can be either a buyer or seller expense

**Recorded release of mortgage**: The seller needs to pay off their old mortgage, home equity line of credit (HELOC) and other liens that affect the property. To release each one of those liens a separate document must be filed.

**Interest on loans to be paid off**: Home sellers often forget that the interest owed on most home mortgages and home equity line of credits (HELOC) are paid in arrears. That means that you pay the interest on that loan not in advance but for the month that just ended. Your June 1st payment to your lender paid interest on that loan through the end of May. So a closing on June 15, will require you to pay up interest at the closing through June 15 or the date the lender actually receives the loan payment. A seller thinking his loan balance is $111,111 will be surprised to find out that his actual payoff to his lender at closing will be more than that amount.

**Lender fees**: Most lenders now charge a fee to fax the demand statement or payoff statement to the closing agent. This is the official document showing the amount due at closing.

**Prepayment penalties**: If you obtained your mortgage during the last several years, you might be surprised to find out that your loan has a prepayment penalty. Some loans require payment of a stated percentage if the loan is paid off before its termination.

**State and local transfer tax**: These add many thousands of dollars to the closing costs of the seller.

Closing costs are the bane of a seller’s existence. They are seemingly endless, pesky in nature and can add up to a whole lot of cash.
**OMIT, EXCEPT, INSURE, INFO (MARKING UP THE TITLE REPORT)**

The title closer will diligently go over the title report page by page to be certain that all charges are correctly stated and any issues raised by the title company are addressed. To accomplish this, each exception is marked omit, except, insure or info.

**OMIT**: This designation indicates that this issue has been satisfactorily disposed of and the title company and underwriter will insure that this item is no longer an issue as a potential threat or defect to clear title.

**EXAMPLE**: The title report indicates that there is ONE open mortgage. This will be marked as OMIT as the title closer will personally payoff this mortgage from the proceeds of this closing and the mortgage obligation will be satisfied and will no longer continue as a lien against the property. The title closer on behalf of the title company guarantees and insures that this will be paid off at closing.

**EXCEPT**: This designation clearly indicates that the item will NOT be insured by the policy and will continue as an exception under the policy. There is no monetary amount satisfactory or affidavit or proof that may be offered to allow the title underwriter to insure this item under the new policy.

**EXAMPLE**: The title report states that the property is designated as a Landmark. This is NOT an insurable item for the underwriter and so the title closer will mark this as an EXCEPT.

**INSURE** - This designation clearly conveys the intention of the title company to cover this as an insurable item under the title policy.

**EXAMPLE**: The Legal Description that is to be marked INSURE is solely the one prepared by the title company and the one that is made part of the title report.

**INFO** – This designation is used for items raised on the report that are neither insurable items nor exceptions to the policy. Instead these are items raised as strictly informational to the parties involved and are marked as such accordingly.

**EXAMPLE**: any amounts to be collected as title charges in an amount exceeding $500.00 MUST be in Certified funds at the time of the closing. This exception is strictly informational to both the Purchaser and Seller and as such will be marked accordingly on the report as INFO.

The marked up title report will be held by the title company for years to come and may be held up to scrutiny at some future time should a claim be raised necessitating litigation. Bearing that in mind, it is a preferred practice to note the actual reason for a designation chosen so that the rationale is clear to someone reviewing the file at that future time. Once the title report has been thoroughly reviewed and all the exceptions and back-up information in the report dispensed with in a satisfactory manner, then the title bill may be finalized.

**VERIFYING INFORMATION ON THE DEED**

In New York State, the Deed is commonly no more than a three-page document. The first page of the Deed includes information that if prepared incorrectly can impact the ability to transfer title several owners down the line for years to come. The Party of the First Part refers to the Seller. It is important to list the names of the Seller(s) in this area EXACTLY as it was written in the prior deed when they took possession as the Purchasers. Failure to adhere to this rule may be considered a break in the chain of title or devolution as it will not be clear to future parties looking at the document either who the participants were or what happened to any omitted parties.

**EXAMPLE**: Robert Smith and Amanda Jones, his fiancée purchase 123 Main Street, Anywhere, NY in 2006 and take title as Robert Smith and Amanda Jones. In late 2007 they marry and decide to sell this property to move into a bigger home. At the closing, their attorney submits a Deed he prepared reflecting the Party of the First Part as Robert Smith and Amanda Smith, his wife. While accurate, this is not proper form as it may not be crystal clear that Amanda Smith, the Seller in this transaction, is the same person as Amanda Jones, the Purchaser in the prior transaction. A better way to reflect these parties so there is continuity between the Deeds is to denote the Sellers in the current transaction as Robert Smith and Amanda Jones aka Amanda Smith, his wife. This bridges the information between the two deeds making it clear that the Amanda in both Deeds is one and the same person.
The Party of the Second Part refers to the Purchaser(s). For the purpose of taking possession of property this section is crucial for the prospective owners. It is the only time that the Purchasers will be able to make a decision as to how they want to take title. Once the Deed is signed and recorded, this decision cannot be easily changed.

**FORMS OF OWNERSHIP**

At the time of the signing of the Deed, the Purchaser’s attorney will advise the Seller’s attorney who prepared the Deed, how the Purchasers wish to take title. We studied these in depth in Estates & Interests.

**Joint tenancy** is a form of ownership by two or more individuals together. It differs from other types of co-ownership in that the surviving joint tenant immediately becomes the owner of the whole property upon the death of the other joint tenant. This is called a Right of Survivorship. The designation is sometimes reflected as JTWROS (Joint Tenants With Rights of Survivorship) after the parties names on the Deed. The parties need not be a married couple to create this form of ownership, simply two or more individuals.

**Tenants by the Entirety** is a special kind of property ownership that’s only for married couples. Both spouses have the right to enjoy the entire property, and when one spouse dies, the surviving spouse gets title to the property (again, called a right of survivorship). It is similar to joint tenancy, but it is available in only about half the states.

**Tenancy in Common** is another form of co-ownership. It is the ownership of an asset by two or more individuals together, but without the rights of survivorship that are found in a joint tenancy. Thus, upon the death of one co-owner, his or her interest will not pass to the surviving owner or owners but will pass according to his or will. If there is no will, his or her share will pass according to the law determining heirs.

Creating Joint Tenancy is not automatic; the parties MUST have the designation in place at the time of the signing of the Deed in order to create this form of ownership.

**SIGNATOR**

The only party to sign the Deed is the Seller, either individually on their own behalf or as a representative of a corporate entity in title. This signature is verified by the Notary Public present, the Title Closer, who will then date and complete the acknowledgment.

**TITLE CLOSER COMPENSATION**

As independent agents, title closers are not paid a salary by the title companies they represent. Title closers rely almost solely on what is commonly known within the industry as ‘pick-up fees’ from the Seller’s side and ‘attendance fees’ from the Purchaser. A pick-up fee, is a fee actually charged and included in the title bill on the Seller’s side. The fee charged is considered compensation for properly preparing the payoff package for overnight delivery to the Lender. Let’s say the pickup fee is $225.00 per payoff. If a Seller currently holds two open mortgages of record that must be paid at closing, the title closer will add $450.00 to the final title bill for two pick-up fees. From that fee collected, the closer will expense gasoline, travel time to and from the closing, time spent notarizing and overnight mail delivery fees such as Fed-X or UPS.

On the Purchaser’s side of the transaction, there are no fees ‘charged’ to the Party. Instead it is the customary practice to compensate a title closer with a ‘gratuity’ or a tip at the closing representing an attendance fee. The title company is actually present at the closing on behalf of the Purchaser to insure that the Purchaser receives the property free and clear of any title defects. The actual amount of the attendance fee varies and is determined by the Purchaser’s attorney at the time the final checklist is created at the termination of the closing. It can be anywhere from $50 to $200. While the pick-up fees are an expense reflected as a fee on the title bill, the attendance fee, as gratuity, is not a title bill item.
ISSUANCE OF THE ALTA POLICY – (AMERICAN LAND TITLE ASSOCIATION)

After all the administrative duties of the title closer have been performed, and it is certain that the file will close successfully, the title closer gives the Bank Attorney the original Loan Policy, one for each insured mortgage, to take with him as part of his closing package. The Loan Policy must be forwarded to the Lender to be held until the loan is repaid in full sometime in the future. This policy will be in full force and effect during the entire life of the loan and will not be extinguished until the loan is refinanced, creating a new loan for the same Borrower or the property is sold and the loan is repaid in full.

As a final act to insure accuracy, the title closer must double-check the Loan Policy to be certain that all documents agree.

On average, barring any unforeseen circumstances or delays, the closing for a residential property takes between 2 and 3 hours.

POST CLOSING

Once the closing file has been returned to the title company, it will be matched with the company’s working file. The file will be broken down into what needs to be paid, what needs to be recorded, what needs to remain in the file at the title company, what needs to be sent to the underwriter (copy of policies). The checks will be deposited into the companies operating account and a portion designated for the escrow account. The escrow agent will review any escrow agreements in the file and it will be his responsibility to generate any payments to be made on behalf of the Seller or Purchaser.

Once these tasks have been completed, the file will be closed and placed in storage where it can be easily retrieved should the need arise because of a title claim in the future or, more commonly, for future clearance issues should the need arise.

This closing is now complete.
CHAPTER 18 REAL ESTATE MATHEMATICS

KEY TERMS

Acre  Perimeter
Commission  Points
Front foot  Principal
Gross income/net income  Square foot
Interest

The following must be learned by the student in order to successfully understand the methodology of the math to be discussed.

Please memorize these prior to the teaching of the math chapter

PERCENT X WHOLE = PART

WHOLE = PART DIVIDED BY PERCENT

PERCENT = PART DIVIDED BY WHOLE

INCOME = RATE X VALUE

CAPITALIZATION - INCOME DIVIDED BY RATE = PRICE

WIDTH X DEPTH = AREA

ONE ACRE = 43,560 SQUARE FEET

MILL = ONE TENTH OF ONE PERCENT, A TAX RATE OF 52 MILLS WOULD BE: $.052 TAX FOR EACH DOLLAR OF ASSESSED VALUATION OF PROPERTY

ONE SQUARE YARD = 9 SQUARE FEET

FRONT FOOT = WIDTH

TRANSFER TAX = $4.00 PER $1,000 OF PURCHASE PRICE ON RESIDENTIAL PROPERTY IN NEW YORK STATE

ADDITIONAL 1% OF SELLING PRICE IN NEW YORK CITY, UNDER $500,000 AND 1.425% OVER $500,000. This is an example and is not accurate in all locations.
QUESTIONS
MATH QUESTIONS
1. Mr. and Mrs. Seller list their home for sale with you. They tell you that they want to net $195,000 and will pay a commission of 7%. They also want to be certain that their closing costs of $1,000 are covered in their net. How much must their house be listed for in order for them to accomplish their goal:
   a. $208,650      b. $210,752.68      c. $210,000      d. $209,677.41

2. The selling price of a house is $175,000. The total commission rate is 6% of which the listing office receives 3.5% and the selling office 2.5%. Maria, the selling salesperson splits the commission with her broker on a 50/50 basis. How much will she earn?
   a. $5250.00      b. $3062.50      c. $2187.50      d. none of the above

3. Your credit card interest rate is 11% per year. If your interest this month is $67.00, how much do you owe on this card?
   a. $888.44      b. $737.00      c. $609.09      d. $7309.09

4. A home was purchased in 1982 for $125,000. It was sold recently for $190,000. What is the rate of return on profit on this house?
   a. 52%      b. 65.78%      c. 19.23%      d. 23%

5. Mr. and Mrs. Purchaser have a combined annual income of $72,000 and long term debt of $600.00 per month. They need to know how much PITI they will qualify for with a 28/36% ratio. What amount will you tell them?
   a. $2160.00      b. $1680.00      c. $1560.00      d. $1900.00

6. If they reduced their monthly LTD to the allowable percentage, how much would they then be able to allocate to PITI?
   a. $2160.00      b. $1680.00      c. $1560.00      d. $1900.00

7. An investor bought an apartment house for $435,000. He paid his broker a commission of $25,000. What percentage of commission did he pay when rounded to the next .05%.
   a. 5.5      b. 5.75      c. 6.      d. 6.5

8. A borrower will have to pay $5000 in points in order to get a loan in the amount of $125,000. How many points will he be paying?
   a. 4      b. 4.5      c. 5      d. 5.5

9. Another loan in the amount of $200,000 will have a point charge of $6,000. How many points will this be?
   a. 2.5      b. 3      c. 3.5      d. 4

10. A house sells for $250,000. The buyer is getting mortgage financing of $175,000 and the lender is charging 3.5 points. How much will he have to pay for the points at closing?
    a. $8750      b. $8500      c. $7175      d. $6125

11. A house has 3 bedrooms. Bedroom #1 is 15 ft. x 12 ft. Bedroom #2 is 12 ft x 10 ft. and Bedroom #3 is 10 ft. x 8 ft. What is the total square footage of the 3 rooms?
    a. 180      b. 120      c. 80      d. 380
12. If the owner of this house wants to buy carpeting, how many square yards will be needed?
   a. 43    b. 37    c. 28    d. 21

13. A lot has a depth of 100 feet and a width of 60 feet. What is the perimeter?
   a. 200 feet    b. 160 feet    c. 320 feet    d. none of the above

14. How many square feet are in this same lot?
   a. 600 sq.feet    b. 1000 sq feet    c. 5000 sq. feet    d. 6000 sq feet

15. This property will sell for $125.00 per front foot. What is the selling price?
   a. $1250    b. $12,500    c. $750,000    d. $7,500

16. A house is sold for $190,000. It is appraised for $185,000. If the bank is willing to lend an 80% LTV, how much of a downpayment will the buyer be required to make?
   a. $38,000    b. $42,000    c. $37,000    d. $40,000

17. Real estate taxes have been prepaid for the entire year in the amount of $2400. The closing takes place on Sept. 15. How much will be credited to the seller as a proration?
   a. $700.00    b. $600.00    c. $800.00    d. $1650.00

18. A home has a market value of $225,000. It is assessed for tax purposes at 80% of its’ value. If the tax rate is $1.50 per hundred, how much are the monthly taxes?
   a. $2700    b. $270.00    c. $2250.00    d. $225.00

19. An apartment house is for sale. The rental income on each of the 25 units is $750.00 per month. The operating expenses on the building are $1000.00 per week. If an investor wants a 25% return on his investment, what is the maximum he would be willing to spend?
   a. $43,250    b. $56,250    c. $692,000    d. $852,000

20. A house in Queens sells for $200,000. How much is the transfer tax?
   a. $1600    b. $2000    c. $2500    d. $2800
ANSWERS TO MATH QUESTIONS

1. b. $210,752.68
   $195000 + 1000 = $196,000, $196,000 divide sign 93%

2. c. $2187.50
   $175,000 x 2.5% = $4375 x 50% = 2187.50

3. $7309.09
   $67 x 12 months = $804, annual interest divide by 11%

4. 52%
   $190,000 - $125,000 = $65,000 profit. $65,000 divided sign $125,000, % key = 52%

5. $1560.00
   $72,000 divided by 12 months = $6000.00 per month x 36% = $2160 monthly, PITI and LTD
   $6000 x 28% = $1680 PITI
   $6000 x 8% = $480 LTD
   $6000 - $480 = $120. $1680 - $120 = $1560

6. $1680. Same as above

7. 5.75%
   $25,000 divide sign, $435,000, then percent key, answer, 5.7471, round to 5.75

8. 4 points
   $5000 divide sign $125,000, then percent key

9. 3 points
   $6000 divide sign $200,000 then percent key

10. $6125
    $175,000 x 3.5%

11. 380 square feet
    15x12 = 180, 12x10 = 120, 10x8 = 80. 180 + 120 + 80 = 380

12. 43 square yards
    380 divided by 9 = 42.2222, which would require 43 square yards

13. 320 feet
    100x2 = 200, 60x2 = 120 feet, 200 + 120 = 320 feet

14. 6000 square feet
    100 x 60 = 6000

15. $7,500
    60 feet x $125.00 = $7,500

16. $42,000
    $185,000 x 80% = $148,000, maximum loan. $190,000 - $148,000 = $42,000

230
17. $700
$2400 per year = $200 per month x 3.5 months = $700 Full months of Oct., Nov., Dec. 1/2 month for Sept.
18. $225.00
$225,000 x 80% = $180,000 assessed valuation. $180,000 x $1.50 per hundred
$1800 x $1.50 = $2700 per year divided by 12 months = $225.00 per month
19. $692,000
$750 per month x 25 units = $18,750 per month x 12 months = $225,000 gross income
$225,000 - $52,000 expenses = $173,000 net income. $173,000 divide sign 25 percent key =
20. $2800
$200,000 = 200 one thousands x $4.00 per thousand = $800.00, New York State transfer tax
$200,000 x 1% = $2000.00. $2000 + $800 = $2800
**CHAPTER 19 LAND USE REGULATIONS**

**KEY TERMS**
- Abutting
- Accessory apartment uses
- Accessory uses
- Air rights
- Building code
- Building permit
- Census tract
- Co/certificate of occupancy
- Condemnation
- Cul-de-sac
- Deed restriction
- Demography
- Doctrine of laches
- Easement
- Eminent domain
- Escheat
- Family, defined
- Group home
- Home occupations
- Zoning ordinance
- Infrastructure
- Lead agency
- Master plan
- Moratorium
- New York State Office of Parks, Recreation and Historic Preservation
- Non-conforming use
- Police power
- Restrictive covenant
- Right-of-way
- Setbacks
- Spot zoning
- Subdivision regulations
- Survey
- Topography
- Transfer of development rights
- Variance/area variance/use variance
- Zoning ordinances

**INTRODUCTION:** Without question, landowners possess a great many rights to his/her land. There are however, it is important to note that these rights are not in any way absolute. Some of the reasons are:

- Restrictions / controls can be placed on the land
- Zoning ordinances
- Deed restrictions
- Covenants
- Variances

**COMMON DEED RESTRICTIONS**
- For residential use only
- No parking of boats or RVs in the driveway
- Specifics of architectural design
- Cannot be used as an accessory apartment
- Outside color of property
- Property size
- Number of units allowed

For example, picture a buyer and his family who find their dream house in the suburbs. They just know that when they put a swimming pool and a deck in the backyard, it will be perfect for them. However, they learn that there is a restriction in the form of an easement (discussed in depth later) over the land that they were planning to use for the pool and deck. This would certainly result in the end of a possible sale.

Therefore, it is our responsibility as a real estate licensee to be alert and knowledgeable about different land use regulations. It is not uncommon for regulations to change over time and we need to be confident that what we present to the public is correct at the time. Also, keep in mind that many regulations applicable in today’s real estate market were of little significance in the past, and that is why getting the proper real estate education is obviously quite an effective way to keep up with these changes.
PRIVATE LAND USE CONTROLS
The controls on land use have actually been part of different cultures all around the world since the days of the Greek and Roman Empires. However, in the United States, this was not significant until the 20th century, when Americans shifted from rural to urban communities. The different levels of government, local, state and federal, regulate land use in varying ways. However, there are still many controls that come from private developers.

Perhaps a town was developed within the last fifty years and the zoning laws allow multi-family homes. Developers, however, included deed restrictions that the community is restricted to single family only. They did this to preserve the nature of the homes being built so that they will be owner occupied.

DEFEASIBLE FEE ESTATE
They occur when one party gives land to another, with specific stipulations.
**Example:** Chad conveys a parcel of land to Brian, subject to it being used for educational purposes. The effect of the defeasible fee is that it restricts the use of the land by Brian. In the future, Brian wants to use the property for another type of business venture. Because there is a restriction for educational purposes, if Brad did change his use of the property, it would automatically go back to Chad.

**Example:** A parcel of land is transferred for the specific purpose of farming. After a period of time, the possessor of the property wants to increase his income by allowing hunters to use his property after paying him a fee for the privilege. Even though hunting is legally permissible, the restriction is for farming only. If hunting were permitted, the previous owner could institute legal action to have his property returned to him.

In today’s world, many communities have refused to honor defeasible fee estates because they do not allow for “unforeseen circumstances” and can be unduly restrictive.

Remember, the restrictions in the deed “run with the land”. That is, they pass from one owner to another unless specific legal action takes place to remove it.

EASEMENTS
An easement allows the use of the subject property by another for a specific purpose.
**Example,** a private landowner allows a telephone company to run lines across the property. Alternatively, they permit a neighbor to cross over their land in order for a child to get to school without walking on highly trafficked roads.

REQUIREMENTS TO CREATE EASEMENTS
- Should be in writing
- By deed conveyance
- By court order
- By prescription (open, notorious, and hostile use over a specified period of time) This is sometimes referred to as squatters rights.

EXAMPLES OF DIFFERENT TYPES OF EASEMENTS
- Aviation easement
- Railroad easement
- Utility easement
- Solar easement
- Driveway easement
- View easement (restricts or protects the view from the property)

Easements can significantly impact the value of property. An easement for a highway to be built in the future would certainly deter developers from building homes nearby.
EQUITABLE SERVITUDES
They are created in the form of a covenant (agreement) between two parties, where one declares and assures the other that they will or will not do something. For instance, Mike owns a parcel of land near the coast of a town on Long Island. He decides to subdivide that piece of land into six different lots, Lots A – F. He goes to the town and records a declaration of restrictions so that the lots could only be used for the construction of residential single-family homes. Now Mike can sell the six different lots to six individual purchasers, and each lot would hold a declaration of restrictions governed by the town. Equitable servitudes must be created in writing and they “run with the land”. The restriction will be enforceable by future owners or burdened by it, as the case may be.

EQUITABLE DEFENSES
Equitable servitude will not be enforced when:
- An individual looking for enforcement is violating a similar restriction on his/her own land
- Holder of the central estate acted in such a way that would lead another individual to believe that the covenant was abandoned
- Owner of the central estate fails to bring a lawsuit against the violator within a reasonable period of time
- The quality of the neighborhood changed sufficiently through growth and development, zoning modifications, or through non-enforcement of the equitable servitude

RESTRICTIVE COVENANTS
These occur when a seller or landlord impose legal obligations in the form of restrictions in a deed or lease which will affect owners or tenants both current and future. They are generally used to prohibit misuse of the land by the future landowners. Deed restrictions, or restrictive covenants as they are commonly referred to, limit allowable uses and development of a specific property. In many cases, however, state laws limit enforceability of deed restrictions to a particular time frame. Remember, the word “deed” is associated with ownership.

Examples of restrictive covenants:
Setbacks: requirements for the distance between houses or from the road or street
Fees: usually included when some of the property is owned in common with others
Leasing vs. owning: communities may restrict the owners ability to have tenants. Instead, they may require the property to be “owner occupied”.
Use of the land: specifying what can and cannot be done with the property.
- No horses
- Single family only
- No alcoholic beverages can be consumed
- No farming, etc.
- No fencing

Restrictive covenants can usually be formed by a legal agreement between two individuals / parties. However, in order to make a restrictive covenant enforceable by law, it must be recorded. One important note is that once a restrictive covenant is recorded, all future purchasers must hold title subject to the restriction, even if it is not said in the actual deed. Once again, it runs with the land unless there is a specific time period included for the restriction. It is important for all buyers to review restrictive covenants before deciding to go ahead with the purchase.

COMMERCIAL VS. RESIDENTIAL COVENANTS
Commercial properties often have restrictive covenants. It may be in the type of business allowed in the neighborhood, or parking requirements.

Perhaps the deed has a restriction that it can only be used for a medical office building. In some areas it is easier to get a building permit for a medical building than it might be for general use so developers put this in the deed. Over time, however, there aren’t enough medical type tenants to fill the building and the owner has a major problem. He might be willing to accept non-medical tenants in order to fill his building. The agent must be aware of this type of situation and stay far away from it. What would
happen if you found an accounting firm who wanted to be in this neighborhood and they leased the property through you. After a while, they have to move because it is discovered that they are in violation of the deed. No doubt, lawsuits will appear immediately and you will be a defendant. Do not risk it.

**DEED RESTRICTION ENFORCEMENT**

Restrictive covenants may be enforced by owners taking action in a court of law. Fully enforcing deed restrictions may be very challenging because they are only enforceable by the previous owner or a third party to the original transaction.

Also, when restrictive covenants are not enforced in a timely manor, the courts may not be able to restrict the violators and the covenant would become void. If a restrictive covenant becomes void as a result of inaction, it is referred to as the **Doctrine of Laches**. Doctrine of Laches states that the individual invoking laches is asserting that another individual has “slept on its rights.” He has not exercised his legal rights in a timely fashion and may be denied his claim. In other words, this is the case where if you snooze, you lose!

It is interesting to know that in New York, land owners only have two years to claim their rights. This begins on the date the violation of the deed restriction took place.

**SUBDIVISIONS**

These allow property owners to maintain the value and stability of their homes in the subdivision. These would include:
- Sewage waste disposal
- Water systems / Irrigation / Drainage
- Roads and streets
- Other public interests

Typically, subdivision regulations are required to protect communities. They also make certain that the homes constructed provide a good living environment for future families. These regulations ensure adequate lot size, public access, and the availability of public services to each property. They also assist in preserving natural, scenic, landmark, and recreational spots.

**NUISANCE**

This is the interference of the rights of a specific person such as a land owner or tenant. It would be considered unreasonable or unnecessary and it interferes with their enjoyment of the property. Most cases of nuisance take place in residential areas.

For example, let us say in the town of Orange, Larry is throwing a big party in his house. The music is very loud and continues into the early morning hours. This would be a nuisance to his next door neighbor, Joe. Since Joe can’t enjoy the peace and quiet that he needs in order to fall asleep. If there is a town ordinance against noise then the local authorities could require the music to be turned down so that Joe isn’t disturbed. Many communities have noise ordinances, which are time sensitive. They apply during specific hours, often from 10 or 11 p.m. until 6 or 7 a.m.

Some other examples of a nuisance:
- Creating foul odors
- Smoking chimney
- A pile of rubbish
- Uncared for property
- Old cars stored on the driveway

**PUBLIC LAND USE CONTROLS**

Public land use controls allow the different government levels (state, local, etc.) to provide and protect the general public health, safety, and overall well being of all its inhabitants. This falls into the category of **“police power”**. It is the legal right of a governmental agency to create laws and the means
of implementing the obedience to those laws. Police power is protected in the constitution of each state. The Constitution of the United States grants some police power to the federal government, but for the most part, allows the state to create their own laws and means of implementing them.

**For example**, in your state, the government has the ability to create and enforce taxes on the public. If they want to raise money to prevent a reduction in services, they might institute a gasoline tax, which would increase the price of the gasoline.

**Another example** that directly applies to anyone taking this course; is that you are required to do so as a result of the police power in your state. The number of hours required to obtain a license, any continuing education requirements and the fees to obtain them are all a result of “police power”.

Some other examples of local police power:
- Right to control pollution
- Subsidized rent control
- Use of public parks
- Building permits
- Zoning

Everything from traffic law to vice law to land use regulations are considered police power and it differs from state to state, city to city and town to town. Elected officials can write enforceable laws in any area as long as it does not interfere with the constitutional rights of the citizens. According to the 10th amendment to the Constitution, local governments can adopt any rights that are not given to the Federal government.

**TAXATION AND LAND USE**
Property tax on real estate is typically imposed by the local government, at the municipal or county level. Real estate property taxes are considered local. The proceeds generated from these taxes are used to support and finance public entities such as schools, parks, roads, the local government and many other public establishments. All land owners bear the burden of ad valorem taxation (fair market property value) due to the fact that land value must be assessed on an annual basis. *Ad valorem* refers to the Latin phrase meaning ‘according to value.’

Personal property tax is another form of tax. These are the taxes assessed for items that belong to an individual and are not attached to the land. The tax rate varies from state to state. You will probably be more familiar with this type of tax when we use the more common term, sales tax.

Examples of items that would be subject to sales tax
- Trucks
- Boats
- Mobile homes
- Leased and recreational vehicles
- Motorcycles
- Utility trailers
- Aircraft
- Stocks and bonds
- Artwork / jewelry
- Any other items the taxing authorities wish to include such as food, or clothing.

**TAX ADVANTAGES OF LAND CONSERVATION**
The intent of land conservation is to protect the land and in some cases, prevent building. Conservation easements exist where a property owner adds a restriction such as not allowing future development. Often this is done because of the impact on taxation. It can be very beneficial to the owner. The tax benefit comes in two forms. It may be a federal tax deduction or an estate tax exclusion.
In terms of the income tax deductions benefit, the Internal Revenue Service allows the easements to act as a charitable gift, meaning that the donation would have to be in the form of an everlasting conservation easement. In addition, the donation has to be made for exclusive conservation purposes.

Conservation purposes for income tax deduction may include:

- Protect natural habitats for fish, plants, ecosystem
- Preserve landmarks and other historic structures
- Preserve open space such as farmlands
- Preserve outdoor recreational areas such as camp sites

The estate tax exclusion would act in a similar manner. The intent is to provide relief from estate taxes for farmers and ranchers passing a parcel of land to their heirs. If not for this exclusion they might be forced to sell the land to pay the estate taxes. Many states have created agencies that deal solely with land preservation and conservation.

**NY OFFICE OF PARKS, RECREATION AND HISTORIC PRESERVATION**

The primary purpose of the New York Office of Parks, Recreation, and Historic Preservation commonly referred to as OPRHP, is to govern public recreation areas and manage federal and state preservation developments.

The State of New York operates many different venues, these include:

- Miles of trails
- Nature centers
- Campsites
- Log cabins
- Full service cottages
- Golf courses
- Water recreational facilities
- Beaches
- State landmark sites
- State parks

**NEW YORK STATE REAL PROPERTY LAW ARTICLE 9-A**

Article 9-A of the New York State Real Property Law refers to sub-dividers (i.e. individual, partners, corporation, company or association) filing for the sale or lease of subdivided vacant parcels of land to New York State inhabitants. This filing is done with the Department of State. This article also provides protection for New York State residents. It is based on an installment land contract. The subdivided lands can be located either within New York State or other states. In these types of contracts, the payments are made periodically based on an amortized (payment) schedule. However, the buyer does not get title to the property until he has reached the point of contributing an agreed upon amount to the principal. Finally, all installment land contracts for the sale or lease of subdivided land must offer a right to cancel the contract within seven days following the signing.

**ESCHEAT**

The laws of escheat refer to property which is forfeited or transferred back to the government (state) because the owner has died with no surviving relatives and no will, referred to as intestate.

The theory of escheat goes back to feudal times in England in order to preserve the wealth of a family by designating that only one heir could inherit. This was done to prevent the ownership going to several different people who might want to break up the estate. The king established the determination of who will inherit and if there were no heirs, the king would become the owner of the estate. It is a common law doctrine, which refers to the decision of the courts.

Sometimes escheat is confused with forfeiture. However, they are quite different. Forfeiture is often regarded as a penalty, perhaps for an illegal act. The party relinquishes his right to the property without compensation. Escheat occurs when there are no legal heirs or a will.
PROPERTY SUBJECT TO ESHEAT
When the theory of escheat originated, it applied, for the most part, to real property. Over time, it has evolved into including personal property as well. This would include bank accounts, jewelry, shares of stock or mutual funds and any other property of value. Before the property reverts back to the government, there is a long procedure that will be undertaken to ensure that there are no legal heirs to the property. If there are heirs, but no will, the property will be distributed according to the laws of escheat in that municipality. The statues regarding estate vary from one state to another.

THE EFFECTS OF ESHEAT
Example: Bob Jones has passed away. Regrettably, he did not leave a will. He also is not survived by a wife, parents, grandparents, children, siblings or any other close relatives. The result, his massive estate with his lovely mansion will go to the state (government).
Another example: escheat can take place when an entity like a bank or holding company holds money or property and it goes unclaimed or abandoned. In many cases, it would revert to the government after a specific period of time. Plus, in the world of corporate America, surprisingly, quite often, unclaimed payroll checks, stocks, and dividends from untraceable owners would go to the state authority. All the major corporations have to file unclaimed property report usually on a yearly basis with the state.

UNCLAIMED PROPERTY
Any property that is abandoned by the rightful owner and is held for a specified time. Time limits may vary depending the type of property. There is generally a long list of property governed by any of the states’ escheat laws and regulations including:
✓ Court deposits
✓ Forgotten paychecks
✓ Forgotten insurance policies
✓ Money orders
✓ Overpayments to creditors
✓ Neglected safe deposit boxes
✓ Travelers checks
✓ Dormant bank accounts
✓ Gift cards / certificates

STATE ENVIRONMENTAL QUALITY REVIEW ACT (SEQRA)
The State Environmental Quality Review Act was created by the New York State Department of Environmental Conservation. It was created in order to avoid or limit possible negative impact on the environment. This might be the result sub-dividing land, housing developments, and roadways, filling wetlands or adopting any land use plans. When a land use plan is being implemented, SEQRA gives consideration to the impact on the environment, human and community resources and economic impact of the proposal. It was put in place in order to determine the environmental influence of any ‘action’ taken. An ‘action’ can refer to any project, plan or policy that would result in the making, changing, or new usage of any structure.

ACTIONS
Type I Actions, are the actions that are more probable to have a major negative impact on the environment and sometimes need to be accompanied by an Environmental Impact Statement (defined later). For example, a commercial development project restructuring 10 or more acres of land and zoning changes affecting 25 or more acres of land.

Type II Actions, are actions realized to either not have a considerable impact on the environment or to be exempt from environmental review for other reasons. Also, State Environmental Quality Review is not needed. For example, the reconstruction of a facility would be a Type II Action.
**Unlisted Actions** are actions, which do not quite conform to the Type I Action level but still need to be checked by the agency to decide if they may cause a major adverse environmental impact.

Examples of ‘action’ taken by agencies that need SEQRA review
- Road work for expansion of streets and highways
- Cutting and salvation of trees
- Residential development projects
- Development in the usage of wetlands
- Forming districts
- Public health regulations
- Toxic waste dumping
- Groundwater and surface water control
- Traffic control and pedestrian safety

**ARTICLE 78 PROCEEDING**
An Article 78 Proceeding refers to a section of the Civil Practice Law and Rules that permits distressed parties to take an action against a government entity or officer. This mechanism allows the courts to review the state and local body proceedings. The petitioner is the party taking a proceeding to battle against an “unfair” administrative result. The respondent is simply the opposing party.

**Example:** The license of a real estate salesperson expires in June. The salesperson is on an extended visit to their native country and doesn’t renew the license in time. The Department of State changes the rules governing license renewals during the agent’s absence. The agent could begin an Article 78 proceeding to determine whether or not the rule change was done in a fair manner.

The process of an Article 78 proceeding
It is a New York procedure filed in the State Supreme Court in your county when challenging a decision made by a governmental agency. Although a lawyer is not required, it can be difficult to navigate the filing of necessary papers. The proceeding must be filed within four months of the date of the hearing decision.

These cases are extremely difficult to win unless the agency against which you are petitioning did not follow its own rules and it can be proven. Other possibilities include finding that the decision was “arbitrary and capricious”: the decision was not based on the facts presented. Also, was there “substantial evidence”. This is usually defined as logical, relevant and reasonable evidence that a person would accept to support a decision.

**ENVIRONMENT**
When we are involved in land use regulations, we must be aware of the impact that it could have on the environment. Concerns exist regarding:
- Population trends and density
- Community growth and spirit
- Physical conditions such as air, water, land, minerals, noise

Whether or not the public favors the proposed use of the land, the SEQRA still mandates a state agency to follow through a number of steps in order to achieve an accurate assessment. These steps are set forth in an Environmental Assessment Form.

**INFRASTRUCTURE**
The New York State Department of Transportation was formed in 1967 in order to deal with the state's intricate transportation system. Eventually, other public governing agencies such as the Department of Public Works were consolidated into it. The New York State Department of Transportation is in charge of the construction, upkeep, and operations of major infrastructure within the state of New York.
Included in the infrastructure are:
- All waterways throughout the state
- Major public and private ports that transport more than 110 million tons of freight yearly.
- Public and private flight centers where more than 31 million people fly each year
- Railroads make up of a network of 5,000 miles holding over 42 million tons of equipment, raw materials, manufactured goods and produce every year
- Local and state highways covering over 110,000 miles of highway and 17,000 bridges
- Public mass transit systems serving over 5 million passengers every day
- Drinking water
- Sewers
- Energy
- Telecommunications

**EMINENT DOMAIN**
It has its origins all the way across the Atlantic Ocean to Europe. In the early 16th century during the days of feudalism, the British Parliament took private parcels of land for the new construction of roads and bridges. Having done so, it was determined that necessary compensation must be paid to the landowners. Later, this notion of eminent domain shifted to the American colonies. At first, barren parcels of land were taken without compensation because land was plentiful and cheap. However, as more and more settlers came to the American colonies, this was quickly changed.

It was President James Madison who created the need for the Fifth Amendment to the Constitution of the United States. It stated that the government had the power to use eminent domain and that the property owner in return would be fairly paid for giving up the land for the better interest of the public.

**Example:** the borough of Queens has an interest in building a new highway in order to reduce traffic going towards a bridge. Obviously, this is in the best interest of the public since people will be able to get to their destination much faster. Nonetheless, the new highway has to be built alongside the water so that it can connect to the bridge. Unfortunately, there are many residential homes along the water that would have to be demolished. The governing body must offer the owners of those homes a just compensation at fair market value so that they can move to a new location and the new highway could then be constructed.

**FUNDAMENTALS OF EMINENT DOMAIN**
It has to be private property. Private property may be anything such as equipment, agreements / leases, options, stocks and bonds
**It has to be ‘taken’**. The actual taking is either a part or a whole of some physical property such as land.
**It has to offer public usage**. The property taken must be used to benefit the public rather than specific individuals. Note that the courts have the right to make the distinction that something is for public use.
**There has to be just compensation**. This is a part of the civil liberties that are written within the Constitution of the United States.

The right of eminent domain is not strictly limited to real estate. Private personal property can also be acquired by governmental agencies. An example would include seizing supplies for the military during times of war. The process of eminent domain varies from state to state, but the results are essentially the same. You may also see the word “appropriation” substituted for eminent domain. It is always executed without the consent of the owner.

**CONDEMNATION**
In order to have eminent domain, you must have condemnation. It is the legislative process where the use of eminent domain may transfer title of real property from a private owner to the government.
THE INTERSTATE LAND SALES FULL DISCLOSURE ACT

Good for the buyer and bad for the developer

The Interstate Land Sales Full Disclosure Act was established by Congress in 1968. It was actually derived from the Securities Law of 1933 during the times of the Great Depression. The primary purpose of the Interstate Land Sales Full Disclosure Act is to protect out of state consumers / buyers from fraud and abuse in the sale or lease of parcels of land. The Act was administered through the Department of Housing and Urban Development, in order to try to avert developer created promotional schemes that would lure buyers to buy land from a site never even seen.

REQUIRED PROPERTY REPORT
Developers involved in subdivisions of 25 or more non-exempt land lots must register with HUD and give each buyer a disclosure statement called the Property Report. The Property Report serves as a narrative disclosure that consists of pertinent detailed information regarding a particular subdivision. It must be given to the buyer a minimum of three days in advance of the contract of sale being signed. The buyer has two years to cancel the sale if he / she does not get the Property Report.

UNITED STATES ARMY CORPS OF ENGINEERS
The United States Army Corps of Engineers has an interesting history. They go back to the 1800’s during the pre and post revolutionary war. President Thomas Jefferson established the United States Army Corps of Engineers to assist with the defense and development of the country. Today, they serve as a national agency and a major Army command. Its headquarters are located in Washington D.C. It is roughly comprised of over 35,000 civilians and about 650 military personnel. It is also the world's largest public engineering, design, and construction management agency. Additionally, it provides support for the Department of Defense, Department of Homeland Security and Federal Emergency Management Agency. The primary focus is to provide military and public works services. Public works services refer to the engineering and construction development projects executed by the state (government) while representing the public community.

Some of their responsibilities:
✓ Planning, designing, constructing and operating water related sites such as flood control, dams, coastal defense of beach erosion, waterway navigation
✓ Designing and administering the building of flood protection systems
✓ Designing and controlling military facilities for the Army, Air Force, and other Federal agencies
✓ Environmental regulation
✓ Ecosystem restoration such as plants, animals, and micro organisms

US DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD)
The United State Department of Housing and Urban Development is commonly known as HUD. HUD is a department of federal government. It was established in 1965 by President Lyndon Johnson in order to expand and develop housing related projects in cities. HUD is governed by the United States Secretary of Housing and Urban Development and serves to provide depressed urban neighborhoods with economic incentives and stimulus.

ZONING ORDINANCES
Zoning ordinances refer to the local governing authorities that determine the type of use of a particular property within a certain area. It serves as one of the oldest legal binding regulatory documents for implementing land use policy and managing development. Zoning is usually a state responsibility. However, it is frequently delegated to local zoning authorities within the community.

In many areas, land use zones are combined with development and planning proposals to ensure that a satisfactory outcome is the result of new development. Zoning can be used to prevent new
development from interfering with current residents or businesses and to preserve the well being and character of the community.

**Zoning maps** play a significant role as they give the zoning classification for each property. The maps have to be created for easy understanding by board members and the public.

**Zoning text** is the narrative information written in order to spell out the terms and conditions of zoning requirements. At best, zoning and land use may be very complicated issues. These ordinances can control and cover anything from counties, cities, towns, villages, municipalities, land subdivisions, and even local streets. Ultimately, zoning protects the public through many regulatory measures.

**ZONING CLASSIFICATIONS**

- Residential
- Commercial
- Industrial
- Institutional
- Agricultural
- Public open space
- Vacant land
- Parkland / Recreational

**RESIDENTIAL ZONING**

An area where the predominant land use is allocated to housing. Residential zones are, of course, the most common zoning districts. High and low density requirements are included.

Examples of residential zoned housing:

- Apartments
- Duplexes
- Townhouses
- Condos
- Modular homes
- Cluster zoning

Different sub-zones under residential zoning

- Inner city residential
- Inner mixed
- New development
- Rural residential

In addition to typical residential occupancy of a property, there may be other uses. One of the most common is accessory use. For example, a home occupation can be considered an accessory use. This means that the owner, while occupying the residence, conducts his business from his home.

Some things that are not usually permitted for accessory use units:

- Advertisements, signs, or displays on the property
- Employing people to work in the residence in order to conduct the owners business
- Hold any activities related to the home occupation on the porch, deck, backyard, patio, or garage
- Make loud noises that may disturb the public
- Invite customers and sell products on the premises
- Create parking congestion that interferes with neighbor’s ability to park their own cars

Another example of an accessory use would be an accessory apartment. These are self-contained secondary units that are attached to the primary residence. Accessory apartments are usually smaller than the main residence and are sometimes simply renovated basements. These are usually illegal because in many areas basement apartments are not considered living space. They may also be referred to as mother/daughter apartments.
Some locations of possible legal accessory apartments:
- Cottages
- Guesthouses
- Converted garage
- Barn

Some advantages and benefits of legal accessory apartments
- Offers economical and efficient use of current housing
- Preserves the character of the community
- Saves tax dollars
- Allows the elderly to live independently

GROUP HOMES
Group homes are small, facilities located within a residential zoned community that are structured to serve at least three people (children and adults) who are unrelated to each other. Group homes cater to specific categories of disabilities in order to preserve a family environment for them.

Examples of group homes
- Foster homes
- Rehab centers
- Halfway houses

Even today, there is a lot of debate over whether group homes should be permitted in residential zones. Many homeowners feel that these needed facilities change the character of their neighborhood. They will often use the term “family” as a defense against unrelated people occupying a home. To many, the definition of family may not be black and white but instead is usually some shade of gray.

COMMERCIAL ZONING

GENERAL CLASSIFICATIONS OF COMMERCIAL ZONING:

Neighborhood Commercial: offers basic convenience goods and services within proximity to nearby residents.

Examples of Neighborhood Commercial
- Delis
- Grocery stores
- Barber shops
- Hair dressers
- Laundromats
- Day care centers
- Bakeries

Mixed Commercial: offers retail and personal services locations fulfilling daily needs of local residents and pedestrians. Buildings are typically built close together. There will usually be off street parking.

Examples of Mixed Commercial
- Medical clinics and dental offices
- Banks
- Post office
- Service stations

Professional Commercial: office settings for professionals

Examples of Professional Commercial
- Business and professional offices
- College or university
- Art galleries
- Churches
- Funeral homes
Florists
Pharmacies

**General Commercial**: considered a central retail marketing location for the town. It gives consumers / shoppers a variety of shops and boutiques.

**Examples of General Commercial**
- Department stores
- Movie theaters
- Cocktail lounges
- Jewelry stores
- Nightclubs

There may be regulations concerning the proximity of specific types of businesses to others. For example, there could be zoning regulations that restrict adult entertainment stores to a certain geographical area or at least a certain distance from existing schools or churches.

**INDUSTRIAL ZONING**
In most cases, the facilities are in use to make products or store goods. Environmental considerations may decide the industrial level a specific business may fall into. One example of this would be the level of noise. Industrial zoning also depends on the amount of lot coverage and building height.

**Examples of Industrial Zoning**
- Warehouses
- Nuclear power plants
- Factories

**INSTITUTIONAL ZONING**
Zoning which permits use for the greater good of the community. Generally, institutional zoning is broken up into three different categories.

**Neighborhood Institutional**: permits local uses that have minor impact on the adjacent residents.

**Examples**
- Churches and temples
- Elementary schools
- Senior care centers

**Community Institutional**: allows larger uses that would have moderate impact on nearby residents.

**Examples**
- High schools
- Emergency shelters

**Major Institutional**: the general population could benefit from this usage.

**Examples**
- Hospitals
- Technical colleges and universities
- Correctional facilities

**AGRICULTURAL ZONING**
Protects parcels of land that are in use for farming. Agricultural zoning ordinances may prevent farmland from conversion to nonfarm uses.

**PUBLIC OPEN SPACE ZONING**
Land that deliberately remains undeveloped. This is land, both public and private, that will remain natural and open.

**PARKLAND ZONING**:
These areas are set aside for leisure activities and maintained for their visual, natural, and educational value for the general welfare and safety of the public.
In most instances, national and state governing bodies have the control over parklands, their use and zoning.

**Examples of Parkland Zoning**
- Picnic areas
- Campground sites
- RV sites
- Fishing amenities

**RECREATIONAL ZONING**
Areas zoned recreational may be owned by local municipalities as well as individual landowners. Recreational zoning includes a wide range of permitted uses that protect our natural resources.

**Examples of Recreational Zoning**
- Golf courses
- Horse riding trail ways
- Tennis clubs
- Swimming clubs
- Playgrounds

**ZONING CAN BE BROKEN DOWN INTO DIFFERENT CATEGORIES:**

**AS OF RIGHT ZONING**
These are uses automatically permitted by zoning regulations. The standards are determined before a development is planned. A builder can build under these rights without having to go through an approval process as long as he complies with all regulations in existence at the time he is beginning his project. The developer has to go through the process of obtaining the necessary building permit and certificate of occupancy.

This type of zoning gives a great deal of discretion to builders and developers and permits everyone to operate under the same set of rules. Problems sometimes occur with as of right zoning when community needs and values change, but zoning laws are stagnant. Among other rights, the developer and subsequent owner is granted a “bundle of legal rights” to his property.

Remember, as of right zoning means that the particular zoning activity does not need a permit; it is permitted under the law. For example: Zoning on Prospect Street allows for 2 families per home. However, many of the owners utilize the entire structure for only one family. If, at any time in the future they want to exercise their rights and convert the property to a two family home, they would not have to seek any sort of permit. Since zoning allows two family homes, they will always have the right to utilize the property as such.

**CLUSTER ZONING**
A design strategy allowing the developer / builder the right and ability to have lot sizes and housing options that are at a variance with zoning in the community. This would allow the developer to increase the density so long as he protects an agreed upon area as open space. It would be accomplished by building on “sub-standard” lot sizes for that community and designating the balance of the land for recreational use. The great expanse of open space is available for all residents and leads to a high quality of life. These open spaces are maintained through funds raised in the community and the residents have a say in what is being done with it.

Cluster zoning is used in order to develop a Planned Unit Development, which is often referred to as a PUD. It is a type of land development and a land use regulatory process all in one. A PUD commonly consists of a group or mixture of compatible land uses all contained within a single development or subdivision. Generally, the main intent for a planned unit development is to encourage more resourceful, imaginative, and effective design of land development projects following zoning regulations.
INCENTIVE ZONING
This classification gives a bonus or reward to encourage land development that otherwise might not be considered. An example of the use of incentive zoning would be offering a developer the opportunity to build a project that is not permitted by current zoning. In order to allow this, the developer might have to include a percentage of living units for low-income housing.

SPOT ZONING
Changing the zoning of one parcel of land to allow use that is contrary to existing zoning is referred to as spot zoning. It is a special privilege granted to one owner, which is not available for all owners. It is often done for the good of a community. Perhaps a community is in need of a school and the necessary zoning is non-existent. In that case, spot zoning allowing the school to be constructed would be in the best interest of the community and would probably be allowed. It is important to recognize that it is “spot specific”. That is, it relates to one property only. Spot zoning has been found to be illegal in many areas of the country because it often interferes with other owner’s property rights and privileges.

For instance, it could be illegal when a parcel of land is selected for industrial use in a residential zoned area. Even though the purpose is to keep businesses in the specific municipal district it could hurt residential land values. In some rural areas, spot zoning may also exist because they have no zoning plan in place.

Rezoning is quite different. Rezoning results in the change of zoning laws and affects everyone in the zone.

TRANSFER OF DEVELOPMENT RIGHTS (TDR)
This planning strategy allows private land owners to transfer the right to develop one parcel of land to another developer.

Putting it to work: an area is identified which the community would like to see protected and left undeveloped. This is referred to as the “sending zone”. Another area is identified which would benefit from development and is referred to as the “receiving zone”. If you are a property owner in the sending zone, you will receive a specific number of “development credits”. These can be sold to interested builders or speculators. In some instances, the community itself will buy the credits in order to discourage any new building.

If the development credits are sold, the property owner agrees to have a permanent conservation easement placed on their land. The purchaser of the development credits can then use them to build at a higher density than current zoning permits. These programs are quite complex. However, they do have the advantage of using the free market to attract funding in order to protect open space and farmland that might be developed in other ways. In order for TDR programs to be successful, the community must be willing to do comprehensive planning and to exert total control over the program.

To understand the value of the TDR program; let’s use farmland as an example. Perhaps it is worth $3,000 per acre in its present state. However, a developer is willing to pay $7,000 per acre so that he can build homes.

If there was a TDR program in existence, the farmer can sell his development credits for the difference between $3,000 and $7,000, or $4,000 per acre. This would be an incentive for the owner to keep his property in its’ present state without suffering financial setbacks. Once the transaction is complete, the development opportunity for his land is frozen. The developer would now apply these credits to building in the “receiving zone”. Remember, in a TDR program they are buying and selling rights not land.
OPEN MEETING LAW (SUNSHINE LAW)
The Open Meeting Law allows public access / transparency to the governmental decision making process. The result is that meetings held by government agencies and departments are fully open to the public.

Open Meeting Laws apply to:
- Local government
- State Commissions
- School Boards
- Nonprofit Organizations
- Hospital Boards
- Advisory Committees

PLANNING BOARD
The Planning Board is an organization / unit within a municipality that holds the powers and responsibilities to influence the process of development and change, safeguard the heritage through the preservation of natural landscapes and other valuable resources, and promote excellence in design and structure of the lands. Planning boards are covered in the chapter on Municipal Agencies.

ZONING BOARD OF APPEALS
The major responsibility of the Zoning Board of Appeals is to administratively evaluate and assess questions and appeals which come up under the provisions of the city's zoning laws. It does not make policies of any kind.

EXCEPTIONS TO ZONING LAWS
Zoning ordinances establish standards for the growth and development of property within zoning districts. Often zoning laws are open to interpretation. There are some limited exceptions to zoning laws, these include:
- Nonconforming use
- Variances
- Conditional uses

NON-CONFORMING USE
Refers to land use that legally existed prior to the effective date of the new zoning ordinance. Perhaps there is a deli and gas station in an area that has been rezoned. They are now considered to have nonconforming use because they legally existed prior to the district rezoning.

Non-conforming use is permitted under the following guidelines:
- The use may not be expanded or extended in any manner
- The use may not be changed, except to a use which conforms to the regulations of the district where the land is located
- If the use is discontinued for six months or more, it may not be re-established

VARIANCES
A deviation from the set of regulations a municipality applies to land use and the zoning code. It is an administrative exception to the zoning laws. There are two main variances; use variance and area variance.

USE VARIANCE: gives landowners the approval to use the land in a manner that is not allowed by the existing zoning code. Example: a factory, which should be built in an industrially zoned area, is allowed to be constructed in an area zoned for commercial use. This sort of variance is usually only allowed when the landowner has an unnecessary hardship under the existing zoning laws.

Conditions for evidence of unnecessary hardship
- Applicant cannot gain a reasonable return and can provide financial proof of this.
- The hardship relevant to the property is unique and not common to the district.
The granted use variance will not change the essential character of the neighborhood. 
✓ The hardship is not self-created.

Area variance: a request for a change of dimensions from those currently in the zoning code. This could occur when the proposed building or renovation will not meet zoning code criteria such as setbacks, height or area of the lot. Example: a family wants to have an addition built on the back of their house so a relative can move in. The architectural plans do not meet the setback requirements in their area. They would apply for a variance and unless there was something about their request that was detrimental to the health, safety or welfare of the community more than likely, it would be granted.

Conditions for granting of an area variance
✓ There will not be an undesirable change or harm to nearby properties
✓ Requested area variance is not substantial
✓ Proposed variance will not have an adverse effect or impact on the physical or environmental conditions within the district
✓ Difficulty was not self-created
✓ Applicant cannot obtain the benefit by some other methods

CONDITIONAL/SPECIAL USE PERMIT
Allows a city or county to consider special uses which may be essential or desirable to a particular community. It allows the community to have some flexibility regarding zoning. Neighbors who might be affected by the issuance of the permit are allowed to have a voice in the granting process. This could include allowing houses of worship or schools or public health facilities to be built in an area that does not have the necessary zoning code. Other examples might include parking facilities or utility structures to name just a few. 
Conditional use permits are also referred to as special use permits.

A special use permit allows exceptions to the zoning laws. There is usually acceptable criteria for granting the permit so that it does not change the essential character of the neighborhood.

Conditions for granting a special use permit
✓ The use is not detrimental to the public health, safety, and welfare
✓ Traffic conditions are not adversely effected
✓ The use is consistent with the city general plan
✓ The structure is compatible with surrounding structures in terms of use, mass, scale, and so forth.

FIRE PREVENTION
There is generally a uniform fire code which sets minimum acceptable standards in all buildings. These include specifications for material, safety and sanitation. In areas where the local code is stricter than state code, local code will override state. When there is no local code, the state code applies.

BUILDING DEPARTMENT
The building department is the branch of the municipal governments that enforces the building codes, zoning regulations, and inspects new and existing buildings. They govern code enforcement officers and inspectors in order to assure the public’s well being and safety.

BUILDING CODES; a set of standards that specify the minimum acceptable level of safety for construction of buildings and other structures. The main purpose for having building codes is to protect public health, safety and general well being with regard to the construction and occupancy of buildings and structures. The local municipalities establish building codes and hold the authority to issue permits.
For example, Joe wants to build an office building. He must submit his plans to the local building department for approval. If his plans comply with the building codes, then he would be allowed to start construction.

Local building inspectors periodically inspect the project during construction. When the construction is finished, a final inspection is done. If Joe’s building is up to code, he is awarded a certificate of occupancy. A certificate of occupancy is a legal document issued by a local government agency or building department certifying a building’s compliance with applicable building codes and other laws, and indicating it to be in a condition suitable for occupancy. A certificate of compliance would be issued for a renovated building. Without these documents, the property cannot be inhabited.

**DEPARTMENT OF HEALTH**

A governmental agency that concentrates on issues related to the general health of the citizens. Even though it is not associated with the Buildings Department, it may also scrutinize any possible building code violations that may negatively influence the health of the public community. For example, the Department of Health may inspect food sanitation of a restaurant.

Professional Service Providers

Professional service providers are essentially the hundreds and thousands of people that cater to the needs of enforcement for land use regulations, zoning and building code.
In this chapter, we will be learning about construction in residential housing. As we move through the sections we must be aware, there are towns, cities, villages, incorporated villages and counties that all have the right to make their own construction guidelines. They also create their own zoning regulations. It is recommended that everyone check with his or her local Planning Department or Building Department before starting any construction project.

Obviously the first task in building a home is choosing the building lot. They vary in size, location and topography. Considerations include:
- How much of a backyard will my home have
- How much frontage will my home have
- How close will my house be to my next-door neighbor
- What is the location of the house on my property
- Is it near a school
- Near a shopping center
- Is it in walking distance to recreation

When making this decision, the buyer needs to always keep in mind that the house can be made larger, but the lot-size will always remain the same. Sometimes it makes sense to buy a larger lot and construct a smaller home. Extensions and dormers can be added later.

What is the topography of the land?
The term topography means the “lay of the land”. What you see when you look at the vacant land is the topography. Is it hilly, sloping or flat, does it have trees or rolling hills. So much to consider!

If the buyer wanted a swimming pool, then, obviously, a flat lot would be important, others prefer trees and rolling hills, the choices are many.

**SELECTING THE CONTRACTOR**
The contractor must be licensed in the municipality in which the construction is being done. A contractor may be licensed in one county or one village and not in another. It is very important to select a contractor who has the proper credentials in the area that the home is being built.

They must be aware of code requirements including:
- Zoning
- Electrical
- Plumbing
There are many more code requirements which are just too numerous to mention at this point.

Legal representation is always a good idea when purchasing something as expensive and important as a home. In many areas, brokers will draw up the contract, but it is in the buyer’s best interest to have their own attorney look it over and be sure that the buyer is well represented.

**TITLE SEARCH and TITLE INSURANCE**
The buyer’s attorney will order a title search, which will determine whether the land is free and clear and able to be transferred. Remember, the title search looks at the history of the title and exchange of ownership over the years between buyers and sellers. We need to make sure that the land is

- Free and clear
- The person selling the land is the owner of the land and has the right to transfer title
- There is no gap in the chain of title.

Now that the home site has been selected and the title is free and clear the next step is selecting the type of home that we’d like to build. Is it going to be a colonial style, a ranch house, single and multifamily. We need to determine our needs, wants and uses for the home we are looking to purchase. Is the home going to be just for my immediate family or will we have extended family living with us now or in the future?

Or am I looking to build a home for investment purposes. An investment house is just that. An investment means that we are looking for an increase in value over a period of time. Always remember that an investor is a person that is willing to lose their money. So, if you are not willing to lose your money stay out of the investment game. As one can never predict the future, do your research and know the local codes in the area you are looking to buy. And remember the land can never be made larger but a home that has expansion possibilities always can.

**SITE PLANNING AND BUILDING**
Let’s talk a bit about site planning. There are many decisions you need to make before you even think about breaking ground. You only get one chance to set the building on a site – one chance to get it in the right place. If a structure is misplaced on a site, and that’s fairly common, it will hinder the property for the rest of its life.

To take advantage of the sun, the lot should ideally be sloped to the southeast. South is good, east is better than west and you should avoid a northern slope. Take advantage of the way the sun travels seasonally. Overhangs can protect windows when the sun is high and hot in the summer and allow the winter sun to come in when it is lower in the sky. Solar energy is an important consideration, so consideration should be given to placing the house in the most advantageous position is important.

**BUILDING PLANS**
They are also referred to as blueprints and are drawn up by a licensed architect or building engineer and then submitted to the local municipality for approval. The architect or engineer should be familiar with the local building code requirements. The blueprints will describe the size of the rooms and the location of doors, windows, bathrooms, garage, closets, and location of appliances in the kitchen and laundry room as well. The dimensions of the interior and exterior of the house are included. The blueprint is the guide that contractors use when constructing the house.

**LEGAL RESTRICTIONS**
There may be setback requirements on the front, rear and sides that will restrict where you may place the building on the site. There may be height restrictions or view restrictions. You may not be able to build a structure higher than 2 stories, or 30 feet. You may not be able to block the view of a neighbor.

These restrictions may come from zoning ordinances or may be encompassed in deed restrictions or subdivision regulations. There may be required distances between the well and septic system – most
codes call for at least 100 feet. FHA requires that the well be 50 feet from the septic tank, 100 feet from the drain field and at least 10 feet from a property line.

**SPECIFICATIONS**
The specifications’ are different from the blueprints. The specifications are the written narratives that describe how the house will be constructed. Such as:

- Building materials
- Electrical
- Plumbing
- Heating
- Cooling
- Grading of the property
- Landscaping

**SOIL CONDITIONS**
The bearing capacity of the soil is extremely important. This can vary from one to eight tons per square foot. If the soil is sandy or not very strong, wider footings and additional supports such as pilings may be required.

Soil loses strength in proportion to its’ water content. Some soil may be unstable, such as a peat bog, or subject to slippage, such as landslides or sink holes. The composition of the soil itself can vary dramatically. It can be sampled by test borings or you may refer to soils maps.

Soil maps are available at what used to be known as Soil Conservation Service or Agricultural Extension offices. They are published FREE by the U.S. Department of Agriculture in a book for each county. The USDA Soil Conservation Service is now known as the Natural Resources Conservation Service. The maps show soil types superimposed over black-and-white aerial photographs of the county.

**BUILDING RESTRICTIONS**
There may also be restrictions on building in a flood hazard area. You need to check the FEMA maps. Or there may be restrictions on financing. FHA will not allow new construction in a flood hazard area.

Some designated wetland areas may prohibit building in the wetland or in the buffer zone around it.

Some areas may have a low water table, which will mean deeper wells and perhaps seasonal water shortages. Some areas have a high water table and the water is near the surface of the ground. This makes it easier to drill for water but may lead to chronic moisture problems in a basement or crawl space. Local well drillers may be able to give estimates of typical water depths in an area.

There may be rock underground. The good news is that it would provide a stable base if you dig down to it. The bad news is that it may require expensive blasting if it is too near the surface. Ledge rock can support up to 20 tons/SF and bed rock up to 80 tons/SF.

Drilled wells need to use steel casing until the drilling enters bedrock. Therefore, rock near the surface will save on drilling costs. A negative factor might be the presence of Radon, which occurs from the decay of Uranium rocks. The soil maps usually only provide information on the soil composition three or four feet deep. You may have to sink test borings to find out the depth of the bedrock. In some areas, ledge rock is obviously poking through the surface and will probably indicate a shallow soil covering.

**VIEW**
Obviously, you want to maximize the view from the dwelling – a view of the lake is nicer than one of a parking lot.
**PRIVACY AREAS**
You need to plan ahead to include areas for outdoor activities. Do you want a pool or deck, play area for the children?

**SITE PREPARATION**
After all the planning is finished, and you find the perfect spot to place the house on the site, there are still some things to be accomplished before the excavator arrives.

Some of the things involved are physical in nature and some are legal. The building site must be cleared of rocks, trees and stumps and any debris. Then the property needs to be rough graded. The top soil should be stripped and saved to put back later. Batter boards and strings need to be erected for the exact foundation layout. A surveyor or the contractor will establish the exact corners and make sure the house is “square.”

A sub-base for the driveway and parking area needs to be installed – at least sufficient to support a concrete truck and building material delivery trucks. A temporary “service drop” needs to be arranged from the power company and an electrician dispatched to set the meter and temporary power panel. Power will be required as soon as actual construction starts. Water and telephone lines should be run as well. The exact corners of the lot will be established so that the house is “square”.

**BUILDING PERMITS AND REQUIREMENTS**
Blueprints are submitted to the local municipality for approval and the building department will issue a building permit. The permit must be posted so that it is visible from the street.

**Codes:** When the contractor or sub contractor builds or renovates a home, they must follow the code requirements of that municipality. These include:
- Type of wood framing members
- Location of wood beams
- Construction requirements
- Safety requirements
- Electrical
- Plumbing
- HVAC

**CERTIFICATE OF OCCUPANCY**
As the home is being constructed a building inspector visits the property periodically and does inspections of the premises. They visit the property many times during the construction process.

The building inspector will usually do his first inspections after the concrete foundation is poured. The foundations must be inspected before the next phase of construction is permitted. Imagine if the building inspector only visited the home at the end of construction for the purpose of issuing the certificate of occupancy. When he does his inspection, he finds that the foundation of the house does not meet the building code requirements, at that point the house might have to be torn down. OOOPS!

Both electrical and plumbing inspections should be completed before the sheetrock and sheathing is placed on the walls of the house. As the completion of building nears, the inspector will visit one last time to do his final review of the property making sure the contractor followed the code requirements and issue the C/O certificate of occupancy.

A certificate of occupancy is good forever unless you planning to make a change in the structure. Always check with your local municipality regarding questions in building.

**NEW YORK STATE ON-SITE WELL, REQUIREMENTS**
In most urban areas in New York State drinking water comes from local reservoirs but in rural areas in our state the drinking water comes from the ground. Ground water as it is referred to is drilled from
the surface deep into the earth to create a well. This well water is used to supply a home. This is where we get the term on-site well. In our area the well requirements are regulated by the New York State Department of Health (NYDOH).

Any time you have two or more wells that supply 25 or more people they are referred to as a community wells.

A home drinking well would need to me maintained and tested by the homeowner, but a community well will be regulated by the New York Department Of Health and the DEC (Department of Environmental Conservation). The Department of Health sets the guidelines for the construction and regulations for a drinking well in NYS. Always check with your local municipality to determine the current guidelines for construction of an on-site well.

About 40% of American homes have their own private water supply. Some areas with high water tables lend themselves to hand dug wells or use of naturally occurring springs. Hand dug means just that – someone stood there with a shovel and dug a hole. Artesian wells are ones in which water is forced to the surface by hydrostatic pressure and overflows by itself. In some cases a point (metal pipe with sharp end) is driven into the ground.

**MUNICIPAL WATER**

In urban areas town or city water is delivered directly to your home. Let us try to understand where our water comes from. Let’s use New York City as an example. New York City residents get their drinking water from a municipal water supply. How and where does it come from? Let’s do some exploration.

**THE WATER WE DRINK AND USE FOR ALL OF OUR WATER NEEDS COME FROM TWO SOURCES.**

**RAIN**

Rain water is collected in the reservoirs in upstate New York and then it will move from the reservoirs to the treatment plant. The treatment plant has the responsibility to test, treat and evaluate our drinking water to making sure that the water is potable for us to drink. The Department of Environmental Protection oversees our drinking water in the city of New York. Once our water has been tested and evaluated for drinking the municipality will add chlorine for the purpose of killing any bacteria. The water is then delivered through underground pipes directly to our home for us to drink.

**MOUNTAIN RUN OFF**

Snow that accumulates in the mountains in upstate New York and will melt in the spring time and the run off of the mountain snows will accumulate in the reservoirs. It will then go through the same process as rain water being tested and evaluated for delivery and drinking.

We hear so much about drought conditions due to the lack of snow or rain. This will affect the amount of drinking water available to us during a drought period. Most of us in the affected areas are told to conserve water, this can be done in many ways such as watering our lawns on alternate days rather than every day.

There are many water conservation measures a person can take; such as replacing your showerhead with a water reduction head. This is very inexpensive and quite simple to do. We also can purchase washing machines that would use less water to launder our clothes. Replace old toilets with water conservation toilets that use less water when flushing. Another simple idea is to shut the water off when you brush your teeth, as well as filling the sink when shaving and not allowing the water to run.

By following some of these easy steps just imagine how much water we could conserve of the course of the year.
Registration - The N.Y.S. Water Well Driller Registration Law, as amended by the N.Y.S. Legislature in July 1999, requires any business conducting "water well drilling activities" to register annually with NYSDEC before doing business anywhere within the State of New York.

NEW YORK STATE ON-SITE SANITARY WASTE SYSTEM
An on-site system is a house waste system that will collect and distribute house waste into the soil on your own personal property. The homeowner is responsible for the maintenance and upkeep of the system. In urban areas, housing waste is removed from the house to a sewer system. This sewer system runs underground from your home to a treatment plant that will treat and distribute the house waste and dispose of it.

In rural areas where there are no sewer systems, the only way to dispose of the house waste is through a septic system. The septic system will distribute the house waste into the soil on the homeowner’s property.

The drainage capacity of the soil can be a crucial factor. In percolation tests, water is poured into a hole and stands there and timed to see how long it will take to drain away. The results of the “perc” test will determine if there is suitable drainage and the size of the drain field that will be required for a septic system. In some rural areas, “perc” tests have to be done before a Building Permit may be issued. If the drainage capacity of the soil is poor, other arrangements may have to be made. Above ground or “mound” systems may be installed. A mound of varying size gravel and sand is piled up to create a favorable environment and then the drain field lines are laid in that. It may also require a pump in order to move the sewage uphill to the mound.

Remember if looking to purchase land to build a home the most important thing to remember is do the soil perc test. If the soil does not perc, the municipality may not issue a building permit for that property.

A septic system works differently. The main drain in the house will remove all waste such as toilet, sink, shower and washer waste. Once the main drain goes outside of the house it is connected to a septic tank. House liquid passed through the septic tank and goes to a distribution box. The purpose of the distribution box it to distribute the house waste into the ground which is known as the absorption field or the leaching field.

There are specific requirements that need to be followed when installing a septic tank:
- Proximity to the drinking well
- Proximity to the front and rear of the yard
- Proximity to the neighbors

There may be required distances between the well and septic system – most codes call for at least 100 feet. FHA requires that the well be 50 feet from the septic tank, 100 feet from the drain field and at least 10 feet from a property line.

About 1/3 of the houses in America use private septic systems. Older systems consisted of merely a cess pool. This was just a hole dug in the ground and filled it with rocks or loose blocks so wastes would filter into the ground. In modern septic systems, the sewage leaves the house through a solid 4 inch line and goes to the septic tank. Older tanks were made of steel – most today are concrete or fiberglass. Steel tanks generally have a life of 25 years or so, depending on conditions in the ground.

NEW YORK STATE ENERGY CODE
New York State Energy Code sets standards for the design of new construction and renovation and additions of existing buildings. The code covers:
- Building envelope
- HVAC
- Energy efficiency
• Lighting systems
• Hot water
• Electricity

OTHER CONSIDERATIONS

BUILDING ENVELOPE
This refers to the material that makes up the exterior of the building and allows air to pass through. Imagine an ordinary envelope, what goes inside an envelope? Correct, a letter. So, if the letter goes inside the envelope what is the envelope made of? Correct, paper. In a building envelope the material that makes the exterior of the house such as the wood, brick, stone which encloses the structure is called the building envelope.

DRAINAGE
It is important to drain water away from the house so it doesn’t lie against the foundation and ultimately seep in. Drains made of 4 inch perforated plastic pipe are laid outside and below the level of the footings. The driveway must be graded to allow for proper drainage so that when it rains the rain water goes away from and not into the house. It also has to be graded so that it doesn’t freeze and crack in the winter.

Finally, our gutters are connected to our house. They remove the rainwater from the roof of the house down a leader to the ground and drain the water away from the house to prevent seepage to the foundation and water running back under the eaves of the home.

LANDSCAPING

Beautification: We all want our house to look as nice as possible so after the initial construction we are going to landscape our property. The selection of our trees and shrubs are very important because some trees flower early and some late, trees drop their leaves and shrubs maintain their green. Most garden centers have design teams ready to increase the value of your home by beautification.

Privacy: Some people like to have privacy nature’s way. That would be by landscaping with trees or shrubs on the perimeter of the property. This can reduce noise as well as having neighbors seeing into your back yard.

Prevent Erosion: Trees and shrubs have the ability to prevent erosion. The tree roots grab the soil and prevent it from washing away. For example we have a sloping back yard and every time it rains the soil washes down the hill. By planting trees or shrubs the soil will be held together by the roots preventing erosion.

ZONING
When doing any type of construction make sure you check with your local municipality for the current zoning laws and requirements. Zoning regulations change periodically and updates are made to the zoning laws so a homeowner looking to develop a project must have the most up to date zoning regulations.

FOOTINGS
The concrete base that supports the structure. They are one of the most important building blocks in new construction. Footings need to be at least a foot below average frost penetration levels. This varies all over the country from zero in Key West to eight feet or better in Lake Placid. They need to be on undisturbed, unfilled ground. Footings should be twice as wide as the foundation wall and as deep as the wall is wide. Depending on the soil conditions and local codes, they may or may not have metal reinforcing rods called Rebar. Small footing pads also need to be constructed on the interior of the foundation wherever posts will be employed to support the floor beams.
FOUNDATION WALLS
Typically we refer to a house that has foundation walls as a house that has a basement. Probably 90% of foundations in the northern regions of the U.S. are full basements. It is estimated that about 40% leak or have water problems. Historically, cellars were used to store root vegetables and winter foods as well as to keep out cold winter winds under the floor boards. Then, cellars became the logical place to put furnaces and coal bins. Today, many are dry and become finished into living space.

If there are soil conditions that prohibit basement building, such as ledge rock near the surface or a high water table, partial basements or crawl spaces may be utilized. Crawl spaces have shorter walls but still need to have footings that go below the frost level. Crawl spaces need moisture protection, good ventilation and must have an adequate height to allow access for repairs. In cold climates they may be heated or at least have insulation and perhaps insulated heating pipes.

The earliest foundations were made of stone (loose or mortared) and brick. Today most foundations are constructed of poured concrete or concrete block. Wood foundations have been used successfully in Canada for more than 40 years but have received a lukewarm reception here in the U.S. They have proven to be durable, easy to erect and come in panels that are insulated and easy to finish on the inside. These foundations are constructed of pressure-treated wood. They probably will never see wide scale usage until they experience better press and more general lender acceptance.

Poured concrete walls require that forms be erected which usually are steel braced sheets of plywood. They create the form mold for the foundation. Rebar is inserted into the openings and then the forms are filled to the top with concrete.

Anchor bolts are set into the top of the wall, to fasten down the sill plate later. When poured, the concrete on the bottom of the wall flows down into a keyway – a slot that was created in the top of the footing when it was poured. The inside of the forms are treated with some sort of coating; ranging from engine oil to plastic, to special form-release coatings that may be sprayed on. This facilitates stripping the forms off without damage to the walls. The concrete should be left to harden for at least 2 days before the forms are snapped off. Then, ideally, the wall should be left to cure for another week or so. Unfortunately, this step is ignored by many builders in a hurry and it can lead to future cracks.

CONCRETE BLOCK WALLS
Concrete block walls are laid up one at a time. They take a little more time and skill. When completed, block walls are not as strong or waterproof as poured walls, but cost less. Two coats of cement is applied to the exterior of the wall for moisture control. Then, an additional layer of tar or other waterproofing material.

Reinforcing mesh is laid between the courses and rebar may be applied vertically, through the holes in the blocks. Sometimes the holes are poured full of concrete. Long walls may need additional support from pilasters. In addition, insulating material, such as Vermiculite, may be poured into the blocks.

In areas where termites are a problem, a metal termite shield can be installed between the foundation and the sill. It will prevent termites from crawling up the side of the house. Termites live in the ground and just come into the house to dine. Termite shields are very low-tech - but they work. Obviously, they can’t be retrofit – this is the only chance to do it right.

It is important to drain water away from the house so it doesn’t lie against the foundation and ultimately seep in. Drains made of 4 inch perforated plastic pipe are laid outside and below the level of the footings. They are laid in crushed stone and covered with a fabric filter to keep dirt from clogging the pipes. The lines must be carefully graded away from the house and continue for a reasonable distance. Water seeps into the pipes and is carried away by gravity.
WOOD FRAMING MEMBERS

Wood is used to construct the house. The type of wood is specified by the local municipality based on the local code requirements in your local area. Such as 2x4 2x8 2x10 2x12

SILL PLATES

The bottom horizontal member of a wall or building to which vertical members are attached. Sill plates are usually composed of lumber. It usually comes in sizes of 2x4, 2x6, 2x8, and 2x10. In the platform framing method the sill plate is anchored to the foundation wall. The bottom of the sill plate is kept 6 inches above the finished grade. The sill plate is anchored to the concrete foundation. When the concrete foundation is poured it will take a few days for it to cure, moments after the foundation is poured the contractor will place metal anchoring rods into the cement for anchoring the sill plate to the foundation.

After a few days the foundation will be completely dry and the sill plate will be attached to the foundation. The anchoring rods are threaded and holes drilled in the sill plate and the washers and metal nuts will be tightened down making a tight fit to the foundation. The sill plate is usually pressure treated. This is to prevent the it from rotting as the finished grade contains chemicals. As we mentioned before between the sill plate and the foundation metal will be placed to prevent termites form entering the home.

BEAMS/JOISTS

Joists are horizontal structural members placed on edge, which carry the house loads to girders and sills. The thickness, width and spacing are determined by the live loads placed on them. They commonly are 2 x 10’s or 2 x 12’s. The joists are laid perpendicular to the girder. They may rest on top or be at the same height as the girder.

The outside ends of the joist rest on top of the foundation wall and are butted into the header joist. A recent innovation is computer designed floor trusses. They have greater strength and allow long clear spans without girders or posts. The open web design allows easy installation of plumbing and wiring.

Bridging is inserted between the joists, in an “X” pattern to stiffen the floor structure and resist twisting of the joists. It used to consist of wooden 1 x 3’s cut and fit at the site. Today, bridging is primarily factory fabricated metal strips. Sub-flooring at one time consisted of 1 x 6 tongue and groove boards laid diagonally for more strength. Today it is almost always 4 x 8 foot sheets of plywood. ½ inch may be an acceptable minimum. 5/8 inch or ¾ inch is much more desirable. A good way to combat floor squeaks and improve structural rigidity is to glue the plywood down to the joists and use tongue and groove plywood.

GIRDERS

These main support beams are set in pockets that were formed in the top of the end walls of the foundation. Steel girders may be used and are very strong. Wooden girders may be fabricated by nailing together three or more wooden planks. Usually these members have plywood spacers for additional strength and are glued as well as nailed. Both kinds are supported by lally columns. The size of the girders can be calculated from beam formulas, span tables or local codes.

LALLY COLUMNS

Named after an Irish inventor, John Lally, who owned a construction company that started production of these columns in the late 1800s. Lally column is an architectural term for a long, round, steel pipe oriented vertically to provide support to beams or timbers stretching over long spans. Lally columns are typically positioned in the middle of the span to bear the weight of the structure, and to reduce the tendency of the structure to sag or flex. They are usually, but not always, filled with concrete to provide additional rigidity and strength. Years ago, before steel columns were used, tree trunks were cut to size and placed in the basement for support. It is very common to see tree trunks as lally’s in houses dating back to the early 1900’s
STUDS
Vertical members in the light frame construction techniques called Balloon framing and platform framing of a building's wall (variously also called "stick and platform", "stick and frame", or "stick and box" construction colloquially)—where the 'sticks' carry the vertical loads, and the rectangular platforms made of floor joists, headers and sub-floors. They hold the outward forces in check and keep the walls in parallel and from bulging. The "sticks" refer to the wall studs and the wall plates which are much thinner in cross section than the structural elements in the older, post and beam and balloon framing methods of light frame construction.

Being thinner and lighter, stick construction techniques are easier and speedier than the older methods, and balloon framing has been made illegal in new construction in many jurisdictions, for fire safety reasons—the plates and platforms in platform framing provide an automatic fire stop inside walls, and so are deemed much safer by fire safety officials. Traditionally, studs were made of wood, usually 2×4 or 2×6 dimensional lumber. In North America, studs are typically placed 16 inches (400 mm) from each other's centre, but sometimes also at 12 inches (300 mm) or 24 inches (600 mm). Steel studs are gaining popularity, especially for non load-bearing walls.

ROOF
Roof rafters: one of a series of sloped structural members that extend from the ridge or hip to the down slope perimeter or eave, designed to support the roof deck and its associated loads. A type of beam which supports the building roof. In home construction, rafters are typically made of wood. Exposed rafters are a feature of traditional roof styles.

In many buildings, rafters have been replaced by engineered trusses (trussed rafters), normally because of span limitations and/or roof load (weight from above). The slope of the roof is described as a precise relationship of the rise over run. The rise is how high it goes up vertically over a certain horizontal run.

For example, if the roof rises 4 inches as it goes 12 inches sideways – the slope or pitch of the roof is 4 over 12 or 4/12.

Roof sheathing serves the same purposes as the wall sheathing – strength and nailing surface, plus moisture protection. It typically consists of plywood sheets. A sheathing paper is also applied – usually asphalt paper.

Some roofs are sheathed with wooden planks, particularly if they are to be left exposed on the interior. As the weight of the roof presses down, it tries to push the sidewalls out. The joists hold the walls together. Conventional rafter systems consist of boards that are set at an angle and meet at the ridge. There may or may not be additional cross pieces to help hold the stresses. Roof truss systems resist the spreading stresses and transfer all the weight to the outside walls. They are about 3 to 4 times as strong as a conventional rafter system and none of the interior walls are load bearing.

There are many types of roofs. The simplest and cheapest is the flat or shed roof. The gable roof has two similar pitches. As the style gets more complex, the framing requirements become more complex and more expensive. The type of roof can add greatly to the overall style of the house. You can’t have a Dutch Colonial without a gambrel roof or a Second Empire house without a mansard roof.

Roof ridge beam: Is the highest point of the roof, imagine we placing a pen between our two hands and then position our hands like a steeple. The pen would represent the ridge beam. The roof rafters would be nailed to either side of the ridge. This would create the sloping of the roof to allow rain water to run off the house.
SLAB-ON-GRADE CONSTRUCTION
A slab on grade is a house that does not have a basement. The concrete is poured directly on the surface. It is the quickest and cheapest way to get a foundation. It is essentially one giant footing so the weight is distributed over its entire surface. A standard slab is only 4 inches thick but then is thickened an extra eight inches on the edges and wherever concentrated loads will occur; such as under a partition, bearing post or chimney.

Monolithic slab: the footing and the foundation were poured at the same time.

Pre-Fab house: roof truss systems are usually factory built to custom specifications, trucked to the site and erected with cranes.

POST AND BEAM
For over a thousand years the framing system utilized was the Post and Beam system. This consists of large vertical posts that support horizontal beams. The posts and beams were joined together by various interlocking joints, such as mortise and tenon, and then secured by wooden pegs.

BALLOON FRAMING
Balloon framing was introduced about 1850 in America. It was made possible by the invention of the steam powered saw mill which quickly and economically produced machined lumber. Also, the introduction of machinery to mass produce metal nails and the advent of rail transportation were important factors. This technological revolution meant house-building was easier and quicker. We went from massive rigid frames to a matrix of relatively light structural members covered by a rigid skin. It required less skilled labor, as compared to notching complicated joints. It allowed architects and builders to break out of the mold of building basic rectangular shapes and made it easy and economical to create meandering houses with many corners.

Balloon framing employs studs that run continuously from the sill to the rafter plate. The second story floor joists are hung and attached to the studs. Balloon framing gave good structural rigidity and was well suited for the plaster interior finishes of the day. The disadvantages were that the two story cavities between studs were dangerous in the event of a fire. This could be ameliorated by installing horizontal “fire stops” made of 2 x 4’s but by the 1930’s and 1940’s, balloon framing was outlawed in many municipalities.

PLATFORM
Due to the fire hazard and the difficulty of getting good lumber 20 feet long, balloon framing is rarely used today. It has been replaced by platform framing. The studs run one story high. The wall sections are framed on the convenient “platform” consisting of the floor joists and sub-floor. If there is a second floor, a whole new platform is erected on top of the walls. Then a second story is framed up with one story studs. It also makes it more efficient to build as the second floor platform makes a perfect staging area to layout and frame the second story walls – before they are erected. With Platform framing, the studs are mounted vertically and have a sole plate nailed across the bottom. If the studs are 2 x 4’s, they are installed 16 inches on center. If 2 x 6’s are used, they are put 24 inches on center. With 2 x 6’s there is a bigger wall cavity, so more insulation can be inserted. At the top of the studs is a double top plate. There is additional support needed over and around openings in the wall, such as doors and windows. Headers are built over the openings to spread the load out to the sides and prevent the windows and doors from getting crushed or

BRICK CONSTRUCTION
Brick construction may be solid brick. The wall is laid up in two layers with interlocking bricks. The brick themselves can be laid in different patterns and come in many colors.
A cheaper alternative is to apply a brick veneer, a layer of brick over a frame wall. It may be applied to all four walls or may be just the front façade. A fairly new product is called thin bricks. It consists of brick material that is only about an inch thick and applied over the wood sheathing.

STUCCO
Stucco is a lime-based mortar finish applied to a wall. It can be easily applied over concrete blocks. Two or three coats are sprayed or troweled. Stucco can be applied over frame walls, with the proper preparation. Wire mesh is first attached to solid sheathing and then the stucco finish is added.

EXTERIOR INSULATION AND FINISH SYSTEMS
Referred to as EIFs, are sometimes known as Synthetic Stucco. They combine the insulation and exterior finish in one process. The exterior surface is quite water resistant but there have been many problems with water infiltration where they meet other components such as windows, doors, roofs and chimneys. They have been used in recent years, primarily in the South, and have gotten a bad reputation for leaking.

ROOF FINISHING
Roof covering has the basic function of keeping out the rain and snow. It can also serve aesthetic purposes and adds texture and color to a house design. The following is a list of popular roof coverings arranged in order of their costs – from low to high.

1. Composition roll roofing
2. Composition shingle
3. Built-up rock
4. Metal
5. Wood shakes or shingles
6. Cement fiber shingle
7. Clay tile
8. Slate
9. Copper

Most new construction today employs fiberglass composition shingles. The average life ranges from 20 to 35 years, depending on the thickness and weight of the shingles. The life may be less in the South, where the sun is more intense. Remember, the weight of the shingles is a literal term describing the weight sufficient to cover 100 square feet, or a square. Newer, low maintenance products being used include metal roofs and fiberglass tiles that look like clay tiles.

SIDING
Wood siding, both shingle and clapboard, was the standard in this country from the 1600’s through the 1800’s. During the last 50 years or so, there have been many innovations in lower maintenance siding materials. Many have the color baked in and textures are available to resemble wood. As before, a list follows with sidings in approximate order of cost.

1. Hardboard
2. Wood clapboard
3. Aluminum
4. Vinyl
5. Stucco
6. Wood shakes
7. EIFS
8. Brick
9. Stone

A recent innovation in siding is fiber-cement. It is composed of cement, sand and cellulose fiber to prevent cracking and increase strength. It comes in various styles, textures and colors.

ENERGY EFFICIENCIES
R-factor: R-stands for resistance. The higher the R value the greater the resistance. When we talk about R-value we need to understand that houses are required by local code to have insulation to protect the house from both the heat as well as the cold entering the home. In today’s market even garage door are sold with R-values to insulate the garage during the changing times of the year.

Let’s explore the different types of insulation used in the construction of homes today.
Blanket insulation are rolls of fiberglass insulation typically 15 ½ inches wide. The reason that the insulation is 15 ½ inches wide is so that it can fit between the studs and beams of the house that are usually 16’’ on center. The blanket insulation is used in attics and interior walls of houses.

**Vapor Barrier insulation** is similar to rolls of fiberglass insulation. The main difference is the vapor barrier has one of the sides of the insulation covered with a vapor barrier that is used in all exterior walls of the house to prevent condensation from building up on the interior walls of the home.

**Loose fill insulation** is ground up paper cardboard insulation that is fire retardant and is blown in to the attic, walls, and areas that are difficult to reach.

**Foam insulation:** All foam insulation that is used today is not UFFI insulation with formaldehyde (banned back in the 1980’s). Foam insulation is injected into the walls and expands and cures inside.

**Location of insulation:** the insulation locations are around doors, window, skylights, foundations, roof rafters, walls and floor beams.

**HEATING, VENTILATION AND AIR CONDITIONING (HVAC)**

Ventilation: We are told to ventilate our home by opening a window. That seems simple when the temperature is above 50 degrees. However, when the temperature drops below freezing it is unlikely that you would open a window to ventilate your home. So the installation of a ventilation system is a good idea. The purpose of a ventilation system is to move fresh air throughout the home through a system of ductwork and remove the hot air through an exhaust fan to the outside. The air circulates 24/7. Ventilation can be very important in order to prevent “sick building syndrome” which is covered in the chapter on environmental issues.

**HEATING**

As we move through the different types of heating systems we learn there are three types of heating systems:

**Hot water system:** the water is heated by the boiler and delivered through copper pipes to either baseboards or radiators. Once the hot water is delivered, the heat will radiate from the baseboard and radiators.

**Steam system:** similar to a hot water system; the boiler heats the water at a high temperature creating steam that runs through pipes and radiators to radiate into the room. Steam systems are usually used in commercial buildings or apartment buildings.

**Forced warm air:** a furnace heats the air and a blower blows the hot air through a series of ductwork to the individual rooms throughout the house. It is also common to have a humidifier attached to the furnace because forced air tends to be a dry heat and a humidifier will put moisture in the air.

**Heating propellants:** the system needs a propellant to energize it and allow it to work. Typically these include electric, oil and gas to fire the heating.

**Oil Tanks:** there are two types of oil tanks a homeowner might have.

A UST or underground storage tank, described as having at least 10% of the tank buried in the ground. An AST above ground storage tank outside the house

Both of these types of tanks are regulated by the DEC (Department of Environmental Conservation) for the testing and abandonment of oil tanks.

**Central air conditioning:** Much more common now then in the past. Most builders either include central air conditioning or have it as an option when building a home.
Five major components make up a central air conditioning system:
1. Evaporator
2. Compressor
3. Condenser
4. Receiver
5. Refrigerant used to propel the system

The system draws the air from the outside and the five components work together to cool and deliver cold air in the summer months. This is done through a series of ductwork in the house. A major advantage of having forced warm air heating in a home is that in the future it would be easy to install air conditioning. The duct work is already in the home and you would only need to purchase the five major components for the air conditioning. Hot or cold air would travel the same path at different times throughout the year.

Water-cooled systems: a water cooled system is exactly what it sounds like, water runs through the coils in the unit and the refrigerant cools the water and the blower pushes the cold air out the front of the unit.

BTU ratings: BTU stands for British thermal units. It measures both heating and cooling capacity. When purchasing an air conditioner or a heater the salesperson will ask what is the size of the room you are looking to heat or cool. Based on the size they can determine the BTU’S necessary.

Heat Pumps: Air to air heat pumps are systems that convert air from the outside to warm air on the inside. It also works in reverse it can draw warm air from inside the home and expel it outside making for cooler air inside the home. A thermostat is used to regulate the temperature with the cycling on and off of the system to a set temperature.

PLUMBING
Plumbing encompasses two main systems: the distribution system and the drain/waste/vent (DWV) system.
In addition there may be a third sub-system with hot water or solar heating. The distribution system brings water, under pressure, into the house – usually through a ¾ inch or one inch line. This divides after going through the water heater into cold and hot water distribution lines that run to each fixture or appliance. Better quality systems use ¾ inch main lines and ½ inch branch lines. Lesser quality installations use ½ inch throughout.

Good plumbing practices include:
- Keep piping runs as short as possible
- Put the hot water heater close to the main point of use
- Insulate supply pipes – both hot and cold
- In cold climates, do not run supply pipes in exterior walls and unheated areas
- Design the system so it can be shutdown and drained easily
- Install shutoff valves on every fixture riser pipe.

The drainage system carries off waste water. Grey water from the sinks and laundry are carried off in drain lines and may vary from 1 ½ inches to 3 inches. Black water from the toilets is taken away by soil lines, which are usually 3 inch lines. “U” shaped, water filled traps are installed under each fixture to keep sewer gases from leaking back into the house. The drain system funnels waste water into a stack (3 or 4 inch diameter), which leads out to the sewer or septic system. The stack must be vented to the outdoors to allow gases to escape through the roof and to prevent water being siphoned from the traps.

PIPING
Cast Iron: Distribution lines have traditionally been copper after bad experiences with galvanized iron pipes. Drain lines have traditionally been cast iron. In recent years there has been general acceptance of plastic pipes, but they are still prohibited in some building codes.
**Copper piping** is used for both hot and cold-water applications. One of the main reasons copper piping is used for hot water is because copper is a conductor of heat. When the boiler heats the hot water and the water runs from the basement to the third floor of your home the water remains hot.

**Polyvinyl chloride:** PVC is used for both cold-water return and cold-water supply applications. PVC is now used often in new construction for the main drain in a home due to the fact it is much less expensive than other piping materials. PVC is used under sinks and showers and supply lines to toilets and underground conduits. It’s lightweight and resistant to corrosion.

**Brass piping** is common in older homes and was in use for many years. However, the cost now prevents contractors from using it. Brass piping may still be used today but usually for cosmetic reasons.

A licensed plumber should always do pipe sizing. They should be familiar with the local code requirements and determine the type and size of piping material that should be used for adequate pressure. If the pipe is too large the pressure may be low and if the pipe is too small the water pressure may be too great. Venting requirements of plumbing fixtures

On the top of a house, you will notice that there is a small vent pipe on the roof. This vent pipe is vital to the plumbing fixtures (toilets) in your home. The vent pipes first responsibility is to vent out bathroom gasses that build up in the plumbing fixtures. The second purpose is to allow for the proper flow of water in your toilets.

**For example:** fill a bottle with water and then pour it into a glass. You will notice as the water flows out of the bottle it will burp and draw air into the bottle. If you take a knife and poke a hole in the bottom of the water bottle you will then see the flow of water in one straight stream. This is because the bottle is open at the top and bottom. The same goes for your toilet. If you capped the vent on the roof you would not have a proper flow down your pipes, but because the vent pipe is open on the top of your house and opened to the sewer or septic system the flow of waste water will drain properly.

**ELECTRICAL**
The best analogy is to compare electricity running through a wire to water flowing through a hose. The volts are the pressure that is pushing it (similar to pounds per square inch of water pressure) and the amps are the total volume that will fit through the hose (similar to gallons per minute of water).

Voltage = Pressure  
Amperage = Volume (current)

Power will be delivered from a utility pole to a building via three wires – two wires are hot and the third is neutral. The wires may run through the air as three separate wires, or as a braided triplex wire. Of course, they may also be buried under the ground. If you measure the voltage across both hot legs, it will be 240 volts. Between either hot leg and the ground, it will be 120 volts.

These are nominal voltages but they vary a little between 110 and 120 and between 220 and 240 volts. We need more power – more pressure – to run certain items. Electric dryers, electric ranges and heavy duty power equipment runs on 220/240 volts. Normal receptacles, lighting, small appliances, computers, etc. run on 110/120 volts. Doorbells and thermostats require little in the way of power and have transformers that reduce the power to only 12 volts. 12 volts is a obviously a minimal amount power.

This power comes in through the meter to a service panel. There it is divided into branch circuits. These serve various parts of the house and each is protected by a fuse or a circuit breaker, in the event of an overload.
Fuses contain a small metal strip that melts in the event of an overload and breaks the circuit. Breakers act in the same way and are no more than a reusable fuse. If there is an overload, the breaker trips and the circuit is broken – but it can be reset by rocking the breaker back into position.

Fuses are rarely used in new construction anymore, but are adequate. If there are enough circuits and enough amperage in an existing installation, fuses don’t need to be replaced with breakers – except for convenience. Amperage is the total amount of electricity that you have available. In small houses with light loads and perhaps gas appliances, you might be able to get by with 60 amps. 100 amps is a more normal minimum amount. A house with electric heat would require at least 200 amps. It is not unusual today to find large houses with 300 amps or more.

**TYPES OF WIRING**

BX (metallic) or armored cable was common. There were two wires and a ground inside a metal jacket that protected the wires. It was a good system for interior wiring of a house but the cable was hard to work with, hard to cut and didn’t bend very well.

Aluminum wiring was used for a short period in the mid-50’s, due to a shortage of copper during the Korean War. It proved to be a fire hazard, in many instances, as the aluminum was subject to oxidation where it joined the electric boxes and receptacles.

Since the 1960’s, the most popular wires have been plastic coated or Romex. (non metallic)

**Above Ground:** As homeowners we never get to decide whether of not we want to have our electrical wiring above or below ground, it comes with the house. There are some disadvantages of above ground wiring. The above ground wires are more likely affected by the weather such as wind, rain or ice which could lead to an interruption of service during bad weather.

**Below Ground:** Underground cables that run to your home. The obvious advantage of underground wires are that being below ground there is no affect based on the weather. Additionally, there are no unsightly wires hanging in you back or front yard.

However, we do not get to choose which one we want. The utility company has already done it for us.

**Utility company responsibilities:** bring electricity to your home. They are responsible for all of the electrical wiring from the electric plant, all wires running through the town and to the top of the electric meter. They may also be responsible for the delivery of underground gas to buildings and homes.

**Land owner responsibilities:** the electric meter on the house and all of the electrical equipment such as lights, outlets, electric dryers and stoves and any other electrical items inside the home.

**Conduit:** typically a galvanized steel pipe that runs on top of the electric meter and provides protection for the wires against the weather elements such as rain, wind, snow, and ice. A conduit can also be mad of PVC or aluminum. They are used for both above ground and below ground.

**Greenfield:** The best way to describe a Greenfield is to imagine a straw. If we look inside a straw we can see straight through to the other end. A Greenfield works the same way. It is a metal cable with no wires inside. The electrician can now make the cable any length desired, as he/she inserts the wires in to the metal cable.

This type of wiring is used for electric dryers, stoves, air conditioners etc.

The National Electrical Code (NEC), is a United States standard for the safe installation of electrical wiring and equipment. It is part of the National Fire Codes series published by the National Fire Protection Association (NFPA). "National Electrical Code" and "NEC" are registered trademarks of the
NFPA. The National Fire Protection Association sponsors work on the NEC. In our area the New York Board of Fire underwriters inspects all electrical installations when the dwelling gets the approval. Then a certificate is issued saying the structure has met the code requirements. Remember the NEC sets the minimum standards. Local municipalities can set a standard greater but never less than the NEC.

MANDATED GUARANTEES AND WARRANTEES

HOME IMPROVEMENT - New York General Business Law requires that all home improvement contracts for more than $5000 must provide that all payments received prior to completion go into an escrow account.

An owner can enter into a contract, which allows for the release of money as the work is completed. In this case, the contract must tell exactly when money is released and what work must be completed before such money is released. An owner can cancel a home improvement contract up to 3 days after it has been signed. A contractor who violates the escrow provision can be fined up to $250 or 5 percent of the contract price up to $2,500.

NEW HOME WARRANTIES - New York General Business Law requires a builders warrantee as follows: one year against defects in construction, two years for all plumbing, heating, electrical and air conditioning, and six years for all material defects.
In today’s world, we hear all about global warming and the effect our personal habits have on the environment. We are going to learn about the laws that protect us as well as the personal actions of each one of us that could help or hurt everyone else. We will be better able to determine how we can keep our environment safe for all.

Environmental damage may not always be as apparent as a water stain in the basement. If the seller is unaware of a problem and therefore doesn’t reveal it, it does not relieve him of liability. We are not expected to be specialists in environmental areas, but we are expected to deal honestly and fairly with the public. Buyers should be encouraged to have the property professionally inspected and if need be, tested by an impartial company. This is a right and responsibility afforded all buyers. We should keep the following in mind:

- Learn the basics of environmental hazards.
- Be informed of laws protecting the public against them.
- Become familiar with harm that might be encountered because of an environmental hazard.
- Keep accurate records of any and all conversations or observations of environmental issues.
- If there seems to be a serious problem or concern, become familiar with the experts who can be called on to better determine whether there really is a problem.
- If there is a real or perceived problem, reveal it immediately. Both the buyer and seller need to be informed.

Who is effected by the environment: EVERYONE.

ENVIRONMENTAL PROTECTION AGENCY
The EPA as it is commonly referred to, leads the nation’s environmental science, research, education and assessment efforts. They develop and enforce regulations that implement environmental laws enacted by Congress. They are responsible for researching and setting national standards for a variety of environmental programs. They delegate the responsibility for issuing permits, monitoring and enforcing compliance to individual states. When national standards are not met, the EPA can issue sanctions and take other steps to assist the states in reaching the desired levels of environmental quality.

They provide other financial assistance through programs such as the Drinking Water State Revolving Fund, the Clean Water State Revolving Fund, and the Brownfields program. At laboratories located throughout the nation, EPA works to assess environmental conditions and to identify, understand, and solve current and future environmental problems.
BROWNFIELDS.
These are abandoned or under-used industrial and commercial property. It is land that may be contaminated by low concentrations of hazardous waste or pollution and has the potential to be reused once it is cleaned up. Land that is more severely contaminated and has high concentrations of hazardous waste or pollution, such as a Superfund or high concentration hazardous waste sites, do not fall under the Brownfield classification.

Generally, Brownfield sites exist in a city or town's industrial sections, on mountains containing abandoned factories or commercial buildings, or other previously polluting operations. Small Brownfield’s also may be found in many older residential neighborhoods. For example, many dry cleaning establishments or gas stations produced high levels of subsurface contaminants during prior operations, and the land they occupy might sit idle for decades as a Brownfield.

It was very common for contaminated sites to be idle and unused for many years. In order to clean them up and be brought to safe standards for building the costs could be quite high and possibly be more than the land would actually be worth if it were redeveloped. However, redevelopment of the sites has become more common in recent years, because of the lack of available land in highly populated areas. Additionally, the ability to clean up environmentally distressed property has become much simpler.

Many developers insist that a site be thoroughly investigated (via a Phase II Site Investigation or Remedial Investigation) prior to starting the cleanup process. Environmental firms have teamed up with insurance companies to underwrite the cleanup of distressed Brownfield properties and provide a guaranteed cleanup cost for a specific property to limit land developers' exposure to environmental remediation costs and pollution lawsuits. Research is under way to see if some can be used to grow crops, specifically for the production of bio-fuels. If these were successful there would be a positive impact on the development of biofuels at a reasonable cost for our everyday needs.

REGULATION OF BROWNFIELDS
Investigation and cleanup of Brownfield sites is largely regulated by state environmental agencies in cooperation with the EPA. Many of the most important provisions on liability relief are contained in state codes that can differ significantly from state to state. The EPA, together with local and national government, can provide technical assistance and some funding for assessment and cleanup of designated sites, as well as tax incentives for cleanup that is not paid for outright.

GREYFIELD LAND
This term is used to describe economically obsolescent, outdated, failing, and/or underutilized real estate assets or land. Typically this describes retail and commercial shopping sites that are no longer being used. Generally this will occur when larger, better designed malls and shopping centers are built. These newer sites will be more attractive and usually have better anchor tenants to attract the buying public.

Another term for this obsolete real estate is “ghostboxes”. Typically used when the major anchor tenants have simply vacated stores leaving behind empty shells. These Greyfields are not environmentally hazardous but simply abandoned. Developers are often drawn to Greyfields because they can be redeveloped more easily and with significantly less cost than Brownfields.

CERCLA/SUPERFUND
The Comprehensive Environmental Response, Compensation, and Liability Act, CERCLA, commonly known as Superfund, was enacted by Congress on December 11, 1980. This law was enacted in the wake of the discovery of toxic waste dumps such as Love Canal and Times Beach in the 1970s. It allows the EPA to clean up such sites and to compel responsible parties to perform cleanups or reimburse the government for EPA-lead cleanups.
This law created a tax on the chemical and petroleum industries and provided broad Federal authority to respond directly to releases or threatened releases of hazardous substances that may endanger public health or the environment. Over five years, $1.6 billion was collected and the tax went to a trust fund for cleaning up abandoned or uncontrolled hazardous waste sites.

The law authorizes two kinds of response actions: **Short-term removals**, where actions may be taken to address releases or threatened releases requiring prompt response. **Long-term corrective response actions**, that permanently and significantly reduce the dangers associated with releases or threats of releases of hazardous substances that are serious, but not immediately life threatening.

These actions can be conducted only at sites listed on EPA's National Priorities List.

**How Superfund Works**
The Superfund cleanup process is complex. First, the property is assessed in order to place it on the National Priorities List. Appropriate cleanup plans then must be established and implemented. This is the long-term cleanup process. In addition, the Agency has the authority to:

- To conduct removal actions where immediate action needs to be taken;
- To enforce against potentially responsible parties;
- To ensure community involvement;
- Involve States;
- Ensure long-term protectiveness.

The blueprint for these activities is the National Oil and Hazardous Substances Pollution Consistency Plan (NCP). These regulations are applicable to all federal agencies involved in responding to hazardous substance releases. Over the past 20+ years, they have located and analyzed tens of thousands of hazardous waste sites, protected people and the environment from contamination at the worst sites, and involved others in cleanup.

EPA's Office of Solid Waste and Emergency Response (OSWER) in Washington, D.C. oversees the Superfund program. The Superfund cleanup process begins with site discovery or notification to EPA of possible releases of hazardous substances. Sites are discovered by various parties, including citizens, State agencies, and EPA Regional offices. Once discovered, sites are entered into the Comprehensive Environmental Response, Compensation and Liability Information System (CERCLIS). Some sites may be cleaned up under other authorities. EPA then evaluates the potential for a release of hazardous substances from the site through these steps in the Superfund cleanup process.

1. Community involvement
2. Enforcement
3. Emergency response (can occur at any time in the process)

The Superfund Enforcement program gets Superfund sites cleaned up by finding the companies or people responsible for contamination at a site, and negotiating with them to do the clean up themselves, or to pay for the cleanup done by another party (i.e., EPA, state, or other responsible parties.

Under CERCLA, a potentially responsible party (PRP) is subject to strict liability. Potentially Responsible Parties are individuals, companies, or any other parties that are potentially liable for payment of Superfund cleanup costs. They would include:
- Companies that generate hazardous substances disposed of at a Superfund site
- Current and former owners and operators of the site
- Transporters who selected the site for disposal of hazardous substances may be responsible for part or all of the cleanup costs.

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EPA attempts to identify PRPs early to achieve a PRP lead cleanup rather than EPA performing a Superfund (Fund-lead) cleanup. A PRP search generally is initiated around the time of site discovery. If a PRP having sufficient financial assets is unwilling to settle, EPA may issue a Unilateral Administrative Order.

This means that the federal government can hold a PRP liable without proving that the PRP was at fault and without regard for the PRP's motive. They would NOT be liable if:
- The problems caused by the release of the hazardous substance were unforeseeable.
- The PRP acted in good faith.
- State-of-the-art hazardous waste management practices were followed at the time the materials were disposed of.

The potentially responsible party can be required to conduct the cleanup. Failure to comply may result in the imposition of fines, damages, and court orders to conduct the cleanups. If EPA feels the site requires immediate action, EPA uses Superfund monies to proceed with cleanup, with the authority to later recover its costs from PRP's through Administrative actions, if less than $500,000. When more than $500,000 is sought, EPA must go to court to recover its expenses. These lawsuits usually result in a settlement (consent decree), but may go to full trial. CERCLA also imposes joint and several liability. Joint liability means that more than one defendant is liable to the plaintiff. Several liability means the plaintiff may choose to sue only one of the defendants and recover the entire amount claimed. Sometimes the defendants can prove that they were not completely liable. In these cases, the harm is apportioned and each defendant is only liable for the harm he personally caused.

The possible defenses which CERCLA lists are:
1. Act of God
2. Act of war,
3. Act of a third party.

The burden of proof for these defenses is upon the PRP. They must prove that they had no contractual or other relationship with the third party. It must be proven that they did not hire the third party or act as their agent.

The PRP also must prove that it:
- Exercised due care with respect to the hazardous substances
- Took precautions against foreseeable acts or omissions of the third party.

**HAZARDOUS WASTE**

Waste with properties that make it dangerous or potentially harmful to human health or the environment. Hazardous wastes can be liquids, solids, contained gases, or sludge. They can be the by-products of manufacturing processes or simply discarded commercial products, like cleaning fluids or pesticides.

**Characteristics of Hazardous Waste**

- **Ignitability** – wastes can create fires under certain conditions, are spontaneously combustible, or have a flash point less than 140 °F. These would include waste oils and used solvents.
- **Corrosivity** – acids or bases that are capable of corroding metal containers, such as storage tanks, drums, and barrels. Battery acid is an example.
- **Reactivity** – These are unstable under "normal" conditions. They can cause explosions, toxic fumes, gases, or vapors when heated, compressed, or mixed with water. Examples include lithium-sulfur batteries and explosives.
- **Toxicity** – Toxic wastes are harmful or fatal when ingested or absorbed (e.g., containing mercury, lead, etc.). When toxic wastes are disposed of in or on the land. Contaminated liquid may leach from the waste and pollute ground water.
Congress directed EPA to create regulations to manage hazardous waste from "the cradle to the grave." Under this mandate, EPA developed strict requirements for all aspects of hazardous waste management including the treatment, storage, and disposal of hazardous waste. In addition to these federal requirements, states may develop requirements that are broader in scope than the federal regulations.

**Underground Storage Tanks**

About 640,000 underground storage tanks (UST’s) nationwide store petroleum or hazardous substances that can harm the environment and human health if they release their stored contents. These are tanks and any underground piping connected to the tank that has at least 10 percent of its combined volume underground.

The federal UST regulations apply only to underground tanks and piping storing either petroleum or certain hazardous substances. When the UST program began, there were approximately 2.1 million regulated tanks in the U.S. Today there are far fewer since many substandard UST systems have been closed. The existing sites are predominately owned by companies who sell gasoline to the public (such as service stations and convenience stores) and in private use by people who have tanks solely for their own needs (such as fleet service operators and local governments).

A leaking UST can present other health and environmental risks, including the potential for fire and explosion. In 1984, Congress responded to the increasing threat to groundwater posed by leaking USTs by requiring EPA to develop a comprehensive regulatory program for USTs storing petroleum or certain hazardous substances. There are financial responsibility regulations designed to ensure that, in the event of a leak or spill, an owner or operator will have the resources to pay for costs associated with cleaning up releases and compensating third parties.

**DREDGING**

Dredging is an activity or operation usually carried out at least partly underwater, in shallow seas or fresh water areas with the purpose of gathering up bottom sediments and disposing of them at a different location. This is done mostly to keep waterways navigable. The process of dredging creates excess material, which will be transported to a location different from the dredged area. It can produce materials for land reclamation or other purposes (usually construction-related), and has also historically played a significant role in gold mining. Dredging can create disturbance in aquatic ecosystems, often with adverse impacts.

There is no doubt that dredging is needed in order to sustain and improve our lives. However, it also can have many negative results. It can create a disturbance to aquatic ecosystems. In addition, dredge material may contain toxic chemicals that may have an adverse effect on the area.

Federal Water Pollution Control Act Amendments of 1972 established a regulatory program. Under this Act, it is unlawful to discharge dredged or fill material into waters of the United States without first receiving authorization (usually a permit), unless the discharge is covered under an exemption.

**WETLANDS**

Wetlands provide a number of important and beneficial functions. During periods of heavy rainfall, they serve as flood storage areas, where water can spread out without damage to developed uplands. As the water passes through the wetlands, pollutants are filtered out. Wetlands also stabilize shorelines, preventing the harmful effects of erosion. They produce the basic food material used by many fish and other aquatic life. Some wetlands also serve as nursery grounds for fish and rookery areas for birds. Many wildlife species, some of which are threatened or endangered, need to live in wetlands for all or part of their life. A change of wetlands and other surface waters may have a detrimental impact on the environment. That impact could extend beyond the limits of the work site, affecting other public or private property.
For regulatory purposes under the Clean Water Act, the term wetlands means "those areas that are inundated or saturated by surface or ground water sufficient to support, vegetation typically adapted for life in saturated soil conditions. Wetlands generally include swamps, marshes, bogs and similar areas."

**MARSHES**
Marshes sustain a diversity of life that is way out of proportion with its size. Unfortunately, like many other wetland ecosystems, freshwater marshes have suffered major acreage losses to human development. Fortunately, most states have enacted special laws to protect tidal marshes, but much diligence is needed to assure that these protective measures are actively enforced.

**SWAMPS**
Swamps are any wetland dominated by woody plants. Swamps are characterized by saturated soils during the growing season, and standing water during certain times of the year. Some swamps are dominated by shrubs, plants, birds, fish, and invertebrates such as freshwater shrimp, crayfish, and clams. Many rare species depend on these ecosystems as well.

**Bogs** are quite distinctive from other wetlands. They have spongy peat deposits, acidic waters, and a floor covered by a thick carpet of sphagnum moss. Bogs receive all or most of their water from rain rather than from runoff, groundwater or streams. They create communities of plant and animal species that exist only in the unique characteristics of bogs such as low nutrient levels, waterlogged conditions, and acidic waters.

**Clean Water Act (CWA)** is the cornerstone of surface water quality protection in the United States. The Act does not deal directly with ground water or with water quantity issues. Its’ purpose is to sharply reduce pollution into the waterways, finance municipal wastewater treatment facilities and manage polluted runoff. The broader goal is to restore and maintain the chemical, physical, and biological integrity of the nation's waters so that they can support "the protection and propagation of fish, shellfish, and wildlife and recreation in and on the water." The main focus is on protecting healthy waters and restoring impaired ones.

**CLEAN AIR ACT**
Congress passed the Clean Air Act in 1963, the Air Quality Act in 1967, the Clean Air Act Extension of 1970, and Clean Air Act Amendments in 1977 and 1990. The Clean Air Act Amendments of 1990 proposed emissions trading, added provisions for addressing acid rain, ozone depletion and toxic air pollution, and established a national permit program. The amendments also established new auto gasoline reformulation requirements. The Clean Air Act requires EPA to set National Ambient Air Quality Standards for six common air pollutants. These common air pollutants are found all over the United States. They are:

- Particle pollution (often referred to as particulate matter)
- Ground-level ozone
- Carbon monoxide
- Sulfur oxides
- Nitrogen oxides
- Lead.

These pollutants can harm your health and the environment, and cause property damage. Air Pollution Trends: Pollutants are tracked in two ways: through the actual concentration at monitoring sites throughout the country and engineering estimates of the total tonnage released each year. Despite the progress made in the last 30 years, millions of people live in counties with data showing unhealthy air for one or more of the six common pollutants.

The National Environmental Policy Act (NEPA) requires federal agencies to consider the environmental impacts of their proposed actions and reasonable alternatives to those actions. To meet this
requirement, federal agencies prepare a detailed statement known as an Environmental Impact Statement (EIS). EPA reviews and comments on EIS’s prepared by federal agencies, maintains a national filing system, and assures that its own actions comply with NEPA.

**ENVIRONMENTAL IMPACT STATEMENT (EIS)**
Federal agencies are required to prepare environmental impact statements for major actions that significantly affect the quality of the human environment. Many, if not all states have enacted similar laws in order to protect the environment. Some of the issues that could be covered in an EIS would include:

- Air Quality
- Public Health and Safety
- Vegetation
- Wildlife
- Noise
- Sewer and water requirements
- Amount of energy anticipated consumption
- Population Density
- Traffic
- Employment
- Schools

An EIS is a full disclosure document that details the potential for positive or negative impact. Typically there are public hearings which are well publicized in order to give the affected community opportunities to have an input in the future project.

**ENVIRONMENTAL SITE ASSESSMENT (ESA)**
This is quite different from the Environment Impact Statement since it deals with the potential for hazards or concerns in the property. It is considered a “due diligence” audit which investigates any problems that might incur financial liability to the owner in the future. Lenders in particular want to know if there are any potential or current hazards before they agree to lend money. Buyers want to know that they will not be liable for an expensive cleanup. They need to have assurance they have met the “appropriate inquiry” elements of the Brownfield Act. The ESA must be done by an environmental engineer to assure protection. Potentially, there are three phases to an ESA.

**Phase I**: any real estate can be the subject of a Phase I ESA. It is a report prepared for real estate holdings which identifies the potential or existing environmental contamination liabilities. The analysis usually addresses both the underlying land and the improvements to the property. It is generally considered the first step in the process of environmental Due Diligence. If a site is considered contaminated, a Phase II Environmental Site Assessment may be conducted. This is a more detailed investigation involving chemical analysis for hazardous substances and/or petroleum hydrocarbons.

Residential property purchasers need only conduct a site inspection and chain of title survey.

**Actions triggering the Phase I ESA**

A variety of actions can cause a Phase I study to be performed for a commercial property, the most common being:

- Purchase of real property by a person or entity not previously on title
- Contemplation by a new lender to provide a loan on the subject real estate.
- Partnership buyout or principal redistribution of ownership
- Application to a public agency for change of use or other discretionary land use permit.
- Existing property owner’s desire to understand toxic history of the property.
- Compulsion by a regulatory agency who suspects toxic conditions on the site.
- Divestiture of properties
Asbestos-containing materials are not typically surveyed or sampled in a Phase I site inspection, but suspect building materials may be noted.

The most common tasks for almost all Phase I ESAs: An on-site visit to view present conditions (chemical spill residue, die-back of vegetation, etc); hazardous substances or petroleum products usage (presence of above ground or underground storage tanks, storage of acids, etc.); and evaluate any likely environmentally hazardous site history.

Some items looked at in the Phase I Environmental Site Assessments can include visual inspections or records review searches for:
- Asbestos Containing Building Materials
- Lead-Based Paint
- Lead in Drinking Water
- Mold
- Radon
- Wetlands
- Threatened and Endangered Species
- Earthquake Hazard
- Vapor Intrusion

**Phase II Environmental Site Assessment** is an investigation which collects original samples of soil, groundwater or building materials to analyze for quantitative values of various contaminants. This investigation is normally undertaken when a Phase I ESA determines a likelihood of site contamination. The most frequent substances tested are:
- Petroleum
- Hydrocarbons
- Heavy metals
- Pesticides
- Solvents
- Asbestos
- Mold

**Phase III Environmental Site Assessment** is an investigation involving remediation of a site. This study normally involves assessment of alternative cleanup methods, costs and logistics. This study is done with the approval of a regulatory agency. Generally, remediation means providing a remedy, so environmental remediation deals with the removal of pollution or contaminants soil, groundwater, sediment, or surface water for the general protection of human health and the environment or from a Brownfield site intended for redevelopment.

**GREENHOUSE GAS EMISSIONS AND GLOBAL WARMING**

Over the last many years we have been hearing about the effects of Greenhouse Gas Emissions and the impact on the earth. We are reminded of the consequences of Global Warning when we see the disintegration of icebergs and the impact on polar bears and other animals that live in cold climates. We learn about the loss of plants and trees, and the extinction of animals. In short, we are at a strategic point in time when we must seriously consider how to save our environment and the future of our planet, as we know it.

Throughout most of the history of humans, and certainly before they emerged as a dominant species, all climate changes were the result of natural forces. That changed with the Industrial Revolution. New agricultural and industrial practices began to alter global climate and environment. Before that time, human activity didn’t release many greenhouse gases, but with population growth, deforestation, factory farming and the widespread use of fossil fuels are creating an excess of greenhouse gases in the atmosphere and contributing to global warming.
Human activity has been a major force in contributing to climate change since the industrial revolution in the mid 1700’s. Scientists traditionally don’t claim findings are certain or absolute. Instead, they will state that it is “very likely” that a situation exists. This will indicate that there is still a possibility for additional research. However, when the statement “very likely” is used, it is generally accepted that there is 90% certainty.

Greenhouse gases, such as carbon dioxide accumulate in the atmosphere and trap heat that normally would exit into outer space. We need greenhouse gases to support life on earth, as we know it. These gases keep the Earth warm so that it can support life and occur naturally. Problems arise due to excessive human use of fossil fuels. This is the main source of excess greenhouse gases. By driving cars, using electricity from coal-fired power plants, or heating our homes with oil or natural gas, we release carbon dioxide and other heat-trapping gases into the atmosphere. Deforestation is another significant source of greenhouse gases. Fewer trees mean less carbon dioxide conversion to oxygen. Trees use carbon dioxide and give off oxygen in its place. This helps to create the necessary balance of gases in the atmosphere. As more forests are logged for timber or cut down to make way for farming, however, there are fewer trees to perform this critical function. Many rain forests throughout the world are being destroyed either to allow building for human use or for the harvesting of the trees commercially.

As the concentration of greenhouse gases grows, more heat is trapped in the atmosphere and less escapes back into space. This increase in trapped heat changes the climate and alters weather patterns, which may hasten species extinction, influence the length of seasons, cause coastal flooding, and lead to more frequent and severe storms. Our activity is increasing the concentration of greenhouse gases in the atmosphere at a rate that has probably never been seen before in the planet’s history. There is no serious scientific disagreement or debate on this point. If we do not act now to lower greenhouse gas emissions that contribute to global warming, we will have a planet that is unrecognizable in the not too distant future.

**THE GREENHOUSE EFFECT**

After 150 Years of Industrialization, climate change is Inevitable. The “greenhouse effect” often gets a bad rap because of its association with global warming, but the truth is we couldn’t live without it. Life on earth depends on energy from the sun. About 30 percent of the sunlight that beams toward Earth is deflected by the outer atmosphere and scattered back into space. The rest reaches the planet’s surface and is reflected upward as a type of slow-moving energy called infrared radiation.

As infrared radiation is carried aloft by air currents, it is absorbed by “greenhouse gases” such as water vapor, carbon dioxide, ozone and methane, which slows its escape from the atmosphere. Although greenhouse gases make up only about 1 percent of the Earth’s atmosphere, they regulate our climate by trapping heat and holding it in a kind of warm-air blanket that surrounds the planet. This phenomenon is what scientists call the "greenhouse effect." Without it, scientists estimate that the average temperature on Earth would be colder by approximately 30 degrees Celsius (54 degrees Fahrenheit), far too cold to sustain our current ecosystem.

**How Do Humans Contribute to the Greenhouse Effect?**

The greenhouse effect is an essential for life on earth. That is a given. However, as we have all experienced, sometimes too much of good thing is not good at all. Our actions are causing the natural needed warming to accelerate because we are creating more greenhouse gases than are necessary. Therefore, we are raising the temperature of the Earth beyond what be considered normal. Burning natural gas, coal and oil, including gasoline for automobile and truck engines raises the level of carbon dioxide in the atmosphere. Some farming practices and land-use changes increase the levels of methane and nitrous oxide. Additionally factories produce industrial gases that also contribute to the problems that we are encountering. Population growth is another factor in global warming, because as more people use fossil fuels for heat, transportation and manufacturing the level of greenhouse gases continues to increase. As more farming occurs to feed millions of new people, more greenhouse gases enter the atmosphere. Ultimately, more greenhouse gases mean infrared radiation trapped and held. This gradually increases the temperature of the Earth’s surface and the air in the lower atmosphere.
Today, the Earth’s temperature is increasing with unprecedented speed. During the entire 20th century, the average global temperature increased by slightly more than 1 degree Fahrenheit. Using computer climate models, scientists estimate that by the year 2100 the average global temperature will increase 2.5 degrees to 10.5 degrees Fahrenheit.

NOT ALL SCIENTISTS AGREE
Some scientists disagree with these findings. However, the majority of scientists, politicians, world and business leaders do not. No matter what path America chooses to address Greenhouse Gas Effect, success will require our elected officials, business people and the public at large to address the issue immediately. If we wait too long, it is possible, that we might not be able to reverse the negative impact GGE is having on our planet.

If we do not act now to lower greenhouse gas emissions that contribute to global warming, we will have a planet that is unrecognizable in the not too distant future.

The possible consequences of inaction include:
- Drought damage
- Floods
- Severe storms
- Fires
- Agricultural losses
- Rising energy demand

The costs of doing nothing far outweigh the costs of implementing a national climate policy. We must act now to avoid the devastating environmental, economic, agricultural and human affects that lie ahead if we do nothing to stop global warming.

What can we do? Simple everyday life changing activities can drastically help.

Eliminate the incredible waste attributed to PAPER. A recent study gauging the distribution of catalogs showed that about 17 billion catalogs were distributed in one year. That averages to about 64 catalogs for every man, woman and child. Paper manufacture is one of the most polluting and energy intensive industries. On average, an American uses over 700 pounds of paper each year. If we simply reduced the number of catalogs produced by 30% we would:
- Preserve approximately 16 billion gallons of water each year. This is the amount of water used by 170,000 households.
- Conserve huge amounts of oil
- Keep 3.5 million tons of CO2 out of the atmosphere. This is the amount of CO2 produced by 570,000 cars driven 200 miles/ week annually

Change the light bulbs we use from traditional bulbs to compact fluorescents. CF bulbs use about one-quarter of the energy an incandescent bulb to produce the same amount of light. To replace a traditional 60-watt bulb, we can use a 15 watt CF bulb. If everyone replaced even some of their traditional light bulbs with compact fluourescent ones we would be on our way to true energy conservation. There are some simple actions each of us can take to help the environment: We know all about them and have heard them over and over and over.

But the real question is “have we”?
- Fixed all leaky faucets?
- When replacing toilets get water efficient ones?
- Lower thermostats to conserve energy?
- Put thermostats on timers?
- Bought energy efficient appliances?.
- Driven our cars at a lower speed to increase mileage per gallon?
- Opened window blinds and drapes to take advantage of natural light and heat?
• Brought our own bags to grocery stores instead of using many dozens of new plastic ones each year?

So many little things each of us can do which when multiplied by the millions of people who live in the United States combine to make a significant impact on our environment. This impact can be a positive one if we do the right things and a horribly negative one if we continue doing all the things we have gotten used to.

Recently it was noted that the Wilkins ice shelf, a major one in the Antarctica is in a precarious state of collapse. It lost about 6% of its size or about 390 square miles in 1998 and has shed about 230 square miles recently.
In 1993 it was predicted that the Wilkens ice shelf would break in about 30 years. No one predicted that it would take less than half that time.

We are destroying our planet by burning fossil fuel such as gas, oil and coal and destroying forests. These activities have caused excesses of CO2 which is the major cause of global warming. Our levels are 25% higher than at any other period in recorded time.

**OZONE LAYER:** a layer in Earth’s atmosphere which absorbs approximately 98% of the ultraviolet rays. These ultraviolet rays have been known to cause damage to life on our planet. The ozone layer is a small part of the atmosphere and is located somewhere between approximately 10 and 20 miles above the Earth’s surface. Small as it may be, it is critical to life as we know it. The thickness of the ozone layer varies by location and season. Roughly 10 percent of the ozone layer is located in the area of our atmosphere that produces our weather.

**Ultraviolet radiation** is divided into three categories:
- **UV-A** - Most UV-A reaches the surface. It is far less harmful then the other two categories but can possibly result in genetic damage.
- **UV-B** radiation can be extremely harmful to the skin. It is the main known cause of sunburn. Excessive exposure can cause genetic damage, and result in problems such as skin cancer. Although the ozone layer screens out most UV-B; some still reaches the surface.
- **UV-C** is the most harmful to life. It is, however, entirely screened out by ozone.

As the ozone layer becomes depleted, more harmful radiation reaches the earth’s surface. This causes increased genetic damage to living creatures, as well as plants.

Ozone depletion became a problem when Chlorofluorocarbons were introduced. A common name for this chemical is the trademarked name “Freon”. Freon was used for many years as a coolant in air conditioning units in homes, office buildings and automobiles. CFC’s were used as propellants in spray cans.

Use of CFC’s were outlawed when it became known that they were destroying the ozone layer. It began to be phased out in most countries between 1987 and 1996 when it was completely banned.
Fortunately in 2003 it was determined that the damage to the ozone layer was slowing down. However, since CFC’s have a very long lifespan of between 50 and perhaps 100 years, the complete recovery will take many life spans.

Environmental issues inside the home are as varied as those outside. The first problem that we will discuss is:

**LEAD PAINT EFFECTS AND DISCLOSURE**
Lead paint is covered in depth in the Law of Agency chapter. It must be remembered that it is highly toxic and there are regulations regarding disclosure that the agent must be fully aware of.
**UREA-FORMALDEHYDE FOAM INSULATION (UFFI)** was developed in Europe in the 1950s as an improved means of insulating difficult-to-reach spaces in house walls. It is typically made at a construction site from a mixture of urea-formaldehyde resin, a foaming agent and compressed air. When the mixture is injected into the wall, urea and formaldehyde unite and "cure" into an insulating foam plastic. During the 1970s, when concerns about energy efficiency led to efforts to improve home insulation in Canada, UFFI became an important insulation product for existing houses. Most installations occurred between 1977 and its ban in Canada in 1980.

In the insulating process, a slight excess of formaldehyde was often added to ensure complete "curing" with the urea to produce the urea-formaldehyde foam. That excess was given off during the curing, almost entirely within a day or two of injection. Properly installed, UFFI might not have resulted in any problem. Unfortunately, however, UFFI was sometimes improperly installed or used in locations where it should not have. Enough complaints were received, particularly from people living in small, well-sealed homes, that authorities became concerned about possible health implications. The further use of UFFI was banned in 1980.

Houses with UFFI show no higher formaldehyde levels than those without it. However, if UFFI comes in contact with water or moisture, it could begin to break down. Wet or deteriorating UFFI should be removed by a specialist and the source of the moisture problem should be repaired.

There are newer versions of foam insulation that are perfectly safe.

Formaldehyde is a pungent, colorless gas commonly used in a water solution as a preservative and disinfectant. It is also a basis for major plastics, including durable adhesives. It occurs naturally in the human body and in the outdoor environment. Formaldehyde is used to bond plywood, particleboard, carpets and fabrics, and it contributes to "that new house smell." While small amounts of formaldehyde are harmless, it is an irritating and toxic gas in significant concentrations.

**POLYCHLORINATED BIPHENYLS (PCB’S)** are part of a group of man-made organic chemicals known as chlorinated hydrocarbons. PCB’s were manufactured from 1929 until 1979. They were banned after that year in the United States. They were an exciting discovery since they were non-flammable, chemically stable, had a high boiling point. They were excellent for their electrical insulating properties. PCB’s were used in hundreds of industrial and commercial applications including electrical, heat transfer, and hydraulic equipment. They were widely used in paints, plastics, and rubber products; in pigments, dyes, and carbonless copy paper; and many other industrial applications.

Although no longer commercially produced in the United States, PCB’s may be present in products and materials produced before the 1979 ban. Products that may contain PCB’s include:

- Transformers and capacitors
- Other electrical equipment including voltage regulators, switches, reclosers, bushings, and electromagnets Oil used in motors and hydraulic systems
- Old electrical devices or appliances containing PCB capacitors
- Fluorescent light ballasts
- Cable insulation
- Thermal insulation material including fiberglass, felt, foam, and cork
- Adhesives and tapes
- Oil-based paint
- Caulking
- Plastics

Today PCB’s can still be released into the environment from poorly maintained hazardous waste sites that contain PCB’s; illegal or improper dumping of wastes; leaks or releases from electrical transformers containing; and disposal of PCB containing consumer products into municipal or other landfills not designed to handle hazardous waste. They may also be released into the environment by
the burning of some wastes in municipal and industrial incinerators. Because PCB’s do not breakdown easily, they tend to remain in the environment for extremely long periods of time.

**WHAT IS RADON?**

- You cannot see radon
- You cannot smell it
- You cannot taste it.
- Yet, it may be a problem in your home.

Radon is a cancer-causing radioactive gas that is formed by the natural decay of uranium into radioactive particles. These particles can become trapped in your lungs when you breathe. As they break down further, small bursts of energy are released. Lung tissue damage could occur which could lead to lung cancer over the course of your lifetime. Not everyone exposed to elevated levels of radon will develop lung cancer.

Radon forms naturally from the ground all over the world, particularly in regions with soils containing granite or shale. Not all areas that contain granite and shale, however, have radon. The Surgeon General has warned that radon is the second leading cause of lung cancer in the United States today. If you smoke and your home has high radon levels, you are at high risk for developing lung cancer. Many thousands of deaths due to lung cancer has been attributed to radon.

**How Does Radon Get Into The House?**

Imagine a house as a chimney. As air is heated, it rises and as it cools it drops. This action creates suction at the lowest level of the house. This suction effect will pull the radon, when present, out of the soil. You may have noticed that on a cold day if you open a window on the top level of your home, the warm air rushes out. Conversely, if you open a window on the lowest level, the cold air will rush in. This circular motion or suction is what causes the radon to enter a house. There are no obvious symptoms that would make someone aware of the presence of radon. Symptoms will take many years of exposure to appear. Testing is the only way to be certain that it is or is not present.

The buyer must always be encouraged to do whatever testing and inspecting of the home they feel is necessary.

If a home has high concentrations of radon there are ways to reduce it to acceptable levels. Most radon problems can be fixed by a do-it-yourselfer for a few hundred dollars. These systems usually work by reducing radon to acceptable levels. There are professional certified radon mitigators in most states.

**ASBESTOS** is the name given to a number of naturally occurring fibrous minerals with high tensile strength, the ability to be woven, and resistance to heat and most chemicals. Because of these properties, asbestos fibers have been used in a wide range of manufactured goods, including roofing shingles, ceiling and floor tiles, paper and cement products, textiles, coatings, and friction products such as automobile clutch, brake and transmission parts.

From studies of people who were exposed to asbestos in factories and shipyards, we know that breathing high levels of asbestos fibers can lead to an increased risk of:

- **Asbestosis** – a serious, progressive, long-term non-cancer disease of the lungs. It causes scarring of the lung tissue making it difficult to breathe. There is no effective treatment for asbestosis.
- **Lung Cancer** – causes the largest number of deaths related to asbestos exposure. People who work in the mining, milling, manufacturing of asbestos, and those who use asbestos and its products are more likely to develop lung cancer than the general population. The most common symptoms of lung cancer are coughing and a change in breathing. Other symptoms include shortness of breath, persistent chest pains, hoarseness, and anemia.
- **Mesothelioma** – a rare form of cancer that is found in the thin lining (membrane) of the lung, chest, abdomen, and heart and almost all cases are linked to exposure to asbestos. This disease may not show up until many years after asbestos exposure. This is why great efforts are being made to prevent school age children from being exposed.
The risk of lung cancer and mesothelioma increases with the number of fibers inhaled. The risk of lung cancer is also greater if you smoke. Most people exposed to small amounts of asbestos, as we all are in our daily lives, do not develop these health problems. Presently, very few products still contain asbestos. Those that do, however, must be properly labeled if there is any possibility that the asbestos might be inhaled.

Prior to the 1970’s asbestos was a common material used in many building products including:
- Steam Pipes
- Boilers
- Furnace Ducts Insulated With An Asbestos Blanket
- Asbestos Paper Tape.

These materials may release asbestos fibers if damaged, repaired, or removed improperly. Resilient Floor Tiles (Vinyl Asbestos, Asphalt, and Rubber), Backing On Vinyl Sheet Flooring
Adhesives Used for Installing Floor Tile.
Sanding or scraping tiles or backing can release fibers. Improper removal of these products could cause health risks.

Other potential asbestos related health risks could occur if any of the following was still present or in use in a home and were improperly disturbed by cutting, or sanding, water damage, drilling and scraping to name just a few actions.
- Cement Sheets
- Millboard
- Paper Used As Insulation Around Furnaces And Woodburning Stoves.
- Insulation.
- Door Gaskets in Furnaces, Wood Stoves, and Coal Stoves.
- Worn Seals Can Release Asbestos Fibers During Use.
- Soundproofing Or Decorative Material Sprayed On Walls And Ceilings.
- Patching And Joint Compounds For Walls And Ceilings,
- Textured Paints.
- Asbestos Cement Roofing, Shingles, And Siding.
- Artificial Ashes And Embers Sold For Use In Gas-Fired Fireplaces.
- Fireproof Gloves,
- Stove-Top Pads,
- Ironing Board Covers
- Hairdryers.
- Automobile Brake Pads And Linings
- Clutch Facings
- Gaskets.

The list goes on and on because asbestos was considered an almost “miraculous” product until it was banned in 1977. Unfortunately, it may still be present. It is important to recognize that if asbestos is not disturbed and is in good condition, it will most likely cause no ill health related risks. Problems will arise when the asbestos begins to crumble, flake, become powdery or deteriorate. This is called friable asbestos.

When friable asbestos is disturbed fibers will enter the air and it has been known to be a carcinogen (cancer causing agent) Also, if it needs to be removed, it must be done by someone who is thoroughly educated in proper removal techniques. Asbestos removal should never be attempted by anyone not trained in its’ proper handling.
MOLD
We hear so much about toxic mold and buildings becoming uninhabitable as a result of mold growth. We read about litigation against builders and landlords and property manager, real estate brokers and salespeople and sellers. Unfortunately what is not necessarily well known are the causes and effects of mold.

Mold spores move through the air continually and reproduce. When mold spores land on a damp spot indoors, they may begin growing and digesting whatever they are growing on in order to survive. Molds grow when there is an excessive amount of water and moisture problems result. If the moisture is not removed, mold will begin to grow. It can be nourished by many different surfaces. There is no practical way to eliminate all mold and mold spores in the indoor environment. The only way to control indoor mold growth is to control moisture. Mold cannot grow without water or moisture.

ESSENTIAL MOLD INFORMATION
• Potential health effects and symptoms associated with mold exposures include allergic reactions, asthma, and other respiratory complaints.
• It must be cleaned immediately and the source of moisture has to be completely eliminated.
• Proper venting of bathrooms, clothes dryers and other moisture generating sources is necessary. This venting to the outside will dramatically decrease the potential for mold.
• Exhaust fans should always be used when cooking, dishwashing, and cleaning or other moisture producing activities are taking place.
• Clean and dry any damp or wet building materials and furnishings within 24-48 hours to prevent mold growth.
• Clean mold off hard surfaces with water and detergent, and dry completely. Absorbent materials such as ceiling tiles, that are moldy, may need to be replaced.
• Prevent condensation: Reduce the potential for condensation on cold surfaces (i.e., windows, piping, exterior walls, roof, or floors) by adding insulation.
• In areas where there is a perpetual moisture problem, do not install carpeting (i.e., by drinking fountains, by classroom sinks, or on concrete floors with leaks or frequent condensation).
• Molds can be found almost anywhere; they can grow on virtually any substance, providing moisture is present. There are molds that can grow on wood, paper, carpet, and foods. Wallpaper and paneling can harbor mold spores.
• Floods and flooding are responsible for a major portion of the growth of mold.

BASIC MOLD CLEANUP
Once mold appears, the only way to control it is to control the moisture and clean up the damaged areas. This needs to be done within 24 to 48 hours in order to prevent mold growth. Unfortunately there may be certain surfaces that cannot be completely dried before mold begins to grow. They will, most likely, have to be replaced. Carpeting and furniture and ceiling tiles would be typical examples.

Sensitivity to mold is extremely individual. Some people have no reaction and others extreme reaction. Typical symptoms when sensitivity exists includes:
• Nasal Stuffyness
• Eye Irritation
• Wheezing
• Skin Irritation
• Fever
• Shortness Of Breath
• Chronic Lung Illnesses
• Obstructive Lung Disease
• Mold Infections In Their Lungs
**ELECTROMAGNETIC FIELDS**

Electromagnetic radiation has been around since the birth of the universe; light is its most familiar form. It is a physical field produced by electrically charged objects. It affects the behavior of charged objects in the vicinity of the field and extends indefinitely throughout space. X-rays are high frequency electromagnetic radiation and are used in radio astronomy, radiography in medicine and radiometry in tele-communications. Other medical applications include laser therapy, which is an example of photo medicine. Applications of lasers are found in military devices such as laser-guided bombs, as well as more down to earth devices such as barcode readers and CD players.

EMF's are invisible lines of force created whenever electricity is generated or used. EMFs are produced by power lines, electric wiring, and electric equipment and appliances. Motors and heating coils found in electronic equipment and appliances are also producers. The frequency of EMFs is measured in hertz (Hz, or cycles per second). People are exposed to both electric and magnetic fields, but scientists are most concerned about magnetic fields. Because the use of electric power is so widespread, humans are constantly exposed to electric and magnetic fields. The few studies that have been conducted on adult exposures show no evidence of a link between residential EMF exposure and adult cancers, including leukemia, brain cancer, and breast cancer.

There is nowhere in our modern world that we can escape exposure to electric and magnetic fields because it surrounds all electric devices.

Some studies have shown that living in areas with high electromagnetic fields or working in industries which allow high exposure have shown an increased rate of leukemia and brain cancer. Other studies have not had the same results. What they have proven is that much more information must be gathered before any conclusions can be drawn.

**PESTICIDES**

The safety of our food supply is set through standards enacted and enforced by the Environmental Protection Agency (EPA). These standards limit the amount of pesticides that can legally remain in or on human or animal food sold in this country. Both domestic and imported foods are monitored by the Food and Drug Administration (FDA) and the U.S. Department of Agriculture (USDA) to ensure compliance with these safety standards. No matter how well our laws protect us, as individuals, we have a responsibility to protect ourselves by taking certain precautions. Simple things such as trimming meat and fish or carefully washing fruits and vegetables should always be done.

Because there is still some uncertainty regarding the long term effects of pesticides, exposure should be limited.

There are concerns that pesticides used to control pests on food crops are dangerous to people who consume those foods. These concerns are one reason for the organic food movement. Many food crops, including fruits and vegetables, contain pesticide residues after being washed or peeled. Chemicals that are no longer used but which are resistant to breakdown for long periods may remain in soil and water and thus in food.

Alternatives to pesticides are available and include methods of cultivation, use of other organisms to kill pests, genetic engineering, and methods of interfering with insect breeding. New pesticides are being developed, including biological and botanical derivatives and alternatives that are thought to reduce health and environmental risks.

**OTHER POTENTIAL INFESTATIONS**

Termites and carpenter ants are common in many homes and can cause a great deal of destruction if left untreated. Both of these problems can be eliminated if early detection and treatment begins. Most real estate transaction will require a termite infestation report.
Years ago the treatment of choice was chlordane. This insecticide and termiticide was banned in the early 1980’s because of the discovery that it could cause cancer. Chlordane was highly effective and it took some time before other effective treatments were developed. Today, there are many successful insecticides and termiticides available and many professionals to evaluate and treat these conditions.

**LIGHT POLLUTION**

Most of us don’t give much thought to the illumination that is all around us. We take it for granted. However, light pollution is excessive light created by humans. Just like any other form of pollution, it has negative effects. Light pollution disrupts ecosystems, can affect our health, prevents us from seeing the stars and can interfere with astronomers observatories.

Light pollution falls into two categories;

1. Annoying Light
2. Excessive Light

Annoying light intrudes in our lives. An example might be a neighbor’s patio lights that shine into our homes. Excessive light, generally indoors, can lead to discomfort and have an effect on health. Our lives have become industrialized and with that comes the resulting light pollution. Lighting outside a building, illuminated advertising, inside lighting in hallways, in factories and office buildings, brightly lit sporting stadiums and streetlights all contribute to pollution.

In recent years private spaceflight has become a reality and with it comes the possibility of space orbiting billboards. This potential problem is so real that the Federal Aviation Administration is seeking legislation to enforce a law prohibiting this type of advertising. Image looking up at the sky and seeing an advertisement for toothpaste! Not a very pleasant prospect.

Some people are more sensitive to lighting than others. One person may be perfectly comfortable with the lighting in an office and another quite uncomfortable. Street and highway lighting might be irritating to some and not to others. Excess lighting has been known to negatively impact vision, raise blood pressure cause headaches and some studies have shown that it might even cause cancer.

Excessive light causes problems for amateur astronomers because they might not be able to observe the sky from their own property. Most major professional observatories are surrounded by areas where there are strictly enforced restrictions on light emissions. Many cities have codes and standards for outdoor lighting so that residents are protected against light trespass. Both the Federal Aviation Administration (FAA) and the Federal Communications Commission (FCC) enforce light trespass laws.

**Over-illumination**

Studies have shown that approximately two million barrels of oil per day are wasted because of the excessive use of light. Further, energy audits provide data stating that approximately 30 to 60% of energy consumed in lighting is unneeded.

**Light Clutter**

Clutter refers to excessive groupings of lights. This might include poorly designed street lights coupled with brightly lit advertising. Light clutter can cause confusion or distraction and can contribute to accidents. Airplane pilots are sometimes distracted by advertising or street lighting when it can be confused with runway lights.

**DISRUPTION OF ECOSYSTEM**

Life exists with natural patterns of light and dark, so disruption of those patterns influences many aspects of animal behavior. Light pollution can confuse animals and change their life patterns. Algae might grow and kill plants that naturally protect our water. Moths and butterflies cannot navigate properly and plants that need to be pollinated at night could become extinct. Migrating birds can be disoriented by lights on tall structures. It is estimated that between 4 and 5 MILLION birds are killed each year after being attracted to tall towers by light. Turtles, frogs and salamanders are also effected by light. With excessive light exposure these species may not be able to reproduce and eventually will become extinct.
Reducing light pollution
We must all take some responsibility to reduce light pollution in order to improve our environment. By eliminating unnecessary illumination huge savings in the cost of energy and the improvement of our everyday lifestyle will result. By choosing light fixtures and bulbs properly we will eliminate wasting precious resources. Reducing light pollution will result in reducing air pollution which in turn will increase our quality of life.

SICK BUILDING SYNDROME (SBS)
An unusual term for a combination of ailments (a syndrome) associated with a work place or residence. Both new and remodeled buildings have been linked to SBS which is related to poor indoor air quality. In the majority of cases the causes are flaws in the heating, ventilation and air conditioning systems (HVAC). Other causes include organic compounds, mold, industrial chemicals being used without proper exhaust ventilation and lack of or improper air filtration. Chemical or biological contamination, toxic mold, improper or inferior lighting, lack of sunlight and artifical fragrances can all cause or contribute to SBS. Renovations and new construction is now being done with an awareness of the possibility of SBS.

SBS is usually suspected when an unusually large number of people become ill within a short span of time. Some sources insist that to be certain that SBS is the cause of the illness that symptoms disappear soon after building occupants go outside of the building. A problem with this rationale is that in some cases people are extremely sensitive to pollutants and may have long term effects. The owner of the sick building will see the symptoms in terms of high levels of illness and absenteeism, lower productivity, low job satisfaction and high employee turnover.

PREVENTION
The most obvious preventative measure would be a thorough inspection of the premises and then a complete modification plan of areas where pollutants are found to be present.

- Removal of pollutants
- Cleaning and modification of any storage facilities used for them
- Replacing water stained carpeting and ceiling tiles
- Adhering to smoking restrictions
- Use paints, adhesives, solvents, and pesticides in well ventilated areas, and only when the premises are not occupied by workers untrained in their use.
- Proper and Frequent Maintenance of HVAC systems

“SOME POINTS TO PONDER”
Perhaps the foregoing information seems to be inferring that we are living in a “doomsday” world. In fact, if we just leave things alone, then we are looking at a time in the not too distant future when we will not recognize this planet. However, if we are aware of the problems and implement the solutions, we are well on our way to a long and healthy life not only for ourselves, but for generations to come. So many people, licensees included never give much thought to PCB’s, radon, mold, asbestos, and many of the other topics we have discussed.

We know about the problems with lead because we must use the Lead information pamphlet. We may know about mold because it is a popular topic in the news and we have all heard of global warming. The question is, however, what are we going to do about these problems?

As a result of this course our hope is that each one of us will take the steps to make this planet a safe one for all the generations to come. We must realize the impact we make each day on the environment and strive to control our own actions, discuss the problems and solutions with friends and family and take whatever measures are necessary to keep the public informed.
CHAPTER 22 HUMAN RIGHTS AND FAIR HOUSING

KEY TERMS

<table>
<thead>
<tr>
<th>Americans with Disabilities Act</th>
<th>Familial status</th>
<th>Marital status</th>
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<tbody>
<tr>
<td>Blockbusting</td>
<td>Filtering down</td>
<td>Non-solicitation order</td>
</tr>
<tr>
<td>Cease and desist list</td>
<td>HUD/Department of Housing and Urban Development</td>
<td>Redlining</td>
</tr>
<tr>
<td>Civil Rights Act of 1866</td>
<td>Development</td>
<td>Steering</td>
</tr>
<tr>
<td>Disability or handicap</td>
<td>Jones vs. Mayer Supreme Court Decision, 1968</td>
<td>Testers</td>
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<tr>
<td>Fair Housing Act of 1968</td>
<td>Court Decision, 1968</td>
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</tbody>
</table>

In order to understand the need for fair housing laws, we must recognize how prevalent discrimination is in our lives. How many times during each day of each week of each month of each year, do we make a determination of the value of our fellow man by simply looking at him?

We look at others and based on the “package”, as I like to call it, that appears before us, we decide whether or not we want them in our lives.

The term “package” simply describes their visible appearance. Think in terms of receiving a gift package in the mail. Sometimes when the box is received, it arrives in less than perfect condition. Perhaps ripped or crumbled, however, when we open it, we find something wonderful that we will truly enjoy. People appear before us in a “package” What they look like has nothing to do with who they are. Who they are is contained in “the package” not in what it looks like

Do we like their skin color, their nationality, their religion, their age, their sex, etc. If these are the criteria we use to judge people it could prevent us from knowing who may be interesting, funny, compassionate and perhaps in the end a good friend, yet different from ourselves.

If we do like it then they are okay and we will let them in to our lives. If we decide that we don’t like what they represent, we ignore them, or worse, in some manner, let them know we don’t want them in any phase of our lives. What a terrible loss to simply discard a human being because of the color of his skin, or the language he speaks or the house of worship he chooses. The loss is really ours because we are preventing ourselves from the joy of learning about people we are not familiar with. Think of how you would feel if you knew that someone was judging you based on YOUR “package”.

In order to eliminate discrimination we need to learn about other races, religions, nationalities, lifestyles, etc. We need to understand that people in general are all looking for similar things, love, family, financial security, a successful career, peace, happiness, and anything else that fulfills our days and years.

None of us should determine whether another person is a valuable human being based on our definition of valuable. If we have the right to judge someone then doesn’t that give them the right to judge ourselves?

**IN FACT, EVERYONE IS A VALUABLE HUMAN BEING.**

We certainly can pick and choose who our friends are based on common interests, as long as we make that decision recognizing who is “inside the package” and not what the “package” looks like.

But, we cannot chose with whom we are going to work in the real estate profession, based on anything other than the type of housing they are looking for and the price they can spend. No matter how we feel about other races, religions, ethnicities, sexual orientations, or any other class covered under any law, we must treat every buyer, seller, landlord and tenant the same.
Everyone is entitled to be shown everything that would be of interest to them without regard to covered classes under the law. Owners must allow anyone who has an interest in their particular type of property in a particular price range, to view their property. In fact, probably the safest way to look at buyers or sellers is to understand that in business, the only color we can pay attention to is the color green, the color of money.

_IN THE BEGINNING_

The Declaration of Independence, **ADOPTED ON JULY 4, 1776** one of the most important documents ever written says that

**WE HOLD THESE TRUTHS TO BE SELF-EVIDENT, THAT ALL MEN ARE CREATED EQUAL, THAT THEY ARE ENDOURED BY THEIR CREATOR WITH CERTAIN UNALIENABLE RIGHTS, THAT AMONG THESE ARE LIFE, LIBERTY AND THE PURSUIT OF HAPPINESS. THAT TO SECURE THESE RIGHTS, GOVERNMENTS ARE INSTITUTED AMONG MEN, DERIVING THEIR JUST POWERS FROM THE CONSENT OF THE GOVERRED.**

This memorable document was meant to allow ALL people to pursue happiness as they saw fit, such as owning a home, or getting an education, or holding a job of their choice. Unfortunately, this was not to be so.

Article 1 of the U.S, Constitution, adopted in 1787 declared that slaves, only qualified as “three fifths” of a person when the population was counted to determine the states representation in Congress.

In 1857, the Dred Scott v Sanford, Supreme Court decision caused the rights of African-Americans to be diminished by declaring that no Black, free or slave, could claim to be United States Citizens. Additionally, **Blacks had NO RIGHTS THAT ANY WHITE HAD TO RESPECT.**

It also stated that Congress could not prohibit slavery in any United States territory. This Supreme Court decision fueled the fire that would ultimately result in a civil war. Slavery existed all during the Civil War which was fought between 1861 and 1865. In 1865, after the end of the Civil War Congress passed the thirteenth amendment to the Constitution which banished slavery altogether.

Finally, in 1866 the well known **Civil Rights Act of 1866** was passed. This Act provided the following:

**ALL CITIZENS OF THE UNITED STATES, SHALL HAVE THE SAME RIGHT, IN EVERY STATE AND TERRITORY, AS IS ENJOYED BY WHITE CITIZENS THEREOF TO INHERIT, PURCHASE, LEASE, SELL, HOLD AND CONVEY REAL AND PERSONAL PROPERTY.**

Although the federal Fair Housing Act exempts some housing, the 1866 Civil Rights Act (Reconstruction Act) prohibits racial discrimination in all housing, regardless of the number of units. This law is not enforced by any federal agency, but requires any people who feel they have been discriminated against to file a federal lawsuit. In order to have standing under the 1866 Act, the issue must involve the making of a contract or the right to do so, but intimidation, failure to make a reasonable accommodation, or preferential advertising are examples of discrimination that do not involve making contracts and are covered. The 1866 Act does not cover all classes of persons covered by the Fair Housing Act, such as those with disability or families with children

It wasn’t until the Fourteenth Amendment to the United States Constitution in 1868 that African-Americans were given full citizenship and civil rights. Another result of the Fourteenth Amendment was that all people would be guaranteed due process and equal protection under the law.

Unfortunately, for the next 100 years or so, very little attention was paid to this Act and discrimination was rampant throughout the United States of America. In part this occurred because many courts read the law as saying that only public or governmental discrimination was covered. Private property was not included.

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Finally, in 1968 the Supreme Court famed Jones vs. Mayer decision underscored that all discrimination which was race based was illegal. Not just public or government housing was covered, but private as well. Most laws enacted prior to this time only dealt with public sales, governmental or municipal. Jones vs. Mayer brought discrimination lawsuits to a more important level, private sales.

Joseph Jones, a black man, wanted to buy a home in a subdivision in St. Louis. The developer refused to sell to him because of his race. Mr. Jones finally had his case heard in the Supreme Court in 1968. The Court decided that since the Civil Rights Act of 1866 specifically states that “all citizens shall have the same rights as white citizens to own and dispose of real and personal property”, that Jones had been denied his rights.

Interesting in this case is that one of the judges remarks that anyone is entitled to choose not to live near a black family, but no one can prevent a black family from living where they want to. This Act is still considered the basis for many fair housing lawsuits today.

As we have already discussed, Fair Housing laws allow for some exceptions in owner occupied 1 or 2 family homes, however, where race is concerned there are no exceptions based on the Supreme Court upholding of the Civil Rights Act of 1866, upheld under Jones vs. Mayer.

EXAMPLE: the landlord living in a two family house has the right to choose to whom he will rent the other apartment. He can limit the new tenant based on any class except race. He can decide that he will only accept a single tenant, or a married couple, with or without children. He can decide that his new tenant must speak the same language he does, or go to the same house of worship. What he cannot do is exclude a member of any race. While some exclusions can be legal, there are no exclusions based on race.

In 1896, the Supreme Court decision known as Plessy vs. Ferguson allowed “separate but equal” status for everything from public housing, schools to any public accommodation. This decision ultimately resulted in anything but “separate but equal”. Housing and schools became totally segregated and ultimately unequal.

Another all important Supreme Court decision was in 1948 in Shelley vs. Kramer. This underscored that any covenant that was racially restrictive violated the Fourteenth Amendment.

Buchanan vs. Worley passed in 1917 was another landmark case. In this decision, the common practice of limiting where minorities could live was outlawed. Prior to its’ passage, it was common for cities to designate specific areas for specific groups such as the “Italian area” or the “Irish area” or the “black area”. Although these actions were no longer legal, they continued for many years.

Eventually, the 1954 landmark Brown vs. The Topeka Board of Education Supreme Court decision led to the desegregation of schools. This ruling outlawed the separation of races in schools and ultimately, was followed by several other rulings outlawing separation based on race. The Supreme Court ruled that any form of government sanctioned segregation violated the Fourteenth Amendment.

Executive Order 11063 known as “Equal Opportunity in Housing” was issued by then President John Kennedy on Nov. 20, 1962. While this was a well intentioned Order, it did not have any major impact since there was no provision for enforcement. When laws are passed with no provisions for enforcement, fines or other penalties as an example, they have little or no meaning. This order states that there will be no discrimination in the sale, rental, or use of all residential property that was owned, operated or financed by the federal government.
THE CIVIL RIGHTS ACT OF 1964 prohibited discrimination in public accommodations in all federally assisted programs as well as in employment. The only basis for prohibited discrimination under this law was race, color, religion, sex and national origin.

In 1966 President Lyndon Johnson saw a real need for definitive legislation. This legislation was debated over and over again for almost 3 years. No action took place.

The KERNER COMMISSION REPORT was published by the Commission on Civil Disorders on March 1, 1968. This report underscored that the United States of America was in fact, unequal. There was a clear indication that this country was divided into two distinct societies, one black and the other white. The Senate passed an amended version of the Fair Housing Bill on March 11, 1968 but there was almost no hope that the bill would pass the House of Representatives.

The untimely death of Dr. Martin Luther King on April 4, 1968 lead to the passage of the CIVIL RIGHTS ACT OF 1968 which is more commonly known as THE FAIR HOUSING ACT OF 1968 on April 11, 1968.

While this Act was praised at the time, it ultimately turned out to be totally ineffective in ending discrimination in housing because there were not enough areas of enforcement to make it work as planned. The law prohibited discrimination based on race, color, religion, and national origin. It did not include other classes that are equally or more important. Among them, age, marital status, familial status, sex and disability or handicap.

Sexual discrimination became a covered class in 1974 when Congress passed the HOUSING AND COMMUNITY DEVELOPMENT ACT. While discrimination based on sex was prohibited along with sexual harassment, sexual orientation was not a covered class. Therefore, while a male or female could not be discriminated against, their sexual preference was an area where they COULD be discriminated against.

Perhaps the single most important development in Fair Housing occurred in 1988 when the FAIR HOUSING AMENDMENTS ACT was passed.

Classes protected under this law include

- Familial status
- Families with children, and people with:
- Mental and physical handicaps
- Sex
- Familial status (including children under the age of 18 living with parents or legal custodians, pregnant women, and people securing custody of children under the age of 18)
- Handicap (disability)

Among the sanctions included in this important Act was that a person could collect an award not only for actual damages done to them but also for emotional damages including embarrassment, humiliation, inconvenience and mental anguish. Another important factor was that the limit of $1000.00 was no longer allowed in Federal District Court cases.

Title VIII of the CIVIL RIGHTS ACT OF 1968 (FAIR HOUSING ACT), as amended, prohibits discrimination in the sale, rental, and financing of dwellings, and in other housing-related transactions, based on race, color, national origin, religion.

The ARCHITECTURAL BARRIERS ACT OF 1968 requires that buildings and facilities designed, constructed, altered, or leased with certain federal funds after September 1969 must be accessible to and useable by handicapped persons.

The AGE DISCRIMINATION ACT OF 1975 prohibits discrimination on the basis of age in programs or activities receiving federal financial assistance.
TITLE IX OF THE EDUCATION AMENDMENTS ACTS OF 1972 prohibits discrimination on the basis of sex in education programs or activities that receive federal financial assistance.

Over the years there have been many other Executive Orders with clarified, simplified and added to laws covering education, housing, and other activities regulated by governmental agencies. How amazing, that after all these years, and the passage of all these laws and statutes and orders, discrimination still exists.

Let us now review the most important federal laws and the classes covered.

- Civil Rights Act of 1866, race only
- Civil Rights Act of 1964, non discrimination in FHA or VA loans. Did not include other types of financing for housing
- Fair Housing Act of 1968, prohibits discrimination in the areas of race, color, religion and national origin.

FEDERAL FAIR HOUSING LAW EXEMPTIONS
Although there are several exceptions to Fair Housing laws, there is never an exception for race. Also, a licensee in New York State can never participate in a discriminatory action even if it is exempt under the law.

NEW YORK FAIR HOUSING LAWS
It is important to keep in mind that when the Federal Government was enacting laws, it gave states the right to implement stricter laws if the desired to do so.

New York Human Rights Laws include the following:
- Race
- Color
- Religion
- National Origin
- Sex
- Disability
- Familial Status
- Age
- Marital Status
- Sexual Orientation

New York City Commission on Human Rights has added alienage or citizenship, and lawful occupation to the New York State law. Keep in mind that states, counties, cities and municipalities can add protected classes to the federally protected ones. Therefore, it is important to realize that in New York City and State, there are categories that are not covered under federal law, but which are protected in this city and or state.
It is easy to remember which categories are covered under which laws by studying the following chart.

<table>
<thead>
<tr>
<th>PROTECTED CATEGORY</th>
<th>FAIR HOUSING ACT OF 1968 FEDERAL LAW</th>
<th>N Y STATE LAW</th>
<th>NY CITY LAW</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGE</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>CITIZENSHIP</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
</tr>
<tr>
<td>COLOR</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
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<tr>
<td>FAMILIAL STATUS (CHILDREN)</td>
<td>YES</td>
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<td>YES</td>
</tr>
<tr>
<td>DISABILITY</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>MARITAL STATUS</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>MILITARY STATUS</td>
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<tr>
<td>NATIONAL ORIGIN</td>
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<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>OCCUPATION, SOURCE OF INCOME</td>
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<td>YES</td>
</tr>
<tr>
<td>PARTNERSHIP STATUS</td>
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</tr>
<tr>
<td>RACE</td>
<td>YES</td>
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<td>YES</td>
</tr>
<tr>
<td>RELIGION</td>
<td>YES</td>
<td>YES</td>
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</tr>
<tr>
<td>SEX</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>SEXUAL ORIENTATION</td>
<td>NO</td>
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<td>YES</td>
</tr>
</tbody>
</table>

It is an unlawfully discriminatory practice for the owner, lessee, sub-lessee, assignee, or managing agent of, or other person having the right to sell, rent or lease a housing accommodation, constructed or to be constructed, or any agent or employee thereof to:

To refuse to sell, rent, lease or otherwise to deny or withhold from any person or group of persons such a housing accommodation because of the race, creed, color, national origin, religion, sexual orientation, military status, sex, age, disability, marital status, or familial status of such person or persons, Simply put, not permitting someone to see a property, or not presenting offers on a property because of any of the covered classes is **DISCRIMINATION**.

Remember, the term **STEERING** refers to deliberately showing or not showing a prospect a property in a particular area based on their race, religion, creed, color, or any of the other protected classes under the law.

To represent that any housing accommodation or land is not available for inspection, sale, rental or lease when in fact it is available.

**EXAMPLE:** After showing a rental property to a mixed race prospect, the landlord calls and tells you he will not accept them as tenants. If you tell them that the property has been rented to someone else instead of telling them the truth, no matter how hurtful that might be to them, you are guilty of
participating in a discriminatory action. In this example, we must tell the prospect the truth. We are required to advise the landlord that what he proposes is illegal under Fair Housing laws. If the landlord persists in his discriminatory behavior, we can no longer show the property.

To discriminate against any person because of race, creed, color, national origin, religion, sexual orientation, military status, sex, age, disability, marital status, or familial status IN THE TERMS, CONDITIONS OR PRIVILEGES of the sale, rental or lease of any housing accommodation

EXAMPLE: the landlord tells you that the rent for an apartment is $1000 per month as long as it is just a couple. In the event they have any children, there would be an additional $50.00 per month rent. Once the landlord sets the rent on the apartment, he cannot change the terms based on the number of legal occupants.

To print or circulate or any statement, advertisement or publication, or to use any form of application for the purchase, rental or lease of housing accommodation or to make any inquiry in connection with the prospective purchase, rental or lease of such a housing accommodation which expresses, directly or indirectly, any limitation, specification or discrimination as to race, creed, color, national origin, religion sexual orientation, military status, sex, age, disability, marital status, or familial status, or any intent to make any such limitation, specification or discrimination.

EXAMPLE: advertising which limits the possible tenant to “married couple”, “no children”, “English speaking only” would be just a few of the advertising phrases that is not permitted. An application for housing which asks for marital status or number of children or ages of children is not permitted.

EXAMPLE: we cannot be a party to any ad that would specify any of the covered classes. We are not permitted to include words like, couple preferred, or suitable for one person only, if in fact it could easily be home to a couple. It is very important that the licensee look over any applications that they are using to be sure that discriminatory questions are not included. Asking about age, or marital status or number and age of children are specifically prohibited. It is quite permissible to ask “how many people will be living in the apartment?”

There is a limited exception when a two family home, often referred to as a “duplex” has one unit occupied by the owner or a direct member of his family. In this limited situation, the owner is free to discriminate in any category other than race.

Another exception regards the restriction of the rental of all rooms in a housing accommodation to individuals of the same sex. Example: the owner wishes to restrict the rental of rooms to females only, this would be permitted. Example: the owner, a female, lives in the house and only wants other females. This would be permitted.

A community may limit sales to residents of at least 55 years of age. Only one owner must fall into this category and 80% of the units are covered. These are referred to as “pre-retirement communities”.

Just as the public is prohibited from discrimination, the same applies to licensed real estate brokers, associate brokers and salespersons. We need to be careful when the public makes it a condition of representation that we will be a party to a discriminatory action that we renounce the opportunity to represent them. Remember, we cannot participate in any discriminatory activity.

EXAMPLE: we know, of course, that it is illegal to choose to show prospects to or away from any property based on any of the covered classes. In order to avoid any chance of being accused of discrimination, we show the buyer all houses available, but when he makes an offer, we do not notify the seller because we know the seller does not want to sell to someone of the buyer’s nationality. This is just as illegal as not showing the house in the first place.
EXAMPLE: we show an apartment for rent to a mixed race couple. They tell us they would like to rent it and come back into our office to begin the paper work. When we return there is a message from the landlord that he will not rent to this couple because they are of mixed race. We decide that we want to protect the renters from any feeling of discrimination so; we tell them that the apartment was already leased and we didn’t know about it. Further, we tell them that we would be delighted to show them other apartments. This is not permitted because we are participating in a discriminatory action by agreeing with the landlord that we will deprive this tenant of the opportunity to live where they want. In fact, we have an obligation to notify the landlord that he is guilty of discrimination and that we will have nothing more to do with the leasing of any of his apartments. We must, of course, also tell the tenant the truth, that the landlord was denying him his rights to live in this apartment.

A real estate board or organization may not make a provision of membership that a person is from a specified class in order to join the board and certain classes will not be accepted.

RELIGIOUS ORGANIZATIONS
Any religious or denominational institution or organization, or any organization operated for charitable or educational purposes, which is operated, supervised or controlled by or in connection with a religious organization, can limit employment or sales or rental of housing accommodations or admission to or giving preference to persons of the same religion or denomination.

EXAMPLE: a church may construct apartments to be occupied only be members of that church. There can be no race restrictions. However, a licensee cannot participate in the construction or marketing of the property.

PERSONS WITH DISABILITIES
It is an unlawful discriminatory practice for the owner, lessee, sub-lessee, assignee, or managing agent of, or other person having the right of ownership of or possession of or the right to rent or lease housing accommodations to deny housing to a person with a disability or handicap.

The definition of the word Handicap as it relates to this is as follows: A physical or mental impairment which substantially limits one or more of the persons’ major life activities. Major Life activities would include such functions as caring for one’s self, performing manual tasks, walking, seeing, hearing, speaking, breathing, learning and working. A mental impairment would include any psychological or mental disorder such as mental retardation, organic brain syndrome, emotional or mental illness or specific learning disabilities. The current illegal use of drugs or alcoholism is not covered. Also, no housing need be made available to someone who might cause a threat to the health or safety of other residents.

The owner of the property must permit the tenant to make reasonable modifications to the premises so that they receive the “full enjoyment” to which they are entitled. The landlord may require the premises be returned to its original condition upon the tenant vacating the premises. The renovations will be at the expense of the tenant.

EXAMPLE: a person using a wheelchair requires that the bathroom be made handicap accessible. The tenant makes the modifications at his own expense. The landlord has the right to demand that the bathroom be restored to its’ original condition when the tenant vacates the apartment.

EXAMPLE: the laundry room is down 2 steps from the lobby. The tenant can expect the landlord to build a ramp so that he may use the facility as long as the building of the ramp would be considered “reasonable”. If there would be a necessity for extraordinary demolition of walls or repositioning of doorways, this might not be considered “reasonable”.

EXAMPLE: one of the children of the person who signs the lease has a disability. Reasonable accommodations must be made for that person even though they are not a party to the lease.
To refuse to make reasonable accommodations in rules, policies, practices is also illegal.

**EXAMPLE:** if the building has a policy of no pets, a person using a seeing eye dog or other “service animal” must be permitted to have it.

**EXAMPLE:** a building has a restriction against any kind of wheeled cart being brought through the main lobby. Use of these carts must be through the service entrance. If a person is in a wheelchair or using any other device to assist him as a result of a handicap or disability, they must be permitted to use the main lobby.

In connection with the design and construction of covered multi-family dwellings for first occupancy after March 13, 1991, the design and construction of dwellings must be in accordance with the accessibility requirements for multi-family dwellings found in The New York State Uniform Fire Prevention and Building Code to provide that:

All the doors are designed in accordance with the New York State Uniform Fire Prevention and Building Code to allow passage into and within all premises and are sufficiently wide to allow passage by persons in wheelchairs; and

All premises within covered multi-family dwelling units contain an accessible route into and through the dwelling; light switches, electrical outlets, thermostats, and other environmental controls are in accessible locations; there are reinforcements in the bathroom walls to allow later installation of grab bars; and there are usable kitchens and bathrooms such that an individual in a wheelchair can maneuver about the space, in conformity with the New York State Uniform Fire Prevention and Building Code.

**EXAMPLE:** the buttons on each floor to call the elevator must be at a height accessible to someone in a wheelchair.

**EXAMPLE:** there must be a light in the elevator indicating the arrival at a floor. This would assist hearing impaired occupants.

**EXAMPLE:** there must be a bell sound in the elevator indicating the arrival at a floor. This would assist sight impaired occupants.

**FAMILIAL STATUS**

About ten years before the passage of the 1988 Fair Housing Amendments Act, a study showed that there was an enormous amount of discrimination that impacted on families with children. Families with children of a certain age were barred from some housing. Besides not having housing made available, many families were charged higher rents or additional security deposits based on the number of children in the family. Once the 1988 Act was passed, it became as unlawful to discriminate against families as it was to discriminate against race.

**EXAMPLE:** a landlord might not allow families with children under the age of 10 to live in his building. The landlord might have thought this was a fair way to protect the other families living in the building from the noise that young children might make. Noise laws are frequently enacted under already existing laws and any tenant for any reason who violates these laws might have legal action brought against them.

Landlords still have the right to protect their property and the right of quiet enjoyment of other residents. Therefore, a family could be evicted if the children made unreasonable noise or in any way destroyed the property of the landlord.

Property owners could also have health and safety laws to protect all residents. A landlord would have reasonable expectations that a tenant would not throw trash out a window or down a stairwell. They
could also, certainly, expect a tenant to keep their apartment in reasonably clean condition. This would be expected of all tenants with or without children.

Again, familial status refers to the makeup of the family including the children either natural born, adopted or in custodial care. It also protects pregnant mothers.

**OTHER PROHIBITED DISCRIMINATORY PRACTICES**

It shall be considered a discriminatory act to deny access or membership or participation in any multiple listing service, real estate broker organization or business or facility relating to the business of real estate based on race, color, sex, religion, handicap national origin or familial status.

**EXAMPLE:** a multiple listing service cannot refuse to allow a broker of a minority group to join the service.

**EXAMPLE:** the service cannot refuse to accept a listing because it is in a part of town that is integrated or has a majority of residents of a particular covered class.

**Refusing to accept or give consideration to or negotiate an offer from anyone covered by any of the classes referred to:**

**EXAMPLE:** an offer comes in from a single mother, or member of any other protected class. The owner of the home only wants to allow traditional families (married couples) to buy his home. The agent does not present the offer to the owner fearing that it will anger the owner. Instead, he tells the prospect that his offer has been turned down and no counter-offer has been made. This, of course, is not permitted. As a matter of fact, the agent has a responsibility to advise the owner that he is guilty of a discriminatory action and the office can no longer offer that property for sale.

**Not doing maintenance or upkeep or repairs in residences occupied by members of protected classes.**

**EXAMPLE:** the landlord is trying to prevent a tenant from considering a new lease after the current one expires. He tells the superintendent not to do any repairs or maintenance. He knows that if he doesn’t offer the tenant a new lease it could be assumed that he is discriminating so, instead, he wants the tenant to decide on his own not to renew the lease based on poor maintenance. This action is as discriminatory as actually telling the tenant their lease will not be renewed because of their national origin.

**Prohibiting or preventing the use of facilities in residences occupied by members of protected classes.**

**EXAMPLE:** not permitting children under the age of 10 to use the pool even though they are accompanied by a parent or guardian.

**Putting code words or symbols or notes of any type on listings to encourage or discourage the availability to any member of a protected class**

**EXAMPLE:** the broker devises a code to identify certain covered classes such as: a. married couple, b. Unmarried couple, c. No children, d children under the age of 10, e. African American, f. Jewish, g. Muslim, etc. He then instructs his salespeople to “code” all their listings so they can identify groups of people who might not be welcome in that area.

The real estate licensee has an obligation to assist in the education of the public of the laws of fair housing. Such laws exist on both state and federal levels.

Fair housing means simply that all people have the same right to choose where they want to live with the only limitation being their ability to afford it. If you are asked to provide details on race, national origin, familial status, or any other information regarding any of the protected classes, the only pertinent criteria is whether the buyers, sellers or tenants can fulfill the terms of the lease or contract.
Providing the seller with a qualified buyer or providing the building owner with a qualified tenant is all that should matter.

**EXAMPLE:** a buyer wants to know the racial makeup of the community before they decide to look for a home there. We do not have the right to supply them with information regarding any of the covered classes under the law. The public can certainly do whatever investigating they want, but we cannot assist them.

When interviewing buyers, sellers, landlords or tenants, any questions regarding any of the covered classes must be strictly avoided.

Remember we may not refuse to sell, rent, lease or otherwise deny to or withhold from any person or group of persons land or commercial space because of the race, creed, color, national origin, religion, sexual orientation, military status, sex, age, disability, marital status, or familial status or any other protected category of such person or persons, or to represent that any housing accommodation or land is not available for inspection, sale, rental or lease when in fact it is so available.

**The Fair Housing Amendments Act of 1988** strengthens the enforcement authority of the U.S. Departments of Justice (DOJ) and Housing and Urban Development (HUD). Parties filing complaints as well as respondents can choose who will decide their case: either a jury or judge in a U.S. District Court or an administrative law judge employed by HUD. Prior to enactment of the law, HUD only had the authority to conciliate conflicts between a landlord or broker and the tenant or home buyer charging discrimination. Now, HUD is authorized to bring fair housing complaints before its own administrative law judge. Or, under the trial option, HUD will refer complaints to the DOJ. If the aggrieved party, the respondent or HUD elects a trial in federal district court.

Victims of AIDS fall within the statutory protection afforded to handicapped individuals. According to HUD, real estate agents must not make unsolicited statements about occupants with AIDS, and, if asked by a buyer, they have no obligation to respond. National Association of REALTORS advises members not to answer such questions on the basis that the questions are irrelevant to the sale, and that answering them may violate the law.

There may be people who would prefer to “live among their own”, but we cannot assist them in seeking housing that would fulfill their requirements. Some agents have felt that by not being permitted to answer questions asked of them by the public with regard to any of the covered classes they may be seen as not being helpful. No matter what the perception of the public might be, we, the licensee, must exercise every precaution to avoid any discussion that could be seen as discriminatory.

The New York Executive Law prohibits discrimination because of race, creed, color, national origin, age, marital status or sex by brokers, salesperson, employees or agents thereof in selling or renting housing or commercial space covered by the law and in advertising the sale or rental of any housing or commercial space.
New York City Human Rights Commission has added the category of "domestic partner" to classes covered under fair housing laws, as well as alienage or citizenship and lawful occupation and income.

“Domestic partner” refers to two people who are not married but share housing, bank accounts, and lifestyle.

**BLOCKBUSTING**
Moreover, under a rule put forth by the Secretary of State, licensed real estate brokers and salespersons are prohibited from engaging in the practice of "BLOCKBUSTING" - the solicitation of the sale or lease of property due to a change in the ethnic structure of a neighborhood.
**EXAMPLE:** using scare tactics to convince sellers to sell their homes at less than market price because members of a particular nationality are moving in.
CEASE AND DESIST
Groups of property owners can determine that they don’t want licensees to contact them regarding the sale or listing of their homes. In that case, the Secretary may issue an order to real estate brokers and salespersons requiring them to CEASE AND DESIST from such solicitation. Failure to comply could cause the license of the broker or salesperson, to be subject to suspension or revocation after hearing. Cease and desist areas are designated by the Dept. of State. Homeowners in those areas may request that their names be added to the list so that they are not in receipt of any form of solicitation from licensees. This list is made available to all licensees for a nominal fee twice each year.

Solicitation includes but is not limited to, mailing or hand delivering any material. Placing written material on the windshield of cars parked in the designated driveway, telephone calls and door knocking.
The Dept. of State will take appropriate action against any offender.

In addition, no broker or salesperson may, either directly or by implication, encourage or discourage the purchase of property by referring to the race, color, religion, age sex or national origin of persons living in or near or moving into or near to any particular neighborhood.

Except with regard to senior citizens housing, subsidized, insured, or guaranteed by the federal government, it is illegal to discriminate in the rental of housing on the basis that the prospective tenant has or may have a child or children and no broker or salesperson may participate in such discrimination.
The Department of State is extremely strong in its’ rules and regulations in the principle that discrimination is against public policy and that licensees, in their activities must abide by the law of the State.

PRACTICES SPECIFICALLY PROHIBITED BY STATE OR FEDERAL LAW
Steering - choosing houses based on any area covered under anti-discrimination laws, rather than on the price and type of housing desired. Showing one group people houses in one location and another group in a different location because of their race, religion, national origin, etc. There has been some recent discussion regarding the ability of buyer agents to show property based solely upon the preference of the buyer. This, however, is strongly frowned on by HUD and could result in serious consequences.
Blockbusting - Panic selling brought about to try to force the sale of houses by telling sellers that so called undesirable people are moving into a neighborhood.
Redlining - a bank making decisions not to lend in certain geographic areas because of the makeup of the community. Further, banks may not change their lending practices based on any of the covered classes under the law.
EXAMPLE: changing the way credit for an African American applicant is looked at, or offered, as opposed to a white applicant. The African American needs a larger down payment, or is required to pay more points. The interest rate is higher in the one case than in the other.

MEGAN’S LAW
This was enacted in 1996 and required convicted sex offenders register in a public registry so that anyone could easily find out if such a person lived in their neighborhood. Those required to register would include sex offenders convicted in any state.

Based on the Glazer vs LoPreste case, licensees who are seller’s agents are not required to volunteer information about sex offenders. However, if a direct question is asked, the agent should tell the buyer where they can access the information. In the event the agent is a BUYER BROKER, because of the fiduciary relationship, they would have to disclose the information.

UNLAWFUL QUESTIONS
Many seemingly innocent questions that agents ask buyers are in fact not permitted. Often, the agent asks some of these questions as a way of getting to know the new buyer in order to get a better idea of
what they might be interested in owning. In fact, no matter how innocent the reason for the question, it is not permitted to ask any of the following:

**Subject: Age**  
Lawful Question: None  
Unlawful Questions: how old are you? What is your date of birth? What are the ages of your children?

None of these questions will be permitted because we are not permitted to make a housing decision based on the age of anyone who might be living in apartment or house unless the housing falls into any of the exceptions allowed under the law.

**Subject: Disability**  
Lawful Questions: None  
Unlawful Questions: Do You Have A Disability? Have You Ever Been Treated For Any Disease That Might Cause A Disability? Do You Now Have, Or Ever Had A Drug Or Alcohol Addiction? What Caused You To Be In A Wheelchair?

**Subject: Marital Status**  
Lawful Questions: None  
Unlawful questions: are you married? Are you divorced? Have you ever been married or divorced? Are you living with or separated from your spouse? What is the name of your spouse?

**Subject: Familial Status**  
Lawful Question: how many people will be living in the apartment?  
Unlawful Questions: how many children do you have? How old are your children? Are your children boys or girls? Are any of the children adopted?

**Illegal Action By Landlord:** charging additional rent for children. Once the rent has been established, the landlord cannot charge more because of the number of people living in the apartment. He does, however, have to limit the number of people living in the apartment according to zoning laws and restrictions. Typically, 2 people per bedroom is a generally accepted rule of thumb. The bedroom must be large that 80 square feet. This may vary, however, based on local zoning laws.

**Subject: National Origin**  
Lawful Questions: None  
Unlawful Questions: what country were you born in? What country does your husband come from? Were your children born in the united states? Where are your parents from?

**Subject: Race Or Color**  
Lawful Questions: None  
Unlawful Questions: you have an interesting skin color, are you mixed race? The landlord wants to know what prospective tenant looks like, so we need a picture of you and you’re family to submit along with your application. If you don’t have a current picture of everyone, i will be glad to take one of all of you now. Shall we go inside to take the picture?

**Subject: Religion**  
Lawful Questions: None  
Unlawful Questions? Is there a particular house of worship you would like to be near? What religious holidays do you and your family celebrates? I know that you are going to be comfortable in this neighborhood because i believe that there are many people living here who have the same religious beliefs that you do. You are, Muslim aren’t you? Since the ad said that this house is walking distance to a Jewish synagogue I gather you are Jewish, am i correct? This house is in walking distance to the catholic church, would that be helpful to you and your family? This neighborhood is really fun to live in.
they have a local Easter egg hunt for the children in the neighborhood who belong to the local church.
will you be participating in the egg hunt?

Subject: **Sex**
Lawful Questions: None
Unlawful Questions: is the person who is going to live in this apartment a man or a woman?

It is unlawful to ask questions which will indirectly reveal information about the age, creed, color, race, national origin, sex, disability, marital status or familial status of an applicant. In cases where such information may not be asked directly, the following are examples of indirect inquiries of age, creed, color, race, national origin, sex, disability, marital status or familial status.

**Unlawful:** Requirement that an applicant submit a birth certificate, naturalization or baptismal record, residency papers, passport driver's license, green card, military discharge, this includes asking any questions regarding age either orally or on an application.

Subject: **Disability**
Lawful Questions: None
Unlawful: require that applicant submit medical record, vaccination record, doctor's examination papers, or any other medical documentation, even when the housing provider is using the information with the best of intentions.

Subject: **Familial Status**
Lawful: None

Subject: **National Origin**
Lawful: None
Unlawful: Require applicant to submit naturalization citizenship papers, green card, passport from country of origin military discharge. Making an oral inquiry regarding any of these subjects is not permitted.

Inquiries to applicants about the age, sex or marital status of a person or persons who lives in or may live in a given unit in order to determine occupancy standards is generally not permitted. This type of information may only be requested if it is required by local health or safety ordinances or in compliance with any local zoning or building codes or restrictions.

Seemingly illegal questions or requests on rare occasions might actually be permitted if they were asked in order to avoid overcrowding or to rectify an unsafe condition. In those limited instances, housing providers must justify the necessity for such inquiries.

"**Reasonableness"** should be used when restricting maximum number of persons per room or unit to avoid overcrowding or underutilization. Under no circumstance is the housing provider justified in setting occupancy standards arbitrarily, based on its own personal standards,

**EXAMPLE:** Requiring children of opposite sex of a certain age to have separate rooms, or requiring that only a "married couple" occupy the same bedroom, etc. A landlord does not have the right to violate fair housing laws in order to accommodate any personal beliefs.

**POINTS TO REMEMBER**
In the sale, purchase, exchange, rental or lease of real property, licensees have the responsibility to offer equal service to all clients and prospects without regard to race, color, religion, sex or national origin. This encompasses:
• Standing ready to enter broker-client relationships or to show property equally to members of all races, creeds or ethnic groups.
• Receiving all formal written offers and communicating them to the owner
• Exerting their best efforts to conclude all transactions
• Maintaining equal opportunity employment practices
• Licensees, individually and collectively, in performing their agency functions have no right or responsibility to volunteer information regarding the racial, creed or ethnic composition of any neighborhood or any part thereof.
• Licensees shall not engage in any activity that has the purpose of inducing panic selling.
• Licensees shall not print, display or circulate any statement or advertisement with respect to the sale or rental of a dwelling that indicates any preference, limitation or discrimination based on race, color, religion, sex or ethnic background.

**WORDS THAT SHOULD NOT BE USED IN LISTINGS OR ADS**

**ADULTS ONLY.** There can be no restriction against children unless the housing is specifically built for senior citizens.

**SINGLES ONLY.** There can be no restriction based on marital status.

**BACHELOR ONLY.** There can be no restriction based on sex or marital status

**CHILDREN OVER 10 ONLY.** There can be no restriction based on the age of occupants except in senior citizen housing.

**NEAR A PARTICULAR CHURCH OR TEMPLE OR MOSQUE.** If a particular house of worship is included in the ad or listing, it would seem that the ad is target marketing people of a specific group. Many brokers are now including phrases like “walk to houses of worship” or “near houses of worship”. The reader might wonder which house of worship and begin a dialogue that should not be discussed.

**COUPLE ONLY.** Again, marital status would come in to play here as well as not inviting single people to see the apartment.

**MUST BE EMPLOYED.** While this might seem logical at first glance, since the landlord would expect a tenant to be employed in order to pay the rent, it would prevent people who have retired and are living on pensions, social security or distributions from estates. This could also be considered age discrimination against older people who do not need to work.

**NO HANDICAPPED, OR NO HANDICAPPED ACCESSABILITY.** This, of course, would not be permitted since we have learned that no discrimination based on disability or handicap is allowed.

**MATURE PERSON OR COUPLE.** Once again, age would be the factor in determining to whom the landlord will lease the premises.

**NO CHILD OR CHILDREN.** Age discrimination once again

**EXCLUSIVE AREA, OR EXECUTIVE REGION.** These phrases are generally suspected of being code phrases for non minority buyers or tenants.

**NON SMOKER OR NON DRinker.** These words cannot be used, but it is alright to substitute non smoking or non drinking on premises. The difference would be that the landlord would have the right to refuse to allow someone to smoke or drink on the premises, but could not prevent them from engaging in these acts in any other location.

**ENGLISH SPEAKING ONLY.** There can be no requirements that a tenant or buyer speak either English or any other language.

**NO PLAY AREA.** This would seem to say, don’t bring any children here.

It must be strongly emphasized that both the person placing the discriminatory advertising and the publication accepting the discriminatory advertising could be liable for compensatory and other damages including punitive damages to any person hurt by such discriminatory advertising.

The use of the words “preferred” or “most suitable for” does not change what is permissible and what is not. These terms imply that unless you are included in the class that is mentioned, you should not apply for this particular housing.
It is permissible to use terms such as Happy Easter, or Merry Christmas, Happy St. Valentines Day, Happy Chanukah appropriately. It is also allowed to use symbols such as Santa Claus or the Easter Bunny or a menorah. Terms such as master bedroom or mother-in-law suite or bachelor apartment are allowed. Also permitted: Fourth floor walkup, great view, walk to transportation, jogging trails nearby, etc.

**Responsibilities of brokers and salespeople** - Because intent to discriminate does not have to be proved, but merely that discrimination occurred, it is important to:

Display the HUD poster in all places where housing is offered for sale or rent including model homes

Have a prominent display of company policy as being against any form of discrimination

When a prospect wants to live in a particular area based on race, creed, sex, country of origin, etc., it is important to explain that you will show all houses in your effective service area and that the customer can ultimately decide where he/she wants to live.

To test whether a practice is discriminatory, ask yourself whether it is being **done for everyone**. The licensee assumes the role of educator of the public when complying with fair housing laws

**Reverse discrimination regulations**, enacted by some local governments in an attempt to preserve a racial balance, often pose serious problems for the licensee and actually may be counter to federal and state laws.

Testers are persons utilized by civil rights enforcers, public and private, who pose as potential clients or customers for the purpose of verifying compliance with the civil rights laws. A good way to prevent you from engaging in any illegal actions or conversations is to always ask yourself “if the person with whom I am dealing, I knew to be a tester, would I say or do the following?” If the answer is no then it should never be said or done in any situation.

An agent should study fair housing law, develop sensitivity in this area and learn good business practices which will help avoid the danger of unintentional discrimination.

**PROPER HANDLING OF BUYERS:**

To avoid any thought of discrimination it is imperative that all people be treated the same. A claim for discrimination can occur as easily if it is felt that a customer was treated less favorably because of race, religion, national origin, sex, disability or marital status as it might be for actually insulting or refusing to deal with them at all.

Good record keeping is important to show that such things as financial qualifying, areas of showing and encouragement to continue working with the salespeople does not change because of the race, religion, nationality, etc. of the customer. This record keeping should include logs of phone calls, financial qualifying forms, and records of houses shown among other items.

There have been cases where salespeople, knowing they cannot discriminate, will show houses and then not follow up with the buyer because they don’t want to continue working with the member of a particular religion, as an example.

No matter that the buyer has been shown property. Discrimination is still taking place when the licensee does not work with them the same way they might work with someone else. The offer from the minority must be presented in as timely a fashion as from a non minority. Also, the licensee must take every precaution to deal with all customers and clients regardless of their background.

A customer should never be shown housing in such a way as to downgrade an area intentionally so that the buyer becomes disinterested. Each buyer needs to be shown property so that they may make a decision based on their own lifestyle preferences rather than insinuations of racial or protected class harmony or lack thereof.
EXAMPLE: This is a lovely area, but there has been a lot of racial tension lately, so you might feel uncomfortable living here. This type of remark is highly discriminatory since you would be steering a buyer away from this neighborhood. The agent might think this is allowable since they believe it is in the best interest of the buyer. However, it is a perfect example of steering.

ENFORCING THE LAW

A complainant may make a complaint to HUD as well as the New York Division of Human Rights. The complaint will fall into one of two categories. Intentional acts of discrimination would include actions directed at groups specifically protected under the law.

EXAMPLE: Advertising which solicits buyers who are members of a particular religion. Circumstantial discrimination would relate to a specific individual and action.

EXAMPLE: A tenant was told that an apartment was no longer available when in fact it is.

The licensee cannot use, as a defense, the fact that he did not INTEND to discriminate. Intent does not have to be proven, merely that the act occurred would be sufficient, upon proof, that the licensee violated the law.

HUD is required to refer complaints to state or local agencies whose fair housing laws are equal to or exceed HUD’s laws. New York State is such a state. If, within 30 days the referral agency does not begin proceedings, HUD will once again be responsible for the case. Once the complaint has been filed with HUD, the party starting the action must be notified that they can start a civil action within 2 years after the date the alleged discrimination occurred. HUD will notify the person who is charged with the misconduct of his rights and that he has 10 days in which to answer the charge. Once the complaint has been filed HUD must investigate and attempt to resolve the complaint.

They may also refer the complaint to the local or state agency if that agency has “substantially equivalent” laws. The case might also be referred to the Justice Department in the event local zoning or other land use ordinances are in question.

If it is felt that a temporary restraining order might be required, then the Attorney General would be brought in to the case. This would prevent the defendant from selling or renting property to a third party until the case is decided.

HUD must complete its’ investigation within 100 days unless there is some very specific problem that would prevent that from happening. All parties would have to be notified if HUD could not complete the investigation within the required timeframe.

From the start of the complaint, HUD must try to resolve differences and bring about an agreement between the parties. This resolution of differences would include monetary damages as well as an agreement to end the discriminatory actions. After the investigation, HUD will either find that reasonable cause exists indicating that discriminatory housing practices occurred or they can dismiss the case after determining that no reasonable cause exists.

In the event that it has been proven that discrimination has occurred, there are several ways in which relief might be ordered.

ACTUAL DAMAGES: These would include not only actual out of pocket expenses, but also awards for such things as embarrassment, humiliation, mental anguish, inconvenience and anything else that might be included under this category.

PUNITIVE DAMAGES: Awarded in a civil court action. These relatively high awards are usually made to set an example not only for the defendant, but for others as well not to engage in similar behavior. Damages can go as high as TWO MILLION DOLLARS.

EQUITABLE RELIEF: The party bringing the action could be allowed to have the housing in question or the services they have been denied might be ordered restored.
INJUNCTIVE RELIEF: This would prevent the party who discriminated from taking similar action in the future.
In the event the party is found guilty, after hearing and appeals process, the Administrative Law Judge may impose penalties of up to $10,000 for a first offense, $25,000 if another violation occurs within five years, and $50,000 if two or more violations occur within a seven year period. An individual can be fined $25,000 to $50,000 without limitation of time periods if he engages in multiple discriminatory practices.
Under the Americans with Disabilities Act, a violator may have a fine up to $50,000 imposed for a first offense and a fine of up to $100,000 for subsequent violations.

There is always the opportunity to have a judicial review in the Court of Appeals. This action must be brought no later than thirty days from the date the decision has been issued.

If a discriminatory practice has been proven, a notification to the Dept. of State is required. In addition to the fines and penalties already outlined, the license of the party found guilty could be suspended or revoked after a hearing.

It is so important when discussing fair housing and discrimination to understand the impact continued discriminatory acts could have on someone. It can cause loss of self esteem, anger or a desire to “get even”.
Any of these emotions, while certainly understandable, only contribute to the continuation of discrimination and segregation. It might lead of buyer who wanted an integrated neighborhood in order to raise their children in a diverse area to seek out one where the community more resembles them.
It might lead to a tenant angrily telling her children that all_________________, are no good because they won’t allow us to live where we want to. The emotional effects of discrimination are many and varied and as agents, we need to always consider the impact of our words and deeds on everyone.
Perhaps it would be helpful for each one of us to put ourselves in the shoes of someone who is denied housing based on their race, or religion, or sex, or the ages of their children.

- Think about how we would feel.
- Think about what we might do.
- Think about how we must take a stand to do away with discrimination in housing.
- Think about all the lives we touch in the course of our business day.
- Are we participating in discrimination because we don’t stop people from making choices based on covered classes?

The first response to the public putting us in that position is to question them about whether or not they are aware that what they are asking us to do is illegal. Interestingly, in many cases they are not aware of the law. They may feel since it is their money, they can choose to spend it any way they want to. While this may be true, we cannot assist them in finding housing based on a covered class. We must advise them of the legality, or lack thereof, of their request. If they continue with this requirement, we must advise the buyer or seller or landlord or tenant we can no longer take any action toward marketing their home or in the case of a buyer or tenant in finding them suitable housing.

Discrimination ultimately hurts everyone whether yesterday, today or tomorrow and it is our responsibility to avoid any action that could add to the problem.
CHAPTER 23 COMMERCIAL AND INVESTMENT PROPERTIES

KEY TERMS

- After tax cash flow
- Anchor tenant
- Before tax cash flow
- Capitalization rate
- Cash flow
- Cash on cash return
- Common areas
- Debt service
- Gross income
- Lease escalation clause
- Leverage
- Net operating income
- Proforma statement
- Rate of return
- Rentable square footage
- Tax shelter
- Time value of money
- Useable square footage

We are about to begin the chapter on commercial and investment real estate. It is important to understand this type of real estate both for the sake of our career but also because we are involved with it on a day to day basis. Whether going to the doctor, or the shopping center or the supermarket, we deal with commercial real estate all the time. This chapter is going to explore not only the legal and investment aspects but also the career potential for specializing in commercial property. It is meant to inform you, and to create curiosity so that you will investigate the opportunities available.

GETTING STARTED

Extensive education is required in order to specialize in commercial and/or investment real estate. It is as different from residential as night is today. It requires a vast knowledge of business, economics, financing, as well as good old-fashioned people skills. Without question, the majority of students taking this course can learn most of this. However, success as you might define it will only come to those who are willing to put in the time to learn and hone their craft well. Success means many different things and each person must determine what they are referring to when they use the word success. Without knowing what you expect, how can you possibly know when you have achieved it?

Who will most likely succeed? Commercial real estate is a highly aggressive, competitive field. In order to succeed you must be willing to get out there and meet people, analyze problems and stay abreast of the transaction and everything that can and will arise. Your days will be hectic, and challenging. Procrastinator’s will not make it. Your paychecks will be few and far between, but will be quite large in most cases. You will have to be capable of creating a budget for your income and sticking to it. It will also be necessary for many of you to have a nest egg available to take you through the beginning of your career until you start to collect your commission checks.

A typical transaction might take as long as a year to be completed and you will not collect anything until it is. Obviously not all transactions take this long, but commonly six to twelve months would be average.

WHAT IS “COMMERCIAL” REAL ESTATE?

There are many categories of real estate that go under the umbrella of commercial real estate and this chapter will explore them all.

UNIMPROVED LAND

Land development is very costly and there aren’t all that many developers capable of successfully taking the project from raw land to completed houses. The ones who know how to do it may not have the necessary capital available. Funding for these projects can be difficult to get in traditional banking circles. This is where your creativity comes into play. Being able to create the financing by putting together several different lenders will separate you from the rest of the pack. There are government agencies involved in the process of getting the land zoned appropriately. You must know how to navigate these agencies.
Environmental issues are a major factor in real estate developing and your job would be to know what will be required and how to get it accomplished. We need to be knowledgeable about current prices and the marketplace in general. We need to know the availability of utilities and if they are not available, how do we make them.

The local economy has to be assessed and the determination of the best possible use for the property must be decided. Many developers will spend tens of thousands of dollars to have a professional comprehensive market study done before committing money to a project. An informed and well-educated real estate licensee could specialize in this phase of development in addition to bringing together buyers and sellers.

Another study that a developer might require is a feasibility study. This would consider the existing zoning, codes and land use, engineering details, construction and financing opportunities. Environmental concerns would be addressed which would include drainage, surveys, soil and topography. All of this takes a great deal of time.

Communities have a “master plan” that gives a feeling of stability to the neighborhood because they know what to expect regarding future growth and expansion. Typically, if someone were looking for development outside of the master plan, it could be hard to come by. The master plan might also help the developer determine the highest and best use of his property.

Part of the frustration of development is the fact that there are so many individual agencies to deal with and different municipalities have their own structure, rules and regulations. If everything is not done correctly, keep in mind that just one error will stop the entire project.

There are many municipal agencies and their functions vary greatly. They are explained in detail in the Municipal Agency chapter. These agencies include:

- Architectural Review Board  
- Building Department  
- City/Town Council  
- Conservation Advisory Council  
- Health Department  
- Historic Preservation Commission  
- Landmark Preservation Commission  
- Planning Board  
- Receiver of Taxes  
- Tax Assessor  
- Village Board of Trustees  
- Wetlands Commission  
- Zoning Board of Appeals

Becoming familiar with the functions of municipal agencies will give you the opportunity to prove your professionalism to buyers and sellers. Take the time to visit these agencies and have a chat with some of the employees to become familiar with the particular workings in your area.

In all areas of real estate investment and development, there will be many professionals involved along the way. Some of them include:

- Appraiser  
- Architects, both interior and landscape  
- Attorney  
- Civil engineer  
- Construction company  
- Engineer  
- Geologist
✓ Surveyor
✓ Tax consultant

The list goes on and on. Remember, you will be in touch with many or all of them as the transaction progresses.

**OFFICE BUILDINGS, LOW-RISE, MID-RISE AND HIGH-RISE**

**LOW RISE:** An office building between 1 and 3 stories. When we discuss the number of stories or floors in a building, we will always be referring to those above grade. In many buildings there may be useable space below grade, but for our purposes let us only consider above grade. Many of these are built to this height simply because zoning does not permit anything higher. These buildings are generally occupied by “front office” services such as medical, legal, or accounting. The public can freely enter the building to take advantage of the services of the tenants. Parking and accessibility are important for the success of a low rise building. They are generally found in suburban areas on main thoroughfares. It is important to learn the different terminology in order to understand what an investor might be requesting when he says “I am only interested in high rise buildings, or mixed use, etc.”

**MID RISE:** Buildings are 4 to 10 stories. These may be office or residential. They will usually contain between 50 and 150 units.

**HIGH RISE:** Buildings are 11 stories or higher. These may be office or residential buildings with over 150 units.

**SINGLE FAMILY:** Just as it sounds, it is a house occupied by one single family. This type of property is most interesting to a new small investor. It is usually among the least expensive opportunities and is easier to manage than other investments.

**MULTI FAMILY:** Again, just as it sounds, any building with more than one living unit is a multi family. However, in order for it to be classified a commercial property it generally has five or more units. A new or small investor might be interested in a 2 to 4 multi-family. What he needs to take into consideration is that the more tenants there are, the more headaches he will have. The financing and management is quite similar in a 1 to 4 family unit. When the number of residences increase, things become more difficult. Financing might be harder to obtain and management is more intensive.

Most beginning investors should look for property close to home. It can be very “hands on” because they can readily see what is happening in their investment. It is also a plus because they know the area well. Many also invest in something that can be “owner occupied”. They will buy a small multi-family, occupy one of the units, and take care of the others. Rarely will a multi-family larger than 5 units be owner occupied. It can be highly problematic no matter how many tenants are your neighbors. The more neighbor/tenants, the more problems you will hear on a daily basis.

**MIXED USE:** Generally located in cities or municipalities with dense populations. The term describes a building with stores on the street level and residential units above. They rarely have any parking facilities and are on heavily traveled main streets or roads. They are most successful in areas where public transportation is easily available.

**STRIP or NEIGHBORHOOD MALLS:** These are also known as “mini-malls”. Built facing the roadway they have ample parking and are located in heavily traveled areas. The public enters each business location from the outside. They vary in size and can be as small as 5,000 square feet to over 100,000 square feet. They might be small with only 8 or 10 stores such as a deli, pizza shop, dry cleaners, small gift or card store, hairdresser or nail salon. Or, one with an anchor tenant such as CVS or Target. Major supermarket chains are also sought after anchors. These tend to have many more tenants.
When there is a substantial anchor tenant such as Walgreens, or Target or CVS, other stores are drawn to the location because they realize their business will benefit from the traffic these anchors create. Often, they are “destination locations”. Someone may drive several miles just to be able to shop in the anchor stores.

When possible, banks and gas stations open locations either on the property or nearby. They too, will benefit from the traffic these malls generate. Rents in a strip mall with an anchor tenant would be considerably higher than a small local strip.

When this type of mall was first introduced, they were nothing more than a bunch of independent stores with unmatched signs and appearance. Today, many have undergone changes so that their signs are uniform and in many cases, the general external appearance of all stores is similar. Newly constructed malls are usually built with this in mind. Some of the ones built recently have elaborate detail and styling. In many cases, the malls are not just a straight line of stores but rather clustered around a focal point such as a garden or the parking lot.

Discount or big box stores anchor some malls. Many have more than one anchor. There might be a discount store and a major pharmacy. Alternatively, a supermarket and an appliance store. The mix is important to the success of the mall. These typically do not allow two obvious competitors to become tenants. Example: You would usually not find CVS and Walgreens in the same mall or Stop and Shop and Shop Rite as co-anchors. You would however, possibly find Target and Macy. A customer coming to a supermarket will only shop in one. However, someone looking to buy clothing will possibly browse through two or more stores. A warehouse store (big box) might be co anchored with Borders Books but probably not with Wal-Mart. Depending on the size of the mall, however, the tenant mix might be more competitive in a large one than in a small one.

REGIONAL MALL: These are larger than the neighborhood mall and often have between 400,000 and 800,000 leasable square feet. Malls of this type will have at least two anchors and service a large population. The tenant is usually more upscale than in a neighborhood mall. You probably won’t see a chain pharmacy or low end discount clothing store in these. They are for the most part, enclosed malls and are often destinations for tourists as well as the local population.

MEGA MALL: New in concept these are without question tourist destinations. A prime example of the Mega Mall is the Mall of America in Minnesota. It occupies over 4 million square feet of which approximately 2.5 million is leased. Not only stores and restaurants occupy the space but events as well. Book signings by famous authors, blood drives, special shopping days and guest appearances by television and movie personalities. Miniature golf courses and NASCAR speedways, rides in the Nickelodeon store, an aquarium as well as a huge Multiplex theater are all part of the excitement this type of mall generates. Many tourists come for the entertainment and events as much if not more than for the shopping. The cost to build this mall was about $650 million dollars and it contributes nearly $2 BILLION dollars to the local economy.

OUTLET CENTERS: These would be either neighborhood or regional malls and all tenants are manufacturer’s outlet stores. Each store is dedicated to selling only its own brand of merchandise. Products are often sold at a discount. Many manufacturers even have a special outlet line that they make solely for sale in these locations. These factory outlets are often tourist attractions and are built with easy access to highways and main thoroughfares. They take the form of a strip mall most of the time, but some will incorporate enclosed areas as well.

INDUSTRIAL: Buildings used not only for direct manufacture of products, but also its storage after manufacture. Research and development of products would also require industrial zoning as would service or distribution centers.

MANUFACTURING: Property is used to create a product. Whether it is high tech or clothing or automobile parts, buildings used for manufacturing are very specific in their design. Raw material
converted into a finished product would be the main use for this type of building. Most of the time if the user moves, the space is either unusable by another tenant or requires major renovations. For this reason, the user owns most real estate used for manufacturing. In our economic environment today, a large percentage of manufacturing has left this country and the buildings that had been used for manufacturing are not easily converted into space for a different tenant. When applicable these buildings are converted into another use.

WAREHOUSES: Once a product is manufactured, it is stored in a warehouse. This classification of industrial real estate has very specific features and needs. These would include:

- Accessibility for vehicles such as trucks
- Adequate utilities
- Ceilings are high and clear
- Cinder blocks, metal or concrete are the most common types of structure.
- Community reaction, good and bad
- Loading and shipping space
- Mechanical systems sufficient to support the business
- Topography suited for the intended use
- Zoning

There could be many additional requirements the tenant needs and these must be addressed before they will make a decision to buy, lease, or pass on the property.

LOFT SPACE: A complete change of use has occurred for what is termed loft space. It is open space with few constrictions. It had been used for low cost manufacturing or warehouse/distribution centers. Today many lofts have been converted into upscale condominium apartments. They are also being used for restaurants and retail or office space.

RISK vs. RETURN
Risk is simply the possibility that something negative will occur and have a harmful effect on the outcome. As with any business, there is a certain amount of risk. However, because commercial real estate usually involves so much money, the opportunity and probability of risk is great. Needless to say, the greater the risk the greater the return! A free market demonstrates this principal: strong demand for a safe investment drives its price higher (and its return proportionately lower), while weaker demand for an investment with more risk will drop the price. In this case, the potential for return would increase. As an example of an investment with a low risk, let’s use a U. S. Treasury Bond. This investment carries very little risk when compared to corporate bonds. Therefore, the return on the Treasury Bond would be lower than that on the corporate bond. A perfect example of RISK VS RETURN!

CATEGORIES OF RISKS
Contractual: we have an agreement to have work done or products and equipment delivered at an agreed upon price and rely on it in order to conduct our business. The contractor defaults, our business could be at risk
Economic: Changes in the economy can cause major risk to investors
Environmental: Standards change and the investor must keep up with these changes to be sure his buildings comply
Health and Safety: Buildings, transportation equipment, business equipment, fire, noise, chemical and biological hazards, traffic management, etc.
Market: Fundamental change in supply and demand functions or global prices for commodities
Operational: Are existing building and delivery operations functioning at the highest level? If not, what needs to be done to correct the situation?
Physical: Theft, vandalism, arson, building related risks, Storm, flood, other related weather, damage to vehicles, mobile plant and equipment.
**Regulatory:** Is there a designee to keep abreast of changes in policy or law by local and/or national agencies?

**Socio-cultural:** Demographic change affects demand for services; stakeholder expectations change. Are studies done periodically to determine if there have been any significant demographic changes that could influence the investment, either pro or con?

**Technological:** Obsolescence of current systems; cost of procuring best technology available, opportunity arising from technological development.

**EXAMPLE OF RISK:** A person has the choice between two scenarios, one certain and one not. In the certain scenario, she will receive $50. In the uncertain scenario, a coin is tossed to determine whether she will receive $100 or nothing. The possible payoff is $50.00, $100.00 or nothing.

Depending on their sensitivity to risk, they would decide which option to take. Someone who has a low sensitivity to risk would gamble for the $100.00 payoff knowing that it is possible to receive nothing. A person who has a high sensitivity to risk will take the guarantee of $50.00 because of the certainty.

Individuals have different risk attitudes.

A person is:

- **Risk-averse:** if he or she would accept a payoff of less than $50 (for example, $40), with no uncertainty, rather than taking the gamble and possibly receiving nothing.
- **Risk neutral:** if he or she is indifferent between the bet and a certain $50.00 payment.
- **Risk-seeking** (or risk-loving): if the return is more than the guaranteed amount of $50.00 they will take the risk in order to possibly have a higher return.

**Understanding the fundamentals of risk:** let us explore different types of real estate and their potential for risk:

**LEAST AMOUNT OF RISK:**
- Small apartment buildings in an area that is thriving
- Industrial park or building that has more than one tenant
- Office building with more than one tenant in thriving area
- Regional shopping center in thriving area.

**MEDIUM AMOUNT OF RISK:**
- Suburban office building with a single tenant
- Single tenant industrial building
- Local shopping center
- Motel
- Medium or large apartment complexes

**SOMEWHER MORE RISKY:**
- Big box stores
- Commercial building with a single tenant
- Single use manufacturing building

**HIGHEST RISK:**
- Buildings designed for a single use: churches, banks, gas stations, restaurants, catering halls, etc.
- Buildings occupied under non conforming use
- Unimproved or raw land

Some of the most obvious risks have to do with market conditions. If the economy goes bad our investment might not be worth what we paid for it. If we do not have a good management company,
we might suffer losses because of their inadequacy. The number one fear of investors overall is the prospect of losing their capital investment. A safe investment brings a lower return than one with associated risk. Loss of income is another risk. If the property does not generate sufficient income to pay the equivalent expenses, and just as important, generate a profit, the investment result is more risk than return.

Is this the right time to buy? It would be wonderful if we really knew the answer to this question. How much higher will the market go? Have we reached bottom? Will interest rates go up or down? These are all significant concerns for buyers, but, until we can develop some kind of “sci fi” instruments to predict the future, they will all go unanswered. Nevertheless, they are important.

How long will it take to sell the property if I have a need to? A major risk of real estate in general is that it is difficult to convert into cash quickly. It does not have “liquidity”. A liquid investment would be a savings account or certificate of deposit. Stocks are also liquid because they can be sold almost instantaneously.

Other problems the investor must face if a forced sale were required would include the cost of brokers, attorneys and perhaps prepayment penalties included in their financing. If the property value has gone down since its purchase, the seller might just be trying to recoup his cash investment, but may not be able to. This risk is very real.

Will I need to hire a manager or can I do it myself. This should be a concern from the very beginning of the anticipation of buying property. Too often the investor thinks he can do it all himself. However, he does not have the time, experience, education, or patience so, the last thing he should be doing is self-management. In the event he did not include the salary of a manager in his projections, the investment won’t bring as high a return as he anticipated.

Every investor should have an exit strategy. Remember there is always risk and the possibility that the decision may have been good when it was made, but things change. Risks cannot be eliminated but they can certainly be reduced.

**DUE DILIGENCE**
The contract will generally specify a time limit to perform the due diligence. This is the investor’s opportunity to have professionals thoroughly investigate the property before making the final buying commitment.

Some of the items that should be included are:
- All income: Where does it come from, how much is it?
- All expenses. What are they and what are they for?
- A complete inspection of the interior and exterior to determine what needs to be repaired or replaced and when
- Is the property up to code?
- Are there any environmental hazards?
- A complete financial analysis including any liens. If there are liens they may prevent title from passing easily.
- Are there any existing warranties or guarantees that you need to have transferred to your company
- A good due diligence is a safety net to prevent what looks like a good deal turning into a very bad one.

**THE PROCESS CONSISTS OF THREE ELEMENTS:**
1. Physical – hire a professional inspector/engineer to do an in depth study of both the inside and outside of the property.
2. Financial – hire an accountant who specializes in commercial real estate. Never accept the books or records of the seller.
3. Legal – EVERYTHING ELSE

THE PROCESS OF DUE DILIGENCE
Third party due diligence reviews of a potential acquisition requires a minimum of two to three weeks, and again, is very costly. If the contract demands that a shorter time is allowed it must be viewed as a bright red flag. Sometimes the buyer is pushed to take information submitted by the seller. This should never be allowed! The price for not conducting reviews can be extraordinary. It could result in future repairs that were unanticipated and had they been discovered, might have been the responsibility of the sellers.

The engineering review gives the buyer the opportunity to evaluate the buildings structural quality and deficiencies. It allows him to create a budget that is accurate. If the engineer reports on roof or foundation problems, the contract could be negotiated to reflect the cost of repairs. Are all current building and zoning codes met? If not, the buyer could run into a lot of red tape and expenses after taking title.

Review of the Property’s Business and Legal Status
This is probably the most important step in the whole process. The buyer has the opportunity to learn about anything that could cause a lawsuit in the future.

✓ Are there any landlord/tenant disputes?
✓ Any lease discrepancies?
✓ Warranties and service agreements?
✓ Easements?
✓ Encroachments?

Lease Reviews
First, the rent rolls as stated by the seller must be verified through the leases. Second, the terms of the leases as stated must be accurate. Renewals, options, base year, escalations, tenant expenses, property owner expenses, all must be verified. Any number of discrepancies can be uncovered between what is stated and what is real. Any of these can cause a significant difference in the real income the building produces and what the buyer was led to believe.

Tenant Interviews
It is always a good idea for the buyer to personally meet with and interview each tenant. The buyer would want to know whether the tenant is happy with his space, whether he has any complaints, are you planning to stay?

Tenant Estoppel Certificates
These are documents that certify what the buyer considers the facts of the lease and by signing; the tenant agrees to and accepts these facts. Estoppels certify what the buyer considers the “facts” of the leases, and by their signatures, accept these facts. Some of the items included would be: Where can the tenant park, for how long, how many spaces does he have the right to use?

Sometimes there may have been amendments to a long-term lease that seem to have gotten lost by the seller. This process will ensure that the buyer is buying exactly what he anticipates.

Service Contracts and Warranties
Many sellers will insist that the buyer assume existing service contracts. These might include porter or janitorial, landscaping, security or alarm, trash removal, snow plowing or anything else the owner has agreed to. These contracts must be carefully reviewed because they can cause a great many problems. Are the vendors charging fair market rates and giving excellent service? Are the contracts assignable?
**Title and Survey**

The buyer’s attorney will review the property’s title and survey to determine the following:

- ✓ Are there any outstanding liens that need to be satisfied prior to closing such as tax, mortgage, mechanics, etc?
- ✓ Easements
- ✓ Encroachments onto adjoining property
- ✓ Are all zoning ordinances in compliance
- ✓ Does the legal description in the survey and title report match the one in the contract
- ✓ Are there any covenants, conditions and restrictions violations (CC&R’s)
- ✓ Surveys can sometimes contain surprising information.

**Surprise #1:** Perhaps the utility company has an easement that could allow them to have a gas line running through the property, *Exactly where the building sits!* Not a good thing! If the easement is old and there was never any action to use their right, the easement probably will never come into play.

**Surprise #2:** Perhaps the survey will show that the driveway leading to the building next door is partially on your property. This encroachment could interfere with the investor’s plans for future use of the property.

The attorney must address the possibility of a problem and clear it up before title passes. These issues should be called to the attention of the title company and have them properly addressed in the title insurance policy.

**Surprise #3:** The zoning regulations are not what the investor thought they were. A major restaurant is planned for part of the property; however, zoning will not allow the type of restaurant unless many more parking spaces are available. OOPS!

Finally, does the survey show exactly what I was told was being sold? Is the building accurately depicted? If there is more than one building do they both appear on the survey?

Other items that might be surprises revealed in the title report that must be handled long before the closing:

- ✓ Did the person who signed the contract have the legal right to do so? Get proof that he has the right to enter into a legally binding agreement
- ✓ Mortgage liens: Are there any that have been satisfied but still show as unpaid? Does the current mortgage lien match what the seller acknowledged?
- ✓ Mechanics liens: Are any contractors still unpaid for work completed?
- ✓ Judgments: Are there any that are outstanding and is there a lawsuit still pending?
- ✓ Leases: Has the seller entered into any leases that will remain in force and effect when title transfers?

**Risk Due to Incorrect insurance:** The investor has to protect his investment by being certain that his property has the proper insurance coverage. A knowledgeable commercial insurance broker will be a great asset in determining the best way to lower risks through insurance.

The attorney will review all the documents, but the buyer has to know exactly what was uncovered and then make a decision how to proceed. The lawyer will give guidance, but the final decision belongs to the buyer. She needs to ask herself some hard questions at this point in order to decide whether to go ahead with the project:

- ✓ Am I getting good value for my money?
- ✓ Are my projections and forecasts valid?
- ✓ Are there assumptions that might cause this deal to fail?
- ✓ What are the things that could go wrong?
- ✓ Can I handle them?
- ✓ Am I willing to handle them?
If I had all the information available to me that I have now at the very beginning of my interest in this property, would I have gotten involved in it. Is the risk worth the return?

**RETURN**

There are at least four ways in which an investor might measure his return. They include:

1. **Cash flow**: the amount remaining after all expenses and mortgage debt is paid. This falls into two categories:
   a. Before tax cash flow
   b. After tax cash flow

2. **Appreciation**: the amount the property, both land and building is worth at any given time after the buyer acquires the property. It is the difference between what he paid and what it is worth. The property will appreciate based on economic conditions and scarcity.

3. **Reduction of Principal**: The investor will look at his principal balance as compared to what it was when he purchased it. This reduction of principal increases as payment is made in an amortized mortgage. Some investors may choose to finance the property with an interest only loan. This will lower their payments; however, the principal does not decrease.

4. **Tax Benefits**: Owning investment real estate has many tax benefits. The ability to keep more of your money based on the expenses and income of your investment property. Tax laws allow for the depreciation of the property to lower the tax burden. If the property shows a loss, it might be possible to deduct it from other income.

Depreciation is a term used in taxes and accounting, which spreads the economic life of an investment over a specified period. Residential real estate (single or multi-family homes) can be depreciated over 29 ½ years. The period is 39 years for commercial non-residential property.

**Straight Line Depreciation**: Reduces the value of the property by a set amount each year until it has only salvage value. Depreciation is an interesting word because it also means the actual wear and tear during normal usage that reduces the value of the property. Property can depreciate based on outside forces as well, such as changes in zoning or practical uses. An experienced tax advisor should guide the investor.

**RISK MANAGEMENT**

If we assess the potential for risk and take the steps to minimize it, we will be far ahead in our quest for investments that make sense. Whether we are the investor or the agent, keep in mind the following basis for risk:

**Economic**: Has the investor truly investigated the market, the economy, the demographics, zoning and land use laws? Along with these, has she also analyzed the income potential including worse case scenarios? Can she readily survive if there is a higher vacancy rate than expected or will she lose her investment?

**Liquidity**: Since real estate is not a liquid investment, can she sustain her investment during the time it might take to sell it? Has she looked into the cost of liquidating that asset?

**Environmental, Legal or Political**: Has the property undergone a substantial environmental study? What are the possibilities that land use or zoning laws may change in the near future? Are building codes on the agenda for discussion and review which might bring about a change that will have an impact on the property?

Are property taxes expected to increase substantially in the near future?
Crime: Is there insurance in the event there are criminal acts by employees such as theft or embezzlement? Does it also cover loss of money or securities from robberies or burglaries?

Business Management: Is the investor going to manage the property herself? If she is, what is her background and experience in this area? Poor management can destroy the best opportunities. If she is going to hire a management company does she have a clear idea of what to look for? Is she fully aware of the income and expense budgets, past, present and future? Does she have a qualified accountant and lawyer to offer guidance?

As licensees, we have to protect ourselves as well. Some of the greatest potential for risk exists regarding property disclosure. All too often, the buyer finds problems after the closing and lawsuits begin. We are going to be asked many questions and we have to clearly think through the answers so that they are accurate and do not violate our fiduciary responsibility.

FRAUD AND MISREPRESENTATION
It is usually difficult to have one without the other. Typically this is defined as “a false representation of important facts or issues which are relied upon by buyer’s or seller’s who are later damaged as a result of relying on the information they were given”. These would be applicable to material facts but not to insignificant issues. There are usually three factors that must be present for liability to exist:

1. Misrepresentation
2. Reliance
3. Liability

The consumer has to receive information that is pertinent, incorrect or misleading. They must rely on it or depend on it and then, be damaged because of this reliance. The most common types of fraud that are present in a real estate transaction would include intentional misrepresentation (active fraud) and intentional concealment (constructive fraud).

Intentional misrepresentation or active fraud is defined as a representation of a material fact, which the real estate licensee knew was false. They presented these facts to the buyer and they were relied upon to assist in the decision making process and as a result, the buyer was harmed.

An example of this would be a situation where the seller tells the listing agent that the basement is damp or has toxic mold. He received this information from a professional inspector. The seller instructs the agent not to reveal these facts because it might make the property more difficult to sell or bring a lower than market price. The seller needs all he can get from this building to buy the next one. The agent agrees, and the seller and the listing agent conceal the facts. The seller is asked a direct question by the buyer’s agent such as: Is the basement wet? The listing agent responds, no, it is musty and if you just open the windows, it will be fine. The buyer relies on this information, buys the building, learns that there is toxic mold present and spends $30,000 to correct the problem.

Who created the buyer’s problem? The listing agent and the owner! In the buyer’s mind, however, the buyer’s agent is also involved because the misinformation was delivered by his own agent.

Intentional concealment or constructive fraud occurs when the agent has information that would be important and fails to deliver it. Example: the buyer has specified that he wants to buy in a particular subdivision. The building he falls in love with is in the next district. His agent is fully aware of this and does not reveal it. The buyer’s agent knowingly failed to deliver information that is pertinent to the buyer and has committed constructive fraud.

Negligent or Innocent Misrepresentation: Black’s Law Dictionary defines negligent misrepresentation as “a careless or inadvertent false statement in circumstances where care should have been taken” and “innocent misrepresentation” as “a false statement not known to be false; a misrepresentation that, though false, was not made fraudulently.” This has been a significant factor in charges against
licensees. The licensee truly believed the statement was true, made the statement, and someone was harmed. The agent “meant well,” but committed fraud through carelessness.

**Negligence** exists when an agent does something that another prudent agent would not do in a similar situation, or the agent fails to do something that a more responsible agent would.

**Suppression**: the withholding of a material fact that an agent knows would be important to a client where the client acted and suffered damages due to the lack of knowledge of the material fact. Suppression requires three conditions:

1. Knowledge of the defect by the agent
2. A duty to disclose by the agent
3. Failure to disclose by the agent

**FINANCIAL CONSIDERATIONS**
An investor is someone who buys the property and holds onto it for a long period. At the end of this period he sells it or exchanges it (exchanges will be covered at another point). A dealer, however, is quite different. The dealer buys the property, renovates it and then sells it, hopefully at a profit.

In order to help understand the various financial aspects of commercial/investment real estate, please take the time to understand the following terms. Every agent should have a working knowledge of these terms. The examples and calculations are included as examples for understanding and do not have to be memorized.

**APPRECIATION**: The increase in the value of an asset such as real estate, the land and the building. Since the total amount of land is limited, the scarcity allows it to grow over time based on competition. When inflation is high, appreciation rises and can cause an economic “bubble”. This bubble can burst when the economy worsens.

**AFTER TAX CASH FLOW (AFTC)** This is commonly referred to as “profit”. It is the amount left after paying all expenses and taxes. If there is nothing left or there is a negative cash flow, the property is operating at a loss and the owner would most likely have to put more cash in to allow the business to continue operating.

**BASIS/COST BASIS**: This is the amount paid for the property including some adjustments. It is reduced by depreciation and increased by improvements. Once this is determined, the difference between the basis and the selling price is the capital gain. Naturally, the higher the gain, the higher the tax payment. If a property has been owned by the investor for a long time, it has usually had a low basis and is often the subject of a 1031 Exchange in order to defer taxes.

**BEFORE TAX CASH FLOW (BTCF)**: The cash flow before an adjustment for income tax is made. This includes debt service which is the amount paid to retire the mortgage.

**BREAK EVEN POINT**: The point at which there is sufficient potential income to cover expenses. This is a critical element in analyzing a property. If the breakeven point is very high and for whatever reason there are unexpected vacancies for a period of time, this building will be operating at a loss.

**Example**: If the effective gross income is $96,000, the fixed expenses and debt service are $48,000, and the rent is $1,000 per unit with the building containing 8 units, our breakeven point is 4 units producing rental income.

\[
\begin{align*}
\text{Net Income} & = 96,000 - 48,000 \\
& = 48,000 \\
\end{align*}
\]

$96,000 income
- $48,000 expenses
$48,000 effective net income

8 units x $1,000 per month x 12 months = $96,000 divided by $48,000 expenses = 50% occupancy required for break even.
**CAPITALIZATION (cap) RATE**: Converts the estimated income into value. It is a simple way to determine how much a buyer is willing to pay for a property and a seller is willing to accept. A common method of determining the cap rate is to: Divide the net operating income (NOI) by the value (V).

**Example**: A building has an NOI of $100,000 and a V of $1,000,000. The capitalization rate is 10%. Net operating income ÷ sales price = capitalization rate. This is the way an investor would ascertain whether or not the investment is good for him. While it may sound logical to a novice that the higher the cap rate the better the investment, in fact the opposite is true.

**Example**: A property has a net operating income of $100,000 and sold for $500,000. $100,000 ÷ $500,000=5%. If that same property had a NOI of $50,000 and a selling price of $500,000 the cap rate would be 10%. Which would you prefer, $100,000 NOI or $50,000. The answer is obvious.

**CAPITAL GAINS**: Instead of being taxed as ordinary income, profit from investments is taxed at a separate “capital gains rate”. The amount of capital gains taxes an investor has to pay is often the determining factor in whether or not he will sell his property. There are many variables in determining the tax rates applicable to capital gains; however, the IRS requires the property to be held for a minimum period.

**CASH FLOW**: The amount left after computing the net income minus debt service. This is usually divided by 12 to get a monthly amount.

**Example**: The net operating income is $100,000 and the debt service (mortgage payment) is $36,000. $100,000 minus $36,000=$64,000 annual cash flow. Divide $64,000/12 months=$5300 cash flow. Every investor wants a positive cash flow. In fact, commercial banks look at the cash flow before the credit of the borrower.

**CASH ON CASH RETURN**: It can be determined by using the annual cash flow and the amount of cash used to purchase the property. Annual cash flow divided by total cash required for purchase. Cash on cash return can be extraordinary. As an example, if we deposit $50,000 in a one-year certificate of deposit when interest rates are 5%, we would receive a return of $2,500. The result is 5% cash on cash return. When investing in real estate the returns can be much higher. Again, the risk is much greater because with the certificate of deposit we know that we are going to get our $50,000 back at the end of the term. Cash on cash return is also important because the faster she gets her cash back the faster she can buy another investment property.

**Example**: $100,000 annual cash flow divided by total of cash expended. The buyer made a $35,000 down payment and paid $15,000 in closing costs. His cash on cash return is $100,000÷$50,000=50%. This, of course is an incredible return. Don’t count on anything like this in the real world. It is just an easy example to see how to analyze the property the property correctly. To compute this number, all cash outlay must be included. Not only down payment and direct lending costs, but cash used to repair or improve the property as well would be included. Every expense must be included in order to do it correctly.

**DEBT SERVICE**: The amount paid monthly to pay off financing obligations. Example: If the payment is $4,000 per month, the debt service is $48,000. $4,000 x 12 months = $48,000.

**DEPRECIATION**: As it applies here refers to an accounting practice approved by the Internal Revenue Service. It allows the investor to reduce the income from a property. It is based on a property’s future loss of value. The concept of depreciation says that eventually the improvements to the land will have no value. In reality, he may be depreciating the property for tax purposes while it is actually increasing in value due to market conditions. An owner who has put up only a small amount of his own money to
purchase the property is ahead because he can depreciate the full value of the building not just his
investment.

Until 1986, residential and commercial rental property was depreciated on an accelerated basis over
19 years. In the early '80s, the depreciation period was as short as 15 years. Depreciation was
calculated under the accelerated cost recovery system, or ACRS, pronounced like "acres." Back then,
many properties were built just because they made great tax shelters: You could write off the cost in
less than half the time it took you to pay off the mortgage, and on an accelerated basis, most of the
deductions were in the early years. ACRS was one of the reasons cited for the savings and loan debacle
of that decade.

When the tax laws changed and the value of depreciation changed, many investors who were more
interested in the ability to write off losses against their income than in actually making a profit simply
abandoned their real estate. To make matters even worse, corporations formed for the simple
purpose of acquiring the property owned most of these properties and the corporation were
abandoned. This left the lender holding the property and the investors walking away without any
personal liability.

EXAMPLE: Keep in mind that tax laws change and any tax information given in examples must be
checked to be sure that it is applicable under present day tax codes. It might work this way today:
The property is worth $500,000 total, with the land value being $100,000. Therefore, the depreciable
amount is $400,000. If it were a residential investment property, the following would occur:

$400,000 divided by 27 ½ years = $14,545 annual depreciation. If it were a non residential property,
then

$400,000 divided by 39 years = $10,256. The depreciated allowance lowers the investor’s tax
responsibility because it is deducted from his income.

If the residential building had a taxable income of $100,000, it would be reduced by $14,545 making his
taxable profit $85,455. In a non residential building the $100,000 taxable profit would now become
$89,744. In each case, a considerable savings on taxable income! Depreciation is treated as a line item
on the expense statement just as salaries or supplies or insurance would be.

GROSS INCOME: The total of all income expected on the investment. This would include rent, parking,
vending & laundry machines, late fees and penalties. This should be both monthly and annually.
Example: $50,000 rent

3,000 parking
1,200 vending machines
1,500 late fees and penalties
$55,700 – Gross annual income ÷ 12 = $4,642 Gross monthly income

EFFECTIVE GROSS INCOME: The actual amount collected. If 10% of the apartments were vacant, then
the effective income would be $45,000 allowing for $5,000 in expected income to be unavailable.

NET OPERATING INCOME: The effective gross income minus the operating expenses. Perhaps the
single most important number the buyer will want to consider. The greater the NOI, the greater the
value of the property. The prudent investor will always be looking at ways to increase his income while
lowering his expenses.
Example: $50,700 effective gross income

- 23,500 operating expenses
$27,200 net operating income
OPERATING EXPENSES:
- Real estate taxes
- Insurance
- Management fees
- Marketing fees
- Telephone
- Utilities
- Repairs and renovations
- Landscaping
- Pest Control
- Supplies

VACANCY RATE: The number of vacancies divided by the number of units available for rent.

Example: The building has 100 units and 10 of them are vacant. The vacancy rate would be 10%.

When you are calculating vacancy rate, only consider apartments that are not producing income. If an apartment became vacant and was re-rented in time to produce income for that month, then it is not considered vacant.

As we have stated, in order to get a return in real estate there is risk. The greater the return the greater the risk! There are natural born risk takers. Sometimes we refer to them as gamblers. Just keep in mind that if losing the amount invested will drastically change your life you cannot afford to make the investment. If it means you will lose your house or your child’s college fund, DON’T DO IT. Only invest or risk what you can afford to lose.

Now let us start to concentrate on minimizing that risk by taking all the necessary precautions and being a truly prudent investor. We know we have to have due diligence to have an in depth view of the workings of the property. Once we have the information we need to analyze the risk.

LEVERAGE: This is a term we haven’t used before but one that is really at the heart of many investments. Simply put, leverage means using other people’s money. We use the term “OPM”. To many investors, these are perhaps the 3 most important letters in anything she looks at. Most investors will seek to put as little of their own money into the investment as possible. She will look to banks or other sources to limit her own cash outlay. If this is done successfully, the investor will be able to amass a large portfolio of investments. The biggest problem with leverage is that if you have too much debt, the investment doesn’t return as much as anticipated, and there is a downturn in the market, it can create a disaster. If the investor bought the property anticipating selling it as it increases in value then she might be prepared if there is little or no positive cash flow or profit for a reasonable period of time. That time frame is a personal decision. However, if there is a significant downturn in the economy and the property is worth less than she paid for it, selling will be a major problem. Remember leveraging has an impact on the return the investor will receive in direct proportion to the percent leveraged.

ANALYZING THE STATEMENTS
Admittedly we are not the accountants relied upon by investors, but we should have a working knowledge of financial statements.

DETERMINING NET OPERATING INCOME: RENTAL PROPERTY
Simply put:
- Effective Gross income (EGI)
- Operating expenses (OI)
=Net Operating Income (NOI)

GROSS INCOME: This is fairly straightforward. How much rent would be generated if all the units were rented at their highest expected rent?
Example: 100 units, which should each bring in $1,000 per month
100 x $1,000 = $100,000 per month x 12 months = $1,200,000 gross rental income.

We would determine the vacancy rate based on experience and the current market and reduce the gross income accordingly.

Let us assume that the vacancy rate is 10%. $1,200,000 gross income - $120,000 vacancy rate = $1,080,000

EFFECTIVE GROSS INCOME. This is the amount we are going to use to begin our study of the investment.

EXPENSES: (these are by no means all expenses to be considered, we are just using a short list for ease in understanding the process)
- Real estate taxes: $82,900
- Insurance: $15,000
- Common area electric: $28,000
- Porter/Handyman Service: $120,000
- Water: $12,000
- Trash removal: $2,400
- Supplies: $75,000
- Professional services $12,000
- Property management: 4% of Gross income = $48,000 (using potential income rather than actual. This is negotiated in management contract)
- Reserve Fund: $50,000
- Effective Gross Income $1,080,000
- Total Operating Expense $ 445,300
- Net Operating Income $ 634,700

We can now determine how much to pay for the property. An in depth study of sold property and their net operating income will result in a “CAPITALIZATION RATE” also called a “cap rate”. This cap rate usually signals the maximum amount an investor is willing to pay. For purposes of illustration, let us say that property sold in the past year in this area and of the same type had an average cap rate of 8%. We would now look at the net operating income and divide it by 8%. The maximum to be paid for this property would be $7,933,750, rounded to 8 million.

When doing this kind of calculation you simply input the following:
Part, then divide sign, then percentage amount and hit the percent key without an equal sign.
$634,700 ÷ 8% = $7,933,750

Get used to using the percent key. It prevents you from having to input decimal points and zeros.
Remember, when you use the percent key on most regular calculators, you do not use the equal sign.
If you are using a financial calculator, follow the manufacturer’s directions.

Another way of calculating the desirability of a property is to use the following formula:
CAPITALIZATION OF NET INCOME:
I – INCOME (NET OPERATING INCOME)
R – RATE OF RETURN (EXPRESSED IN A PERCENTAGE)
V – VALUE

Simply multiply the value by the desired rate of return.
If the net operating income is $500,000 and the investor wants an 8% return we are looking at $40,000. $500,000 x 8% = $40,000
By using Income, rate and value, you can determine many aspects of the financial picture of a property. Now we have to calculate the debt service, the amount we have to pay each month to reduce the amount we borrowed. If the property is going to sell for 8 million dollars, perhaps the buyer is going to use a total of $3 million in cash and finance the balance. He would then be seeking $5 million in borrowed funds.

The lender would be as interested, if not more so in the income the property will generate than the appraised value of the physical property. It is always possible for the location to cause a low appraisal. However, the current income stream and the future income potential could be of far greater importance to the lender.

Without using actual figures, let us just pretend the monthly principal and interest payment is $20,000. Multiply this by 12 months and his annual debt service is $240,000. If we add this to his operating expenses, his total annual expenses are $240,000 Debt Service + $445,300 Net Operating Expenses = $685,300 Gross expenses

$1,200,000 Potential Gross Income - $685,300 Gross expenses including debt service = $514,700 Potential cash flow before taxes

Another approach that could be used would be a “GROSS RENT MULTIPLIER” In this analysis, the investor would look at the rental income of similar properties and their percentage of selling price.

Again, an oversimplification of this method:

3 apartment houses have sold recently.

<table>
<thead>
<tr>
<th>INCOME</th>
<th>SELLING PRICE</th>
<th>GROSS MULTIPLIER</th>
</tr>
</thead>
<tbody>
<tr>
<td># 1</td>
<td>$ 94,000</td>
<td>$450,000</td>
</tr>
<tr>
<td># 2</td>
<td>$ 58,000</td>
<td>$300,000</td>
</tr>
<tr>
<td># 3</td>
<td>$122,000</td>
<td>$625,000</td>
</tr>
</tbody>
</table>

Using this process, the investor would be willing to pay 5 times the gross income.

REPLACEMENT RESERVES
In creating an expense budget, another factor would be replacement reserves. A prudent investor will be certain that a percentage of income is deposited into a reserve account so that future repairs will be funded without having to borrow money or fund them through his own personal resources. Some items that would be included in considering what will need replacement or renovation in the future in a residential building would include:

✓ Kitchen and bathroom fixtures
✓ Air conditioning units
✓ Washers, dryers and refrigerators
✓ Lobby and hallway decorations
✓ Site improvements such as driveways, landscaping, fencing and security lighting
✓ Roof
✓ Painting

Once the items are identified, a cost factor would be assigned as well as a lifespan. Apartments would need repainting more often than the roof will need replacing. Therefore, each capital item would be analyzed to determine its’ lifespan and a yearly amount necessary to replace or repair that issue is assigned.
Example: A washer/dryer has a life expectancy of 10 years. The present price would be about $1000. Therefore, if we budget $100 per year, in 10 years, we can replace the washer/dryer with funds we have available in our capital fund.

If the need for a capital reserve were ignored, the building would be considered poorly managed because there is a need for the investor to have an understanding of any major future expenditure he might have to incur. Co-operative and condominium communities collect an amount that goes into a capital reserve fund each month when the owner pays his maintenance charge.

CASH FLOW
There is often confusion in understanding the difference between cash flow and net operating income. Cash flow is the amount remaining after the payment of debt service. Net operating income refers to income before the payment of debt service. If, however, the investor were going to evaluate the property as though there was no financing, then the cash flow and net operating would be the same. The reality of investment is that many different aspects will be investigated. The more savvy the investor, the more many views he will take of the property.

It is important to remember that any investment should be broken down into three separate parts:
- Analyze the expenses
- Analyze the debt
- Analyze the income

This may seem like an almost impossible feat, but remember, we are dealing with a great deal of money whether it is our own or our clients. Just a reminder, when we work in the investment/commercial real estate field, we are much more involved in the transaction than in residential. There is more information we must obtain, more time spent and the results are higher commissions.

We have looked at several different analyses but should always keep in mind that we are not the professional accountant. If we get involved in any of these areas, we must stress the importance of the buyer using a certified public accountant. I know you have read this several times in this course, it just cannot be stressed often enough. The investor might also do himself a favor by running some of these analyses past any lender or investor he will be working with. Sometimes an extra pair of eyes can be amazing.

Another investor consideration would be the BREAKEVEN POINT. This is the point at which income equals expenses. An easy example would be: The rent is $1,000 per month and there are 100 apartments. This would bring in a potential of $100,000 per year if there were no vacancies. The operating expenses and mortgage debt are $70,000 per year. In order to learn our breakeven point we do the following analysis: $70,000 expenses = 70 apartments. Therefore, our breakeven point is 70 rented apartments. As long as the occupancy rate is higher than 70 apartments, the investment returns a positive cash flow.

VACANCY AND COLLECTION LOSSES
The investor must factor in to the equation the potential for vacancy and loss factors. If the property has historical information available, then a reasonable assumption could be drawn that perhaps 6 apartments are usually turned over annually and they take approximately 2 months to rent and renovate for the new tenant. In that case, the vacancy factor would be 12 months of potential income lost. Additionally, most buildings have a percentage of rent due that goes uncollected. Again, historical data would be used to get a general picture. Let us say that on average 2 tenants do not pay rent for 2 months before vacating their apartments. That would mean that an additional 4 months of rent would be uncollected. The vacancy and loss factor in this building 16 months of rent. If the seller’s statement does not show a vacancy and loss factor, it needs to be questioned and clarified.
**PERMITTED USE**

**EXAMPLE:** A vacant property comes on the market in an area an investor wants to build a small apartment house. The location is great, the property is flat and it seems that it would be perfect for the apartment house. When checking with the local authorities you find that it is zoned for agricultural use. This means that instead of putting up an apartment house you can grow corn. Obviously, this land is not worth nearly as much as property zoned for residential or commercial use might be.

**LEASING THE PROPERTY**

Since leases are usually the basis for the profit an investment property will generate, we are going to explore them in depth. Leases are binding contracts and the buyer is required to abide by all of the terms. When investment property is sold, it is sold with the leases. These can be the best or worse part of the investment.

As a reminder commercial leases are:

- Much more difficult to terminate than residential leases
- There are no standard forms so whatever the parties agree to is binding
- There is little if any consumer protection in a commercial lease
- They are usually long term. Between 10 and 20 years duration is not rare

The value of property is generally directly related to the value of the leases. Another indication of the value of a property is its’ location.

- If it is a retail location is it near highways and main thoroughfares with ample parking?
- If it is an upscale mall does the economy of the surrounding community support those types of stores?
- If it is industrial does the area have a good supply of workers to fill its’ needs?
- Is the area being revitalized?
- Has it been allowed to run down with no planning for improvements?

We are going to look at leases from the perspective of both the tenant and the investor/landlord. If the agent and investor/landlord understand the process the tenant will use to decide whether to lease a particular property, it might put the investor/landlord in a better position to determine whether a property is a good investment.

**Determining factors for leasing:** Commercial leases are as different from residential leases as day is to night. The commercial tenant is as different from the residential tenant as winter is to summer. Yet, agents who are not conversant in commercial real estate will treat residential and commercial landlords and tenants the same.

It is critical to the success of the agent to immediately understand and always keep in mind the basic differences. The residential tenant makes an emotional decision. Needless, to say this is governed by their ability to afford the premises. The commercial tenant makes the decision logically. “Where will my business grow most readily and how little can I spend for that space?” Very different motivations and therefore, very different tactics are needed to properly handle the participants.

**Is It Better to Buy or Lease Office Space?**

Before a commercial tenant decides that leasing is the right choice, he should do a study to determine which really is better, owning or leasing. If the prospect knows for sure that they plan to stay in the location for at least ten years and there is an availability of useable space for sale at a fair market or below market price, it is certainly something that needs investigation.

For many entrepreneurs and small business owners, the question of whether to buy property or to lease office space can be a confusing. If you ask a professional real estate broker, he or she will probably tell you that it depends on the particular situation. The truth is, when it comes to this important business decision, there really is no “one size fits all” solution.
The first part of the decision relies on the availability of capital to purchase rather than lease. If the capital is not available, then, no option is either. Leasing is the only way to go. Most new business owners start out by leasing office space, and many business consultants advise leasing is the right decision until the business is off to a good strong start. There are many advantages to a business owner in leasing rather than owning. Among them would be:

- **Flexibility**: The tenant is only bound to the premises for the life of his lease. He can relocate to another rental or buy a building. The choice is his.
- **Fewer headaches**: Because he does not own the building, he doesn’t have to worry about maintaining or managing it. He can concentrate on building up his new enterprise.
- **Less startup capital needed**: He can use his available resources to fund his business growth without concern for capital improvements or overhead of the building. This is sometimes the most important consideration.

PLANNING FOR NEW TENANTS

The investor needs to think about the best use of the office space in the building he purchased. Keeping in mind that different tenants have different needs. When buying a building that needs renovation before it is available for prospective tenants to look at, subdivide the space and clean up the building. Paint, new floor covering and renovated bathrooms will make the building inviting. It is important for a new investor to recognize that her tenants may not stay there for long periods. The reality is that when a business flourishes the owner often thinks in terms of buying his own building and perhaps becoming a landlord instead of remaining a tenant. Once again, the new owner should not make major site renovations before he knows what his tenant’s needs will be.

WHAT YOU SHOULD KNOW ABOUT COMMERCIAL LEASES

By understanding what is entailed in the commercial lease, the investor can protect the future of his building. Understanding the lease is a huge responsibility and cannot be taken lightly. Professional legal assistance should be sought.

DIFFERENCES BETWEEN COMMERCIAL AND RESIDENTIAL LEASES

Most people are reasonably familiar with residential leases. However, it is imperative that the commercial lease is completely understood because it is quite different. Some of the important considerations in commercial leasing that are not necessary in a residential lease:

- What is the tenant mix in the building?
- Will there be onsite management?
- What are the terms of the lease?
- Is there an option to sublease or assign the premises?
- Is there a personal guarantee on the lease?
- Is there a stated use provision?
- Is there a limit to the type of improvements the tenant can make?
- Is there a relocation clause in the lease? (landlord can force a tenant to relocate to another space if so desired).
- If there is a relocation clause, be sure to spell out the terms such as:
  - How much in concessions will the landlord have to pay?
  - Will the new space have a similar location or view or other favorable aspect that attracted the tenant in the first place?
  - How much time will the tenant be given to make the move?
- Fewer consumer protection laws
- No standard forms
- Long-term and binding
- Negotiability and flexibility up to landlord

IS LOCATION IMPORTANT FOR THE SUCCESS OF THE BUSINESS?

For some businesses, the classic advice "location, location, location" is right on the mark -- location can mean the difference between feast and famine. However, for other enterprises, location may be much
less important than finding affordable rental space. In fact, location is almost irrelevant for some businesses: service businesses that do all their work at their customers' locations (such as roofers and plumbers) and businesses that have little contact with the public (such as mail-order companies, internet-based businesses and wholesalers). If these types of companies can pass on rent savings to their customers and their profit margin, picking a low-cost spot in an out-of-the-way area might be an advantage.

The tenant gives great thought to:

**What Type of Location Is Best for Your Business?**
The key to picking a profitable location is determining the factors that will increase customer volume for your business. Such as:

- Will customers come on foot?
- Will customers drive and, if so, where will they park?
- Will more customers come if you locate near other similar businesses?
- Will the reputation of the neighborhood or even of a particular building help draw customers?

A major error of real estate agents is that they don’t take the time to analyze the real needs of their buyer/tenant. This can make success difficult for the agent, but not properly analyzing prospective tenants for an investment can be financially fatal.

**TERMS OF THE LEASE**
More than likely the landlord will present the tenant with a lease prepared by his attorney. Keep the following two rules in mind:

- Rule 1: The landlord always has the lease written in his favor.
- Rule 2: Every lease has negotiable points.

In real estate, we learn that just about all terms are negotiable. However, the reality is that the amount of negotiability is totally dependent on the current market conditions. If the market is tight there is little room, if there is a great deal of available space then terms tend to be more. If it is a specialty property no doubt the landlord is fully aware and will be less likely to give much in the way of concessions.

**WHO IS THE TENANT?**
What a silly question you might say. However, it is not silly by any means. Just because Mr. Smith is looking at the property does not mean that Mr. Smith will be the tenant. In fact, in most cases he will not. Who then is the tenant? Smith Printers, Inc. This is a huge difference. The property owner might not want to rent to Smith Printers because they have just started in business. Alternatively, because he knows that the corporation could be ended and no one will be personally responsible for the terms of the lease, he might not accept the corporation without a personal guarantee from Mr. Smith. As you can see, it is extremely important to have a clear understanding of the business name under which the lease will be signed and whether the landlord will insist upon a personal guarantee. Even in situations where the landlord insists on the guarantee, there may be an agreement that it remains in effect for a specified time and not for the entire term of the lease. This is something the tenant will want to negotiate but the landlord may not.

**WHAT IS THE TERM OF THE LEASE?**
Of particular importance is the term of the lease...how long will he be obligated to the space and is there an option to renew the space if things are going well? The space is attractive now, but will it still fulfill his needs if his business grows? If he signs a long-term lease, what are his obligations and responsibilities if it does not grow or he has to end the venture and leave the space? This is a difficult decision for the tenant to make because, on the one hand, obviously, he hopes to be successful. However, realistically, he must look at the downside if the business fails. One possibility would be a short term, perhaps two or three years with one or more five year options. By doing this, he is assured that he can terminate in two or three years with no penalty or, if things go according to his plan, he can stay on in the same space for a long time.
When considering this possibility the tenant needs to look at the terms of the option as well. The rent will increase in the future, but will it go up appreciably just because he is guaranteed the opportunity to remain in the space in the future. Alternatively, will it increase based on market factors? In determining the choices here, another consideration should be if he does grow his business, is there more space to which he might be able to expand in the future?

**DETERMINING RENT AMOUNTS**

**NET LEASE:** The tenant pays the rent as well as all the expenses of occupancy such as utilities, taxes, water, insurance and any other agreed upon payments. This, of course is the most variable since the tenant has no way of knowing how much utilities and taxes, etc. could increase in the future. Nevertheless, commercial leases are usually written with the tenant being obligated to pay some or all of the expenses of the premises.

**GROSS LEASE:** The tenant pays the rents as stated and the landlord pays all other occupancy expense. There may be an exception for the payment of electricity. The tenant is most secure in a gross lease since, obviously, he knows exactly how much he will have to pay each month for the life of the lease. That is exactly why commercial leases are seldom written this way. Remember rule #1.....the lease always favors the landlord.

**PERCENTAGE LEASE:** The tenant pays a stated amount for the rent and the occupancy expenses. In addition, they pay a percentage of their gross income. This is most common in a shopping center lease. The landlord may allow a new tenant a fair market rent or slightly below to get their retail business up and running. The percentage of sales the tenant pays would then allow the landlord to participate in the growth of his tenants.

Often as an inducement to get a qualified tenant the landlord may offer rent concessions. He might allow two or three free months or pay a substantial portion of the renovations necessary. These inducements should be factored into the rent in order to determine the actual cost of the rent over the period of time the lease will be in effect. Frequently these concessions can make one space much more attractive than another can when figuring out the real cost of occupancy. Another point to think about would be to try to negotiate a maximum amount the rent will increase based on the cost of utilities or some other variable. This will give the tenant some level of comfort.

**THE TRUE COST OF THE RENT**

In commercial real estate, the rent is usually stated as dollars per square foot. If the space is 1000 square feet and the rent is $24.00 per square foot then the annual rent would be $24,000 and the monthly rent $2,000. $24,000 annual rent divided by twelve months equals $2,000 per month. Sounds simple, however, there are many different ways to calculate the square footage.

Rentable refers to the total amount of square footage that the tenant will actually use plus a percentage of the building that is considered “common space”. Common space would include areas such as hallways, elevators, lobbies, parking areas and staircases and any other portion of the building that is used or could be used by all tenants. This can add considerably to the cost of the space and must be closely scrutinized.

Useable on the other hand refers to the total space the tenant has access to when he enters his premises. This includes hallways, closets, bathrooms, etc.

Carpetable refers to the space that will be used for his business purposes. Not really important in calculating the rent, but certainly a consideration to the tenant.

Let us say the landlord determines he is renting us 1000 square feet as we earlier determined at $24.00 per square foot. We now want to know the real cost of the space. We measure the useable space and find it is only 900 square feet, the balance being our portion of common area.
Now a different set of calculations occur. The $24,000 has to be divided by 900 to determine the real cost of the space. It is actually a bit more than $26.00 per usable square foot. We are only able to use 900 square feet, but are paying for 1000 square feet.

This is important because it is a truer way of comparing the real cost of space. By understanding and using this method, the tenant might realize that a space costing $25.00 per square foot might be cheaper than one at $24.00 because of the amount of common space included in the calculation.

**OTHER LEASE CONSIDERATIONS**

**Electricity and air conditioning:** who pays and what are the terms of use.

**Business failure:** a clause to determine how tenant can terminate lease:

**Assignment of a lease** generally requires the permission of the landlord and an approval of the new tenant. When the lease is assigned, the original tenant no longer has any obligations under the terms of the original lease. The assignee is responsible

**Subletting** is quite different. Again, this is done with the permission of the landlord. When a location is subleased, the original tenant is still obligated under the terms of the lease if the sub tenant goes into default.

The tenant needs a clause stating that the right to assign or sublet will “NOT BE UNREASONABLY WITHHELD”. In some cases the landlord may want the right to “recapture” the premises. That is, if the tenant wants to assign or sublet, the landlord has the right to take the space back and use it for his own purposes. If this clause exists, the tenant may receive some profit on the lease based on his potential for sublease or assignment.

**HOW MUCH RENT CAN THE TENANT AFFORD?**

This is one of the most important issues in choosing a location. Too often new business owners think too positively about the potential for growth and commit themselves to rent that is impossible to sustain. Remember, without a good business plan, most businesses are doomed to fail.

**Avoid Zoning Trouble** – Both Landlord and Tenant. Be sure the type of business is legal in the chosen location. Is the location properly zoned for this business? If you are opening a restaurant will it be permitted in this space?

**COMMERCIAL LEASE CHECKLIST**

Let us create a checklist for commercial leases to simplify the process of determining whether or not the space is appropriate for the tenant:

- Space and rent specifications
- How is it determined?
- Do zoning laws permit the intended use and the terms in the lease broad enough to allow for expansion or change of operation?
- In the event of a need for a sublease or assignment are the terms too restrictive to obtain a new tenant?
- Is the use permit simply “for any lawful purpose”?
- When does it begin and when does it end?
- Is the tenant entitled to any compensation if it is not ready for occupancy on the first day of the lease?
- Can the tenant terminate the agreement if the space isn’t ready on time?
- Can the tenant terminate early and if so, what are the penalties if any?
- Is there a provision for a handyman or superintendent 24/7?
- If not, what are the tenant’s responsibilities in the event of a malfunction or breakdown of the landlord’s equipment?
- If the tenant has to repair the landlord’s equipment in the event of an emergency, what steps does he have to take?
- How long does the property owner have to reimburse him?
- Will plans for improvements made by the landlord be submitted to the tenant and when?
If permits are required who will obtain them and at whose expense?
What improvements can the tenant make without consulting the landlord?
At the end of the lease, who owns the improvements?
Does the tenant have to return the premises to its’ original condition at the end of the lease?
Under what terms can the premises be assigned or sublet?
Does the tenant get a readout of the meters and when?
Are they presented with a calculation of the charges?
Under what circumstances will the landlord or tenant be permitted to terminate and what penalties will prevail
How much and what type of insurance does the landlord require?
Does the landlord have to be named in the policy?
What provisions are made and what obligations prevail if the building is sold?
In the event the landlord or tenant breach the terms of the lease, is there a cure period?
What penalties will prevail?
Warranty of quiet enjoyment
Are there penalties in the event the tenant is prevented from quiet enjoyment of his premises?

THE USE CLAUSE AND EXCLUSIVE CLAUSE
This is so important but often overlooked by the novice tenant. Remember, you do not know what the future will bring and you want to be sure that you have a wide scope of opportunity to use the space as necessary. Is there a non-compete clause based on other tenants use? What will happen to your lease if that tenant moves? Are you prevented from operating any type of similar business in the future if your expansion requires it? The use clause can be a major problem to the tenant.

EXCLUSIVE USE CLAUSE
Is there an exclusive clause? Does anyone have the right to be the only one of its kind on the premises? This is most typical of an anchor store in a shopping mall but might also be present in other situations.

TERM CLAUSE
A residential lease would have a beginning date, which signifies the date the tenant gains possession to the premises and the rent payment begins. In commercial leases, there might be more than one “beginning”. Does the tenant pay rent and all occupancy expenses from day one or is there a start date for construction of renovations and improvements and another for occupancy? If there is a rent concession for this period, are other occupancy charges also waived? As an example, while the renovations and improvements are being done does the tenant pay the utility bill and their share of the taxes, water or other charges in the lease? This can add up to a sizeable amount of money if the renovations are extensive. Therefore, there should be at least two start dates, one for the renovations and one for the actual occupancy and responsibility for payment of other charges.

SECURITY DEPOSITS
It is most common for the tenant to give a substantial sum of money as a security deposit. This could amount to two, three, or more months rent that the landlord will hold to protect him if the property is damaged or vacated early. The tenant might be able to negotiate for the return of some of the security deposit after a specified number of years. This is especially true in a start up operation where the landlord is not sure about the stability of a new business. It also may hold true if the landlord has agreed to make substantial improvements and wants the security in case the tenant defaults. Again, there is always the possibility that a portion of the security will be returned during the life of the lease.

The tenant has the right to know where the security deposit is held and, if interest rates are high might be able to negotiate the money being put into a certificate of deposit or other interest bearing instrument and both parties share in the income. Again, remember, everything is negotiable. You just have to try!
IMPROVEMENTS AND ALTERATIONS
If the new space will have to be customized to fit the tenant’s needs, a big chunk of the lease should address this issue. Both tenant and the landlord will have to reach an agreement about who does the design, who does the work, when can it be expected to be completed, and who pays for it.

Maintenance, Utilities, and Code Compliance
The property owner’s lease will undoubtedly contain a Maintenance clause that concerns tenant’s duties to care for his own rented space (or for the entire building, if they are the sole tenant). If she is a tenant in a multi-tenant building, tenant and property owner will also have to settle on how the utilities will be billed and paid for. Often there will be a Utilities clause near the Maintenance clause in the lease. Finally, the landlord may expect the tenant to keep the building “up to code” -- whatever that means (it often isn’t clear), in a lease clause sometimes titled “Compliance” or “Compliance with Laws.” It is always in the interest of the tenant to get this clause as specific as possible.

PARKING, SIGNS, LANDLORD’S ENTRY, AND SECURITY
It is likely to find several clauses in the lease that concern practical understanding’s the tenant will have with the landlord. These could be about such things as parking and business signs. Remember every line in that lease will define what the tenant can and cannot do and what they do and do not pay for. Read it carefully and negotiate it well.

INSURANCE CLAUSES FOR THE TENANT
Several kinds of insurance are available to cover the risks of leasing commercial space. These would include property and liability insurance, rental interruption insurance (this covers you if your business is unexpectedly interrupted, as would happen after a natural disaster), and leasehold insurance (this coverage protects the tenant if the lease is canceled due to circumstances beyond their control and they have to rent elsewhere at a higher rent). Each type of insurance coverage needs to be analyzed in the context of the lease and the landlord’s requirements, as well as the tenants business needs. Negotiate accordingly! It is important to use the services of a good insurance broker at this point to help determine the best possible policies for in keeping with the landlord’s requirements.

Perhaps by now you are beginning to think about what makes a good or a bad deal. Well, truth be told, there is no single answer. The goals of the investor will determine whether it is good or bad for her. What might be the deal of a lifetime for one investor is very uninteresting to another.

TYPES OF INVESTORS
Typically, there are three types of investors.

Those looking for cash flow: The investor simply wants a cash return each month and year. They would do best with a retail shopping center or a rental building. These properties can bring in a good cash flow year after year as long as they are well managed. This type of investor needs to be leery of a rental building in an area with lots of rentals when the market is not too strong. They also need to stay away from an investment with lots of OPM (other people’s money) which causes the building to be highly leveraged. If this is the case, should there be a worst case scenario when there is a high vacancy rate; the investor might have to put his personal money into running the building.

Those looking for a long term investment: Shopping centers or residential rental buildings in areas that have begun to build up are great opportunities for this type of investor. A shopping center in an area with a stable economy and demographics would also be interesting. These investors should not buy anything in an area that is dominated by one industry or one employer. If that company leaves, it might take a great deal of time to get it rented again. An old building in an area where there is a lot of new construction underway will also be problematic for the long-term investor.

Those who are looking for short-term investments: These buyers generally buy, fix and sell, perhaps within no more than 2 to 3 years. These buyers do best with “fixer upper” properties. They do well when the economy is uncertain and they have the desire to renovate the property. The problems that
could exist would include not timing the purchase correctly. If they buy and the market tends to decline, their goals will not be met because they will have to hold on to the property longer than they anticipated. They need to be certain that the amount they budgeted for rehabilitation of the property is realistic. If the budget falls short of the real cost, the possibility for a profit in a short time might not be there.

At this point, it is important to take into consideration the term “HIGHEST AND BEST USE’. When an appraiser uses the term “highest and best use” she is analyzing the property without a given buyer in mind. She would be looking at a best-case scenario. What could I do with the property that will bring the highest return? The answer may be very far from what the investor is planning for its use. Each investor must evaluate the property based on his own priorities. Therefore, the highest and best use varies from property to property and investor to investor!

**SOME IMPORTANT TERMS**

**Value**: The future benefit of present worth. The word “value” has many possible uses and could mean different things to different people. The end use of the property will dictate its’ value to the purchaser. A retail strip mall investor will find value in a different type of property than a widget manufacturer.

**Contribution**: If improvements are made, will their costs be effectively offset by future income?

**Cost**: Dollars expended to purchase or acquire the property as well as any amount needed to make the property useable. It can also be used when referring to “replacement cost” perhaps in insurance.

**Demand**: The opportunity to sell something in a given location at a given price. The lower the demand, the lower the price!

**Depreciation**: Decrease in value of improvements to real property due to obsolescence or deterioration. The land itself does not depreciate.

**Economic obsolescence**: Outside forces that play a negative role in the value of a property. Planes flying overhead daily, a cemetery across the street, flood areas would be examples of economic obsolescence.

**Functional obsolescence**: The loss of value due to the physical premises. Non-working elevators, lack of air conditioning, inadequate wiring to meet today’s needs are some examples.

**Goodwill**: An asset created by good customer relations.

**Income**: The buyer will put great emphasis on the income potential as well as the actual current income. They will compare the current income with the potential for future income.

**Price**: The amount the property would sell for in an arm’s length transaction. Both buyer and seller interested in getting the best terms for themselves. Both parties are knowledgeable about the current marketplace.

**Risk vs. Return**: Is the risk worth the return? A very personal decision!

**Supply**: The number of items of a particular type available in a given market at a given price. The greater the supply, typically, the lower the price.

**Transferability**: The ease with which possession and/or use can be conveyed from one party to another.

**Utility**: The ability of a property to fill a need. A lovely property that would seem perfect for building single-family homes is found to have a creek bed running through it. This would greatly reduce its’ value to the developer/investor.

**COMMERCIAL MORTGAGE FINANCING**

An important consideration for anyone buying anything is simply, “how will I pay for it?” Although general financing is covered in depth in another chapter, let us explore commercial financial exclusively. Similar to a residential mortgage loan in that it uses real estate as collateral to secure repayment, the collateral is commercial real estate rather than the traditional residential.

The commercial borrower may be a partnership, incorporated business, Limited Liability Company, or Limited Liability Partnership. Typically, the ability for the lender to evaluate the credit worthiness of the borrower is much more complicated in commercial lending than it would be in residential.
residential, the lender would look at the borrower’s credit history and availability of funds and determine whether to grant the loan.

In commercial lending, income and expenses of the property as well as those of the borrower will be taken into consideration. An analysis of the tenant and guarantor of the loan may be required. Neighborhood and market trends are considered. The composition of the surrounding areas and activity are analyzed. New construction, traffic congestion or lack thereof and neighborhood vacancies could affect the lenders decision.

**PROVISIONS OF A COMMERCIAL LOAN**

**Prepayment terms:** Not all loans allow a prepayment. If prepayment is allowed, the lender may dictate when the note may be prepaid. The lender can also require the payment of a prepayment or penalty fee. This fee will reimburse the lender for income he might have received had the loan been held to its term.

**Cure periods and notice requirements:** The existence and length of cure periods for defaults and whether notice of defaults must be given to the borrower are not automatic. The provisions for cures and notice are negotiated.

**Default provisions:** The note should include the events, which will cause it to be in default. A reference to make timely payments is generally a provision in all loans.

**Acceleration of maturity:** Hand-in-hand with the default provision is the acceleration of maturity provision without which the ability to foreclose or to exercise the power of sale could be fatal.

**Late charges and default rate of interest:** These amounts are often negotiated, but in any event must be limited by the maximum rate of interest permitted under applicable law.

**Joint and several liabilities:** This provision is always appropriate, even when there is only one borrower at loan inception. This protects the lender in the event that the loan is modified after closing to add additional borrowers.

**Usury:** Charging interest above the legally permit rate.

**Recourse versus non-recourse loans:** In most jurisdictions the note is recourse, which means that the borrower is personally liable for the repayment of the debt. If the loan is nonrecourse, the lender will want protection against liability in specific situations; such as liability for environmental contamination, failure to pay taxes and insurance premiums and retention of rental income after a default. The general purpose for this is that many laws significantly prevent the creditor from going after the borrower for any deficiency. Some lenders will require an assurance that in the event the borrower files for bankruptcy protection, they will have the right to take back the property.

**Balloon payment:** Unlike residential loans, which typically pay off the entire amount borrowed over a specified period of time, most commercial mortgages require a balloon payment. This is to keep the monthly payments manageable over a period, but not to extend the length of loan for too long in order to protect the lender. These types of loans might allow the borrower to repay the loan based on a 15 or 30-year payout, but in reality, the balance could come due in the form of a balloon payment after 10 years. When the balloon comes due, the borrower would most likely refinance the outstanding balance. There are two fundamentals applied to the term of a commercial mortgage: The length of time allowed until the Balloon Payment is due: This is known as the term and it can vary from anywhere between 5 to 30 years.

**Amortization:** The monthly payment which is based on an amortization chart of perhaps 30 years even though the balloon is due in 10 years. They payments are made as though the loan was for 30 years, but in the 10th year, the balloon comes due and the entire loan is retired.

**TYPES OF COMMERCIAL LOANS**

Commercial Mortgages can be used for a wide range of purposes. Most often, they are used to purchase the premises in which the business operates and for renovation or remodeling of the premises. In addition, purchasing new businesses or commercial or residential investments and developments would probably require this type of financing. An important point to remember on this subject is that if there is a mortgage default, often, the business itself could be in jeopardy.
Any number of banks offer commercial mortgages and there are many different requirements. Some banks will accept an applicant with a poor credit history if the business is credit worthy and there is enough of a down payment. Most banks, however, want the borrower and the business to be considered credit worthy. They will want the borrower to invest a portion of his own money. The bank will also look at the stability and profitability of the business or the potential for future growth.

When dealing with new or start-up businesses there is no doubt that there will be a requirement for a strong business plan and long term financial projections. After all, if they lend money they want to have a certain degree of certainty that the money can be repaid. Another interesting requirement from some lenders is the type of business planned. There are banks that specialize in certain types of commercial property and they will not entertain lending for anything else. Nevertheless, just about all lenders will analyze the type of business and the premises before granting a loan.

There is a good possibility that the lender will insist that the property be owned as a single asset such as a corporation or LLC, which was created specifically for this one business. By requiring this structure, the bank ensures itself that in the event of a default, they will have an easier time foreclosing on the property than if several premises or the same corporation owned different businesses.

**Bridge Loans:** Often referred to as short term or gap financing. They are used until more permanent financing can be obtained. Usually bridge loans are needed when the borrower must close on the property quickly. This might be the result of having to close on a purchase before the subject property closes. They are used in commercial real estate for other purposes as well. These loans are usually for up to about 3 years and can be very costly. They have high interest rates and can require the payment of a significant amount of points. Let’s see how these loans work

**EXAMPLE:** A developer has spent a lot of time working on plans for his next project and is now awaiting the necessary permits to begin building. Unfortunately, there is no guarantee that the plans as submitted will be approved. Since there is no guarantee the plans will be approved, there is also no guarantee that the project will be completed. The lender must be willing to take the speculative risk. Once the permits are issued and the project begins, the developer would be more likely to obtain a construction loan from a conventional source. This would give him long term financing at a lower cost. The bridge loan would then be satisfied.

**Balloon Mortgage:** During the life of the loan, installment payments are made that do not pay the entire principal and/or the interest that would normally be due. At a specified time, the unpaid balance of principal and/or interest becomes due and payable. This is referred to as the balloon.

**Blanket Mortgage:** A mortgage lien on more than one parcel of land. These are most often used by developers.

**Package Mortgage:** Personal property as well as real estate is pledged as security for the debt. If furniture or major appliances or equipment were included in the sale, the financing would be referred to as a “package mortgage”.

**Subordinate Mortgage:** A second or third mortgage that has a lower priority in the event of a default than the first mortgage. This priority is established based on the date and time of recording. In the event there is a foreclosure action on the property, the mortgage liens would be paid based on their “priority”. The first mortgage would be fully satisfied before any proceeds are released to holders of subordinate mortgages.

**Construction Loans:** The borrower would submit his building plans to the lender along with all specifications for building. The lender then establishes a value based on an appraisal of the impending construction. Once approved, the loan will have specific times when funds can be disbursed. This is usually at stated stages of development. Once all the money is disbursed and the house is completed the lender will usually convert the loan to long term permanent financing.
**Hard Money Loans:** A highly specialized loan where the funds are available based solely on the quick sale value of the property. Traditional, conventional lenders never make these loans, because they are extremely high risk. These loans are expensive and are usually the “last resort” available to the borrower. Many people confuse hard money loans with bridge loans. While there may be some similarities, there are many differences. Both are fairly short term. The bridge loan rarely longer than 3 years, the hard money loan a negotiated term. Both have higher than normal interest rates and high points. The most significant difference is that the bridge loan is given to a credit worthy borrower and the hard money loan to one who may not be.

Hard money is needed in a distressed situation, perhaps a pending foreclosure, bridge loans are needed to fill a temporary gap in funding. Private investors in their local areas are usually the source for these types of loans. This type of loan usually requires a mix of capital.

**ZONING, LAND USE, ENVIRONMENTAL ISSUES, ARCHITECTURE, DESIGN and CONSTRUCTION**

An interesting point to recognize about land use and zoning is that every county, town, municipality, village and city has the right to create their own agencies. As a result, there is no “one size fits all” and we must be aware of all the agencies in our community, how they work and what their jurisdictions are. This is a complex matter. Zoning plays an important part in the investor’s decision to go ahead with the project. It will determine not only what it can be used for now, but also what can be done with it in the future.

The investor also has to be certain whether the building use is classified as “non-conforming” and the current owner is “grandfathered” Remember “grandfathered” from previous chapters, the use was permitted under earlier laws or it began before zoning laws existed. In either case, renovations or improvements might prove to be either difficult or impossible. In many areas, once the property is sold the “grandfathered” use is no longer permitted. In fact, the real value in the property may be only the land and the buyer would have to consider the costs of demolishing the existing structures.

Other zoning considerations and restrictions are concerned with land preservation and retaining usage for specific purposes and utilization. It could prevent building that could overwhelm the existing infrastructure or streets and roads in the community. It might protect open parkland or prevent building simply to preserve open space.

For these reasons, zoning plays a huge part in determining the value of the property. Different zones and laws could be written for the following:

Zones would minimally be:
- Urban
- Suburban
- Occupancy restrictions would minimally be:
  - Office buildings
  - Residential, single family
  - Residential, multi family
  - Retail
  - Industrial

We use the term “minimally” because within each of these classifications the municipality will create as many sub areas as they need. Once the general area is identified, then specifics will be implemented. These are covered in greater depth in other sections of this course.

**Zoning will include:** Density, Permitted use, Historic areas, Park areas, Noise restrictions, Architectural design, Height limits. Different types of zoning will affect the value of the property.

**Building restrictions:** Materials used, Height restrictions, Property setbacks, Parking, Landscaping, Drainage, Easements
ENVIRONMENTAL ISSUES
Another concern to an investor would be the environmental issues entailed in the property. Because environmental issues are covered in depth in another chapter, let us just take a moment or two to recognize the importance environmental impact could have on an investor’s decision. The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) of 1980 was enacted in order to clean up contaminated property and assess and assign liability. Although the Environmental Protection Agency is at the helm of environmental laws and regulations, we tend to deal with local authorities when these issues are addressed.

Underground storage tanks (UST), contamination due to PCB’s or petroleum products used decades ago as well as asbestos are just a few of the environmental issues that cause concern. Sometimes a problem involves an adjacent property, but could still impact the subject property. As an example; contaminated soil on the next lot could require a cleanup on the subject lot before anything can be built. Buyers are, needless to say, extremely cautious about necessary clean up because there have been cases where the cost of cleanup exceeds the value of the property. Sellers are probably aware that the liability for clean up follows ownership. The only exception would be a clear indication of a guilty party. This can often be difficult to prove.

Tenants don’t want to live in buildings with contamination even if it has been cleaned and businesses don’t want to conduct their day to day operation in that environment. So, all in all, environmental considerations run high when an investor is considering the value of a property.

ARCHITECTURE, DESIGN and CONSTRUCTION
Although architects are not required on every renovation, most jurisdictions require architectural plans in order to file for a building permit. In some areas engineers are allowed to create the drawings. Whether you are working in residential or commercial real estate, a good agent will get to know about both architecture and costs. We certainly aren’t in a position to quote a price; however, we should be able to “ballpark” a dollar amount. That is, give a general idea of a range of costs. If the building is going to require extensive construction, the buyer may want to put the project out for what is referred to as open bidding. The plans for what needs to be done are sent to several competing companies and they submit their bids along with specific actions and material that they will use. When using this process, it is important to be sure that every phase of the construction is addressed. Usually the lowest bid will be accepted. I say usually because there may be bids that are lower than others, but do not really address all of the requirements of the project.

Negotiated bids occur when the buyer negotiates a price with the contractor. The price will include the general contractor’s fee for overseeing design and construction of the project and the costs to the subcontractors who will actually be doing the job.

Remember, architects and contractors can be some of your best customers. Often they are involved with the project personally and by cultivating a strong relationship, they might rely on your services when the property they are building or renovating or sub-dividing is going to be put on the market.

CONSTRUCTION: Once the bidding process is completed, the contractor chosen and the permits obtained, the construction will begin. Depending on the complexity of the project, this could take weeks, months, or even years. Other variables would include the weather conditions, availability of subcontractors and material.

SURVEYS
An exact legal description of the subject property shown on a drawing. The relationship to close surrounding sites is also noted.
**PRICE EFFECTS EXPOSURE**
The higher the price the more likely there will be fewer buyers who would be interested in seeing the home. The lower the price, the more likely there would be more buyers interested in seeing the home.

**USES FOR MARKET VALUE**
An estimate of market value could be used for:
- **A Transfer of ownership** - To establish how much money or like property should be exchanged to transfer a property from one party to another.
- **Financing and Credit** - To obtain a mortgage, to protect the lender in case the borrower defaults on the loan.
- **Condemnation** - The government takes a property or a part of a property for the common good.
- **Taxation** - Usually the assessed value is based upon some percentage of market value as of a particular point in time.
- **Rental/Leases** - Landlords or tenants could use this to determine how much they should charge or pay.
- **Feasibility Study** - When trying to decide what would be a good use for a property.

**ECONOMIC FORCES THAT DRIVE REAL ESTATE**
**Supply and Demand** - In economic theory, this is the interrelationship of the desire for a commodity and its’ scarcity.

Demand represents the desire to buy or rent a specific type of real estate in a given market for a given period of time.

Price will be affected by demand as well as supply. The more we want it and the harder it is to get, the more we’ll pay for it provided we have the means to pay. The easier it is to get, the less we will pay for it. The more we have of any one item the less special each individual item becomes.

**Anticipation** - A good amount of the value in real estate is in the anticipation of occupancy, possible income and/or the sale of the property afterwards. It represents long-term considerations. Consumer goods on the other hand, are often “used up” during the time we own them. The value is created by the expectation of benefits to be derived in the future. Value is the present worth of the rights to all prospective future benefits, tangible and intangible, accruing to the ownership of real estate.

**OTHER CONCEPTS THAT RELATE TO REAL ESTATE:**
**Increasing and Decreasing Returns** - the concept that adding enhancements to the property may not always bring a return on the investment. Simply put, there comes a point when putting additional money for improvements into a property will not bring a return on the owner’s investment.

**Example**: Perhaps the strip shopping center is in an area of town that is decreasing in desirability due to a great deal of residential and retail building several miles away. If the owner puts a lot of money into rehabbing the stores, it may not bring a return on investment because the area is still going to deteriorate.

**Balance**: A point of maximum value. Maximum value occurs when land, labor, capital and coordination are proportionately balanced.

**Contribution**: What is the desirable or detrimental effect of one component of real estate in relation to the norm? This concept considers each individual component and whether it adds to or subtracts from the whole of the value of property. **Example**: If you were buying a house and the owner has just put on a new deck that cost him $5,000 - would you be willing to pay $5,000 more for that house than the identical house next door that doesn’t have the deck?

**WHAT ARE THEY REALLY BUYING?**
**Estates** - or the bundle of rights that go along with ownership is a very important concept in the appraisal and pricing of real estate because it defines what rights are attached to that particular property.

**Air Rights** - These are limited by governmental controls, and the practicalities of engineering and economics. This is the right to the air space over your land. Often air space is purchased to preserve
views, such as in a community near a body of water. Or in high rise apartment buildings to ensure whatever views were accessible when the building was first built. In other situations, air rights are purchased or leased for the installation of satellite dishes or communication opportunities.

**Water Rights**- If you have water frontage you have a right to common use of that body of water with other people who also have water frontage. Riparian Rights refer to smaller bodies of water while Littoral Rights refer to larger bodies of water.

**Mineral Rights**-The right to remove minerals from the site

**Profits**- The right to take part of the soil or produce of the land. (Sand mining, forestry)

**License**- Giving someone the temporary right to use or have access to your land. **Example**: The current owner is allowing cars going to the next property to park in his parking area.

**Easement**- Allowing access and or use for a specific purpose (utility lines, common driveways)

**Encroachment**- Trespassing on the property of another.

**Liens**-These would include voluntary or involuntary holding of collateral for repayment of some kind of debt. Typical liens would include: Mortgage lien, Tax lien, Mechanic lien, Judgments

**Development Rights**- The concept that the right to develop can be transferred from one property to another. Used in open space preservation, agricultural preserves, or to protect historic buildings.

**HIGHEST AND BEST USE**

In formal terms, Highest and Best Use is defined as: “The use from among reasonable, probable and legal alternative uses, found to be physically possible, appropriately supported, and financially feasible which results in the highest land value.” Highest and Best Use analysis takes all the theories and forces the appraiser to put them all to the test that will ultimately determine which is the most probable. The following are the determining factors used by appraisers.

**Legally permitted**- What could we build given the zoning, building codes, environmental regulations, historical districts, and any other restrictions that may be placed on the property?

**Physically Possible** - What we can build will be limited by the physical aspects of the site as well as capacity and availability of public utilities.

**Economically Feasible** - There must be a demand for the property type. To determine financial feasibility of potential income producing uses, the appraiser estimates the future gross income. Vacancy and collection loss are then subtracted to obtain net operating income. From this a rate of return is established. If the expected profits are greater than the cost, then the project is considered economically feasible.

**Most Profitable or Maximally Productive** - Taking into account all the economically feasible uses, which one would create the maximum return on the investment? Which one results in the highest residual land value?

The tests of highest and best use are important because an investor must understand this concept in order to determine whether the property is right for his goals.

**OTHER CONSIDERATIONS**

**View**: What can be seen from the building such as other residential properties, commercial properties, water?

**Specific Zoning Classification**: The municipality in which the subject is located will have zoning maps and zoning code books.

**Zoning Description**: This will summarize what you can build- such as single family residential on ½ acre lot minimums.

**Zoning Compliance**: The appraiser notes whether or not the subject property complies with zoning regulations.

FEMA special flood hazard area: The federal government maps out areas prone to flooding and designates them based upon the probability of flooding within a certain time period. The zone, map number and date all come from our comp services.

**Adverse site conditions**: Is there anything about the site that would make it less desirable than typical properties in the area. Things like railroad tracks running through the site, high tension wires next to the site, a landfill nearby, or a big oil spill. In the cost approach these types of things are known as external obsolescence.
Quality of Construction: Sometimes quality differences are hard to detect but to make an extreme example, let’s think of the three little pigs, a house made of straw, a house made of twigs and a house made of bricks. The bricks cost more but most would agree that the extra strength and protection and longer life of the structure is well worth it!

Condition: Certainly someone would pay more for a property that is in excellent condition than one they have to fix up before or soon after moving into.

Gross Useable Area: This is discussed in depth in other portions of this subject.

Functional Utility: When considering improvements a major consideration would be “is it providing the use for which it was intended”.

Heating/Cooling: Sometimes the type of heat or the fuel will make a difference in values. Investors will look long and hard at this.

Energy Efficiency: In today’s world, energy efficiency can be a major factor in pricing real estate. Buyers will pay more when they know that it is highly energy efficient.

Parking: How much and what type? Also, does it comply with current regulations?

ANATOMY OF A TRANSACTION:
Let’s spend some time putting together a mock transaction to get a better understanding of what is involved in the purchase of investment real estate. Some of the following is presented as a review.

NEGOTIATING THE CONTRACT
Immediately after signing a letter of intent, sometimes referred to as an offer, the buyer and seller begin negotiating the purchase contract. Typically this is done by the respective brokers or, investment manager.

For example, the investor may require 10 days’ advance notice that the terms were accepted so that she can have the necessary cash available. Or, they may want the terms of the contract performed in a specific order.

Since the contract forms vary from transaction to transaction, care must be taken that the elements of the transaction as well as the language are in their client’s best interest. Never lose sight of the fact that there will, no doubt, be two brokers and two attorneys involved. We are not giving legal advice, nor acting as an attorney, however, it is our job to oversee the transaction so that it benefits our client.

Some of the more standard provisions of the contract would include:
- Assignability
- Due diligence
- Representations
- Warranties
- Provision for default
- Casualty
- Condemnation

While these are considered “standard” provisions, depending on the market and desirability of the property, the buyer might be willing to eliminate or lessen some of them. The buyer could agree to a shortened time for warranties. For instance, she might have asked for three years, but is willing to accept 18 months because there are other parties interested in acquiring the property. These warranties will include such items as structure, income, litigation and environmental problems. In order to avoid future problems the buyer and her advisors must pay careful attention to all phases of the due diligence and spend the necessary time evaluating each and every item.

The contract needs to state what forms the closing documents and statements will take. These will include but are not limited to:
1. Type of deed
2. Lease assignments
3. Contract assignments
It is amazing how often you will attend a closing and see the mad scramble for an agreement on some major points. This occurs because there wasn’t enough time spent on analyzing every aspect of the contract so that there won’t be pressure to re-negotiate what should have been pre-negotiated. Often this will result in one party having to compromise on an important issue.

**HANDLING EARNEST MONEY**

As soon as the contract is signed, the buyer will be expected to deposit the prerequisite sum into an escrow account. There will be a specific period in which this must be accomplished. If the buyer has not made the necessary provision to have the funds available and cannot deposit them according to the terms of the agreement, they will be in default.

It is the duty of the investment advisor or attorney to be certain that the investor is well aware of how much must be available and in what form. It might be in cash or a letter of credit. The investor must also be given instructions as to the name in which the funds are transferred and the exact location. Since the deposit can be a substantial amount of money, the investor should try to have the funds deposited in an interest-bearing escrow account. The terms of the interest must also be stipulated.

If a letter of credit is used the expiration date needs to be carefully monitored so that it does not expire due to ongoing inspections or negotiations or obtaining of information.

**DUE DILIGENCE, THE PHYSICAL PROPERTY**

The seller’s experts might have uncovered things that should have been negotiated between the parties so that the seller would be responsible for correcting the problem. Always remember, cheap can be very expensive. By having their own engineering report, the buyer will be able to determine what might need correction in the near future and, therefore, budget for the expense. Alternatively, negotiate for the seller to make the correction and pay for it.

Some of the items that might be uncovered could include:
- Estimated life of the roof
- Estimated life of the heating and air conditioning systems
- Foundation problems
- Building or zoning violations

If these items are problems, the seller should realize that no matter who buys the property these situations will be there. Therefore, they might be more willing to negotiate, knowing that any buyer will uncover the same problems.

A Phase I environmental study of the property is particularly important. It will signify any environmental problems and could call for a Phase II study and testing. The study will look at the history of ownership and uses. This has been known to uncover the fact that there is an underground storage tank that could cause problems. This part of the process is time-consuming and, frankly, can seem boring. However, it is critical to the success of the investment both now and in the future if the buyer intends to sell it.

**BUSINESS AND LEGAL DUE DILIGENCE**

Perhaps, this is the single most important step in the entire process. Unfortunately, lawsuits most often stem from an inadequate business or legal review. If it is not done properly and in a timely fashion, the result can be financial problems on the buyer’s side that should have been the seller’s responsibility. By the time they are uncovered, the seller is either long gone or the company that sold the property has been dissolved and has no assets.

Some of the items that will be scrutinized include:
- Differences between how the contract/lease reads and what has been told to the buyer
- Discrepancies between the landlord and tenants
✓ Warranties
✓ Service contract agreements
✓ Possible easements or encroachments
✓ UBTI (unrelated business taxable income)

No fewer than the following four items should be reviewed: The size and scope of the investment property will dictate what else needs to be reviewed.
   1. Leases
   2. Personal interviews with tenants
   3. Tenant Estoppel Certificates
   4. Title and Survey

LEASE REVIEWS
The first and foremost part of this is to be certain that the seller’s representation of the rent roll is accurate. The next part would include certainty that the seller was accurate in advising the expenses paid by the tenant.

TENANT INTERVIEWS
The next step would be face-to-face interviews with each of the tenants when possible. If there are too many then a representative number must be determined.

Some important questions that need to be asked include:
✓ Do you have any complaints about the landlord?
✓ Are you happy with your space?
✓ What are your future leasing expectations or needs?
✓ The answers could give the buyer some assurance that the tenants will remain and there is stability in his future income. It will also give her an opportunity to learn about any long-standing issues that remain neglected. This interview would also determine whether the landlord has promised to do something specific for a tenant that still hasn’t been completed

✓ Tenant Estoppel Certificates

There is an old saying, “communication is the perception of the recipient”. We know what we are sending, but we do not know what has been received. What does this have to do with leases? Actually, a great deal! As you pursue your career in real estate you will be amazed by the number of times people do not realize or perhaps understand what they have agreed to. A perfect example would be the mortgages that were bought with outrageous terms, which led to foreclosures and bankruptcies. Nevertheless, let us get back to tenants and leases. The buyer should obtain signed certification of the ‘facts’ of the lease. Example: The lease you have is the entire lease and there are no additions or amendments. Additionally, the financial aspects of the lease. This research will uncover any potential misunderstandings between the landlord and tenant.

SERVICE CONTRACTS AND WARRANTIES
A good many agreements will call for the buyer to assume the balance of existing contracts for service. These might include:
✓ Building security
✓ Porter/janitor
✓ Landscaping
✓ Fire/smoke monitoring
✓ Garbage and trash removal

Often it is advantageous for the buyer to assume these contracts if they are carefully reviewed and documented and represent no less than fair market pricing. Sometimes, they can even be a bargain because the landlord has had a longstanding good relationship with the vendor. Many times, however, they are not good and there needs to be some agreement between the landlord and the buyer that the contracts can be cancelled within a specified period after closing. Perhaps 30 to 60 days would be sufficient. This would give the buyer time to evaluate the services rendered and determine if the vendor is acting in the buyer’s best interest when performing his services.
The closing documents should contain an exhibit, which clearly identifies the service contracts and guarantees and warranties. This exhibit should state which are being retained and which are not. It is always a good idea to be as specific as possible to prevent a misunderstanding.

**TITLE AND SURVEY**
The buyer’s attorney must review the property’s title and survey to determine the following:
- Determine whether there are any liens against the property that the seller has to satisfy before closing.
- Are there any easements that could cause a problem?
- Are there any encroachments onto adjoining property?
- Are all zoning laws in full compliance?
- Ascertain that the legal description in the title report and on the survey match exactly.
- Are there any violations under the covenants, conditions and restrictions (CC&R’s)?

**THE NEW ENTITY**
The attorney or investment manager will form an entity to acquire the property. Investors do not generally buy property in their own personal name. They will form a company specifically for that purchase. Most investors will form a new entity for each property they own. This is done to protect other assets in the event of litigation. This is good advice for new investors who may not be well educated in this process.

**BANK ACCOUNTS**
The first account that comes to mind would be the most obvious, the one that receives the income and pays the bills, the working account. However, depending on the law in the area in question and local practices, there may be a need to establish an escrow account or maybe more than one. Is there a requirement that security deposits be deposited in a separate escrow account? If so, is it interest bearing? If yes, who is entitled to the interest? If the tenant pays a share of the taxes, where is that to be deposited?
So many questions to be answered!

**PRO-RATIONS AND ADJUSTMENTS**
As we draw closer to the closing date, there needs to be a checklist of necessary documents relating to financial information so that they know what pro-rations will be called for. This is at best a difficult task and needs to be taken quite seriously. Remember, if it isn’t adjusted correctly at the closing, the buyer and/or seller will be out of luck in trying to recover money that they might be due or responsible for once ownership changes hands.

Let’s create a list of some of the items that might need to be determined and understood:
- How much are current tenants being billed?
- Has anyone prepaid rent
- Current property tax bills
- An in depth schedule of rental income that has been collected
- Base rents vs. additional rent charges
- Operating expense recoveries
- Additional rental income i.e. storage facilities
- Income derived from garage or parking facilities
- Are there any unpaid commissions due for existing leases?
- Are there any improvements promised tenants. If so, their cost and how costs are apportioned

Additional information necessary to be received and understood prior to closing:
- Aged receivables (money that is past due)
- A schedule of security deposits
- Any dues, association fees or assessments that have not been paid (copies of invoices sent for these items should be available)
A list of any expenses relating to service contracts. This would include any prepaid fees or past due expenses

UTILITIES: Unfortunately there have been many closings both residential and commercial, which become chaotic because no one ordered final meter readings. Or, no one arranged to have the utilities transferred to the new owner at the time of closing. Let’s not forget that in most cases there will be pro-rations regarding utilities. How much did the seller prepay that the buyer must reimburse? Unless there is a final reading for all utilities, it now becomes a free for all of guesses and will usually result in errors. The title company does not have the responsibility to determine whether these pro-rations are fair and accurate. That is the responsibility of the buyer or seller, his attorney, financial advisor or asset manager. Each party should designate this responsibility to an individual who will oversee the collection of the information. They will also investigate and determine the authenticity of the information and report back to their client the results.

How much money will be needed to close the transaction? The pro-rations and adjustments will be calculated and the buyer will be notified as to the exact amount he will need at the closing. This includes but is not limited to:

- The balance of the purchase price owed
- Closing costs
- Financing charges
- Legal, advisory, administrative charges
- Capital reserve
- Pro-rations and adjustments

SIGNING DOCUMENTS AND CLOSING THE TRANSACTION

There are six general steps that should be taken prior to the closing. They include:

- Necessary documents in hand, accuracy checked
- All necessary attachments properly attached
- A thorough check of all documents to determine that any required signatures have been checked
- Necessary notarization
- Funds required in proper form and location

This process should begin at least two weeks before the scheduled closing so that anything missing or incorrect can be properly disposed of within plenty of time. We are really stressing the need for proper check of all documents and funds. Depending on how close the closing date is to a default date in the contract, the greater the possibility of an inability to close, which could result in a default. The default, quite possibly, could give one the parties the ability to end the agreement with the other forfeiting a great deal of money.

Often the seller is going to use the funds from one transaction to finance another and he will insist that they be available by a certain date. Or, he is paying off the existing loan on the property sold and all interest payments have been calculated as of the anticipated closing date. If the funds are not available, he could incur additional expenses, which reasonably would be transferred to the buyer. The buyer must recognize the need to know and observe deadlines.

The Closing Statement

This is usually prepared by the attorney for each party or in some localities by the escrow agent. No matter who prepares it, buyer and seller should have ample opportunity to review and question the documents. Care should be taken to calculate all pro-rations and determine credits due. Since dealing with investment property typically could involve huge sums of money, it is imperative that the funds called for are accurate.
For those of you who are going to be involved in residential sales, you will no doubt attend a closing here or there where the buyer does not have adequate funds available at the closing. Sometimes they may have to call a relative to deposit money in a bank account that can be easily accessed. Closing problems with investment real estate call for greater sums of money and a shortfall at closing is not so simply corrected.

DO WE REALLY NEED TO KNOW ALL THIS?
We have no doubt that a good part of what we have covered in this last section may be more than the agent will have to deal with. However, by knowing and understanding the complexities of an investment transaction, we are better equipped to help buyers and sellers and give them assistance and assurance where necessary. Remember, we are not suggesting that you commit all of this to memory. By understanding the steps along the way, you will be a more professional agent.

Attorneys and advisors will oversee the transaction, but even the best in their field sometimes make errors or miss a step. By having the knowledge of the components of the transaction and closing process, we can be a “second pair of eyes”. We could also be in a position to discuss the need for an asset manager. Without saying, this is way beyond the expertise of the new agent, but something that an experienced commercial/investment agent should be familiar with.

ADDITIONAL COMMERCIAL/ INVESTMENT CONSIDERATIONS
We have spent a great deal of time exploring very traditional commercial real estate and investing. However, some other types should be briefly explained.

FLIPPING: buying an under priced property and then quickly reselling it at market value. In order to accomplish this, the investor looks for homes that are usually owned by people in distress. Typically, they have lost their jobs or are facing foreclosure action. Homes that are in an estate might also be sold at a discounted price. Sometimes, the homes are in poor condition and require a great deal of capital to bring them up to real market value. These homes might also have mold, asbestos, or other environmental problems that will be costly to correct. However, these problems will generally cause the property to be sold at a great discount and could offer a high return on total investment. Occasionally an owner is caught with two homes, the one he is trying to sell and the one he has already purchased. In this case, he might be willing to sell at a below market price just to get himself out of a bad situation.

More than likely as you are going into this section you are thinking to yourselves, “boy this sounds good, I can’t wait to get into the business so I can buy low and sell high”. The idea of flipping is enticing, the reality is depressing. When there are many properties that can be purchased at a low price, it probably means there is a problem with the economy, the location of the house, or some other situation outside of the property itself. Flipping is great for someone who has a very high tolerance for risk.

TAX LIENS
These are not always considered a type of real estate investing; however, they are worth a brief mention. Because each state sets its own rules regarding lien sales, it is imperative that there is very careful research on the part of any interested party. There also may be differences county-to-county or municipality to municipality. We are going to give only a brief overview on the subject.

Typically, the owner of a property will be sent a tax bill which gives an in depth summary of how much is due and the different authorities or agencies who will share in the payment. The tax bill will also set a date by which the taxes must be paid. In the event the taxes are not paid in a timely fashion, and after receiving fair warning, the taxing authority will begin the legal process required to collect the unpaid bill.
**TAX LIEN STATE**
The sale of tax liens is governed by the area in which the property is located. For instance, a county might sell the lien at an auction. In some areas, the lien is sold for exactly the unpaid amount, in others there is a bidding process, which could easily result in the lien being sold for more than it is worth.

Each state sets the amount of interest the lien holder can collect from the owner based on the amount paid for the lien. They also set the period of time the owner would have to redeem the lien. This redemption would call for the payment of the unpaid taxes as well as earned interest. If the owner does not pay the amount within the statutory timeframe, the lien owner can foreclose on the home.

If the investor forecloses, any other liens including mortgage liens will evaporate and the investor will own the home free and clear. For this reason, lenders try to avoid tax lien sales and will usually pay off the delinquent amount in order to prevent the tax sale.

Some unpaid debts that might cause a tax lien sale
- Property tax
- Water charges
- Sewer charges
- Sidewalk repairs
- Vacant lot cleanup

Not all property with delinquent charges can cause a lien sale. There are many with exemptions such as:
- Senior citizen
- Disabled homeowners
- Low income homeowners
- Low market value

Also, there are usually rules governing the length of time the debt is overdue and the amount of the debt that will trigger a tax lien sale. Typically, if a tax lien is sold the property owner will be notified and will then owe the unpaid debt along with interest to the new lien holder. They may also have to pay for legal or administrative fees that were incurred in order for the tax lien to be sold. The law will specify when the owner has to pay the interest and if it is not paid, how soon after a foreclosure action could begin.

It is important to restate that a tax lien sale does not automatically trigger a foreclosure action. If the owner satisfies the debt, all interest, and other related charges within the required span of time, they will continue to own their home as before.

The intention of the lien buyer is to eventually have the owner come forward and satisfy the lien and all outstanding charges. While this is usually the case, there are many times when it just does not happen. Owners will often try to sell their own property and retain whatever equity they might have accumulated. The buyer would be required to pay the tax lien and all charges. In some cases, the owner will simply walk away from the property because he has no way to pay the lien and does not want to go through the legal process.

For these reasons, the lien holder will need to pay the property taxes and other charges for the length of time required before he can begin the foreclosure process.

Within each state, municipalities have differing laws governing tax lien sales. As an example, in New York City tax liens are sold “in bulk” to large institutional investors. In other parts of the state, individuals can still invest in tax delinquent property.
**WHOLESALING**
Investors who specialize in this type of property must have a great deal of available capital since they buy property in bulk and sell them at a small profit. As an example, let us use a developer who built 150 homes in a subdivision. He sold 125 and then the market slowed down and he wanted to rid himself of the last 25 homes. A wholesaler would enter the picture and buy the homes at a below market price. Perhaps the homes were for sale at an average of $250,000 each. The wholesaler might buy them for $100,000 each and sell them for $150,000. In the end, everyone wins. The developer is out of the project, the wholesaler made a small profit per house and the purchasers bought at a bargain price. This is a simplistic explanation of a very complex specialty.

Another practical use for wholesaling occurs when a co-op or condominium project is nearing the end of their marketing life and there are still units that are for sale. The sponsor or developer would look to “wholesale” the remaining units so she can go on to her next project. In co ops that were converted from rent-stabilized apartments, wholesalers may come in and buy occupied apartments. They buy them knowing there is a rent stabilized tenant and that the unit cannot be sold until the tenant moves out or dies. They are responsible for collecting the rent and paying the maintenance charges and any assessments. These units are usually sold considerably below market price and when they are eventually vacated, the wholesaler will make his profit.

This is a highly specialized form of investing because the investor is gambling on the lifespan of the tenant or his desire to move and whether or not the future price of the units will appreciate enough to offer a profit when sold.

**SHORT SALE OR PRE-FORECLOSURE**
No doubt, we all hear these terms from time to time. When the market is strong, people do not think in terms of short sale or pre-foreclosure, but when times get difficult and people lose their jobs and fall behind on their mortgage payments, unfortunately, these terms are with them all day, every day.

Perhaps a buyer obtained financing that had an adjustable rate. As time progresses and the adjustments kick in, the monthly payment far exceeds the ability to pay. After a period of time as the owner begins to fall behind on his payments the bank might begin a foreclosure process, which will usually, take several months to complete. The bank will file a notice of default which is a document filed in the public records for all to see. The owner will be made aware of the process. This is an unpleasant situation, which is extremely emotional for most owners.

In other cases, short sales are a result of the value of the property going down and now the house is “under water”. A term used to describe property that has an outstanding mortgage balance that is more than its’ market value. In some cases, the lender will consent to the home being sold for less than the balance of the mortgage in order to prevent the foreclosure action. They would do this because they do not want to become property owners. The lender also realizes that there are many expenses they will have to incur if they foreclose and become responsible for maintaining the property.

This would include paying the taxes, insurance and upkeep. They would have to create some kind of security oversight to be sure that the home is not vandalized making it unsalable. Overall, it is often very much in the lenders best interest to allow a short sale rather than going through the process of foreclosure. Not all lenders will allow a short sale and not every seller’s situation will qualify.

Another potential problem with short sale investing is that of a house with more than one mortgage lien. The total of both loans might be more than the value of the house, but individually this is not the case. There would be very little likelihood of a short sale in this situation since both lenders would want to recoup some of their investment.

Many investors specialize in seeking out and buying property via this short sale approach. In all cases, we need to stress that experienced professional guidance is required. Both legal and tax advisors who
are familiar with all the ramifications of short sales need to be part of the process of buying this type of investment.

Both buyer and seller need qualified consultants to help determine whether he will have a taxable situation because of selling the home below the balance of the mortgage. There may be a deficiency judgment or claim and only experienced professionals would be qualified to give sound advice.

One of the possible advantages of a short sale to the buyer is that some lenders do not report the adverse credit situation to credit agencies. This is not always the case and each lender makes his decision. If the information is reported, as is often the case, it will have a negative impact on the seller’s credit rating.

This type of transaction is very complex and often will fail even when both the buyer and seller have the best of intentions due to the complexity and period usually required. The lender will make extreme demands on the seller and buyer. Short sale buying is not for the average investor. It takes a very determined, educated in this type of sale person to know the strategy required to make this a kind of investment successful.

SHORT SALE COMMISSION
Just as in any other type of sale, any or all participants in the transaction can pay commission. There might be an agreement for the buyer or seller to pay their respective agents or, perhaps, all the commission will come from the proceeds of the sale of the house. The problem you encounter with the short sale is that the lender will look at the commission as having come out of his pocket and will almost certainly try to renegotiate the amount paid. When a seller sells his house, he walks away from the closing with cash. In a short sale, the lender is losing money so he is going to try very hard to limit his expenses and liabilities.

LIKE-KIND EXCHANGES – 1031 Starker Tax Deferred Exchanges (also covered in income tax chapter)

WHAT DOES LIKE-KIND EXCHANGE MEAN?
Quite simply it is an exchange of similar investment assets such as real estate, which will prevent the requirement to pay taxes on the sale at that time. When we own investment property and it increases in value we have a few choices, keep it and watch it grow, sell it and pay capital gains tax on the profit or, enter into a 1031 exchange. Deciding to exchange the property creates a tax-deferred situation whereby the money that might be received from the sale is invested into another property and there are no taxes due at this time.

If the property sold for $500,000, which gave the investor a profit of $100,000, he would have to pay taxes on the $100,000 profit. However, if he rolls this money over into a new property that costs more than $500,000, he has no tax responsibility. The idea behind this section of the tax code is that when an individual or a business sells a property to buy another, no economic gain has been achieved.

There has simply been a transfer from one property to another. For example, if a real estate investor sells an apartment building to buy another one, he or she will not be charged tax on any gains he or she made on the original apartment building. When the investor sells the original apartment building and purchases a new one, the value used from the original to buy the new one has not changed - the only thing that has changed is where the value is being held.

This is a very short explanation for a very complicated transaction. It should never be attempted without the consultation of lawyers, accountants and advisors who are thoroughly familiar with the process. Extreme care must be taken to ensure that there will be no tax liability on the sale of the asset.

Let us look at the three most important areas to consider to understand the 1031 exchange.

✓ The asset being sold must be an investment property and can't be a personal residence.
✓ The asset being purchased with the proceeds must be similar to the asset being sold. Property outside the United States cannot be exchanged for property in the United States.
✓ The proceeds from the sale must be used to purchase the other asset within 180 days of the sale of the first asset, although you must identify the property or asset that you are purchasing in the like-kind exchange within 45 days of the sale.

As with any investment property, the current rules and laws must always be taken into consideration before attempting this type of activity.

There are specific assets or properties that are considered for a tax-free exchange. The two assets must be of the same type. For example; real estate for real estate. They do not have to have the same value or even be in the same state, but they must be like/kind. They can be of different quality. A high-rise apartment house and an office building might qualify as an exchangeable asset. An investor owns a 15-unit apartment house and wants to sell that and buy a yacht for the same amount of money. This is not permitted.

In the event the two properties are not of equal value and money has to be included to equalize the amount of the exchange, the cash is taxable and is referred to as the “boot”. When tax laws were first written, in order to qualify for an exchange, the property had to be transferred simultaneously. This meant that if property #1 transferred on Jan 10, so must property #2. This caused obvious problems. Eventually, a lawsuit was brought and a change was made to this area of the rules.

As the laws exist presently, the new property must be identified within 45 days of the sale and there is a **180 day window** in which to close the second property. This is referred to as a Starker Tax Deferred Exchange (named for an investor who challenged and won a case against the IRS).

Exchanges of shares of corporate stock in different companies will not qualify. Exchanges of partnership interests in different partnerships and exchanges of livestock of different sexes will not qualify. Think about it, they are not “like/kind”.

For real property exchanges under Section 1031, any property that is considered "real property" under the law of the state where the property is located will be considered "like-kind" so long as both the old and the new property are held by the owner for investment, or for active use in a trade or business, or for the production of income. However, there is a stipulation that real property outside the United States and real property located in the United States are not/like kind.

**BOOT**

It is very common for exchanges to be financially unequal. That is, one property is worth more than the other. The difference is referred to as the “boot”. The term is not used in the Internal Revenue Code and many people would wonder where it came from. It is an old English term that simply meant “something given in addition to”. Therefore, anything received in addition to the exchanged property is referred to as the “boot”. Perhaps one property is worth $800,000 and the other $900,000. In order to get a fair exchange $100,000 in cash would be required. This would then be the boot.

Some practical tips to follow when dealing with a 1031 exchange:
✓ Always trade "across" or up, but never down in order to avoid receipt of boot. Receiving cash or a reduction of debt is considered a taxable boot.
✓ Always bring cash to the closing of the replacement property to cover loan acquisition fees that are not considered part of the qualified exchange
✓ Never agree to accept property, which is not like/kind.
✓ Don’t finance the replacement property for more than is necessary. Financing should be limited to the amount of money necessary to close on the replacement property.
**BASICS OF AN EXCHANGE:**
In order to qualify, the property must be held for future appreciation or for the production of income. Property that is bought and sold quickly will not qualify for an exchange. A rule to follow is that the property should have been owned for at least a year and a day.

**The 45 day rule:** In order to comply with the rules, the investor has 45 days from the day he closes on the sale to come up with a list of properties. The list of properties must be submitted by the 45th day or the exchange cannot proceed and taxes are due. There are no exceptions to the 45 days even if it falls on the weekend or a holiday. He can identify exchange properties by any of the following:
- **The Three-Property Rule:** Any three properties regardless of their market values.
- **The 95% Rule:** Any number of replacement properties if the fair market value of the properties actually received by the end of the exchange period is at least 95% of the total Fair Market Value of all the potential replacement properties identified.
- **The 200% Rule:** Any number of properties as long as the total fair market value of the replacement properties does not exceed 200% of the total Fair Market Value of all of the exchanged properties as of the initial transfer date.
- **The 180 day Rule:** All property must be closed within 180 days. If they do not, the exchange is cancelled and again, taxes are due.

If the identified property is destroyed by hurricane, flood, or fire after the 45 day period, the Exchanger cannot identify a new property. Misidentifying a property due to an incorrect address, or in the case of a townhouse or condominium, the wrong unit number will cause the exchange to fail once the 45 day identification period cannot be changed.

As long as the money continues to be re-invested in other real estate, the capital gains taxes can be deferred. However, rental income received on real estate investments will continue to be taxed as net income is realized.

**No control of proceeds during exchange period:** The investor cannot receive nor have access to any of the funds used for the sale and purchase of the property. They must use a third party called a Qualified Intermediary.

**Ownership must be in the same name:** The tax return for the sold and acquired property must be in the same name. This would prevent an investor from selling a property owned by ABC, Inc. and buying the new property as DEF, Inc.

**Purchase price requirements:** The price of the new property must be equal to or greater than the net proceeds from the sale of the old property.

**Cash reinvestment:** There can be no cash taken from the exchange. If the investor receives any cash it is considered part of a sale and not of the exchange and is therefore taxable (boot). Unless all of these rules are followed explicitly, the IRS can claim that you did not have a bona fide 1031 tax free exchange and it is possible to have to pay not only tax but interest and penalties as well.

**QUALIFIED INTERMEDIARY**
The Qualified Intermediary is the expert who handles all the details. Again, since 1031 exchanges are incredibly complex transactions, investors are required to use a “Qualified Intermediary” to put the transaction together. The Qualified Intermediary (also known as an Accommodator) should be a corporation that is in the full-time business of facilitating 1031 exchanges. The role of a QI is similar to, but not identical to, the role of an escrow company.

The investor cannot use its current attorney, certified public accountant or real estate agent as the QI because there can be no prior relationship for at least two years before the close of the exchanged properties. Incredible as it may sound the qualified intermediary is not required to be licensed in most states. Anyone who wants to can take on this role. Considering that they will be holding all the proceeds of the sale as well as title to property, a great deal of investigating must be done before hiring the accommodator.
The IRS's strict rules regarding certain requirements underscore the value of the qualified intermediary and the importance of choosing an appropriate one. One of the major services they offer is to keep transaction participants on track and to ensure that they meet the requirements necessary for taxpayers to qualify for preferential tax treatment of their real estate profits. It is important that investors research and select their transaction's intermediary carefully. Members of the Federation of Exchange Accommodators belong to a national organization specializing in 1031 exchanges.

The QI enters into a written agreement with the taxpayer, which allows them to transfer the relinquished property to the buyer. She then transfers the replacement property to the taxpayer based on the exchange agreement. The QI holds the proceeds from the sale of the relinquished property so that it is out of the control of the exchanger. The QI also prepares the necessary documents to accomplish a tax-deferred exchange. She acts as the bridge between the parties, the property and the money. She is a “facilitator”.

**Duties of Qualified Intermediary**

- All documents necessary to conclude the exchange are prepared by the QI. She is charged with being certain that all parties receive any and all documents that are necessary to the transaction.
- All funds must be deposited into an escrow account and all disbursements are made from that account. She is the receiver of funds and property and the disburser as well. Upon completion of the transaction, she is responsible for a full accounting of all funds received and disbursed. This is for the taxpayers records. She must also submit a 1099 form to both the Internal Revenue Service and the taxpayer. Additionally, it is her responsibility to ascertain that all necessary taxes and capital gains taxes are paid.

**PROCESS OF A TYPICAL 1031 EXCHANGE**

1. Research and retain a tax advisor and attorney.
2. Be certain they are familiar with all the ramifications of the exchange process.
3. Research and retain a Qualified Intermediary and enter into a written agreement, which spells out all the terms and duties required. They will be named as principal in the sale of your relinquished property and the subsequent purchase of your replacement property.
4. The 1031 Exchange Agreement must meet with IRS Requirements, especially pertaining to the proceeds. The escrow agreement will name the QI who will be named as the seller. However, the deed will name the taxpayer and the true buyer. This is called direct deeding. It is not necessary to have the replacement property identified at this time.
5. Sell the property, which must include a “cooperation clause” in the sales agreement. This is required since the buyer must know that the seller intends to complete a 1031 Exchange and he will have to cooperate so that the seller can accomplish his mission. He is also assured that he, the buyer, will not have any additional expenses or liability.

The QI must be provided with all necessary documents to ensure compliance with 1031 Exchange rules.

At this point, the relinquished property closes and the closing documents state that the QI was the seller and received the proceeds of the sale. These funds must be deposited into a separate escrow account. The closing date of the relinquished property escrow is Day 0 of the exchange, and that is when the exchange clock begins to tick. Written identification of the address of the replacement property must be sent within 45 days and the identified replacement property must be acquired by the taxpayer within 180 days.

This notification should be sent by any means that will allow the sender to have a signed receipt for his records in the event a problem with the date occurs.

Now the taxpayer can enter into an agreement to purchase his chosen replacement property. Again, there needs to be a “Cooperation Clause” in the purchase contract to notify the seller that the buyer is
going to complete a 1031 Exchange and the seller agrees to cooperate with buyer at no additional cost or liability to seller. An amendment is signed naming the Qualified Intermediary as the buyer. Again the deeding is from the true seller to the taxpayer.

Prior to the 180th day the QI forwards the funds being held and the closing takes place. The closing statement reflects the Qualified Intermediary as the buyer. The Qualified Intermediary sends a final accounting to the taxpayer, showing the funds coming in from one escrow, and going out to the other. The taxpayer has not had the use of these funds at any time during the period of the exchange.

Finally, the taxpayer files the required forms with the IRS (8824) and any other forms required by local taxing authorities when taxes are filed. The “amount recognized” capital gain or loss is reported to IRS for tax purposes.

**EXAMPLE OF A 1031 EXCHANGE**
An investor buys an apartment house for $800,000. After owning it for several years, he decides he is tired of being a residential landlord and sells it for $1,200,000. At this point he has a profit of $400,000 which would require payment of capital gains tax. Instead, he trades for a strip shopping center also valued at $1,200,000 and avoids having to pay tax at that time.

**IMPORTANT INVESTMENT TERMS**

**Capital Gain**
An increase in the value of a capital asset such as investment or real estate that gives it a higher worth than the purchase price. Long-term capital gains are usually taxed at a lower rate than regular income. This is done to encourage entrepreneurship and investment in the economy.

**Capital Loss**
A capital loss occurs when there is a decrease in the capital asset value compared to an asset's purchase price. If the property was purchased for $500,000 and sold for $400,000, the capital loss would be $100,000.

**Unrealized Gain**
Profits that result from holding on to an asset rather than cashing it in and using the funds: The price of stock that you own has tripled. As long as you do not sell it, the increase is called an unrealized gain. If the owner decides that he wants to have the profit, he can sell it off slowly and not be faced with a large capital gain. Real Estate, on the other hand, is sold as one entity and the profit is taxed as one lump sum.

**Principal Residence**
Tax laws are quite different when we are dealing with our personal residence. When a personal residence is sold, the first $250,000 of profit per individual, ($500,000 for a married couple filing jointly) is tax free under most circumstances. It must have been owned and occupied as a principal residence for a total of at least two years in the five-year period ending on the date of sale. There is a two-year waiting period if you claimed another sale within the previous two years.

**LET’S EXPLORE SOME ADVANTAGES OF RENTAL REAL ESTATE:**

**Current Income:** The amount left over each month after expenses have been paid. Landlords, needless to say, are very attracted to the idea of receiving income for which they did not actually work.

**Appreciation:** In most markets, the property will increase in value as time goes on. Granted, there may be periods of little no appreciation, or even depreciation. But, historically real estate does appreciate if held for a long enough period of time.

**Leverage:** The use of OPM, (other people’s money) makes rental property very attractive to the investor. It can be purchased using only a small percentage of the purchase price and financing the balance. The equity in the entire property is controlled by paying only a small portion of the price. Additionally, the security for the debt is the building itself and not any other assets the investor may own. You may lose the rental property, but you should not lose your own home.

**Tax Advantages:** Rental income may be tax free if no cash is distributed after expenses are paid. The rental income pays down the mortgage balance so that the amount of equity increases without any tax responsibility. The investor can also take out tax-free money by refinancing the loan if the property
appreciates and the interest rates have fallen. These funds are often used to purchase another investment property. Finally, as we have discussed, all taxes might be deferred on the sale of the property if it becomes part of a 1031 Exchange.

**DISADVANTAGES OF RENTAL REAL ESTATE**
Pretty nearly everything that has advantages will also have disadvantages. Investment real estate is not different.

**Liability:** With ownership of property comes responsibility. If a tenant or their guest falls on your property, there would be liability. If a porter repairs a closet door and as a result, there is damage to the wall, you are responsible. To ensure that your liability is limited, insurance must be carefully investigated and reviewed to be certain that risk is limited.

**Unexpected Expenses:** This is virtually a given when owning property. Something will go wrong or break at the most unexpected time. Pipes will break, sidewalks will crack, and the roof will leak. There is no possible way to anticipate or avoid unexpected expenses. However, a prudent investor will be certain to have a capital improvement/repair fund so that these unexpected expenses can be dealt with. When problems occur they must be repaired in a timely fashion, it is quite possible that the tenant may vacate the premises and the investor is left with no income. Additionally, if building codes change and compliance with new laws and restrictions are not met, fines and other legal problems may result.

**Tenant Problems:** Investors do not usually buy buildings expecting to have to use legal means to collect rent. Sadly, most landlords can tell more than one story about the time they may have to spend in landlord/tenant court in order to collect back rent. Many can also tell stories of the number of times tenants have avoided paying the rent for four or five months and then slipped out in the dark of night never to be heard from again.

Vacancy: An empty apartment could equal an empty wallet. Every landlord should have an emergency fund in the event there is a vacancy problem. This would not be the same fund as one for capital improvements.

**How to Minimize the Problems**
No one can teach you how to eliminate all the disadvantages of investing in real estate, but some simple rules to follow will certainly minimize them

- Keep Your Expectations Reasonable: Owning your first investment property will not generate a million dollars a year in spendable income for most people.
- Determine just how much time and effort you are willing to invest in the property.
- Familiarize yourself with building codes and rules. Have the Property Inspected: One of the best ways to avoid unexpected expenses is to have the property inspected by a professional before you buy it.
- Have every legal document scrutinized by an attorney
- Take the Time To Call References and Run Credit Checks
- Network with other landlords
- Find a Lawyer, a Tax Professional and a Banker with whom you feel comfortable
- Investigate your Insurance needs
- Create an Emergency Fund

**CONCLUSION**
Investing in real estate can be an excellent decision or a disaster. The investor will be the one who determines his own fate.
KEY TERMS
- Anchor stores
- Capital expense
- Capital reserve budget
- Corrective maintenance
- Eviction - actual/constructive
- Fiduciary
- General agent
- Lessee
- Lessor
- Management agreement
- Management proposal
- Operating budget
- Planned unit development
- Preventative maintenance
- Property management
- Property management report
- Property manager
- Resident manager
- Risk management
- Stabilized budget
- Tenancy for years
- Variable expense

WHAT IS PROPERTY MANAGEMENT?
Efficiently managing property for investors in order to create the greatest return on their investment.
There are four aspects to the job of property management:
1. Leasing
2. Managing
3. Marketing
4. The overall maintenance of another’s property

They handle the day to day tasks to keep the operation running efficiently. They oversee both residential and commercial real estate and work toward the goal of making sure the property lives up to its’ potential revenue stream. This should be done creating as little involvement from the owner as they want. Many investors want little or no involvement in the day to day running of the property. However, when dealing with cooperative boards of directors or condominium boards of managers, there is a more hands on approach.

There are both on site and off site managers and they are exactly as they sound. The onsite manager has an office and desk on the property and is there during agreed upon working hours. Their sole responsibility, sometimes with additional staff, is at that location. Offsite managers, on the other hand, are usually assigned several different buildings and visit them on an agreed upon schedule. The balance of their work is done at the location of the property manager. Typically, smaller properties are well served with offsite managers.

Community association managers do work that is much like the onsite property managers. These managers oversee the common property in condominiums, cooperatives and planned communities. They are usually hired by a representative of the elected board of directors of the association and are paid through funds that are collected from the various homeowner associations.

WHAT TYPES OF PROPERTY ARE MANAGED?
- Residential: Rental homes, apartment buildings, condominiums, cooperatives, large neighborhoods with a homeowners association that contracts with a property manager
- Office: Office buildings, office parks and Commercial high rise buildings
- Retail: Stores and shopping centers including strip malls and large shopping centers
- Industrial: Industrial parks or areas of land that are used for industrial development.

WHO NEEDS A LICENSE?
Property management companies must be licensed real estate brokers in most states as long as they are collecting rent, listing properties or doing any kind of lease negotiations. A real estate salesperson can also take any of these actions in New York AS LONG AS they are working under the supervision of a
broker. If a real estate management company collects rent or fills vacant units on behalf of a landlord client, the company must have a real estate license. However, if the company is only performing maintenance services, a license is not needed.

**THE MANAGEMENT AGREEMENT**

Before a person can start acting as a property manager, they will need a formal agreement with the owner of the property. One of the most important results of a fully executed management agreement is that it creates an agency relationship. The agency agreement means that the manager owes loyalty to the property owner. Usually, property managers are considered general agents, because they can make decisions that are binding on the owner. In a typical sales or rental transaction, the broker is usually a special agent meaning he cannot make any decisions that are binding on the owner. In any case there is a fiduciary or trust relationship in all agency agreements. No matter which type of agency agreement is created, the property manager must comply with the following fundamentals of agency:

- Notice
- Obedience
- Skill
- Care
- Accounting
- Loyalty

The management agreement is also a contract, and must be in writing. Though the specifics of management agreements will vary widely, all management agreements should contain the following items:

**Description of the property**- The management agreement is property specific, so the property to be managed must be clearly indicated and defined in the agreement.

**Length of the agreement**- The amount of time that the management agreement will be enforced must be specified with a stated beginning and end.

**Management authority / Manager’s duties**- Every duty that a manager must perform is included. Often, the agreement will also list any restrictions or limitations of the manager’s duties. It details the manager’s authority when dealing with, hiring, firing, and supervising employees, fixing rental rates for space, and making repairs and authorizing expenses for repairs (Often, management authority for repairs will have a set dollar limit, and repairs or expenses above a set amount will require the owners’ written approval). One of the most important authorities granted to a property manager is the ability to sign and execute leases on behalf of the owner. It is common for restrictions to be placed in the agreement. Marketing costs are sometimes listed in the management agreement as well and often there are dollar limitations.

**Authority over personnel**: If the property manager will be expected to hire and fire staff for the maintenance of the property, they will need to have that authority spelled out. They will work with the owner’s accountant to be certain that tax obligations are met. They will also have to obtain liability and workmen’s compensation insurance for those employees. If there are union workers they need to know the rules and regulations and be prepared to negotiate contracts.

**Reporting**: A property manager is expected to provide periodic, detailed reports to the owner regarding the function, operations, finances and overall status of the property being managed. These reports contain all the information of the overall status of the business including monthly and annual income and expense information. It would include personnel reporting and year-end reports as well as annual budgets.

**Management fee**: Any agreement should contain the compensation or fee that will be paid for the management services rendered. This fee can take a variety of forms, from a fixed amount, to a percentage of the rents, a commission on new rentals, or a combination of the three.

**Example**: Leon the Property Manager has negotiated a deal where in addition to a monthly fee, he earns a 7% commission for any new tenant. This commission is based upon the annual rent. If the monthly rent for the property were $1,200, how much commission would Leon earn? $1,200 monthly rent X 12 Months = $14,400. $14,400 x 7% = $1,008 for the month.

**Accounting responsibilities**: Depending on the type of agreement and type of management needed, a property manager will have specific accounting duties. The duties may be as simple as maintaining a
ledger of rents received and expenses paid, to a complete set of books including payroll, advertising and other expenses. The management agreement will specify what the property manager must do in regard to proper accounting. For instance, in most states it is illegal for a real estate agent to commingle funds, meaning that they are forbidden from placing their client’s funds in their own personal accounts. The management agreement may stipulate that the property manager create a separate account for the funds generated by the property.

Insurance and risk management

An important duty of the property manager is to manage and reduce the risk of loss to the property. This is accomplished via insurance protection, as well as a well defined risk management program. The property agreement should spell out the steps the property manager will take to accomplish this task.

The manager must a have an in-depth knowledge of insurance for the property and employees.

One form utilized to demonstrate coverage is called a Certificate of Insurance. This form is obtained from the tenant’s insurance agent. Similarly, when a property manager hires a contractor, a Certificate of Insurance should be obtained to ensure that coverage has been obtained by the contractor should an incident occur. With all of these different insurance coverage’s to consider, it becomes readily apparent why the insurance responsibilities of a property manager must be detailed in the management agreement.

REPORTS

The most common report required by a property owner is the “statement of operations”. This report is usually comprised of the following components;

1. Summary of operations
2. Rent roll
3. Statement of disbursements
4. Narrative report of operations

OWNER’S RESPONSIBILITIES AND OBJECTIVES

At first glimpse, it seems strange to include an owner’s objectives in an agreement. After all, the owner wants to make as much profit as possible for little or no expense! This clause is important in an agreement, as the owner should clearly state what is precisely expected from the manager. For instance, one owner may simply want a manager to increase overall profitability in the property, while another owner would prefer that all efforts be made to improve the overall capital value of the property by overseeing renovations and other improvements. A property manager will base their decisions and actions on the long term stated goals of the owner. The owner of a property also has a variety of responsibilities and obligations to a management company. Many of those obligations are financial. The management agreement should clearly spell out the owners responsibilities that were not covered under management authority. These obligations include:

- Payroll
- Making sure there are sufficient funds available.
- Insurance
- The agreement should specify what types of insurance coverage the owner would carry along with any agreement about coverage limits.
- Purchasing
- What can be purchased without further authority from the owner. What are the spending limits?
- Fixed expenses
- The owner should agree to the payment of, and provide a schedule of payments for, taxes, debt payments, special assessments and insurance premiums.
- Building expenses
- The management agreement should contain a clause that requires the owner to make any repairs or improvements necessary to keep the property in operating condition. The presence
of this clause will also make the owner responsible for complying with the terms of lease agreements, building codes and any other laws pertaining to the property.

- Advertising and marketing
- Management fees

**HOW OR WHY THE AGREEMENT MAY BE TERMINATED**

A management agreement will include language that provides for the termination of the agreement by either party. If a specific cancellation date is not set, then the process of termination will be included. This process will include timelines for cancellation, where notices should be sent and the time from notice to actual contract cancellation.

The termination clause will also list reasons for termination prior to a set expiration date. A major cause for early termination occurs if the manager suffers damages or liability due to the owners’ failure to comply with the statutes of any applicable law. In this case, the agreement is terminated immediately upon notice from the manager to the owner. It is important to note that the cancellation of the agreement by the manager due to the illegal actions of the owner does not release the owner from the obligations set forth in the agreement.

**MANAGEMENT PROPOSAL/ PLAN**

One of the very first things to be completed is a management proposal setting recommendations. Investors have a wide variety of goals and objectives. These goals and objectives are different throughout the holding period of the investment. The management plan should reflect them. It should produce the greatest yield when compared to other investment strategies. This is the result of the gathering, analysis and interpretation of all information pertaining to a specific property. It is made up of seven components and can be organized as follows:

**REGIONAL ANALYSIS**

This section identifies the general economic and demographic conditions, trends of the area surrounding the property and determines which will affect the property. Data needed includes:

1. Population
2. Business and Industry
3. Households
4. Employment
5. Tourism and Recreation
6. Public Improvements and Facilities
7. Public Transportation and Traffic Conditions
8. Education
9. Economic Stability
10. Political, Governmental
11. Social Climate
12. Real Estate Market

Statistical data is available from the Federal Government through the Census Bureau, Department of Labor or Department of Housing and Urban Development; and various trade associations.

**NEIGHBORHOOD ANALYSIS**

A neighborhood is an area with common characteristics of population and land usage. A survey of the population trends is necessary to determine the life-cycle stage of the neighborhood. The characteristics of the population, family unit and economic level will determine the trend of the neighborhood. A thorough inspection of the building’s condition and the types of property use is essential to understanding the neighborhood. It should answer the following questions:

- How does the subject property relate to its neighborhood?
- What types of transportation are available, public or private?
• Where are such amenities as schools, shopping, hospitals, recreation and employment located in relationship to the subject property?

PROPERTY ANALYSIS
The only way to accomplish a complete property analysis is to physically walk through the property, inspecting it. How many units (residential) or how much square footage (commercial) does the property contain? What is the desirability of the property? A description of the visual impression presented by the property, its age, the layout of interior spaces and public spaces, exposures, views you can see from the space and fixtures and equipment provided within the space provides a pretty clear picture of the property. The physical condition of the building is essential. A thorough inspection of the roof, mechanical equipment, masonry and windows should be conducted. In what condition are the common areas? A complete review should be made of the current staffing levels and standards of management.

MARKET ANALYSIS
Each property belongs to a specific submarket and the property manager must identify these smaller markets in order to design a management plan for a specific property. Once the submarket has been determined, the size and character of the properties in that market need to be defined. What are the average layout, size, amenities and fixtures provided within the submarket? What is the current price per square foot for the average unit?

A comparison of the trends within the general real estate market and review of the history of price and occupancy levels should complete the overall analysis. The next step is to compile an analysis of the comparables within the market, which entails determining what other specific buildings offer and how they compare or contrast with the property in question.

ANALYSIS OF ALTERNATIVES
After analyzing the property operated on an “AS IS” basis, alternative programs must be studied to determine whether it may be more profitable to alter its use. Alternative programs may include:

A. Rehabilitation of the building and correction of deferred maintenance without changing the basic plan of the building.
B. Modernization of the building during rehabilitation by replacing outdated equipment with equipment that has more updated and modern design and features.
C. Alterations that fix functional obsolescence or increase earnings. These should be economically feasible.
D. Conversion to condominium or cooperative ownership should be examined if a higher yield can be obtained by selling units. This requires a formal appraisal of the and a feasibility study of the conversion.

PROPOSED PROPERTY ANALYSIS
The manager must develop an operational budget. This budget should be a realistic one for the manager and management organization. A sound budget gives the manager and the owner a clear understanding of what is expected from each other through the relationship. Rental and other income as well as fixed and variable expenses are needed to create this analysis. Variable expenses are incurred through the operation of the property. These include, but are not necessarily limited to, utility costs, ground maintenance contracts, advertising, etc. Planning for the financial administration of the property is not the only function of the property manager. In addition, the manager must plan for the daily operations. A thorough review of the on-site personnel and an evaluation of the work and tasks to be performed must be determined. Establishment of clear policies and procedures is essential to the continuous effective day to day operation of the property.

INVESTMENT ANALYSIS
The property manager needs to be familiar with sources and techniques of financing, the appraisal process, methods of depreciation, income tax as it relates to real estate and the calculation of cash flow. If improvements or alterations are recommended, a financing plan to complete these items is
necessary. When calculating cash flow, it is necessary to examine both the before-tax and after-tax projections. Cash flow is best summarized by the following:

- Gross Scheduled Rental Income - Vacancy and Credit Loss = Effective Gross Income (EGI)
- Effective Gross Income + Other Income = Gross Operating Income (GOI)
- Gross Operating Income - Operating Expenses = Net Operating Income (NOI)
- NOI - Debt Service = Cash Flow

The analysis should conclude with an estimation of the property’s value before and after any improvements or alterations.

**MARKETING THE PROPERTY**

In order to fill vacancies as they occur, the property manager must start marketing the property and that takes more than a sign. This requires a well thought out marketing plan, which should be established for every project. Its purpose is to determine the best steps that need to be taken to lease the facility and should focus on a number of points including:

- Supply of competitive projects
- Market demand for vacant space
- Market rental rates
- Typical lease terms
- Types of tenants who would be interested in space

Based on thorough knowledge of the competition, the project’s saleable features can be identified. All competitive projects should be analyzed in comparison to the subject facility. Strengths and weakness should be recognized. Typical lease terms are also important features. In a weak market, landlords will consider lower rental rates for apartments or offer lease concessions to office tenants, such as rent abatements or construction allowances. If the market generally demands 3 months free rent on a 5-year lease and the subject project is offering 5 months free rent on a similar lease; the property manager would not be maximizing income potential for the owner.

Finally, analysis of potential tenants who could exhibit interest in the apartment or office space must be performed. For example, families with school-age children usually prefer apartments in good school districts with recreational facilities. Apartments located in the central business district might appeal more to people who work nearby. Recognizing the market that would be interested in the project and directing the marketing efforts at that market should minimize the vacancy time and maximize the investment made in reaching and securing that market.

**TYPES OF MARKETING ACTIVITIES**

There are a variety of different marketing activities that will help a property manager attract tenants. However, the single most effective form of marketing is the word of mouth from satisfied clients. A property manager that hopes to attract more clients should do everything in their power to delight current residents.

Advertising - How a property is advertised is very closely related to the type of property being managed. Residential, Commercial, and Retail properties attract clients from very different demographics. In addition, the number of clients necessary will dictate the type of advertising needed. For instance, a brand new apartment complex will need hundreds of tenants right away, while an older, more established complex will only need enough renters to fill vacancies as they occur.

The main types of advertising are:

- Newspapers and periodicals
- Television and Radio
- Signs and billboards
- The internet

Each type of advertising has pros and cons, and each type reaches a different target audience. A plan needs to identify who needs to be reached, and then research which medium would be best suited for attracting that desired tenant.
Leasing and Rents: The process of managing leases and handling tenant relations is a very large part of the property manager’s duties.

SETTING RENTAL RATES
The most basic concern of any rental rate is that the amount collected is enough to cover the expenses of the property while still providing a return on investment. This doesn’t mean that the rents can be simply set at an amount that meets these goals. Competition in the market becomes a factor, for if the rents are significantly higher than the competition, there will be an increase in vacancies. Essentially, rates are driven by supply and demand. Because supply and demand is never a fixed motivator, it is prudent to look at the rental rates constantly, and adjust them annually.

One indicator that can tell a property manager that the rental rates are set appropriately is the vacancy rate. If the vacancy rate is very high, the rents are possibly too high as well. A high vacancy rate, however, does not always indicate that the rents are set too high. There can be other factors such as poor management, or some type of defect in the property. If the occupancy rate is high, then it’s possible that the rents are too low and could be raised.

NEGOTIATING LEASES
A lease is a contract. Like all contracts, it must contain certain items to be valid and enforceable. Leases must spell out specific rights and obligations of both parties and follow all applicable local laws. Components of a valid lease (discussed in-depth in commercial/investment chapter)

- Names of tenants (lessee) and competent party signatures
- Name of property’s owners or agent with authority to lease
- Legal address of leased premises
- Statement of rental amount, including time and place of payment of rents, deposits, if any, and time period to which rent applies
- Legality of use
- Start and end date, with any resident options after the initial term expires.
- List of rights and obligations of both parties (lessee and lessor).

DIFFERENCES BETWEEN RESIDENTIAL AND OTHER LEASES
Residential leases are often billed as a monthly fee, and the utilities and other costs may be paid by the tenant or the landlord. However, other types of leases are usually charged per square foot used. This means that a 1,000 square foot apartment may rent for a flat $1,200 per month, while an office space of the same size would be quoted as $1.25 per square foot. (Please note that these numbers are nowhere near anything realistic. It is important to note how different types of leases are quoted).

Usually, the tenant has one main obligation and that is to pay the agreed upon rent on time. A lease will generally indicate a penalty if the tenant fails to do so. In addition to paying the rent, the tenant agrees to abide by local laws, and make a good faith effort not to destroy the property. The landlord is obligated to abide by the laws, as well as maintain the common areas of the property so that the tenant is provided with “quiet enjoyment” of his leased premises. One important function of the lease is handling tenant alterations and tenant concessions. While the property manager wants to maintain the “bottom line” on the property financially, they should also be willing to allow certain concessions that will attract tenants to the property. This is a balancing act that requires a certain amount of diplomacy on the part of the property manager.

COLLECTING RENT
If every tenant abided by the terms of their leases, collecting rent would never be an issue. However, the real world doesn’t work like that, and sometimes the property manager must become proactive in collecting rents. To accomplish this, she should have a firm, consistent collection policy in place before a problem ever arises. Any collection effort must be documented, and a property manager should make every effort to amicably resolve the rent issue before resorting to legal action. There are varieties of local laws that govern rent collection, and a property manager should familiarize themselves with those laws prior to entering into any proceedings.
COMMON LEASING TERMS

Gross Lease: The tenant pays a set amount each month and the owner pays all other property expense. (Most often used with apartments.)

Net Leases: Net Tenant pays the base rent plus some or all of the real estate taxes.

Triple net: In addition to the base rent, tenant assumes payment of all expenses connected with operation of the property: all services, including cleaning, insurance, utilities, maintenance, and contract services (e.g., landscaping), and perhaps even the lessor’s mortgage payments. This is typical of office and industrial properties.

Percentage Lease: Tenant pays fixed rental plus percentage of the gross income that exceeds a predetermined amount. This is most common in retail stores that are located in shopping centers.

Escalation Clause: Rental adjustments based on external economic factors, such as Consumer Price Index, property tax or changes in cost of overall operating expenses.

Leasehold Estate: Tenant is granted the right to occupy the owner’s property for a specified time period.

TYPES OF LEASEHOLD ESTATES:

Estate for years: Tenant is granted the right to occupy for a specified time period. When the time period (term) expires, the estate terminates without notice. Tenant must surrender the property to the owner. The death of the tenant or landlord does not terminate the estate. It is binding on their heirs.

Periodic Estate: This can also be known as tenancy from year to year, month to month or week to week. The tenant is granted the right to occupy from a specific period of time, which is determined by the term of the payment of rent.

Tenancy at Will: Tenant is granted right to occupy for an indefinite period of time. It is a casual arrangement, generally between family members. This estate is terminated by the death of either party.

Tenancy at Sufferance: Tenant is granted right to occupy initially but remains on the property after the expiration of the leasehold interest without consent of the owner. He is referred to as a “holdover tenant”.

SKILLS REQUIRED OF A PROPERTY MANAGER

So far in this chapter, we have discussed a variety of the duties of a successful property manager. Now that we know what a property manager will need to do, let’s take a look at the specific skill set and knowledge that a property manager must possess in order to succeed.

Supervise Others: A successful property manager must understand how to supervise others. This becomes crucial when dealing with larger properties, such as retail operations, that require a variety of employees. There is simply far too much that needs to be accomplished on a daily basis for a single person to do. A property manager must be able to identify what needs to be done, and assist employees in accomplishing their tasks. A successful supervisor will have not only a strong knowledge about the property, and their obligations, but will also possess personality traits that make for successful managers.

Understand generally accepted accounting principles (GAAP), monthly and yearly reports: The variety of budgets, marketing plans, and other reports required make it essential that a property manager understand general accounting principles. When financial reports are generated by professional accountants, it is expected that those reports will have three main qualities:

1. The information must be reliable, verifiable, and objective.
2. Consistency in the accounting information: For example, if a company has typically used the FIFO (First in, First out) cost flow assumption, individuals who are using the company’s most current financial statement will expect that the company is still using the FIFO cost flow assumption. If for some reason the company starts to use the LIFO (Last In, First Out) cost flow assumption, the company must clearly disclose this change.

3. Comparability: Lenders and other users of financial statements expect that the financial statements of different companies within the same industry can be easily compared. Generally accepted accounting principles help to provide easy comparisons between the financial statements of different companies. For example, the Financial Accounting Standards Board requires that any expenses that are related to research and development (R&D) must be expensed when they occur. Before this rule, some companies would expense R&D when incurred and other companies would put the R&D expenses on another balance sheet and actually expense them at a later time. This would naturally cause confusion when comparing the financial statements of companies that used different systems.

**Time Period Assumption**

This accounting principle assumes that a company can report the ongoing and complex activities of its business in short and distinct time intervals. The person reading the document needs to know if the statement is only covering a single week that ended December 31, 2008, the entire month that ended on December 31, 2008, the three month period that ended December 31, 2008 or the year that ended on December 31, 2008.

**Cost Principle**

From an accountant’s perspective, the term “cost” refers to how much cash (or cash equivalent) was spent when an item was originally obtained, whether the purchase just happened last year, or twenty five years ago.

**Full Disclosure Principle**

Information that is important to an investor or lender using the financial statements should be disclosed within that statement or within the notes in that statement. This is why there are often many pages of “footnotes” attached to financial statements.

**Budgeting**

So far in this chapter, we have discussed preparing and reporting budgets. Let’s take a moment and look at what it takes to prepare a budget for a property. The purpose of a budget is to establish a solid financial foundation for the operation of a property. There are many different components of a budget.

- Income
- Operating expenses
- Debt service
- Capital replacement reserves
- Owner objectives

**Glossary of Budget Terms**

- **Debt Service**: Periodic payments of principal and interest on a loan.
- **Cash Flow**: Amount of cash available after deducting from income, operating expenses and mortgage principal and interest.
- **Net Effective Income**: Income figure after totaling gross income, minus the vacancy/credit loss, plus miscellaneous income.
- **Gross Potential Income**: Total scheduled rental income.
- **Net Operating Income**: Net effective income less operating expenses.
- **Security Deposit**: An established amount of money advanced by the tenant, held by the owner for a specific period of time, to be applied towards possible damages and assurance of compliance with lease terms by tenant.
- **Capital Expenditure**: One time major purchase that extends the economic life of the asset.
- **Capital Reserves**: Funds set aside for capital expenditures.
- **Capitalization Rate**: Profit index for a property, usually expressed as a percentage. The larger the capitalization rate, the more profitable the investment of the property.
- **Return on Investment (ROI)**: Measure of profitability determined by ratio of money invested to net income after taxes.
Operating Expenses: Costs related to the maintenance, upkeep and repair of the building’s equipment or other structural components and fixed expenses.

UNDERSTAND BUILDING SYSTEMS
An effective property manager needs to understand the various systems used in buildings. These systems include:

- Heating, Ventilating and Air Conditioning (HVAC)
- Structural Engineering
- Waterproofing
- Plumbing
- Electrical
- Gas
- Oil
- Chiller
- Water
- Maintenance
- Security
- Elevators

Although they don’t perform the actual maintenance, they must be able to recognize problems and formulate solutions. This includes evaluating the cost effectiveness of various alternatives to resolve a particular problem. Maintenance decisions can be broken down into the following categories:

Preventive Maintenance - Professional property managers are trained that most major maintenance problems can be prevented through an effective preventive maintenance program. Preventive maintenance can be defined as a preplanned, routine, and systematic schedule of inspecting, maintaining and repairing a facility and its equipment. As a result, a building can operate at peak efficiency because problems are recognized and solved before they become expensive and dangerous.

Examples of preventive maintenance include:
- Changing filters on a heat pump unit before the winter and summer season.
- Inspecting a roof every six months for damage to the membrane and flashing.
- Inspecting the hoist cables on an elevator for damage or excessive wear.
- Developing an effective preventive maintenance plan includes:
  - Assessing the facility and equipment’s needs.
  - Compiling a list of all equipment and areas requiring inspection and maintenance.
  - Estimating the time required to perform each duty.
  - Evaluating personnel to assign each duty.
  - Recording the results of each preventive maintenance task when complete and retaining the same for future reference.

Curative Maintenance - No matter how detailed and systematic a preventive maintenance program is developed, problems will arise which require immediate repair. The property manager should assess the problem, determine a solution, and decide if the repairs should be performed by building employees or contracted services (outside contractors).

As you can see, the effective maintenance of a property requires a broad knowledge of how the systems work, but also knowledge of who to contact to best address any issue with a building system.

UNDERSTAND CODES AND REGULATIONS
There are many other responsibilities that are required of the landlord. In most jurisdictions some or all of the following are required:

Landlord’s Duty of Repair
Landlords must keep the apartments and the buildings' public space clean, free of pests, trash and all other harmful material. Landlords must also maintain electrical, plumbing, sanitary, heating, ventilating systems and appliances that they install. An example is that any refrigerator or stove that has been installed must be kept in working condition.

Lead Paint and other environmental factors
Tenants have the right to protect against the chance that their children will be poisoned as a result of peeling lead based paint. Landlords have to remove or cover walls where there is peeling lead based paint. The law assumes that lead based paint was used if the apartment building was constructed before to January 1, 1978. Landlords are required to give tenants a pamphlet developed by the Environmental Protection Agency (EPA). This pamphlet warns tenants of the hazards of lead based
paint and includes a disclosure form that tells the tenant everything the landlord knows about the presence of lead-based paint in the building.

Property Managers must also have knowledge of other issues pertaining to the environment/ecology such as lead in water, air quality, and soil contamination.

**CRIME PREVENTION**
Tenants are entitled to an expectation that the landlord/property manager has taken at least minimal steps to prevent criminal activity in the building.

**Entrance doors** should have automatic self-closing and self-locking doors if they are multiple dwellings of 8 units or more. These doors have to be locked at all times unless an attendant is on duty. It is often a requirement that these buildings have a 2-way intercom system.

**Elevator Mirrors**
There may be a requirement that there are mirrors in every self-service elevator in multiple dwellings to that people can see if anyone is in the elevator before they enter.

**Individual Locks, Peepholes and Mail**
Tenants in multiple dwellings can add and maintain their own locks on their apartment entrance doors in addition to the lock supplied by the landlord. However, the tenant must give the landlord/property manager a key. There may be a requirement for the apartment to be equipped with a “peephole” and chain on the front door to each apartment. United States Postal regulations require landlords to provide secure mail boxes to every apartment with in a three or more unit building unless the landlord plans to distribute mail to each separate apartment. Landlords are also required to keep mailboxes and locks in good repair.

**Smoke Detectors and Carbon Monoxide Alarms**
Outside New York City and in Buffalo, each apartment in a multiple dwelling (three or more apartments) must be equipped by the landlord with a minimum of one smoke detector that is clearly audible in any sleeping area. Landlords of multiple dwellings in New York City also have to put in one or more smoke detectors in every apartment close to every room that is used for sleeping. Owners may ask tenants to reimburse them up to $10.00 for the cost of buying and installing each battery-operated detector. During the first year after installation, landlords are responsible for repairing or replacing any broken detector as long as the malfunction is not the tenant's fault. Landlords must also install at least one approved carbon monoxide alarm within each unit. The landlord is allowed to charge the tenant up to $25 for each alarm installed. It is important that tenants check their detectors on a regular basis to make sure they are working correctly.

**Window Guards**
Landlords of multiple dwellings in New York City must install government approved window guards in every window of any apartment where a child ten years old or younger lives. Tenants must have these guards installed. Also, landlords must install window guards if the tenant requests them. Windows giving access to fire escapes are excluded. Protective guards also have to be installed on the windows of all public hallways. Landlords must give tenants a notice annually that explains their rights to window guards and must provide this information in a lease rider. Rent controlled and stabilized tenants may be charged for these guards.

**Heating Season**
Typically, heat must be made available between October 1 and May 31, to tenants in multiple dwellings if:

a) The outdoor temperature falls beneath 55 degrees Fahrenheit, between the hours of 6 A.M. and 10 P.M., each apartment must be heated to a temperature of at least 68 degrees Fahrenheit;

b) The outdoor temperature falls below 40 degrees Fahrenheit, between the hours of 10 P.M. and 6 A.M., each apartment must be heated to a temperature of at least 55 degrees Fahrenheit.
Security Deposits
Most leases require tenants to provide a security deposit. It is usually the equivalent of one month's rent. It is returned to the tenant at the end of the lease or within a reasonable time thereafter unless they have a lawful reason to withhold it. A landlord may use the security deposit: as reimbursement for the reasonable cost of repairs beyond normal wear and tear, if the tenant does damage to the apartment; or as reimbursement for any rent that is not paid. Landlords must treat the deposits as trust funds belonging to their tenants and they cannot commingle deposits with their own funds.

Discrimination
A landlord cannot discriminate (example: refuse to rent an apartment to or renew a lease) against anyone based on the following items: race, creed, color, national origin, sex, disability, age, marital or familial status. New York State prohibits discrimination based on sexual orientation and New York City also prohibits discrimination based on lawful occupation or immigration status. Landlords also may not discriminate against someone because they have a child or children living with them. The exception to this rule is housing units specifically for senior citizens which are subsidized or insured by the federal government or to one or two family owner occupied houses or manufactured homes.

Eviction
A landlord can bring a summary non-payment court proceeding to evict a tenant, after giving appropriate notice, for the following reasons:
- A tenant fails to pay the agreed rent when due
- A tenant does not pay outstanding rent
- A tenant significantly violated an obligation of the lease

Warranty of Habitability
Tenants are entitled to a livable, safe and sanitary apartment. It is illegal for a landlord to make any rules or lease provisions that go against these basic rights. An example of a violation of this right is a landlord who does not provide heat or hot water regularly.

Subletting and Assigning
Subletting or assigning is a way that one tenant’s legal interest in an apartment is transferred to another person. The difference between subletting and assigning is that a sublet only transfers part of the tenant’s interest while assignment transfers the entire interest. Also when a person subleases, the original tenant still retains some right of reentry onto the premises. However, when a tenant assigns, he has no right of reentry to the property.

A tenant’s right to assign the lease is more restricted than the right to sublease. A tenant is not allowed to assign the lease without written consent from the landlord. It is the landlord’s option to withhold this consent without cause and if the landlord reasonably refuses consent, the tenant is not allowed to assign and can’t be released from the lease. If however the landlord unreasonably refuses consent, the tenant can be released from their lease after a notice of 30 days.

Tenants Organization
Tenants have the right to organize and they may form an organization to protect their rights. Landlords are not allowed to harass or penalize tenants in any way for joining or participating in these types of organizations. These tenant groups are allowed to use common areas in the building such as hallways or lobbies for meetings. These meetings must be held in a peaceful manner, and if they are held in public common areas, it must be at reasonable hours and not obstruct access to the facilities.

Right to Privacy
Tenants have the right to privacy inside their apartments. However, it is important to note that the landlord does have the right to enter an apartment at a reasonable hour and with reasonable prior notice for the following reasons: to provide repairs or services or to show the apartment to a prospective tenant. If an emergency arises such as a fire, the landlord is legally allowed to enter into
the apartment without prior notice or consent. A landlord must never abuse this right to harass a tenant.

**HOW DOES ONE BECOME A PROPERTY MANAGER?**
The applicant usually begins with entry-level positions in property management offices and moves up to assistant property managers. From there they will often move on to be a full property manager. They need to have good speaking, writing, computer and financial skills. It is also necessary that a property manager be able to handle people in a respectful and tactful manner.

**LICENSURE**
In New York, it is necessary to have a broker’s license or work under a broker in order to rent, negotiate rent or collect rent. A real estate management company has to have a broker’s license if it collects rent or puts tenants in vacant spaces on behalf of a client. However, it is not necessary to have a license if the service the company performs is only maintenance related.

**OTHER QUALIFICATIONS**
It would be very beneficial for an onsite manager to have previously worked as a real estate sales agent. This experience would be helpful when showing apartments or office space. In the past, individuals that had building maintenance backgrounds easily advanced into onsite management positions simply because they had a strong base of knowledge about building mechanical systems. In the current market, employers put a greater emphasis on things such as administrative, financial and communication abilities for manager jobs.

There are many professional property management organizations that offer education and designations.

**New York Accredited Realty Manager:** NYARM designation shows that a property manager is certified by the New York Association of Realty Managers to be an accredited realty manager.

**Registered Apartment Manager (RAM):** is a competency-based certification presented by the National Association of Home builders (NAHB). **Advanced RAM:** This is a higher-level credential for more advanced property managers.

**Certified Property Manager (CPM):** recognized internationally and presented by the Institute of Real Estate Management (IREM). Most CPMs are partners, directors, officers or owners of their own companies.

**Accredited Residential Manager:** The IREM’s Accredited Residential Manager (ARM) program recognized outstanding Certified Property Managers. Both are NAR programs.

**BOMA:** The Building Owners and Managers Association (BOMA). BOMA international has great information about office building development, leasing, local and national building codes etc.

We know that because of this course you will be able to work with property managers in a professional manner because you have a full understanding of the tasks they are faced with in their day-to-day operation. We hope that this information will give you an opportunity to explore a facet of the real estate profession that, perhaps, you had not considered as an option to enhance your career.
CHAPTER 25 INCOME TAX ISSUES IN A REAL ESTATE TRANSACTION

KEY TERMS
Adjusted basis
Appreciation
Basis/adjusted basis
Boot
Capital gain
Capital loss
Cash flow
Debt service
Passive activity income/active income
Tax depreciation
Tax depreciation/recaptured
depreciation/straight-line depreciation
Tax shelter
Tax-deferred exchange

OVERVIEW
First and foremost, we cannot give tax advice to the public. However, we can guide them through the maze involved in buying and selling a home. We can give an overview of tax issues and then refer them to a tax specialist.

HISTORY OF THE FEDERAL INCOME TAX
The passage of the 16th Amendment in 1909 (or its 1913 ratification) is generally viewed as the beginning of federal income tax on individuals. However, while this could be considered the start of the modern tax system, there were other earlier attempts to tax citizens’ personal income.

During the Civil War, Congress passed the Revenue Act of 1861, which included a tax on personal income to help pay for the war. This Act called for a flat 3% tax on all annual incomes above $800. In 1862, with the war still raging and the Union facing a mounting debt, a new Revenue Act was passed that converted the flat tax on income into a two-tiered model that looked a little more like the income tax system we have today—with people making less than $10,000 per year still paying the 3% rate and those making more than $10,000 per year paying a 5% tax on their income. Once the Civil War ended, the need for an income tax on citizens became so unnecessary that, by 1868, the vast majority of government revenue came solely from excise taxes. As such, the personal income tax was finally completely repealed in 1872.

Congress, once again, passed a flat rate federal income tax in 1894. This time, however, the tax did not stick. The Supreme Court decided the tax was unconstitutional in 1895 because it failed to account for the states’ population numbers in assessing the tax. So, the country turned back to tariffs (import taxes), bonds, and taxes on products like gum and beer to bring in revenue.

Nevertheless, the personal income tax discussion continued well into the early 1900s, with the Congressional representatives of the farming communities of the South and West demanding a tax on the income of industries in the Northeast. This demand led to the 16th Amendment, which did not have the state population stipulation previously required by the Supreme Court.

By October 1913, with 36 states onboard as having ratified the amendment, a new income tax law was passed by Congress that required people making below $500,000 per year to pay a 1% tax. Those making more than $500,000 annually were assessed a 7% tax. In addition, everybody was required to file their taxes for the first time, using the 1040 form, which (with both major and minor changes) we still use today.

TAX BRACKETS
Our federal income tax is structured as a progressive tax. The easy explanation for this sort of tax system is this: the more money we make, the more taxes dollars we pay. However, because of deductions and credits, many do not pay the taxes indicated in their bracket. The following table is an example of tax brackets based on tax laws in 2009.
### Married Individuals Filing Joint Returns and Surviving Spouses

<table>
<thead>
<tr>
<th>Income:</th>
<th>Tax Rate:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $16,700</td>
<td>10%</td>
</tr>
<tr>
<td>Above $16,700 – $67,900</td>
<td>$1,670, plus 15% of the amount over $16,700</td>
</tr>
<tr>
<td>Above $67,900 – $137,050</td>
<td>$9,350, plus 25% of the amount over $67,900</td>
</tr>
<tr>
<td>Above $137,050 – $208,850</td>
<td>$26,637.50, plus 28% of the amount over $137,050</td>
</tr>
<tr>
<td>Above $208,850 – $372,950</td>
<td>$46,741.50, plus 33% of the amount over $208,850</td>
</tr>
<tr>
<td>Above $372,950</td>
<td>$100,894.50, plus 35% of the amount over $372,950</td>
</tr>
</tbody>
</table>

### Heads of Household

<table>
<thead>
<tr>
<th>Income:</th>
<th>Tax Rate:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $11,950</td>
<td>10%</td>
</tr>
<tr>
<td>Above $11,950 – $45,500</td>
<td>$1,195, plus 15% of the amount over $11,950</td>
</tr>
<tr>
<td>Above $45,500 – $117,450</td>
<td>$6,227.50, plus 25% of the amount over $45,500</td>
</tr>
<tr>
<td>Above $117,450 – $190,200</td>
<td>$24,215, plus 28% of the amount over $117,450</td>
</tr>
<tr>
<td>Above $190,200 – $372,950</td>
<td>$44,585, plus 33% of the amount over $190,200</td>
</tr>
<tr>
<td>Above $372,950</td>
<td>$104,892.50, plus 35% of the amount over $372,950</td>
</tr>
</tbody>
</table>

### Single (other than Surviving Spouses and Heads of Household)

<table>
<thead>
<tr>
<th>Income:</th>
<th>Tax Rate:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $8,350</td>
<td>10%</td>
</tr>
<tr>
<td>Above $8,350 – $33,950</td>
<td>$835, plus 15% of the amount over $8,350</td>
</tr>
<tr>
<td>Above $33,950 – $82,250</td>
<td>$4,675, plus 25% of the amount over $33,950</td>
</tr>
<tr>
<td>Above $82,250 – $171,550</td>
<td>$16,750, plus 28% of the amount over $82,250</td>
</tr>
<tr>
<td>Above $171,550 – $372,950</td>
<td>$41,754, plus 33% of the amount over $171,550</td>
</tr>
<tr>
<td>Above $372,950</td>
<td>$108,216, plus 35% of the amount over $372,950</td>
</tr>
</tbody>
</table>
Married Filing Separately
Income:

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Tax Rate:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to $8,350</td>
<td>10%</td>
</tr>
<tr>
<td>Above $8,350 – $33,950</td>
<td>$835, plus 15% of the amount over $8,350</td>
</tr>
<tr>
<td>Above $33,950 – $68,525</td>
<td>$4,675, plus 25% of the amount over $33,950</td>
</tr>
<tr>
<td>Above $68,525 – $104,425</td>
<td>$13,318.75, plus 28% of the amount over $68,525</td>
</tr>
<tr>
<td>Above $104,425 – $186,475</td>
<td>$23,370.75, plus 33% of the amount over $104,425</td>
</tr>
<tr>
<td>Above $186,475</td>
<td>$50,447.25, plus 35% of the amount over $186,475</td>
</tr>
</tbody>
</table>

**TAX REFORM ACT OF 1986**

TRA86 as it is commonly called was supposed to simplify the tax code, squeezing the number of individual income tax brackets from fifteen to just four. However, some negative changes occurred that have been blamed by some economists for torpedoing the booming real estate market—a major one being the revision of the guidelines for figuring depreciation on real property.

Investing in real estate in the early 1980s was a smart move—one that many people took. However, that real estate boom quickly dried up after the passage of TRA86, which dealt crippling blows to the real estate industry by making changes to recovery period and depreciation method guidelines.

One of the main attractions to real estate for investors was the short recovery period allowed for recouping costs and the accelerated depreciation. An investor could recover the total cost of a property by writing off depreciation within 19 years after purchase—with the majority of the depreciation coming in the early years of ownership.

Nevertheless, with TRA86, the allowed cost recovery period was lengthened from 19 years to 27 ½ years on residential rental property and 39 years on commercial property. The act called for real estate investors to use the straight line method to figure depreciation for tax purposes. That meant you could depreciate the property the same amount each year instead of having greater depreciation at the beginning of ownership that would gradually decline. Coupled with the 30-year (give or take) cost recovery period imposed by TRA86, this change in depreciation method represented one of the last nails in the coffin of the real estate industry. Without the attractive incentives of short recovery periods and accelerated depreciation tables, the demand for real estate plummeted. No one was buying and everyone was selling.

Prior to 1986, the “active” and “passive” designations for income did not exist in tax law. All income and losses were interchangeable. And it was this tax advantage that attracted investors to real estate—not the profitability of the investment. Many investors would not worry so much about losses in a rental arrangement because they would offset gains in other income areas and, in turn, possibly lower their tax burden. TRA86 changed that by citing differences in types of income and restricting how their gains and losses could interact at tax time. The elimination of this tax shelter took away another major factor that drew investors to rental property. And, in some ways, this was the point.

In its sweeping agenda to do away with shelters that overcomplicated the tax code, the Reagan Administration made a conscious decision to emphasize homeownership over real estate investment. The problem with this decision was that investment was foundation of the industry at the time—precisely because of incentives such as accelerated depreciation tables and the ability to treat all losses equally. Taking away these incentives effectively wiped away real estate as a viable investment option.
overnight, causing investors to quickly dump their properties. This, in turn, plunged the real estate market into a tailspin that may have even contributed to the Savings and Loan crisis of the late 80s.

TRA86 was a case of good intentions that were poorly executed. While the idea behind the act was to diversify the American economy so it would not be dependent only on real estate for its financial health, the act itself effectively killed the industry as a viable investment opportunity.

**TAXPAYER RELIEF ACT OF 1997**
In August 1997, President Bill Clinton signed the Taxpayer Relief Act, which offered a myriad of real estate-related tax benefits. One major change in the act allowed a single seller to exclude from taxable income up to $250,000 from the profits of a primary residence sale. For married homeowners, this number jumped to $500,000. The only stipulation on this tax break was that the sold home must have been the primary residence for the seller(s) for at least two of the previous five years before the tax return was filed. The act also dropped the top bracket capital gain rate from 28% to 20%, with the lower bracket sinking from 15% to 10%.

While the Taxpayer Relief Act of 1997 made many other positive changes to the tax landscape, it was not so kind to real estate investors. The act required a recapture tax for investment properties sold after May 6, 1997. This meant that any depreciation that was accumulated over the years would cause the taxpayer to be taxed at 25% rather than at the 15% rate for long term gains.

**FEDERAL INCOME TAX TREATMENT**
Remember, as we stated previously, to enjoy the tax benefits under the current law, the home you sell must have been your primary residence for at least two out previous five years before your tax return is filed. A primary (or principal) residence is where you spend the majority of your time—the place you call home. However, a primary residence isn’t just a brick and mortar house. It could also be a trailer (or manufactured home), a co-op, condominium, or even a house boat.

Of course, if you own more than one property where you stay throughout the year, you might have difficulty determining which one is your primary residence. Obviously, if you actually spend more time in one home than another, then you will know if the home you are selling is your primary residence. However, if you spend an equal amount of time in each property you own, you might have some difficulty determining which home is considered your primary residence for tax purposes. In such cases, the IRS does not provide a firm rules for how much time you have to spend in a home for it to be considered a primary residence. Instead, they provide circumstantial criteria, such as:

- Employment address
- Bank address
- Recreational or religious club addresses

In addition to this information, the IRS will consider the address listed on your:

- Bills or accounts
- Tax returns
- Driver’s license
- Voter registration
- Car Registration

Your address should be consistent across all of these documents. If so, then you have found your primary residence. If not, then you take the tax benefits based on your home at your own peril, because, if you’re ever audited, proving that those benefits were justified might be tough.

**AVOIDING PENALTIES WHEN USING IRA MONEY FOR A DOWN PAYMENT**
Since the Taxpayer Relief Act of 1997, a first time homebuyer under 59 ½ is allowed to use $10,000 of his or her IRA funds towards a down payment or transaction expenses on a home, while still avoiding
the 10% penalty for withdrawing funds early. However, these withdrawals could be taxed. Under the IRS definition, anyone who hasn’t owned a home for the last two years would be considered a first time buyer. The first time homebuyer can be the owner of the IRA, the IRA owner’s spouse, or any of his or her (or his or her spouse’s) direct descendants (such as children or grandchildren).

But, even though the IRS definition of a first time homebuyer is lenient, there are some other strict limits to this $10,000 amount. First, the buyer must make the purchase no more than 120 days after the withdrawal. Second, the property must be used as the buyer’s primary residence. Finally, $10,000 is all one buyer gets. A buyer cannot make a $10,000 withdrawal from his or her IRA now and then, later on down the road, sell the house, wait two years, and do it all over again. One $10,000 go-round is the limit.

**PERMITTED DEDUCTIONS**

One of the many benefits of owning a home is that certain items can be deducted on your tax return. These deductions save the taxpayer money by reducing your taxable income. They include:

Property taxes are taxes that are paid ad valorem, meaning that the taxes are assessed according to the value of the property.

**THE LAW RECOGNIZES THREE KINDS OF PROPERTY:**

1. Land
2. Buildings on the land (usually called “improvements”)
3. Personal (usually moveable objects made by people)

Even though land and improvements can be taxed individually in some states, typically, when someone talks about “real estate” or “real property”, they are talking about both the land and the buildings (or improvements) on it. Some states will also tax personal property, such as vehicles, valuable artwork, stocks, bonds, etc.

**Mortgage interest** is an acceptable deduction on an itemized tax return when mortgage funds are used to purchase or refinance either a primary or a secondary home. To claim this deduction, the taxpayer must have the legal responsibility to repay the debt. A tenant paying rent could not claim the deduction even though his rent is used to pay the mortgage, because the landlord has the legal obligation and, therefore, is the only party allowed to take the deduction.

**Secured debt:** The mortgage must be a secured debt—meaning that the taxpayer signs a legal document for a loan with the property as collateral to protect the lender’s interest.

**Home equity loan interest:** A home equity loan involves a homeowner borrowing against the equity he or she has in a property. Typically with a second mortgage, interest on this loan is an allowable deduction, as long as it meets the IRS requirements (which we’ll talk about a little later).

**Mortgage pre-payment penalty:** This is a financial penalty for repaying a mortgage loan early. It is a deductible expense as long as the penalty is mortgage interest and not a fee for a service on the loan. Points are sometimes charged in making mortgage loans. Each point constitutes 1% of the loan amount and generally represents prepaid interest. Points are a one-time expense, usually paid at or before the loan closing. As with many IRS rules, when and how you deduct mortgage points depends on passing tests and meet requirements.

Typically, the IRS requires you to deduct points equally across the life of the mortgage loan. You are allowed to deduct points in this way, as long as:

- A cash accounting method is used—meaning that an individual reports his or her income and expenses in the same year as they are received and paid. (Most people do this.)
- The loan is secured by a home, even if it’s not a primary residence
- The loan period is less than 30 years
The terms for loans that have a 10-year or longer period must be the same as other loans in the same geographical area.

- Either, the loan amount is less than (or equal to) $250,000, or you pay
- Less than 4 points on a loan with a period of less than 15 years; or
- Less than 6 points on a loan with a period of more than 15 years
- The loan is not a home improvement loan

But, sometimes you can deduct all of the points in the same year you pay them—if you meet certain requirements (of course). Under IRS rules, points on a mortgage loan are fully deductible in the same year they are paid, as long as:

- They are paid on a mortgage loan secured by a primary residence as collateral.
- They are paid in a geographical area where it is a common and accepted method of doing business.
- The normal amount of points is charged for the geographical area where the loan is made.
- A cash accounting method is used—meaning that an individual reports his or her income and expenses in the same year as they are received and paid. (Most people do this.)
- They are not paid for documents or services that would appear on a settlement statement, such as inspection, appraisal, and attorney fees, or property taxes.
- The money paid at or before closing (along with the money paid by the seller) covers the amount for both buyer and seller points. This money does not necessarily have to be used to pay the points, but could be applied to other expenses (like a down payment, escrow, etc.), and it cannot be a loan from the broker or lender.
- The loan is for the purchase or construction of a primary residence.
- Each point is figured at 1% of the mortgage loan principal.
- The point amounts are plainly stated on a HUD-1, or other such settlement statement, as being paid for a mortgage loan. They can be listed as coming either from the buyer’s or the seller’s money.

**HOME EQUITY FINANCING**

This financing is used when a homebuyer borrows against the amount of money he or she has already paid into a mortgage loan and/or the current value of the home. A borrower’s equity in a home is figured by taking the value of the property (usually determined by a bank appraisal) and subtracting it from the amount the borrower still owes. Home equity loans are limited to the original purchase price plus any improvements the homeowner has made to the property.

If a person owns a property free and clear, a home equity loan can be a first mortgage. Typically, though, a person will take out a home equity loan as a second mortgage to pay down other bills, make home improvements, or pay for college tuition. These loans should not be entered into lightly, though. The interest rates are often much higher than a normal mortgage loan because the repayment period is usually much shorter.

In some situations interest on a home equity loan is deductible. Consult a tax preparer to receive the most up to date information.

**CONSTRUCTION FINANCING**

A construction loan is made to finance improvements on the land. In this type of short term financing, funds are usually disbursed by the lender in deferred payments according to a construction schedule agreed upon by the bank, the contractor and the homeowner. Often, a homeowner/borrower will have to make payments during the construction period. These payments are usually just interest on whatever money the lender has already doled out to the contractor. The interest rate on such a loan should be a typical short-term rate. Payments on the principal will begin only after the construction is over and the homeowner has a certificate of occupancy, which means the project is complete. The interest on a construction loan can usually be deducted, as long as the construction for a house that becomes or remains a primary residence for the borrower for at least 24 months. The upside to this is that the 24-month period can begin at the same time as the construction or it can be sometime after.
HOME ACQUISITION DEBT
Home acquisition debt is exactly what it sounds like—debt taken on to construct, purchase, or even make significant improvements to a home. Interest from this kind of debt is usually deductible, and there are fundamental limits and rules.

REFINANCING RULES AND LIMITATIONS
At one time or another, many homeowners will refinance their properties for a variety of reasons. Usually, people decide to refinance to lower their monthly payment or fix the interest rate on the loan.

However, people can also refinance with loans that are higher than what they already owe on the mortgage. They may do this to pay off credit cards or other debt with higher interest rates. While such refinancing is another way to get access to the equity in a property without having to go through a high interest rate home equity loan, there are also rules and limitations regarding how the new loan is treated at tax time.

If you take out a refinance loan that is more than your current mortgage, only the amount of the original mortgage will be viewed as home acquisition debt by the IRS. In addition, the interest on that part of the refinance loan will be allowed as a home acquisition debt interest deduction. Anything beyond the original mortgage amount that is included in the refinance loan will not be treated as home acquisition debt, but may be eligible for home equity debt interest deductions.

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA)
In the mid-70s, it was common practice for the various parties involved in a mortgage transaction to provide kickbacks to one another for referrals. So, for example, let’s say an agent has a client who is on the verge of buying a house. This agent says to the client, “Hey, I know this guy named Steve over at ABC Bank who can help you out with the loan. He’s great, you’ll love him.” Before 1974, if the client went to ABC Bank for the loan, the agent would have gotten some money for referring him.

On the surface, this seems like a fair proposition, one professional gives another a good word of mouth advertisement and makes a little money for it. But, by the mid-70s, the practice had become so widespread that it was causing consumer costs to skyrocket. Instead of dipping into advertising money or profits to pay the kickbacks, companies were just building the cost into the fees charged to the consumer at for settlement and closing. Passed in 1974, the Real Estate Settlement Procedures Act (RESPA) was a law designed to protect homebuyers by shining a spotlight on the settlement process and the costs associated with it. Covering mortgages on one-to-four family homes, RESPA’s mission was two-fold:

1. To familiarize consumers with the settlement process and the charges associated with it; and
2. To do away with kickbacks that inflated consumers’ settlement and closing costs.

To accomplish this mission, RESPA required mortgage professionals to provide disclosures to borrowers at critical stages of the transaction process—application and closing. When applying for a mortgage loan, the borrower must receive:

THE HOMEBUYER’S GUIDE TO SETTLEMENT COSTS
This booklet explains, in clear and concise language, the purpose of various legal settlement/closing costs, while also offering examples of illegal kickbacks that the borrower should look out for. The broker or lender must give this booklet to the borrower when the mortgage application is completed, but only for purchases. Other types of loans do not require this booklet.

The Good Faith Estimate
This document estimates what costs the borrower might have to pay at closing. As the name suggest, this form only approximates the charges—the real fees could be different.
These are the two main disclosures required by RESPA at application. If they are not given to the borrower when the mortgage application is completed, the booklet and the good faith estimate must be mailed to the borrower within three (3) business days afterward.

**The HUD-1 Settlement Statement**
At or before the closing, the lender must provide the HUD-1 Settlement Statement to the borrower. This document itemizes all of the fees that both the buyer and seller will pay for the transaction.

While buyers and sellers may have their own individual statements prepared by their respective attorneys, this statement will offer exact figures for both parties on what they will each have to pay at closing. This form is not required for assumptions or commercial loans.

**THE CLOSING**
Prior to closing, a buyer will usually have a final walk-through of the property to make sure that everything is how it is supposed to be and that any agreed upon repairs have been completed. At the closing, the title actually passes from the seller to the buyer. Most of the work at the closing will be done by the buyer and seller’s attorneys, the bank representative, and the title person. But when all is said and done, the buyer will have a new property and the seller will have to find somewhere else to live.

**WHAT’S DEDUCTIBLE AND WHAT’S NOT: FIRST**
The usual disclaimer. Tax laws change and it is necessary for the licensee to be armed with current tax information before making any statements to the public.

Not all of the settlement charges and closing costs a borrower/buyer pays are deductible. In fact, the only costs associated with buying a house that are deductible outright are mortgage interest and real estate taxes. But, some of the fees connected to settlement and closing can, according to the IRS, be “added to the basis” of the home. This means that they are, essentially, added into the cost of the home for tax purposes, but only in the year they are paid. The only settlement and closing costs that are deductible are the ones the buyer would have had to pay no matter what—whether the house is paid for through a mortgage loan or by cash. Some settlement and closing costs that are deductible:

- Abstract/Title Fees
- Legal Fees
- Recording Fees
- Survey Charges
- Transfer Taxes
- Owner’s Title Insurance
- Utility Installation Fees

Also, if the buyer pays a fee, tax, or commission that the seller would otherwise be responsible for, then the borrower could deduct those costs on his or her tax return. On the other hand, if the seller takes over a fee or cost from the buyer, then the buyer has to subtract that amount from the basis—unless the buyer ends up paying the fee at closing.

**SECOND HOME/ VACATION HOME**
Mortgage interest is tax deductible on a second home/vacation home, as long as the house is actually a residence. The limit for renting the property is 14 days per year. Any rent collected beyond that timeframe constitutes taxable rental income. Mortgage interest and property taxes are both deductible on a second home. For mortgage interest, the usual limits apply. Property taxes, on the other hand, can be deducted just as you would on your primary residence.

**CAPITAL GAINS AND LOSSES (AND CALCULATING THEM)**
In order to understand capital gains (and losses), you have to start with capital assets. For tax purposes, your capital assets are all of your possessions—houses, furniture, vehicles, stocks, bonds—whether it’s something that only you use or something that you invest in.
The IRS uses the word “basis” to refer to the purchase price of something. Not only the cost of the item, but also the ability to buy a capital asset. For example, buying a house isn’t just a matter of paying the sales price. You also have to pay for the services of the professionals helping you complete the deal. Since there is no way for buyers to purchase a house without these fees, the IRS allows them to be included as part of a home’s “basis” for deduction.

All of your capital assets have a basis—even if it’s just the sticker price. And the basis is the pivot point that decides a capital gain or loss when selling a capital asset. If the sales price on your capital asset is higher than its basis, you’ll record a capital gain. If the sales price is less than the basis, you’ll record a capital loss.

**EXAMPLE 1: CALCULATING A CAPITAL GAIN**

Tammy and David bought their house for $200,000. Then, five years later, after property prices rise a little in their area, they sell it for $225,000. But, along the way, they have to pay $10,000 in expenses to sell it.

Look at the math:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Price</td>
<td>$225,000</td>
</tr>
<tr>
<td>Purchase Price</td>
<td>$200,000</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>-$15,000</td>
</tr>
<tr>
<td>Capital Gain</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

So, David and Tammy come up with a capital gain of $10,000.

**EXAMPLE 2: CALCULATING A CAPITAL LOSS**

Susan originally paid $150,000 for her home. But, when she goes to sell it ten years later, the market for her area is in a slump and she only gets $135,000 for it. On top of this, she has to pay $8,000 for various expenses.

Here’s the math:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price</td>
<td>$150,000</td>
</tr>
<tr>
<td>Sale Price</td>
<td>-$135,000</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>- $8,000</td>
</tr>
<tr>
<td>Capital Loss</td>
<td>$ 7,000</td>
</tr>
</tbody>
</table>

Notice that, based on the information we have about Susan’s home sale, the Purchase Price and the Sale Price switched positions for easier subtraction. After the value drop and expenses, Susan’s capital loss is $7,000.

**SHORT-TERM VS. LONG-TERM GAINS/LOSSES**

The two classifications for capital gains and losses are:

- Short-term—when you have a capital asset for less than one year before selling it; and
- Long-term—when you have a capital asset for more than one year before selling it.

The tax rates for capital gains depend on what kind of asset you sell and whether it’s a short-term or long-term capital gain. And the taxes aren’t just federal, either. States will, most likely, lump capital gains in with regular income at tax time, as most of them don’t have a separate rate for such income. Right now, the long-term capital gains tax rate is at 0% for people in the 10% and 15% tax brackets. This is set to expire in 2010, with the rate increasing to around 15%. Check current brackets.

While capital losses from selling personal capital assets (like furniture) are not tax deductible, capital losses from investment property (like a home or art) can lower capital gains and, in turn, possibly lower your taxes. Usually, this relationship between capital gains and losses results in what is called a “net capital gain” or “net capital loss”.
A net capital gain occurs when you actually make money, overall, from selling capital assets, even after the capital losses have been subtracted. A net capital loss occurs when you lose money, overall, on all of your capital asset sales, even after your capital gains have been added.

If you find yourself with a net capital loss on investment capital assets, you can write off some of that loss.

**SALE OF A PRIMARY RESIDENCE ($250,000/$500,000 RULE)**

Remember, the Taxpayer Relief Act of 1997 made it possible for a single seller to exclude from taxable income up to $250,000 from the profits of a primary residence sale. For married homeowners, this number jumps to $500,000. The only stipulation on this tax break was that the sold home must have been the primary residence for the seller(s) for at least two of the previous five years before the tax return was filed. This deduction is called the realized gain (or the adjusted cost basis), and only applies to the seller’s profits—not the purchase price or sales price. To find the realized gain, you simply take the:

Selling Price - Purchase Price - Selling Expenses = Realized Gain

**EXAMPLE:**

Tom and Margo sell their house for $550,000. When they bought the house ten years before, they paid $325,000 for it. Now, after all is said and done with their transaction, they end up paying $15,000 in selling expenses of various types.

Based on this info, let’s do the math to find out Tom and Margo’s realized gain.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Price</td>
<td>$550,000</td>
</tr>
<tr>
<td>Purchase Price</td>
<td>$325,000</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>$15,000</td>
</tr>
<tr>
<td>Realized Gain</td>
<td>$210,000</td>
</tr>
</tbody>
</table>

Since the allowable deduction on realized gains from home sales is $500,000 for married couples, Tom and Margo owe nothing in capital gains tax on this sale.

**SALE OF INVESTMENT PROPERTY**

When thinking about investment properties and how selling them is treated on tax returns, we need to understand how the IRS classifies income.

The three classifications for income are:

**ACTIVE INCOME**—Money you make by actually working, including:
- Salary
- Bonuses
- Commissions
- Tips (if applicable)

The IRS uses the term “material participation” in relation to active income, meaning that the earner participated meaningfully in a business for compensation.

**PASSIVE INCOME**—Money you make from not working (if you’re so lucky). Passive income can come from:
- Rental properties
- Being involved in a limited partnership
- Any other business investment where you do not actively participate, except for anything classified as portfolio income.
- Portfolio Income—Money you make from assets you own, but hire someone with financial know-how to oversee, including:
a. Mutual funds
b. Stocks
c. Bonds
d. Capital gain

**HANDLING LOSSES**

How you handle losses personally is your business. How you handle them on paper is the IRS’s business. And, as such, the income classifications we’ve discussed so far come with some restrictions about how you can handle their respective losses on your tax forms. As we saw above, the main difference between the types of income is, essentially, how you made the money; which is where the term “material participation” comes into play. Material participation means being hands-on. For example, if you’re a sole proprietor, you actively (or materially) participate in the day-to-day management of your business. You had better if you’re going to have a chance at success!

Any income you make from being significantly involved in a business translates to “active income” for tax purposes. This means that any losses you see from running your business can be subtracted from the active income gains to possibly reduce your tax burden.

**Portfolio income** lies somewhere between active income and passive income. It’s the interest, dividends, and other earnings from investments like stocks, bonds, and mutual funds. Losses from this type of income could, possibly, be used to offset gains from active income.

At the other end of the spectrum, you have **passive income**. This type of income usually comes from being a “silent partner” or owning something like rental property that generates income without you having to be on-site all of the time. In other words, if the checks show up in your mailbox every month with little effort on your part, then you have some passive income to deal with at tax time.

**Passive losses cannot be used to reduce active gains or portfolio gains.** Passive losses can only be used to reduce passive gains, and that is it for individuals (or couples) filing taxes. The cap on passive losses is $3,000.00.

**DEPRECIATION AND THE DEPRECIABLE BASIS**

In everyday life, depreciation means that something is wearing away. In tax terms, though, depreciation is a good thing, because it refers to recovering the basis (or cost) of a property through a yearly tax deduction. We’ve used the word “basis” a few times in this course. The reason this word comes up often in tax talk is that it is a little more comprehensive than the word “cost”. A rental property’s basis represents not just its purchase price, but also some closing costs, as well as money spent getting it ready to rent. In addition to these elements, the basis could also include what’s called “assumed debt”. This is when you take over the mortgage or some other kind of debt connected to the property from the previous owner.

So, let’s say you put down $40,000 on a house. On top of this, you take on the previous owner’s mortgage of $150,000. In figuring your basis on the property, you would add these two numbers together, along with any other eligible closing and repair costs to get the basis. There might also be some extra fees charged to transfer ownership in such a transaction. Added together, we have the “basis”. But to deduct depreciation you need to find the property’s “depreciable basis.”

Depreciation doesn’t apply to actual land, therefore, in order to find a property’s depreciable basis, subtract the value of the land. If it doesn’t depreciate in the eyes of the IRS, you can’t deduct it.

In many areas, 20% of the value is considered land, with the remaining 80% constituting the home or building value. Assessors and appraisers would have the most accurate split. Once you subtract the land value, and add in any eligible closing and repair costs, you will then have the property’s depreciable basis.
**COST RECOVERY PERIODS**

Now that you have the depreciable basis, the next step to finding out your annual depreciation. The cost recovery period is the useful life of an object or property—on paper.

Although homes and buildings can last hundreds of years, the cost recovery period, taxable lifetime, or useful life is the shortest timeframe in which an investor can recoup the cost of the house or building. For residential property, the cost recovery period is 27 ½ years. For commercial property, which is a building with five or more rentable units, it is usually 39 years. The cost recovery period does not begin on the property’s purchase date. It actually begins when the property is “put into service”, meaning when it’s rented out. According to the IRS, the first and last months of this period are always half months. So, for example, if you rented out a property on June 3rd, the allowed cost recovery period would begin June 15th.

**THE STRAIGHT-LINE METHOD**

Once you know the property’s depreciable basis and its cost recovery period, under IRS rules, you have to use the straight-line method to figure the yearly allowable depreciation deduction. The idea behind the straight-line method is that the property value will decrease an equal amount every year until it is fully depreciated. To figure your depreciation deduction, you take the depreciable basis and divide it by 27 ½ years (for residential property) or 39 years (for commercial property). And...that’s it. The only catch is, since the first and last years that you own the property will be partial years; you will have to do some math to find out what your depreciation deduction will be for those years.

**EXAMPLE**

Let’s say Chris has a $200,000 rental property that he finally rents out on March 7th. The land the house sits on is worth $50,000. After looking at his HUD-1, Chris finds $5,000 in eligible closing costs. And, before the property is actually ready for tenants, Chris puts $3,000 of his own money into paint and repairs. When tax time rolls around, how much will Chris be allowed to write off for first-year depreciation? What about every year after that?

Let’s do the math:

| Overall Purchase Price: | $200,000 |
| Land Value: | - $ 50,000 |
| Eligible Closing Costs: | + $5,000 |
| Repair Costs: | + $3,000 |

Depreciable Basis: $158,000

Now that we have figured Chris’ basis, we need to take that number and divide it by the cost recovery period. So: $158,000 ÷ 27.5 = $5,745.45

Remember, the IRS allows a cost recovery period of 27 ½ years (or 27.5). But with this equation, we’ve actually figured Chris’ second year depreciation deduction first. Don’t forget, Chris purchased the property on March 7th, which (to the IRS) means his depreciation period kicks off March 15th. So, to figure the first-year allowable depreciation deduction, the math will look like this:

$5,745.45 ÷ 12 = $478.79 x 8.5 = $4,069.72

Here, we take Chris’ full-year depreciation deduction ($5,745.45) and divide it by the 12 months of a full year to get his monthly depreciation of $478.79. Next, we multiply this monthly depreciation by 8.5, because Chris only owns the property for 8 ½ months in that first year. When we do this, we get $4,069.72—Chris’ first-year depreciation deduction. Along the way, we’ve also found Chris’ full-year depreciation deduction of $5,745.45. This should be his number for nearly every year until the 27 ½-year cost recovery period is up.

**TAX RATE ON RECAPTURED DEPRECIATION**

Depreciation is not optional. The IRS requires the investing taxpayer to take it. That sounds great. However, under the Tax Relief Act of 1997, if you sell an investment property after May 6th, 1997, any gain from it could be subject to two different tax rates—the depreciation recapture rate and the capital
gains rate. The only way to get around these taxes is to either sell the property at a loss or do a 1031 exchange (which we’ll cover later).

As we’ve discussed, when you own a rental property, you’re allowed to deduct a certain amount of its depreciation every year for tax purposes. Well, when you sell that property, the government takes back or “recaptures” some of the depreciation you’ve claimed all along by taxing it at a 25% rate. But that’s not all. The government also taxes any capital gain you see from the sale, beyond the depreciation amount, at 15%. But, remember, the depreciation amount is taxed first. And, if the gain isn’t more than the depreciation, you will be taxed at 25%. It’s a little ugly and confusing, but let’s see if we can clear it up with a couple of examples.

**EXAMPLE 1**
Jane sells a rental property for $300,000. Her original basis for the property was $250,000, and during the time she owned it, Jane claimed $50,000 in depreciation.

Let’s take a look at the math:

| Original Basis | $250,000 |
| Depreciation | -$50,000 |
| Adjusted Basis | $200,000 |

Here, we find Jane’s adjusted basis, which is, basically, the property’s current value. This is important because it leads to this:

| Sale Price | $300,000 |
| Adjusted Basis | -$200,000 |
| Capital Gain | $100,000 |

So, Jane realized a gain of $100,000, which is twice her depreciation. That means that she will be taxed at two different rates on this sale. Of that $100,000, the first $50,000 will be treated like this:

$50,000 x .25 (or 25%) = $12,500

We multiply the first $50,000 of Jane’s gain by the 25% depreciation recapture rate to get a $12,500 tax. But we’re not through. The remaining $50,000 of her $100,000 gain will be treated like this:

$50,000 x .15 (or 15%) = $7,500

The other $50,000 is multiplied by the capital gains tax rate of 15% to get an additional $7,500 tax. So:

- Depreciation Recapture Tax: $12,500
- Capital Gains Tax: + $7,500
- Total Tax on the Gain: $20,000

Jane will pay a total of $20,000 in taxes on a $100,000 gain from her sale of rental property.

**EXAMPLE 2**
Aaron’s original basis in his rental property was $400,000. By the time he sells the property, he has claimed $100,000 in depreciation. He sells the property for $380,000.

Here’s the math:

| Original Basis | $400,000 |
| Depreciation | -$100,000 |
| Adjusted Basis | $300,000 |

This, then leads to:

| Sale Price | $380,000 |
| Adjusted Basis | -$300,000 |
| Capital Gain | $80,000 |

So, Aaron’s realized gain on this sale is $80,000, which is less than the $100,000 he has already claimed in depreciation while he owned the property. So: $80,000 x .25 (or 25%) = $20,000

The entire gain will be taxed at the depreciation recapture rate, giving Aaron a tax bill of $20,000 on an $80,000 gain.
**REDUCING TAX LIABILITY**

**Itemized Deductions**
Sometimes your income doesn’t just come from making more money, but also finding ways to save it. For investors and business owners of any kind, this means having an accounting professional scour their tax returns for allowable deductions. The deductions permitted by the IRS can lower your net income (on paper) and, in turn, reduce your tax liability.

Some examples of such deductions are:
- Prepaid interest (points)
- Closing costs
- Alimony
- Mortgage interest
- Real estate taxes
- IRA contributions
- Certain tuition expenses
- Allowable business expenses
- Half of self employment tax
- Local taxes

The IRS allows you to use these deductions in certain situations to offset income that you earn from sources such as:
- Wages
- Tips
- Commission
- Business profit
- Social security income
- Interest and dividends
- Capital gains
- Alimony received

The basic idea here is that you add up all of your income, and then subtract all of your deductions from that to come up with your adjusted gross income (AGI). Once you have the AGI, you’ll then be able to figure out how much you owe in taxes for the year.

**STANDARD DEDUCTIONS**
Of course, this system of deductions only works if you have enough itemized deductions to make it worthwhile—and if you (or your tax professional) take the time to use it. Most work-a-day-Joes don’t do this. Instead, they prefer to simply their tax filing experience by using the standard deductions set up by the IRS.

Standard deductions are typically revised every year to keep up with inflation and, as you’ll see below, they depend on your marital status, age, ability to see, and whether you have financial dependents.

For example, in a recent year, standard deductions were as follows:
- **Single person**: $5,450 (plus $1,350, if you are 65 or older or blind)
- **Married couple filing a joint tax return or qualifying widow(er)**: $10,900 (plus $1,050, per person who is 65 or over or blind)
- **Married couple filing a separate tax return**: $5,450 (plus $1,050, if you are 65 or older or blind)
- **Head of household**: $8,000 (plus $1,350, if you are 65 or older or blind)
- **Dependent Children**: $900 or earned income plus $300—whichever is greater.

These are basic standard deduction categories, but others can be added on a year-to-year basis. For example, in 2008, there was a standard deduction for people who paid state or local real estate taxes during the year—up to $500 for single filers, and up to $1,000 for those who were married and filing jointly. This deduction only applied to residential housing, no business or foreign properties allowed.
TAX CREDITS
There are two types of tax credits—non-refundable and refundable. And, as you might guess, the refundable ones are a little more desirable than the non-refundable ones.

Non-refundable tax credits can reduce your tax liability to zero, which is good. But, if you are eligible for more tax credits than you owe in tax dollars, you will not get a refund from them. That’s where the “non-refundable” designation comes from.

Some examples of non-refundable tax credits are:
- Credits for dependent children’s expenses for child care
- Child tax credits
- Education credits
- Disabled or elderly credits
- Retirement savings contribution

Refundable tax credits are great because they will reduce your tax bill to zero...and then some. If you are eligible for more in refundable tax credits than you owe in tax dollars, you will get the excess back as a refund.

Examples of refundable tax credits include:
- Earned income credits
- Additional child tax credits
- First-time homeowner credit
- Again, these are revised quite often.

THE LOW INCOME HOUSING TAX CREDIT
If you’ll recall, President Reagan’s Tax Reform Act of 1986 (TRA86) was pretty damaging to real estate investment. However, it also introduced a measure that benefitted real estate investors and developers called the Low Income Housing Tax Credit (LIHTC). Since TRA86 was geared toward homeownership, the LIHTC was included to make sure that housing would still be available for low income families. The idea was that, even with the changes made by TRA86, low income families would still not be able to purchase a home. So, there would still be a demand for affordable rental housing.

While the LIHTC programs are funded by the federal government, they are state-run, because different states will have different needs for low income housing. And, no one understands those needs better than the states themselves.

Typically, developers will submit their project applications to the state agency in charge of the LIHTC program for review. In New York, this agency is the New York State Division of Housing and Community Renewal (DHCR). The developer’s application is reviewed against other competing projects, based on cost and the developer’s pledge to honor “set asides”, which means that either:
1. No less than 20% of the apartments in the project are for people who make 50% (or less) of the median gross income for the area; or
2. No less than 40% of the apartments in the project are for people who make 60% (or less) of the median gross income for the area;

Of course, these are called “set asides” because the developer holds back a certain percentage of apartments for a designated income bracket. The states also keep an eye on the projects to make sure the developers comply with the various rules and regulations for the LIHTC program. In order to keep receiving the benefit of the LIHTC, developers are not allowed to sell the project property for 15 years after it is finished. This is called the “compliance period”. If the compliance period and other requirements of the LIHTC program are not met by the developer, not only would the tax credits claimed on the project be taken back (or “recaptured”) from the developer, but that person would not be able to claim any other credits in the future.
FORMULA FOR CALCULATING THE FEDERAL TAX ON INCOME DERIVED FROM OPERATIONS
When we talk about “income derived from operations”, we’re talking about net income—otherwise known as the bottom line. In a business or investment, this is the money you make after all of your expenses are taken into account.

The basic formula looks like this: \[ \text{Gross Income} - \text{Expenses} = \text{Net Income} \]

In this equation, gross income represents all of your earnings for the year. On an investment or rental property, this would be all of the rent you collect in a given year. An important thing to understand is that the IRS requires you to report rent based on the date it’s actually paid, not on the period it’s paid for. So, for example, let’s say you rent out a house on November 1st, 2009. The tenant pays the rent through March of 2010. You would still report all of that rent on your 2009 taxes because you received it in 2009. While this might inflate your income for 2009 taxes, it will decrease your 2010 income by the same amount. So, it will even out eventually. Just as you report only the income you receive in a given year, you would also only subtract the expenses you actually pay in that year. Typical expenses on an investment property would include:

- Maintenance and/or repairs
- Property taxes
- Advertising for tenants
- Mortgage interest
- Legal fees
- Utilities

Of course, these are just examples. Depending on a property’s situation, there could be other expenses that might come up.

LIKE/KIND (OR 1031) EXCHANGE (covered in-depth in Commercial/Investment chapter)
Remember, like/kind exchanges only allow investors to defer taxes on gains. That means that, while the gains are only realized as long as the investor holds onto the property, if he sells it down the road, those gains could become recognized—meaning they would be taxed. The only way around this would be for an investor to either keep exchanging properties for the rest of his or her life, or to hold onto the replacement property for the rest of his or her life. Until death do us part, indeed!

One element that we should underscore here is that any one type of property can be exchanged for any other type. Buildings or no buildings, as long as both properties are for investment purposes, they can be exchanged.

The 3-Property Rule—This rule allows an investor to earmark no more than three possible replacement properties. Their value doesn’t matter.

The 200% Rule—This rule allows an investor to identify as many possible replacement properties as he or she chooses, as long as the total value of the possible replacements is not more than twice the relinquished property value.

The 95% Rule—This rule allows an investor to identify as many possible replacement properties as he or she chooses. But, before the exchange period is over, the investor has to receive replacement properties with a total fair market value equivalent to no less than 95% of the total fair market value of all of the possible replacement properties.

In order to do a like/kind exchange involving several properties, the investor has to satisfy at least one of the above regulations.

WHEN IS REAL PROPERTY NOT ELIGIBLE FOR A LIKE/KIND EXCHANGE?
The restrictions on real property being involved in like/kind exchanges are more about circumstances than the properties themselves. As we’ve already stated, a property involved in a like/kind exchange must be an investment property. It cannot be the investor’s primary residence or even a second home he or she personally uses. “Flipped” properties are also not eligible. Even though these are considered
investment properties by the people who buy them, the IRS does not view them in the same light as a property that a person holds as a long-term investment. In the event of an audit, the IRS would check into the business practices of the investor trying to offer up a flipped property for a like-kind exchange to see what that person’s track record for buying and selling properties has been. The idea here is that the IRS doesn’t want the tax benefits of a like-kind exchange to be abused by investors who flip homes (either with or without repairs and improvements).

Finally, real property cannot be exchanged for personal property in a one-to-one situation. The only time personal property can be mixed with real property is in a transaction involving boot (which we’ll talk about later). As we saw a little earlier, even with exchanges of hotel/motel property, personal property is split out and treated differently than real property.

**BOOT**

“Boot” is the term used for any property, object, or money a person receives in addition to the like-kind property in an exchange. While a straight like-kind (or property-for-property) exchange is usually tax-deferred, if you get more boot than you give in the transaction, then that extra cash, property, or object will be taxable. The three types of boot are:

**Cash boot**—money an investor receives in addition to the property in a like-kind exchange. One very common reason cash is included in a like-kind exchange is for repairs. If the seller agrees to pay repairs to a property, he or she might give the money to cover those costs to the investor as part of the deal. While both parties see this as a selling point, the IRS views it as a capital gain for the investor. And, as such, it would be taxed. But there’s another rule you should know here. Also, if an investor uses funds from the sale of a relinquished property to pay for service fees that are not related to the like-kind exchange closing, this could be considered cash boot by the IRS and taxed accordingly.

The boot an investor receives in a like-kind exchange must be less than the realized gain, because the lesser of the two will be taxed at capital gains rates. So, if your gain is less than the cash you receive, you’ll be paying the taxes you were trying to avoid in the first place. It’s always a good idea for investors to bring money to the closing to pay for fees that might trigger a tax on cash boot if they are paid for with the funds from the relinquished property sale. Better safe than sorry.

**Mortgage boot**—when an investor takes on the debt on a replacement property, he or she is paying mortgage boot. When the investor decreases his or her debt through a like-kind exchange, then the investor is receiving mortgage boot.

The rule for investors here is to find a replacement property with a mortgage debt that is at least equal to (if not greater than) the property he or she is relinquishing. Otherwise, the investor is looking at paying a capital gains tax on the difference.

**For example**, let’s say the investor’s relinquished property had a $150,000.00 mortgage, and the replacement property has a $135,000.00 mortgage. The math looks like this:

| Relinquished Property Mortgage: | $150,000 |
| Replacement Property Mortgage: | - $135,000 |
| Taxable Mortgage Boot: | $15,000 |

The investor will pay capital gain tax on the $15,000.00 taxable mortgage boot.

**Personal Property Boot**—this is a less common situation where other things besides the property are included in the deal, like appliances included with a rental property that is being exchanged. Much like hotel/motel exchanges, the best way to avoid paying capital gains tax on personal property boot is to split it off from the exchange transaction and buy it separately.

**TAX ISSUES FOR REAL ESTATE AGENTS**

**Who Do You Work For?**
For real estate agents (and direct salespeople, in general), income taxes can seem quite challenging. While we’ve all had jobs where our employer takes taxes from every paycheck, once we step into “being our own boss”, we realize how confusing taxes can be. Luckily, the IRS has some pretty easy-to-understand rules about this issue.

As a real estate agent, you are considered a **statutory non-employee**, which means, to the IRS, you are an independent contractor when it comes to taxes. Even though licensing laws require your broker (or brokers, if you work for more than one) to supervise your activities, you are still treated as an independent contractor for tax purposes, as long as:

- You are paid based on sales and not by-the-hour; and
- You have a written agreement or contract with your employer specifying that you will not be considered a regular employee.

**THIS AGREEMENT MUST SPELL OUT THAT:**

- Your pay structure is based on sales and not how many hours you work;
- You are in control of the hours you work
- Your employer may supervise your work, but cannot tell you how to do your job or make you do your job a certain way; and
- That either you or the employer can back out of the agreement at any time. Both you and your employer must willingly sign this agreement. Then, as long as you have a relationship with that employer, you will both have to review and resign the same type of agreement **at least every twelve months, but no less than every fifteen months.**

This agreement is not an employment contract with your broker (or brokers). The employment contract is a document you would sign in addition to the independent contractor agreement. While the employment contract might contain some information that overlaps with the independent contractor agreement—like payment information—it also contains other clauses not related to tax concerns.

**WHAT DO YOU PAY (BESIDES INCOME TAX)?**

Because you don’t get a paycheck with taxes withheld every couple of weeks, you have to pay what is called a self-employment tax (or SE tax), in addition to normal income taxes. This tax covers the social security and Medicare taxes that you would split with your boss if you worked for a regular paycheck.

You’ll do the math for the SE tax on the Schedule SE (Form 1040), which you’ll use if you’re an independent contractor (or a statutory non-employee).

The SE tax rate breaks down like this:

- 12.4% for social security; and
- 2.9% for Medicare

Some quick addition tells you that this comes up a 15.3% tax on your earnings. Now, this entire 15.3% SE tax rate applies to your first $106,800 of self-employment income for 2009. Beyond $106,800, the social security part drops off, but you still pay the 2.9% Medicare tax no matter how much you make.

(Tax rates change, so check for the most current ones, these are simply examples)

The good news is that you’ll be able to deduct 50% of the SE tax when figuring your adjusted gross income. That is done on the Form 1040, not on the Schedule C where many itemized deductions are taken. Remember, the SE tax is paid in addition to your regular income tax. Refer to the “Tax Bracket” subsection of Section 1 to get an idea of your income tax liability. Finally, if you pay on a schedule other than a normal calendar year—say a fiscal year schedule—then you should use the guidelines for tax rates and earnings limits when your year starts, no matter what happens to the rates and limits during the year.

**PAYING THE SELF EMPLOYMENT TAX**

The “how” of paying the SE tax is pretty simple. You just have to have a social security number (SSN) or individual taxpayer identification number (ITIN). If you don’t have a SSN, you can usually get one if
you’re citizen of the United States. If you’re not a citizen or can’t get a SSN for one reason or another, then you’ll have to get an ITIN.

**ESTIMATED TAX PAYMENTS**

If you think you’re going to owe more than $1,000 in SE and income taxes at the end of the year, as an independent contractor, you have to pay estimated tax payments. This means you’re being taxed on the installment plan. The only way you would not have to pay estimated taxes for the current year would be if all of the following were true:

1. You didn’t have a tax bill for the previous year;
2. You were a citizen of the United States for the entire year; and
3. Your previous tax year covered a 12-month timeframe.

The rule about having no tax bill (or “tax liability”) is that if you made nothing for the year or not enough to be required to file a tax return, you had no tax liability. But if you did have a tax bill last year, you have to make estimated tax payments this year. In addition, if your husband or wife is also an independent contractor, you can file joint estimated tax payments. The only way you wouldn’t be allowed to file joint estimated payments is if:

1. You file your normal tax return with a single status;
2. You or your spouse is a not a citizen of the United States;
3. You and your spouse don’t pay estimated tax payments on the same schedule. (Note: this does not happen very often.)

Just because you pay estimated tax payments jointly, that does not mean your actual tax return also has to be filed that way. Going the married, filing separately route just means you’ll have to decide which portion of the payments you each get for your respective returns.

**HOW TO FILE ESTIMATED TAX PAYMENTS**

You have to fill out the one-page Form 1040-ES and send it in with your check. Also, after your first estimated tax payment, you can use the Electronic Federal Tax Payment System (EFTPS). It also has other features such as payment history that will be helpful for recordkeeping purposes, and ensure that you pay enough.

**ESTIMATED TAX PAYMENT SCHEDULE**

For most people, the first estimated tax payment is due on the dreaded April 15th. One important thing to realize is that, even though you’re paying estimated taxes on that day, you also have to file a tax return by that date. In addition, if you owe money with your tax return, you will have to write separate checks for the return and the estimated tax payment, because they don’t go to the same P.O. Box.

Therefore, the entire schedule for estimated tax payments (for most taxpayers) goes like this:

- Payment 1: April 15th
- Payment 2: June 15th
- Payment 3: September 15th
- Payment 4: January 15th

**THE STARTING GATE FOR FIGURING ESTIMATED TAXES**

If you’ve never paid estimated taxes before, the best way to get started is to look at your previous year’s tax return—using your adjusted gross income, taxable income, deductions, and any credits you took as a guideline. Then, you just use the worksheets in the Form 1040-ES to find out how much you could owe. Remember to include both the SE tax and income tax, because the estimated payments cover them both. Getting the right tax figure is important, so that you’ll avoid penalties. But, it’s not an exact science. Your first year paying taxes this way might be a little hit or miss. As such, the IRS allows you to refigure up or down from quarter to quarter, depending on what happens to your income.
DEDUCTIONS
When thinking about deductions, you should also remember these two words—“necessary” and “ordinary”. The IRS calls an expense “necessary” if it is industry-appropriate and extremely useful in your business success. “Ordinary” means the usual expenses related to your field. These expenses don’t have to represent vital parts of your operation, but they can’t be extravagant, either. Be sure to consult with an accountant or tax attorney for professional advice about any deductions before filing them on your return.

Now, let’s take a look at some categories where you might find deductions that could save you hundreds (if not thousands) of dollars.

ADVERTISING
Because advertising is directly-related to your business, it is a deductible expense. Signs, business cards, and ballpoint pens with your logo on it are all examples of advertising items that could be deducted at tax time. Clothing emblazoned permanently with your logo might also qualify. But you should check with a CPA before marking that deduction down in ink.

GIFTS
The IRS limit for gifts to clients is $25 per person, per year. For example, let’s say you give gift baskets to three new homeowners as housewarming gifts. Each basket is worth $50—meaning that you spend a total of $150. Under IRS rules, you would be able to deduct $75 for these three gifts. After that, you may want to stick with holiday cards for the rest of the year.

Also, for the purposes of this rule, the IRS views you and your spouse as a single taxpayer. So, if you both happen to give gifts to the same person—even if it’s for a different business—you still only get a $25 deduction for that person. Partners and partnerships are treated the same way.

The two exceptions to this rule are:
1. Items costing $4 or less that have your name (or your company’s name) emblazoned on them, and are bulk things you normally hand out; or
2. Signage, displays, or other promotional stuff you leave for clients to use in their offices.

MEALS AND ENTERTAINMENT
Meals and entertainment are probably the most popular deduction that taxpaying business owners or independent contractors report. When looking at possible entertainment deductions, the IRS provides two tests to see whether the event is worthy of you getting the break. These two tests are:
1. Is the event is directly related to your business; or
2. Is the event is associated with your business.

Being “directly-related to your business” means that the idea behind the entertainment event was clearly to talk business—like a convention meet-and-greet, where you talk about your products or services with clients. But, business discussions during parties at your home, or meeting clients at the country club or at a nightclub are not events that would be considered directly related to your business.

If an entertainment event is “associated with your business”, it means that you talk business with a client, but it could be before or following the entertainment event. This is where stage plays and sporting events come into the picture. The IRS requires, in order to pass the associated test, the business discussion must take place directly before or after the entertainment event. However, the definition of “directly” can be pretty flexible. For example, if you have clients that come in from out-of-town and stay overnight, you’ll probably take them out for meals and/or catch a show or a game. If the business discussion took place on the same day as the entertainment, it would be ideal for tax purposes. But that doesn’t always happen. That’s why the IRS gives you some wiggle room when it comes to defining “directly”. In this case, it could mean the next day. Meetings at conventions that
include entertainment expenses could also be partially deductible—as long as the convention is designed to help you do business more effectively.

The bad news about meal and entertainment expenses is that you are only allowed to deduct 50% of them. That means for event tickets, for example, you’re getting two for the price of one. One interesting note about the 50% limit is that it does not apply if you provide free food and entertainment as a way of advertising yourself and your services to the community. This could be a good way if you’re an agent who is new to a neighborhood to get started off on the right foot—and it would be fully deductible.

HOME OFFICE
Because most real estate agents are licensed to a broker, a home office deduction probably will not be available to you. But, you should check with your accountant or a tax attorney if you think you might have a special situation.

AUTOMOBILE
For independent contractors, deducting automobile expenses can be a huge help. As a real estate agent, you’re constantly leaving the office to meet with buyers or sellers and show or look at properties, so this deduction can be very helpful at tax time. The IRS offers two methods for figuring deductions on automobile usage:

1. Standard per-mile deduction; or
2. Actual expenses.

As you might guess, the standard per-mile deduction is a figure provided by the IRS that you will multiply by the business mileage you put on your car in a year. This number changes nearly every year, so check with your accountant or a tax attorney to see what it is at tax time. The standard mileage deduction covers everything you would deduct as part of your actual expenses for the vehicle. But, even with the standard deduction, as an independent contractor, you might still be able to write off:

- Car loan interest equal to the car’s business usage (e.g. 75% of the interest if you use the car for business 75% of the time);
- Some state and local personal property taxes; and
- Parking fees and tolls related to your business (not including any fees you pay to park at the office)

As always, check with your accountant or tax attorney about these deductions before you take them.

While the standard deduction does eliminate a lot of the hassle of collecting receipts and keeping detailed records, you might want to deduct based on the actual expenses you incur every year. Doing so could offer you other deductions beyond what you would get from the standard deduction.

Of course, you have to be sure to keep track of the amount of business versus personal use to figure accurate deductions. The IRS suggests dividing the expenses by the miles you feel you drive for business to find the correct amount. With either method you must keep accurate records of mileage and/or expenses.

INSURANCE
As an independent contractor, you might also be allowed to deduct medical, dental, and long-term care insurance premiums. Check with your accountant to see if you qualify.

TRAVEL
If you need to travel overnight or longer for business purposes, you could be eligible to deduct some of the costs associated with the trip. Usually, when travelling for business, you can deduct:

- Transportation costs (unless you were given a ticket or are using frequent flier miles);
- Commute between airport (or station) and the hotel;
- Commute from the hotel to your business location;
• Car expenses (as discussed above);
• Hotel (including tips);
• Meals (including tips);
• Dry cleaning costs;
• Shipping costs for any materials you need for business, but cannot carry yourself; and
• Any other expense that is important to your business.

In addition, you can deduct expenses for another person, as long as that person is either your employee or has a good, business-related reason for being with you—such as a potential client.

EDUCATION
You can deduct education expenses if they relate to your current job. This means that, once you become a real estate agent, you can write off your continuing education expenses, as well as expenses from seminars and conventions focused on professional development. Unfortunately, initial or pre-licensing education is not deductible, because it violates the IRS rule that the education cannot be for training in a “new trade”.

EQUIPMENT, FURNITURE, AND SUPPLIES
The cost of computers, cell phones, office furniture, phones and other related items you use for your business could be deductible expenses. It depends on whether you bought them specifically for business usage or if they were/are personal items that you use for work. For the most part, supplies like pencils, pens, paper, etc. should be deductible, but be sure to ask your preferred tax professional about your individual case to see what you are eligible for.

DUES AND SUBSCRIPTIONS
As a real estate professional, you will benefit greatly from subscribing to trade newspapers and being a member of professional associations such as:

• NAR (National Association of Realtors)
• NYSAR (New York State Association of Realtors)
• Local Realtor Boards
• MLS (Multiple Listing Service)

KEEPING TRACK OF DEDUCTIONS
Of course, none of these deductions really matter if you don’t have any proof that you ever paid the expenses. So, be sure to keep extensive and accurate records on all of your business-related expenses. The IRS requires documentation such as:

• Receipts
• Bills
•Canceled checks
• Invoices
• Expense diary or other written record

They require this documentation because, if you ever have to show an auditor proof that your itemized deductions are real, you will have detailed information to back up your claims. Using a computer spreadsheet or other financial tracking program is a great idea for keeping the best possible records. If you make using the program part of your business routine, you’re going to be prepared at tax time.
CHAPTER 26 MUNICIPAL AGENCIES

KEY TERMS
Architectural Review Board  Planning board
Building department  Receiver of Taxes
Conservation Advisory Council  Tax assessor
County Health Department  Village Board of Trustees
Historic Preservation/Landmark Commissions  Zoning Board of Appeals

OVERVIEW
A town, village, city or county with its own local government is known as a “municipality”. In each municipality, there are governing bodies, which have the authority to oversee and regulate various issues pertaining to the health, welfare and safety of the residents. There are many different types of municipal agencies that exist and their functions vary greatly.

ARCHITECTURAL REVIEW BOARD
In charge of approving new construction and remodeling projects in accordance with municipal ordinances. These are laws or rules made by the government of a municipality. They are enacted to preserve and protect the quality of life of the residents of the municipality. Architectural Review Boards encourage the most appropriate land use within the community. They are authorized by local laws to review building plans and specifications, to make sure that proposed construction projects will conform to the architectural nature of the area. They consider items such as building sizes, building materials and architectural styles to determine how well a proposed construction project will fit in to an area.

If a proposed new construction or remodeling project is found to be inappropriate or very dissimilar to other structures within certain distances, the Architectural Review Board can require that the plans be revised or they can even withhold the approval of building permits. They are also concerned with protecting the historic nature and heritage of communities.

They are typically composed of appointed members with backgrounds in architecture, planning and art. A property’s market value is directly affected by its surroundings. Areas that have reasonable degrees of uniformity will often have higher property values than those that do not. It is the Architectural Review Board’s duty to ensure that properties share and benefit from a reasonable degree of conformity in accordance with the character of the community.

Example: A property owner is planning to tear down his existing house in order to build a new one. The house is located in an urban setting that is comprised mostly of brick, 2-story colonial style dwellings that range from 1,600 – 2,000 sq. ft. of living space. These homes were built in the 1930’s and are very similar in architectural style and overall appeal. The owner would like to tear down his brick 2-story colonial, and build a 2.5 story frame contemporary style dwelling. The plans call for sharply angled walls and rooflines, and over 3,500 sq. ft. of living space. The exterior walls will be cedar and vinyl siding in bright pastel colors.

In this case, the Architectural Review Board would review the plans for this construction project and likely find that the proposed building is too dissimilar to the other structures in the area. It would clearly detract from the architectural nature of this community. As a result, the current building plans would be considered inappropriate and the Architectural Review Board would either require that they be revised to a more reasonable design for this area; or withhold the approval of the building permits altogether.

BUILDING DEPARTMENT
In charge of enforcing building codes. As such, they act as the “gatekeeper” of construction. These are regulations that protect the public by imposing structural, material, design and other requirements on
buildings. Building codes apply to all building types, including residential, commercial, industrial and other types of structures. Many states, including New York, follow the National Building Code, which sets minimum standards for all residential and commercial building types. The New York State building code is known as “The New York State Uniform Fire Prevention and Building Code”. This code must be followed when no local building codes exist, or when local codes are less restrictive than the NY State code.

Property owners must obtain building permits before constructing or renovating residential and commercial buildings. They specify the materials to be used as well as the specific codes that need to be followed.

Property owners are typically required to submit building plans, specifications and architectural drawings to the building department before building permits are issued. It is the building department’s responsibility to ensure that the plans comply with the building codes. They also ascertain that the construction will be performed by licensed and insured professionals. Once the construction project is started, inspections of the project is done several times throughout the building process. This is to ensure that the work being performed complies with the building code.

The building inspector will walk the property and compare the buildings to the plans and specifications that were submitted. Often, the building inspector will take photos of the work in process as well. If the work is not in accordance with the applicable code, the inspector can stop the work if necessary.

Once a construction project is completed in compliance with the building codes, the building department will issue a certificate of occupancy. This is an official document issued by the building department, which is proof that the construction was done in compliance with the law.

In remodeling projects such as extensions and additions, some municipalities will issue a certificate of completion. It is similar to a certificate of occupancy, in that it is an official document indicating that the construction was done in compliance with the law. These terms are often incorrectly interchanged. In order to avoid confusion, real estate agents should be aware of the correct terminology in the municipality where a property is located.

CITY/TOWN COUNCIL
The purpose of a city or town council is to preserve order and protect the peace, health, safety and welfare of the people. Additionally, the city or town council is concerned with the protection and security of each citizen’s property. They are the legislative body that sets policies, approves budgets and passes ordinances regarding land use, zoning, cluster zoning and many other issues. Cluster zoning permits residential uses to be clustered more closely together than normally allowed, which leaves substantial land area to be devoted to open space or recreational use.

Town and city councils are made up of elected members. Their terms vary depending upon the town or city charter. A town or city charter is a legal document establishing a municipality such as a city or town.

The New York City Council for example, is made up of 51 members from the 51 council districts throughout the five boroughs of New York City. Each member is elected for a term of four years. The New York City Council is considered an equal partner with the mayor, when it comes to governing the city. As the legislative body for the city of New York, the City Council considers solutions to the issues facing the city today. They put forth legislation to try to deal with these issues.

Legislation pending in the City Council is called an “Introduction”. Once an introduction is signed by the mayor, it becomes law. If the mayor objects to a certain legislation introduction, the City Council can override the mayor and enact the legislation through a veto override process. This process protects the balance of government and ensures that the City Council and the mayor are doing what is best for
the city. Members represent the best interests of their “constituents”, the residents who elected them.

In order to accomplish this, a city council member must have a very good understanding of the issues facing the people in his or her district. City council members must stay current and stay connected with the people they represent. Their best interests can then be protected by the passing of laws and resolutions, which promote their health, safety and welfare.

CONSERVATION ADVISORY COUNCIL
They study matters pertaining to the preservation, development and use of natural resources. They advise various municipal agencies of their findings and make recommendations pertaining to the environment.

Conservation advisory councils are created by local governments and are made up of appointed members. They act to coordinate environmental activities and organizations; and develop public information programs. Informing the public of the importance of protecting the environment has become a major function of the Conservation Advisory Council in recent years. In addition, they prepare maps of open spaces, such as wetlands. Wetlands are lands that are covered mostly with water, with occasional marshy and soggy areas. Wetlands are protected areas and their development is usually not permitted. In some areas there are separate Wetlands Commissions.

Conservation advisory councils are extremely important agencies since they ensure that environmental issues are handled in accordance with the municipal ordinances that are in place to protect our natural resources.

Understanding the Conservation Advisory Council:
A municipality’s planning board is reviewing the current Master Plan and are considering some changes in land use. One of the issues at hand pertains to a large vacant tract of land, owned by the municipality. This parcel is currently a wooded area, with several streams and a small lake. There have been many proposals for the use of this land and the Planning Board is considering three of them. One of the proposals is for a new shopping center, which would alleviate congestion at some of the other area shopping centers. It would generate revenue for the municipality and provide jobs for the residents.

Another proposal is for an expansion of a nearby college, which needs additional classroom facilities, dormitories and parking. The expansion of this college would alleviate many issues facing this college and potentially attract more students. Additionally, the proposal does not call for the removal of the lake and streams, which would be left intact.

The final proposal is for a corporate office complex. There is a shortage of corporate office space in this area and there is a very low vacancy rate. A new office complex would also create substantial revenue for the municipality and provide jobs for the residents.

The Planning Board is considering the merits of all of these proposals. They consult the Conservation Advisory Council for advice on the environmental impact of these proposals. The Conservation Advisory Council then researches the various proposals and the impact on the environment of the community. It prepares maps of the land as it currently exists, including the lake and streams. After substantial research, the Conservation Advisory Council finds that the proposal for the expansion of the college has the least environmental impact. They inform the Planning Board of their findings, who will now consider them.

In this example, the Conservation Advisory Council has done their part to protect the natural resources of this community. They have recommended the proposal that will have the least impact on the environment of their community.
COUNTY HEALTH DEPARTMENT
This agency oversees the health concerns of the community. They do this by assessing the health status of the community and developing policies and plans to meet the needs, which were identified in the assessment.

County health departments enforce laws and regulations to protect the health and safety of the community. They are responsible for the supervision of food service establishments, such as restaurants, food stores, food vendors, fast food establishments and others. They also supervise and regulate issues pertaining to swimming pools, tanning salons and many other businesses. In addition, they monitor health concerns and educate the community about healthy living and preventive care. They train public health care providers and connect the public with needed services. They are constantly evaluating and updating public health programs to ensure the health and safety of the public.

Another important function is the approval of septic systems and other sanitation systems, including certain types of sewer systems. They regulate wastewater, which has become a very large concern in recent years. Wastewater is water that has been used by people or in manufacturing and is sometimes referred to as sewage. Everything that goes down the drain or is flushed in a toilet adds to the amount of wastewater created by our society. Many municipalities have sophisticated treatment facilities and spend billions of dollars to safely dispose of wastewater. Whether it’s a septic system in your backyard, or a public wastewater treatment facility, the County Health Department must ensure that the disposal of waste is handled properly.

Understanding the county health department:
A real estate agent is showing vacant residential land parcels in a suburban area to a perspective buyer. One of the properties is an oversized lot, measuring 200’ x 100’. It is located in an area where the zoning requires a minimum of 50’ x 100’ to build a house. The buyer believes that this parcel can be subdivided (split) into 4 lots, since 50’ x 4 = 200’. There are no public sewers in this area and septic systems are prevalent. The real estate agent contacts the County Health Department and finds out that in order to install a septic system; a minimum lot width of 200’ is required. As a result, the County Health Department would not approve the septic systems of the subdivided lots. In this case, the prospective buyer may decide not to purchase this parcel since the subdivision of this property would not result in lots that could be developed.

HISTORIC PRESERVATION COMMISSION
Charged with protecting the historical nature of local communities and buildings. Many buildings have historical, cultural, architectural or aesthetic significance. It is the Historic Preservation Commission’s responsibility to preserve and protect these buildings. They give guidance and make recommendations to property owners and government agencies about properties to be preserved as “Landmark” buildings. A landmark building has notable physical features, historical or cultural significance; and may be of interest to tourists.

The Commission is concerned with identifying and protecting these types of buildings. A major responsibility is to determine if a building slated for “demolition” has any historic significance. Demolition is the act of destroying a building. The Historic Preservation Commission will provide advice to the property owner and relevant government agencies.

They also identify “historic districts”. These geographically definable areas possess a significant concentration of buildings that are united architecturally, historically or aesthetically. Once a historic district is identified, the Historic Preservation Commission will typically recommend to the municipality the adoption of ordinances to protect the structures in this district. The Historic Preservation Commission is made up of appointed members, with backgrounds in architecture, history and archeology. They need to be familiar with historic preservation, and be able to work closely with planning boards, planning departments, historical societies and tourism boards.
Many towns, villages and cities are rich with history, culture and architecture. It is the Historic Preservation Commission’s responsibility to preserve and protect this history from being lost in these communities.

**LANDMARK PRESERVATION COMMISSION**

Similar to Historic Preservation Commissions, in that they are concerned with “Landmarks” which include buildings, bridges, cemeteries, parks, trees and many other structures. In order for a building or structure to have landmark status, it must be at least 30 years old and possess special historical, architectural, aesthetic or cultural significance. Some of the many types of landmark buildings include houses, libraries, museums, churches, synagogues, theatres and skyscrapers.

Buildings are sometimes deemed “interior” or “exterior” landmarks. Interior landmark status is the result of components such as ceiling panels, stair railings, lobbies, sculptures or the general quality of materials used in the finishing of the interior of the building. For example, an 80 year old hotel lobby with tin ceilings, ornate statues and wall hangings, brass stair railings, marble floors and other similar items might be considered for interior landmark building status.

Exterior landmark buildings (also known as “Individual” landmark buildings) are designated as such due to their exterior features. Some examples include facades, window types, arches, roofs and ornaments.

Once a building or structure has been given landmark status, it is legally protected from alteration or demolition. If the owner of a landmark wishes to alter or demolish it, the Landmark Preservation Commission must approve the proposed plans. Some owners of Landmark properties feel that the restrictions on alteration or demolition create interference with their use of the property. While this can be argued in court for individual cases, the bigger picture is that Landmark preservation ordinances are in place to preserve and protect the architectural, cultural and historical heritage of communities.

Real estate salespeople must keep this fact in mind when working with the buyers and sellers of landmark properties. Unfortunately some significant buildings have been demolished because they were not designated as “landmarks”.

**Understanding the Landmark Preservation Commission:**

A municipality’s Historic Preservation Commission has designated a geographic section of town a historic district, and recommended to the Landmark Preservation Commission that all the houses on a particular street be preserved as landmark buildings. After some research, the Landmark Preservation Commission agrees and designates these homes as landmarks.

One of these homeowners contacts a real estate agent to list their home. Upon visiting the home, the agent notices that several of the front windows are cracked. The agent also observes that these windows are original (approximately 60 years old) and are not energy efficient. Normally, this agent’s policy is to advise a homeowner to replace older, broken windows with new, energy efficient ones prior to listing the home. In this case, however, there may be alteration restrictions in place due to the building’s status as a landmark. The proper course of action in this scenario would be to contact the Landmark Preservation Commission to ascertain what restrictions, if any, are in place with respect to replacing the windows.

**PLANNING BOARD**

Planning Boards can exist on the county, city, town and village levels of government. Their primary function is to plan for the future of their region. They consider and research land use matters, hold public hearings and make recommendations to the appropriate municipal agencies.

The members who are appointed either by a mayor, town board, supervisor or other legislative body, are concerned with the development and growth of a municipality. One function is to create a capital budget with respect to a municipality’s growth. They also create and oversee a “master plan”, which is a long term plan to guide the physical development of the community. A master plan is sometimes referred to as a “comprehensive plan”.

They implement the master plan by regulating the subdivision of parcels. They also regulate density and traffic patterns. They review “plats”, site plans and other matters relating to the development of the municipality. A plat is a map that shows actual or planned features of an area, such as streets and building lots. Lastly, Planning Boards take specific zoning actions and make recommendations for amendments to existing zoning ordinances or maps. These zoning actions and recommendations have a direct impact on the growth of a community. Municipalities with well thought out planning will have a much better chance to thrive, and provide opportunity and quality of life to its residents.

**EXAMPLE:** A developer would like to build a 50 unit townhouse development on a vacant parcel in the municipality. The developer must first seek approval from the local Planning Board. The board may not want this development to proceed, or may decide that changes to the plans are necessary. Once the Planning Board approves the project, they may hold public hearings to ensure that the proposed development will benefit the community. Upon completion all of its research, including the results of any public hearings, the Planning Board will make its recommendations to the appropriate agency or board.

**RECEIVER OF TAXES**

The office of Receiver of Taxes is primarily responsible for collecting taxes. They also are responsible for disbursing funds and keeping tax records. They do **not set tax rates or estimate assessed values.** These functions are performed by other entities. Tax rates are set by school boards, village boards, town boards and county legislatures. Assessed values are determined by the Tax Assessor, which will be discussed later in this section. The Receiver of Taxes collects property and school taxes; as well as water fees, sewer fees and permit fees. The funds are then disbursed to the proper entities, and records of all transactions are stored.

The office of Receiver of Taxes is not a policymaking office. It is more of an administrative office, which provides accounting functions. If a property owner feels that their taxes are too high, this is not the office to contact. The owner would need to contact the Tax Assessor’s office for this.

**TAX ASSESSOR**

A local government official, who is either appointed or elected, depending on the municipality. The primary function of the Tax Assessor is to estimate the value of all real property within the municipality in which they serve. This is a very complex task! A Tax Assessor must have an excellent understanding of property valuation to be able to perform this function properly.

For example, the methods for estimating the value of an industrial building are vastly different from those used for estimating the value of a single-family residence. The Tax Assessor must be able to determine value for both and many other property types accurately.

Let us use as an example a mixed-use property, a 2-story building with a small convenience store on the 1st floor and a residential apartment on the 2nd floor. How would a Tax Assessor value this property? First, one must understand that Tax Assessors use the same methodology that appraisers use in valuing properties.

- The Sales Comparison Approach
- The Cost Approach
- The Income Approach

Some properties are non taxable, such as property owned by religious organizations, or by the government. These properties must still be valued, even if they are not taxed. It can be very difficult to estimate the value of these types of properties, as they are not sold very often; and complex appraisal methodology, such as the cost approach must be used.

The Tax Assessor must also keep records of the physical description of each property in the municipality. This huge task can be done with field inspections, research, aerial photos and cooperation with other agencies. All physical descriptions and value estimates must be kept as current as possible. Once the market value of each property in the municipality has been estimated, the
assessor must now convert each market value estimate to what is known as assessed value. Assessed value is a key component in calculating a property’s taxes, and is known as a property’s assessment.

A property’s assessment (or assessed value) is calculated by applying a uniform percentage to the market value. A uniform percentage (also known as level of assessment) is a percentage of market value to be applied equally to all properties in the municipality.

Some municipalities have posted information such as tax maps online. These tax maps are sometimes overlaid onto aerial photos making the information easily accessible.

Sales information is critical to the Tax Assessor. It is often the basis for property valuation and keeping good records is extremely important. It is frequently obtained from the County Clerk’s office, in the form of deed recordings. The more correct the sales information, the better the Tax Assessor will be able to perform their job. Information on ownership and tax amounts are also critical elements of the record keeping function of Tax Assessors. In order to grant a veteran’s exemption for example, the Tax Assessor must be sure that the person claiming the applicable military service is the actual owner of the property. Information on tax amounts for each property must be kept current by. This is important for many reasons, such as aiding a property owner in determining if they are overtaxed. It is also important to various towns, villages and school districts that rely on this information with regard to taxation.

Real estate agents must have a good understanding of the functions of the Tax Assessor. Property tax issues arise frequently in real estate transactions, and the answers can usually be found at the Tax Assessor’s office.

**VILLAGE BOARD OF TRUSTEES**

These are elected officials, including the mayor of the village. The term of office depends on the state in which the village is located. In NY State for example, the term of office is 2-years, although it can be changed to 4-years by resolution or local law. Much like a city council or town board, the function of the Village Board of Trustees is to manage the business of a village.

The Board has the power to make and amend local laws, as long as they do not violate state law or a state’s constitution. They set the policies for a village, in order to best serve the residents. An important function is the adoption of a budget. The members are responsible for the management of the economic affairs of the Village.

Another important function is the management of land use. They have the authority to pass ordinances that govern the land use in their village. They can approve or reject various development projects, such as residential, commercial or infrastructure projects. The key factor is the determination of whether or not a project will be in the best interest of the residents of the village. All the elected officials must fully understand the issues facing their village, and make decisions that will be in the best interest of the residents.

**Example:** Mr. and Mrs. Smith decide to sell their home and contact a local real estate agent. The house is located in a village and is next to a residentially zoned vacant parcel of land. Beyond that parcel is the parking lot for a group of retail stores. Mr. and Mrs. Smith tell the agent that the owner of the retail stores would like to purchase the vacant parcel next to their house, in order to expand the parking lot and he has contacted the Village Board of Trustees for approval. The Village Board of Trustees is now considering the request to change the zoning of the vacant parcel from residential to commercial, in order to allow this.

Mr. and Mrs. Smith want to know what their house is worth and have asked the real estate agent for a market analysis. How should the real estate agent proceed?
In this case, the decision of the Village Board of Trustees will have a direct impact on the market value of Mr. and Mrs. Smith’s house. If they approve the request to change the zoning, and allow the parking lot to be expanded, the Smith’s house will now abut a parking lot. If they reject the request to change the zoning, and not allow the parking lot to be expanded, the Smith’s house will still abut a vacant residential parcel. Furthermore, it is likely that the vacant residential parcel will eventually be developed with a house.

The real estate agent knows that in this area, the market value of a house, which is next to a commercial parking lot, will be significantly lower than a house, which is next to a vacant residential parcel, or a new house. The Smiths have a very high mortgage loan on this property, and any potential decrease in market value could prohibit them from paying off the existing mortgage with the proceeds from a sale.

The real estate agent contacts a member of the Village Board of Trustees and is told that the decision will be reached by the end of the month. The agent informs Mr. and Mrs. Smith of this, and they decide to wait for the decision before listing their home.

As you can see, the actions of the Village Board of Trustees have a direct impact on the plans of the Smiths. They also have a direct impact on the real estate agent, who now has to wait until the end of the month to find out if the property will be listed for sale.

After the month has ended, the Village Board of Trustees reaches their decision. They have determined that there is insufficient parking at the retail stores and the expansion of the parking lot would benefit the community. They have approved the request to change the zoning and will allow the parking lot to be built onto the parcel next to the Smith’s house.

As a result, the Smiths decide that they cannot sell their house, as they now owe more on the mortgage loan than the property is worth. They inform the real estate agent that they will not be listing the property. In this example, the actions of the Village Board of Trustees have directly affected the Smiths, the owner of the retail stores and the real estate agent.

**WETLANDS COMMISSION**

A Wetlands Commission is very similar to a Conservation Advisory Council. In fact, in some municipalities, these two agencies are one in the same. Wetlands Commissions are created by local governments and are made up of appointed members. The primary goal of a Wetlands Commission is to protect the environment, specifically wetlands.

As we discussed earlier, wetlands are lands that are covered mostly with water, with occasional marshy and soggy areas. Some examples of wetlands are coastal areas, shorelines, marshes and swamps. These are protected areas and development in or near them are often not permitted.

In NY State, the Department of Environmental Conservation (D.E.C.) is the agency that oversees wetlands. Large areas of wetlands (over 12.4 acres) fall under their control. Smaller wetland areas that are not deemed of “unusual importance” are under the control of the municipality in which they are located. A municipality’s Wetlands Commission can recommend the adoption of regulations of land under the jurisdiction of the D.E.C., as long as they are more protective than current state regulations.

An important function of a Wetlands Commission is to prepare inventory maps of open spaces, marshlands, swamps, shorelines and other types of wetlands. These maps are then used to resolve land use issues and protect the natural resources of the municipality. Wetlands Commissions conduct studies and advise municipal agencies, such as Planning Boards, City Councils and other governing agencies of their findings. They ensure that environmental issues are handled in accordance with applicable municipal ordinances. They also make recommendations regarding the development of land and its impact on the environment. Any proposed changes in land use in or around wetlands will be
carefully reviewed by the Commission. In order to protect the future of the environment in which we live, there needs to be a balance between the development and the conservation of natural resources.

The tendency of some developers is to build on every vacant parcel, regardless of the impact on the environment. It is up to the Wetlands Commission and/or the Conservation Advisory Council to protect our natural resources, by ensuring that all development is done responsibly, with respect to the environment.

Example: A builder is considering purchasing a vacant parcel of land for development of single family homes. It is in a waterfront community and is close to the open bay. Prior to making an offer on this parcel, the builder performs some research and finds out that part of this parcel is deemed wetlands, and contains several varieties of protected plants and grasses. The builder is considering buying the parcel and only building homes in the section which is not designated as wetlands. The builder contacts the Wetlands Commission to see if this is possible. The Wetlands Commission reviews area maps and performs considerable research to determine the effect of the proposed construction.

After several weeks, the Wetlands Commission determines that the development of any part of this parcel would jeopardize the current wetlands and the protected plants and grasses on this parcel. As a result, no building on this parcel should be permitted. They then advise the builder that this parcel cannot be built on. They also advise the relevant municipal agencies of their findings, such as the city council and the building department. Based on the findings of the Wetlands Commission, no building permits can be approved.

In this example, the Wetlands Commission has protected the natural resources of this community, by not allowing the development of wetland areas. The builder will have to find somewhere else to develop and build houses.

ZONING BOARD OF APPEALS
This agency is concerned with, just as the name implies, zoning. As we have discussed earlier, zoning is the act of dividing an area into sections reserved for different purposes, such as residential, commercial or industrial uses. Zoning exists to maximize the land use of an area and enhance the quality of life of its residents.

Without zoning, land uses would be inconsistent and properties would suffer from adverse external influences. For example, a typical street might consist of a commercial building, next to a single family dwelling, next to an industrial building, next to a school, etc. There is no planning in this type of setting and the land uses are too dissimilar to offer a reasonably desirable quality of life.

Zoning laws and ordinances are enacted to prevent this type of inconsistent land use. For example, industrial areas are typically separated from residential areas. Ideally, commercial areas are separated from residential areas, however are close enough to provide needed goods and services.

Unfortunately, zoning is not always perfect and some exceptions to zoning ordinances are necessary. The Zoning Board of Appeals is the agency charged with interpreting zoning laws and making exceptions where necessary.

These exceptions to zoning ordinances are typically referred to as “variances”. A variance is an approval by the Zoning Board of Appeals to improve, develop or use a specific property in a manner that is not authorized by the current zoning ordinance.

The Zoning Board of Appeals holds public hearings or meetings, to hear appeals from residents. They also review various administrative decisions, with respect to zoning. Ultimately, the Zoning Board of Appeals must determine if a request for a variance will be granted.
Much like the Architectural Review Board, a primary concern of the Zoning Board of Appeals is to protect the architectural character of an area. The overall quality of life of the residents is another major concern. If a request for a variance will adversely affect the community, the Zoning Board of Appeals will not approve it.

The Zoning Board of Appeals consists of appointed members. The term of office depends on the municipality in which they serve and the number of members on the board.

Another function of the Board is to grant special use permits. A special use permit (also known as a conditional use permit) allows a specific exception to an existing zoning ordinance for a particular parcel of land. The owner of the property may be required to meet certain conditions in order for a special use permit to be granted. In some municipalities, special use permits are granted by municipal agencies other than the Zoning Board of Appeals.

Obviously, the Zoning Board of Appeals is an extremely important agency. The task of interpreting zoning laws is complex and the Board must have a thorough understanding of how exceptions to these laws will impact the community as a whole.

For many of those seeking variances, the decisions rendered by the Zoning Board of Appeals will have substantial financial implications. They must perform as much research as possible to render decisions that are in the best interest of the community in which they serve.

**Example:** Mr. and Mrs. Johnson own a single-family residence, which is situated on an oversized lot. The lot dimensions are 95’ x 100’. They are located in a suburban neighborhood, with a minimum zoning requirement of 50’ x 100’. All of the other houses on their street are on 50’ x 100’ lots. Their house sits to the left side of their lot. The right side is vacant and measures 45’ x 100’. A builder has contacted Mr. and Mrs. Johnson and offered to buy the vacant portion of their property for $300,000. The Johnsons can really use the money and would like to sell the vacant portion of their property to the builder. In order to sell it however, they will need to subdivide their property. Under the current zoning, the vacant portion of their property is 5 feet short of the minimum frontage requirement of 50’. They contact the Zoning Board of Appeals to see if they can get a variance to subdivide this property. The Zoning Board of Appeals researches their request and schedules a public hearing. They send notices to the immediate neighbors to notify them of the upcoming hearing regarding the proposed subdivision.

During the hearing, it is revealed that there are several homes in this community, which exist on 45’ x 100’ lots. The majority of these were built prior to the current zoning ordinance. Regardless, the existence of these homes is good for the Johnson’s case. In addition, the builder’s plans call for a home, which is very similar in nature to the surrounding homes and meets all setback requirements.

None of the Johnson’s neighbors has objected to the subdivision and the Zoning Board of Appeals does not see any adverse affect of allowing the builder to build the proposed dwelling on the 45’ x 100’ lot. As a result, they grant the variance allowing the subdivision of the property. The Johnsons can now sell the subdivided lot to the builder.

Becoming familiar with the functions of municipal agencies will give you the opportunity to prove your professionalism to buyers and sellers. Take the time to visit these agencies and have a chat with some of the employees to become familiar with the particular workings in your area.
CHAPTER 27 PROPERTY INSURANCE

KEY TERMS
- Actual cash value
- Deductible
- Liability insurance
- Package policy
- Property insurance
- Replacement cost
- Umbrella policy

INSURANCE DEFINED
It is a contract between two parties, the insured and the insurer, which will reduce the risk of loss to the insured. This is done by redistributing risk to a large pool of people, each of whom will pay a fee, called a premium. In return, the insurer will pay the insured or his beneficiary for a loss that is specifically covered under his insurance policy. Because there is a pooling of income (premium) and expense (payment for loss), the insurer is able to absorb any loss and protect a policyholder.

HISTORY OF INSURANCE:
Insurance has an interesting history. It began when companies wanted protection to cover ships and their voyages as far back as the 1300’s. The insurance was paid at the completion of the successful trip. The Romans formed “burial clubs”. The members would receive benefits to cover the cost of burying their dead. Eventually, there were provisions for payments to survivors.

As time went on coverage included losses from fire, shipwrecks and ransoms to pirates when ships were captured. Fire insurance started sometime in the 17th century, and other types of property insurance became more prevalent in the 19th century with the rise of industrialization.

Ship owners, underwriters and merchants would often meet in Lloyd’s Coffee House in London to transact business. By the end of the 18th century, Lloyd’s had grown into one of the first modern insurance companies and is now known as Lloyds of London. They are famous for insuring not only the usual, but also the unusual such as actresses and dancers legs, singer’s voices, etc. As British commerce rapidly developed during the 17th and 18th centuries, so did insurance.

It became almost a business of gambling; with individuals assuming risk for others while writing their own name down as well as the amount they were willing to risk in exchange for the payment of a premium. This is the foundation for the term “underwriter” that we now use, although the definition in the modern world is quite different. Today the underwriter reviews the policy to assure the company of its terms. Eventually companies were formed for the sole purpose of writing insurance policies. As time went on coverage was extended to social organizations, labor groups and others interested in banding together to buy protection. Today, many companies participate in insurance for their employees. Social Security and Unemployment insurance are two examples of government coverage.

After 1944, the constitutional interstate commerce clause made companies subject to regulation by Congress. Companies were only permitted to offer one type of policy and everyone specialized. In the 1950’s legislation allowed fire and casualty companies to provide varied types of insurance and the policies were complicated and difficult to understand. Finally, in 1971, Insurance Services Office (ISO) was formed and standardized policies became the norm. Now multiple line polices dominate the insurance field. Prior to 1999 there were banking laws that prevented banks from participating in the insurance business, but in 1999 congress repealed these laws.

PURPOSE OF PROPERTY INSURANCE
Insurance enables organizations or individuals to protect themselves from the risk of a big loss by making small periodic payments called premiums. The transfer of risk is spelled out in the insurance policy. This legal contract gives the specifics of the compensation, the coverage and/or other benefits.
If a loss does happen, then the policyholder is able to be in the same condition as before the loss. Insurance covers actual losses not any speculative.

Below are some examples of risks that are covered by insurance:

- Theft
- Tornadoes
- Fire
- Being sued for causing harm to another person
- Motor vehicle crashes

There are two main parts of risk and both of these parts help determine insurability:

1. **Severity**
2. **Frequency**

“**Severity**” is how expensive it might be to replace the potential loss. In other words, does the particular type of loss have the potential to be inexpensive or catastrophic? “**Frequency**” means how often a loss can happen; whether or not the risk is common or rare.

Property insurance, at the most basic level protects the insured from the physical or financial risks arising from fire, theft or vandalism.

For homeowners, a property insurance policy is usually divided into two parts:
- Part 1 detailing the insurance coverage protecting the physical property of the insured,
- Part 2 providing the coverage for liability.

Virtually every person that owns or leases property should have property insurance. If a homeowner has a mortgage on their property, property insurance coverage is mandated by the lender as a term of the loan.

The insurance policy is the plan showing how the insured will be paid, in what amounts, and under what conditions. The policy is a legally binding contract that details the specific duties of both parties, and lists the terms and conditions of the coverage. Standard types of insurance coverage on an apartment or home can provide protection against monetary loss suffered in the event of the following situations:

- Hail
- Fire
- Tornadoes
- Windstorm
- Smoke Damage
- Vandalism
- Theft of personal property
- Other physical damage to the home or belongings
- Injury on the property caused by negligence of the insured or a member of insured’s family; or if someone else’s property is damaged because of negligence.

**PURCHASING PROPERTY INSURANCE**

A person shopping for property insurance has a wide variety of options. Different insurance companies provide different types of coverage at different costs. Today’s insurance market is highly competitive, with companies presenting certain benefits to the purchaser.

To obtain insurance from an insurance company, a purchaser will likely use an independent insurance agent, or an insurance broker. There are distinctions between both types of professionals.

**Independent agents** usually represent one or more licensed insurance companies, though they may not be actual employees of that company. It is important to note that some insurance companies
employ the use of independent agents, while some companies are “direct writers” and only use their employees, sales agents, and websites to generate insurance business.

**Insurance Brokers** represent the customer, or proposed insured, rather than the insurance company. Most brokers do not have the ability to approve or issue policies. Instead, a broker will search for an insurance company that meets their client’s specific insurance needs. Once the broker has located that company, and the company has agreed to provide coverage, any amounts or premiums paid to the broker are treated as if the insured had made the payments directly to the insurance company.

**TYPES OF POLICIES**

When insurance policies are sold, they are issued either as a monoline or package policy. A monoline policy only includes a single type of coverage; such as liability insurance, which protects against claims alleging that the insured’s inappropriate action or negligence caused property damage or bodily injury. A package policy is generally the homeowner or tenants policy of choice because they usually include liability, property, theft and medical payments coverage.

Policies range from those that provide very basic coverage at a lower cost, to costlier policies that provide extensive coverage for a wide variety of perils.

Perils are events such as fire or vandalism that are the cause of a loss. The homeowner can determine the amount of coverage she wants, although the lender will likely mandate a minimum amount. There are perils such as earthquakes that are not usually included but these can be purchased at an additional cost. A policyholder can reduce the cost of their insurance by requesting that certain coverage’s be excluded if they feel an event is unlikely (coverage for power loss could be excluded if the policyholder owned power generators and a supply of emergency fuel).

The only excluded coverage that cannot be “bought back” is flood coverage. Flood insurance is excluded from all policies, and can only be purchased through federal insurance programs.

**STANDARD HOMEOWNERS POLICIES**

There are five kinds of policies that give coverage to owners living in a one or two family house. There is a sixth type of coverage for tenants of a house, apartment building or cooperative owners. In addition, there is a seventh type of coverage that is specifically for condominium owners.

A licensee should be familiar with the different types of policies, but should by no means advise the public which is best for them. That is left up to the insurance professional.

**The Homeowners-1 (HO-1) policy or Basic Policy:** This policy insures both the home and everything in the home against the perils listed. Not very many insurers actually offer these types of policies because most like to offer policies that are more comprehensive.

**The HO-1 provides coverage for the following perils:**

- Burglary and Theft
- Glass Breakage
- Windstorm and Hail
- Riot and Civil Commotion
- Bodily Injury
- Medical Payments
- Fire, Lightning and Smoke Damage
- Explosion

- Vehicle or Aircraft Damage
- Vandalism and Malicious Mischief
- Damage to Property of Others
- Personal Property (Away)
- Personal Property (at Home)
- Civil Judgments
- Additional Living Expense (If forced to live away from home temporarily)

**The Homeowners-2 (HO-2) policy or Broad Form Policy:** This policy insures the home and the contents of the home against everything listed in the HO-1 policy AND additional perils like falling objects.

- Weight of Snow or Ice
- Falling Objects

- Freezing of Plumbing System
- Electrical Damage to Appliances
Water from Plumbing Systems

Rupture of Water Heating Systems

The Homeowners-3 (HO-3) or Special Form Policy: This policy is the most commonly used. It is quickly becoming the standard homeowner’s policy and it is recommended by many lending institutions. This will cover the home for all types of physical loss, except ones that are specifically excluded like earthquake, flood, war or nuclear accident. The homeowner should review the policy for excluded perils. In addition to providing coverage to the home, it also covers the contents of the home from the same perils.

The Homeowners-5 (HO-5) policy or Comprehensive Form Policy: This policy protects a home against the same things listed in the HO-3 policy. Additionally, personal possessions would also be covered for all of the risks, except for risks that are specifically excluded. This added protection can also be obtained by getting a HO-3 policy with the “Special Personal Property” endorsement.

The Homeowners-8 (HO-8) or Market Value Policy: This policy is a modified version of the HO-1 or Basic Policy. It provides actual cash value coverage instead of replacement cost coverage for a building. Never will the company’s settlement amount be greater than the amount needed to replace or repair the dwelling.

This policy form is typically used when the replacement value of the property is greater than its actual market value, such as many older homes. To avoid moral hazard, insurers will refuse to insure a home for more money than it is actually worth. Moral hazards occur when the insured attempts to profit from an insurance claim.

In the case of older homes, it is very easy for the insured to claim that the materials lost were of a value much higher than what can be obtained on the market today with modern materials. Thus, a homeowner could claim that they would need the most expensive materials in order to restore their home, but then not purchase those materials and keep the difference. The HO-8 policy solves this problem by paying what it would cost to repair or replace damaged property, using common construction materials and methods.

HO-8 provides functional replacement, which is less expensive. For example, hardwood floors can be replaced by plywood and plaster walls can be replaced by drywall. Theft coverage is limited to the main residence only and is capped at $1,000 per occurrence.

Contents Broad Form or Tenants Policies (HO-4) and Unit Owners Policies (HO-6): These policies insure against any damage that may be done to the contents of a condominium, cooperative or apartment. They also protect against any personal liability of the insured if someone was to be injured or sustain property damage on the premises.

There is no need for a tenant to insure the actual building that he or she lives in because that is the responsibility of the landlord. The HO-6 policy provides coverage for any appliances, alterations, improvements and fixtures inside the insured unit, but cooperative buildings and condominiums (including their common areas); need to be insured by policies issued to the cooperative corporation and condominium owners associations. They also cover the insured for any extra living expenses they may have if their home is unlivable because of one of the covered perils. Keep in mind that not ALL living expenses will be reimbursed. Only the difference between what the expenses would normally be and any extra expenses will be covered. Some examples of this are restaurant bills, telephone bills, hotel bills etc.

Every homeowner’s policy that we have discussed so far protects the policyholder from personal liability if another person injures himself or herself or has property damage due to the negligence of the insured or anyone on the insured homeowner’s policy. Typically, the homeowner is also protected if one of his or her pets harms someone. There are exceptions to this if the pet is considered a dangerous animal. In these cases, the company may exclude coverage for that pet and write the
coverage for an extra premium. Some examples of these types of pets are pit bulls, spiders, snakes, amphibians etc.

If an incident does occur on the premises and someone is hurt, the insurer will reimburse the policyholder for medical expenses, usually up to a limit of $500 or $1,000. Transportation to a hospital or a doctor’s bill for first aid are two examples of the types of expenses that can be covered.

**AMOUNT OF INSURANCE NEEDED**
The insurance purchaser has to be able to analyze how much insurance is needed. This can be difficult at best. Sometimes, it is easier to understand a topic when it is placed in terms that are more personal. For this exercise, please get a piece of paper, and list the following items, as they pertain to your own home.

- How much is your actual home currently worth?
- What do you think the cost would be to rebuild your home if it were destroyed?
- Detail the contents of your home, including items such as major appliances, and expensive electronics like a television. How much do you think those items are worth today? (Imagine you were to sell everything in a garage sale.)
- How much would it cost you to go to the store today and replace the items mentioned above? Do you have any jewelry? If so, how much is it worth? Do you own any rare collectibles? (Stamps, coins, baseball cards, etc.)?
- If you do own collectibles, detail the items, and how much they are worth.

Using the information you have listed, what amount of insurance do you think is necessary to cover your home? Once you do this, you will probably recognize that you have too much, too little, or no insurance covering necessary items.

**ACTUAL COST VALUE vs. REPLACEMENT COST VALUE**
Actual cash value (ACV), which is called market value, is the preferred standard of insurance companies when reimbursing policyholders. It is the replacement cost minus the depreciation. It is the amount of money one would expect to get for the item if they sold it today. It considers the depreciation of the items.

Replacement cost is the cost to replace the property with new comparable material within the range of the limits of the policy.

**HOW THESE DIFFERENT METHODS AFFECT THE INSURED**
Both are based on today’s cost of replacing the damaged property with new property. Let’s take a look at a very simple scenario using both approaches, before we move on.

Imagine that a home has a roof blown off by a storm. Normally, the roof is expected to have a functional life span of 10 years, and costs $5,000 brand new. When dealing with insurance claims, the insurance company will look at the expected life of an item, and then look at how old the item currently is.

**With Actual Cash Value**, the insurance company would pay for the depreciated value of the roof (after deductible) – if a new roof cost $5,000 and has a life of 10 years, and the roof is 5 years old, the insurance company pays $2,500, or 50% of the actual value, toward the cost of a new roof.

**With Replacement Cost** coverage, the insurance company would pay the entire cost of a new roof (after deductible), even if the roof was at the end of its useful life when it was blown off in a storm.

**DETERMINING REQUIRED COVERAGE**
The first step is to make an analysis of the value of the home (minus the land value) and all of the personal property inside the home. The owner needs to calculate how much it would cost to replace
the home if it were destroyed. Typically, insurance companies will do an inspection of the home before they insure it. They will look at all the components and after completing this analysis, the company should be able to give an accurate replacement cost value.

**STRUCTURE**
In most instances, the amount of insurance coverage will be based on the replacement cost of the home. The home is usually insured for a minimum of 80% of the replacement cost. If a loss were suffered, the insurance company would pay based on how much it takes to replace or repair the home without subtracting anything for depreciation. Obviously, this kind of coverage is going to be more costly than actual cash value coverage. If the home is not insured for a minimum of 80% of the replacement cost, then the homeowner will not get full payment for a loss.

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Coverage for any contents in a home is typically issued on an actual cash basis in both tenants and homeowners policies. The insurance company will figure the dollar amount of coverage by taking the replacement costs of the contents minus depreciation. Unlike determining the replacement value of a structure, no specific formula is used to figure the depreciation on contents. Different insurance companies use different formulas depending on the items that have been damaged. The insured will probably not get the full amount that is needed to repair or replace the stolen or damaged property. However, endorsements that provide replacement cost coverage for the contents are available at an additional cost. It is important to video the entire interior of the home showing exactly what personal property exists. Keep in mind specialized items such as jewelry, fur, fine paintings, etc. require additional separate coverage.

**BASIC AMOUNTS OF COVERAGE**
If the policyholder’s home is insured for a minimum of 80% of the replacement cost, the policy will pay the full claim, minus the deductible, up to the amount of coverage. However, if the house is insured for anything under 80% of the replacement cost, the amount paid will be reduced, even in the event of smaller claims. This smaller amount will be based on the difference between the percentage of coverage the policyholder has and 80% replacement cost value. Inflation guards increase the coverage as the cost increases. Homeowners should review their policies annually.

**PERSONAL PROPERTY COVERAGE**
Most policies allow the total amount of coverage for household items to 50% of the real property coverage. Therefore, if the house is covered for $100,000, the contents are covered up to $50,000. If the personal property is not on the premises (e.g. the insured is away on vacation), then it is typically covered up to 10% of the insured property on the premises, or $5,000 using the numbers in our example. There may be limitations for vacant houses. There is also additional coverage available for items such as jewelry, cameras, golf equipment or computers.

Many homeowners’ policies cover injury or damage that occurs in the home in addition to coverage for personal and real property. There are two common extra features:

Living expenses necessary to maintain a normal level of living during the time that the house is being rebuilt or repaired is generally included. The amount is typically 10% of the total coverage on the home.

Liability protection will cover any damages for which the policyholder is legally responsible. The standard policy will pay up to $100,000 to someone if a claim is filed due to an injury or damage the policyholder or a member of his family caused. Accidents that occur on the property are also covered as well as medical payments are included.

**PROBLEMS OBTAINING INSURANCE**
The New York Property Insurance Underwriting Association (NYPIUA) is a joint underwriting association that was founded in 1968, in order to meet the public’s basic insurance needs. Since its creation, the
Association has grown into a true residual market mechanism that is responsive to the different needs of providing insurance to the public. NYPIUA is a group of insurance companies that offer fire and extended coverage, coverage for malicious mischief, vandalism and sprinkler leakage to those who cannot buy this type of insurance from individual insurance companies. NYPIUA does not offer flood, liability or theft coverage. “Wrap-around” coverage is available whereby fire and extended coverage are provided through NYPIUA and the theft, liability and other coverage are underwritten by a licensed insurer offering such wrap-around coverage. With the fire coverage’s from NYPIUA and the wrap-around coverage’s from a licensed insurer, an insured can obtain coverage’s much like one they would find in a homeowner’s policy. Since all coverage that is offered by NYPIUA is sold at a higher premium than coverage that is offered in the voluntary market, both the insurance agent and broker and the homeowner would be wise to consider it the insurer of last resort and do everything possible to get this insurance from a voluntary insurer.

**NATIONAL FLOOD INSURANCE PROGRAM (NFIP)**
Because flood insurance is not typically included, insurers must give a onetime notice for newly issued dwelling and homeowners policies that states that the policy does NOT cover flood damage and that flood insurance must be purchased under a separate policy. Property owners can buy insurance that protects against loss from flooding through NFIP if they live in a community that is designated as a special flood hazard area that implements measures to reduce the risk of future flooding. Most of the cities, town and villages in the state of New York participate in the NFIP.

This program lets tenants and owners buy insurance that will protect their homes and property against loss that is caused by flood, flood related erosion and mudslide. The amounts of coverage go from $35,000 under the Emergency Program, to $250,000 under the Regular Program for a single-family structure and from $100,000 to $250,000 for other types of residential structures. Contents coverage can go from $10,000 to $100,000 for residential units. Higher deductibles can be purchased in order to help reduce the total cost of this type of insurance.

**Once a policy has been effective for 60 days, it must be renewed and cannot be canceled for a 3 year time except for:**

- Nonpayment of the premium (if the company receives the payment within 15 days of the mailing of the cancellation notice, the policy can’t be canceled.
- If the insured is convicted of a crime that is related to acts increasing the hazard insured against
- If the insurance company finds out there was material misrepresentation or fraud when the insured was getting the policy or putting in a claim under the policy.
- Reckless or willful acts of omissions that increase the possible hazard.
- If there is a physical change to the property that happens after the policy takes affect or after the last annual anniversary date of the policy that makes the property uninsurable based on the insurance company’s objective, uniformly applied underwriting standards.
- If the superintendent of insurance decides that continuing, the policy would violate or would put the insurer in violation of insurance law.

When the 3 year time period ends, the insurance company can decide not to renew a policy, however, they must provide at least 45 days, but not more than 60 days notice of the non renewal.

**THE COST OF INSURANCE**
The cost of tenants and homeowners insurance depends on a number of different things including:

- Age
- Location
- Residential / commercial
- Type of building
- Choice of deductibles
- Local fire protection
- Application of discounts
- Scope and amount of insurance coverage
Earthquake coverage would be far more expensive in Los Angeles than in New York. A frame building would be less resistant to fire than a brick building, and therefore would be more expensive to insure against a fire. Fire protection in the community and crime statistics will affect the cost of insurance.

**RATING TERRITORIES**
Each of the five boroughs in New York City make up a separate rating territory for homeowner’s insurance. Throughout the rest of New York State, territory rating depends on the quality of the community’s public fire protection. This rating scale goes from Class 1 (which is the best protection) to Class 10 (no protection).

**DEDUCTIBLES**
The higher the deductible, the lower the insurance premium. It is always a good idea to take look at the savings involved and determine how much you can afford to pay out of pocket in the event of a loss. Next, determine how long it would take to “break even”. Example: if we save $500.00 per year by taking a $5,000 deductible, at the end of ten years you will break even and after that, be ahead financially.

**Hurricane Deductibles**
In an effort to limit their exposure many insurance providers are offering policies with percentage deductibles for storm damage rather than the traditional dollar deductibles like those used for other types of losses. For example, if a policyholder has a $500 standard deductible he must pay the first $500 of the claim out of pocket. However, percentage deductibles are based on the value of the insured home. If a house is insured for $200,000 and has a 2% deductible, the first $4,000 of a claim will be paid out of the policy holder’s pocket. Many insurers will require a homeowner to have a hurricane deductible in their homeowner’s policy if they live in certain areas.

**CREDIT INFORMATION**
During the past several years, insurers have used consumer credit information, in addition to other information, to help make the decision to issue a policy and how to price it. According to New York law, any insurer that uses credit information must follow these consumer safeguards:

- They have to send the insured a notice disclosing this, along with the name of the credit reporting agency.
- If their score results in a higher premium, they must be given a notice explaining this fact.
- In the event of a credit report error, the credit company must be notified and once the correction is made, the insurance company needs to be notified in order to modify the premium.
- The insurance company must review a policy holder’s up to date credit information at least once every 3 years, upon request, unless the company already reviews this information more frequently as part of the renewal process. When the company reviews the updated credit information and discovers that the policy holder’s credit score has improved, and may be eligible for a lower premium, the company needs to make any adjustments necessary.

An insurance company can’t increase the renewal premium or terminate a policy based only on credit information.

**“Multi-Tiering”**
Some insurers use “multi-tier” rating programs, where more than one rate level can be established in the same company. Based on their underwriting guidelines; insurers put those who are insured in different rating “tiers” with others who have similar characteristics. During renewal, the experience and characteristics are re-evaluated to help decide if the insured is qualified to move to a different tier.

**REDUCING THE COST OF INSURANCE**

- Raise the Insurance Deductible
- Combine Homeowner’s Insurance and Auto Insurance Policies
- Inquire about Other Homeowner’s Insurance Discounts
- Don’t Buy Unnecessary Homeowners Insurance Coverage
✓ Make the Home a Better Insurance Risk
✓ Fully Understand What the Homeowner’s Insurance Policy Covers and Keep it up to Date
✓ Avoid Risks That Insurers Charge More For (certain species of dogs, swimming pools, trampolines, etc.)
✓ Improve Your Credit Score
✓ Pay bills on time
✓ Pay down debts, and reduce the amount of credit used
✓ Avoid closing old, paid off accounts
✓ Shop around for Homeowner’s Insurance

As with any purchase, comparison shopping pays off. However, be careful to factor in any discounts your present company may offer because of your safe history or the fact that you are a longtime customer.

**OTHER TYPES OF INSURANCE**

**COMMERCIAL**
Though commercial properties require much of the same type of insurance coverage that a residential property requires (fire, flood, wind, etc.), a commercial property also has unique coverage needs, which are served through additional policy types.

**BUSINESS OWNER’S POLICY**
BOPs combine some of the basic coverage’s that are typically needed by a small business into one standard package at a premium that is usually less expensive than if all of these types of coverage were purchased individually.
Typically a BOP policy includes:
- Property insurance (covers inventory, equipment and buildings).
  ✓ Business interruption insurance (covers losses that cause the business to stop operations or reduce production for any length of time).
  ✓ Casualty or liability protection (covers harm done by the employees or products to other people or their property).
  ✓ Crime insurance (covers the loss of money or securities due to robberies, burglaries, or destruction) as well as losses from employee theft or embezzlement.
  ✓ Liability insurance covers lawsuits that are due to accidents (ex: if someone trips and falls on your business’s property) or when you sell a product that damages the customer’s property or you are accused of offenses such as copyright infringement, slander or invasion of privacy.
  ✓ Vehicle coverage for borrowed or rented vehicles.
Other types of coverage like earthquake, flood insurance, owned vehicle coverage and specialized liabilities are usually not included in BOPs. These may be available separately for additional premiums.

**GENERAL LIABILITY POLICY**
The insurer must pay the legal costs of a business in a covered lawsuit or liability claim. Covered liability claims include property damage, personal injury, bodily injury, advertising injury (damage from false advertising or slander). The insurance company will also cover general and compensatory damages. Punitive damages aren’t covered under general liability insurance policies because they are considered punishment for intentional acts. General liability insurance policies list a maximum amount that the insurer will pay during the policy period as well as per occurrence.

**UMBRELLA POLICY**
This policy covers claims that are in excess of the coverage under the homeowner’s or automobile coverage. Before a person can purchase an umbrella policy, they need to have both an automobile and a homeowner’s policy from the same insurance company. They must have the highest liability that the insurance company provides. Once those limits are reached, the policyholder can purchase an umbrella policy.
For example, if the limit on the homeowner's policy is $250,000, then the deductible on the umbrella coverage is $250,000. This leaves uninterrupted coverage from the time the insured pays the initial deductible until the claim is paid. Umbrella policies are usually inexpensive. Typically, a million dollars worth of coverage is a few hundred dollars a year. The reason that an umbrella policy is so inexpensive is because they are not used very often. However, many insurance experts claim that when people find themselves being sued for an exorbitant sum, the coverage is invaluable. They typically cover:

- Slander
- Libel
- False arrest
- Invasion of Privacy
- Liability coverage for rental units you own

Umbrella policies are so inexpensive that it makes sense for anyone to purchase one. In particular, if a homeowner has a high risk of exposure, for example, if they have a swimming pool an umbrella policy is worth investigating.

**REAL ESTATE AGENTS ROLE**
The sales and issuance of insurance requires an insurance license. Therefore, a real estate agent must be careful not to offer advice or opinions to their buyers regarding specific coverage, or any other activities for which they are not licensed. That type of information is best left to the insurance professionals. That being said, a real estate agent still has an important role or duty to their buyer when it comes to providing information about homeowners insurance coverage.

**EXPLAIN THE PURPOSE AND COSTS OF PROPERTY INSURANCE TO A BUYER**
An agent should make it a point to explain to their buyers that homeowners insurance is an added cost of ownership. This information becomes vital when a buyer is trying to determine the affordability of a property. For instance, if a buyer was considering purchasing a home in a designated flood plain, the agent should explain to them that they would need to purchase flood insurance along with a regular homeowner’s policy, both of which would add to their monthly cost.

**EXPLAIN THE LENDERS’ INTEREST IN PROPERTY INSURANCE**
If the property has a mortgage, the agent should make sure that the buyer understands that the property is collateral for the loan. If there was no insurance, and a disaster were to occur, the lender would lose their security interest in the property. It is the borrower’s responsibility to always maintain adequate coverage on the property.

**ESCROW OF PROPERTY INSURANCE ALONG WITH PROPERTY TAXES**
Once the borrower understands how insurance protects not only them, but also the lender, it is easy to explain why a lender will sometimes require that property insurance premiums be escrowed, along with property taxes. Typically, in an effort to better protect their interests, a lender may require that both the insurance and taxes be escrowed.

**WHEN TO OBTAIN PROPERTY INSURANCE IF THERE IS A CASH SALE**
In the event of a cash sale, many of the usual requirements imposed by a lender, such as an appraisal, title insurance and specific homeowner’s insurance are not required. An agent should remind the buyer that, even though they may not be required, these items are still vitally important to protecting them. Additionally, the agent needs to explain that homeowners insurance should be purchased prior to the sale, with the coverage commencing on the date the loan closes. The buyer should not wait to obtain coverage, as nobody can predict when an accident or disaster can occur and the buyer should be protected from day one.
CONCLUSION

Now that you have completed all the subjects, take the necessary time to review what you have learned, study the Key Terms and, if you have purchased the 2000 question EXAM PREPARATION section, go over the questions until you are able to answer them easily.

Congratulations and welcome to the wonderful world of real estate.

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